



# The Differences of Audit Quality on the Regulation of Audit Tenure and Auditor Rotation in Indonesia



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## Keywords

audit quality;  
audit tenure;  
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regulations;

## Abstract

This study examines the differences in audit quality on the regulation of audit tenure and auditor rotation in Indonesia. In Indonesia, there have been several audit-related scandals that occurred after the implementation of regulations on the audit tenure limitation and auditor rotation. The last regulation that applies to date is the Peraturan Pemerintah Republik Indonesia No. 20/2015 about Public Accountant Practices Chapter V regarding the Limitation of Audit Services in Article 11 that the provision of audit services on a historical financial statement on an entity by a Public Accountant is limited to a maximum of five consecutive financial years. These analyses use discretionary accruals as audit-quality proxies. In this study, the output of audit quality is measured, namely the earnings quality. This research was conducted on all non-financial companies listed on the Indonesia Stock Exchange start from 2012 to 2017, using the purposive sampling method obtained 554 research samples. Hypothesis analyses in this study use different test analysis. Specifically, there is a significant difference in the audit quality in the first year of the tenure and the last year of the tenure. We also find significant differences in audit quality before and after auditor rotation.

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## 1 Introduction

The financial statements of a company are a source of information regarding operational activities and financial position which will later be used for decision making. The purpose of financial statements is to provide information regarding the financial position, performance, and changes in the financial position of a company that is useful for a large number of users in economic decisions making. Company data will be more easily trusted by investors and other users of financial statements if the financial statements that reflect the company's financial performance and condition have received a fair statement from the auditors (Komalasari, 2004). Audit quality of a financial statement is intended to reduce the risk of information contained in it and will help to improve the quality of decision making (Arens, 2008; Kirana & Ramantha, 2020). The way to improve the quality of financial statements is to increase audit quality. DeAngelo (1981), defined audit quality as the probability of an auditor to discover and report the breach in the client's accounting system, and the ability to detect a breach and report it to depend on the auditor's ability. Thus, audit quality is a function of the technical proficiency/competence of the auditors and the auditor's independence relative to company management so that he can report these accounting breaches. Improving audit quality can be achieved by increasing the competence and independence of auditors.

The regulations regarding public accounting have begun to be drawn to the government since the United States established the Public Company Accounting Oversight Board (PCAOB) (Wibowo & Hilda, 2009). Much researches have been conducted, but it still cannot provide evidence of the success in implementing the SOX Law. This is related to the loss of public trust in the lack of regulation by professional associations, starting with the failure of CPA firm Arthur Andersen to maintain its independence from its clients, Enron and Worldcom, which led to the bankruptcy of Arthur Andersen as a member of The Big 5 Auditors. Coupled with the emergence of a case in 2004 Kanebo (large Japanese cosmetics company), a longtime client of ChuoAoyama, revealed a massive accounting fraud and began an internal investigation which resulted in Kanebo dropping ChuoAoyama as its auditor (Skinner & Srinivasan, 2012). ChuoAoyama is a PwC Japan affiliate and one of the largest auditing firms in Japan. Many parties placed the auditor as the part that most responsible for this case. This condition also raises the presumption that if an audit takes too long to be carried out by an auditor will be emotionally bound and reduce auditor independence. The emergence of various scandals and company collapse lately raises doubts about the audit quality (Hoyle, 1978; Imhoff, 2003), as well as indicates a decrease in the level of auditor independence, so that the need for audit firm rotation and auditor rotation is believed to improve audit quality. Schemes of limiting the length of the audit tenure and auditor rotation are among the solutions that arise to achieve a good level of audit quality. In Indonesia, the last regulation that applies to date is the Peraturan Pemerintah Republik Indonesia Nomor 20 Tahun 2015 concerning Public Accountant Practices Chapter V regarding the Limitation of Audit Services in Article 11 that the provision of audit services on a historical financial statement on an entity by a Public Accountant is limited at the latest for 5 (five) consecutive financial years. Public Accountants may return to provide audit services on the historical financial statement for the entity after 2 (two) financial years have not provided audit services to the client. In Indonesia, there have been several audit-related scandals that occurred after the implementation of regulations on the audit tenure limitation and auditor rotation. Quoted from the PCAOB page (9 February 2017) Public Company Accounting Oversight Board (PCAOB) or the Supervisory Board of the United States Public Accountant Company sentenced the Public Accounting Firm Purwanto, Suherman, and Surja along with partners Ernest and Young (EY) Indonesia, proven to play a role in the failure of PT Indosat Tbk's financial statement audit in 2011. Also, citing the Ministry of Finance's website, quoted by CNBC Indonesia, Thursday (30/08/2018), administrative sanctions were imposed on Public Accountant Marlinna, Merliyana Syamsul, and Public Accounting Firm Satrio Bing Eny and Deloitte Indonesia affiliates in connection with a complaint from the Financial Services Authority which informed the Public Accounting Firm of a breach in audit procedures. The emergence of these scandals raised questions and

