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Three Solutions to Your Audit Lag Problems

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Three Solutions to Your Audit Lag Problems

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Bad audit reports affect us all.

Audit reports help ensure that financial statements are correctly reporting the assets, liabilities, and equity of a company. These reports are created each year, and investors heavily rely on them to make investment decisions. The period between the end of a company's fiscal year and the audit reports release is referred to as the audit report lag.[1] Long lags create two risks: ineffective conclusions, and re-issuing of the financial statements.

Audit lags can be shortened through understanding three factors: the audit committee, the engagement partner, and the firm's expertise.

Audit Committee

The audit committee is the liaison between the company and the audit firm. A study in Indonesia showed that the expertise, size, and independence of the audit committee directly impacted the audit report lag time.[2] Of these three factors, it seems that expertise is the most paramount. According to an article in the CFO Dive, companies that had a previous firm audit partner on their committee were 21% less likely to make mistakes on their financial results as well as 26% less likely to be late reporting weaknesses in their reporting systems.[3] When members of the committee have in-depth and personal knowledge of the firm, efficiency and productivity will rise.

Engagement Partner

The second factor to consider is the lead engagement partner, including partner workload and partner tenure. A study done in Malaysia showed that engagement partners with heavy workloads tend to delay the issuing of audit reports.[4] As a partner is given more and more engagements, the level of quality cannot be sacrificed, so the time to issue the reports is pushed back.

Partner tenure on a client is another factor in audit report lag time. One study showed that audit report lag is one of the costs of the United States requiring engagement partners to rotate every five years: partners in their last year before rotation had a shorter audit report lag period than those in the first year of auditing a client.[5]

