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Business Strategy and Audit Efforts - Focusing on Audit Report Lags: An Empirical Study in Korea

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Abstract

This study examines the association between a firm's business strategy and audit report lags. This study employs 5,072 firm-year observations from 2015 to 2019. Our sample comprises all of the firms listed on the Korea Composite Stock Price Index (KOSPI) market and Korea Securities Dealers Automated Quotation (KOSDAQ). We perform OLS regression analysis to test our hypothesis. The OLS regression analysis was conducted through the SAS and STATA programs. We find that business strategy is positively associated with audit report lags. Especially, we find that defender firms are negatively associated with audit report lags. The findings of this study suggest that prospector-like firms would increase their performance uncertainty as well as audit risk. Therefore, prospector-like firms interfere with the efficient audit procedures of auditors. On the other hand, our findings indicate that defender-like firms would decrease their performance uncertainty as well as an audit risk because they focus on simple product lines and cost-efficiency. For this reason, auditors will be able to carry out the audit procedures much more easily. Our results present that a prospector-like business strategy degrades audit effectiveness as it exacerbates a company's financial risk, willingness to accept uncertainty, and the complexity of organizational structure.

Keywords: Business Strategy, Audit Report Lags, Audit Efforts, Audit Delay, Audit Report Lag

JEL Classification Code: M40, M41, M42, J54, M21

1. Introduction

This study examines the association between a firm's business strategy (PROSPECTOR) and (DEFENDER) and audit report lags. Prior literature uses the measure of business strategy as an explanatory variables for the accounting information (Bentley, Omer, & Sharp, 2013; Higgins, Omer, & Phillips, 2015; Ittner, Larcker, & Rajan, 1997). According to Miles, Snow, Meyer, and Jr (1978), prospectors focus on innovation, pursue new products and markets, which are related to the business risk. On the other

hand, defenders focus on stable and predictable areas and their aversion to risk and uncertainty would lead to being lower business risk. In the other words, business strategy can affect audit quality in both positive and negative directions, because auditors make different audit risk assessments and audit plans according to the firm's business strategy. We hypothesize business strategy is associated with greater audit report lags because certain organizational strategies are more complex and risky.

To investigate how business strategies are associated with the audit report lags, we adopt the business strategy measure (STRATEGY) underlying by Bentley et al. (2013) and Bentley-Goode, Newton, and Thompson (2017). The measures of business strategy follows Miles et al. (1978). Audit report lags (ARLs) indicate the number of days between a firm's fiscal year-end and the audit report date. It is implied that longer audit delays reduce the quality of financial information (Khlif & Samaha, 2014).

Examining 5,072 firm-year data in Korea for the period 2015 to 2019, we find that business strategy is positively associated with audit report lags. Specifically, prospectors are positively associated with audit report lags. On the other hand, defenders are negatively associated with audit

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report lags. The results suggest that firms' business strategy would increase a firms' performance uncertainty as well as an audit risk. In addition, prospectors may make it difficult for auditors to perform effective auditing procedures. Defenders, conversely, focus on simple product lines and cost-efficiency. For this reason, auditors will be able to carry out the audit procedures much more easily. The findings of this study regarding business strategy are important for investors because firms' business strategy can significantly affect audit procedures. The results indicate that business strategy under prospector may aggravate the firms' business and financial risk, willingness to take the uncertainty, complexity of organizational structure, etc. These empirical results demonstrate that auditors consider these business strategies by evaluating the significance of our business strategy measure in audit report lags.

The research contributions are as follows. We contribute to the business strategy literature and the audit report lags literature. Also, to the best of our knowledge, no prior study has investigated the firms' business strategy and audit report lags. Our paper contributes by showing that business strategy affects audit report lags, which is important to investors for decision making. Our findings are important for auditors because business strategy significantly affects audit risk. Finally, we expect that the findings of this study convey useful information to managers, auditors, investors, and security market regulators.