subsequently became a debate as to whether the limitation of the audit tenure period and the existence of audit rotation regulations in Indonesia could improve audit quality.

Audit quality can be measured in terms of input, output, and process. In this study, the output quality of the audit will be measured, namely the earnings quality. The better the earnings quality resulting from an audit process, the better the audit quality (Fitriany *et al.*, 2015). This study follows Velury & Jenkins (2006) which divides earnings quality into four dimensions, namely predictive value, neutrality, timeliness, and representational faithfulness. In this study the dimension used is neutrality.

Prior audit research literature that examining the audit quality variables as previously described has led to the desire of researchers to re-examine audit quality related to the existence of regulations on the audit tenure and auditor rotation in Indonesia. Research that examines audit quality using tests of different related to the existence of regulation of the tenure and auditor rotation is rarely encountered by the authors. Therefore, we add to this literature to obtain empirical evidence about the differences in audit quality on the regulation of audit tenure and auditor rotation in Indonesia.

#### *"Honeymoon Effect" in the auditor and client relationship*

Levinthal & Fichman (1988), found the following pattern in client and auditor relationships. First, there is a period when both parties have trust in each other, which is called the 'honeymoon' period. The likelihood of a qualified opinion increases just after that period but decreases in the continuing relationship. This is consistent with Knapp (1991), which found that after several years there is some kind of turning point in the auditor and client relationship that can harm auditor independence. Deis & Giroux (1992) also found a negative relationship between audit quality and the length of the auditor and client relationship. Levinthal & Fichman (1991), stated that the audit relationship begins with a "honeymoon" period where there is a psychological bond that is one of the assets that will affect the relationship.

#### *Audit*

The audit is a systematic process of obtaining and evaluating objectively the evidence of economic actions taken by management with the main purpose of proving the suitability of management assertions with predetermined criteria and then communicating the results to interested parties (Boynton *et al.*, 2001). In fulfilling the needs of users or decision-makers for quality information, the information presented in the financial statements must be checked by an independent party capable of assuring the reliability of the information.

#### *Audit quality*

Widiastuty & Febrianto (2010), stated that in the practical literature, audit quality is how appropriate the audit is to the auditing standard. DeAngelo (1981), defined audit quality as the probability of an auditor to discover and report the breach in the client's accounting system, and the ability to detect a breach and report it to depend on the auditor's ability. Lee *et al.*, (1999) define audit quality as the probability that the auditor will not issue the audit report with an unqualified opinion for financial statements containing material errors. Audit quality is also measured in terms of the auditor's ability to constrain the provision of discretionary accruals (Lai & Gul, 2008). Discretionary accruals represent the part of total accruals that is more prone to manipulation by managers and are frequently used in the literature as a proxy for earnings management (Jones, 1991; DeFond & Jiambalvo, 1994). The definition of audit quality above can be taken the important point that a quality audit is an audit carried out by a competent person and an independent person.

