Factors Associated with Audit Reports in Saudi Arabia

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Abstract

Considering audit reports as the results of any audit task and their importance in communicating an auditor?s opinion about the credibility of financial statements, this study aims to investigate the effect of firm-related factors and auditor-related factors on the kinds of audit reports in Saudi Arabia, which is considered one of the biggest markets in the MENA region. Data for 153 listed companies are employed in the analysis, collected as at the end of 2013. A multiple regression model is developed taking audit reports as the dependent variable. The results indicate that the auditor?s size, firm size, and leverage significantly affect audit reports, with large auditors tending to issue modified audit reports more than smaller auditors, and small companies and leveraged companies being more likely to receive modified audit reports. Neither profitability nor the age of the company (as a listed company) affects audit reports. These results are consisted with the literature and the nature of the Saudi stock market formally established in 2003.

Index terms— audit report, auditor size, modified reports, saudi, listed companies.

1 Introduction

s the result of any auditing process, the audit report provides valuable information for all those interested in the financial statements through the content message about the fairness of the representation included in the financial statements, providing a tool to increase the credibility of the financial statement (Maggina & Tsaklanganos, 2011). Habib (2013) argues that the audit report is a significant communication tool that auditors employ to inform users of the report about an auditor's work, suggesting that an audit report can considered a multi-functioning communication tool that reports the financial statement and the quality of the audit function at the same time. The value of the information content of audit reports can be noted when considering the kinds of audit reports that are listed in the International Auditing Standards (IAS), influencing auditors to express their opinions based on specific forms: unqualified opinions, explanatory language, qualified opinions, adverse opinions, and disclaimer of opinion.

Audit reports affect the decisions of the users of financial statements through providing relevant information on whether the financial statements have been prepared in accordance with the adopted accounting standards or not (Zureigat, 2010). In Saudi The Big Four audit firms (Ernst & Young, Deloitte, PwC, and KPMG) hold around 80% of the market share in Saudi Arabia due to the high level of trust in their audits and the argument that they provide high quality audits. However, in 2014, there was an accounting scandal in Saudi Arabia following the announcement that one of the largest Saudi telecommunications companies audited by one of the Big Four audit firms had disclosed inflated profits. This scandal was revealed by the internal auditor and led to a huge market reaction that resulted in a drop in the share price of the company of 35% over a couple of days. This incident damaged investor trust in the audit profession and made the quality of the Big Four auditors questionable, especially as internal information was disclosed by the media concerning the involvement of both the management and the auditor in the issue. This led to new questions being asked about factors that affect auditors' reports in Saudi Arabia.

Tina and Nikola (2012) assert that audit reports and related factors have become topics of particular interest since the start of the global financial crisis due to thee mp has is on management attitudes toward audit reports and financial statements. This study aims to explore factors that may affect audit reports in one of the largest emerging economies in the MENA region, namely Saudi Arabia, based on significant signals about the quality of audits and the motivations for providing specific kinds of audit reports. The research takes 2013 as the year of the study as this was the year in which the events resulting in the scandal that affected trust in the auditing profession occurred. Firm-related factors and auditor-related factors are investigated as having the potential to affect the auditors' judgments and opinions (Habib, 2013;Maggina & Tsaklanganos, 2011;Martens et al., 2008;Masyitoh et al., 2010). This work contributes to the auditing literature as one of leading studies on this topic in Saudi Arabia for the time at which there were signals of an accounting and auditing scandal. Also, it provides valuable information for regulators, Arabia, two kinds of accounting and auditing standards are adopted: the International Financial Reporting Standards (IFRS) and International Auditing Standards (IAS), which are applied in the financial sector (banks and insurance companies), and the Saudi Accounting Standards and Saudi Auditing Standards, adopted by other companies. This leads to a "noisy" environment in the accounting and auditing profession.

investors, policy makers, and all financial stakeholders concerning the determinants of audit reports in Saudi Arabia. The reminder of this paper is organized in four sections: a literature review and hypothesis development, data and methodology, analysis and results, and the conclusion.

2 II.

3 Literature Review

The International Standards of Auditing (ISA) clarify how audit reports should communicate the auditor's work to the users of financial statements by providing a broad explanation of each kind of audit report and the reasons for auditors to issue a specific kind of report. ISA 700 describes the sequence for an unqualified audit report, starting with an introductory paragraph that determines both the auditor's and management's responsibilities, followed by the scope, setting out the nature of the audit procedures and how the auditors performed their work, and finally closing with a paragraph that provides the auditor's opinion and conclusion concerning the financial statement. Other ISAs set out the modifications that auditors should make to audit reports to communicate other issues regarding the financial statement. This detailed structure for the audit report informs the users of financial statements that an unqualified audit report communicates no additional information other than the creditability of the financial statement, whereas a modified audit report (an audit report that is not unqualified) sends direct signals to users of the financial statement concerning additional information, meaning that modified audit reports are taken as signaling bad news for all investors (Zureigat, 2010).