In the next section, we review the literature on business strategy and audit report lags. Then, we develop our hypotheses. In section 3, we provide an overview of our data and model. In section 4, we present our results. In section 5, we summarize and conclude our research.

2. Theoretical Background and Research Hypothesis

2.1. Business Strategy

Prior literature shows that a firm's business strategy could affect the firm's financial reporting and tax planning practices, as well as auditors' assessment of the firm's operating risks (Bentley et al., 2013; Chen, Eshleman, & Solieau, 2017; Higgins et al., 2015).

Miles et al. (1978) empirically examine the relationships among organizational strategy, structure, and process. Also, they indicate three commonly occurring configurations called the prospector, defender, and analyzer. Furthermore, their framework contains a dynamic dimension called the adaptive cycle, and a diagnostic checklist that designers or managers could use to guide them through the cycle. A firm's business strategy contains relevant information that is separate from firm's specific information factors.

Prospectors, defined by Miles et al. (1978), maintain organizational flexibility to quickly respond to uncertain environment. Hence, prospectors tend to have a decentralized structure, a low division of labor, and low formalization and centralization. In contrast, defenders maintain centralization to focus only on one part of the market. Bentley et al. (2013) find that auditors differentially assess their clients' business strategies. Further, they argue that business strategy is a separate composition that contains information content that goes beyond the measure of the firm's complexity and risk. Abdelsalam and Street (2007) argue that timeliness is a necessary component of substantial financial information. For instance, in the USA the Securities and Exchange Commission (SEC), New York Stock Exchange (NYSE) have issued recommendations regarding the timely dissemination of financial information.

2.2. Audit Report Lags

The timeliness of the audit opinion disclosure is significant in providing evidence about the qualified opinions to convey information to the market (Afify, 2009). Particularly, audit report lags play an important role in the timeliness of conveying audit information to capital markets (Lai & Cheuk, 2005). In other words, it must allow investors to know the private information of the firms in advance.

Audit literature suggests that the extent to which the firms' characters are widely held is one of the factors related to audit business risk (Bamber, Bamber, & Schoderbek, 1993; Henderson & Kaplan, 2000). Hwang, Kim, and Lee (2008) examine that the effect of internal control systems on audit report lags. They find that audit report lags have increased after the introduction of the internal control system. Major shareholders can exert a strong influence on management behavior for their benefits. (Jaggi & Tsui, 1999). Abernathy and Street (2017) investigate the determinants of audit report lag, including firm-level corporate governance mechanisms (i.e., board characteristics, CEO duality).

Ettredge, Li, and Sun (2006) show that the concentration of ownership is negatively associated with audit delay. It means that more investors are relying on financial statements. Cohen and Leventis (2013) argue that Big 4 firms tend to have a stronger incentive to finish their audit work more quickly to maintain their reputation. Prior research of reporting lag varies across firms has motivated several studies. It has been suggested that managers have incentives to exercise discretion over the timeliness of reporting (Givoly & Palmon, 1982).

2.3. Research Hypothesis

Prior literature suggests the determinants of audit quality: client size, complexity, and risk, etc. (Cobbin, 2002).

Research on the determinants of audit report lag beyond the US setting includes Australia, China, Egypt, Vietnam, and Malaysia (Bhuiyan & D’Costa, 2020; Habib, 2015; Khlif & Samaha, 2014; Wan-Hussin & Bamahros, 2013). The determinants of audit quality may require a more comprehensive approach than individual proxies (e.g., proportion of foreign sales, firms size). In addition, the concept of business strategy can provide insight into underlying reasons for audit risk. Miles et al. (1978) introduce the types of business strategies: Prospectors, Defenders, Analyzers, and Reactors. Prospectors are expected to have higher audit risks due to their business complexity and decentralized corporate governance. On the other hand, defenders are expected to have lower audit risks due to their simple product lines, non-complex, and centralized corporate governance. Previous studies have reported that firms’ business strategies affect accounting information. If auditors regard the firms’ business strategy as an underlying driver of the complexity, the auditors will evaluate the audit risk based on the business strategy. Bryan and Mason (2020) show that auditors could perceive either higher or lower levels of earnings quality as increasing risk. If auditors adjust effort in response to the risks associated with earnings quality, we expect the effort adjustment to be reflected in audit report lag, since prior research suggests that audit report lag is a reasonable measure of audit effort (DeFond, Lim, & Zhang, 2016). Considering the above together, we expect the firms’ business strategy to affect accounting quality and then will be associated with the audit report. To verify this, the following hypothesis is established.

