

The Substitution Role of Audit Committee Effectiveness and Audit Quality in Explaining Audit Report Lag

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ABSTRACT

Objective – This study aims to examine the relationship between audit committee effectiveness on Audit Report Lag (ARL), and the moderating effect of audit quality on the relationship between audit committee effectiveness and ARL.

Methodology/Technique – 109 non-financial Indonesian listed companies are examined from 2012 to 2016. The data is analysed using multivariate regression analysis.

Findings – The results show that audit committee effectiveness negatively affects ARL. This indicates that an effective audit committee can accelerate the delivery of audit reports. The results on the interaction between audit committee effectiveness and audit quality also negatively affects ARL. These results indicate that audit quality strengthens the influence of audit committees on the timeliness of financial reporting by reducing audit report lag.

Novelty – The results show that there is a relationship of substitution between audit committee effectiveness and audit quality (Big-4) on ARL. The results of this study are consistent with agency theory which states that the implementation of corporate governance, such as an effective audit committee and audit quality, can improve the quality of financial reports.

Type of Paper: Empirical.

Keywords: Audit Committee Effectiveness; Audit Quality; Audit Report Lag; Agency Theory.

JEL Classification: M42, M41.

1. Introduction

The financial statement is the important information for some users including investors and potential investors in making business decisions. Therefore, timeliness is one of the important qualitative characteristics of financial statements (Soltani, 2002), and they can also be used to reduce information asymmetry (Alfraih, 2016). Unfortunately, some empirical and anecdotal evidence shows that some companies publish their financial statements late due to audit report lag. Some previous studies also found that the effectiveness of audit committee influences Audit Report Lag (ARL), both individually and in composite. In the context of individual dimensions, Sultana et. al. (2014) shows that the skills, experience, and independence of the audit committee are negatively associated with ARL.

* Paper info: Revised: December 12, 2018
Accepted: March 18, 2019

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In contrast, Oussii and Taktak, (2016) and Abernathy et. al. (2014) conclude that only expertise has an effect on ARL. Meanwhile, for a composite dimension, Ika and Ghazali (2012) conclude that the effectiveness of audit committees tends to reduce ARL.

On the other hand, quality external audits (Big-4) are also an important oversight mechanism in the timeliness of financial reporting. Some studies show that audit delay is significantly reduced when audits are conducted by Big-4 companies (Leventis & Weetman, 2005; Alfrah, 2016; Ahmed & Che-Ahmad, 2016; Sakka & Jarboui, 2016; Basuony et. al., 2016; Rusmin & Evans, 2017). Other studies show that the Big-4 have no effect on ARL (Afify, 2009; Hashim & Abdul Rahman, 2012; Ika & Ghazali, 2012; Sultana et. al., 2014). In contrast, Hassan (2016) and Asthana (2014) conclude that the Big-4 have a positive effect on ARL.

Furthermore, there is still very limited literature demonstrating the interaction of audit committee effectiveness and audit quality (Big-4), particularly in relation to ARL. In the corporate governance mechanism, the financial reporting process is strongly influenced by internal mechanisms, such as the role of the audit committee, and external mechanisms, such as audit quality (Big-4). The results of research by Idris et. al. (2018) shows that there is a positive interaction between the size of the external auditor (Big-4) and audit committee effectiveness on earnings management. Therefore, the audit committee's interaction with audit quality (Big-4) is predicted to reduce audit delay.

Based on the inconsistency of the results of previous research on the relationship of the audit committee effectiveness and ARL, this study uses a moderating variable to re-examine the relationship between audit committee effectiveness and audit quality on ARL with audit quality as the moderating role.

