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## Auditor Industry Specialism and Reporting Timeliness

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### Abstract

This study investigates whether industry specialist auditors could speed up the audit work using a sample of 873 public listed companies. The multivariate results indicate that industry specialist auditors do not statistically offer faster audit work than non-specialists. In contrast, Big Four firms do perform significant faster audits as compared to their non-Big Four counterparts. Larger companies, companies reporting profits, and financial companies are found to be associated with faster audits. Conversely, companies receiving qualified audit opinions, reporting extraordinary income, and higher in leverage, are associated with longer audit report lags.

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### 1. Introduction

Timely dissemination of financial statements is crucial to reduce information asymmetry and is important for a well-functioning capital market (Owusu-Ansah, 2000). Late release of financial statements increases the uncertainty associated with investment decisions. A number of studies undertaken to examine the determinants of audit report timeliness, both in the public and private sectors, have established that Big Four (formerly Big Five/Six/Eight) auditors can improve reporting timeliness. We, however, know relatively little about the role of industry specialist auditors to improve audit report time lag. It has been argued that the quality of audit services, especially within the Big Four group, can be differentiated further through their specialization in their clients' industry. For instance, Gramling & Stone (1992) posit that auditor industry specialists should provide higher quality audits due to: (i) better

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audit technology; (ii) lower costs as a result of economies-of-scale; and (iii) superior knowledge. Further, in industries that are heavily regulated (e.g., banking and financial services), the presence of specialist auditors could enhance clients' compliance with certain industry-specific regulations or reporting requirements (Abidin et al., 2010). Within this quality framework, it can be argued that specialist auditors will deliver better quality audit and hence, faster reporting timeliness. Hence, the present study aims to examine the association between auditor industry specialism and reporting timeliness.

The results suggest that Malaysian auditors spend around 101 days to complete the audit assignment. The majority of auditors do not face major problems to conclude the audit works within a reasonable time. In addition, the audits of financial companies are found to be relatively faster than companies in other industries. We, however, do not find any evidence to support the proposition that industry specialist auditors offer faster audit work compared to non-specialists. The rest of the paper is organized as follows. Section 2 discusses prior studies and presents testable hypothesis. Then the methods employed are presented in Section 3. It is followed by the discussion of the empirical results in Section 4. Section 5 summarizes and concludes the study.

## **2. Reporting Timeliness and Auditor Specialism Hypothesis**

Accuracy and timeliness are the two criteria indicating the usefulness of corporate reports. The usefulness of the information disclosed in the annual report will decrease if the time taken to complete the auditing process of financial statements increases (Abdulla, 1996). Financial statements are prepared to provide useful information for making business and economic decisions (Dogan et al., 2007). This information is important for the users to assess the financial condition and performance of related companies. This is especially true in emerging capital markets, as the audited financial statements are likely to be the only reliable source of information available (Leventis et al., 2005). Due to limited availability of financial information beyond the financial statements, the timely release of these financial statements in an emerging market is vital to ensure a constant flow of capital. However, as required by laws and regulations, a company can only release financial statements after verification by the external auditor. Consequently, the speed of financial statements to be released to the public is significantly determined by the speed of the audit work.

### *2.1 Auditor quality / Auditor specialism hypothesis*

Prior studies have widely used auditor industry specialism to differentiate high quality auditors from those who provide par quality audit (Gramling & Stone, 2001). DeFond (1992) argues that industry specialisation by auditors can provide greater assurance that financial statement breaches can be detected. Specialist auditors are perceived as having the ability and incentive to provide high quality audits as they have a disproportionate amount of reputation at stake as well as the superior knowledge in the industry in which they specialised (Craswell and Taylor, 1991). The presence of industry specialist auditors is said to increase audit quality and thereby the earnings quality as well (Craswell et al., 1995). A number of industry-specific factors that may affect auditor incentives or abilities to concentrate in specific industries are discussed by Hogan and Jeter (1999). The difficulty of compliance with industry-specific regulations and reporting requirements (e.g., banking and financial industries) may result in greater auditor concentration within those industries. In addition, auditors are also likely to be interested in attracting large or growing clients, and so may focus their specialization efforts on industries characterised by relatively large clients or by relatively rapid growth. Gramling and Stone (2001) argue that industry specialists should provide higher audit quality due to: (i) better audit technology; (ii) lower costs as a result of economies-of-scale; and (iii) superior knowledge due to economies-of-knowledge. Several archival and survey-based studies provide evidence that indicate superior audit quality provided by

industry specialist auditors. For instance, O’Keefe et al. (1994) find that audit quality (measured by an assessment of auditor compliance with GAAS) increases with auditor industry specialisation. Craswell et al. (1995) find that in specialised industries, specialists earn a 34% fee premium over non-specialists. Shockley and Holt (1993) find that bank loan officers appear to use industry expertise to assess audit firm credibility. In view of the above evidences, it can be argued that industry specialist auditors have the ability to perform the audit process faster compared to non-specialists, *ceteris paribus*. As such, the following hypothesis is proposed.

