

Auditor Switching Behavior In LQ45 Companies In Indonesia

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Abstract: Auditor switching is a management action to switch the most recent company auditor. The management of public companies listed on the Indonesia Stock Exchange are known to use auditor switching. There are some reasons that encourage management of public companies to make auditor changes. These include audit opinions, the size of public accounting firms and changes in management. The study was conducted on companies that meet criteria of LQ45 index, and this companies are recalculated twice a year by Indonesian Stock Exchange research and development department. Based on the sample selection criteria a sample of 33 companies was obtained. Data analysis used logistic regression analysis. The results of the study indicate that audit opinions and management changes had no effect on auditor switching, but the size of the public accounting firm was evidently influence the decisions of the public companies' management to implement an auditor switch.

Keywords: Auditor Switching, Audit Opinion, Public Accounting Firm Size, Management Changes

1. INTRODUCTION

Financial report users (such as managers, investors, creditors and the government) need financial information for decision-making. Financial reports provide information that is useful for these stakeholders. To ensure that financial information received by stakeholders is not misleading, it is necessary to have an independent party perform an audit of financial statements. According to the regulations of the Indonesia Stock Exchange, a public accounting firm must audit the financial statements of each public company. The audit results are expected to ensure that the issuer's financial statements are presented fairly in all material respects of financial position, financial performance and cash flow in accordance with the Financial Accounting Standards in Indonesia. This form of unqualified opinion is highly expected by management. In order to obtain an unqualified opinion, a conflict can occur between management and the auditor. There are various problems that cannot be agreed upon and consequently the behavior of management is to switch the auditor for the following year. This study aims to explain and predict the reasons that encourage management to switch the auditor. The factors for the switch of an auditor are audit opinions, the size of public accounting firms and changes in company management. According to the results of previous research in foreign countries shows that factors influencing auditor switch behavior were conflicts that occur between clients and the auditors regarding the opinions (Haskins and William, 1990; Poels, 2011), conditions of client financial difficulties (Chen et al. 2005), the size of the public accounting firms (Weiner, 2012; Suyono et al., 2013), audit fees (Ho and Wang, 2006; Ismail and Aileahmed, 2008), changes in management (Beattie and Fearnley, 1998; Poels, 2011), reputation of public accounting firms (Lenno, 1999), the length of the audit engagement (Al-Koury et al. 2015; Suyono et al, 2013), etc.

The focus of this study was on audit opinions, the size of the public accounting firms and management changes. Management often considered these three factors when they switched auditors. This study was conducted in LQ45 companies in the Indonesia that have shares that are highly liquid and traded on the Indonesia Stock Exchange and to our knowledge there has not been a similar study conducted on LQ45 companies in Indonesia. The final conclusion from the audit work on financial statements is the auditors formulated opinion on the audited financial statements. Management expects unqualified opinions while on the other hand the auditor provides modified opinions in addition to unqualified opinions. In this case, there are different interests between management and auditors, which can cause management to conduct opinion shopping by using other auditors (Poels, 2011). The purpose of opinion shopping is to avoid modified opinions (Teoh, 1992) because modified opinions are not profitable for companies, by showing a bad managerial performance in the eyes of investors. This will result in the deterioration of company stock prices, which also reduce managerial utility if their compensation is related to market value (Fleak and Wilson, 1994; Chen and Church, 1996; Jones, 1996). Therefore, management insists on rejecting the modified opinion. There are two classification of public accounting firms, such as large and small firms. Large firms have greater advantages, including larger resources and opportunity to provide audit services for large companies that are in stock exchange's top list. On the other hand, small firms obviously cannot meet certain requirements asked by exchange authority. Small public accounting firms also have enormous dependency on their clients, because their clients contribute a significant amount for the total income of the firm, which will result in reduced of independency attitude of auditor (Mautz & Sharaf, 1961). When a business is thriving and become larger and stronger company, it is a must for them to move from small public accounting firms to larger public accounting firms that are more qualified (Weiner, 2012). Management changes in a public company are very common due to many factors such as poor managerial performance, failure to achieve profit targets, the company president (director) or commissioner dies, disharmony with and within shareholders, business mergers and so on. Changes in management will always followed by changes in significant accounting policies and management strategies, including

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switch of an independent auditor. The switch of independent auditors by management is carried out and inseparable from the motivation to fulfill management's own interests (Williams, 1988). The new manager or director prefers to switch the independent auditor in order to obtain a cooperative relationship with the auditor related to the selection and application of accounting policies (Schwartz and Menon, 1988). In addition, the appointment of new auditors is expected to help management solve problems that arise (Khasharmeh, 2015). This study is expected to provide a useful insight for both management and investors, or even auditors of LQ45 indexed public companies regarding the influencing factors of auditor switching and to contribute to provide a better understanding of the client's characteristic and public accounting firms. This article is organized as follows: The second part is a literature review which presents the results of previous research. The third part explains the research method. The fourth part presents the results and discussion. The fifth part is the conclusion and suggestions for further research.

