

Auditor Industry Specialisation, Brand Name Auditors and Financial Reporting Lag

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Abstract

It is important to understand factors that influence financial reporting lag since it directly affects the timeliness of financial reporting which is one of the important qualitative attributes of financial statements. While audit quality has been recognised to improve reporting timeliness, its effect has never been tested empirically. This study examines the effect of quality-differentiated auditors and industry specialists on audit lag. Specifically, the purpose of this study is three-fold. Firstly this paper attempts to provide evidence concerning financial reporting lag based on the data of emerging market namely Malaysia. Secondly, this paper extends prior studies by considering the effect of auditor specialisation on the timeliness of auditee's financial reporting. Thirdly, this paper provides further evidence on the effects of brand name auditors (i.e. the Big Six audit firms) on financial reporting lag.

Using the data of total Malaysian public listed companies, the regression results supported the contention that audit quality improves financial reporting timeliness. The variable for the Big Six auditors was consistently significant in all estimations. However, the results for the industry specialists were mixed. The variable was significant only when the measure of specialist was based on audit fee. This research would be useful to the regulators and the academicians in understanding factors affecting audit lag. The findings also shed some light on the influence of audit quality on financial reporting timeliness.

1. Introduction

The importance of timely reporting have been recognised by most stock exchanges around the world. In Malaysia, the provision that requires companies to submit their audited accounts is stated in Section 60 of Main Board Listing Requirement (MBLR) and Clause 3.22 of KLSE Second Board Listing Requirements (SBLR). Section 60 and Clause 3.22 explicitly states that all companies must produce their audited accounts to the exchange within four months after closing their accounts. Breaching these provisions will cause the companies to be publicly reprimanded and fined.

Besides regulatory bodies, the standard-setting bodies also recognise the importance of financial reporting timeliness. [1] for example, addresses its importance in the Statement of Financial Accounting Concepts No.2 as an "ancillary aspect" of relevance. Meanwhile, the Malaysian Accounting Standard Board (MASB) emphasises that the usefulness of financial statements is impaired if they are not available to users within a reasonable period after the balance sheet date.

Timely reporting could help reduce the level of insider trading, information leakage and rumours in the stock markets [2]. Consequently, it should enhance the efficiency of stock evaluation and pricing. Researches have proven that timely information does effect the price of securities [3] and [4]. Further, an analytical analysis by [5] has shown that the timely information affects a decision-maker's pay-off.

A numbers of studies have investigated the issues surrounding the timeliness of financial reporting. [6] has come to the conclusion that the time length of the audit is the single most important determinant of the financial reporting timeliness. According to [7], this is because the financial statements cannot be issued until the audit has been performed and concluded. Therefore, it could be said that the auditor plays an important role in the process of producing financial statements and does influence on timeliness. However, previous studies on financial reporting lag that investigated the potential effects of auditor quality (Big Five vs. Non-Big Five) on financial reporting lag have produced inconsistent results. Therefore, this study is interested to further investigate the effect of auditor quality by using the data from a developing country, namely Malaysia. Further, it is recognised that some audit firms differ from others in term of their industry expertise [8]. [9] asserted that audit firms acquire reputation as industry specialists by developing industry specific skill and expertise over and above normal auditor expertise. With the specialised knowledge, it is expected that auditors with industry specialisation will complete the audit task within a shorter time period than the non-specialist auditors and subsequently will enable the companies to produce more timely financial reports. Therefore, it is also the intention of this study to investigate the possible effect of auditor industry specialisation on financial reporting timeliness.

Despite the importance of timeliness, relatively little research has investigated its determinants [10]. Further, most of the studies have concentrated on the developed countries such as United States, Australia, New Zealand and Canada. Not much has been done to investigate the issue in the developing countries especially those in the emerging markets. According to [11], the study of financial reporting timeliness is important to understand the cause of the lag as users of financial information need timely results in making decisions.