H1: There is a positive association between business strategy and audit report lags.

3. Research Methods and Materials

3.1. Business Strategy

Refer to Bentley-Goode et al. (2017) and Bentley et al. (2013), we measure an entity’s business strategy based on Miles et al.’s (1978) business strategy methodology. The measure uses six ratios to reflect the different aspects of business strategy. The six ratios are as follows. (1) New product development (measured by R&D expense to sales); (2) Marketing effort (measured by SG&A expense to sales); (3) Growth pattern (measured by the annual percentage change in sales); (4) Production efficiency (measured by employees to sales); (5) Capital intensity (measured by net PP&E to total assets); and (6) Organizational stability (measured by the SD of the total number of company employees). In this way, we measure the business strategy using the six ratios.

For each firm-year, we measure each of the six ratios as the average over the prior five years. Then, we compare each

measure to other companies in the same industry and rank them into quintiles for each firm-year (based on the two-digit KSIC-Korean SIC). After that, the quintile rank scores are summed over each firm-year. Therefore, each company could get a minimum of six points and a maximum of 30 points. Companies with higher STRATEGY scores indicate companies with greater prospector-like characteristics, while companies with lower STRATEGY scores indicate companies with greater defender-like characteristics. Refer to prior literature, we created dummy variables representing PROSPECTOR and DEFENDER by defining the company’s STRATEGY with 23 points or higher as PROSPECTOR, and 13 points or less as DEFENDER (Higgins et al., 2015).

3.2. Audit Report Lags (ARLs)

We test the association between business strategy and audit report lags (ARLs). Consistent with prior literature, we measure audit report lags (ARLs) as the logarithm of the cumulative number of days from the end of the firm’s fiscal year of firm *i* in period *t* to the date of the audit report.

3.3. Research Model

In this study, we use the following OLS regression model to examine the association between information asymmetry and audit report lag following Bamber et al. (1993), Knechel and Payne (2001), and Sultana, Singh, and Van der Zahn (2015). To test Hypothesis 1, we estimate the following Equation (1). To test the hypothesis, we use the SAS program for data processing and the STATA program for OLS regression analysis. Regression models are as follows:

$$\begin{aligned} \text{ARL}_t = & \beta_0 + \beta_1 \text{STRATEGY}_t + \beta_2 \text{SIZE}_t + \beta_3 \text{GRW}_t \\ & + \beta_4 \text{LEV}_t + \beta_5 \text{ROA}_t + \beta_6 \text{LOSS}_t + \beta_7 \text{OPN}_t \\ & + \beta_8 \text{CON}_t + \beta_9 \text{BIG4}_t + \beta_{10} \text{OWN}_t + \beta_{11} \text{FOR}_t \\ & + \beta_{12} \text{FRN}_t + \beta_{13} \text{HOUR}_t + \beta_{14} \text{MK}_t \\ & + \sum \text{YR} + \sum \text{IND} + \varepsilon_t \end{aligned} \quad (1)$$

Our expectations for the model coefficient are discussed below based on Bentley et al. (2013) and the prior audit report lag literature. Based on the Hypothesis, the coefficient of STRATEGY is expected to be positive if auditors put more audit effort on prospectors and less audit effort on defenders.

