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Audit Tenure, Audit Firm Reputation and Audit Quality Study on Indonesian Manufacture Companies

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ABSTRACT

The debate on audit quality still continues due to different results and arguments on audit tenure, audit firm reputation and audit quality. This study provides empirical evidence on the differentiation of audit quality by considering the audit tenure and audit firm reputation. Using the data from IDX of manufacturing companies in 2019 and 2020, the researcher examines the difference in audit quality, measured by discretionary accruals, in terms of audit tenure and audit firm reputation. This study also examines 247 companies that are analysed using the Mann-Whitney test. Findings from this study reveal that there is no significant difference between the audit quality of companies that have repeated and non-repeated audits. However, this study indicates that there is a significant difference in the audit quality of a company that is audited by the big 4 and non-big 4 audit firms. Based on the result, it can be suggested that auditor rotation is not necessary to enhance the audit quality since independent auditors tend to sustain their reputation and maintain their service qualifications.

INTRODUCTION

A Financial statement is written information that presents the financial performance and business operation of a company. External users, such as investors and creditors need the financial statement because it helps them to improve their economic decision-making (White, Sondhi, & Fried, 2002). Therefore, each manager of the company has the responsibility to report the financial performance and company's activities through a financial statement to the investors. Due to the differences in interests between management and external users, they require a competent and independent third party to audit the financial statement. The financial statement that has been audited substantially will help the users to make a better decision because it reduces the risk that is caused by material errors and other misstatements. An audited financial statement is used to determine whether the financial statement is fairly stated based on the true business operating result and in accordance with accounting standards (Arens, Elder, Beasley, & Hogan, 2017).

Good audit quality will make an excellent financial report, while poor audit quality will not guarantee the accuracy of the financial reports. Therefore, improving the audit quality will also improve the financial statement quality. By using the report as a tool of estimation, it will help the investors to calculate the value of traded securities. Furthermore, improved audit quality does not only make the

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misstatement detection better, but also fix up the auditor's behaviour to make an appropriate response against the findings (Al-Thuneibat, Al Issa, & Ata Baker, 2011). From those explanations, an auditor has high audit quality results if he/she is able to find and give suggestions to the material misstatement. If the auditor fails to correct the misstatement once it is detected and is not able to issue a clean audit report, the audit quality is considered low.

Audit quality has two elements, which are auditor competence and auditor independence (Barbadillo, Aguilar, Barberá, & Benau, 2004). The research by Knechel & Vanstraelen (2007) assumed that long duration of audit engagement can make the auditor's competence value increases since the auditor may conduct more extensive procedure and make audit decisions based on client's knowledge that is developed from time to time. Long audit tenure may also decrease the auditor's independence because longer tenure will enhance the engagement between the auditor him/herself and the company's management.

On the other hand, the short duration of audit tenure may undermine the auditor's competence as the auditor does not know much regarding the company's operation and condition in the early year of audit. Short audit engagement will also decrease the auditor's independence because auditors are required to maintain their new client so that it will compensate for the initial audit setup cost. Taken from the assumptions by Knechel & Vanstraelen (2007) above, audit quality will decrease in long audit tenure due to loss of independence. While the decrease in audit quality in short tenure is due to both loss of audit competence and audit independence.

Most prior research stated that most companies use the same auditor for a long engagement period (Davis, Soo, & Trompeter, 2011). Therefore, questions regarding the positive or negative impact of audit tenure towards audit quality arises. Since the question has not been fully answered, this study will provide information about audit tenure or the length of time that auditor serves the client and audit quality (Knechel & Vanstraelen, 2007). The researcher will measure the audit quality by considering the discretionary accrual rate.

The study from Francis (2004) stated that audit quality can be measured by the audit outcome. The audit outcome that can be observed are audit reports and financial statements that have been audited. Therefore, the researcher uses discretionary accrual rate as the indicator of audit quality because this variable can be observed in the audited financial statement. Besides, earnings management is a new measure of audit quality and has already had some extensive arguments regarding its connection with audit quality (Wibowo & Rossieta, 2009). Earnings management as measured by discretionary accruals is also affecting the audit quality because high audit quality indicates low earnings management (Ahmad, Suhara, & Ilyas, 2016). Audit quality that is affected by audit firm reputation as the second independent variable will be discussed in this study as well because bigger audit firms tend to have a better resources and more independent (Sawan & Alsaqqa, 2013). Thus, the larger the firm, the better the audit quality.