2. Literature Review

2.1 Audit Committee Effectiveness and ARL

The audit committee is a board of director's sub-committee tasks with oversight of the company's financial reporting process. In Indonesia, the establishment of audit committees began to be regulated by the regulations of the Capital Market Supervisory Agency (BAPEPAM) in 2000, which subsequently became mandatory for all listed companies with the 2003 BAPEPAM regulation as amended in 2004. Currently, the regulation that requires the establishment of audit committees in Indonesia is the Financial Services Authority (OJK), 2015. That regulation explains that the responsibilities of the audit committee are among others related to; financial reporting, internal controls, external audits, and various other corporate governance mechanisms, such as ensuring compliance with laws, facilitating communication between management and external auditors and more. In addition, the OJK Regulation also indicates the establishment of an effective audit committee, related to the number of members, independence, expertise, and implementation of meetings, as stated by DeZoort et. al. (2002), Ika and Ghazali (2012) and Idris et. al. (2018).

Previous research (e.g. Sultana et. al., 2014; Oussii & Taktak, 2016; Abernathy et. al., 2014; Ika & Ghazali, 2012) conclude that the effectiveness of audit committees can improve the quality of financial reporting with a timely presentation of financial statements. Timeliness is indicated by the audit process period from the end of the reporting year to when the external auditor signs the audit report (Ghafran & Yasmin, 2018; Rusmin & Evans, 2017; Afify, 2009). In Indonesia, the 2016 OJK Regulation states that the deadline for submitting financial statements is at the end of the fourth month after the financial year ends. If the audit report is signed by an external auditor past the limits of the regulation, this indicates a delay in the issuer's annual financial reporting.

Research on the effectiveness of the audit committee and ARL has been carried out, among others, by Sultana et. al. (2014) on 100 Australian companies. The results of that study show that expertise, experience, and independence all negatively affect ARL. Oussii and Taktak (2016) use panel data of 162 observations on companies registered in Tunisia to demonstrate that the audit committee's financial expertise had a negative effect on ARL, while the independence, authority, meeting, and size of the audit committee had no effect on

ARL. Shukeri and Islam (2012) conclude that audit size and meeting of committees negatively affect ARL, while independence and qualification skills did not affect ARL. Abdullah (2007) found that the independence of audit committees does not affect the timeliness of financial reporting. However, Wan Hussin et. al. (2018) states that audit committee size has a negative effect on ARL. Meanwhile, the audit meeting committee has a positive effect on ARL, while independence and expertise are not related to ARL. Likewise, the research of Abernathy et. al. (2014) concludes that expertise from experience as public accountants is related to the timeliness of financial reporting.

Meanwhile, research by Ika and Ghazali (2012), which sampled 211 non-financial companies in Indonesia using a composite based framework developed by DeZoort et. al. (2002) in measuring the effectiveness of audit committees, shows that the effectiveness of audit committees tends to reduce the waiting time for releasing audited financial reports to the stock exchange. Other research using composite audit committee effectiveness was carried out by Idris et. al. (2018) on the Amman Stock Exchange, where the composite value of the effectiveness of the audit committee is the score of the audit committee's independence, size, meetings, and financial expertise. The results of Idris et. al. (2018) show that the effectiveness of the audit committee negatively influences earnings management. The results of both Ika and Ghazali (2012), as well as Idris et. al. (2018) show that the effectiveness of the audit committees can improve of the quality of financial reporting. In this study, financial reporting quality is indicated by the timeliness of the submission of financial statements proxied by ARL. Based on the discussion above, the first hypothesis is as follows:

H1: Audit committee effectiveness is associated with ARL.

2.2 Audit Committee Effectiveness, Audit Quality, and ARL

The effectiveness of the audit committee and audit quality in the perspective of agency theory is seen as an important monitoring mechanism to reduce agency problems (Inaam & Khamoussi, 2016), because it is able to detect misstatements and opportunistic behavior by management (Yoonseok et. al., 2013), to improve financial reporting quality (Zgarni et. al., 2016; Kamolsakulchai, 2012; Mitchell et. al., 2008). Audit quality is often proxied by the size of the audit firm, because large audit firms have a greater concern for reputation, have superior resources and are supported by many expert technicians to conduct audits, so that they are expected to provide quality audit services and are able to maintain independence at the auditee (Kane & Velury, 2004; DeAngelo, 1981).