#### *Auditor-Client relationship and audit quality*

The long-term auditor-client relationship significantly increases the likelihood that the auditor will issue an ineligible audit report or, long service tenure significantly reduces the auditor's willingness to qualify for the audit report. According to St. Pierre & Anderson (1984), in the first three years of the audit tenure period, audit quality is still low. The low audit quality is because auditors do not understand their clients in-depth

(Francis & Simon 1987; Balvers *et al.*, 1988; Beatty, 1989; Craswell *et al.*, 1995). Meanwhile, according to Chi & Huang (2005), the level of use of abnormal accruals is low in the initial year of the audit engagement period (both at the audit office and audit executor) when compared to the following year. According to Vansterlaen (2000), auditors are more willing/less likely to issue a 'clean' audit report in the first two years of their mandate than in the last year of their mandate. This could be an indication that the decision to renew the auditor's mandate is already taken and known by the auditor before he has issued his audit report. Levinthal & Fichman (1988) found the following pattern in auditor client attachments. First, there is a period when both parties have trust in each other, which is called the 'honeymoon' period. The likelihood of a qualified opinion increases just after this period but decreases in a continuing relationship. This is also consistent with Knapp (1991), which found that after some years there is some kind of turning point in the auditor-client relationship that can be detrimental to the auditor's independence.

### *Public accounting firm*

General audits of financial statements on companies operating in Indonesia are carried out by Public Accountants in a Public Accounting Firm, except for certain government-owned companies. Apart from performing financial statement audit services for clients, the Public Accounting Firm also offers accounting and bookkeeping services, tax services, and management consulting services. Public Accounting Firm in Indonesia can cooperate with foreign Public Accounting Firm. Cooperation can take the form of networks or associations (Adityasih, 2010). There are four (4) large public accounting firms in Indonesia associated with four (4) international CPA company networks, namely Deloitte Touche Tohmatsu, Ernst & Young Global, KPMG International, and PricewaterhouseCoopers.

### *Audit tenure*

Audit tenure shows the duration of the engagement between the Public Accountant or the Public Accounting Firm in conducting audit services for a company in succession. The audit engagement period or audit tenure can have an impact on the auditor's performance in the client company such as the auditor-client emotional relationship, independence, fees, competence, and so on (Hamid, 2013).

### *Auditor rotation*

The mandatory rotation has been widely accepted and has received recommendations from many parties because it is expected to have a significant effect on auditing practices. Although mandatory rotation has been widely discussed and is now a mandatory provision, the accounting profession has not much agreed on this matter. The accounting profession argues that this proposal will increase audit costs for clients, reduce audit quality, and provide little benefit. The government determines that the provision of audit services for historical financial statements on an entity by a Public Accountant is limited to a maximum of 5 (five) consecutive financial years. Public Accountants can return to provide audit services on historical financial statements to the entity after 2 (two) financial years have not provided audit services to the client. These regulations have caused long polemic among public accountants to date.

H1: There are differences in audit quality between the beginning and the end of the audit tenure.

H2: There are differences in the quality of audits before the auditor rotation and after the auditor rotation.

## **2 Materials and Methods**

This research begins by determining the objectives where this study aims to obtain empirical evidence about the analysis of differences in audit quality based on the neutrality value of the regulation of the audit tenure and auditor rotation in Indonesia. The location of this research is conducted on the Indonesia Stock Exchange (IDX) through the Indonesian Capital Market Directory (ICMD). Apart from using ICMD, this research was also carried out by directly accessing the Indonesia Stock Exchange website, namely [www.idx.co.id](http://www.idx.co.id) to obtain the

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information needed for this research. The population in this study were all non-financial companies listed on the IDX for the period 2012-2017. The sampling method used was the purposive sampling approach. The data was collected using documentation from the source used, namely the audited financial statements of the sample companies. There were 290 samples in the year of observation, the namely first year of audit tenure and the last year of the audit tenure. And 264 samples in the year of observation, namely two (2) years before the auditor rotation and two (2) years after the auditor rotation.

### Operational Definition of Variables

#### 1) Audit Tenure

The audit tenure variable shows the length of time both Public Accountant level and Public Accounting Firm perform audit services in a company consecutively in years.

For grouping:

The beginning of the audit tenure period: when the first initial year of the engagement period.

End of the audit tenure period: when the last year of the engagement period.

#### 2) AP Rotation

In this study, the form of rotation that was tested was rotation at the Public Accountant level, because according to the latest regulations in Indonesia, rotation regulations at the Public Accounting Firm-level are no longer required.