*H1: There is a positive association between industry specialist auditors and audit report timeliness, ceteris paribus.*

### 3. Research Method

#### 3.1 Sample selection and Research Model

The sample for the present study was selected from the 2007 list of Malaysian listed companies as issued by Bursa Malaysia. In particular, 873 companies (from a population of 985 companies) were selected for inclusion in the study. One hundred and twelve (112) companies were excluded due to unavailability of data.

To investigate the association between the audit report timeliness and independent variables, we estimated the following Ordinary Least Square (OLS) regression:

$$ART = f(\text{auditor quality, auditor characteristics, auditee characteristics})$$

The dependent variable, i.e., audit report timeliness (ART), is defined as the number of days from the end of the accounting year to the date of the audit report. In this study, ART is modelled as a function of auditor quality and characteristics (Specialist vs non-Specialist, Big-Four vs. non-Big-Four, audit report, and audit fee) and auditee characteristics (i.e., listing status, size, industry, year-end, auditor change, profitability, extra-ordinary reporting and leverage). The main proxy for specialist auditor is based on an auditor’s market share in the client’s industry and requires an industry specialist auditor to have a 30% or more audit fee industry market share (*spec\_30fee*). Consistent with Palmrose (1996), the decision to use a minimum 30% cut-off for specialization was to ensure that only a ‘reasonable’ number of firms can be regarded as industry specialists with a distinctive industry market share. The variable was assigned the binary value ‘1’ if the company is audited by an industry specialist or ‘0’ otherwise. Alternatively, companies were also regarded as having specialist auditors if they were audited by the largest auditor (based on audit fee) with at least 10% larger market share compared to the second largest (*spec\_topfee*) (Mayhew and Wilkins, 2002; Balsam *et al.*, 2003).

### 4. Results

#### 4.1 Descriptive statistics

The descriptive statistics indicate that the mean audit delay for the total reporting sample is 101 days. The Malaysian reporting delay, however, is longer than in other countries (e.g. New Zealand - Carslaw and Kaplan, 1991 - 88 days; Zimbabwe - Owusu-Ansah, 2000 – 62 days). This difference suggests that Malaysian auditors normally take a longer time compared to complete the audit compared to auditors from other countries. The observed delay is probably influenced by the fact that companies in Malaysia are allowed to publish their annual audited reports within 120 days following the end of the financial year.

Breaking down the analysis into a specific time frame, audit performed on the majority of PLCs was completed within 120 days. In fact, 690 (79%) companies' audits were fulfilled within 61 to 120 days. Three audits were concluded in less than 30 days, while another 104 audits took from 31 to 60 days. Altogether, 91% of companies managed to get their auditors to sign-off their audit work on time for submission to the Bursa Malaysia. However, the remaining companies faced the risk of being fined and reprimanded by the stock exchange for failure to submit their accounts on time. Another 9% of the companies failed to deliver information to their investors in a timely basis, possibly disrupting investors' abilities to make sound investment decisions.

The analysis also reveals that companies in the finance sector were the fastest (77 days) to get their auditor to complete the job. The fastest audit also comes from this sector (14 days). Despite the encouraging speed, the statistics for finance companies are not unexpected, given that these companies are required to maintain accounting records and prepare financial statements on a daily basis as well as exceptional internal control systems. Besides finance, other sectors that produced audit report below average (i.e., 101 days) include the Hotel, Infrastructure Project, Mining, and Plantation sectors. The rest of the sectors (i.e., Construction, Consumer Products, Industrial Products, Property, Technology, and Trading/Services) however, performed just slightly above the average and well below the 120 days cut-off point. If the fastest production of audit reports comes from Finance, the slowest is from the Property sector. Unlike companies in the Finance sector, auditors in other sectors might need to deal with large amount of inventory as well as several risk considerations. This nature of business might contribute to the longer time taken to complete the audit field work.

#### 4.2 Multivariate results

As shown in Table 1, the F-statistics of Model 1 and 2 are significantly different from zero, indicating that a subset of the independent variables does explain the variation in ART.