Research on the influence of audit committees and ARL moderated by audit quality can be developed in two perspectives, namely substitution perspective and complementary perspective, because both audit committees and audit quality (Big-4) are seen as control mechanisms (Hay et. al., 2008; Miettinen, 2008). According to Hay et. al. (2008) from the perspective of substitution, there is a negative effect between governance and external audits, whereby a stronger function means that other functions can be reduced. On the other hand, from a complementary perspective, there is a positive relationship between control mechanisms because these relationships complement each other. Furthermore, Miettinen (2008) explains that with a substitution perspective and complementary perspective, audit quality can strengthen and weaken the correlation between audit committee effectiveness and financial reporting quality.

The results of Hay et. al. (2008) show that the size of internal audit, corporate governance, and ownership concentration are positively related to audit costs, hence, it is concluded that the control mechanism is complimentary. Furthermore, the results of the study by Idris et. al. (2018), shows that Big-4 auditors (audit quality) as moderators of the audit committees effectiveness in limiting earnings management practices for sample companies listed on the Amman stock exchange, where audit quality is concluded to be more a substitute than a compliment in reducing earnings management. In other words, the Big-4 audit companies are less efficient in limiting earnings management when the audit committee is effective. Meanwhile, research by Zgarni et. al. (2016) on a sample of 29 non-financial companies registered in Tunisia, concluded that there is a substitution effect between the Big-4 auditors and effective audit committees to reduce

earnings management before the enactment of rules relating to financial securities. Contrary to this, Zgarni et. al. (2016) concludes that there is a complementary correlation between the effectiveness of the audit committee and the auditor's industry specialization in limiting earnings management after the regulations took effect. The results of previous studies indicate the moderating effect of audit committee effectiveness and audit quality in improving the quality of financial reporting. ARL is also one of the characteristics of financial reporting quality.

Various studies have indicated that the substitution effect of audit quality on the correlation the effectiveness of audit committees and ARL, including Sultana et. al. (2014) in Australia, which shows that the characteristics of the audit committee (expertise, experience, and independence) can reduce ARL. While the audit quality (Big-4) is not related to ARL. Ika and Ghazali (2012) show that the effectiveness of audit committees negatively affects ARL, whilst the Big-4 auditors have no effect on ARL. The results of other research by Maggy and Patricia (2018) indicate that both the size of the audit committee and the Big-4 auditors did not affect the decline of ARL in the Indonesian Capital Market. Further, Afify (2009) shows that the existence of an audit committee has an impact on the short duration of the audit period, while Big-4 are not related to ARL. The same results were also shown by Hashim and Rahman (2012) who tested internal corporate governance and ARL in Malaysia, concluding that the independence and expertise of the audit committee has a negative relationship to ARL, while the Big-4 did not affect ARL. Based on the above discussion, the second hypothesis is as follows:

H2: Audit quality moderates the relationship between the effectiveness of the audit committee and ARL.

3. Research Methodology

The population of this study is non-financial companies listed on the Indonesian Stock Exchange from 2012 to 2016. The samples were selected using purposive sampling. Based on the results of the sample selection, as much as 109 companies of non-financial companies meet the criteria, with the number of observations being 545. Table 1 below presents the measurement of the research variables.

Table 1. Variable Measurement

Variable	Measurement	Reference
Dependent variable		
Audit Report Lag (ARL)	The number of days between the audit process periods from the end of the reporting year to when the external auditor signs the audit report date.	Ghafran and Yasmin (2018); Rusmin and Evans, (2017); Afify (2009)
Independent variables:		
Audit Committee Effectiveness (ACE)	A composite score of four constructs of the audit committee; independence, size, meeting, and financial expertise.	Idris, et al., (2018)
Audit committee independence	Dummy, 1 if the proportion of board's independent on the audit committee is above the sample median, 0 otherwise.	
Audit committee size	Dummy, 1 if the total audit committee is above the sample median, 0 otherwise.	
Audit committee meeting	Dummy, 1 if the total audit committee meeting is above the sample median, 0 otherwise.	

