THE ASSOCIATION BETWEEN AUDIT QUALITY, INTERNAL GOVERNANCE MECHANISMS AND FINANCIAL REPORTING QUALITY: EVIDENCE FROM UAE

BY

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ABSTRACT

The aim of this study is to investigate financial reporting quality in the United Arab Emirates (UAE) and the impact of audit quality and internal governance mechanisms (board of director including Royal family members and audit committee) on financial reporting quality. The study also tests whether internal governance mechanisms moderate the association between audit quality and financial reporting quality. Financial reporting quality in this study is measured by faithful representation and financial reporting timeliness. Faithful representation and financial reporting timeliness were proxied by earnings management, specifically discretionary accruals (DA), and total report lag (TRL), respectively. Three theories were applied to explain the hypotheses in this study namely, agency theory, resources dependence theory and elitism theory. The sample of the study consists of listed companies on the Abu Dhabi Securities Exchange (ADX) and the Dubai Financial Market (DFM) totalling 437 firm-years. This research's study period was for eight years from 2011 to 2018, thus panel data were used in testing the hypotheses. Multivariate and hierarchical regressions were the main tests conducted to meet the research objectives of this study. The audit quality measures used in this study are audit size, audit fee, audit tenure and specialist auditor. The board of directors' characteristics are royal family members on board, board size, frequency of board meetings, board meeting attendance, board independence and multiple directorships. Whereas audit committee's characteristics are audit committee size, frequency of audit committee meetings, audit committee expertise and audit committee independence. Supporting elitism theory, the findings of the study showed that the existence of a Royal family member on the board of directors contributed towards deterring earnings management practices and expediting total report lag, hence enhancing financial reporting quality. In addition to royalty on board, audit committee expertise is found to be effective in hindering earnings management practices and shortening report lags. Moreover, board attendance and independence as well as audit committee size seem to promote timely financial reports. Then, in testing the moderating effect of board of directors and audit committee, generally, the findings showed that these internal governance mechanisms moderate the association between audit quality and financial reporting quality to a certain extent. The findings of this study could be of interest to investors and regulators as it reveals the financial reporting quality of listed companies in the UAE and the monitoring mechanisms, especially royalty on board, that are effective in augmenting the quality of financial reporting. This study should also be useful to future researchers as it has used and found support for elitism theory in accounting research. Furthermore, this study has extended the literature on corporate governance and financial reporting by testing the moderating effects of internal governance mechanisms on audit quality's association with financial reporting quality, particularly in the context of the UAE.

ملخص البحث

يهدف هذا البحث إلى فحص جودة القوائم المالية في دولة الإمارات العربية المتحدة، ودراسة مدى تأثير جودة المراجعة وآليات الحوكمة الداخلية على جودة القوائم المالية، والكشف عن وساطة آليات الحوكمة الداخلية بين جودة المراجعة وجودة القوائم المالية، وتُقاس جودة القوائم المالية في البحث بمقياسين؛ أحدهما عدالة عرض القوائم المالية، ويُقاس بإدارة الأرباح، ولا سيما المستحقات التقديرية، والآخر توقيت عرض القوائم المالية، ويُقاس بتأخُّر التقرير الإجمالي، وقد توسَّل البحث ثلاث نظريات لصياغة فرضياته؛ هي نظرية الوكالة، ونظرية استقلال الموارد، ونظرية النخبة، واشتملت عينة البحث على ٤٣٧ شركة غير مالية مدرجة في "سوق أبوظبي للأوراق المالية" و"سوق دبي المالي" بين عامي ٢٠١١-٢٠١٨، كما توسَّل البحث منهجية "البانال داتا"؛ لفحص مدى تأثير جودة المراجعة وآليات الحوكمة الداخلية على جودة القوائم المالية، وكان الانحداران الخطي المتعدد والهرمي من أهم الاختبارات التي أجريت لتحقيق أهداف البحث؛ دعمًا لنظرية النخبة، وأظهرت النتائج أن وجود فرد من أفراد الأسرة الحاكمة في مجلس الإدارة يسهم في منع الإدارة من ممارسة إدارة الأرباح، وتسريع إصدار القوائم المالية، ومن ثم تحسين جودة التقارير المالية، وتساعد في ذلك أيضًا خبرةُ لجنة المراجعة، علاوة عن أن حضور مجلس الإدارة، واستقلاليته، وحجم لجنة المراجعة؛ كلها تعزز إصدار التقارير المالية في الوقت المناسب، أما حين استخدام مجلس الإدارة ولجنة المراجعة وسيطًا بين جودة المراجعة وجودة التقارير المالية؛ فبيَّنت النتائج أن آليات الحوكمة الداخلية تعمل على تحسين الارتباط بين جودة التدقيق وجودة التقارير المالية إلى حدٍّ معين، وعليه؛ سيكون لنتائج هذا البحث تأثير على أسواق المال، وصانعي السياسات، والهيئات التشريعية، والباحثين والمحللين في القضايا المرتبطة بجودة المراجعة، وآليات الحوكمة الداخلية، وجودة القوائم المالية.