Due to the previous study that only concentrates on the public companies in Australia, the researcher will be more focused on the public manufacturing companies in Indonesia, where the researcher believes that audit tenure and audit firm reputation give a difference quality in audit. Besides, as stated by Indonesia Stock Exchange (IDX), the number of manufacturing companies is increasing every month and they always need an audit service to measure the quality of their performance and to make the reported earnings are reflecting the real economic condition so that it can be used by the outside parties (Burgstahler, Hail, & Leuz, 2006). Therefore, the samples to prove the effect of audit tenure towards audit quality under this study will be more diverse because the number of the manufacturing company is greater compared to other sectors. Financial and annual reports of the public manufacturing companies are also easy to access to study the issue at hand.

The debate about the relationship between Audit Tenure and Audit Quality continues due to the different results in the prior research. The study from Manry, Mock, & Turner (2008) stated that long audit engagement with the same company may increase the audit quality. This is because the earnings or the costs that auditors get will become higher in the first year of audit engagement and the knowledge about the client also increases over the repeated audit. On the other hand, the study of Simamora & Hendarjatno (2019) showed that long audit tenure may decrease the auditor's independence and objectivity due to the enhancement of the auditor and the client's relationship. The potential of this affair is not only impacting the audit report but also the audit opinion and judgment during the audit process.

Another argument comes from Knechel & Vanstraelen (2007) that used the likelihood of issuing a going concern opinion as the indicator of audit quality. The result of the study is that audit tenure positively affects the audit quality, shown by the reduction of Type I error rate (i.e., companies that are not declared bankrupt in the following year, receive a going concern opinion from the auditor) when long auditor tenure is applied. On the other hand, the research by Al-Thuneibat et al. (2011) stated that audit tenure negatively affects the audit quality as measured by discretionary accruals. The particular

reason for this circumstance is that long audit tenure may reduce auditor's independence and objectivity. Auditors tend to lose the urge to conduct an audit process based on compliance and regulation. In consequence, the auditor will perform biased behaviour that is detrimental to financial statement users.

Those different results and arguments in the prior study provoke the researcher to conduct a further investigation in Indonesian firms and it also will add some explanation in the researcher's study. Besides, this study is expected to increase the knowledge about audit tenure, audit firm reputation and audit quality, especially in Indonesia. This research had a purpose to provide empirical evidence on the differentiation of audit quality by considering the audit tenure and audit firm reputation of manufacturing company in 2019 and 2020. The result will be useful for audited financial statement users and regulators as well because it consists of information that may help them to develop and evaluate the audit quality in Indonesia and to make a better decision by considering the audit tenure and audit firm reputation. The study by Wibowo & Rossieta (2009) stated that when the audit quality is high, the quality and the transparency of audited financial statements will also be increased. Hence, Indonesia's economic condition will be enhanced as the capital market becomes more efficient. Furthermore, the researcher also hopes that this paper can help and add the next researcher's argument when conducting the next study.

MATERIAL AND METHOD

Audit Tenure and Audit Quality

Barbadillo, Aguilar, Barberá, & Benau (2004) stated that audit quality consists of two elements, which are auditor competence and auditor independence. Many prior studies show that audit tenure may have both positive and negative impacts towards audit competence and independence that also may affect the audit quality. Audit tenure is basically the length of audit engagement between the auditor and the client (Simamora & Hendarjatno, 2019). In other words, audit tenure is the period of time when auditors conduct an engagement with the same client.