In their paper, Geiger and Rama (2006) contend that audit reports provide valuable information about the future of the financial situation for audited companies, although this information is subject to reporting quality. In measuring the accuracy of audit reports and the extent to which they send accurate signals concerning the future, they found that the Big Four audit firms provide better quality reports than on-Big Four audit firms, as the former have the lowest rate of inaccurate audit reports. This would seem to indicate that audit reports do not provide an accurate reading all the time due to the nature of the auditing process, which is based on sampling. This issue has led to greater concern on the part of auditors regarding their modified opinions and the risks associated with their audits, especially when considering the cost of modified audit reports. Chen et al. (2001) argue that companies receiving modified audit reports will be criticized by investors and regulators, and consequently face greater political and economic costs. Carey et al. (2008) assert that modified audit reports are costly both for the auditors is suing such reports as they could be replaced by another auditor having given modified opinions, and for the audited companies that receive a modified audit report due to the external influence of the negative information contained in the report. This complex environment presents huge challenges for both the audited companies and the auditors providing modified audit reports. Modified audit reports tend to be the final solution, issued after auditors have had discussions with their clients about the modifications that should be implemented in financial statements, resulting in a decrease in the number of modified audit reports. Chen et al. (2001), using data from 1995 to 1997, reported that only 10% of Chinese companies received modified reports.

Previous studies have investigated audit reports, their implications, and factors associated with those reports. A leading study conducted by Firth (1978) concluded that audit reports contain valuable information that affects investors' decisions, and many researchers have since corroborated this (Chen et al., 2000;Fields &Wilkins, 1991;Keller & Davidson, 1983; **??**artinez et al., 2004;O'Reilly, 2009). Such studies have provided the motivation to investigate the factors and circumstances that are associated with different audit reports. **??**opuch et al.'s (1987) study was one of the first papers in this area to investigate how financial and market variables could affect auditors' decisions to issue qualified audit reports. They present a model to determine the variables that have the power to predict auditors 'modifications to opinions. The results show that current year loss, industry return, and changes in leverage (the ratio of total liabilities to total assets) are the most powerful variables in predicting auditor's qualifications. Keasey et al. (1988) studied 540 financial reports for small firms in the U.K. using 20 financial and non-financial variables to explain auditors' qualifications. They found that audit qualifications in small companies are more likely to take place when companies are audited by one of the Big Four audit firms, have received an auditor's qualification in the previous year, and have large audit lags. Koh and Killough (1990) followed the same approach to assess the effect of financial ratios on predicting going concern audit opinions. Their results indicate that financial ratios can predict more than 80% of auditors' going concern reports, which provides strong evidence concerning the message contained in going concern audit reports and the effectiveness of auditing.

Laitinen and Laitinen (1998) aimed to identify the reasons for auditors' qualifications in Finland by developing a model using financial statement information. The results indicate that audit report qualifications are associated with low profitability and low growth. Also, a qualified audit report is negatively associated with the share of equity in the balance sheet and the number of employees.

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Volume XIV Issue V Version I Year ( ) D management; they found that companies with more years listed on the stock exchange and highly leveraged companies are more likely to receive qualified audit reports, whereas large size companies are less likely to receive such reports. Spa this (2003) investigated if financial and non-financial information can be used to distinguish between the auditor's choice of qualified and unqualified audit reports in Greece. The results revealed that an auditor's qualifications are associated with financial information such as distress and non-financial information such as firm litigation. Ireland (2003) investigated variables that determine audit report qualifications (going concern and non-going concern qualifications) in the U.K., finding that large companies, companies that are highly geared, and companies that have received audit qualifications previously are more likely to receive qualified audit reports.