Audit committee financial expertise	Dummy, 1 if the percentage of members who have financial expertise in the committee is above the sample median, 0 otherwise.	
Audit Quality (Big-4)	Dummy, 1 if the company has been audited by a Big-4 company, 0 otherwise.	Idris, et al. (2018); DeAngelo (1981)
ACEi* Big-4	Interaction of audit committee effectiveness and audit quality.	Idris, et al. (2018)
Control Variables:		
Board Size (BS)	The total number of the company's board of commissioners.	Idris, et al. (2018); Alfraih (2016); Sakka and Jarboui, (2016)
Profitability (ROA)	The comparison of profit after tax and total assets.	
Firm size (SIZE)	The natural logarithm of firm total assets.	
Leverage (LEV)	The comparison of total liabilities and total assets.	

The research model in this study is as follows:

$$\text{Model (1): } ARL_i = \beta_0 + \beta_1 ACE_i + \beta_2 BS_i + \beta_3 ROA_i + \beta_4 Lev_i + \beta_5 Size_i + \varepsilon_i$$

$$\text{Model (2): } ARL_i = \beta_0 + \beta_1 ACE_i + \beta_2 Big4_i + \beta_3 BS_i + \beta_4 ROA_i + \beta_5 Lev_i + \beta_6 Size_i + \varepsilon_i$$

$$\text{Model (3): } ARL_i = \beta_0 + \beta_1 ACE_i + \beta_2 Big4_i + \beta_3 ACE_i * Big4_i + \beta_4 BS_i + \beta_5 ROA_i + \beta_6 Lev_i + \beta_7 Size_i + \varepsilon_i$$

4. Results

4.1 Descriptive Statistics

Table 2, panel A shows that the ARL average is 75.88 or 76 days (std. deviation 17.73 or 18 days), indicating that the mean company sample presents timely financial reports in accordance with regulatory requirements in Indonesia. The average ACE of 2.79 (std. deviation 0.80), indicates that the company's audit committee in Indonesia is relatively effective. Table 2, panel B shows that 41.80% of the sample companies are audited by the Big 4 public accounting firms and as many as 58.20 are audited by non-Big 4 firms.

Meanwhile, for the control variable, Table 2, panel A shows that the average BS is 4.41 or 4 persons (std. deviation 1,816 or 2 persons), this indicates that the board size has complied with regulatory requirements in Indonesia being a minimum of 3 people. Profitability (ROA) shows an average of 0.06 or 6% (std. Deviation 0.12), indicating that the company's ability to generate profits is still low. Firm size (SIZE) shows the results of the average natural assets total logarithm of 28.40 (std. Deviation 1.72), indicating that the size of the companies' sample is relatively the same. Finally, the Leverage variable (LEV) shows that the average debt of a company is 0.52 or 52%.

Table 2. Descriptive Statistics

Panel A - Continuous Variables				
Variable	Minimum	Maximum	Mean	Std. Deviation
ARL	12.000	178.000	75.881	17.733
ACE	1.000	4.000	2.793	0.802
BS	2.000	11.000	4.407	1.816
ROA	-1.070	1.000	0.064	0.121
SIZE	23.060	33.130	28.403	1.723

LEV	0.000	8.310	0.521	0.595
Panel B - Categorical Variables			Frequency	Percentage
BIG-4			228	41.80
NONBIG-4			317	58.20
Total obs. (n)			545	100.00
ARL = Audit Report Lag; ACE = Audit Committee Effectiveness; BS = Board Size; ROA = Profitability; SIZE = Firm size; LEV = Leverage; BIG-4 = Audit Quality.				