Another assumption comes from the study by Knechel & Vanstraelen (2007). They used the likelihood of issuing a going concern opinion as the indicator of audit quality, and it shows that the decrease in audit quality in long tenure is due to loss of independence. This is because longer tenure will enhance the engagement between the auditor and the company's management. On the other hand, the decrease in audit quality in short tenure is due to both loss of audit competence and audit independence. Audit competence is reduced because the auditor does not know much about the company's operation, characteristics and condition in the early year of the audit (Asmara & Situanti, 2018). Audit independence is also reduced because auditors tend to maintain their new client so that it will compensate for the initial audit setup cost (Knechel & Vanstraelen, 2007). Moreover, the study by Geiger & Raghunandan (2002) found that the likelihood of auditors issuing a going concern is low in the initial year of engagement. This study contradicts the concern of long audit tenure negatively impacts audit quality.

According to the prior discussion of the relationship between audit quality and audit tenure, the auditor is likely to be independent and gives opinions based on the real condition in the initial year of engagement (Carey & Simnett, 2006). However, in the coming years of engagement, auditors will develop their knowledge and expertise so there will be a higher chance of material misstatement detection failure. To mitigate this risk, the audit firm is conducting quality control to ensure the new engagement benefits. In the following year, after the initial year has passed, the auditor will obtain the knowledge and expertise about the company's environment. In this period, the audit quality is expected to be maximum.

The other argument comes from Manry et al. (2008). The study stated that long audit engagement with the same company may increase the audit quality. This is because the earnings or the costs that auditors get will become higher in the first year of audit engagement and the knowledge about the client is also increased over the repeated audit. On the other hand, the study of Simamora & Hendarjatno (2019) showed that long audit tenure may decrease the auditor independence and objectivity due to the enhancement of the auditor and the client relationship. The potential of this affair is not only impacting the audit report but also the audit opinion and judgment during the audit process. From the prior research arguments, this may lead to the researcher's hypothesis:

H₁: There is an audit quality difference between companies that have repeated audit and non-repeated audit.

Audit Firm Reputation and Audit Quality

Ahmad et al. (2016) stated in her study that bigger size of audit firms tends to have a greater audit firm reputation. Therefore, audit quality is also often associated with the size of Public Accounting Firms (Wibowo & Rossieta, 2009). They stated that the particular reason for this circumstance is that when the audit firm is large, the clients handled will be more numerous and diverse. Other than that, the services provided are more varied, the geographic coverage (i.e., multinational cooperation) is wider, and the number of human resources in the audit firm is greater. Based on the study by Sawan & Alsaqqa (2013), when the number of clients is large, auditors tend to be more independent to maintain their engagement with the same client because it will benefit the audit firm by giving a significant initial audit and transaction cost.

Larger audit firm size provides a higher audit quality is proven in the studies by Lawrence, Minutti-Meza, & Zhang (2011). This is because the ambition of larger auditors to serve a high audit quality service is higher than smaller ones in order to protect the audit firm's reputation since the possibility of experiencing more serious reputation loss related to audit failures is bigger. Large audit firm also provides a proper audit opinion because larger auditors are more competent and better at detecting an indication of financial distress experienced by the company (Lennox, 1999) as they often fight against the pressure given by the client to report financial misstatements (Choi, Kim, Kim, & Zang, 2010) and they have greater experience and expertise when dealing the clients (Sawan & Alsaqqa, 2013).

Assumption by Asthana, Balsam, & Krishnan (2010) is supporting this study. The study stated that companies tend to switch audit firms or do auditor rotation if its reputation is damaged. Whereas, Rezaei & Shabani (2014) found that high reputation audit firms give high audit quality because they consistently use trained, competent and efficient auditors to sustain the firm's reputation. Therefore, the researcher assumes that when audit tenure is long, where the auditor is suspected not to be independent, an audit with a greater reputation will still maintain its quality. Following the first hypothesis, the researcher develops another hypothesis:

H₂: There is an audit quality difference between companies that audited by Big 4 CPA Firms and non-Big 4 CPA Firms.

Table 1.
Variables, Definitions, Indicators, Measurements

Variables	Definitions	Indicators	Measurements
Audit Tenure	Audit tenure is the length of auditor's engagement with the client's company (Pramaswaradana & Astika, 2017)	Length of engagement between auditor and client.	Dummy variable with a value of: 0: Non-repeated audit. 1: Repeated audit.
Audit Quality	Audit quality is the auditor's prospects for detecting and reporting misstatements and the auditor's obedience to audit principles (Pham, Duong, Pham, & Ho, 2017).	Discretionary accruals.	Cross-sectional version of the Jones (1991) model.
Audit Firm Reputation	Audit firm reputation is the organization's image that consistently develops from time to time (Aronmwan et al., 2013).	The audit firm included in International big 4 audit firms. The big 4 consist of <i>Deloitte, Ernst & Young, KPMG, and PricewaterhouseCooper</i> .	Dummy variable with a value of: 0: The company employs non-big 4 audit firms. 1: The company employs the services from one of the big 4 audit firms.