$$\begin{aligned} \text{ARL}_t = & \beta_0 + \beta_1 \text{PROSPECTOR}_t + \beta_2 \text{DEFENDER}_t \\ & + \beta_3 \text{SIZE}_t + \beta_4 \text{GRW}_t + \beta_5 \text{LEV}_t + \beta_6 \text{ROA}_t \\ & + \beta_7 \text{LOSS}_t + \beta_8 \text{OPN}_t + \beta_9 \text{CON}_t + \beta_{10} \text{BIG4}_t \\ & + \beta_{11} \text{OWN}_t + \beta_{12} \text{FOR}_t + \beta_{13} \text{FRN}_t + \beta_{14} \text{HOUR}_t \\ & + \beta_{15} \text{MK}_t + \sum \text{YR} + \sum \text{IND} + \varepsilon_t \end{aligned} \quad (2)$$

We also examine the hypothesis using alternative independent variables. The alternative variables are PROSPECTOR and DEFENDER. For the independent variables, we estimate the following Equation (2). Based on the hypothesis, we expect that the coefficient for PROSPECTOR to be positive and the coefficient for DEFENDER to be negative if auditors put more audit effort on prospectors and less audit effort on defenders.

We control for known determinants of ARLs to capture the impact of important determinants of ARLs (Chae, Nakano, & Fujitani, 2020; Sultana, Singh, & Van der Zahn, 2015). We control for firm size (SIZE) using the natural logarithm of the year-end total assets. We expect the coefficient of SIZE to be negative (–) due to greater audit efforts for larger firms. Bigger firms are expected to show a lower level of audit report lag compared to their smaller firms (Kim & Zhang, 2014). We control for asset growth ratio (GRW) using the change in assets scaled by lagged assets to control the firm’s performance. Profitable firms tend to provide information sooner than firms reporting bad news. Thus, we expect a negative coefficient for ROA and GRW.

We include the following variables to control for risks likely to affect audit effort; return on assets (ROA); indicator variable equal to 1 if the firm is required to report consolidated financial statements (CON); indicator variable equal to 1 if the firm is listed in KOSPI (MK).

To control for financial risk, we include leverage (LEV) using the total liabilities scaled by total assets (Francis, 1984). Thus, we expect the coefficient of LEV to be positive (+). We include LOSS for firm performance (Asthana, 2014). LOSS is an indicator variable equal to 1 if a firm has negative net income in the last year. According to Raghunandan and Rama (1995), there is a positive relationship between audit report lags and audit opinion. Also, the audit committee affects the audit report delay (Omer, Aljaaidi, & Al-Moataz, 2020). Therefore, we include an audit opinion (OPN) variable. Auditors’ ability to detect internal control deficiencies is an important aspect of audit quality. Therefore, we control BIG4 using an indicator variable equal to 1 if the firm is audited by BIG4. Also, we control for outside monitoring using the percentage

ownership of controlling shareholders (OWN) and the percentage ownership of foreign investors (FOR). These are controlled for corporate governance mechanisms because the attributes of corporate governance play an important role in the disclosure of accounting information and the quality of reporting (Dang, Pham, Nguyen, & Nguyen, 2020), thereby reducing audit report lag. Following Doyle, Ge, and McVay (2007), we include FRN (exports scaled by sales) to control business complexity. Finally, to control the effect of year-to-year and industry-by-industry differences, the year dummy and industry dummy are included in the model.

3.4. Sample Selection

Our sample was taken from FN-Guide and TS2000. Our sample comprises all of the firms listed on the Korea Composite Stock Price Index (KOSPI) market and Korea Securities Dealers Automated Quotation (KOSDAQ). We examine the period from 2015 to 2019.

We exclude utilities and financial industries due to the regulated nature of the industries. We exclude companies whose year-ends are not in December because of data homogeneity. We exclude firms with missing financial data for computing the ARLs, business strategy, or control variables. After eliminating missing data, we have a final sample of 5,072 firm-year observations from 2015 to 2019 for our study. We winsorize each continuous variable at 1% and 99% percentiles to control the effect of extreme values on the results. In our sample, the largest industry segment is the Electronic components, computers, video, sound, and communication sector, which consist of approximately 14.31 percent of the total firms (untabulated).

