CHAPTER I

INTRODUCTION

1.1 Background

Auditor is a independent person who conduct auditing, who assesses whether financial information is presented fairly according to GAAP. Auditor must perform the audit with high-quality in order to assure the user of that financial information will make an appropriate decision based on the audited information of a company financial statement.

In some extent, auditor already stated as the third party in the relationship of management and principal by Jensen and Meckling (1976). They stated that the agency relationship involves between the principal (owners) and the agent (management). The principal delegates behalf of their authority to the agent in running a business. There are chances that agent will not fulfill their responsibility as accordance with principal's point of view. It is the reason of occuring the cost of monitoring the agent (agency cost). According to them, auditor involving in this scenario as the third party who assess the agent's (management) work. It is primarily becoming more serious in the capital market, where owners are from the public. The roles of auditor is needed to provide owners the high-quality audit that will give higher assurance in the management financial information.

Statements on Auditing Standards (SAS) AU-C Section 200 by American Institute of Certified Public Accountants (AICPA) regulate about the auditing practice. The standards states that in conducting an audit of financial statements the overall objectives of the auditor are (a) to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement; and (b) report on the financial statements, and communicate as required by GAAS, in accordance with the auditor's findings. Then, the principal expect the auditor to have a competence and independence when conduct audit process.

The reality itself shows a lack of quality in audit. Some cases are related to deviation of financial information that affect management, users, and auditor. The most well known case is the Enron, which led the collapse of Arthur Andersen in 2002, the well known public accountant firm in the world (at that era; The Big Five). After that, users (internal and external parties) confront auditor to give them the high quality audit. Criticism sprang up towards the independence and the function of auditor being questioned. Then, the Sarbanes-Oxley Act (SOX) emerge in 2002 as one of the regulation which purposes to improve the audit quality. According to the DeFond and Zhang (2013), the effects of the implementation of SOX towards audit practice are audit committee provisions, internal control audit, and restrictions on former auditor employees.

Dehghan et al. (2013) identify and rank factors that affects audit quality. This study relates the factors that in charge of the entire process of auditing. The result of the study is that audit quality is determined by audit firm, company (client), and external effective factors.

By those factors that affect audit quality and the AICPA regulation for audit practice. There are many considerations to be studied in determining the audit quality. As for that matter, the researcher main focus for this research of audit quality are on the variables that exist during the audit process, especially in the aspect of the auditor, because it is the one who conduct the audit itself based on its own competence and independence. The variables studied are as below.

First is size of the audit firms. DeAngelo (1981) states that the larger the size of public accountant firm (BIG4), then the higher is the quality of audit itself. According to DeAngelo, BIG8 (known as BIG4 firms at that era; 1980) firms will deliver high quality audit because they are not economically affected by clients. They can be independence towards any circumstances, differ with the non-BIG8 audit firm condition which depend towards client economically.

Choi et al. (2010) find that larger audit firms less likely to depend on particular client. They also better to resist client's pressure on substandard or biased reporting due to higher fees. It is also supported by Zakaria and Daud (2013) who find that audit quality, which is proxied by BIG4 firms, deliver high earnings quality, which lead to better earnings response coefficient (ERC). BIG4 firms have more power (based on the dependence perspective), which will give better act in controlling earnings management itself. Meanwhile, research by Nindita and Siregar (2012) find that audit firm size is not significantly affect the audit quality. It implies, whether a company audited by large or small audit firm, there is no differences of quality in the audit itself. Du and Zhou (2014) found a different result between US and China (accepted in US while rejected in China), regarding the effect of BIG4 on earnings quality. They argue that the differences might be due to differences between markets that might impair the research. The different might be in term of audit industry, regulation changes, and market development.

