

# Audit Quality

*by Hariman `*

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## Kualitas Audit: Wawasan Dari Jasa Audit Nyata

*AUDIT QUALITY: INSIGHT FROM REAL AUDIT TENURE*

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### ABSTRAK

Penelitian ini bertujuan untuk menguji hubungan antara masa kerja nyata dan kualitas audit. Ada dua alasan utama yang mendasari penelitian ini: yang pertama adalah perdebatan tentang dampak masa kerja pada kualitas audit antara perspektif peraturan dan ekonomi. Sudut pandang regulasi berpendapat bahwa pembatasan masa kerja dapat meningkatkan kualitas audit, sedangkan perspektif ekonomi menyatakan bahwa pembatasan tersebut dapat meningkatkan biaya perikatan audit awal dan oleh karena itu menurunkan kualitas audit. Kedua, penelitian ini mengelaborasi fenomena rotasi auditor semu yang mungkin menyesatkan perhitungan masa kerja auditor di suatu perusahaan. Penelitian ini menggunakan 238 perusahaan dari berbagai sektor industri. Hasil uji Regresi menunjukkan hubungan positif antara tenurial riil dengan kualitas audit. Oleh karena itu, hasil ini sejalan dengan perspektif ekonomi yang bertentangan dengan pembatasan masa kerja audit baik pada auditor maupun kantor akuntan publik.

**Kata kunci:** *kualitas audit, masa audit nyata, bias keakraban*

### 2 BSTRACT

*This study intends to examine the association between real tenure and audit quality. There are two main reasons underlying this study: the first is the debate on the impact of tenure on audit quality between regulatory and economic perspectives. Regulatory viewpoint argues that tenure restriction could increase audit quality, while economic perspective states that such restriction could increase initial audit engagement costs instead and therefore decrease audit quality. Secondly, this study elaborates the phenomenon of pseudo auditor rotation which possibly misleads the calculation of auditor tenure in a company. This study utilizes 238 companies from various industrial sectors. The Regression test result shows positive association between real tenure and audit quality. Therefore, this result is in line with economic perspective which contradicts the restriction of audit tenure both on auditor and public accountant firms.*

**Keywords:** *audit quality, real audit tenure, familiarity bias*

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## INTRODUCTION

Audit quality has always become an interesting topic (Read & Yezegel, 2016; Lee & Levine, 2020). Studies on audit quality are encouraged by significant numbers of manipulated financial statements. The user of financial statements questions the ability of auditors to guarantee the quality of the financial statements. Some of the most notable cases are Enron Worldcom, Chrysler (automobile company), Lehman Brothers, Washington mutual (bank), Xerox group, etc.

The previous researchers have long attempted to investigate factors influencing audit quality. Some of those investigated factors are client importance (e.g: Dopuch & King, 1996 and Gul et al., 2009), non-audit service (M. Frankel et al., 2002 and Srinidhi & Gul, 2007), client affiliation (e.g.: Menon & Williams, 2004 and Geiger et al., 2005) and audit tenure (Myers et al., 2003; Chen et al., 2008; and Carey & Simnett, 2006). Each antecedent has various association with audit quality.

Audit quality construct needs to be further analyzed due to several logical reasoning. First, there are contested ideas on the associated between audit tenure and audit quality. Those in favor of the regulation argue that long tenure could obstruct the creativity of audit procedure due to familiarity effect. Furthermore, they believe that such

tenure could cause emotional bond between auditor and client hence disrupts their independence. Those who oppose the regulation argue that the length of tenure could enhance the auditor's experience and knowledge of business environment of a company. This later enables them to identify risky accounts and ultimately decrease economic cost in audit.

Secondly, the previous research yields inconsistent result. Some researchers find positive association between audit tenure and audit quality (Van Johnson et al., 2002; Carcello & Nagy, 2004; and Jenkins & Velury, 2008). Other researchers support the argument that long audit tenure would decrease audit quality (Deis & Giroux, 1992; Bazerman et al., 2002; and Davis et al., 2009). Some others do not find any association between audit tenure and audit quality (Myers et al., 2003 and Carey & Simnett, 2006).