4.2 Correlation Analysis

Table 3 presents the statistical correlation variables used in the empirical analysis. This analysis is to ensure that there is no correlation between the independent variables, so there is no multicollinearity problems in the dataset. Based on the results, the overall correlation coefficients between the independent variables are very low, being less than 0.8 (Gujarati & Porter 2003). These results indicate that there is no multicollinearity problems in the research model.

Table 3. Correlations Matrix

Variable	ARL	ACE	BIG4	BS	ROA	SIZE	LEV
ARL	1						
ACE	-0.034	1					
BIG-4	-0.148**	0.099*	1				
BS	-0.362**	-0.135**	0.382**	1			
ROA	-0.137**	-0.020	0.291**	0.190**	1		
SIZE	-0.178**	-0.062	0.519**	0.565**	0.119**	1	
LEV	0.294**	-0.010	-0.130**	-0.142**	0.045	-0.257**	1
Notes: *p < 0.10; **p < 0.05; ***p < 0.01							
ARL = Audit Report Lag; ACE = Audit Committee Effectiveness; BIG-4 = Audit Quality; BS = Board Size; ROA = Profitability; SIZE = Firm size; LEV = Leverage.							

4.3 Hypothesis Testing

Table 4 presents the results of the analysis using multiple linear regression, indicating that the F-statistic values for each model are (29,051; 24,178; and 22,600) and on all models $p < 0.01$, with adj R-square of each model (0.205; 0.204; and 0.217). Furthermore, the results of testing the model (1) show that the ACE variable has a significant negative effect on ARL ($\beta = -1.708$, $t = -2.000$, $p > 0.05$). These results indicate that hypothesis 1 is supported. Model (2) shows that the ACE variable has a significant negative effect on ARL ($\beta = -1.747$, $t = -2.012$, $p > 0.05$), whilst the BIG-4 variable has no effect on ARL ($\beta = 0.431$, $t = 0.253$, $p < 0.10$). Model (3) shows the results that ACE and BIG-4 interactions have a significant negative effect on ARL ($\beta = -5.565$, $t = -3.249$, $p > 0.01$). These results indicate that hypothesis 2 is supported. The test results of the control variables show consistent results for all models, demonstrating that BS has a negative effect on ARL, ROA has a

significant negative effect on ARL, SIZE has a significant positive effect on ARL, and LEV has a significant positive effect on ARL.

Table 4. The Results of Hypothesis Testing

Independent variable	Model (1)		Model (2)		Model (3)	
	Coef.	t-stat	Coef.	t-stat	Coef.	t-stat
(Constant)	60.829	4.572***	62.371	4.260***	50.673	3.389***
ACE	-1.708	-2.000**	-1.747	-2.012**	0.879	0.744
BIG-4			0.431	0.253	16.048	3.150***
ACE*BIG-4					-5.565	-3.249***
BS	-3.702	-8.027***	-3.715	-7.999***	-3.765	-8.174***
ROA	-13.511	-2.358**	-13.901	-2.341**	-15.946	-2.694***
SIZE	1.154	2.360**	1.100	2.060**	1.265	2.379**
LEV	8.113	6.855***	8.116	6.851***	8.516	7.213***
Adj. R Square	0.205		0.204		0.217	
F-Stat	29.051***		24.178***		22.600***	
Obs. (n)	545		545		545	
Notes: *p < 0.10; **p < 0.05; ***p < 0.01						
Dependent variable Model 1, 2, and 3: ARL = Audit Report Lag						
ACE = Audit Committee Effectiveness; BIG-4 = Audit Quality; BS = Board Size; ROA = Profitability; SIZE = Firm size; LEV = Leverage						

5. Discussion

Based on the results of the testing, Model (1) shows that ACE has a significant negative effect on ARL. The results of this study indicate that the more effective the audit committee is, the shorter the audit process carried out by public accounting firms will be. This result supports the agency theory which states that the audit committee, as one of the subcommittees of the board of commissioners, can carry out effective oversight mechanisms to improve the quality of financial reporting. The effectiveness of the audit committee in this study is the composite value of independence, size, meeting, and expertise of the audit committee. These results support previous studies which state that ARL will be shorter when the company's audit committee has financial expertise and independence (Sultana et. al., 2014; Oussii & Taktak, 2016).

