CHAPTER I

INTRODUCTION

1.1 Background

Audit quality is one most significant topic in the auditing profession. Audit quality is defined as the auditors being capable of detecting and reporting material misstatements exist in the sample being investigated during the audit process (Vanstraelen, 2000; Mohamed, 2010). According to Pittman and Zhao (2017), the primary role of financial statement audits is to increase the informational value of financial disclosures via independent verification. To fulfill this role, the auditor is responsible for detecting and correcting all types of material misstatements in magnitude, classification, presentation, and disclosure of financial reports. As the auditor is able not only to detect but also to report on the existing material misstatements, the audit process is considered as more effective and of a higher quality.

Wallace (1980) defined audit quality in the form of the ability of an independent auditor to decrease abnormalities of the reflected information in the financial statements and the increased in the accuracy of this information. On the other hand, the conflict of interests of managers and owners, potentially affects the quality of distributed information and the importance of auditing role in protecting the interests of capital suppliers of profit sectors. Directors, as they are responsible for preparing financial statements with the full knowledge of the financial situation of the company and by having more knowledge than users of financial statements, potentially try to show the image of financial sectors well and the investors, as the main providers of resources for companies, request complete and accurate information from companies.

Many studies have been conducted related to audit quality and several factors associated with it (among others, see par. 4). Several factors that have been proven related to audit quality are; audit firm size, industry expertise, audit tenure, auditor’s independence, audit fee, and auditor reputation. This research is focused on studying the effect of audit tenure on audit quality. Audit tenure has strong relationship with the auditor’s independence which directly can affect the quality of audit work. To limit the audit tenure, the government in many countries began to implement a mandatory rotation of Public Accounting Firm and Auditor Partner. The effectiveness of this mandatory rotation still raises many questions.

According to Lennox, Wu, and Zang (2014) the effect of mandatory partner rotation on audit quality is far from obvious. On one hand, a change of partner may worsen audit quality because of the loss of partners who have gained more knowledge from longer tenure with their clients. Rotation may result in the incoming partner being less well informed about the client and, therefore, less likely to identify a financial reporting problem. On the other hand, a change of audit partner may improve audit quality by bringing a fresh perspective.

In U.S, the merits of auditor rotation have received heightened attention lately, with Congress ruling not to support Public Company Accounting Oversight Board (PCAOB) efforts to require audit firm rotation. This ruling has brought the existing audit partner rotation requirement back into the limelight, with some questioning its effectiveness in increasing audit quality (Litt, Sharma, Simpson, and Tanyi, 2014).

In Indonesia, in order to improve audit quality, the Ministry of Finance of the Republic of Indonesia began to implement a rotation policy of Public Accounting Firm and Certified Public Accountants (Auditor Partner) in 2002. This rotation rules also stated in Public Accountant's Law No. 11 year 2011. In article 4 paragraph 2 of the Public Accountant's Law stated that "the provision of audit services by Public Accountant and/ or Public Accounting Firms on a client's historical financial information for the fiscal year in a row can be limited within a certain period." In addition, as for financial industry, the Financial Services Authority (OJK) has released POJK No. 13/ POJK.03/ 2017 on The Use of Public Accountant and Public Accounting Firms Services in Financial Services Activities.

Before 2002, there is no single rule which governs the auditor and public accounting firm rotation. The absence of this rotation rule will give the opportunity to the auditors for as long as possible to maintain its relationship with their clients, even though it will reduce their independence. So that, the rotation rule which limits the term of auditor's duty on the clients' dependence would be limited and possible violations of the independence will be reduced (Febrianto, 2009; Perdana, 2014).

The fact that supports the previous statements – Febrianto, 2009 & Perdana, 2014 – is Enron scandal on 2001. This scandal made one of the Big 5 audit firm in the world, Arthur Andersen, lost its reputation. The close relationship between its auditors and clients made this audit firm involved in fraud committed by Enron. While the scandal in Indonesia that involving auditors is the scandal of PT Bank

Lippo on 2002. The company has been proved manipulated its financial statements where that time is audited by Public Accounting Firm named Prasetio, Sarwoko & Sandjojo.