Third, previous studies have also tried to examine the association of both. Yet those studies have not really examined the phenomenon of real tenure. In Indonesia, there are regulations restricting audit tenure, which oblige audit firm and public accountant to switch after six and three years respectively. In practice, such change is not done properly. Accounting firms sometimes change their names so that it continues auditing the same company that

exceeds the specified regulatory restriction, i.e., six years (Febrianto et al., 2017 and Junaidi et al., 2012). Thus, research on audit tenure so far has not included the additional tenure caused by pseudo rotation. This aspect is the novelty of this research.

Fourth, though this study has similar basic concept to research on auditor rotation which examines regulation-based audit quality, this current study has its own uniqueness. Research on rotation only captures the phenomenon of audit quality when auditor rotation takes place; it does not really observe the decrease of audit quality when tenure is getting longer.

Fifth, audit quality is a crucial construct to reflect on the auditor's capability to detect misstatements and to report it (DeAngelo, 1981). Inability to detect misstatements in financial statements could mislead the stakeholders since financial statement is one of the basic information in decision-making process.

This research responds to the regulation regarding audit tenure restriction. Based on the concept of familiarity bias (International Federation of Accountants (IFAC), 2018), auditors, who perform repeated audits and are exposed to a business environment for a long period of time in a company, may have considerations influenced by the risk information in a certain

account which happens more frequently. Consequently, they ignore the risks of other accounts that may be present at the time the audit is being done. However, this assumption contradicts the concept of independence and skepticism the auditor has to possess. Therefore, examination on audit tenure towards audit quality attempts to provide empirical evidence for the two contradicting concepts by using real tenure to capture the phenomenon of pseudo rotation. This research utilizes quantitative approach based on capital market data. The sample of this research is companies listed in the Indonesia Stock Exchange (BEI) from 2015 to 2019.

This research contributes to the provision of empirical evidence of the policy of tenure restriction made by the government. This study, furthermore, aims at producing evidence whether or not real tenure (tenure which exceeds the regulation limit due to pseudo rotation) affects audit quality.

## **LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT**

### **Previous research on audit quality**

The researcher utilizes various proxies when examining audit quality. There are some proxies frequently used in secondary-data-based research: discretionary accrual (DA) (Chi et al., 2009 and Bills et al., 2016), tendency of issuing going

concern opinion (M. Geiger & Raghunandan, 2002 and Read & Yezege, 2016), restatement (Bills et al., 2016 and Lobo & Zhao, 2013). Non-core earnings and small earning (Gul et al., 2013), Investor's perception (Dee et al., 2015), total Non-compliance incidents (Elder et al., 2015) and Adjustment of profit (Lennox et al., 2014).

DA is the most used audit quality proxy in secondary-data-based research. A number of factors related to DA have been investigated by the previous researchers. Tenure/rotation (Van Johnson et al., 2002; Myers et al., 2003; Carey & Simnett, 2006; and Davis et al., 2009), association membership (Bills et al., 2016), concentration of audit market (Huang et al., 2016), individual characteristic (Goodwin & Wu, 2016), contagion effect (Francis & Michas, 2013), regulation and disclosure (Dee et al., 2015), Audit Effort (Kwon et al., 2014), type of public accounting firms (Asthana et al., 2015), Experience (Cahan & Sun, 2015), dan Audit Fee (Gul et al., 2009) ) are all explanatory factors of audit quality.

Besides DA, another audit quality proxy commonly used is the tendency of issuing going concern opinion. The use of this proxy is associated to various factors: tenure (e.g., M. Geiger & Raghunandan, 2002; Read & Yezege, 2016; and Carey & Simnett, 2006), concentration of audit market (Huang et al., 2016),

individual characteristic (Gul et al., 2013), and managerial skill (Krishnan & Wang, 2015).