Caraman is and Spa this (2006) aimed to test whether financial and non-financial information variables can be used to predict qualified and unqualified audit reports in the Athens stock market; they also used audit firm-related variables in their tests to investigate their association with qualified audit reports. The results revealed that neither audit fees nor auditor size (Big Four and non-Big Four auditors) affect audit reports, whereas financial variables such as operating margin to total assets and current ratio are significantly associated with auditors' qualifications. Masyitoh et al. (2010) explored factors that enhance the issuance of going concern audit reports in Indonesia. Their results reveal that audit committee, profitability, cash flow, and liquidity do not significantly affect the issuance of audit reports, but that there is a significant effect from auditor size and solvability. In a recent study, Habib (2013) provided an analysis of auditor-related factors and firm-specific factors that affect an auditor's decision to issue a modified audit report. The results indicate that audit firm size and audit report lag are positively associated with the issuance of modified audit reports, where as audit fees are negatively associated. Also, he found that company size and profitability yare negatively associated with modified audit reports, and at the same time leverage and company losses are positively associated with these reports.

The previous literature clearly indicates the importance of both auditor-related factors and company-specific characteristics in an auditor's decision to issue a modified audit report, and there is evidence for both developed countries and emerging markets. This study aims to investigate factors that affect audit reports in Saudi Arabia as an emerging and growing market that needs such studies to clarify the nature of auditing in greater depth, especially bearing in mind that there is no prior research in this area in Saudi Arabia. Based on this discussion, the first hypothesis of this study is: H1: Auditor-related factors and firm-specific factors affect audit reports in Saudi Arabia.

5 Auditor-related factors

Auditor-related factors can be considered a proxy for audit quality, especially when considering audit firm size, e.g., Big Four or non-Big Four. In her leading research, DeAngleo (1981) linked audit firm size to performance, finding that large firms follow more restrictive rules and procedures in per forming the audit process, which leads to higher quality audits. Many researchers have followed this line of argument and provided evidence for the auditor's size as a proxy for audit quality (Francis & Yu, 2009;Krishnan, 2003;Zureigat, 2011). Also, the literature provides insights in to the effect of auditor's size on audit reporting (Caraman is & Spathis, 2006; Habib, 2013; Keasey et al., 1988;Masyitoh et al., 2010). This study considers only auditor size as an auditor-related factor as no information is available on audit fees or auditors' specialization in Saudi Arabia. The second hypothesis thus aims to investigate the effect of Saudi auditors' size on audit reports: H2: Auditors' size significantly affects audit reports in Saudi Arabia.

6 Firm-specific factors

Firm-specific factors have been researched widely in developed economies to assess whether or not financial and non-financial variables affect audit reports; however, these factors have not been investigated at the same level in emerging markets (Chen et al., 2001;Habib, 2013). Firm-specific factors are important in this area due to their importance to auditors, who assess their clients' risks through any auditing process. Gissel et al. (2010) argues that if companies that receive modified audit reports show similar characteristics, identifying these would be very helpful for auditors and stakeholders in forecasting. Firm size is one of the most important factors that have been investigated in the literature, based on the argument that large firms are less likely to receive modified audit reports (Chen et al., 2001;Habib, 2013;Ireland, 2003). Hence, the third hypothesis in this study investigates firm size and its effect on audit reports: H3: Firm size significantly affects audit reports in Saudi Arabia.

In the same vein, company age is related to company size, especially when considering the length of time a specific company has been listed on the stock market. Both ??opuch (1984) and Habib (2013) show that the length of time a company has been listed is negatively related to modified audit reports, so the fourth hypothesis in the study is as follows: H4: The length of time for which audited firms have been listed significantly affects audit reports in Saudi Arabia.

were affected by different variables related to earnings Other firm-specific factors related to financial variables have also been investigated due to their impact on a firm's risk. Researchers have shown that a company's profit ability negatively affects modified audit reports (Habib, 2013;Laitinen & Laitinen, 1998;Masyitoh et al., 2010). Thus, the fifth hypothesis is: H5: Profitability significantly affects audit reports in Saudi Arabia.

Leverage is also a factor that appears to affect audit reports due to its important role in assessing a firm's risk, which affects auditors' judgments regarding financial statements. Research has indicated that leverage is positively associated with modified audit reports (Chen et al., 2001;Dopuch et al., 1987;Habib, 2013). In this study, the sixth hypothesis is: H6: Leverage significantly affects audit reports in Saudi Arabia.

7 III.

8 Data And Methodology

In Saudi Arabia, all listed firms are to disclose their information through the Saudi Stock Exchange (TADAWUL), which publishes all the financial reports and financial statements for listed companies. For this study, all financial reports for Saudi listed companies that disclosed financial statements as at the end of 2013 were analyzed based on information submitted to TADAWUL. Data were collected for 168 listed firms in total. Of these, 15 companies had incomplete information and were therefore excluded from the analysis, resulting in a final sample of 153 companies.

