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Audit Firm Reputation versus Auditor Capability: Their Effect on Audit Quality in Indonesia

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ABSTRACT

Objective –The emergence of the ASEAN Single Window has triggered the need for higher audit quality in ASEAN countries, including Indonesia. A recent study conducted in Indonesia reveals that the reputation of auditing firms, as rated by clients and users, and auditor's competence, as rated by the auditor, are the primary determinants of audit quality. The purpose of this study is to analyze whether the reputation or competence of an auditor affects audit quality, within manufacturing companies in Indonesia.
Methodology/Technique –This paper contributes to the creation of new measurements for auditor capability, by highlighting empirical evidence concerning the determinants of audit quality in Indonesia.
Findings – By using discretionary accrual as the inverse determinant of audit quality, the result show that financial statements audited by reputable auditing firms contain the same discretionary accruals as those audited by other firms. The results further demonstrate that auditor capability does not affect audit quality. Audit quality in Indonesia is therefore not determined by firm reputation or auditor capability. Hence, it is important to search for new determinants of audit quality.
Research Limitations/Implications – The limitation of this research is the low number of reputable audit firms and specialized auditors used by the sample firms, which lead to the exclusion of numerous controlled variables that may be integral when explaining audit quality. Future studies may use other sample firms and use additional controlled variables, to further explain audit quality.
Type of Paper: Empirical

Keywords: Audit Quality; Discretionary Accrual; Audit Firm Reputation; Auditor Capability.

JEL Classification: M40, M42.

1. Introduction

The ASEAN Single Window, which began in 2013, has lead to an increase in competition between corporations in ASEAN countries, including Indonesia (Ministry of Finance Republic of Indonesia, 2014). With this renewed and intense competition, companies are finding it increasingly challenging to continue in a

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profitable state, and in particular, to demonstrate a stable financial position. This contributes to an increase in earnings management through the use of discretionary accruals. Auditing plays an important role in reducing discretionary accruals and information risk, and improving the decision-making process of companies in these situations. Thus, audit quality is very important. Finding the determinants of audit quality provides the ability for companies to focus more strictly on improving the standard of auditing quality.

A number of studies concerning audit quality have been conducted, focusing on a number of different variables. A recent study conducted in Indonesia (Dunakir, 2016) reveals that the reputation of auditing firm, as rated by their clients, and auditor capability, as rated by the auditor, are the primary determinants of audit quality. Recently, a highly successful auditing firm (Ernst & Young Indonesia) was fined \$1 million for improper audit work; issuing unqualified auditing opinions without sufficient evidence (Danubrata, 2017). Further, studies focusing on auditor capability have provided mixed results (e.g. Sutaryo and Lase, 2015; Akhtari, 2014). Thus, it is crucial to conduct further quantitative research to determine whether audit firm reputation and auditor capability are in fact determinants of audit quality in Indonesia.

In 2011, the big four accounting firms (Price Waterhouse Coopers, Deloitte Touche Tohmatsu, KPMG International, and Ernst & Young Global) received 15.17% of total clients in Indonesia, and 65.5% of the total revenue received by all public accounting firms (Center for Supervision for Finance Professions-Ministry of Finance, 2015). The reputation of the big four accounting firms contributes to their increased use by various clients. This strong reputation and corresponding client base makes it difficult for other local accounting firms to thrive and grow. This paper hypothesizes that non-big four accounting firms have a quality of audit than the big four, as a result of their reputation. However, the recent audit violation by Ernst and Young triggers the question: is audit firm reputation still relevant in determining audit quality in Indonesia?