Another frequently used audit quality proxy is restatement. Restatement indicates low audit quality. Some studies examine the association between restatement and tenure/rotation (Myers et al., 2003), association membership (Bills et al., 2016), audit committee (Archambeault et al., 2008), and audit effort (Lobo & Zhao, 2013). Myers et al. (2003) find that auditor tenure does not associate with the probability of earnings restatement. Bills et al. (2016) find that clients audited by association members have lower annual misstatements compared to non-member ones. Archambeault et al. (2008) state that there is a positive correlation between short-term stock option grants for audit committee with restatement probability.

### **The concept of familiarity bias in judgment**

Familiarity bias is a concept referring to the impact of making alternative decision which has been frequently done or based on the previous experiences without really considering objective, empirical-data-based information (Baker & Nofsinger, 2011). ). Familiarity bias concept has been utilized in investment research field (Baker & Nofsinger, 2011 and Grullon et al.,



2004). This bias is adopted as an alternative to rational decision making based on portfolio theory. Investment decisions are triggered not only by rational decisions but also familiarity bias.

Studies comprising familiarity bias are mostly conducted in the field of investment decisions. De Vries et al. (2017) find that investors would rather invest in local, more accessible companies rather than invest in companies they are not familiar with. Other researchers have also found that investors show preference in investment in companies they are more familiar with and would be less considerate of other investment alternatives (Huberman, 2001; Speidell, 200; and Grullon et al., 2004).

In psychology, familiarity effect could also affect one's judgment against others. This effect would probably threaten objectivity and then result in biased decision making. Stroud et al. (2011) examine the objectivity of assessments towards medical students. They find that the assessors' familiarity with the students is positively associated to the scores assigned to them.

Familiarity bias is also assumed to be present within the **relation between the auditor and the client**. For this reason, the regulator creates regulations on tenure restriction. By referring to familiarity bias, the auditor's independence would potentially be undermined and

therefore affect the audit procedures and the reported audit results.

### **The relation between audit tenure and audit quality**

The relation between audit tenure and audit quality is built upon two distinct opinions. The first opinion claims that long audit tenure would decrease audit quality (Mautz, 1972) while the second opinion states that long audit tenure would enhance the understanding of client's business operation to later on improve audit quality (DeAngelo, 1981).

The first opinion is based on the argument of familiarity threat which may disturb the auditor's independence and decrease audit quality as stated in International Federation of Accountants (IFAC), (2018):

*"Familiarity threat – the threat that due to a long or close relationship with a client or employer, a professional accountant will be too sympathetic to their interests or too accepting of their work".*

Other than familiarity threat, IES also states that there is self-review threat. It refers to threat to professional accountant who fail to evaluate past consideration done by himself or other accountants in the same firm. This argument imply that audit quality would decrease when audit tenure improves.

Mautz (1972) explains that long-time relation between auditor and client does not necessarily disrupt one another, but still potentially

causes independence problems. The previous arguments also state that long audit tenure would undermine the independence and ultimately decrease audit quality. Such decline is also affected by self-review threat—failure in making use of past consideration, which could possibly affect present audit and its quality.

The second argument based on DeAngelo (1981) states that audit tenure is positively associated to audit quality. there is a learning effect for auditors with a long tenure. Such learning will provide accumulated knowledge about the client and that knowledge could improve auditor skill in detecting material misstatements. Lack of knowledge about the client during the initial engagement will lead to the lack of detectability and thus take time to understand the client in order to produce a audit quality. Empirical evidence supports the above arguments. Some find that there is a positive association between audit tenure and audit quality, while the rest exhibits negative association.

Studies on audit quality utilize several proxies, i.e. earning restatement, going concern opinion, accrual, and investor's reaction. Research on audit tenure and earning restatement presents negative correlation between audit tenure and earning restatement (M. Geiger & Raghunandan, 2002 dan Carcello & Nagy, 2004). This result indicates that audit tenure has positive correlation to quality of earnings. Research on audit quality using accruals as the proxy supports the first argument

claiming that there is positive correlation between audit tenure and audit quality (Myers et al., 2003; Gul et al., 2009; Chen et al., 2008; and Kwon et al., 2014).