The purpose of this study is three-fold. First, this paper attempts to provide evidence concerning financial reporting lag based on the data of an emerging market, i.e., Malaysia. Second, this paper seeks to extend prior studies on financial reporting lag by considering the effects of auditor specialisation on the timeliness of auditee's financial

report. Thirdly, this paper will further investigate the effects of auditor brand name on financial reporting lag. In the absence of any study done to investigate the effect of auditor specialisation on the timeliness on financial reporting, this study could add further evidence to the literature. Further, this study is also important in providing evidence on the issue in the developing country.

The remainder of this paper is organised as follows. The next section provides a review of prior studies. The third section discusses the theory and states the hypotheses to be tested. Section four outlined the research designs to be employed. Section five considers the empirical findings while the final section concludes the study.

2. Prior Studies on Financial Reporting Lag

Empirical study on financial reporting timeliness has been pioneered by [12]. Based on the data of 120 companies listed on the Sydney Stock Exchange, they found that client size and fiscal year-end significantly determined reporting lag. Following [12], many studies have tried to provide more explanation on the reporting timeliness. [13] found that companies in fuel and energy, as well as those in the finance industries, provide timelier reporting. A study by [14] found that Australian companies with serious audit qualification were associated with greater reporting lag. [15] examined company ownership and debt proportion for two separate time periods, i.e. 1987 and 1988. Their findings indicate that company ownership, which was defined as owner controlled or manager controlled, was significant only in 1987 but not for 1988.

[16] found that mean audit delays are associated with the type of industry, in that the financial clients have been found to have a shorter audit delay than the non-financial clients. This finding is consistent with [17]. [16] also found that audit delay has a positive relationship with financial losses and the existence of extraordinary items. Surprisingly, [16] found that clean audit opinions were associated with longer audit delay. Although the result is contrary to [17], they do not offer any explanation for the unexpected result.

[14] examined the effect of audit qualification on the timeliness of corporate annual report by using a univariate relationship test approach. The result of the study indicated that “first time” qualifications delay the release of companies’ preliminary profit and the distribution of corporate annual report. This is due to an increase in the year-end time taken to complete the audit and also an increase in auditor-client negotiation time as a result of impending qualification. In general, the study concluded that “... the more serious the qualification, the greater the delay” ([14], p. 576).

[18] developed a more comprehensive model that focused on audit delay. They suggested that the amount of audit work required as one of the factors that effect the time taken to finish the audit task. Further, they divided the factor into three sub-factors: auditor business risk, audit complexity and other audit work related factors. Prior research indicates that financial reporting timeliness is associated with client and auditor size, complexity of ownership, type of audit opinion and the presence of extraordinary items. While most of the studies have relied on public data, at least two studies ([17] and [19]) focused on survey data. [17] examined a sample of 488 companies that were US clients of Peat Marwick Mitchell & Co in 1981. Among others, they found that the length of audit delay is significantly longer for companies that are categorized as non-financial, received qualified audit opinion, audited during busy periods and have poor internal controls. Meanwhile, [19] examined the relationship between audit report lag and incremental audit effort, audit resource allocation and the provision of non-audit services. Their results indicate that audit report lag is increased by audit effort and decreased by the use of more experienced external auditor personnel. Further, audit report lag is decreased by potential synergistic relationship between management advisory services and audit services.

3. Theories and Hypotheses

3.1 Brand Name Auditor (Auditor Quality)

Literature in audit market research has suggested that the audit assurance differs amongst auditors and the amount of assurance is directly related to the quality of audit opinion. Although, the audit quality does not vary in form (as standards and acts govern its content) it can be differentiate between firms according to the amount of expertise and effort to gather audit evidence. Further it can also be differentiated according to the willingness of auditor to report the true content of financial statements [20].