4. Empirical Analysis

4.1. Descriptive Statistics

Table 1 provides descriptive statistics for the key variables in Equation (1). Consistent with expectations, several items are worth noting.

The interesting variable is STRATEGY, calculated from six to thirty. Companies with higher STRATEGY

Table 1: Descriptive Statistics (= 5,072)

Variables	Mean	Std.	Min	Mdn	Max
ARL	4.308	0.091	3.689	4.317	4.898
STRATEGY	17.678	3.943	6.000	18.000	29.000
PROSPECTOR	0.078	0.268	0.000	0.000	1.000
DEFENDER	0.094	0.292	0.000	0.000	1.000
SIZE	26.236	1.478	23.696	25.947	31.103

scores indicate companies with greater prospector-like characteristics, while companies with lower STRATEGY scores indicate companies with greater defender-like characteristics. 7.8 percent of total observations are classified as prospectors. 9.4 percent of total observations are classified as defenders. The mean value of ARL equals 4.308 or approximately 74 days. The mean of SIZE is 26.236, consistent with prior literature.

4.2. Correlation Analysis

Table 2 presents Pearson correlation coefficients between ARL and STRATEGY. Audit Report Lags (ARL) is positively correlated with STRATEGY. For control variables, ARL is positively correlated with LEV, LOSS, OPN, and

Table 2: Pearson Correlation Matrix

	ARL	STRATEGY
ARL	1	
STRATEGY	0.06***	1

Note: ***, ** and * indicates significant at 1%, 5% and 10% level of significance based on *t*-statistics.

Variable definitions: refer to Research Model (1).

CON. On the other hands, ARL is negatively correlated with SIZE, ROA, OWN, FOR, TIME, and MK (Un-tabulated). Our correlations are similar to prior literature. We believe that Equation (1) is well specified for ARL determinants.

4.3. Regression Analysis (1)

Table 3 provides regression results of the hypothesis. Column (1) examines the relationship between STRATEGY and ARL using the natural logarithm ARL as the dependent variable. Consistent with Hypothesis 1, the coefficient for STRATEGY is a significant positive. The result indicates that higher strategy scores (greater prospector-like characteristics) are associated with a longer ARL. Overall, the significance and sign of control variables are broadly consistent with prior empirical research.

Table 3, Column (2) shows the results of the hypothesis using the number of days of ARL as the dependent variable. Consistent with the hypothesis, the coefficient for STRATEGY is positive and significant. The results indicate that business strategy is positively associated with audit report lags.

4.4. Regression Analysis (2)

Table 4 presents the results of the Hypothesis. Column (1) examines the relationship between PROSPECTOR,

Table 3: The Effect of Business Strategy on ARL-Continuous Variable Model (*n* = 5,072)

Variables	Coeff.	t-stat	p-value	Coeff.	t-stat	p-value
	(1) Dep. = Natural logarithm of ARL			(2) Dep. = Days of ARL		
Intercept	4.406***	129.79	0.000	80.912***	33.98	0.000
STRATEGY	0.001***	3.32	0.001	0.073***	3.32	0.001
SIZE	-0.008***	-4.55	0.000	-0.551***	-4.56	0.000
GRW	0.006	1.25	0.213	0.431	1.30	0.195
LEV	0.072***	10.04	0.000	5.183***	10.30	0.000
ROA	-0.021	-1.25	0.212	-1.765	-1.47	0.143
LOSS	0.016***	4.55	0.000	1.171***	4.77	0.000
OPN	0.079***	3.45	0.001	6.683***	4.17	0.000
CON	0.028***	8.37	0.000	1.984***	8.38	0.000
BIG4	0.010***	3.39	0.001	0.692***	3.25	0.001
OWN	0.008	0.96	0.337	0.495	0.84	0.401
FOR	-0.076***	-5.11	0.000	-5.354***	-5.13	0.000
FRN	-0.001	-0.15	0.880	-0.048	-0.17	0.866
TIME	0.004	1.10	0.272	0.325	1.39	0.166
MK	-0.022***	-7.34	0.000	-1.605***	-7.51	0.000
Adj. R-squared	0.137			0.142		

Note: ***, ** and * indicates significant at 1%, 5% and 10% level of significance based on *t*-statistics.

