



The Effect of Auditor Reputation, Audit Tenure, and Firm Size on Audit Quality

(A Study of Manufacturing Companies Listed on the Indonesia Stock Exchange for the 2013-2017 Period)

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ABSTRACT

We intend to study the effect of auditor reputation, audit tenure and firm size on audit quality in manufacturing companies listed on the Indonesia Stock Exchange for the 2013-2017 periods. Logistic regression analysis is the appropriate regression model for this study that uses categorical independent variables (nominal or non-metric) and metric and non-metric dependent variables. Logistic regression analysis does not require assumption of normality for the independent variable data. From the analysis described in earlier sections, we have come to the conclusion that (1) auditor reputation affects audit quality; (2) audit tenure does not affect audit quality; and (3) firm size affects audit quality.

Keywords: *Audit Tenure, Firm Size, Audit Quality.*

1 INTRODUCTION

The development of capital market activity encourages investors to demand relevant and reliable information obtained from the financial statements prepared by the management. The financial statement serves as a tool providing information that connects companies with stakeholders with regard to the company's performance and financial condition [1]. Relevance and reliability are the characteristics of financial statement based on Financial Accounting Standard (FAS).

To guarantee the quality of their financial statements, the company and the stakeholders need a third party, i.e., an independent party that provides services to examine the fairness of presentation of information in the financial statements. This is an important thing to consider because it makes up one of the main aspects in performing the capital market functions. From the description in the above section, we intend to study the effect of auditor reputation, audit tenure and firm size on audit quality in manufacturing companies listed on the Indonesia Stock Exchange for the 2013-2017 periods.

2 THEORETICAL FRAMEWORK AND HYPOTHESIS DEVELOPMENT

Agency theory is the core of the contractual view of the company [2]. According to Jensen and Meckling (1976) in [3], agency theory describes the contractual relationship in which one party (the principal) hires another party (the agent) to perform the job and delegates a decision-making authority to the agent. Audit quality as the auditor's ability to detect misstatement and errors in financial statement [4]; the likelihood that an error could be detected depends on the auditor's ability, while auditor's courage to report errors in financial statements depends on his or her independency.

Auditor's reputation represents his achievements and the public trust in his performance. Tenure is the period of auditor-client engagement agreed upon as the length of bonds between the auditor and the client. According to [5], the firm size is the measure of a company as indicated by the total assets, total sales, profitability, tax rate, etc.

3 HYPOTHESIS DEVELOPMENT

The reputation of the Public Accounting Firm (PAF) has a positive effect on audit quality [3]. Big PAFs are identical with highly reputed PAFs. Big PAFs tend to have better capacity of audit functions because they are well-experienced and knowledgeable in their particular field. From the opinions described earlier, it can be concluded that the auditor's reputation can improve audit quality. The better the auditor's reputation, the higher the audit quality will be. From the points described earlier, the hypothesis might be developed as follows:

H1: The auditor's reputation has an effect on audit quality.

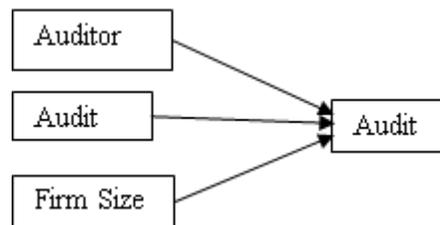
The results of high-quality financial audit are characterized by auditor's independence and professionalism. Therefore, audit tenure is of necessity to maintain auditors' independence and to improve their performance. The period of auditor-client company engagement, during which the former audits the latter's financial statements, is intended to provide higher audit quality of the company's financial statements. This might be the case because the auditor keeps from getting too close to the client in order to maintain his independence in performing his auditing functions. This indicates that audit quality improves with an increase in audit tenure. Furthermore, this provides Public Accounting Firm with a lesson to learn in every economic bond between the auditor and the client company. From the above description, the following hypothesis can be developed:

H2: Audit Tenure has an effect on audit quality.

Company size may affect audit quality. Large-sized companies, because of their operational complexity and increased separation of management and shareholders, are indispensably need PAFs to reduce agency cost. Greater agency conflicts may lead to an increasing need to identify quality auditors. Therefore, large-sized companies tend to choose large PAF to provide quality audit report. Audit quality is perceived to be higher in small companies [6]. Company has an effect on audit quality and proves that the size of client company has an effect on audit quality and, therefore, indicates that the larger the client company size, the higher the audit quality is [7]. Based on the above description, the following hypothesis can be formulated:

H3: Company size has an effect on audit quality.

