THE IMPACT OF CORPORATE GOVERNANCE CHARACTERISTICS ON AUDIT REPORT LAG: EVIDENCE FROM MALAYSIAN LISTED COMPANIES

BY

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A dissertation submitted in fulfilment of the requirement for the degree of Master of Science in Accounting

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ABSTRACT

Timeliness of corporate annual financial reports is considered to be a critical and important factor affecting the usefulness of information that is made available to external users. The length of the audit process highly affects the timeliness of corporate financial reporting as documented by prior literature. The purpose of this study is to examine the impact of corporate governance characteristics on audit report lag in Malaysia. The corporate governance characteristics are board independence, audit committee size, audit committee meetings and audit committee qualifications. Consequently, the study applied the agency theory and formulated seven hypotheses that guided the analysis. The study sample comprised 703 Malaysian listed companies from Bursa Malaysia, which complied with the regulatory requirements and subjected to supervision of the Central Bank of Malaysia. Regression analysis was performed to examine the audit report lag determinants. The results show that audit report lag is influenced by audit committee size, auditor type, audit opinion and firm profitability. However, no evidence was found to support the effects of board independence, audit committee meetings and audit committee qualifications on audit report lag. Apart from contributing to the literature on corporate governance and audit timeliness, this study also falls under the strand of literature that examines the consequences of regulatory changes. Detail explanations of the findings of the study along with its implications, limitations and future research suggestions are highlighted.

خلاصة البحث

هذه الدراسة هو دراسة تأثير الخصائص حوكمة الشركات على تأخر تقرير مراجعة الحسابات في ماليزيا. خصائص حوكمة الشركات واستقلال الإدارة، ومراجعة الحسابات حجم اللجنة، لجنة مراجعة الحسابات، والمؤهلات لجنة التدقيق. وبناء على ذلك، طبقت دراسة نظرية الوكالة وضعت سبعة الفرضيات التي وجهت التحليل..عينة الدراسة شملت703 من الشركات المدرجة في البورصة الماليزية بورصة ماليزيا، الذي ينسجم مع المتطلبات التنظيمية وتخضع لإشراف البنك المركزي في ماليزيا. تم إجراء تحليل الانحدار لدراسة المحددات تأخر تقرير التدقيق. وتظهر النتائج أن يتأثر المراجعة تأخر التقرير حجم جنة التدقيق، اكتب المراجع، رأي مراجعي الحسابات وربحية الشركة. ومع ذلك، لم يتم العثور على أدلة لدعم آثار استقلال مجلس، واجتماعات لجنة التدقيق والمؤهلات لجنة التدقيق في تأخر تقرير مراجعة الحسابات . وبصرف النظر عن المساهمة في الأدب حول حوكمة الشركات وتوقيت المراجعة، فإن هذه الدراسة تندرج أيضا تحت بنوع من الأدب الذي يدرس عواقب التغييرات التنظيمية. ويعتبر توقيت التقارير المالية السنوية للشركات لتكون عاملا حاسما والهامة التي تؤثر على فائدة المعلومات التي تتاح للمستخدمين الخارجيين.طول عملية المراجعة يؤثر للغاية في الوقت المناسب لتقديم التقارير المالية للشركات كما هو موثق من قبل الأدب. والغرض من ويسلط الضوء على تفسيرات تفاصيل النتائج التي توصلت إليها الدراسة جنبا إلى جنب مع آثارها، والقيود واقتراحات البحوث المستقبلية.

APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a research paper for the degree of Master of Science in Accounting.

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DECLARATION

I hereby declare that this dissertation is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

Siti Norwahida binti Shukeri

Signature……………………….. Date…………………………..

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LIST OF ABBREVIATIONS

AC	Audit Committee
ACCA	Association of Chartered Certified Accountants
ARL	Audit Report Lag
CG	Corporate Governance
CMA	Capital Market Authority
FASB	Financial Accounting Standard Board
GAAP	Generally Accepted Accounting Principles
IASB	International Accounting Standard Board
IFRS	International Financial Reporting Standard
KLSE	Kuala Lumpur Stock Exchange
MCCG	Malaysian Code of Corporate Governance
MICPA	Malaysian Institute of Certified Public Accountants
MIA	Malaysian Institute of Accountants
NYSE	New York Stock Exchange
SEC	Securities and Exchange Commission
TSE	Toronto Stock Exchange

CHAPTER 1

INTRODUCTION

1.0 INTRODUCTION

This chapter serves as the introductory chapter for the study. This first section starts with the background of the study, followed by the problem statement, objectives of the study and motivation of the study. The next section discusses the significance of the study and finally the chapter concludes with a presentation of the organisation of the study and conclusion.