APPROVAL PAGE

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DECLARATION

I hereby declare that this dissertation is the result of my own investigation, except where authorized stated. I also declare it has not been previously or concurrently submitted as a hole for any other degrees at IIUM or other institutions.

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To my parents who prayed for my excellence and taught me never to give up.

To my beloved wife, Doa'a, and my daughter, Bian.

To my brothers and sisters.

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LIST OF ABBREVIATIONS

AAA	Accountants and Auditors Association
ACEXP	Audit Committee Expertise
ACIND	Audit Committee Independence
ACMEET	Audit Committee Meeting
ACSCORE	Audit Committee Score
ACSIZE	Audit Committee Size
ADX	Abu Dhabi Securities Exchange
AED	Arab Emirates Dirham
ARL	Audit Report Lag
AUDFEE	Audit Fees
AUDSIZE	Audit Firm Size
AUDSPE	Industry Specialist Auditor
AUDTEN	Audit Tenure
BDATT	Board Attendance
BDIND	Board Independence
BDMEET	Board Meetings
BDSCORE	Board of Director Score
BDSIZE	Board Size
BUSY	Multiple Directorship
CCG	Code of Corporate Governance
CEO	Chief Executive Officer
CFO	Operating cash flow
CG	Corporate Governance
CIAs	Certified Internal Auditors
CRD	Corporate Risk Disclosure
CSE	Colombo Stock Exchange
CSR	Corporate Social Responsibility
DA	Discretionary Accruals
DFM	Dubai Financial Market
DSE	Dhaka Stock Exchange
EM	Earnings Management
FASB	Financial Accounting Standards Board
FRQ	Financial Reporting Quality
GAAP	Generally Accepted Accounting Principles
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
IAF	Internal Audit Function
IASB	International Accounting Standard Board
IPO	Initial Public Offering
ISPPIA	Professional Practices of Internal Auditing
KAMs	Key Audit Matters
LEVE	Firm Leverage

LLPs	Loan loss provisions
NGT	Nominal Group Techniques
NT	Earnings Before Extraordinary Items
OLS	Ordinary Least Squares
PPE	Property, Plant and Equipment
PROF	Firm Profitability
ROA	Return on Assets
ROYAL	Membership of Royal Families' Members
SCA	Securities and Commodities Authority
SIZE	Firm Size
TA	Total Assets
TAC	Total Accruals
TRL	Total Report Lag
TWSE	Taiwan Stock Exchange
UAE	United Arab Emirates
UK	United Kingdom
US	United State
VIF	Variable Inflation Factor
∆REC	Change in Accounts Receivables
∆REV	Change in Sales or Revenue

CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND OF THE STUDY

There are 22 countries in the Arab region; 6 of these countries in the Arab region has formed Gulf Cooperation Council (GCC), hence are known as Gulf countries. One unique feature of Gulf countries is that they are ruled by Royal families. United Arab of Emirates (UAE) is one of the Gulf countries and it consists of seven emirates and every emirate is ruled by a Royal family. The Royal family members in the UAE are allowed to engage in economic practices (Kamrava, Nonneman, Nosova and Valeri, 2016). Many of the Royal family's members in UAE have seats on the board of directors in several listed companies. As they are royalty, they have considerable influence on the board, thus possibly could have repercussions on the corporate governance (CG) mechanism, and consequently financial reporting practices of the company.