Table 4: The Effect of Business Strategy on ARL-Dummy Variable Model ($n = 5,072$)

Variables	Coeff.	t-stat	p-value	Coeff.	t-stat	p-value
	(1) Dep. = Natural logarithm of ARL			(2) Dep. = Days of ARL		
Intercept	4.428***	133.45	0.000	82.479***	35.43	0.000
PROSPECTOR	-0.003	-0.56	0.578	-0.121	-0.38	0.706
DEFENDER	-0.013***	-3.23	0.001	-0.893***	-3.05	0.002
SIZE	-0.008***	-4.57	0.000	-0.555***	-4.59	0.000
GRW	0.007	1.45	0.148	0.497	1.50	0.134
LEV	0.070***	9.80	0.000	5.059***	10.07	0.000
ROA	-0.022	-1.30	0.195	-1.826	-1.51	0.130
LOSS	0.016***	4.63	0.000	1.190***	4.84	0.000
OPN	0.079***	3.46	0.001	6.704***	4.18	0.000
CON	0.028***	8.40	0.000	1.992***	8.40	0.000
BIG4	0.011***	3.56	0.000	0.727***	3.41	0.001
OWN	0.006	0.68	0.500	0.327	0.56	0.578
FOR	-0.074***	-5.01	0.000	-5.242***	-5.02	0.000
FRN	0.000	-0.04	0.964	-0.021	-0.07	0.942
TIME	0.004	1.07	0.285	0.322	1.37	0.170
MK	-0.024***	-7.78	0.000	-1.687***	-7.94	0.000
Adj. R-squared	0.137			0.142		

Note: ***, ** and * indicates significant at 1%, 5% and 10% level of significance based on t -statistics.

DEFENDER, and ARL using the natural logarithm ARL as the dependent variable. According to prior literature, this study uses the natural logarithm of audit report lag as a proxy for audit report lag (Chan, Luo, & Mo, 2016). The results partially support hypothesis. The coefficient for PROSPECTOR is not significant. However, the coefficient for DEFENDER is negative and significant, indicating defenders are negatively associated with audit report lags.

Table 4, Column (2) presents the results of the hypothesis. The dependent variable is the number of days of ARL. The coefficient for PROSPECTOR is not significant. However, the coefficient for DEFENDER is negative and significant. The results are consistent with the Hypothesis. The results suggest that defenders are negatively associated with audit report lags as well. Overall, the results of Table 4 partially support hypothesis.

5. Conclusion

This study investigates the association between firms' business strategy and audit report lags. If auditors regard the firms' business strategy as an underlying driver of the complexity, the auditors will evaluate the audit risk based on the business strategy. Auditors could regard the higher

complexity of firms' strategy as an increasing risk. Further, we conjecture that more complex business strategies exacerbate audit report lag because of their greater complexity and stronger incentive to higher litigation risk. Examining 5,072 firm-year data in Korea for the period 2015 to 2019. We show that audit report lags are related to greater possibilities of strategy. The results indicate that the firms' business complexity derivatives decrease the quality of audit quality. Especially, prospectors with audit report lags are positive and defenders are significantly negative. Furthermore, the results of this study regarding business strategy are important for investors because firms' business strategy can significantly affect auditing procedures. These results extend that firms' business strategy and audit report lags. Also, our results provide evidence of the determinants of audit report lags. In addition, our results are important that it helps provide an understanding of the factors that affect audit report lags. These findings are useful for shareholders, managers and auditors by showing that business strategy can affect audit report lag in financial markets.

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