*Grouping:*

Before rotation: at the end of the two (2) years audit engagement period (audit tenure) before Public Accountant rotation.

After rotation: in the initial two (2) years of the audit engagement period (audit tenure) after Public Accountant rotation.

#### 3) Audit Quality

In this study, audit quality will be measured based on the output, namely the earnings quality. This study follows [Velury & Jenkins \(2006\)](#), who divides earnings quality into four dimensions, namely predictive value, timeliness, neutrality, and representational faithfulness. In this study, the dimensions used are neutrality, which means that earnings must provide unbiased information. Profit is said to be neutral if profit is not managed for a specific purpose (no earnings management). Referring also to the study of [Manry et al., \(2008\)](#), use discretionary accruals as a measure of audit quality, so this study also uses discretionary accruals as a proxy for audit quality. This study uses the [Kaznik \(1999\)](#), model to measure the value of discretionary accruals because based on the research of [Siregar et al. \(2009\)](#), the Kaznik model gives better results than other models. [Kasznik's \(1999\)](#) model is:

$$TACC_{it} / TA_{i,t-1} = \alpha_1(1/TA_{i,t-1}) + \alpha_2(\Delta REV_{it} - \Delta REC_{it}) / TA_{i,t-1} + \alpha_3 PPE_{i,t} / TA_{i,t-1} + \alpha_4 \Delta CFO_{i,t} / TA_{i,t-1} + \varepsilon_{it} \quad (1)$$

Information:

$TACC_{it}$  = The total accruals of the company  $i$  in year  $t$ , ie *income before extraordinary items* reduced by operating cash flow (CFO).

$TA_{i,t-1}$  = Total assets of the company  $i$  at the beginning of year  $t$ .

$\Delta REV_{it}$  = Change in the company  $i$ 's income between years  $t$  and  $t-1$ .

$\Delta REC_{it}$  = Change in receivables of the company  $i$  in years  $t$  and  $t-1$ .

$PPE_{i,t}$  = Company  $i$ 's gross fixed assets in year  $t$ .

$\Delta CFO_{i,t}$  = Change in operating cash flows between years  $t$  and  $t-1$ .

$\varepsilon_{it}$  = Discretionary accruals (DAC).

### 3 Results and Discussions

#### Hypothesis 1

Table 1  
Descriptive statistics

Descriptive Statistics					
Variable	N	Mean	Std. Deviation	Minimum	Maximum
Initial DACC	145	0,057855	0,69643491	-2,09837	2,08798
Final DACC	145	-0,057855	0,71272588	-1,91027	2,07022

Source: authors' summary based on SPSS result, 2019

Table 2  
One-Sample Kolmogorov-Smirnov

One-Sample Kolmogorov-Smirnov		
Description	Initial DACC	Final DACC
N	145	145
Test Statistic	0,105	0,066
Asymp. Sig. (2-tailed)	0,000	0,200
Distribution	Not Normally Distributed	Normal
<i>Lilliefors Significance Correction</i>		

Source: authors' summary based on SPSS result, 2019

Table 3  
Wilcoxon Signed-Rank test

		Ranks		
	Description	N	Mean Rank	Sum of Ranks
Final DACC	<i>Negative Ranks</i>	79	81,33	6425
Initial DACC	<i>Positive Ranks</i>	66	63,03	4160
	<i>Ties</i>	0		
Total		145		

Table 4  
Statistics test

Statistics Test	
Initial DACC – Final DACC	
Z	-2,235
Asymp. Sig. (2-tailed)	0,025
<i>a. Wilcoxon Signed Ranks Test</i>	
<i>b. Based on positive ranks.</i>	

