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Tone Management and Timely Submission of Audit Reports: The Moderating Role of Corporate Governance

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Abstract

Purpose: Annual textual reports of companies have consistently been one of the most crucial sources for decision-making in the capital market. The qualitative characteristics of these disclosures, including tone and comprehensibility, are critical factors that enhance the usefulness of such information for decision-makers and protect shareholders' rights a point repeatedly emphasized by capital market regulators. Therefore, the objective of this study is to examine the relationship between tone management and the timely submission of audited financial statements, as well as the moderating role of corporate governance in this relationship.

Method: To test the hypotheses, the study uses one of the most important textual disclosures of companies (the Board of Directors' activity report) and a sample comprising 896 observations from 112 companies listed on the Tehran Stock Exchange, covering the research period from 2014 to 2021.

Results: The results indicate a significant and positive relationship between tone management and the timely submission of audit reports. The independence of the board of directors and CEO duality (respectively) strengthen and weaken this relationship. Further analyses reveal that auditor fees subsequently increase, and the findings remain robust even when considering the control variable of auditor change and the median lag in audit reporting.

Conclusion: Based on the study's findings, company managers can reduce audit costs by avoiding tone management in textual disclosures. Auditors, in turn, can adjust their fees in proportion to the risk associated with tone management in other company disclosures.

Contribution: This paper is grounded in the perspective of tone management and analyzes the impact of the quality of textual information on audit work and the moderating role of corporate governance. Additionally, it enhances our understanding of the consequences of tone management in timely reporting and the sensitivity of auditors' efforts to the tone of qualitative disclosures.

Keywords: Tone, Tone Management, Audit Report, Timely Reporting, Audit Report Lag.

Research Article

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Introduction

Selecting an appropriate investment requires timely reporting, whereas information availability in emerging capital markets is limited, and significant delays exist in disclosures (Afify, 2009: 56). The most prominent indicator of timely financial reporting is the extent of audit report delay (Sultana et al., 2015: 72). Timeliness in financial reporting is a key aspect of defining financial information quality (Ahmed et al., 2023: 148). Moreover, qualitative reports serve as the basis for economic decisions that impact organizational and shareholder interests. However, there is a research gap concerning the consequences of qualitative report attributes (such as readability and tone) on timely reporting. Therefore, given the importance of delivering high-quality information promptly, this study aims to examine the impact of tone management in board activity reports on the timeliness of audit report issuance. Any inconsistency between the disclosed quantitative performance data and the tone of qualitative information is referred to as tone management. Prior research indicates a relationship between an optimistic tone in annual reports and litigation risk (Rogers et al., 2011: 2155). Additionally, tone management in textual disclosures reflects uncertainty in financial reports, increasing the need for extensive audit procedures (Rich et al., 2016: 93). Thus, tone management may influence auditors' assessment of audit engagement risk. Higher audit risk necessitates broader procedures and the collection of more evidence, leading to increased auditor effort and time. Since audit report delay represents abnormal audit effort (Knechel et al., 2009: 1607), the delay in the audit report increases, so a direct relationship between tone management and timely submission of the audit report is expected. On the other hand, strong corporate governance (independent boards, absence of CEO duality, and gender diverse boards) strengthening internal controls and enhances management oversight. Strengthened internal controls reduce misreporting, improve financial reporting quality, and ultimately lower audit risk (Abbott et al., 2004: 69; Al-Ajmi, 2008: 217; Farumi et al., 2023: 58). Consequently, corporate governance moderates the relationship between tone management and timely submission of the audit report.

Materials and Methods

The study employed a systematic exclusion method for selecting the sample, which included companies that meet the following criteria: (1) the required information for conducting the research is available for the study period; (2) they have not changed their financial year or operation during the specified timeframe; and (3) they are not part of investment companies, financial intermediaries, banks, or insurance companies. To test the hypotheses, the Ordinary Least Squares (OLS) regression model was utilized and the study uses one of the most important textual disclosures of companies (the Board of Directors' activity report) and the audited financial statements, along with a sample comprising 896 observations from 112 companies listed on the Tehran Stock Exchange, covering the research period from 2014 to 2021.

Results and Discussion

The results of the hypothesis testing model, as presented in Table 1, indicate that abnormal tone affects audit report delay. Therefore, the first research hypothesis is confirmed. Since the coefficient sign of abnormal tone in Table 1 is positive, it can be inferred that an increase (or decrease) in abnormal tone of textual disclosures within board reports leads to an increase (or decrease) in the time required for issuing audit reports.