The primary objective of financial reporting is to provide useful information for effective decision making (Beest, Braam & Boelens, 2009). International Accounting Standards Board (2018) defined decision-useful information as "information that are likely to be most useful to present and potential lenders, investors and other creditors for making decisions about the reporting entity". Moreover, many studies argued that decision usefulness is the main indicator of financial reporting quality (Jonas & Blanchet, 2000; Beuselinck & Manigart, 2007; Salehi et al., 2019).

According to Beest et al. (2009) and Hareth and Albarqi (2017), financial reporting quality can be defined in terms of the fundamental and enhancing qualitative characteristics of financial information. The fundamental qualitative characteristics (i.e. faithful representation and relevance) define the content of financial reporting information whereas the enhancing qualitative characteristics (i.e. timeliness, comparability, understandability and verifiability) can enhance information usefulness when the fundamental characteristics are in place. This study will investigate the quality of financial reporting in light of two of these characteristics namely, faithful representation of financial reporting and timeliness of financial reporting. According to Imhoff (2003) and Nelson and Shukeri (2011), investors and creditors need to be provided with accurate and timely information for making appropriate investment decisions.

In order for financial information to faithfully represent economic phenomena, it has to be neutral, complete and free from material misstatement (IASB, 201۸). When earnings manipulation takes place, financial information does not fulfil the requirement of neutrality (Velury, 2003). Therefore, faithful representation of such financial statements may be considered distorted. This means that earnings management may impair the financial reporting quality, particularly faithful representation.

Schipper (1989) defined Earnings management as an interference in financial reporting process with intention of gaining personal benefits. Likewise, Healy and Wahlen (1999) defined earnings management as managers using their judgment in structuring transaction and financial reporting to distort financial reports to either influence contractual outcomes which depend on reported accounting figures or to mislead some stakeholders about the company’s economic performance.

Even Generally Accepted Accounting Principles (GAAP) provide managers a level of discretion and flexibility in reporting the companies’ financial performance. This discretion may be used either to opportunistically manipulate earnings or to communicate private values with relevant information regarding the future performance of the firm (Johl, Jubb and Houghton., 2007). Several studies provided evidence to the former instead of latter (Chen, Lin Lin, Zhou., 2005; Gul, Fung and Juggi., 2009; Habbash & Alghamdi 2015; Al-Amri et al., 2017). The new business environment (advancements in communication, information and transportation technologies) has put pressure on the financial reporting process (Peecher, Schwartz & Solomon, 2007). They argued that this leads to financial statement fraud and opportunistic management of earnings, which are as broadly practiced today as it was earlier.

Many studies stated that managers use their power opportunistically to achieve their personal goals such as avoid losses, increase their own bonus and compensation (Burgstahler & Dichcv, 1997; Healy & Wahlen, 1999; Baker, Collins & Reitenga, 2003; Yasser & Soliman 2018; Bouaziz, et al., 2020). However, it has been claimed that managers' motivations for earnings manipulation are not always opportunistic. Subramanyam (1996) presented the informative role of earnings management. He stated that managers sometimes practice earnings management to enhance earnings quality and to deliver some significant information to the outsiders to diminish the gap between managers and the external users. Thus, managers use earnings management to affect the firm's value and provide signals about its future performance.

Timeliness is another characteristic of qualitative financial information. Financial reporting recognized as an important channel that provides investors with information that enable them to make effective decisions. For information to have economic value, it needs to be delivered to users on a timely basis. Late information losses its usefulness. Thus, timeliness is an essential element of financial information (Hassan, 2016) and a qualitative characteristic of financial reporting (IASB, 2018). Consequently, capital markets around the world have set specific time period within which annual reports must be submitted; otherwise penalties will be imposed against late filers by the capital market authorities.