A regression model was developed to investigate the relation between audit reports and other variables and determine the effect of those independent variables on auditors' reports as follows:???? = ?? + ???????? + ???????????? + ???????? + ?????? + ??????

where: AR de notes audit reports, which were classified based on ISA into five categories: unqualified audit report (1), explanatory note (2), qualified report (3), adverse report (4), and disclaimer of opinion (5).

AS represents auditor size, classified as Big Four (taking the value 1) or non-Big Four (taking the value 0).

L n FS is firm size, measured using the natural logarithm of total assets as an index for firm size.

TL is time l is ted, indicating the number of years each company has been listed on the Saudi Stock Exchange. P represents profitability, measured using net profit after tax.

L denotes leverage, measured by dividing total liabilities by total assets.

9 IV.

10 Analysis and Results

Here the results are presented for 153 Saudi listed companies which had complied with all disclosure requirements and submitted full financial information in their financial reports to the Saudi stock market (TADAWUL) as at the end of 2013. Table 1 shows that more than 80% of these companies received unqualified audit reports, whereas less than 20% received modified audit reports. Of these, 13.7% of the listed companies received unqualified reports with explanatory notes, 3.3% received qualified audit reports, and 2.6% received a disclaimer of opinion, and none received an adverse opinion.

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Volume XIV Issue V Version I Year ( ) D Saudi Arabia, auditing 78.4% of the Saudi listed companies. This suggests that Saudi companies are willing to hire large international audit firms rather than local or smaller audit firms, which could be an indicator that they perceive audits by large firms as being of higher quality.

The numbers of years for which the 153 firms in the sample have been listed on the Saudi stock exchange are shown as frequencies in Table 2.As can be seen, most Saudi listed companies have been listed and trading in TADAWUL for less than 10 years. Only 6% of Saudi listed companies have more than 30 years of experience as listed companies. These results indicate that Saudi listed companies are not yet mature and the Saudi stock market is still considered an emerging market, especially considering that in 1975 there were only 14 public companies in Saudi Arabia, the Saudi market remained informal until the early 1980s, and the Saudi stock market was only formally established and named TADAWUL under capital market authority in 2003 (TADAWUL, 2014). Source: Own elaboration based on data from TADAWUL Table 3 presents the Pearson's correlation statistics showing the relationship between the audit reports and the study variables. The results show that audit reports are significantly correlated with firm size, profit, and leverage, but they are not correlated to auditor size or years listed on the stock exchange. The negative relation between audit reports and both firm size and profit indicates that unqualified audit reports are more likely to be issued for those companies that are larger and have higher profits, while the positive correlation between audit reports and leverage indicates that highly leveraged companies are more likely to receive modified (not unqualified) audit reports. The model summary statistics are presented in Table 4, which shows anR2 value of17.6% and adjusted R2of14.7%.Thus, the independent variables explain around 15% of the changes in the dependent variable (audit reports). The regression results show significant relations between audit reports as the dependent variable and auditor size, firm size and leverage as independent variables. There is a significant negative effect for auditor size (T=-1.983, p=0.05), indicating that Big Four auditors tend to be more flexible in issuing modified audit reports than non-Big Four auditors. This result provides support for H2, namely that auditor size significantly affects audit reports in Saudi Arabia. This result is in line with previous literature (Habib, 2013;Keasey et al., 1988;Masyitoh et al., 2010). A significant negative relation is also found for firm size (T=-2.769, p=0.01), which supports H3 and indicates that auditors in the Saudi context tend to issue modified audit reports for small companies rather than large companies. This result is consistent with the findings of Chen et al. (2001), Ireland (2003), and Habib (2013).

H4 and H5 concerned the effect of years as a listed company and profit on audit reports. The results of the regression model show that neither of these firmrelated factors affects auditors' reports in the Saudi context (time listed, T=-0.883, ns; profit, T=-0.654, ns). Thus, H4 and H5 are not supported. The result for the years a company has been listed can be explained by the fact that the Saudi stock market is an emerging market that was regulated only 11 years ago (in 2003), and also that most of the companies have been listed for less than 10 years (Table 2). They oung age of the Saudi stock market could be the reason why this study has not capture dan effect of time as a listed company. Furthermore, the result for the relation of profit and audit reports is not entirely surprising as prior studies have found the same result (Masyitoh et al., 2010), and this could also be explained by the fact that most Saudi listed companies are audited by Big Four audit firms, which tend not to be driven by firm-related factors.

