

CHAPTER I

INTRODUCTION

1.1 Background

Listed companies are required to disclose their financial statements to its users as a basis in decision making. Since there are a number of parties concerned with the financial statements, then the informations provided in the financial statements must have a good quality so that it could be used by those parties. The quality of a financial statement can be judged from its characteristics. According to FASB in Statement of Financial Accounting No.2, the two most important characteristics are relevance and reliability. However, both of these characteristics are very difficult to measure, so that the users of information require the services of a third party. This is where an independent auditor takes part. They can provide assurance that the financial statements are in accordance with GAAP. That service helps to increase the confidence of both internal and external users.

Independent auditor must ensure quality of their works. Audit quality is important because high quality audits will produce reliable financial reports as a basis for decision making. A good quality of audit is when auditor is able to discover material mistatement in client's financial statements and willing to report the mistatement to users (DeAngelo,1981). Auditor's ability to discover mistatement is based on their competence, while their willingness to report the mistatements is based on their independence.From the auditor experience perspective, audit quality increases with audit firm tenure as the auditor gains a better understanding of the client's system, business and industry environment,

and internal controls (AICPA, 1978). From the auditor independence viewpoint, on the other hand, audit quality decreases with audit firm tenure as the auditor bonds himself to the client due to either economic bond or social bond (Brooks et al., 2012).

Size of audit firms can be used as an indicator of independence because the main concern of big audit firms are not the same as the smaller one in terms of the possibility of losing a client. Therefore bigger audit firm can result in higher audit quality since the firm is not afraid to be objective (DeAngelo, 1981). Yu (2007) found that there is a significant relationship between the size of audit firm with audit quality. He found that bigger audit firms that are systematic will definitely result in a higher quality audits. He based his research on two arguments made by previous studies. First, auditors working in a bigger company has more experience of meeting with different types of clients, and make them have a collective experience so that they are able to provide higher quality audits. Second, economic dependence can compromise the objectivity and independence of auditors. It creates incentives for small local practice offices to be lenient and report favorably in order to retain clients.

Other than audit firm's size, audit tenure can also be an indicator of auditor's independence. According to Flint (1988), independence might be lost if the auditor is involved in a personal relationship with the client, since this may influence their mental attitude and opinion. One of the cause of low independence is lengthy tenure. He argued that lengthy tenure in office may cause the auditors to develop over-cosy relationships as well as strong loyalty or emotional relationships with their clients, which could be a threat to auditor independence.

Lengthy tenure also results in over familiarity and consequently, the quality and competence of auditors' work may decline when they start to make unjustified assumptions instead of objective evaluation of current evidence.

Regulation regarding audit rotation may be established based on an assumption that longer relationship between auditor and its client will reduce auditor's independence (Siregar et al.,2011).Regulation regarding audit rotation is published by government in Decree of the Ministry of Finance No. 423/KMK.06/2002, which was amended to Decree of Ministry of Finance No. 359/KMK.06/2003 that obliged companies to limit the auditor assignment period within 5 years and the public accountant within 3 years. That decrees were then revised with Decree of the Minister of Finance No. 17/PMK.01/2008 on public accountant service which limited the auditor assignment period within 6 years and public accountant within 3 years.

There is no concrete evidence of the effectiveness of the ideas of this rotation. However, there are already a substantial amount of previous studies that tests on the effects of auditor rotation to audit quality, whether audit quality increases or decreases with auditor rotation. The results of those studies have been conflicting. Some studies indicate that rotation enhances audit quality (Carey and Simnett, 2006), while others indicate that there are no significant beneficial effects of audit rotation on audit quality (e.g.,Cameran et al., 2008 and Jackson et al., 2007).

In Indonesian context there are also several studies regarding audit rotation. Siregar et al. (2011) concludes that there should be rules to overcome the negative effects of too long period of audit, but not the audit firm rotation rules

that exist today because it seems not too effective. There is also research by Nadia (2015) that concludes that audit rotation results in lower audit quality. And research by Siregar et al. (2012) that shows that auditor rotation before regulation (voluntary rotation) did increase audit quality, whereas mandatory auditor rotation does not show having positive effects on audit quality.

