

Audit fees contribution as moderating auditor switching on audit quality: Evidence from Indonesia

St. Dwiarso Utomo, Sherly Mardian Sutanto, and Zaky Machmuddah*

Accounting Department, Faculty of Economic and Business, University Dian Nuswantoro, Indonesia.

Abstract

The case of an audit failure conducted by one of the KAP that occurred in Indonesia resulted in obtaining a penalty from the Public Company Accounting Oversight Board (PCAOB) as the main issue in this study. Testing the effect of auditor switching on audit quality with audit fees as a moderating variable was the main objective of the study. The logistic regression method was used as an analytical tool to process data. The data used were secondary data in the form of quantitative. To get a representative sample, a purposive sampling method was used. During seven years (2012 – 2018) of observation, 321 company data were obtained which included in the sample criteria. The data were used to be processed as research findings. The results showed that auditor switching affects audit quality and audit fees moderate the effect of auditor switching on audit quality. The contribution of this research is public accountants to be able to maintain public trust through the quality of the published audit and support the previous theory related to auditor switching, audit fees and audit quality.

Keywords: Auditor switching, audit fees, audit quality.

Article history: Received 26 November 2019 Accepted 24 April 2020

1. Introduction

Case of audit failure conducted by KAP Purwanto, Suherman and Surja along with Roy Iman Wirahardja, EY Indonesia partner, so that received a penalty from the Public Company Accounting Oversight Board (PCAOB). KAP Purwanto, Suherman and Surja received the sentence for failing to reveal evidence supporting the calculation of the lease of 4,000 cellular towers in the annual report of PT. Indosat, Tbk fiscal year 2011 and instead provided a unqualified opinion (WTP) opinion on the annual report and the calculation and analysis has not been completed. This causes PT. Indosat, Tbk conducted auditor switching in 2012 and evaluated accounting policies and internal controls to ensure compliance with applicable standards [1].

This case is the example that there are still public accountants with low audit quality on the annual report, even though it is very important to maintain the integrity of the annual report with audit quality. The Increasing user's credibility of financial statements is obtained from the results of credible annual reports because audit quality is high [2]. Annual reports that can be used for making the decision are annual reports with good audit quality results, which are produced

by auditors with the assumption of high fees as well [3]. Audit fees or fees for audit services are fees that received after carry out auditing services to an entity. Audit fees can be determined by many factors, such as the size of the entity, the location of the firm and the size of the firm. However, the determination of audit fees in Indonesia has not been made clear as in several developed countries in Europe, America and Australia. [4] considers that high quality auditors can detect the condition of entities that are not good and inform it to the public, so that if the entity's condition is not good, entity managers who had naturally think will not choose KAP with high quality so they also pay the high fees.

The assumption replaces the entity by auditor switching to reduce the risks that might appear. [5] declare that non-conformities expected by the company from the auditor cause the auditor switching or KAP. Auditor switching also can occur if the KAP or public accountant takes too long to do audit the entity, so that it can put independence so escalation commitment problem appears and makes bad decisions from an auditor [6]. The regulations about auditor switching are contained in the Minister of Finance Regulation (PMK) No.17/PMK.01/2008 concerning "Public Accountant Services" which said the deadline for KAP to do their job on an entity for a maximum of six years the accounting period while the accountant public did

*Corresponding author; email: zaky.machmuddah@dsn.dinus.ac.id

their job are three-year accounting period.

Many researchers about audit quality have examined, but the results of each research illustrate different results from each researcher. [7] proves that auditor switching does not influence on audit quality. [8] revealed that the regions where have weak legal institutions must be doing the rotates of audit partners can improve audit quality more effectively when compared to regions that have strong legal institutions. [2] revealed that auditor switching has a positive effect on audit quality but audit tenure has a negative effect on audit quality. [9] declare that there were no significant differences in audit quality at the time after or before auditor switching, while [10] shows the influence of audit fee on auditor switching.

[11] revealed that between audit fees and audit quality from an independent auditor there was a significant influence. However, [12] revealed that more often an entity rotates the audit it will reduce audit quality. While [13] declare that if the audit fee is bigger, the audit quality results will be better. The result of [14] research by using audit fee as a moderating variable revealed that audit fee tends to cause a weak relationship between auditor switching and audit quality. The results of research that are still varied become the reason why this needs to be reviewed. Based on the description it can be taken several problems there are, that auditor switching has an effect on audit quality and that audit fees can moderate the influence of auditor switching on audit quality. So it can be clear that the purpose of this study is to examine the effect of auditor switching on audit quality by using audit fees as a moderating variable.