1.1 BACKGROUND OF THE STUDY

An efficient and effective capital market needs a transparent financial reporting system to boost investors' confidence in making investment decisions. The financial information should be of higher quality before it is delivered to outside stakeholders because users of financial information demand for complete, transparent and timely information. Thus, timely financial reporting is considered as one of the qualities of financial reporting that leads to quality decision making.

Investors in today's markets rely on accountants to provide greater information on a timely basis. Timeliness of financial reporting has allowed the information to be available to decision-makers before it loses its capacity to influence decisions. Greater benefits will be derived from the timely reporting of financial statements, and specifically timely reporting refers to the shorter time between the date of accounting financial year end and the date an independent auditor issues an audited annual report.

The delay in releasing the financial statement is most likely to boost uncertainty associated with the decisions made based on the information contained in the financial statements (Ashton, Willingham and Elliott, 1987). Therefore, timely reporting will enhance decision making and reduce information asymmetry in the capital market (Owusu-Ansah and Leventis, 2006). The issue of timely reporting also affects regulators and policy makers since they need to play a role in ensuring the shorter gap of financial report delay. Hence, exploring the determinants of timely reporting would enhance the regulators of emerging capital market in formulating new policies to improve the allocation efficiency of their markets.

Given the importance of financial reporting timeliness to investors, identifying the determinants of financial reporting delay has become a significant move to improve the financial reporting quality and also continue to motivate researchers to examine the factors that may influence the timeliness of financial reporting. Hence the financial reporting timeliness and audit timeliness are placed to be important factors affecting the quality of financial reporting. The financial reporting timeliness refers to prompt issuance of corporate annual report by the organization to the stakeholders and public. Whereas, the audit timeliness is found to have a great impact on financial reporting timeliness and it has become a main concern for researchers to investigate the possible factors that may influence audit timeliness or in other words audit report delay. Audit timeliness refers to prompt issuance of audited annual report issued by the independent external auditor to its client. Long audit report delay has been discussed in prior studies; as the number of days from fiscal year end to audit report date might jeopardizes the quality of financial reporting by not providing timely information to stakeholders.

In Malaysia, Bursa Malaysia views the delay of issuing audited annual reports as a serious offence and warns company directors about their responsibility to maintain appropriate standards of corporate responsibility and accountability. The delay of the report to be released to the company's shareholders is of interest since it has a close association with the audit functions. This is because the financial statement cannot be issued until an audit has been duly performed and concluded (Che-Ahmad and Abidin, 2008). Bursa Malaysia also requires a timely financial reporting according to the provision in Chapter 2 (2.03-2) and Chapter 9 (9.01-3) of the Listing Requirements of Bursa Malaysia Securities Berhad. This section stipulates that the interval period between the close of the financial year of the company and the issue of the annual report to the company's shareholders and the exchange shall not exceed six months.

Hence, investigating the determinants of timely reporting would provide information that would help the regulators of emerging capital markets in formulating new policies to improve their markets (Owusu-Ansah and Leventis, 2006). One of the factors that affects the financial reporting timeliness is the timeliness of the annual audit performed by the independent auditor. Based on prior literature, it is reported that over 70 percent of all companies wait until at least the annual audit report date before releasing the earnings report to the public and shareholders (Bamber, Bamber and Schoderbek, 1993). Thus, regulators need to know the factors that contribute to audit delay before effective measures can be implemented to overcome the problems of financial reporting timeliness.

Awareness of the importance of corporate governance has now become a worldwide concern as many countries are actively working to develop the tools and institutions necessary to practice good corporate governance systems at each national level (Afify, 2009). Prior studies provide evidence that strong corporate governance mechanisms may improve financial reporting quality such as strength of the board of directors and AC (audit committee) is significantly associated with the quality of the financial reports, as it potentially affects the auditor's risk assessments (Abbott, Parker and Peters, 2004). The evidence from prior literature provides strong support with the agency view of the board and audit committee. Fama and Jensen (1983) posit that a firm's internal governance plays an important role in shaping and effectively enhancing the operations of its internal control system. The board of directors, through the audit committee, is the primary internal governance mechanism that is responsible for the effective oversight of the overall control environment. The effectiveness of this oversight function is largely dependent on the independence of the directors serving on the board and the audit committee. Such independence from outside directors who have the incentives to protect their reputation and avoid litigation and audit business risks, which in the end would give an impact to a better audit timeliness.