In the light of several researches that are still showing contrary results and several scandals arising due to the weaknesses of an audit quality make the researcher is interested to conduct a study. This study wants to examine whether the mandatory rotation policy of audit firm and auditor partner affect the audit quality of a client's financial statements.

Audit quality will be measured by using the incident of financial restatements as a proxy. According to Weele (2011), investors will react to the announcement of restatement and it will decrease the market value of restating companies because investors lose confidence in the restating companies. Restatement might be affected by audit quality – high audit quality should prevent mistakes and fraud in financial statements, therefore it should prevent restatement (Weele, 2011). Thus, by referring to study conducted by Weele (2011), the researcher chooses financial restatements as a proxy to measure audit quality.

There are two interested reasons to study the implementation of mandatory rotation (audit firms and auditor partner) using financial restatements as a proxy in Indonesia. First, most of prior researches on mandatory rotation (especially auditor partner rotation) and financial restatements are undertaken using developed countries setting. There is little evidence upon these topics employs developing countries such as Indonesia. Second, unlike in US, auditor's opinion in Indonesia discloses both auditor partner and audit firm name. This is advantageous to identify cases where mandatory rotation occurs.

Banking companies are chosen as the population in this study in order to get the results that will be focused on the type of the company, so the results can be generalized and the bias can be reduced. In addition, among many researchers who conduct study about audit quality there's still a few of them who chose banking companies as their study object. The data used to assess this research is from all of listed banking companies on the Indonesia Stock Exchange in 2015.

1.2 Problem Statement

Based on the explanation above, the problem to be studied are:

1. Does Public Accounting Firm rotation affect the incident of financial restatements?
2. Does auditor partner rotation affect the incident of financial restatements?
3. Do Public Accounting Firm rotation and auditor partner rotation simultaneously affect the incident of financial restatements?

1.3 Research Objectives

Based on the description of the background and the formulation of the problem that has noted earlier, the objectives of this research are:

1. To analyze and obtain empirical evidence on the effect of Public Accounting Firm rotation on audit quality (the incident of financial restatements).
2. To analyze and obtain empirical evidence on the effect of auditor partner rotation on audit quality (the incident of financial restatements).

3. To analyze and obtain empirical evidence on the effect of Public Accounting Firm and auditor partner rotation on audit quality (the incident of financial restatements) simultaneously.

1.4 Research Benefits

The results of this study are expected to give contributions to, as follows:

1. Theoretical Benefit

   The results of this study are expected to provide additional reference in the field of accounting in the development of research on audit quality in Indonesia and provide an overview on the effect of Public Accounting Firm and Public Accountants (auditor partner) rotation on audit quality.

2. Practical Benefit

   The results of this study are expected to give practical contribution and benefit to the Public Accounting Firm to be able to provide a better quality of audit services and provide added value to the company as the owner of financial statements and to the public as the users of financial statements.

1.5 Writing Systematic

Writing systematic is a pattern in the presentation of scientific papers to obtain a clear picture of research plot. This will facilitate the reader in understanding the content of the study. The writing systematic of this study is as follows:

CHAPTER I INTRODUCTION

This chapter consists of the background of the problem, the problem formulation, the objectives and benefits of the research, and the writing systematic.

CHAPTER II LITERATURE REVIEW

This chapter explains the theoretical basis and previous researches, describe the framework and explain the research hypothesis.

CHAPTER III RESEARCH METHOD

This chapter explains the research design, research variables, population and sample, types and sources of data, data collection method and data analysis method.

CHAPTER IV RESULT AND DISCUSSION

This chapter explains the analysis of the results from the research based on the data and the information that has gathered, answers of hypotheses developed, and discussion.

CHAPTER V CONCLUSION

This chapter describes the conclusions from the analysis of data, the implication of research, the limitations in this research, and research suggestions as a feedback.