Data Collection

This research involves public manufacturing companies in Indonesia because the researcher believes that this environment makes a higher likelihood of audit tenure affecting the audit quality. In this analysis, the researcher will analyze a factor, which is audit tenure that may affect the discretionary accruals as the indicators for audit quality in Indonesia's firms. This research will use secondary data that will be taken from the financial statements of manufacturing companies published by the Indonesia

Stock Exchange (IDX). The researcher also selects 2019 and 2020 as the years of analysis in order to reflect the current situation and to provide an up-to-date result. In 2022, IDX starts to divide manufacturing companies into three sectors, which are industrials, consumer cyclicals and consumer non-cyclicals. The population of companies listed by the IDX based on these sectors on 12 January 2022 is 282. Of these, 30 companies are removed due to the unavailability of 2020 financial statements and 5 are removed due to missing data with respect to the incomplete financial information that may result in the inability of data processing. This results in a final sample of 247 Indonesian manufacturing companies.

Research Method

This descriptive quantitative research uses the non-parametric test (Mann-Whitney) to compare the audit quality of companies in terms of audit tenure and audit reputation. This type of research is chosen to obtain the data and empirical evidence about audit tenure, audit firm reputation and audit quality because there is still a lot of debate regarding these variables. There are also different results and arguments whether audit tenure positively or negatively affects the audit quality. Consequently, some companies in the world are facing a dilemma whether to conduct an audit rotation after a period of time or to maintain the engagement with the same audit firm (Adeniyi & Mieseigha, 2013). Besides, the researcher uses an audit firm's reputation as the second independent variable that may have significant difference in audit quality. International Big 4 audit firms consist of *Deloitte*, *Ernst & Young*, *KPMG*, and *Pricewaterhouse Cooper*.

There are also several steps that must be taken before conducting the data analysis. The first step is making the Descriptive Statistic that include the calculation of the average value of all independent variable. Then, normality test is conducted using the Kolmogorov-Smirnov statistical test. Due to nonnormality, the researcher uses a non-parametric test (Mann-Whitney) to test the difference between two independent samples since the data is not normally distributed.

In this analysis, the researcher determines that Discretionary Accruals is the dependent variable. While, Audit Tenure and Audit Firm Reputation are the independent variable.

DA = Discretionary accruals value of a company in year t calculated using the cross-sectional version of the Jones (1991) model.

TENURE = Calculated by the times of engagement between auditor and client. Dummy variable with the value of 0 if non-repeated audit and the value of 1 if repeated audit.

ADFRep = A dummy variable with the value of 0 if the company employs non-big 4 audit firms and the value of 1 if the company employs the services from one of the big 4 audit firms.

To predict the discretionary accruals, the researcher uses the cross-sectional version of the Jones (1991) model. Accordingly, the researcher begins by regressing total accruals with delta revenue and gross PPE with the following formula:

$$\frac{TACC_{j,t}}{TA_{j,t-1}} = \delta_0 + \delta_1 \left(\frac{1}{TA_{j,t-1}} \right) + \delta_2 \left(\frac{\Delta REV_{j,t}}{TA_{j,t-1}} \right) + \delta_3 \left(\frac{PPE_{j,t}}{TA_{j,t-1}} \right) + \varepsilon_{j,t} \quad (1)$$

Where,

$TACC_{j,t}$ = Total accrual for company j in year t

$NI_{j,t}$ = Net income for company j in year t

$OCF_{j,t}$ = Cash flow from operating activity for company j in year t

$TA_{j,t-1}$ = Total asset for company j in year $t - 1$

$\Delta REV_{j,t}$ = Change in net revenue for company j (year t minus year $t - 1$)