Corporate governance is an important entity-level factor that sets the tone for the overall control environment that has significant implications for auditors' risk judgments. Therefore, this study aims to investigate the impact of corporate governance mechanisms on audit report delays by predicting that strong corporate governance will reduce client-related risks, hence reducing the timing and extent of substantive testing. In this study, it is proposed that if auditors perceived stronger corporate governance, then less substantive testing would be performed by the auditors. This study includes board of directors and audit committee attributes (size, frequency of meetings and qualification) as explanatory independent variables where it is suggested that effective monitoring by the board and audit committee increases the strength of the internal controls and reduces the audit business risk hence leading to shorter audit report delays.

Apart from contributing to the existing literature on corporate governance and audit timeliness, this study also falls under the strand of literature that examines the consequences of regulatory changes introduced around the world to strengthen corporate governance and financial reporting transparency, and also assist to shorten audit delays. Specifically, the study extends prior research in Malaysia since the existing literature provides insufficient empirical evidence to suggest that audit report delays are influenced by the strength of a client's corporate governance. Thus, client's corporate governance is examined in this study to further provide evidence on the role of corporate governance in financial reporting and the auditing process.

1.2 STATEMENT OF THE PROBLEM

Recognising the theoretical and practical importance of timely financial reporting, regulatory agencies around the world have set statutory maximum time limits within which public companies are required to issue audited financial statements to shareholders and other external users and file them with regulatory bodies. Generally, most of the organised stock exchanges around the world have similar or more stringent reporting and listing requirements. The earnings report is considered of high quality if it is able to provide a very timely reporting and relevant to users in decision making processes. Timely reporting will give a huge impact on capital market as investors rely heavily on annual reports to assist them in making wise and relevant investment decisions.

The timeliness of financial reporting had become a great concern to regulators and policy makers such as the Financial Accounting Standard Board (FASB, 1980), where the board has raised a concern about the timeliness of public information disclosures. The issue of financial reporting timeliness has become a great concern in many countries such as Saudi Arabia, Canada, Singapore, Bangladesh, Malaysia, Egypt, USA, Australia, New Zealand, Pakistan, China and Greece.

In Saudi Arabia, the joint stock companies listed on the stock market fall under the regulation of two separate bodies with regard to audited financial reports. First, the Companies Act administered by the Ministry of Commerce states that audited annual financial statements should be made available to the public within 90 days from the financial year end. Second, the Capital Market Authority (CMA) in its listing requirements and regulations states that annual audited financial statements along with other information especially the auditor report should be filed with the CMA within 90 days of the end of the fiscal year of the joint stock company (Almosa and Alabbas, 2008). In Bangladesh, in the year 2000, the country's Securities and Exchange Commission (SEC) imposed a mandatory maximum of 120 days for listed companies to complete their audits (Karim, Ahmed and Islam, 2005). Whereas in Egypt, listed companies are required by law to present their annual financial statements within three months of the fiscal year-end and also listed companies must present their financial statement 45 days after the end of each quarter (Afify, 2009). In the USA, the Securities and Exchange Commission (SEC) and New York Stock Exchange (NYSE) have issued requirements and recommendations regarding the timely dissemination of financial information. The issue of timely reporting has received attention in US markets with the announcement of phased reductions in reporting time limits from 90 days after the financial year end to 60 days by 2005. Knowing the importance of timely dissemination of information, the European Union (EU, 2004, Para. 1) quoted from Afify, (2009) states:

> [. . .] The disclosure of accurate, comprehensive and timely information about security issuers builds sustained investor confidence and allows an informed assessment of their business performance and assets. This enhances both investor protection and market efficiency.

The EU Market Transparency Directive further stresses timely dissemination of information and indicates issuers should produce:

- an annual financial report within three months of the end of the financial year;
- a detailed semi-annual financial report; and
- quarterly financial information for the first and third quarters of a financial year.