The results of this study also support research by Shukeri and Islam (2012), and Wan Hussin et. al. (2018) which state that the size and meeting of the audit committee can also reduce the audit process by an independent auditor. The results of this study also clarify, while supporting research by Ika and Ghazali (2012) and Idris et. al. (2018), that audit committees that can effectively improve the quality of financial reporting.

Furthermore, Model (2), which shows that ACE has a significant negative effect on ARL, but that Audit Quality (Big-4) has no effect on ARL, indicates there is a substitutionary role between audit committee effectiveness and audit quality in explaining ARL or the timeliness of financial reporting. These results support the results of Sultana et. al. (2014), Ika and Ghazali (2011), Hashim and Rahman (2012) and Afify

(2009) which state that ACE has a negative relationship with ARL, while audit quality does not have an effect on ARL.

This is in accordance with Hay et. al. (2008) who state that there is a negative relationship between governance mechanisms and external audits, whereby if a function is stronger, other functions can be reduced. This result is also supported by the results of Model (3) which shows that ACE and Big-4 interactions have a significant negative effect on ARL. These results indicate that audit quality (Big-4) moderates the relationship between the audit committee effectiveness and ARL. The results of a negative interaction test, indicate that there is a relationship of substitution between the audit committee effectiveness and Audit Quality (Big-4) on ARL. These results indicate that companies that have an effective audit committee and are audited by Big-4 public accounting firms will have a shorter audit process. This can explain the perspective of audit quality substitution (Big-4) which can be seen as a control mechanism and can strengthen the relationship of the effectiveness of the audit committee and ARL as an indication of the quality of the company's financial statements. This result is consistent with the research of Idris et. al. (2018) and Zgarni et. al. (2016) which states that audit quality (Big-4) moderates the effectiveness of the audit committee in reducing earnings management practices, so that the quality of financial statements increases. Therefore it can be stated that audit quality is a substitution rather than a complementary factor.

6. Conclusion

This study aims to examine the relationship between audit committee effectiveness on ARL and the moderating effect of audit quality on the relationship between audit committee effectiveness and ARL. The results of this study conclude that audit committee effectiveness has a significant negative effect on ARL. This result indicates that an effective audit committee can accelerate the delivery of audit reports. The results of testing the interaction between audit committee and audit quality significantly and negatively effects ARL. These results indicate that audit quality mediates the role of audit committees on timeliness of financial reporting by reducing audit report lag. These results also show that there is a relationship of substitution between audit committee effectiveness and Audit Quality (Big-4) on ARL. The results of this study are consistent with agency theory which states that the implementation of corporate governance mechanisms, such as an effective audit committee, can improve the quality of financial reports.

This study has limitations in measuring the timeliness of financial reporting, which only uses the audit report lag / Auditors' Signature Lags proxy. There are other measurements that can be used such as preliminary lag and total lag (Dyer & McHugh, 1975), therefore further research may wish to use all three measurements at once to obtain more comprehensive results.

This research has implications for management, investors and policy makers. Company management must evaluate the existence of an audit committee that meets the characteristics of effectiveness such as independence, size, number of meetings and financial and accounting expertise, in addition to the quality of external auditors. Investors need to consider the quality of the company's financial statements related to the issue of timeliness, the effectiveness of audit committee supervision and the quality of the auditing company. This research can be relied upon by policymakers with respect to audit committees, the interaction of the audit committee and external auditors, as well as the company's compliance with the timeliness of the submission of financial reports in Indonesia.

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