Auditors can be classified as Big Five (previously Big Six) or non-Big Five. Generally Big Five auditors are regarded as high quality auditors. Research on audit pricing found that the Big Five auditors charge a higher audit fee to their client. For example, [21], using U.S. data, found that the Big Five auditors charged a premium of 16% on average audit fee. Meanwhile, [9] documented that the premium on Australian audit fee charged by the Big Six firms s about 31%. According to them, the premium is imposed on clients as a return for the high quality services and for the brand name that the auditor carries. Other studies have also found that the Big Six auditors are of a higher quality than the non-Big Five auditors (see for e.g. [22] and [23]).

It is contended that Big Five (high quality firm) have a larger number of staff and more efficient audit procedures that may decrease the time taken to complete audit assignments. Studies that examined auditor type include [7], [15], [16], [17]), and [23]. Using the US data, [17] found that the audit firm variable was not significant. However, in a study based on Canadian firms, they found a significant but negative relationship. The same negative relationship was also found when using New Zealand data. The study by [15], however, found an insignificant relationship. However, at least three other studies have found significant relationship. First, a study by [7] that investigated the determinants of local government audit delay, found that auditor type to be significant at $P < 0.001$. Meanwhile, a study by [23] also found a significant relationship at $P < 0.05$ for KLSE listed companies. A study by [10] provided comparative results across

countries. The research attempted to determine the determinants of financial reporting timeliness in Canada, US, UK, Australia, France, Germany, Italy and Japan. The auditor variable for four countries was found to significant at $P < 0.05$. The countries are UK, France, Germany and Japan. Since the variable has been reported to have inconsistent results and found to be significant in Malaysia for the year 1993 database, this study includes the variable and tests it by using a larger dataset. The (alternative form) hypothesis is as follows:

H1: There is a negative relationship between High Quality Auditor (Big Five) and Financial Reporting Lag.

3.2 Auditor Industry Specialisation

Some firms differ from others in terms of their industry expertise [8]. This can be achieved by audit specialisation in specific industries. However not all audit firms could become specialists. [24]'s analysis suggests that only Big Eight (now Big Five) audit firms had industry specialisation. The assertion that only large audit firms could become specialists is not surprising since in many cases, the skills and resources of large firms are needed in order to complete the audit function.

[9] found that the Big Eight firms with industry specialisation received a fee premium of about 34 percent over non-specialist Big Eight firms. They asserted that audit firms acquire a reputation as industry specialists by developing industry-specific skill and expertise over and above normal auditor expertise. In order to perform the role as specialist, specialised industry knowledge (in addition to the general knowledge base required for all audits) is required [25]. With this specialized knowledge, it is argued that the industry specialist auditor will complete his/her audit work in a shorter time period than that of the non-specialist. This leads to the following (alternative form) hypothesis:

H2: There is a negative relationship between Industry Specialist Auditor and Financial Reporting Lag.

4. Research Methodology

4.1 Sample selection, data source and data collection

The sample of this study consists of all registered Malaysian companies that were listed on the Main Board and the Second Board of the Kuala Lumpur Stock Exchange in 1995. The data was collected from the annual reports of each company and after discarding some companies that do not have complete information; a number of 388 companies were taken as a final sample.

4.2 Model of the determinants of Financial Reporting Lag

In order to investigate the relationship between audit quality and financial reporting lag, the coefficients were estimated using the following models:

$$\text{FRL} = \alpha + \beta_1 \text{AUDITOR} + \beta_2 \text{DIRSH} + \beta_3 \text{LASSET} + \beta_4 \text{LSUBS} + \beta_5 \text{INVREC} + \beta_6 \text{LEV} + \beta_7 \text{ROE} + \beta_8 \text{BUSY} + \beta_9 \text{OPINION} + \beta_{10} \text{CHANGE} + \hat{\epsilon} \quad \dots(1)$$

The dependent variable is financial reporting lag (FRL) and was measured using the natural log of audit delay, i.e. number of days from the financial year-end to the date of audit report.