Agency theory is applied in various studies to illustrate the relationship between the principal and agent. Agency theory according to [15] is the connection between the contract (nexus of contract) as the holder of economic resources and the manager (agent) who uses and controls these economic resources. [16] said that the relationship between the principal and the agent causes several problems, there are: asymmetric information and conflicts of interest. The entity uses an independent auditor to increase the credibility of the financial statements. And minimize the risk of differences in information in the annual report. However, if the auditor or KAP takes too long to do audit services, it will cause a personal attachment and lead to a decrease in independence so that the issue of commitment escalation has the potential to appear and create bad decisions from an auditor [6]. The statement is supported by the research of [2] which declares that audit rotation has a positive influence on audit quality. [8] revealed that in regions with weak legal institutions should partner rotation can improve audit quality more effectively when compared to regions that have strong legal institutions. Based on the arguments from supporting research, the first hypothesis in this study is: H₁: auditor switching has an effect on audit quality.

The existence of an independent auditor as an intermediary between the two parties (agent and principal) can serve to reduce agency costs arising from selfish behavior by the agent. The agent is acting requires information in the annual report to be considered in making decisions. Annual reports that can be used for decision making are annual reports with good audit quality results [3]. An audit with good and quality results is an audit carried out by someone who has competence and independence [17]. [18] declares that quality belongs to large KAP. Large KAP are assumed to use high fees standards as well. The high fees standard results in the entity performing auditor switching to reduce the risk that might arise if the entity is experiencing poor financial conditions. [19] declares that many multinational entities and many banks in Lebanon choose to find auditors in KAP who can make audit reports that can increase the credibility of annual reports to be able to compete worldwide even for these entities should pay high audit fees. However, auditors with high quality are considered can detect the condition of the entity that is not good and convey it to the public, so that if the condition of the entity is not good, rational entity managers will not choose auditors with high service rewards despite producing high quality [4].

Research results of [10] shows the influence of audit fees on auditor switching. Audit fees charged by the entity for the benefit of auditor services cause a greater influence of audit fees on audit quality than an independent auditor [11]. [13] stated that when the audit fees are high, then the audit quality results being more higher. The second hypothesis in this study based on the statement is: H₂: audit fees moderate the effect of auditor switching on audit quality.

2. Research Method

Companies in the infrastructure, utilities and transportation sectors, as well as companies in the property and real estate sectors listed on the IDX from 2012 to 2018, were made the population in this study. The purposive sampling method was used to obtain a representative sample, the following are the sample criteria used in the study. Measurement of auditor switching used dummy variables that have values of one and zero. If an entity changes the KAP, then the value is one. Conversely, if the entity does not change the KAP, the value is zero. Audit fees were measured using a proxy for the total assets of the entity [20]. The audit quality variable used the auditor scale proxy and its measurement with a dummy variable. If the entity uses the Big Four, the value is one. If an entity uses non-Big Four, the value is zero. Hypothesis testing was done using logistic regression analysis tools (logistic regression). Interaction Test (Moderated Regression Analysis/MRA) is a special application wherein the regression equation there is an element of interaction.

Table 1. Logistic regression test.

		B	Sig.
Step 1	X ₁	47,611	0,002
	X ₂	3,922	0
	X ₁ .X ₂	-2,811	0,002
	Constant	-67,079	0

Source: The data is processed by logistic regression, 2018

Logistic regression models were used to test the hypotheses are:

$$\text{Ln} \frac{p(\text{Quality})}{1-p(\text{Quality})} = \alpha + \beta_1 \text{Switch} + \beta_2 \text{LnFee} + \beta_3 \text{Switch} * \text{LnFee} + \varepsilon \quad (1)$$

Where $p(\text{Quality})$ is audit quality; α is a constant; β is the regression coefficient; switch is a switching auditor; LnFee is a natural logarithm of audit fees; Switch * LnFee is the interaction of auditor switching with audit fees; and ε is the residual error.