4 CONCEPTUAL FRAMEWORK



5 RESEARCH METHODOLOGY POPULATION AND SAMPLE

The population of this study consists of manufacturing companies listed on the Indonesia Stock Exchange for the 2013-2017 period. The study employed purposive sampling, which is a sampling technique based on the researcher's judgment and criteria. The criteria used in this research study are:

1. Manufacturing companies listed on the Indonesia Stock Exchange during the observation period of 2013-2017;
2. Companies that issued annual financial statements from 2013 to 2017 consecutively; and
3. Companies that suffered no losses over the 2013-2017 period.

Operational Definition of Variables *Dependent Variable*

The dependent variable in this study is audit quality. The audit quality here is proxied by earnings benchmarks. Audit quality is related to the company's profit management efforts, such as to avoid net losses, to make sure that the auditor is capable of disclosing and reporting the management profit. We use ROA (earning/total assets) as the formula for audit quality. Earnings benchmarks are represented as $\mu - \sigma < ROA < \mu + \sigma$, where μ is the average ROA of all sample companies and σ is the deviation. Audit quality is divided into two categories:

- a. High-quality audit (MEET_BE=1) for the amount of profit within a normal range.
- b. Low-quality audit (MEET_BE=0) for the amount of profit exceeding a normal range. It is assumed to be low if:
 1. the profit exceeds earnings benchmarks ($ROA > \mu + \sigma$); and

- the losses exceed earnings benchmarks ($ROA < \mu - \sigma$).

Independent Variable

Auditor's reputation represents his achievements and the public trust in his performance. The Big Four PAFs are more independent than their non-big four counterparts [8]. Assuming that the big-four PAFs are better reputed, their auditor reputation will, therefore, affect the audit quality. Reputation in this study is measured on the big 4 and non-big 4 groups. The big-4 auditors are identical with the big PAFs. The big four PAFs are identical with highly reputable PAFs [9]. PAF reputation is measured on dummy variable: 1 for PAFs affiliated with those belonged to the big 4, and 0 for those not affiliated with the big four PAFs.

Audit tenure is the period of auditor-client engagement agreed upon as the length of bonds between the auditor and the client. Audit tenure in this study refers to a study by [1] that used an interval scale in accordance with the length of bonds between the PAF auditor and the client company. Audit tenure is measured by calculating length of bonds in which the auditor of the same PAF build an audit relationship with the auditee; the first year of bonding is numbered 1, and followed by 1 for the next year. This information can be found in the independent auditor' report for several years that tells us how long do the PAF auditors audit the client company.

Firm size may affect the quality of auditing. Large-sized firms, because of their operational complexity and increased separation of management and shareholders, are indispensably needed PAFs to reduce agency cost. Greater agency conflicts may lead to an increasing need to identify quality auditors. Therefore, large-sized companies tend to choose large PAF to provide high-quality audit report. The size of firm is defined as the natural logarithm of total assets. (Firm size = \ln of total asset).

6 DATA ANALYSIS

Logistic Regression Analysis

According to [10], logistic regression analysis is the appropriate regression model for a study that uses categorical independent variables (nominal or non-metric) and metric and non-metric dependent variables. Logistic regression analysis does not require assumption of normality for the independent variable data.

Analysis and Discussion Research Data

Table 1: Data Collection

No.	Description	Total
1.	Manufacturing companies listed on the Indonesia Stock Exchange for the 2013-2017 period.	139
2.	Companies that did not issued annual financial statements from 2013 to 2017 consecutively.	(15)
3.	Companies that suffered losses over the 2013-2017 period.	(56)
4.	Total Companies	68
5.	Grand total of companies over the research period (68*5 th)	340

Overall Model Fit

In the initial block 0, the value of -2LogLikelihood is 229.717. The testing of block 1, by including all variables, resulted in -2LogLikelihood value of 166.490. This decreasing value is, therefore, indicates that the overall hypothesized models fit the data.