Testing on audit tenure toward investors' reactions also support the first argument. Mansi et al. (2004) find that investors insist on a lower rate of return when audit tenure increases. This provides evidence that bond investors pay attention to audit tenure. Ghosh & Moon (2005) use ERC to measure the perception of audit quality; they find that the size of ERC increases when the relationship between auditors and clients are getting longer. They also find that the effect of earnings statements on Standard & Poor's stock gets bigger as tenure increases. This indicates that the agent's perception on earnings statements is more reliable when audit tenure increases.

Some other studies support the second opinion stating that the increase of audit tenure decreases audit quality. Research utilizing earning statement is conducted by Dopuch & King (1996). They find that tenure limitation could minimize the bias toward clients.

Another research using going concern opinion as the proxy of audit quality shows negative correlation between audit tenure and audit quality. Long audit tenure minimizes the tendency to issue going concern opinion (Carey & Simnett, 2006 and Junaidi et al., 2012). This indicates that the restriction on audit rotation seems to be effective in improving audit quality.

The existing literature shows that research on audit tenure has been adequately conducted. However, those studies have not really reflected on the phenomenon of pseudo rotation exhibited by public accounting firms which affect the real tenure. The calculation of audit tenure is often based on the regulation of tenure restriction. Though in practice, a lot of accounting firms conduct an audit in a company exceeding the regulated restriction. The previous arguments show conflicting views regarding the relationship between audit tenure and audit quality. Furthermore, each argument has empirical support, so this study formulates the research question as follow;

H1: Dose real audit tenure have an impact on audit quality?

## RESEARCH METHOD

This study utilizes quantitative approach based on capital market search. This study utilizes all companies listed in the Indonesia Stock Exchange (BEI) from 2015 to 2019 except for the financial sectors consisting of banks, financial institutions, security companies, insurance and mutual funds. We excluded the financial sectors from our samples because the sectors have special regulation that have an impact on earning management which is the measure of the dependent variable in this study.

All data are obtained through the official website of BEI. This study used purposive sampling. The

selection of samples is based on certain criteria, including the companies listed in the BEI during the year of observation, the company presents financial statement data using Rupiah as the currency, there are auditor's reports during the year of observation and the company has comprehensive data encompassing the variables used in this study. The total samples are 238 companies.

This study examines the association between real tenure and audit quality. Independent variable in this research is real tenure for accounting firm not for public accountant. The real tenure is the length of a public accounting firm auditing a certain company. The length of KAP auditing a particular company refers to accumulated tenure after considering pseudo rotation. For instance, ABC company is audited by KAP LM for 6 consecutive years. Due to the obligation of rotation, KAP LM replaces its name into KAP LMN and continues to audit ABC company for the next 3 years. In that case the real tenure is 8 years.

Dependent variable in this study is audit quality. It is measured by using discretionary accruals. The smaller the discretionary accrual, the better the audit quality is and vice versa. This study utilizes a modified Jones model to measure discretionary accruals. The steps of DA calculation with this model are shown below;

1. Calculating the total accruals (TAC), i.e. net income of year  $t$  subtracted by cash flow operation in year  $t$  using this formula:



$$TAC = NI_{i,t} - CFO_{i,t}$$

Next, TA is estimated using Ordinary Least Square as follows:

$$\frac{TA_{i,t}}{A_{i,t-1}} = \alpha \frac{1}{A_{i,t-1}} + \beta_1 \left( \frac{\Delta REV_t}{A_{i,t-1}} \right) + \beta_2 \left( \frac{PPE_t}{A_{i,t-1}} \right) + \varepsilon_i$$

2. Using regression coefficient as formulated above, nondiscretionary accruals (NDA) is determined by using this formula:

$$NDA_{i,t} = \beta_1 \left( \frac{1}{A_{i,t-1}} \right) + \beta_2 \left( \frac{\Delta Rev_{i,t} - \Delta Rec_{i,t}}{A_{i,t-1}} \right) + \beta_3 \left( \frac{PPE_{i,t}}{A_{i,t-1}} \right)$$