3. Result and Discussion

The number of entities in the infrastructure, utilities and transportation sectors was 35 entities and entities in the property and real estate sector, listed on the IDX are 63 entities so that the total entity used was 98. Observations have been made over seven years, so a total of 686 (98*7) data. However, not all data can be processed into samples, because as many as 45 entities did not meet predetermined sample criteria. So that the data used as a sample of this study were 53 entities, with seven years of observations a total of 371 observations were obtained. From 371 data, 50 data were indicated as outliers (* residual casewise diagnostics, outliers outside “1.5 standard deviations”) because the data deviates too far from other data (extreme data). Variables that have extreme values can distort the estimated regression coefficients. Therefore, the outlier data (extreme value) needed to be excluded from the research data by using casewise diagnostics so that the final sample became 321 data.

The data analysis technique used for this study was logistic regression. The logistic regression model obtained, they are :

$$\text{Ln} \frac{Y}{1-Y} = -67,079 + 47,611X + 3,922\text{LN_M} - 2,811X.M + \varepsilon \quad (2)$$

Where Y is audit quality; X_1 is auditor switching; X_2 is the audit fee; $X_1.X$ is the interaction of auditor switching and audit fees; and ε is the residual error.

The test results using logistic regression showed a coefficient value of 47.611 with a significance value of 0.002 which is smaller than $\alpha = 5$ percent (0.002 < 0.05). These results indicated that H_1 is accepted, namely auditor switching effect on audit quality. When an entity performed auditor switching, the

results of audit quality increase because the independence of the KAP is maintained. These results are in line with the self-interest assumptions of the agency theory, where principals who are interested in return on investment for their investments look at the results of the annual report, so the agent will try to maintain its reputation in the eyes of the principal by replacing his auditor to continue to get annual report with audit quality the good one.

The good audit quality is obtained because in working KAP will perform its services professionally, by following the professional standards of public accountants (SPAP), which states that KAP must work independently. So in carrying out auditor switching, the entity will ignore whether the KAP is Big Four or Non Big Four. The research results of [2] revealed that audit rotation has a positive effect on audit quality. In line with this, [21] declare that termination of the relationship with the auditor because may be of poor relations between the auditor and client, accounting disagreements and too frequent rotation of audit staff. Auditor switching is also possible due to dissatisfaction with the performance of the old KAP, fewer appropriate costs, to get better audit quality, financial difficulties experienced by the entity and the auditor's reputation. [8] revealed that in regions with weak legal institutions mandatory partner rotation can improve audit quality more effectively when compared to regions that have strong legal institutions. However, this study is not by following the results of [7] study which states that auditor switching does not influence on audit quality and [9] which revealed that there were no significant differences in audit quality at the time after or before auditor switching. The more frequently an entity rotates an audit, it will reduce the quality of the audit [12].

The logistic regression test results showed a coefficient of 2.811 with a significance value of 0.002 which was smaller than $\alpha = 5$ percent (0.002 < 0.05). The results of this test indicated that H_2 is accepted, that is, audit fees moderate the effect of switching auditors on audit quality. When an entity uses KAP services and pays for audit fees, the resulting audit quality is good and has competitiveness in the world, so increasing auditor turnover will increase because the entity has obtained good audit quality results and wants to keep maintaining the quality of the audit results. The majority of entities in this study used the services of Non-Big Four to carry out audits of their annual reports. Non Big Four with lower audit fees rates still produces good audit quality and can be responsible by shareholders because Non Big Four regulates its services independently and competently. The work of the Non-Big Four replaces the manager who will make changes to the auditor because he wants to maintain good audit quality and shareholder credibility.

The main purpose of agency theory was to explain how parties who have a nexus of contract can design

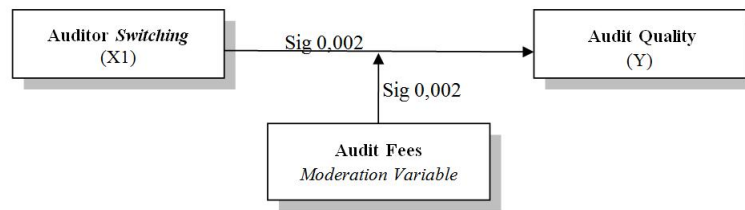


Figure 1: Research results.

their contracts so that costs appearing from asymmetric information and uncertain conditions because differences in objectives and target principals and agents can be reduced. These costs can also be called agency fees in economic terms. Therefore, this agency theory is to provide answers to agency problems that arise due to parties who have different goals in establishing the nexus of contract [7]. The results of this study contradict the research results of [14] which revealed that audit fees moderate the influence of auditors' switching on audit quality. [19] approving audit reports that can increase the credibility of annual reports to be able to compete around the world more needed by many entities, for entities that have to pay large audit fees, as well as [4] rational entity managers will not choose auditors with high service reward resulting in high audit quality. [13] announced the high audit fees, the higher the audit quality results.