Prior literature has further sub-divided financial reporting timeliness into public disclosure timeliness and audit report timeliness. Public disclosure timeliness is the time taken to publish annual audited financial statement to public users, hence it is measured by the number of days between financial year-end and the time when these reports are made available to the public (Davies & Whittred 1980). Meanwhile, audit report timeliness is the time taken by the external auditor to approve the company's accounts, therefore, it is the number of days that elapse between year-end date and the date of issuing the audit report (Bamber, Bamber & Schoderbek, 1993).

Timely information release is necessary in a well-functioning capital market for investor decision–making (Chambers & Penan, 1984). In addition, prior literature stated that financial reporting timeliness provides an indication regarding aspects of financial reporting quality, audit risk, internal control and management integrity (Mande & Son, 2011; Abbott, Parker & Peters, 2012, Baatwah, 2014). It helps augment investors' confidence in the capital market hence attract investors (Leventis, Weetman & Caramanis, 2005; Badawy & Ali 2018). Thus, companies must provide information to investors within shortest lag if possible.

Prior studies have addressed several advantages of timely financial reporting (Carslaw & Kaplan, 1991; Abdullah, 2007; Abbott et al., 2012; Alkhatib & Marji, 2012; Aljaaidi et al., 2015; Harjoto, Laksmana & Lee, 2015; Rusmin & Evans, 2017; Wanhussin & Bamahrous 2018; Abdillah et al., 2019). Moreover, according to Owusu-Ansah (2000) and McLelland and Giroux (2000), timely reporting is a primary initiative to forestall information leaks, decrease asymmetric information and reduce the opportunity to spread rumours, as well as possible insider trading. Based on the above, timeliness is essential to enhance the usefulness of information to users, consequently enhancing financial reporting quality.

The role of financial reporting quality has gained considerable importance in the era of major accounting scandals (e.g. WorldCom, Enron and Andersen). These scandals have weakened the confidence of the investors in capital markets and raised the concern of regulators. Thus, many capital markets are reducing submission deadlines to improve financial reporting quality and to restore the confidence of investors in capital markets. For example, the US Security Exchange Commission (SEC) has reduced the deadlines of the disclosure of annual financial reporting. The deadline of annual report remains 90 days for the first year and shortened to 75 days for the second year and then shortened further to 60 days for the third year (Ettredge, Sun, & Li., 2006). This is an indicator of the importance of timeliness, which is placed by one of the leading securities regulators in the world.

Quality financial reporting is also gaining importance in the emerging markets since it is normally the main reliable source of information for decision makers. According to Afify (2009) and Badawy and Ali (2018) the information made public is limited and the release of financial information in emerging markets has a longer time lag. Also, it has been stated that providing timely information which faithfully represents the financial position of the company in emerging economies is expected to be more essential because the regulatory bodies in emerging markets are not as efficient as in developed markets (Afify, 2009).

As financial reporting quality is fundamental to companies, especially listed companies, they have certain mechanisms to ensure that their financial reports are of an acceptabale quality. Two of these mechanisms are ascertaining a quality audit and maintaining proper corporate governance mechanisms. These are discussed in turn.

Regarding audit quality, it is an important component to ensure the reliability of the financial reporting process (Yassin & Nelson, 2012). There are several definitions of audit quality, however the most common definition in the literature, as provided by DeAngelo (1981), is that the auditor is able to identify material errors in the financial statements and report these errors and irregularities. As audit quality is difficult to measure, other studies have used proxies or indicators of audit quality. Audit quality indicators, as used by prior literature are: Big Four auditors (DeAngelo, 1981; Rahman et al., 2019), audit fees (Yasin & Nelson, 2012; Khan & Abdul Subhan, 2019), auditor tenure (Mohamed & Habib, 2013; Sri & Solimun, 2019) and industry specialist auditor (Rusmin & Evans, 2017; Salehi et al., 2019).