Table 1: Results of Hypothesis 1 Testing

variable	coeff.	t-Stat.	Prob
ABTONE	40/565	2/549	0/011
AGE	8/417	1/879	0/061
BIG	5/804	1/427	0/154
BUSY	-6/655	-1/289	0/198
CURRENT	0/147	0/025	0/98
LEV	1/028	0/173	0/863
SIZE	1/377	1/133	0/257
LOSS	6/335	2/104	0/036
MTB	0/049	0/373	0/71
RECINV	-26/918	-3/705	0/000
RETSUM	0/002	0/079	0/937
RETVOL	0/146	0/723	0/47
ROA	-5/702	-0/828	0/408
The model accounts for year and industry effects, and standard errors are clustered at the firm level.			
R^2		24%	
F-Stat.		11/819	
Prob (F)		0/000	

According to the results presented in Table 2, the second and fourth hypotheses are confirmed, while the third hypothesis is rejected. Based on the coefficients of abnormal tone and moderating variables in Table 2, it can be concluded that board independence strengthens, whereas CEO duality weakens, the relationship between abnormal tone and audit report delay.

Table 2: Results of Corporate Governance Hypotheses Testing

Variable	BOARD INDEPENDENCE		BOARD GENDER DIVERSITY		CEO DUALITY	
	coeff.	Prob	coeff.	Prob	coeff.	Prob
ABTONE	-35/511	0/432	52/525	0/008	78/937	0/000
CG	-12/251	0/151	36/017	0/417	-2/441	0/605
ABT*CG	130/75	0/043	-88/574	0/794	-63/541	0/039
AGE	8/55	0/05	8/282	0/061	7/314	0/084
BIG	6/124	0/137	5/593	0/172	6/967	0/081
BUSY	-5/931	0/255	-5/434	0/3	-6/058	0/227
CURRENT	-0/019	0/997	0/549	0/926	1/633	0/762
LEV	0/08	0/99	0/812	0/9	0/576	0/926
SIZE	1/085	0/383	1/493	0/239	1/616	0/198
LOSS	5/759	0/058	5/926	0/053	5/446	0/06
MTB	-0/018	0/903	-0/007	0/961	-0/022	0/874
RECINV	-31/447	0/000	-31/543	0/000	-31/523	0/000
RETSUM	-0/004	0/895	-0/007	0/817	-0/006	0/821
RETVOL	0/252	0/288	0/284	0/237	0/307	0/182
ROA	-4/999	0/46	-5/42	0/429	-7/157	0/266
The model accounts for year and industry effects, and standard errors are clustered at the firm level.						
R^2	25%		25%		28%	
F-Stat.	10/89		10/887		12/069	
Prob (F)	0/000		0/000		0/000	

Further analysis reveals that auditors consider other critical information from the prior year, such as board activity reports, during the audit process. Any abnormal tone in prior-year qualitative disclosures leads to increased auditor effort and consequently delays audit report issuance. Additionally, auditors respond to an increase in abnormal tone in board activity reports by raising their audit fees, indicating increased audit effort and self-protection against heightened litigation risk (stemming from higher audit risk). Any abnormal tone in prior-year qualitative disclosures also results in greater auditor effort and, subsequently, higher audit fees. Moreover, the study finds that incorporating auditor change as a control variable and using the median audit report delay to measure audit delay does not significantly alter the results, demonstrating their robustness.

Conclusions

The primary objective of this research is to examine the relationship between abnormal tone in board activity reports and audit report timeliness, as well as the moderating role of board independence, board gender diversity, and CEO duality. The empirical findings indicate a direct relationship between abnormal tone in board reports and audit report delay. Consistent with prior literature (Teng & Han, 2023; Hossain et al., 2020; Yang et al., 2018; Blanco et al., 2021), managers use of tone management in qualitative disclosures increases audit risk and as a result, auditors exert additional effort to mitigate this risk, leading to audit report delays. Additionally, board independence strengthens, while CEO duality weakens, the relationship between abnormal board report tone and audit report delay. Based on the research findings, company managers can improve financial reporting timeliness and reduce audit costs associated with increased audit risk by avoiding tone management in textual disclosures. Similarly, auditors can leverage these findings to recognize the implications of abnormal tone in audited firms' qualitative information, assess audit risk accordingly, and adjust their fees based on audit effort. Finally, regulators and standard-setters are advised to implement policies and requirements for textual disclosures, including board activity reports, to ensure timely information delivery and mitigate information asymmetry issues. Additionally, they should revise corporate governance frameworks and regulatory measures to minimize reporting delays.

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