Second is the length of engagement period between an audit firm with its client (company), namely tenure. Auditor tenure is the length (period) of the auditor cooperate with a client. Geiger and Raghunandan (2002) find that longer tenure does not associated with reporting failures. The conclusion is also supported by Ghosh and Moon (2005). They find that capital market participant consider the lengthy tenure as having favorable impact on audit quality. Reported earnings were perceived as more reliable for firms with lengthy tenure by using earnings response coefficients as proxy for capital market participant. It implies that lengthy tenure will contribute such improvement in term of knowledge that auditor already gather from previous years in assessing client business process. Meanwhile, research conducted by Carey and Simnett (2006) find that longer tenure will reduce the quality of audit itself. It is also supported by Panjaitan & Chariri (2014) which also find that longer tenure will negatively affect audit quality. It is possibly because the independence of the auditor is being infected by the auditor-client relationship.

Third is the decision of client (company) in changing or rotate their auditor, namely auditor rotation. It is as an intention of the company whether want to change or not the auditor after the first year's engagement. The regulation in a country to another country regarding auditor rotation mostly different, some only regulate for the audit firm, partner, or both. In Indonesia this regulation is enacted through the Decree of Ministry of Finance No. 423/KMK.06/2002, which was later amended with the Decree of Ministry of Finance No. 359/KMK.06/2003 that obliged companies to limit the public accountant firm assignment period within five years and the individual accountant within three years. That decrees were then revised with Decree of the Minister of Finance No. 17/PMK.01/2008 on public accountant service. The decree regulates, among other things, the public accountant firm assignment period within six years and individual accountant within three years.

The reason for the emergence of auditor rotation is to improve the audit quality itself. As mandatory rotation is to limit the length of tenure since it is believed that longer tenure impairs auditor's independence. There are debate (pros and cons) for this argument. The pros are arguing that auditor rotation especially mandatory rotation is beneficial to sustain the independence of auditor. Carey and Simnett (2006) support the statement above. They find that in order to solve the problem of lengthy tenure that impairs the auditor's independence is by conducting a rotation: mandatory rotation, which gives limit in an auditor-client relationship. Descriptive study by Daniels and Booker (2009) also support the statement above. They are distributed questionnaires through email to bank loan officers in United States. The bank loan officers have familiarity about lending money to a public company. They found the interviewees' point of view is in accordance to pro's argument which auditor rotation is advantageous. Meanwhile, the con's arguing that auditor rotation is disadvantageous in term of the cost that occurs in auditor switching when changing been applied. It is supported by Cameran et al. (2014). They find that the high costs are not followed by the high quality of audit itself. They also find that lengthy tenure makes the improvement in earnings quality.

In Indonesia, Febrianto (2009) states the absence of regulation regarding audit rotation will provide an opportunity for the auditor to maintain the relationship with its client for as long as possible. The existence of the regulation that restricts auditor tenure will limit the dependence of auditor on the client and possibility for violations of the independence will be reduced. Meanwhile, study by Siregar et al. (2012) find that longer tenure decreases the audit quality, but not supporting the auditor rotation as a way to solve it (mandatory rotation). They are arguing that the conflicting results are probably due to the low law enforcement in Indonesia. Besides, there is a loophole in the rotation regulation that allows audit firms to do quasi rotation (pseudo mandatory rotation).

Pseudo mandatory audit rotation is the condition where legally there has been a change of the auditor due to limit engagement period, but substantially the relationship between the auditor and the client is still in progress. In other words, pseudo mandatory audit rotation is an attempt to extend audit tenure with old clients without violating existing regulations. If pseudo mandatory rotation continues, the effect will be the same as long audit tenure.

The effect of those factors in audit quality remains vague. Because the way to measure audit quality until today is still uncertain, whether the value of audit itself already in high quality or not is still blurry. It is due to each researcher has its own dimension in assessing the audit quality (Widiastuty and Febrianto; 2010), resulted in different definition towards audit quality itself. Then, the improvement, such as by tightening the regulation, additional board for monitoring, and others cannot be measured directly, whether the effect of those also improving the audit quality itself.