Source: authors' summary based on SPSS result, 2019

Based on the results of the Wilcoxon Signed Rank Test statistical test in the table, it is known that the Z value is -2.235 at the significance level of 0.05. Asymp Value. Sig. (2-tailed) 0.025 is smaller than the significance of 0.05. This indicates that there is a significant difference in audit quality at the beginning of the audit tenure and the end of the audit tenure period. These results are supported by the result of Chi & Huang (2005) which found that the level of use of abnormal accruals is low in the early years of the audit engagement period (both



at the audit office and the audit executive) when compared to the following years. According to [Vansterlaen \(2000\)](#), auditors are more willing/less likely to issue a 'clean' audit report in the first two years of their mandate than in the last year of their mandate. This could be an indication that the decision to renew the auditor's mandate is already taken and known by the auditor before he has issued his audit report. [Simmons & Lovata \(2009\)](#) who in their research took a sample of public universities in the state of Illinois, United States, found that more audit findings were found in the initial period of the Public Accounting Firm engagement. The difference between the number of findings for the initial period and the end of the engagement period becomes more significant when the regulation of Public Accounting Firm rotation becomes mandatory. [Fitriany \(2011\)](#), proved that audit tenure and quality are quadratic in the form of concave or convex. This proves that there is a certain optimal point in providing audit services where before reaching the optimal point, tenure can be positively related to audit quality. This proves that there is an increase in competence which more dominantly affects earnings quality. However, after the optimal point, the longer the tenure will result in the auditor becoming more familiar with the client, so that independence issues are more dominant in affecting audit quality than competence.

### Hypothesis 2

Table 5  
Descriptive statistics

Descriptive Statistics					
Variable	N	Mean	Std. Deviation	Minimum	Maximum
Before	66	0,13969364	0,553621167	-1,457215	1,782675
After	66	-0,13969417	0,824380928	-3,23704	0,98988

Source: authors' summary based on SPSS result, 2019

Table 6  
*One-Sample Kolmogorov-Smirnov*

<i>One-Sample Kolmogorov-Smirnov</i>		
Description	Initial DACC Regression Model	Final DACC Regression Model
N	66	66
Test Statistic	0,117	0,197
Asymp. Sig. (2-tailed)	0,025	0,000
Distribution	Not Normally Distributed	Not Normally Distributed
	<i>Lilliefors Significance Correction.</i>	

Source: authors' summary based on SPSS result, 2019

Table 7  
*Wilcoxon Signed-Rank test*

		Ranks		
	Description	N	Mean Rank	Sum of Ranks
After	<i>Negative Ranks</i>	42	36	1512
Before	<i>Positive Ranks</i>	24	29,13	699
	<i>Ties</i>	0		
Total		66		

Table 8  
Statistics test

Statistics Test	
	After - Before
Z	-2,597
Asymp. Sig. (2-tailed)	0,009
<i>a. Wilcoxon Signed Ranks Test</i>	
<i>b. Based on positive ranks.</i>	

Source: authors' summary based on SPSS result, 2019

Based on the results of the Wilcoxon Signed Rank Test statistical test in the table, it is known that the Z value is -2.59 at the significance level of 0.05. Hence Asymp. Sig. (2-tailed) 0.009 is smaller than the significance of 0.05, so the hypothesis is accepted. This indicates that there is a significant difference in audit quality before auditor rotation and after auditor rotation. This result is consistent with the research of [Mautz & Shraft \(1961\)](#) found that the length of the relationship between the auditor and his client can have a detrimental effect on auditor independence, therefore rotation is necessary. [Gietzmann & Sen \(2002\)](#), also found that although rotation incurs a high cost, in audit markets with relatively few large clients, rotation improved incentives for independence outweigh the associated costs. [Hamilton et al. \(2005\)](#), stated that audit rotation increases conservatism in the financial condition reporting process. This means that the quality of financial statements is getting better, indicated by the lower number of unexpected accruals

#### 4 Conclusion

This study provides insights into the recent debate surrounding audit tenure, auditor rotation, and audit quality by analyzing the differences of audit quality on the regulation of audit tenure and auditor rotation in Indonesia. Based on the results of statistical testing and discussion as described in the previous chapter, it can be concluded that the first is that there is a significant difference in audit quality during the initial period of the audit tenure and at the end of the audit tenure period. Second, there are significant differences in audit quality before auditor rotation and after auditor rotation. This may be because the length of the relationship between the auditor and his client can affect auditor independence. Future research may consider using different proxies such as using industry specialist auditors, earning surprise benchmarks, or can consider using a questionnaire. The use of samples for further research can focus on one particular type of industry to reduce the bias of the research results.

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