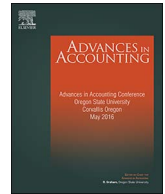




Contents lists available at ScienceDirect

Advances in Accounting

journal homepage: www.elsevier.com/locate/adiac

Auditor-client geographic proximity and audit report timeliness

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ARTICLE INFO

Keywords:

Auditor-client geographic proximity

Audit report timeliness

Non-accelerated filers

ABSTRACT

While investors and regulators value the timely release of audited financial information, recent changes in the regulatory environment have increased the difficulty of providing timely audited financial information. In this paper we examine the association between auditor-client geographic proximity and external audit report delay, since identifying the factors that influence audit delay remains an important issue. We find strong evidence that audit reports are more timely for geographically proximate auditors and clients. Further, we show that the improvement in audit report timeliness is more pronounced for non-accelerated filers relative to accelerated filers. These results are robust to controls for potential self-selection bias.

1. Introduction

Information timeliness is an important quality in assessing the usefulness of audited financial reports and has been a longstanding concern of regulators, shareholders, analysts, managers, and auditors. The extant research documents a heightened market reaction to timely audited financial reports (Chambers & Penman, 1984), and penalties for firms with late audited financial reports (e.g. Alford, Jones, & Zmijewski, 1994; Bartov & Konchitchki, 2017; Griffin, 2003). Regulators' concerns that investors have access to timely financial reports are reflected in initiatives such as the institution of EDGAR, the acceleration of 10-K/10-Q filing deadlines for larger companies, and the adoption of XBRL. Since the timeliness of audited financial statements is a function of the timeliness of the audit report, improvements in audit report timeliness could have a significant impact on the timeliness of audited financial reports. However, recent changes in the regulatory and corporate reporting environment have increased the difficulty of providing timely audited financial reports (Bronson, Hogan, Johnson, & Ramesh, 2011; Krishnan & Yang, 2009), therefore increasing the salience of research identifying the factors that affect audit report timeliness.

In this study we investigate the association between auditor-client geographic proximity and audit delay, defined as the number of calendar days from fiscal year-end to the audit report date (Ashton, Willingham, & Elliott, 1987; Bronson et al., 2011; Krishnan & Yang, 2009; Whitworth & Lambert, 2014).¹ Our focus on audit report timeliness is further motivated by evidence from the extant research that

longer audit reporting delays are associated with lower financial reporting quality (Blankley, Hurtt, & MacGregor, 2014; Kinney Jr & McDaniel, 1993).

Local auditors presumably have an information advantage which reduces information asymmetry between the local auditor and the client, because local auditors can acquire client-specific knowledge more easily relative to non-local auditors (Choi, Kim, Qiu, & Zang, 2012; Jensen, Kim, & Yi, 2015). Further, local auditors are able to interact more frequently with the client and obtain client-specific news from local media, which increases their ability to effectively monitor the client (Agarwal & Hauswald, 2010; Choi et al., 2012; Kang & Kim, 2008; Petersen & Rajan, 2002). The relative convenience of accessing clients' information, as well as a greater awareness of the economic and regulatory environment in the region and its impact on the client, should increase the efficiency of the local audit, thus reducing audit delays.

Conversely, auditor-client geographic proximity may not improve audit efficiency given the availability of technology, the use of standardized audit programs, and the common practice of knowledge sharing within audit firms. Further, while local auditors improve their clients' earnings quality, it is unclear whether this would extend to audit report timeliness since the extant research suggests a tradeoff between timeliness and reporting quality. For example, Bryant-Kutcher, Peng, and Weber (2013) and Doyle and Magilke (2013) find that the acceleration of filing deadlines by the SEC is associated with a decline in the reporting quality, whereas Krishnan and Yang (2009) find a decrease in reporting timeliness following the implementation of

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E-mail addresses: bdong@usf.edu (B. Dong), dmrobinson@usf.edu (D. Robinson), Emily.xu@unh.edu (L.E. Xu).¹ In this study we use the terms auditor-client geographic proximity, auditor locality, local and non-local auditors, interchangeably. In addition, we use audit report lag and audit delay interchangeably. The audit report is deemed less timely if the audit delay or audit report lag is longer.

regulatory changes which improve the reporting quality. Therefore, whether auditor-client geographic proximity improves audit report timeliness is an empirical issue.

To investigate whether auditor-client geographic proximity is associated with more timely audit reports, we utilize a two-step instrumental variable approach (hereafter, IV) to address potential self-selection bias, since the choice of a local auditor is likely non-random (Wooldridge, 2002). Using a large sample of audit report dates, we find strong evidence that audit delays are shorter for clients of local auditors relative to clients of non-local auditors. These results hold after controlling for other auditor characteristics such as auditor (office) size and influential clients, as well as factors identified in the prior research as significant in explaining audit report delays, suggesting that auditor locality is capturing an aspect of auditor characteristics not measured by these variables.

Bronson et al. (2011) document an increase in audit delays during the period when the SEC defined different types of filers based on their size. Therefore, we examine whether the local auditor advantage documented, thus far, is related to whether the client is a large accelerated, accelerated or non-accelerated filer. Regardless of the clients' filing status, we find that firms using local auditors have more timely audit reports relative to firms using non-local auditors. Further, we find that the improvement in audit report timeliness is more pronounced for non-accelerated filers which are more resource-constrained (Boland, Bronson, & Hogan, 2015; Krishnan & Yu, 2012) suggesting that these firms benefit most from using a local auditor. As additional analyses, we extend the timeliness analysis to the timeliness of the 10-K filing and find that clients with local auditors file annual reports earlier than those with non-local auditors. Collectively, these results suggest that local auditors improve the information timeliness of their clients.