Widiastuty and Febrianto (2010) stated that, practically, audit quality is how appropriate the audit with its audit standard itself (GAAP). According to DeAngelo (1981), the quality of auditing services is defined as the market–assessed joint probability that a given auditor will both (a) discover a breach in the client's accounting system, and (b) report the breach. Based on that, the way auditor in discovering the breach is depend on the auditor capabilities. Meanwhile, for auditor act in reporting the breach is depend on the auditor independence. The definition from DeAngelo above has been refused by Watkins et al. (2004). They stated that market assessed which DeAngelo used is based on the perception, not the auditor monitoring strength. Widiastuty and Febrianto (2010) also support this argument. They stated that perception is a subjective quality, due to its based on the other party and based on the past event.

Many models emerge in measuring the audit quality itself, due to a measurement is surely needed to state whether the high quality audit is already achieved or not. United States Department of the Treasury's Advisory Committee on the Auditing Profession, issue the concept regarding how measuring audit quality by using the audit quality indicators (AQI). AQI are divided into two which are input based and output based. Input based indicator is about what the auditing firm puts into its audit work to achieve a certain result. Meanwhile, output based indicator is determined by what the auditing firm has produced in terms of its audit work, which is the financial report that has been assessed by auditor by issuing their opinion.

Proxy of audit quality being used for this research is classified as output based. It means audit quality assesses from the output of audit which is financial statement. Output based being chosen because it is the result of auditor works also possibly comparable between companies. From the output based, audit quality is assesses from quality of earnings. It is due the principal (investor) usually seek the information about earnings as one parameter in determining management achievement. The management tends to do the earnings management (income smoothing) in order to rectify the report. Earnings is being chosen in assessing audit quality because it is the result from auditor works. The competency and independency of auditor should possibly detect the earnings management done by the client. Because of it researcher choose earning as the proxy. Specifically the method being followed is the abnormal working capital accruals (AWCA) by Carey and Simnett (2006).

1.2 Problem Statements

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

1. To investigate the relationship between public accountant firm size with audit quality?
2. To investigate the relationship between auditor tenure with audit quality?
3. To investigate the relationship between auditor rotations with audit quality?
4. To investigate the relationship between types of auditor rotation with audit quality?

1.3 Research Objectives

The purpose of this study is to:

1. Find empirical evidence regarding effect of public accountant firm size on the audit quality.
2. Find empirical evidence regarding effect of auditor tenure on the audit quality.
3. Find empirical evidence regarding effect of auditor rotation on the audit quality.

4. Find empirical evidence regarding effect of types of auditor rotation on the audit quality. Specifically, provide new evidences on the loophole in auditor rotation policy in Indonesia.

1.4 Research Benefits

From this research, researcher expects to:

1. For the author, this research will give knowledge and understanding related to factors affect the audit quality, and also build the competence of scientific thinking.
2. For the investor/creditor, this research will give the consideration regarding in doing some investments or credits activity to a company.
3. For the accountant/auditor, this research will give other perspectives related to factors affect the audit quality, and may improve the performance of audit services.
4. For accounting knowledge and subsequent researchers, this research will provide the information needed regarding the audit quality matters, and as a reference for the subsequent researchers.

1.5 Writing Systematic

The structure of this paper is divided into several sections, which are begins from chapter I, i.e. introduction. This chapter contains the background of the problem, the problem statement, the objectives and benefits of the research, and writing systematic. Chapter II: literature review, examines the theoretical basis and previous research. It describes the framework and formulates the research hypothesis. Then it is continued by chapter III: research method section. This chapter will discuss the research variables and operational definition of variables, population and sample, types and sources of data, methods of data collection, and data analysis methods. After that, continued by chapter IV: result and analysis of research section. This chapter contains the description of the object of research, data analysis, and the results of hypotheses testing, as well as the interpretation of the results of hypotheses testing. Lastly, the chapter V: conclusion. This chapter will present the conclusions and limitations of the research that has been done as well as advice, for further research, and for the parties concerned.