Thus, the enforcement of financial reporting timeliness has now become global in order to maintain financial reporting quality. The same enforcement applies in Malaysia with the Bursa Malaysia and Companies Act 1965 where they demand a timely financial reporting through the provision of Chapter 2 and Chapter 9 of the Listing Requirements of Bursa Malaysia Securities Berhad. Based on the regulation made by the respective countries, it indicates that the timeliness of financial reporting is a very important aspect in order to maintain appropriate standards of corporate responsibility and accountability. In accordance to the effort of improving the quality of financial reporting, prior research has shown evidence that supports the importance of having strong corporate governance mechanisms (Afify, 2009; Mohd Naimi, Shafie and Wan Nordin, 2010).

This study examines the effectiveness of MCCG 2000 in relation to audit committee and board independence to enhance audit timeliness. In 2007, MCCG was revised with amendments to the code that were aimed at strengthening the board of directors and audit committees, and ensuring that the board of directors and audit committees discharge their roles and responsibilities effectively. The following are the recommendations to the audit committee components that have been highlighted in the code:

1) comprises at least three members;
2) all members are nonexecutives and financially literate with at least one being a financial expert i.e., a member of an accounting association or body; and
3) meet regularly with due notice of issues to be discussed.

The Bursa Malaysia Corporate Governance Guide (2009) issued new rules that require that the chairman should be an independent director (Para 15.11) and Para 2.6.2 requires that the audit committee meetings should be held at least four times a year.

Independent directors and audit committees of the company would provide better monitoring of a company's internal control environment and financial reporting process. Therefore, when such mechanisms are in place, it will reduce the company's business- related risks which might reduce the auditor's work due to less extensive testing and audit procedures to be performed. The issues of financial reporting timeliness is closely associated with audit timeliness and thus, for governance factors to affect audit plans, the auditor must first recognize and properly access the strength of corporate governance and appropriately weigh and use the governance assessment to develop an audit plan. If the governance structure is strong, an auditor could potentially reduce substantive testing and thus reduce the audit report delay.

Given the preference for more timely disclosures as discussed above, more efficient auditors should perform more timely audits. Audit efficiency is dependent on the client-related business risks which can be reduced by the presence of a strong corporate governance through the board of directors and audit committee. Thus, an empirical study will provide evidence on audit timeliness that is very important, as it will give some beneficial insights to assess the factors that may influence audit efficiency and hence on financial report timeliness. In addition, given the new regulations by MCCG and Bursa Malaysia, it will also provide rich idea to examine the effectiveness of audit committee and board independence on audit timeliness. This led to the following research question:

> RQ: What is the impact of implementing CG characteristics on ARL in Malaysian-listed companies?

Thus, apart from contributing to the existing literature on audit report lag, this study also compares the audit delay during the pre and post introductions of the MCCG by referring to prior studies that have been carried out from a Malaysian perspective (Mohd Naimi *et al*., 2010). The main objective of this study is to investigate the impact of corporate governance characteristics (board independence and audit committee) on audit timeliness.

1.3 OBJECTIVES OF THE STUDY

The main objective of the study is to investigate the impact of corporate governance characteristics on audit report lag particularly in Malaysian-listed companies. Given the Bursa Malaysia requirements that require listed companies to disclose MCCG practices in their corporate annual report, this provides an avenue for a viable research related to corporate governance effectiveness. The presence of corporate governance characteristics could improve the quality of financial reporting and ensure proper monitoring control of the company through effective board of directors and audit committee.

Therefore, this study aims to examine to what extend corporate governance characteristics (board independent, audit committee size, frequency of meetings and qualification) are able to reduce the period of audit report delay. In relation to that, the study assumes that the presence of strong corporate governance would have an impact on auditor's assessment and audit planning, hence would reduce the time taken by the auditors to complete their annual audit work.

Previous studies report that the corporate governance characteristic, board independence, existence of audit committee and CEO duality, lead to shorter audit report lag. The expectation is clearly that corporate governance mechanisms may reduce the audit business risk of the company and would be able to reduce the time taken by the auditor to complete their annual audit work (Sharma, Boo and Sharma, 2007).

The findings reported by prior literature prove that corporate governance characteristics have an effect on audit report lag. Thus, this study aims to extend the existing literature on audit report lag by including some other corporate governance characteristics as explanatory variables, and other determinants that influence audit report lag such as firm performance, audit type and auditor opinion.