Table 2: Overall Model Fit

Description	Value
-2Log Likelihood pada awal (block number = 0)	229,717
-2Log Likelihood pada akhir (block number = 1)	166,490

Coefficient of Determination (Nagelkerke R Square)

Table 3: Coefficient of Determination

Step	-2 Log likelihood	Cox & Snell R Square	Nagelkerke R Square
1	166,490 ^a	,170	,345

Table 3 indicates the values of Nagelkerke R Square of 0.345 or 34.5%, which means that the independent variable could explain 34.5% of variation of dependent variable, while the rest 65.5% was explained by independent variables not included in this study.

Feasibility of Regression Model

Table 4: Feasibility of Regression Model

Hosmer and Lemeshow Test			
Ste p	Chi-square	df	Sig.
1	1,733	8	,988

Table 4 indicates a significance value greater than 0.05, which means that it can be concluded as capable of predicting its value of observation.

Hypothesis Tests (Wald Test)

Table 5: Hypothesis Tests

	B	Wald	df	Sig.
Rep	-4,703	19,999	1	,000
Ten	,130	,877	1	,349
Uk.prs	,355	6,360	1	,012
Constant	-4,893	1,505	1	,220

Table 5 indicates that the test was conducted by comparing the P value to the significance level (0.05). Therefore, it can:

1. The significance value for auditor reputation is 0.00, or less than 0.05. This means that auditor reputation has an effect on audit quality.
2. The significance value of audit tenure is 0.349, or greater than 0.05. This means that audit tenure has no effect on audit quality.
3. The significance value for firm size is 0.012, or less than 0.05. This means that firm size has an effect on audit quality.

7 RESULTS AND DISCUSSION

The result of the Wald test is -4.703 at a significance level of $0.000 < 0.05$. Because the significance level is less than $\alpha = 0.05$, the results of this study indicate that auditor reputation has an effect of audit quality. According to the study by Nadia (2015), auditor reputation has an effect on audit quality because big PAFs, proxied in this study with the big 4, are identified with highly reputed PAFs. PAF reputation also suggests auditors' capability to be independent in performing their audit functions professionally. This, in turn, makes PAFs less dependent economically on their client, and, likewise, the

client can not easily influence the auditors' opinion. Big PAFs tend to have better capacity of audit functions because they are well-experienced and knowledgeable in their particular field.

The Wald test shows a coefficient of 0.130 at a significance level (p-value) of $0.349 > 0.05$. Because the significance level is greater than $\alpha = 0.05$, the second hypothesis is rejected. The study, therefore, provides no evidence for the hypothesis that audit tenure affects the audit quality. Thus, both long and short period of bonds did not affect the audit quality. According to the study by [3], audit tenure did not affect audit quality because the length of bond between auditor and client may interfere with auditor independence and, hence, affect the auditor opinion in assessing the client company's financial report. This might be the case because, as time goes by, it is highly likely that the auditor is required to fulfill what the management is expected as they develop closer relationship as a result of longer tenure or long-term bond. Auditor independence may actually decrease and, thereby, reduces the audit quality.

The third hypothesis testing is intended to analyze the effect of firm size on audit quality. Firm size is measured by Ln of total asset. The Wald test shows a regression coefficient of 0.355 at a significance level (p-value) of $0.012 < 0.05$. Because the significance level is less than $\alpha = 0.05$, the third hypothesis is accepted. Thus, the results of this study provide evidence that firm size affects audit quality. The results are in accordance with those of [6] asserting that firm size has an effect on audit quality, which means that the bigger the client company, the higher the audit quality will be. Large-sized companies, as it is measured by total asset, tend to have operational complexity and increased separation of management and shareholders, and, thereby, indispensably need PAFs to reduce agency cost. Greater agency conflicts may lead to an increasing need to identify quality auditors. Therefore, large-sized companies tend to choose large PAFs with experienced auditors to provide high-quality audit report.

8 CONCLUSION AND SUGGESTION

From the analysis described in earlier sections, we have come to the conclusion that:

1. Auditor reputation affects audit quality;
2. Audit tenur does not affect audit quality; and
3. Firm size affects audit quality.

Suggestion

1. Considering that the Nagelkerke's R Square value is low, future researches are expected to include additional independent variables such as audit fee, auditor opinion, and audit delay in order to increase the capacity to explain the variation in the dependent variable.
2. Because audit tenure does not affect audit quality, we suggest additional variable, e.g. auditor independence, to make it more possible for the researchers to determine the effect of auditor independence on audit quality.
3. To use other proxies, such as discretionary accrual, to assess the audit quality.

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