Nevertheless, a quality audit is deemed to be an external mechanism whereas corporate governance is internal to the company. Corporate governance is a set of mechanisms adopted and designed to control the management's activates and decisions, to positively enhance the company's market value, company's performance, and its capital resources (Claessens & Yurtoglu, 2013). Corporate governance in UAE have unique characteristics since some boards of directors include Royal family's members which may affect financial reporting quality, and this will be explained extensively in the next section. Prior studies (Jensen & Meckling 1976; Fama and Jensen 1983; DeZoort et al., 2002; Baatwah, 2014; Al-Rassas & Kamardin, 2015) identify board of directors and audit committee as a significant internal governance mechanism. Resource dependency and agency perspectives believe that these mechanisms are the main inputs for firms to ensure the needed resources and decrease agency costs.

This section introduces the main elements of this study, which are: financial reporting quality based on faithful representation (EM) and timeliness as well as audit quality, internal governance mechanisms, i.e., board of directors with Royal family members and audit committee. Subsequent to introducing this study, the next section proceeds with the problem statement, specifically in the UAE, which is the context of this study.

Furthermore, it raises issues in relation to the capital market of UAE, namely, the Abu Dhabi Securities Exchange (ADX) and Dubai Financial Market (DFM).

1.2 PROBLEM STATEMENT

UAE is one of the countries that are ruled by Royal families. Unlike most other countries where one royal family exists, the UAE is a kingdom that comprises of 7 different royal families. In many companies, members of the Royal families have seats on the boards of directors. These royal family members are respected by the other board members due to their prestigious position, their political connections and their economic power (Peterson, 2001). Thus, royal family members could greatly influence the decisions on the board. Due to this unique setting of the UAE, the corporate governance, especially the effectiveness of the board of directors may be different from other countries. According to elitism theory, it has been argued that the existence of members of the Royal family on the board of directors plays an important role in corporate governance practices by improving governance through their influence (Alzaharani & Che-Ahmad, 2015). However, there is no empirical evidence to support whether the existence of Royal family members on the board helps in promoting financial reporting quality in the UAE. Therefore, it is uncertain whether, in the case of UAE, elitism theory applies, and whether a Royal family member on the board of directors does indeed improve governance, or the reverse. In fact, some investors may fear that a Royal family member on the board may use his or her influence on the company for self-benefit instead of the benefit of the stakeholders.

Moreover, UAE is an oil producing country like Gulf Cooperation Council (GCC) countries. Oil constitutes the main source of income. UAE is currently about to reduce their considerable reliance on oil by expanding and developing economic activities to capital, debt and financial markets. Accordingly, Prime minister of UAE, Mohammed Bin Rashid Al Maktoum, announced that UAE about to reduce depending on the oil sector as a main resource of income. He confirmed that to overcome the impact of oil price fluctuations on the economy, UAE should Diversify its economy away from oil by adding several economic sectors and attracting a new national and international investments (Al-bayan, 2016).

To raise the confidence of local investors and to attract foreign investment, high standards of disclosure and transparency are required in these new types of economic activities (Piesse, Strange & Toonsi., 2012). Since financial reporting is a key reference for stakeholders, its accurateness and timeliness are important to make economic investment decisions. Furthermore, most global capital market tries to attract local investors, as well as international investors. These investors, particularly international investors would require quality financial reporting before investing in a specific countries capital market and companies. Therefore, it would seem that it is more essential in countries such as the UAE to have quality financial reporting because if the investors doubt the quality of the reports and the performance of the company due to interference from royalty, they would hesitate to invest in the UAE.

ADX and DFM were established in 2000 and both are regulated and licensed by the Securities and Commodities Authority (SCA) of the UAE. Since both markets are considerably new, being only two decades old, the quality of financial statements is still uncertain and the reporting requirements may not be as stringent as in emerging markets. Thus, the financial reporting quality may be weaker than that found in prior studies associated with other countries. Nelson and Shukeri (2011) argued that regulation authorities in developing countries are less efficient compared to developed countries, so the financial reporting quality may be weaker. For example, in the case of