1.4 MOTIVATION OF THE STUDY

In emerging economies, the provision of timely information in corporate annual reports assumes greater importance since other non-financial statement sources such as media releases, news conferences and financial analyst forecasts are not well developed and the regulatory bodies are not as effective as in developed countries (Karim *et al.*, 2005). In the case of Malaysian companies, prior studies have reported that the mean of audit delay in Malaysia from 1993 to 2003 did not significantly reduce even though the audit delay reported in Malaysia is still below the maximum period of six months as required by the Bursa Malaysia. The audit delay of Malaysian companies is reported to be longer than in Western countries (Che-Ahmad and Abidin, 2008). Thus, this study seeks to identify whether the mean of audit delay has changed from 2003 to 2009. The existing MCCG 2007 provides strong support for this study as it provides a guideline for Malaysian companies to better monitor the firm's performance. Thus, given this enforcement, it provides a viable research idea for audit market research in Malaysia, in relation to the timeliness of financial reporting.

MCCG (revised 2007) makes some recommendations regarding the responsibility of directors and audit committee in order to ensure they effectively perform their duties. Thus, the code suggests that the roles of the Chairman and CEO should be separated and cannot be held by the same person to ensure independence is exercised (MCCG, 2007). Besides the enforcement in relation to the board of directors, the code also make some recommendations to the audit committee components; that the committee should comprise at least three members; all members should be non-executives and financially literate with at least one being a financial expert (Part 2, BBI and BBV) and the meetings of audit committee should be held at least four times a year (Bursa Malaysia Corporate Governance Guide, Para 2.6.2). Given the enforcement by MCCG, it is expected that the code would be able to ensure the effectiveness of the directors and audit committee to better monitor the company's internal control and reduce the audit business risk which might delay the auditor's work. Thus, this study expects that the code enforcement to provide empirical evidence on the effectiveness of directors and audit committee in relation to audit timeliness. This study predicts that the effectiveness of corporate governance characteristics which is proxied by board independence and audit committee would shorten the period of audit report lag. Besides, the study also aims to examine whether corporate governance characteristics have any effects on audit report lag in relation to pre and post establishment of MCCG (revised 2007).

The existing literature in this area provides some useful insights to further investigate on the impact of corporate governance characteristics on audit report lag. The listing requirements made by Bursa Malaysia on the timeliness of financial reporting and also on the enforcement to comply with MCCG have provided the motivation to further investigate its effectiveness by focusing on the audit report lag trend in Malaysia.

1.5 SIGNIFICANCE OF THE STUDY

The main objective of the study is to examine the effectiveness of corporate governance characteristics (i.e., board independence and audit committee) on audit timeliness. Bursa Malaysia requires listed companies to disclose their MCCG practices in the corporate report. The objective of the requirement is to ensure that the listed companies exercise corporate governance system within the organisation. The first MCCG was issued in 2000 and was revised in October, 2007. Apart from contributing to the literature on audit timeliness, this study expects to provide some significant and practical implications to the auditing practices by means of providing evidence on the effectiveness of MCCG practices. This study will be a useful benchmark to examine the effectiveness of MCCG practices especially after the newly revised of MCCG in 2007. In relation to the Bursa Malaysia listing requirement of Chapter 9 (i.e.,companies must issue their audited annual report not more than six months), this study also hopes that the findings of the study on audit delay trend may be beneficial to the regulator (Bursa Malaysia), as to whether the imposed requirement is able to reduce the audit delay period or not.

Secondly, this study is significant as it will provide different findings on the issues of audit timeliness, with regard to the determinants of audit report lag (ARL). This study may also benefit companies as they strive to improve their corporate governance system if the results of the study significantly show that the corporate governance characteristics strongly affect the audit timeliness.

1.6 ORGANISATION OF THE STUDY

The study is organized as follows:

Chapter 1: **Introduction**. The introduction highlights the background and problem statement of the study, objectives of the study, motivation of the study, and significance of the study.

Chapter 2: **Audit Report Lag and Corporate Governance: Literature Review.** This chapter discusses financial reporting timeliness and audit report lag in general. The next section provides a literature review on the determinants of ARL followed by a discussion on the gap to be filled by this study which is a discussion on corporate governance as a factor influencing ARL.

Chapter 3: **Theory and Hypotheses Development.** This chapter focuses on the theory and hypotheses developed in the study. The first section highlights the overview of agency theory, agency theory with corporate governance and audit report lag and the next section focuses on the hypotheses development.