Further studies (ex: Craswell et al. 1995; Beasley and Petroni 2001) have found that auditor capability also positively contributes to the credibility of an auditor. Auditor capability refers to an auditor's ability to work with high professional standards (Dunakir, 2016), professional knowledge, professional skills, and professional values, ethics, and attitudes required to demonstrate competence, and the attributes held by individuals that enable them to perform their roles (IAESB, 2014: 22). Barac et al. (2016) performed an interview on stakeholders of audit reporting and found that an auditor's ability to produce a high-quality audit is directly correlated to the auditor's knowledge of their clients' business and industry risks. Building and maintaining a long-standing business relationship will assist auditor's to gain a better understanding of their clients' business (e.g. Dehkordi and Makarem, 2011; Siregar et al. 2012). In turn, in order to gain a better understanding of their clients' industry, auditors should aim to have further exposure to their specific industrs. Solomon et al. (1999) refers to audit industry specialization as those auditors who spend most of their time auditing clients in one specific industry setting, and whose training and experience are largely concentrated in that particular industry. A number of studies regarding auditor capability have produced mixed results (e.g. Sutaryo and Lase, 2015; Akhtari, 2014). The difference in results may be due to measurement differences (ex: number of training, audit fee, percentage of auditors having professional certificate, auditor's tenure) as there is currently no agreed measure of auditor capability. This research aims to fill that gap, by introducing a new measurement of auditor capability, focusing on knowledge and skill.

The purpose of this study is to gain empirical evidence on high audit firm reputation and auditor capability, which are perceived as the most likely determinants of audit quality by Dunakir (2016). Additionally, due to the mixed findings produced by previous studies as a result of different client characteristics (e.g. Yuan, Cheng and Ye, 2016; Lawrence,Minutti-Meza and Zang, 2011), client characteristics were used as controlled variables in the present study. This research contributes to the area of study in two ways. Firstly, the research provides a new measurement of auditor capability, which is the combination of auditor tenure and auditor industry specialization. Secondly, the research determines whether audit firm reputation and auditor capability are in fact determinants of audit quality, as has been hypothesized by previous research.

2. Theoretical Development

Agency theory can be used to explain the relationship between two parties that are involved in a contract, consisting of the agent as a party who receives the responsibility for completing a certain task, and a principal as the party that provides instructions for the task (Jensen and Meckling, 1976). As the principal to a contract is not involved the in-agent company's operation, the agent is typically required to provide periodic reports to the principal. The principal relies on this information to measure the companies' performance, which is used as a reference when giving rewards or increasing their investment (Fama, 1980). The bonus plan hypothesis states that the manager of a firm is more likely to choose accounting procedures that allow them to get receive higher bonuses (Watts and Zimmerman, 1986). This is known as earnings management.

Earnings management refers to the choice of management for accounting policies (accrual earnings management) and/or the actions affecting earnings (real earnings management), so as to achieve some specific reported earnings objective (Scott, 2007). This paper focuses on accrual earnings management. Managers use earnings management to obtain bonuses when the actual earnings of the company are close to the bonus-earnings minimum level (bogey) or between bonus-earnings minimum level (bogey) and bonus-earnings maximum level (cap) (Scott, 2007). Other than the bonus plan hypothesis, the debt covenant hypothesis also triggers earnings management. The debt covenant hypothesis states that the company's manager is more likely to select accounting procedures that increases the current year's earnings, when a company is at risk of violating accounting-based debt covenants (Watts and Zimmerman, 1986). The threat to the availability of other resources as the result of net income decrease, for example company reputation, also triggers earnings management. Thus, managers often make choices that will improve the status and reputation of the company, and these choices may not always reflect the actual financial state of the company. This is where auditing plays an important role.

In Indonesia, auditors are required to follow the audit standards (SA) which adopt the International Standards on Auditing (ISA). The SA's impose a number of obligations on auditing firms, such as the requirement tht auditors ensure that financial statements reflect the true and fair view of the short and long-term position of an entity. These standards strictly limit the way in which auditor's conduct an audit, to ensure the auditor's integrity, independence, and competence and ensuring that financial statements are free from any adverse earnings management practices. Those quality characteristics help increase audit quality. Audit quality is crucial as the way to detect earnings management measured by discretionary accruals (Balsam et al., 2003; Becker et al. 1988).