$PPE_{j,t}$ = Property, Plant & Equipment for company j in year t

δ_0 = Constanta

δ_1 until δ_3 = Regression coefficient

$\varepsilon_{j,t}$ = An error term

The researcher estimates the non-discretionary accruals (NDACC) by inputting the coefficients δ_0 , δ_1 , δ_2 and δ_3 obtained from step 1 into the equation below:

$$\frac{NDACC_{j,t}}{TA_{j,t-1}} = \delta_0 + \delta_1 \left(\frac{1}{TA_{j,t-1}} \right) + \delta_2 \left(\frac{\Delta REV_{j,t}}{TA_{j,t-1}} \right) + \delta_3 \left(\frac{PPE_{j,t}}{TA_{j,t-1}} \right) + \varepsilon_{j,t} \quad (2)$$

To calculate the Discretionary Accruals as the proxy measurement for audit quality, the researcher subtracts non-discretionary accruals obtained from step 2 by the total accruals:

$$\frac{DACC_{j,t}}{TA_{j,t-1}} = \frac{TACC_{j,t}}{TA_{j,t-1}} - \frac{NDACC_{j,t}}{TA_{j,t-1}} \quad (3)$$

Where,

NDACC_{j,t} = Non-discretionary accruals j in year t

DACC_{j,t} = Discretionary accruals j in year t

DACC divided by total assets at the beginning of the year (TA_{j,t-1}) is a proxy for audit quality

RESULTS AND DISCUSSION

Results

Descriptive Statistics

In this study, the researcher determines to use two independent variables which are audit tenure (X1) and audit firm reputation (X2). As for the dependent variable, the researcher uses audit quality (Y).

Table 2.
Research Data Description

Variable	Audit Tenure	Audit Firm Reputation
Minimum	0	0
Maximum	1	1
Mean	2.09	1.29
Std. Deviation	0.570	0.455

Audit tenure is measured by the amount of engagement year between auditor and client in the unit of years. Table 2 shows that audit tenure variable (X1) has a minimum value of 0 and a maximum value of 1. The value of 0 indicates that the company does not have repeated audit and the value of 1 implies that the company have repeated audit. The average value (mean) of audit tenure is 2,09 which indicates that the average companies are audited by the same individual auditor for 2 consecutive years.

Table 2 shows that audit Firm Reputation variable (X2) has a minimum value of 0 which shows that the company employs the service from non-big 4 audit firms to audit the financial statement. While it has a maximum value of 1 which indicates that the big 4 audit firm is used in auditing the financial statement of the company. The average value (mean) at the amount of 1,29 denotes that on average the companies that use the big 4 and non-big 4 are balanced. This shows that there are fewer companies that use the services of the big 4 audit firms than those that use the services of non-big 4 audit firms.

Normality Test

Table 3.
Normality Test Result

Variable	Tenure (X1)	Audit Firm Reputation (X2)
K-S	0.381	0.387
Sig	0.000	0.000
Explanation	Not normal	Not normal

Table 3 shows the significant numbers for audit tenure (X1) and audit firm reputation (X2) of 0.000 or p = 0.000. This value is lower than the significance level which is 0.05. Therefore, it can be concluded that the data is not normally distributed. These results become the basis for the researcher to use a non-parametric difference test (Mann-Whitney).

Audit Tenure

Table 4.
Mann-Whitney Test Result on Audit Tenure

Audit Quality	Audit Tenure	N	Mean Rank	Sum of Ranks
	Non-Repeated	30	120.53	3616.00
	Repeated	217	124.48	27012.00
	Total	247		
Asymp. Sig. (2-Tailed)		0.777		

Table 4 shows that the mean rank of audit tenure between repeated audit and non-repeated audit is different. In repeated audit tenure, the mean rank is 124.48. This value is greater than the non-repeated audit tenure, which is 120.53.

By calculating the probability value, it is known that the significant number for audit tenure shows the value of $0.777 > 0.05$. This indicates that there is no significant difference between the audit quality of a company that is audited by the same individual auditor and by a different individual auditor. Therefore, the financial statements of companies that have repeated and non-repeated audits have no difference in audit quality.