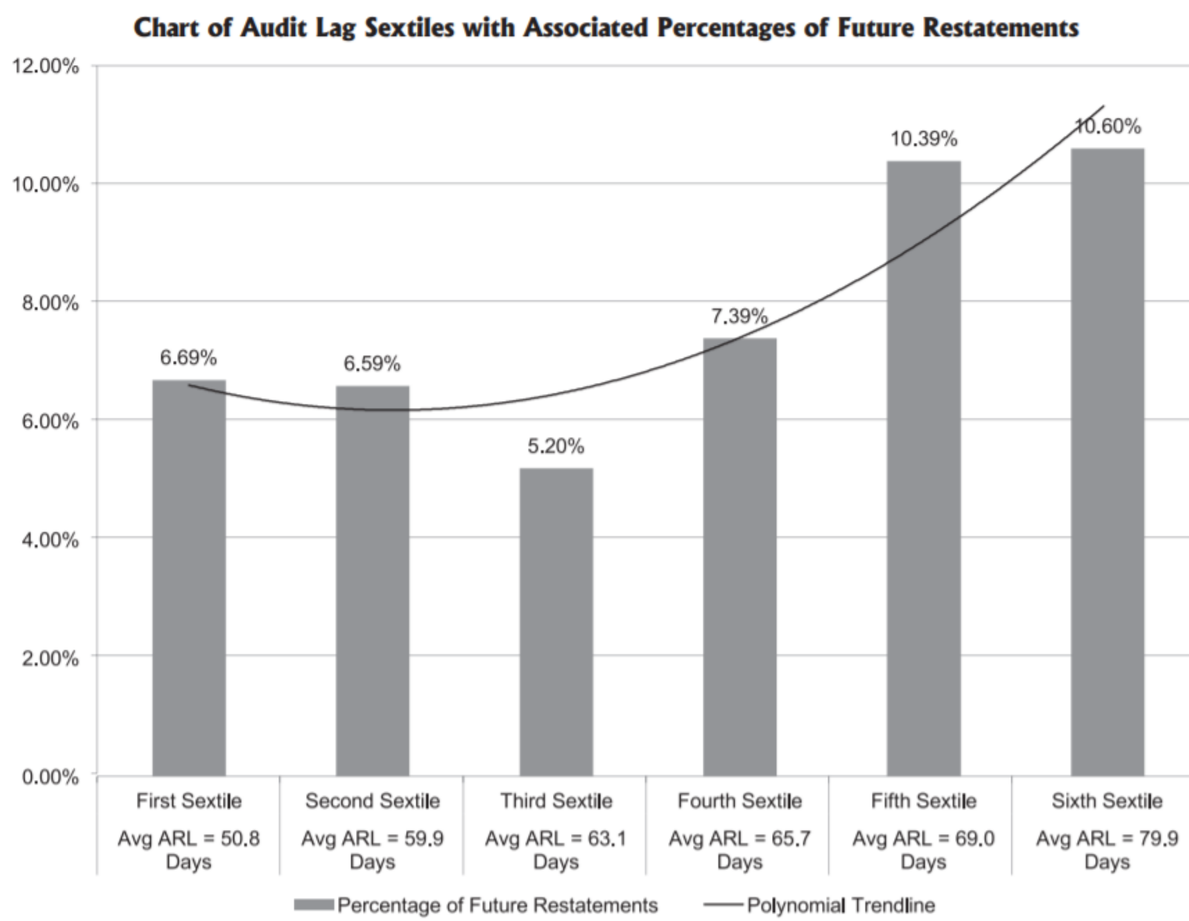
Firm's Expertise

The last factor to be considered is firm expertise. This relates to firm tenure on a client and firm specialization in an industry. One study from the Managerial Auditing Journal observed audit firm tenure has a significant learning curve.[6] The shorter the firm tenure, the longer the audit report lag. This association would be indicative of the firm learning how the new client is organized and how the client works.

However, the study also noted that a longer audit firm tenure does not indicate a shorter audit report lag. After the initial years of learning the inner workings of the client, audit firms tend to normalize the time it takes to audit the client. Additionally, firms that specialized in an industry were able to curb the effect of the lack of knowledge concerning a client and the client's operations. This specialization decreased the audit report lag for shorter tenured clients compared to the learning curve of non-specialized firms.

A Two-Edged Sword

If reports are issued too quickly, accuracy suffers. As the graph below shows, there is an optimal time for issuing audit reports, that is neither too quick nor too delayed.[7] Too long of an audit



report lag, and reports have a risk of inaccuracy. But if firms are too quick to jump to conclusions and speed through procedures, reports also have of high amounts of inaccuracy. This could be a possible explanation for why firms have a learning curve which eventually levels out to the average audit report lag time.

The Final Word

If a company's audit committee has a good level of expertise, the engagement partner has a good knowledge of the client, and a firm is specialized and has enough experience with a company as a client, you can reduce the audit report lag, improve the accuracy of the reports and optimize company resources. Firms can quickly issue accurate reports to provide valuable and reliable information for investors without wasting excess time.

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[1] Alan I. Blankley, David N. Hurtt, and Jason E. MacGregor. "Are Lengthy Audit Report Lags a Warning Signal?" *Current Issues in Auditing* 9, no. 2 (12, 2015). https://search-proquest-com.erl.lib.byu.edu/docview/1767662431?accountid=4488.

[2] Husaini. *The Substitution Role of Audit Committee Effectiveness and Audit Quality in Explaining Audit Report Lag*. St. Louis: Federal Reserve Bank of St Louis, 2019. https://search-proquest-com.erl.lib.byu.edu/docview/2200097161?accountid=4488.

[3] Robert Freedman, "Audit quality improves when former partners sit on audit committee", October 31, 2019, https://www.cfodive.com/news/audit-quality-improves-when-former-partners-sit-on-audit-committee/566346/, accessed November 2019.

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[5] Divesh S. Sharma, Paul N. Tanyi, and Barri A. Litt. "Costs of Mandatory Periodic Audit Partner Rotation: Evidence from Audit Fees and Audit Timeliness." *Auditing* 36, no. 1 (02, 2017): 129. https://search-proquest-com.erl.lib.byu.edu/docview/1866024285?accountid=4488.

[6] Mai Dao and Trung Pham. "Audit Tenure, Auditor Specialization and Audit Report Lag." *Managerial Auditing Journal* 29, no. 6 (2014): 490-512. doi:http://dx.doi.org.erl.lib.byu.edu/10.1108/MAJ-07-2013-0906.

[7] Alan I. Blankley, David N. Hurtt, and Jason E. MacGregor. "Are Lengthy Audit Report Lags a Warning Signal?" *Current Issues in Auditing* 9, no. 2 (12, 2015). https://search-proquest-com.erl.lib.byu.edu/docview/1767662431?accountid=4488.