2. BRIEF HISTORY OF LQ-45 INDEX

The LQ45 index is one index among several other indices on the Indonesia Stock Exchange. For example, there is the Composite Stock Price Index (CSPI); Jakarta Islamic Index (JII); Compass Index 100; and the Sectoral Index. The LQ-45 index was introduced on February 24, 1997 and was used as a benchmark for investors in the stock exchange. The number of companies indexed by LQ45 consists of 45 companies that meet the criteria for the highest market capitalization in the last 1-2 months, the highest transaction value in the regular market in the last 12 months, have high financial conditions and good growth prospects. The recalculation of transaction values occurs every six months by the Indonesia Stock Exchange's research and development division.

3. LITERATURE STUDY AND HYPOTHESES DEVELOPMENT

The financial statements of public companies are under obligation to be audited by public accountants in accordance with the regulations of the Indonesia Stock Exchange. To fulfill these obligations, the management of public companies are faced with the problem of choosing a public accounting firm that has a good reputation in terms of audit quality. Previous academic research focused on signaling theory which states that clients switch their auditors in order to express or signal the quality or reliability of their financial statements to the public by signing the engagement letter with the desired type of auditor (Bagherpour et al., 2010) in the hope of reducing agency risk which is caused by a conflict of interest between majority and minority shareholders (Fan and Wang, 2005). In the literature review, many factors that encourage management to switch auditors include: a) qualified opinions (Takiyah and Ghazali, 1993) and the results did not find a significant relationship between qualified opinions and auditor switching; b) financial difficulties (Lennox, 1999) the results showed a significant relationship between financial difficulties and auditor switching; c) tenure of auditor, financial activities, audit fees (Ismail and Aliahmed, 2008) and the results showed a significant relationship between these three factors and auditor switching. An

empirical study of the implications between auditor switching and the probability of clients experiencing financial difficulties in the following year was carried out by Chen et al (2005). They found that it was likely that clients who experienced financial difficulties were linked to auditor switch. The study of investor reaction to auditor switch depended on the context of the switch itself and the characteristics of the clients. Audit opinion before the auditor switch determined the stock price response to the announcement of an auditor switch. Clients hoped that with the switch of the auditor, they would get a clean opinion (Teoh, 1992). A study carried out by Krishnan (1994) about auditor opinion process development of client switching a year before the switching process actually done. He stated that the switching take place not because of the acceptance of qualified opinion, but more about an auditor's conservative judgements. An overall auditor conservatism affecting the tendency to express a qualified opinion. The author also noted that the switching of auditors in subsidiary companies were caused by parent companies' policy. Increasing competition among auditors and changes in corporate objectives and potential management agency costs lead to auditor switching in Iran. Other important factors such as management changes, audit fees and audit quality were not considered (Bagherpour, et al., 2010). Lin Liu (2010) connected corporate governance mechanisms and the decision to switch auditors in China. They found that weak internal corporate governance mechanisms tended to shift to small accounting firms as well as majority controlling ownership preferring to switch to small accounting firms. In many cases the company switch auditors by appointing one of the Big Four accounting firms, and in some cases the company remained with its auditor. Large companies that were audited by the Big Four accounting firms and then switch their auditors still choose from among the Big Four accounting firms and there was a reluctance to switch to small accounting firms (Weiner, 2012). The characteristics of the accounting firms and the clients are two factors that influence the switch of an auditor for companies listed on the Malaysia Stock Exchange. Client characteristics such as management changes, company size, complexity and company growth significantly influenced the auditor switch (Mazri et al., 2012).

Development of Hypotheses

Opinion shopping usually triggered by management's desire to find a clean opinion. Opinion shopping often characterized by the auditor switch after a qualified opinion, in order to pursue clean audit opinion from the successive auditor. Qualified opinion usually arises following a disagreement between companies' management and the auditors, especially regarding a critical audit matters such as company's going concerns, problems or any abnormal events. Most companies that receive modified opinions suffer losses in several consecutive years and endanger the survival of the company. If the company's management rejects the disclosure of critical audit problems proposed by the auditor, the auditor prefers to withdraw from the audit engagement for the following year. This condition encourages management to look for new auditors who can accommodate their desires. Based on the above description, the following hypotheses can be formulated:

H1: Audit opinion can lead to the auditor switching behavior. The size of a public accounting firms is always a consideration for management in choosing auditors. This is understandable because a large-scale or global operational accounting firms, (for example, the Big Four accounting firms), are highly competitive and the ability to complete for highly complex jobs compared to smaller accounting firms. Stock underwriters, brokers, and audit committees often recommend large accounting firms because they place a high level of trust in the audit reports that they issue. The dependence of the small accounting firms on its clients is also very high because the income from one client contributes significantly to the overall income (Mautz and Sharaf, 1961). In addition, small accounting firms have a tendency to have close relations with their clients which in turn will decrease the attitude of auditor independence. Previous studies found that smaller companies were more likely to receive qualifying opinions than larger companies and in the following year switch their auditors (Gul 1992; Krishnan et al., 1996). Based on the above description, the following hypotheses can be formulated:

H2: The size of a public accounting firms can lead to auditor switching behavior.