Audit Firm Reputation

Table 5.
Mann-Whitney Test Result on Audit Firm Reputation

Audit Quality	Audit Firm Reputation	N	Mean Rank	Sum of Ranks
	Non-Big 4	175	130.93	22913.00
	Big 4	72	107.15	7715.00
	Total	247		
Asymp. Sig. (2-Tailed)		0.017		

Table 5 shows that the mean rank of audit firm reputation between big 4 and non-big 4 is different. In non-big 4 audit firm, the mean rank is 130.93. This value is greater than the big 4 audit firm, which is 107.15.

By calculating the probability value, it is known that the significant number of audit firm reputation shows the value of $0.017 < 0.05$. This implies that there is a significant difference in audit quality of a company that audited by big 4 audit firms and non-big 4 audit firms.

Discussion

There is no difference in audit quality of a company that have repeated and non-repeated audit. How long the company uses the services of the same Public Accounting, either 1 or up to 3 consecutive years, has no impact on audit quality. This study finding is in line with Walker, Lewis, & Casterella (2001) which found that there is no strong relationship between the auditor quality and audit tenure and concluded that the effect is weak. Findings by Knechel & Vanstraelen (2007) has also argued that auditor rotation does not necessarily enhanced the audit quality and tenure does not have either increasing or decreasing effect on audit quality. This also supported by Nigerian audit setting regarding the audit tenure that has no significant regulation yet. As a result, the length of engagement years between auditor and client remains at a much freer level (Mgbame, Eragbhe, & Osazuwa, 2012). Therefore, it can be concluded that the length of audit tenure in terms of engagement between the Public Accountant and the client, has no significant difference on audit quality. The study by Pham et al. (2017) explains that this is because independent auditors tend to sustain their reputation and continue to perform any procedures based on standards in order to maintain their service qualifications.

So, whether it is a repeat or non-repeated audit, the result of insignificance between audit tenure and audit quality will be the same.

Audit firm reputation as the second independent variable shows a contrast result on affecting audit quality. Audit quality of a company that employs the service of big 4 audit firm is different from a company that audited by non-big 4. Discretionary accruals in financial statements as a proxy measurement for audit quality which have negative values tend to be affiliated with the big 4 audit firm. This finding is in line with Aronmwan et al. (2013) that shows a positive and significant relationship between audit firm reputation and audit quality. This is because big 4 audit firms are aware on the weight place on them in terms of client's expectation and able to attract and retain existing client. This understanding is one of the factors that triggers big 4 audit firms to ensure audit quality (Aronmwan et al., 2013). The study by Rezaei & Shabani (2014) also explains that reputable audit firms have a greater motivation to hire and train their auditors in order to provide better assurance service and to protect their reputation. Therefore, it can be concluded that the audit firm reputation has a significant effect on audit quality.

CONCLUSION AND SUGGESTION

The result of this study shows that there is no significant difference between the audit quality of companies that have repeated and non-repeated audits. However, this study indicates that there is a significant difference in the terms of audit firm reputation. Audit quality in companies that are audited by the big 4 audit firms and non-big 4 audit firms are different. Findings from the study reveal that companies that are audited by the big 4 audit firms have a higher audit quality.

This study has several limitations in its writing, which are financial statements of several companies are not completely presented on IDX so that it cannot be tested on the audit quality, audit tenure and audit firm reputation. Besides, the data for audit tenure and audit firm reputation are not normal that leads the researcher to use non-parametric test (Mann-Whitney). The analysis is also conducted during the covid-19 pandemic. Therefore, we cannot necessarily expect that outcome of the discretionary accruals as the proxy measurement of audit quality are the same as those observed before the pandemic. In addition, this study only assesses the audit tenure in terms of the engagement between the Public Accountant and the client which has a maximum time limit of three consecutive financial years. Thus, further researcher should be able to find adequate data sources to complete the entire test object of manufacturing companies in Indonesia. Further testing is also needed in order to see how the actual impact of each of these variables, such as comparing the discretionary accruals before, during and after the covid-19 pandemic. Moreover, the next research should improve on the audit tenure assessment which focus on the relationship between Audit Firm and the client that has a maximum time limit of six consecutive financial years.

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