For H6 on the other hand, concerning the effect of leverage on audit reports, there is support. The results of the multiple regression analysis show that leverage significantly affects the audit reports (T=4.148, p=0.01). This result indicates that companies with high leverage are more likely to receive modified audit reports than those with less leverage, and is in line with prior literature that has provided evidence of auditors' concerns regarding firm risk that can be measured by leverage **??**Chen et Audit reports are considered the final product of any auditing task in which auditors express the results of their work on financial statements to enhance the credibility of financial reports. Auditors are required to form their reports in line with the auditing standards adopted. These reports are important for auditors as their final product, for the companies audited as the reports can be used as an indicator of their integrity, and for the users of financial statement who rely on there ports to identify the level of credibility of the financial statements. In Saudi Arabia, audit reports are classified into five categories. Previous research has argued that audit reports are a function of many firm-related factors or auditor-related factors (Habib, 2013), which provides an incentive to investigate such arguments. The Saudi market is considered one of the largest in the MENA region, and is regulated by two systems: international accounting and auditing standards in the case of financial companies, and national accounting and auditing standards in the case of other companies. This has led to criticism of auditing practice in Saudi Arabia, especially since the recent scandal in 2014 regarding the fraudulent financial statement of one of the largest telecommunications companies, which received an unqualified audit report issued by one of the Big Four auditors.

This study has investigated whether firm-related factors and auditor-related factors affect auditor reports in the Saudi context. A regression model has been developed to explore whether auditor size, firm size, years as a listed company (time listed), profitability, and leverage affect the audit reports. Data were collected as at the end of 2013 for 153 Saudi listed companies. The results of the multiple regression show that auditor size, firm size, and leverage significantly affect audit reports: large auditors (Big Four) tend to issue modified audit reports to a greater extent than smaller auditors (non-Big Four); small companies are more likely to receive modified audit reports; highly leveraged companies are more likely to receive modified audit reports than those with lower leverage. However, the results show that neither time listed nor profitability affect audit reports in the Saudi context. These results are of considerable importance for the users of financial statements, auditors, and regulators, as they provide an insight in to the factors that are associated with audit reports. Future research can focus on other factors, taking long time series into account, with segregation between companies that comply with national and international accounting standards. [1] [2] [3]

Figure 1:

1

Audit Report	Frequency	Percent	Cumulative Percent
Unqualified	123	80.4	80.4
Explanatory note	21	13.7	94.1
Qualified	5	3.3	97.4
Disclaimer	4	2.6	100
Total	153	100	
Audit Firm Size	Frequency	Percent	Cumulative Percent
Non-Big Four	33	21.6	21.6
Big Four	120	78.4	100
Total	153	100	

[Note: Source: Own elaboration based on data from TADAWULThe table also shows the descriptive]

Figure 2: Table 1 :

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2013)

Figure 3: Table 2 :

3

		Audit Report	Auditor Size	Ln Firm Size	Time Listed	Profit	Leverage
Audit Report	Pearson Correlation	1	-0.08	-0.227***	-0.046	-0.204**	0.257***
Auditor Size	Pearson Correlation	-0.08	1	0.149*	-0.158*	-0.001	0.261***
Ln Firm Size	Pearson Correlation	-0.227***	0.149*	1	0.003	0.350***	0.135*
Time Listed	Pearson Correlation	-0.046	-0.158*	0.003	1	0.045	-0.007
Profit	Pearson Correlation	-0.204**	-0.001	0.350***	0.045	1	-0.187**
Leverage	Pearson Correlation	0.257***	0.261***	0.135*	-0.007	-0.187**	1

Note: ***, ** and * indicate significance at the 1%, 5% and 10% levels, respectively

Figure 4: Table 3 :

4

that auditor-related factors and firm-specific factors do indeed affect audit reports in Saudi Arabia.
also presents ANOVA statistics
that clearly show the relevance of the model (F=6.078, p=0.01). This result provides support for H1, indicating

Figure 5: Table 4

5

	Beta	T	Sig.	VIF
(Constant)		6.211***	0.000	
Auditor Size	-0.161	-1.983**	0.049	1.142
Ln Firm Size	-0.233	-2.769***	0.006	1.216
Time Listed	-0.068	-0.883	0.379	1.029
Profit	-0.055	-0.654	0.514	1.222
Leverage	0.343	4.148***	0.000	1.179

Note: ***, ** and * indicate significance at the 1%, 5% and 10% levels, respectively

Figure 6: Table 5 :

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al., 2001; Dopuch et al., 1987; Habib,
2013).
V. Conclusion

[Note: D]

Figure 7: Table 4 :

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