The hypothesised and control independent variables that were utilised in the study are as follows (expected sign is given within parenthesis):

Hypothesis Variables:

AUDITOR (-) = Auditor Quality variable either related to brand name auditor (BSIX) or an industry specialist auditor (SPECF). A dichotomous variable is used to test the hypothesis variable (see section 4.3 below for the measurement of each variable).

Control Variables:

DIRSH (+) = The client's directors' shareholding, calculated by the director's number of common shares outstanding held by the directors divided by the total number of common shares outstanding.

LASSET (-) = Logarithm to the base of 10 of total assets of a client as a proxy to measure company size

LSUBS (+) = Logarithm to the base of 10 of the number of subsidiaries (including the holding companies) held by the client company.

INVREC (+) = Total inventory and receivables divided by total assets. Note that for financial companies, this includes trade bills, bills receivables, advances to customers and lendings.

LEV (+) = Proportion of long-term debt (excluding deferred tax) to total equity in a client company.

ROE (-) = Proportion of net profit to shareholders' equity in a client company

BUSY (+) = A dummy variable coded "1" for client companies with financial year end dates that fall between 31 December to 31 March, "0" otherwise.

OPINION (+) = Audit opinion issued by auditor, represented by a dummy variable "1" for companies with a qualified opinion and "0" for those with an unqualified opinion.

CHANGE (+) = Coded "1" if the incumbent auditor is new to the client company and "0" if is not.

4.3 Measurements and Test

In this study, Big Six auditor refers to Arthur Andersen, Price Waterhouse, Coopers and Lybrand, Deloitte and Touche, Ernst and Young and KPMG Peat Marwick including their respective local affiliates. Note that Price Waterhouse and Coopers and Lybrand merged in 1998 and is now known as PriceWaterhouseCoopers.

Auditor specialists were identified based on the industry market share held. The measure was based on a percentage of total audit fee earned in an industry. Only firms that earned 15 percent or more of the industry total fee were classified as industry specialists. Further, this study also used 20 percent cut-off point as an alternative measure of auditor specialist. The 20 percent and was used by [9] and replicated by several other studies. The 15 percent cut-off point was used to reflect the merger of the Big Eight into the Big Six. This cut-off point has been used by [26] in their study of disclosure quality.

To investigate the effects of auditor quality and industry specialisation on financial reporting timeliness (or audit delay), the variables were tested both simultaneously and separately in the model.

5. Empirical Results and Analysis

5.1 Descriptive Statistics

Table 1 exhibits descriptive statistics of the variables included in the study. The mean delay of annual audit for the overall sample was approximately 113 days. The shortest and longest reporting lag in 1995 were 24 and 485 days respectively. The Big Six audited 77 percent of the listed companies whereas specialist auditors (based on 15% audit fee measure) were found to audit 24 percent of the public listed companies for the year under study.

The mean for directors' shareholding (DIRSH) was 0.38 while the mean of total assets was RM844 millions. More than 71 percent of the companies were audited during the busy season (i.e. December to March). Out of 388 valid cases, only 1.8 percent was issued qualified audit report and 4.6 percent changed auditor during the year under study.

Table 1: Descriptive Statistics

	Mean	SD	Max	Min	%
DELAY (days)	112.67	40.64	484	24	
BSIX					77
SPECIALIST (15% fee)					24
DIRECTORS' SHAREHOLDING	0.3788	0.3502	1.00	0.00	
ASSETS ('000)	833849	2062189	26004300	3984	
SUBSIDIARY (no.)	20	31	293	1	
INVREC	0.3091	0.2015	0.92	0.00	
LEVERAGE	0.0841	0.1047	0.54	0	
ROE	0.2883	0.3768	2.68	-2.66	
BUSY SEASON					71.4
QUALIFIED OPINION					1.8
CHANGE AUDITOR					4.6

5.2 Univariate Results

To provide us with preliminary insight, we performed univariate test on our hypothesised variables (i.e. BSIX and SPECF). As can be seen on Table 2, the mean delay of audit reporting is significantly different between Big 6 and Non Big-Six. Similarly, the results on specialist variables were also significant in the expected direction for both cut-off points. When using 20 percent and 15 percent audit fee cut-off point, the mean delay was significantly different at $p < 0.05$ and $p < 0.01$ (one-tailed) level respectively, between industry specialists and non-specialists. Table 2 presents the results of the univariate analysis.