4. Conclusion

This concluded that auditor switching has an effect on audit quality and audit fees moderate the effect of auditor switching on audit quality. The suggestions for further researchers, they are the addition of other variables outside of research that might affect audit quality can be taken into consideration for subsequent researchers, such as management changes, audit tenure, audit risk to increase knowledge about audit quality.

References

- [1] H. Ashari, Y. Winarto, Mitra Ernst & Young Indonesia fined US\$ 1 Million, 2017.
- [2] E. J. Aronmwan, T. O. Ashafoke, C. O. Mgbame, Audit firm reputation and audit quality, *European Journal of Business and Management* 5(7) (2013) 66 – 75.
- [3] M. U. Tarigan, P. Bangun, Susanti, Effect of competence, ethics, and audit fees on audit quality, *Accounting* 13(1) (2013) 803 – 832.
- [4] R. W. Scott, *Financial accounting theory*, Third Edition, Prentice Hall, Toronto, Canada, 2003.
- [5] M. W. Adhiputra, Effect of issuance of going concern opinions on the change of auditors in companies listed on the Indonesia stock exchange, *Journal of Accounting Dynamics* 7(1) (2015) 22 – 36.
- [6] E. F. Giri, The influence of public accounting firm (Kap) tenure and Kap's reputation on audit quality: Auditor mandatory rotation case in Indonesia, *National Symposium on Accounting XIII Purwokerto*, (2010) 1 – 26.
- [7] B. Hartadi, Effect of audit fee, KAP rotation, and auditor's reputation of audit quality on the Indonesia stock exchange, *Equity: Journal of Economics and Finance* 110 (2009) 84 – 104.
- [8] M. Firth, O. M. Rui, X. Wu, How do various forms of auditor rotation affect audit quality? evidence from China, *International Journal of Accounting* 47(1) (2012) 109 – 138.
- [9] M. Cameran, A. Prencipe, M. Trombetta, M. Control, Does mandatory auditor rotation really improve audit quality?, *European Accounting Review* 8180 (2016) 1 – 53.
- [10] B. Pradhana, D. Saputra, Effects of audit fee, going concern, financial distress, company size, substitution of independent auditors, *Accounting Journal of Universitas Udayana* 3 (2015) 713 – 729.
- [11] M. Kurniasih, R. Abdul, Analysis of factors affecting thin capitalization in multinational companies in Indonesia, *Diponegoro Journal of Accounting* 3 (2014) 1–10.
- [12] F. A. P. Ishak, H. D. Perdana, A. Widjajanto, Quality audit of manufacturing companies listed on the Indonesia stock exchange in 2009 – 2013, *Journal of Organization and Management* 11(2) (2015) 183 – 194.
- [13] I. K. A. Julianto, I. K. Yadnyana, I. D. G. D. Suputra, The effect of audit fee, audit planning, and audit risk on audit quality in public accounting firms in Bali, *E-Business Economic Journal of Universitas Udayana* 12 (2016) 4029 – 4056.
- [14] C. K. Putri, N. Rasmini, Audit fee as a moderating effect of auditor switching on audit quality, *Journal of Accounting* 16(3) (2016) 2017 – 2043.
- [15] M. C. Jensen, W. H. Meckling, Theory of the firm: managerial behavior agency and ownership structure, *Journal of Financial Economics* 3 (1976) 305 – 360.
- [16] W. F. Meisser, S. M. Glover, D. F. Prawitt, *Auditing and assurance services a systematic approach*, McGraw-Hill Irwin, Singapore: Salemba Empat, 2006.
- [17] A. L. Watkins, W. Hillison, S. E. Morecroft, *Watkids.pdf*, (2004) 153 – 193.
- [18] L. E. DeAngelo, Auditor independence, low balling, and disclosure regulation, *Journal of Accounting and Economics* 3(2) (1981) 113 – 127.
- [19] W. El-Gammal, Determinants of audit fees: Evidence from Lebanon, *International Business Research*, 5(11), (2012) 136 – 145.
- [20] M. O. Chandra, The effect of good corporate governance, company characteristics and KAP size against external audit fees, *Journal of Business Accounting* XIII(26) (2015) 174 – 194.
- [21] P. H. Siegel, N. Mohsen, O. John, Factors influencing auditor switching in the European Union, *Florida Atlantic University* (2008).