Audit quality is a debatable topic among many parties. Users, auditors, regulators, and other audit report stakeholders may have many different outlooks on audit quality which will influence the audit (Enofe et al. 2014). From all definitions of audit quality (e.g. Choi et al., 2010; DeAngelo, 1981), it can be concluded that audit quality refers to auditor quality, and their ability to detect material misstatements in financial statements. Since many researches define audit quality with an emphasis on the quality of financial statements, earnings quality in financial statements is used as a proxy of audit quality in this study, as defined by discretionary accruals which can be manipulated by management and are usually intended to achieve a desired profitability or income (Siregar et al, 2012; Teoh et al., 1998). Higher discretionary accrual indicate a lower earnings quality, and lower audit quality.

3. Hypotheses Development

Among all of the potential characteristics, previous studies have found that audit firm reputation and auditor capability are the most powerful determinants of audit quality (e.g. Dunakir, 2016; Barac et al., 2016). Audit firm reputation is used as a surrogate of audit quality (e.g., Becker et al. 1998; DeAngelo, 1981; Francis and Krishnan, 1999; Francis, Maydew, and Sparks, 1999; Teoh and Wong, 1993). DeAngelo (1981) argues that the reputation of an audit firm influences the auditor to produce a high audit quality. Large auditing firms have greater resources to publicize their services and hence increase their reputation (Sawan and Alsaqqa, 2013). This enables them to generate a higher revenue, which allows them to hire more auditors and provide more training to their staff (Dehkordi and Makarem, 2011) as well as enjoy greater independence (DeAngelo 1981) resulting in high audit quality (Francis and Yu, 2009; Lawrence et al, 2011; Alhadab and Clacher, 2017). In addition, Comprix and Huang (2015) found that small auditing firms find it more challenging to restrain a manager's opportunistic use of discretionary accruals.

Ha1: Financial statements audited by reputable auditing firms have less discretionary accrual than those audited by other auditing firms.

Auditor capability is integral in determining audit quality (Duff, 2004; Dunakir, 2016; Barac et al., 2016; Svanberg and Ohman, 2015). Auditor capability refers to the attributes (professional knowledge, professional skills and professional values, ethics, and attitudes) needed by an auditor to demonstrate competence (Barac et al., 2016). Barac et al. (2016) and Duff (2004) found that stakeholders of auditor reports need their auditor to understand their clients' business and relevant industry risks. ISA 315 defines business risk as the risk that significant conditions, event, circumstances, actions or inactions could severely change the company's ability to achieve its goals (IFAC, 2009). Huss and Jacobs (1991) states that auditor ability refers to the clients' economic condition. Economic client characteristics are used to control business risk and industry risks that may have an effect on audit quality. To obtain a comprehensive understanding of business risks, auditors should remain in a company for a prolonged period of time, to increase their awareness of the company's business risk through the audit learning curve (PricewaterhouseCoopers, 2002; Lapre et al., 2000; Lim and Tan, 2010) and to demonstrate better audit quality (Johnson et al., 2002; Ball et al., 2005). On the other hand, shorter auditor tenure can result in increased business risk disclosure, which in turn leads to better audit quality (Fukukawa and Kim, 2017) and increased auditor independence, thus increasing investor confidence to the company (Lee et al. 2009; Dhaliwal et al., 2008; Lambert et al., 2007). One possible reason for these mixed findings is the fact that prior studies do not consider an auditors' knowledge, and the effects of auditor's tenure and knowledge are confounded (Fukukawa and Kim, 2017). An auditor's specific knowledge is the key to understanding industry risk. The more specialized an auditor is within a specific industry, the better their knowledge of industry risk will be and hence the better their audit quality will be (Balsam et al. 2003; Hegazy et al. 2015; Chin and Chi, 2009). Auditors with industry expertise generate more hypotheses on financial reporting errors (Wright & Wright, 1997), are more capable of detecting industry-related errors, irregularities, and misrepresentations (Gul et al., 2009), exhibit greater compliance with auditing standards (O'Keefe et al., 1994), are less likely to be associated with SEC enforcement actions (Carcello & Nagy, 2004), and have a higher level of client satisfaction relative to non-specialist auditors (Behn et al., 1999). In addition, the clients of industry specialists have lower levels of discretionary accruals (Balsam et al., 2003; Krishnan, 2003, 2005; Myers et al., 2005), less likelihood of financial restatement (Stanley & DeZoort, 2007), and higher disclosure quality than clients of non-specialist auditors (Dunn and Mayhew, 2004). A combination of auditor tenure and specialization builds an auditor's ability to understand their clients' business and industry risks, which contributes to a higher quality of audit.