3. Lastly, discretionary accruals (DA) as the measures of earnings management is defined by using this formula:

$$DA_{i,t} = \frac{TA_{i,t}}{A_{i,t-1}} - NDA_{i,t}$$

**Notes :**

- $DA_{i,t}$  : Discretionary Accruals of company  $i$  in year  $t$
- $NDA_{i,t}$  : Nondiscretionary Accruals of company  $i$  in year  $t$
- $TA_{i,t}$  : Total Accruals of company  $i$  in year  $t$
- $NI_{i,t}$  : Net Income of company  $i$  in year  $t$
- $CFO_{i,t}$  : Cash Flow Operation  $i$  in year  $t$
- $A_{i,t-1}$  : Total Assets of company  $i$  in year  $t-1$
- $\Delta Rev_{i,t}$  : Revenue of company  $i$  in year  $t$  subtracted by revenue of company  $i$  in year  $t-1$
- $PPE_{i,t}$  : property, factory, and equipment of company  $i$  in year  $t$
- $\Delta Rec_{i,t}$  : Receivables of company  $i$  in year  $t$  subtracted by receivables of company  $i$  in year  $t-1$

$\varepsilon$  : Error

This study used control variables as in previous studies. The control variables aim to increase the internal validity by restricting the influence of confounding variables or other variables to ensure the relationship between independent and dependent variable. Based on previous studies, this study used leverage and total asset as control variables.

The data are analyzed by using general least square (GLS). GLS was used because the data in this study did not meet the multiple regression assumption, especially heteroscedasticity. The first assumption is normality. The probability value of Jarque-Bera is 0,000. This value means that the data is not normally distributed. However, the analysis regression could still be continued based on central limit theorem.

The second assumption is heteroscedasticity. This study used Meanhitney test to determine whether the multiple regression meets the heteroscedasticity assumption. The result show there is a problem in heteroscedasticity (p-value smaller than 0,05). The third assumption is multicollinearity. The VIF value for tenure, total assets and leverage are below 10. This means that there is no multicollinearity problem.

The following equation is the research model used in this study.

$$DA = \alpha + \beta_1 Tenure + \beta_2 LA + \beta_3 LEV + \varepsilon$$

**Notes :**

DA : Discretionary accrual  
 $\alpha$  : Constant  
 Tenure : The length of relation between KAP and client  
 LA : Ln Asset  
 Lev : Debt to equity ration  
 $\beta$  : Parameter coefficient  
 e : error

**RESULTS AND DISCUSSION**

The distribution of industry-based samples is shown in Table 1. 28.151% of the companies utilized in this study are companies in the sectors of trading, service and investment. Companies in mining sector are the smallest sample in this study (only 8 companies or 3.361%)

**Table 1.** Distribution of Industry-Based

Industrial Sector	Frequency Sample	Percentage
Agriculture	12	5,042%
Mining	8	3,361%
Basic Industry and Chemicals	39	16,387%
Manufacturing Industry	18	7,563%
Consumption Goods	34	14,286%
Properties, Real Estate and Building	35	14,706%
Construction Infrastructure, Utilities and Transportation	25	10,504%
Trading, Service and Investment	67	28,151%
Total	238	100%

Table 2 presents descriptive statistics for 238 companies. Real audit tenure on a single client takes 1 to 11 years. The average of real tenure is 5.187. It indicates that a company conducts an audit repetitively exceeding the restriction by regulation. The range of DA variable is from -0.011 to 0.061 with 0.0001 average value.

**Table 2.** Descriptive Statistics

Variable	Min	Max	Mean	Dev. Std.
DA	-0.0113	0.061	0.0001	0.002
Tenure	1	11	5.1873	3.040
Ln Asset	22.757	35.184	28.624	1.662
Lev	0.0005	973.4	1.4340	28.36

This study examined the influence of real audit tenure on audit quality. Table 3 shows that the coefficient of real tenure is -0.0000000, with 0.0411 of p-value. The result indicates that the higher the tenure, the lower the DA would be. In other words, high tenure contributes to higher audit quality.