Our paper makes several contributions to the existing literature. First, to our knowledge, this is the first study to investigate the implication of auditor-client geographic proximity on audit report timeliness. While Choi et al. (2012) and Jensen et al. (2015) document higher earnings quality from using local auditors, we show that the audit reports from local auditors are more timely.

Second, our study contributes to the ongoing discussion on the effect of SEC's decision to accelerate the deadlines of periodic filings (Boland et al., 2015; Krishnan & Yang, 2009; Krishnan & Yu, 2012). Our findings suggest that amid the timing pressure, the use of local auditors can improve audit report timeliness, with the extent of the improvement being most significant for non-accelerated filers.

The remainder of the paper is organized as follows. The next section develops our research hypotheses. Section 3 outlines our research design and sample selection procedures. Section 4 discusses our empirical findings, Section 5 provides additional analyses, and Section 6 presents our research conclusions.

2. Background and hypothesis development

2.1. Auditor-client geographic proximity and audit report timeliness

Prior literature provides evidence that market participants value timely financial reports. Therefore, to the extent that the audit process hinders the timeliness of audited financial reports, companies may experience adverse consequences such as higher information asymmetry and thus negative market reaction (Alford et al., 1994; Bartov & Konchitchki, 2017; Chambers & Penman, 1984; Griffin, 2003). Additionally, increasing the speed of financial information dissemination to investors was an important reason for the SEC to institute EDGAR, accelerate filing deadlines, and adopt XBRL. For example, the SEC states the most important benefit of the acceleration of filing deadlines is to “accelerate the delivery of information to investors and the capital markets, enabling them to make more informed investment and valuation decisions more quickly” (SEC, 2002). Consequently, audit report timeliness continues to be of importance to various stakeholders, particularly given the adverse effect of the various regulatory changes in the post-SOX period (Ettredge, Li, & Sun, 2006; Lambert, Jones, Brazel, & Showalter,

2017).

Further, the extant research provides evidence that audit report delays are associated with lower financial reporting quality. For example, Kinney Jr and McDaniel (1993) find that longer audit delays are positively associated with corrections of previously reported interim earnings, and that the length of the delay increases with the size of the earnings overstatement. Similarly, Blankley et al. (2014) find evidence that firms with future restatements are more likely to have abnormally longer audit report lags relative to non-restating firms. Both studies suggest that delayed audit reports are likely to be due to ambiguous reporting issues and related disputes between auditors and clients. To the extent that a given mechanism can facilitate the quick resolution of such disputes, it would reduce audit delays and perhaps improve financial reporting quality.

In this paper, we investigate whether auditor-client geographic proximity is associated with audit report delay. Given the availability of technology, the use of standardized audit programs, and the common practice of knowledge sharing within audit firms, geographic proximity to clients may not create any special advantages. However, recent studies document that local auditors improve the quality of clients' financial reports relative to non-local auditors, likely due to the information advantage possessed by local auditors (Choi et al., 2012; Jensen et al., 2015; Lopez and Rich, 2017). Local auditors have better information about clients' businesses, incentives, and risks, and are able to conduct fieldwork more conveniently. Further, local auditors are more aware of the economic and regulatory environment in the region and the impact of such an environment on the clients (Choi et al., 2012). This information advantage would suggest more efficient planning and execution of the audit, i.e. greater audit efficiency.² The efficiency gains to the audit from auditor-client proximity are likely to increase audit report timeliness. Thus, our first hypothesis is stated below in an alternative form:

H1: Clients audited by local auditors file audit reports earlier than clients audited by non-local auditors.

2.2. Legislative changes

Following section 409 of SOX (2002), the SEC accelerated filing deadlines, so that “accelerated filers” (hereafter, *AF*) with fiscal years ending on or after December 15, 2003, are required to file annual reports within 75 days after the end of the period.³ “Large accelerated filers” (hereafter, *LargeAF*) (accelerated filers with a public float of \$700 million or more) with fiscal years ending on or after December 15, 2006, face a 60-day annual report-filing deadline. “Non-accelerated filers” (hereafter, *NonAF*) (filers with a public float of less than \$75 million) continue to file annual reports within 90 days after the end of the fiscal period.

The reductions in filing deadlines are intended to provide investors with more timely access to relevant information. However, simultaneous changes in regulatory requirements (such as the SOX section 404 requirements and (PCAOB standards, 2004a, 2004b, 2007) result in significant additional tasks imposed on managers and auditors, thus making it more difficult to comply with the accelerated filing deadlines (Krishnan & Yang, 2009). Given the varying pressure associated with filing, we posit that the impact of the local auditor on improving audit report timeliness should differ among the three groups of filers. While *NonAFs* face less time pressure in completing their filings, recent studies

² This general notion of geographic proximity providing information advantage is well documented in the literature (for example, see Malloy, 2005; Baik, Kang, & Kim, 2010; Bodnaruk, 2009; Kedia & Rajgopal, 2011; DeFond, Francis, & Hu, 2011).

³ A company is an “accelerated filer” if (1) it has aggregate market value of voting and nonvoting common equity held by non-affiliates (“public float”) of \$75 million or more as of the last business day of the issuer's most recently completed second fiscal quarter; (2) it has been subject to the reporting requirements of the Securities Exchange Act of 1934 for at least 12 calendar months; (3) it has previously filed at least one Form 10-K; and (4) it is not eligible to use Forms 10-KSB and 10-QSB for small businesses (SEC, 2005).

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