According to Febrianto (2009), 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, although such action might reduce their independence. So the existence of the regulation that restrict auditor tenure will limit the dependence of auditor on the client and possibility for violations of the independence will be reduced. But on the other hand, Irianto et al. (2014) reveals that the tight rules has caused many reactions and debate. The debate as to whether or not the existence of regulation of audit firm rotation is required, has result in investigations aimed to provide empirical evidence for each argument regarding the concept of audit firm and audit partner rotation. One of the reaction arising from the regulation of audit rotation is the emergence of tricky attitude which is called as pseudo audit rotation. Pseudo audit rotation is the condition where legally there has been a change of the auditor, but substantially the relationship between the auditor and the client is still in progress. An illustration of pseudo audit rotation is when, for example, company A is audited by Prasetio, Sarwoko & Sandjaja from 2009 until 2014, which means that according to PMK no. 17 2008, company A must switch to other audit firm in 2015. But in order to be able to keep company A as its client, Prasetio, Sarwoko & Sandjaja change its name into Purwantono, Sarwoko & Sandjaja and continue auditing company A in

2015 because legally, audit rotation has occurred. but both of those audit firms are substantially the same which is indicated by same foreign audit firm affiliation, Ernst & Young (EY). In other words, pseudo audit rotation is an attempt to extend audit tenure with old clients without violating government rules. If pseudo rotation continues, the effect will be the same as long audit tenure since both might affect auditor's independence.

In this research, the quality of audit focused on the aspects of independence. Therefore, my research will study audit quality from independence point of view based on the relationship between types of audit rotation and audit firm's size with audit quality.

1.2 Research Question

Audit quality does not seem to escape the general audit standard contained in the Statements on Auditing Standards, namely adequate technical skills and training, independence in mental attitude, and professional proficiency with care and thoroughness. Independence means a mental attitude free from influence, not controlled by others, not dependent on others, there is honesty in the auditor's self in considering facts and there is objective considerations in auditor's self in formulating and expressing his opinion (Mulyadi, 2002).

The issuance of regulations governing the rotation of audit partner and audit firm is intended to maintain the independence of auditors. The financial statements are the basis of decision-making for investors, that is why in the preparation of financial statements, auditor should be independent. Independence

will be lost if the auditor is involved in a personal relationship with the client because it can affect the opinion and attitude of the auditor's mental (Flint 1988). Thus, regulation regarding audit rotation is expected to limit the relationship between auditor and client so that independence is maintained.

Independence is also attributed to the size of the firm's audit. Big four audit firms tend to be seen as having higher independence due to the absence of economic dependence on clients. In addition, Yu (2007) argued that large audit firms will inevitably result in better quality audits because auditors incorporated in large audit firms have more experience with diverse clients, so they are able to produce higher quality audits.

1. What is the relationship between different type of audit rotation with audit quality?
2. What is the relationship between audit firm's size with audit quality?

1.3 Research Objectives

1. This research is aimed to find empirical evidence about the practice of pseudo audit rotation in companies in Indonesia, so regulators can consider new regulation that can actually increase audit quality.
2. This research studies the relationship between mandatory audit rotation, pseudo-mandatory audit rotation and voluntary audit rotation on audit quality.
3. According to DeAngelo (1981), the quality of audit conducted by public accountants can be seen from the size of the audit firm. Therefore this

research is aimed to test the relationship between of audit firm's size on audit quality.

1.4 Research Benefits

The results of this research are expected to provide contributions as follows:

1. Since there are still not many research regarding pseudo audit rotation, this research will provide additional reference in the field of audit quality.
2. The results of this research are expected to be useful for stakeholders in order to be more critical in using financial informations.
3. The result of this research is expected to be a reference for regulators in determining effective regulations to increase auditors' independence.

1.5 Writing Systematic

The writing systematic of this research is as follows:

Chapter I is the introduction. This chapter contains the background of the problem, the problem statement, the objectives and benefits of the research, and writing systematic. Chapter II discusses literature review. This chapter examines the theoretical basis and previous research, describe the framework, and formulate the research hypothesis. Chapter III is the 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. Chapter IV is the 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. Chapter V is the closure. 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.