Ha2: An auditor's capability has a positive effect on audit quality.

This study examines manufacturing companies listed on the Indonesia Stock Exchange between 2013-2015. The secondary data obtained from www.idx.co.id. Manufacturing companies were used to prevent bias in calculating discretionary accruals as a proxy of audit quality (Putri, 2013) and the manufacturing sector has a high vulnerability of fraud, due to the sector's competitive nature (Setiawan, 2011). 2013 is used because the ASEAN Single Window began in 2013, as a 'red flag' of a rapid increase in competition. The data was analyzed using SPSS v.22.

4. Results

230 observations met the study criteria, being a total of 58 companies. Descriptive statistics of other variables are described in Tables 1, 2, and 3.

Table 1. Descriptive Statistics Table

Variable	Min	Max	Mean	SD	Variable	Min	Max	Mean	SD
AQ	0.0002	0.173	0.0396	0.0314	**GROWTH**	-0.48	3.63	0.1304	0.2924
REP	0	1	0.3565	0.4800	**AGE**	1	33	18.796	7.6767
CAP	-1.205	2.373	0.0062	1.0025	**OCF**	-0.22	0.8	0.0751	0.1182
LEV	0.04	3.03	0.519	0.3959	**FC**	-3.91	48.52	4.8539	5.8138
SIZE	25.3	32.15	28.03	1.4968					

AQ = audit quality, measured by discretionary accrual cross-sectional version of Jones' model modified by Kasznik (1999); REP = audit firm reputation, measured by 1 for big 4 audit firms and 0 otherwise; CAP = auditor’s capability, measured by factor analysis of audit industry specialization and auditor tenure; LEV = Debt to total asset; SIZE = natural logarithm of total asset; GROWTH = percentage of change in total asset to total asset last year; AGE = number of years company has been listed in a stock exchange; FC = percentage of cash flow from operating activities to total asset; OCF = Altman Z- Scores bankruptcy prediction model (Z SCORE<1.8 = heading bankruptcy; Z SCORE>3 = unlikely to enter bankruptcy)

Table 2. Descriptive Statistics Audit Firm Reputation and Audit Industry Specialization Table

	Frequency	Percent		Frequency	Percent
Big 4	82	35.7%	Specialized auditor	61	26.5%
Non big 4	148	64.3%	Non Specialized auditor	169	73.5%
Total	230	100%	Total	230	100%

Table 3. Descriptive Statistics Auditor’s Capability Table

	Min	Max	Mean	SD
Tenure	1	6	2.9783	1.71926
Specialization	0	1	0.2652	0.44241

Auditor tenure is the length of time the audit partner has been the auditor of a company in a given years (number of years); Audit industry specialization variable is a dummy variable (nominal scale), 1 for specialized auditor and 0 otherwise. Specialized if audit firm controls > 10% market share in an industry

Table 4. OLS Result

Variable	t	Sig	Variable	t	Sig	Variable	t	Sig
Constant	1.894	0.06	**LEV**	4.322	0.000*	**AGE**	0.063	0.95