The research question states the impact of real audit tenure on audit quality. The result indicates there is a positive association between real audit tenure and audit quality.

**Table 3.** Results of Real Audit Tenure Testing on Audit Quality

Independent Variable	Expected Coefficient	Coefficient	P-value
Real Tenure	-	-0,000005	0,0411

Control Variable			
Ln Asset	+	0,000 017	0,000 0
Leverage	+	- 0,000 000	0,9915
R <sup>2</sup>		0,015	
F-Statistic (P-value)		6,183228 (0,000361)	

The result supports the economic perspective than regulatory one. In other words, this result indicates that high tenure associate with high audit quality. Long real audit tenure enhances client's business understanding. This understanding triggers the auditor's ability to identify business risks and perform appropriate audit procedures and consequently improve audit quality. The data of this study does not support familiarity bias that is presumed to reduce audit quality.

The mechanism of the positive relationship between real audit tenure and audit quality could be explained as follows. Firstly, repeated audit on a client result in accumulated experiences regarding the client's business characteristics. Consequently, the auditor would be able to figure out accounts at risk and conduct appropriate audit procedure. Such accumulated experiences correspond to cumulative learning theory (Gagne, 1968). This theory claims that accumulation of ability and knowledge gained during a particular process would become the

basis of future knowledge development. Therefore, the duration of an audit on a client would help the auditor extend his knowledge and capability to select the most appropriate procedure to improve the audit quality.

Secondly, real audit tenure exceeding 5 years is mostly done by auditors affiliated with the Big Four (PWC, E&Y, KPMG and Deloitte). Public accounting firms affiliated with the Big Four have certain norms and quality standards. This is in connection with social influence theory (S. Davis et al., 2006) stating that one's behavior is determined by his surrounding and could take form of compliance pressure, obedience pressure and conformity pressure. Public accounting firms affiliated with the Big Four are encouraged to obey and follow their affiliations. This argument is supported by previous studies that find audit quality of accounting firm which are affiliated with big four is than those which are not (Tendeloo & Vanstraelen, 2013; Becker et al., 1998; and Francis et al., 1999). As explained earlier, the samples of this study with audit tenure above 5 years are dominated by the Big Four.

Lastly, this finding is in line with previous research. Studies utilizing restatement as the proxy of audit quality argue that long audit tenure affects restatement negatively (M. Geiger & Raghunandan, 2002 and

Carcello & Nagy, 2004). Myers et al. (2003) and Gul et al. (2009) believe that there is a negative association between audit tenure and discretionary accrual. This shows that the longer the tenure, the higher the audit quality would be.

## CONCLUSION

This study aims at investigating the association between real audit tenure and audit quality. The finding of this study does not support the proposed hypothesis. There is a positive association between audit tenure and audit quality after including tenure affected by pseudo rotation. The finding confirm economic perspective does not confirm regulatory perspective that assumed familiarity bias in long relationship between accounting firm and client

The fact that real tenure is positively associated with audit quality serves as suggestion to regulator. The regulator should not focus on the tenure restriction but emphasize the competency enhancement of accounting firms.

However, the limitation of these findings should be considered; first, it is limited to determine the first year's tenure for some companies due to inadequate data availability—data are only available starting from 2009, therefore this study assumes that the tenure starts from 2009. Second, this study focuses on companies listed in

BEI, so that the auditors are big accounting firms. As a consequence, additional audit tenure due to pseudo rotation on small-sized companies could not be generalized. Third, this study has not classified real audit tenure done by the Big Four and those who do not affiliate to the Big Four. To better understand the influence of tenure on audit quality, future research is suggested to investigate such phenomenon on medium and small-sized companies. This would serve as a more comprehensive input for the policymaking process regarding audit tenure restriction.

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