Table 1: OLS estimations of audit report timeliness

| Variables             | Model 1 (spec_30fee) |       |              | Model 2 (spec_topfee) |       |              |
|-----------------------|----------------------|-------|--------------|-----------------------|-------|--------------|
|                       | Coef.                | t     | P>t          | Coef.                 | t     | P>t          |
| <i>spec_30fee</i>     | 0.006                | 0.22  | 0.827        | -                     | -     | -            |
| <i>spec_topfee</i>    | -                    | -     | -            | 0.015                 | 0.44  | 0.657        |
| <i>big4</i>           | -0.099               | -5.25 | <b>0.000</b> | -0.099                | -5.42 | <b>0.000</b> |
| <i>audrep</i>         | 0.173                | 2.91  | <b>0.004</b> | 0.171                 | 2.87  | <b>0.004</b> |
| <i>lnaudfee</i>       | 0.029                | 2.10  | <b>0.036</b> | 0.029                 | 2.09  | <b>0.037</b> |
| <i>boardmain</i>      | -0.044               | -1.88 | 0.061        | -0.043                | -1.86 | 0.063        |
| <i>lnasset</i>        | -0.039               | -3.20 | <b>0.001</b> | -0.039                | -3.24 | <b>0.001</b> |
| <i>finance_ind</i>    | -0.144               | -2.23 | <b>0.026</b> | -0.142                | -2.21 | <b>0.027</b> |
| <i>busy_ye</i>        | 0.013                | 0.74  | 0.461        | 0.013                 | 0.73  | 0.465        |
| <i>aud_chg</i>        | 0.030                | 0.92  | 0.360        | 0.030                 | 0.93  | 0.353        |
| <i>roe</i>            | -0.003               | -4.05 | <b>0.000</b> | -0.003                | -4.04 | <b>0.000</b> |
| <i>sqrtextra</i>      | 0.029                | 2.09  | <b>0.037</b> | 0.029                 | 2.12  | <b>0.035</b> |
| <i>debttoasset</i>    | 0.191                | 3.46  | <b>0.001</b> | 0.192                 | 3.49  | <b>0.001</b> |
| <i>Constant</i>       | -19.494              | -1.66 | 0.097        | -19.757               | -1.69 | 0.092        |
| <i>R-Squared</i>      | 19.93%               |       |              | 20.00%                |       |              |
| <i>Adj. R-Squared</i> | 18.82%               |       |              | 18.80%                |       |              |
| <i>F-stats</i>        | <b>0.000</b>         |       |              | <b>0.000</b>          |       |              |

The value of the Adjusted R-squared of the model is 18.8%. The results suggest that industry specialist auditors do not perform significantly faster audits compared to non-specialist auditors thus, the hypothesis is not supported. This result holds true even when different definitions of industry specialists

are used. As shown in Models 2, the different specialist proxy is not significantly associated with audit report timeliness. The study reports Big Four firms do have significantly less audit report timeliness as compared to non-Big Four firms. The negative coefficient is significant at 1% level ( $P < 0.000$ ), thus indicating a strong inverse relationship between ART and the Big Four. The models also report significant associations between assets (*lnasset*), financial companies (*finance\_ind*), qualified audit report (*audrep*), profitability (*roe*), extraordinary reporting (*sqrtextra*) and leverage (*debttoasset*).

The coefficient estimates for assets (*lnasset*), financial companies (*finance\_ind*) and profitability (*roe*) indicate an inverse relationship between the variables and ART. As expected, big companies might have excellent internal control and experienced staff to deal with financial reporting works due to their resources and monetary capability. Those companies in the financial industry are subjected to different reporting regimes and thus, as expected, their auditors are able to conclude the audit work significantly faster than those in other industries. On the other hand, we also find that companies that received qualified audit reports (*audrep*) tend to have longer reporting lags, possibly due to additional procedures that need to be undertaken by auditors to confirm the audit findings, or perhaps due to the negotiation between the management and auditors. Longer reporting lags are also significantly associated with companies that report extraordinary income or loss (*sqrtextra*). Given that the extraordinary income or loss disclosure is not a normal business transaction, auditors might need more time to verify the item. The positive effect of Leverage (*debttoasset*) on audit report timeliness is also consistent with the prediction in the literature, implying that companies that are heavily financed by debt are subjected to stringent audits due to its business risk. Interestingly, we find that companies that pay higher audit fees are not prompt reporters. Higher audit fees might be the results of extra efforts by the auditor in order to clarify certain issues, rather than as a fee premium paid to 'brand-name' auditors (i.e., the Big Four).

## 5. Summary and conclusion

The paper examines the potential effect of industry specialist auditors on audit report timeliness. The results the audits of financial companies are relatively faster than companies in other industries. Industry specialist auditors do not statistically offer faster audit work compared to non-specialist auditors. This result is robust for different definitions of industry specialists. On the other hand, Big Four firms do perform significant faster audits compared to their non-Big Four counterparts. Further, the study also reports significant associations between company size (i.e., assets), financial companies, qualified audit reports, companies' profitability, extraordinary reporting, leverage and audit report timeliness. Larger companies, companies reporting profit, and financial companies are found to be associated with faster audits. On the other hand, companies receiving qualified audit opinion, reporting extraordinary income, and high in leverage are associated with longer audit report timeliness.

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