REP	1.283	0.201	**SIZE**	-1.32	0.188	**OCF**	-2.981	0.003*
CAP	-1.366	0.173	**GROWTH**	4.23	0.000*	**FC**	1.807	0.072**
adj R2		0.171	**F**	6.897	0.000			

AQ = audit quality, measured by discretionary accrual cross-sectional version of Jones' model modified by Kasznik (1999); REP = audit firm reputation, measured by 1 for big 4 audit firms and 0 otherwise; CAP = auditor's capability, measured by factor analysis of audit industry specialization and auditor tenure; LEV = Debt to total asset; SIZE = natural logarithm of total asset; GROWTH = percentage of change in total asset to total asset last year; AGE = number of years company has been listed in a stock exchange; FC = percentage of cash flow from operating activities to total asset; OCF = Altman Z- Scores bankruptcy prediction model (Z SCORE<1.8 = heading bankruptcy; Z SCORE>3 = unlikely to enter bankruptcy) *significant in 5% **significant in 10%

Table 4 shows that financial statements audited by reputable auditing firms contain the same discretionary accruals as those audited by other auditing firms (sig. 0.201). Therefore, Ha1 is not accepted. The results also show that auditor capability has no effect on audit quality (sig. 0.173). Hence, Ha2 is not accepted.

5. Discussion

Financial statements audited by reputable auditing firms contain the same discretionary accruals as those audited by other auditing firms. As stated by Lawrence et al (2011), there is no difference in terms of audit quality between the big four or non-big four auditing firms, because neither are held under the same regulatory and professional standards. Khurana and Raman (2004) also state that audit quality differed according to audit firm reputation, in the United States only (from 3 other countries they researched) due to the high risk of litigation in the United States. Supporting other Indonesia studies (e.g. Ali and Aulia, 2015; Rusmanto, 2016), litigation risk in Indonesia relatively insignificant. In addition, the samples used are mostly audited by non-reputable auditing firms.

Auditor capability has no effect on audit quality. This is because the sampled companies are mostly audited by non-specialized auditing firms. Yuan, Cheng and Ye (2016) found that audit industry specialization is not homogeneous across clients, and client characteristics moderate the relationship between audit industry specialization and audit quality. Thus, audit industry specialization has no affect on audit quality. To confirm this finding, this study splits the effect of auditor tenure and auditor industry specialization on audit quality. When this occurs, auditor tenure has a positive effect on audit quality, with significance level below 10% (sig. 0.093). However, audit industry specialization still has no effect (sig 0.861) (not tabulated).

6. Conclusion

This research aims to demonstrate whether audit firm reputation and auditor capability are in fact determinants of audit quality in Indonesia according to a survey conducted by Dunakir (2016). The findings show that audit quality of manufacturing firms in Indonesia is not influenced by audit firm reputation or auditor capability. Auditor capability does not have an effect on audit quality because of audit industry specialization. If audit firm reputation has no effect on audit quality, an interview with the board of commissioners is needed to clarify the hidden agenda of external auditor choice (to increase audit quality or not).

The identification of the determinants of audit quality is crucial. To improve the quality of study in this area, researchers should also take part in the auditing process, to capture the real determinants of audit quality. Similar to other empirical investigations, this study is not without certain caveats. First, this paper's findings lack a sensitivity analysis check, particularly for auditor capability which is measured using a new measurement. Further studies may refine the measurement of auditor capability to ensure sensitivity of the results. Secondly, a low number of specialized auditors and reputable auditing firms were used, which has an affect on the results. Examining other industries may achieve different results. Thirdly, other variables that may affect audit quality, such as country characteristics (e.g. Leventis, 2017), board characteristics (Zalata, Tauringana, and Tingbani, 2018) or other auditor characteristics, such as educational background, Big N audit firm experience, ranking within the auditing firm, and political affiliations (e.g. Gul et al., 2013) are not considered in this paper. Future studies should consider these variables as they may affect audit quality.

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