Table 2 Results of Univariate Test for Financial Reporting Lag

Variables	t-statistics
Big Six and Affiliates vs. Non-Big Six	-3.265*
Specialist (15% audit fee) vs. Non-Specialist	-2.581*
Specialist (20% audit fee) vs. Non-Specialist	-1.655#

* significant at the 0.01 level (One-tailed)

significant at the 0.05 level (One-tailed)

5.3 Multivariate Tests

Table 3 presents the results of multivariate regressions used to test the hypotheses stated earlier. Five different models were tested with the first model include variable Big Six (BSIX) as a hypothesised variable. Then in the second and third models, the Big Six variable was replaced by SPEC variables, i.e. auditor specialist variable based on audit fee at 15 percent and 20 percent cut-off points. Further we included both variables of interest in a single regression model and tested them against audit delay. The results in Table 3 show that all models were highly significant as evidenced by the F-Statistics. All of the models reported significant F-Statistics at $p < 0.01$. The adjusted R-Square was reported to be around 8.13 percent to 9.23 percent. Although the results indicate that the models do not capture most of the possible determining factors, it is comparable to most previous studies.

When tested separately (see Models 1 and 2), BSIX and SPEC were significant at $p < 0.05$ (One-Tailed). As hypothesised, both variables were adversely related to the dependent variable. In other word, it is evidenced that the Big Six and auditor industry specialists take less time to audit public listed clients. The results also support the contention that Big Six and specialist auditor provide high quality audit.

The results for SPEC, however, were not consistent when tested using 20 percent cut-off point (see Model 3). The specialist variable was not significant. Meanwhile, Model 4 and 5 reported that BSIX variable was consistently significant at $p < 0.055$. However, the industry specialist variable (SPEC), both of 15 percent and 29 percent cut-off points, was found not significant (albeit in the expected direction) in determining the time taken to complete the audit assignment.

Looking at other independent variables, the results were generally consistent with the theory, with three variables (DIRSH, ROE and CHANGE) were significant at $p < 0.05$. In fact, two of the variables (DIRSH and ROE) were found significant at $p < 0.01$. The variable CHANGE was significant at $p < 0.05$. It is interesting to note that there is no change of signs of direction as well as large change of the coefficients for these variables across all the models tested. The results showed that higher directors' shareholding and new auditor will increase the time taken to audit the companies while higher corporate profitability is associated with less audit lag.

Note that, the overall correlations among the explanatory variables were relatively low, except for the correlation between LASSET and LSUBS. Only four correlations were higher than 0.30. The correlation between SPEC and BSIX is 0.31, while the correlation between LASSET and LSUBS, INVREC and ROE are 0.64, -0.32 and 0.32 respectively. Although, the correlation between LASSET and LSUBS was exceptionally high, [27] suggests that multicollinearity may be a problem when the correlation exceeded 0.90. Meanwhile, the VIF were found to be below two (2), which confirm that the multicollinearity is not a problem in the regression analysis. To further examine the effect of multicollinearity on the regression analysis, we ran additional test by first dropping LASSET and then LSUBS in all models that were tested. The results indicate that there are no significant changes in the signs, size and significant levels of the regression coefficients. The diagnostic analysis also showed that heteroscedasticity is not presence based on the method of [28]. As well, the regression specification error test [29] indicated no specification problem.

Table 3 Multivariate Test Using Audit Fee as a Measure of Auditor Specialist (n=388)

VARIABLES	MODEL 1 Big Six	MODEL 2 Specialist	MODEL 3 Specialist	MODEL 4 Big Six/Specialist	MODEL 5 Big Six/Specialist
		(audit fee 15%)	(audit fee 20%)	(audit fee 15%)	(audit fee 20%)
BSIX	-.0372207	-	-	-.0317898	-.0354396
	(-2.111) #	-	-	(-1.744)#	(-1.983)#
SPECF	-	-.0299445	-.0220251	-.021667	-.0146288
	-	(-1.663) #	(-0.950)	(-1.166)	(-0.625)
DIRSH	.0610018	.0646762	.0660059	.0603385	.0607811
	(2.857) *	(3.042) *	(3.101)*	(2.827)*	(2.844)*
LASSET	-.0270316	-.0245292	-.0293727	-.0224126	-.0255901
	(-1.424)	(-1.265)	(-1.537)	(-1.157)	(-1.338)
LSUBS	.0281546	.0298308	.0321643	.0270722	.0283688
	(1.406)	(1.489)	(1.605)	(1.351)	(1.415)
INVREC	-.0265158	-.02918	-.0261463	-.0298699	-.0277923
	(-0.690)	(-0.756)	(-0.676)	(-0.775)	(-0.722)
LEV	.0198156	.0080261	.0252584	.0033464	.0149605
	(0.270)	(0.107)	(0.341)	(0.045)	(0.202)
ROE	-.0729878	-.0767935	-.0749309	-.0744815	-.072934
	(-3.426) *	(-3.597) *	(-3.504)*	(-3.491)*	(-3.420)*
BUSY	-.02172	-.0231271	-.0215003	-.0239341	-.0228501
	(-1.353)	(-1.428)	(-1.326)	(-1.481)	(-1.413)
COPINION	-.026126	-.0341117	-.038179	-.0266088	-.0284815
	(-0.475)	(-0.620)	(-0.691)	(-0.484)	(-0.516)
CHANGE	.0641126	.0606014	.0617923	.0624724	.0635321
	(1.869) #	(1.762) #	(1.793)#	(1.821)#	(1.850)#
CONSTANT	2.191807	2.157871	2.172647	2.173595	2.185848
	(23.169) *	(22.555) *	(22.800)*	(22.680)*	(22.971)*
F-Statistics	4.90*	4.42*	4.50*	4.58*	4.48*
Adj-R2	0.0915	0.0813	0.0829	0.0923	0.0900
N	388	388	388	388	388

* significant at the 0.01 level (one-tailed)

significant at the 0.05 level (one-tailed)

5.4 Further Analysis

To provide more insight, we also performed OLS regressions based on the alternative measurements of brand name auditors (BSIX) and auditor industry specialist (SPECF). The BSIX was defined as the international Big Six auditors *excluding* their respective local affiliates. The specialist auditors were identified based on the number of clients audited. Firstly, the specialist auditors were identified when they audited more than 15 percent of the clients in particular industries. Secondly, the specialists were determined when the auditors audited more than 20 percent of audit clients.

Based on the results (not presented here), BSIX was still found to be significant (at five percent significant level) when defined without the affiliates. However, auditor industry specialist was found not to be significantly related to reporting lag (albeit in the expected direction). The results were identical when both audit quality variables (i.e. BSIX and SPECF) were tested together. The Big Six variable was significant at $p < 0.05$ and was on the hypothesized direction. The F-Statistics of all models are found to be significant at $p < 0.01$ and Adjusted R-Squared are mainly the same (between 8.1% and 9%) with those on Table 3.

6. Summary And Conclusion

The primary objective if this paper is to investigate the association between auditor type and the timeliness of financial reporting in Malaysia. In particular, this study investigates the effects of auditor industry specialisation and brand name auditor on financial reporting lag. The results confirm our contention that audit quality improves financial reporting timeliness. The results show that the Big Six variable to be consistently significant in all tests. In other words, quality differentiated auditors (i.e. the Big Six audit firms) take shorter time to complete their audit engagements. However, the results of the auditor industry specialist are not robust. Further studies are needed to examine this dimension of audit quality.

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