Shareholder's general meeting or even one's own request can actually altered the management. A conflict of interest between shareholders and management is one of the factors that actually triggered the management alteration. In a study conducted by Hudaib and Cooke (2005), the author found that there was a positive relationship between the replacement of managing director (MD) and auditor switching. A replacement of managing director especially when company is in financial deterioration, often followed by a switching of auditor, and vice versa. Changes in management in terms of the MD replacement were always followed by the appointed new auditors to fulfill the new MD's desire to establish good cooperation with new auditors in the hope of accommodating the selection and application of important accounting policies (Schwartz and Menon, 1985) and to help resolve problems that arise (Khasharmeh, 2015). The majority of shares of companies listed on the China Stock Exchange were owned by controlling shareholders who had dominance in the auditor selection (Tu, 2012). The right to elect auditors by controlling shareholders and management began since the founding of the Chinese stock market in the early 1990s (Liu et al, 2010). Based on the above description, the following hypotheses can be formulated:

H3: Management changes can lead to auditor switching behavior.

4. METHOD OF RESEARCH

The study was conducted on public companies consisting of 45 companies that had the highest market capitalization value in the last 1-2 months, the highest transaction value in the regular market in the last 12 months, have financial conditions that have prospects for growth and high transaction values. This is known as the LQ-45 Index. On the basis of predetermined criteria, a total sample of 33 companies were obtained for the period of observation from 2014-2016, resulted in a total of 99 years of observation. The variables examined were auditor switching (as the

dependent variable) and audit opinion, the size of the public accounting firms, and management changes (as independent variables). Auditor switching is a management action to switch the auditor or public accounting firms. The measurement of auditor switching variables was with dummy variables. Audit opinion is a type of audit opinion on the fairness of the financial statements provided by the auditor. The size of a public accounting firms is on a small to large scale. Change in management is a condition for the switch of directors in the ranks of company management. Measurement of these three variables were with dummy variables. Data analysis using Logistic Regression Analysis with the regression equation as follows:

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \varepsilon$$

explanations:
 Y = Auditor switching
 X_1 = Audit opinion
 X_2 = Size of a public accounting firm
 X_3 = Management change
 A = Constant
 $\beta_1, \beta_2, \beta_3$ = Regression coefficient
 ε = Error

5. RESULTS AND DISCUSSION

5.1 Goodness of Fit regression model

The results of Hosmer Lemeshow's Goodness of Fit Test obtained a chi square value of 0.708 with a significance value of 0.702 greater than 0.05, the model is acceptable because it matches the observational data. Table 1 below presents the results of Hosmer Lemeshow's Goodness of Fit Test.

Table 1. Hosmer and Lemeshow Test

Step	Chi-square	Df	Sig
1	0.708	2	0.702

5.2 Overall Fit model

The Overall Model Fit Test or the Overall Test of Logistic Regression Model aims to test all independent variables simultaneously on the dependent variable. The Overall Model Fit Test results can be seen in table 2 as follows:

Table 2. Omnibus tests of model coefficients

		Chi-square	Df	Sig.
	Step	31.172	3	0.000
Step 1	Block	31.172	3	0.000
	Model	31.172	3	0.000

Table 2 above shows a chi square value of 31.172 with degrees of freedom (df) being 3 and a significance value of 0.000, thus audit opinion, the size of a public accounting firm, and management change can predict auditor switching behavior.

5.3 Nagelkerke R Square

The results of Nagelkerke R Square Test of 0,472 means that auditor switching variability including audit opinion, the size of public accounting firms, and management changes by 47.2%, which means there are 52,8% of other variables

beyond the research model that could influence the management's decision to switch its auditor. Table 3 below presents the results of Nagelkerke R square test.

Table 3. Nagelkerke R Square Test

Step	-2 Log likelihood	Cox & Snell R Square	Nagelkerke R Square
1	53.043 ^a	0.270	0.472

5.4 Results of Hypothesis Testing

The results of the logistic regression model are presented in Table 4, which shows that audit opinions and management changes do not affect the behavior of auditor switches, while the size of the public accounting firm significantly influences management decisions to switch the auditor at a 5% confidence level.

Table 4. Variables in the Equation

		B	S.E.	Wald	df	Sig.	Exp(B)
Step 1 ^a	X1	-23.692	1.550E4	0.000	1	0.999	0.000
	X2	-1.976	0.808	5.981	1	0.014	0.139
	X3	-.570	0.859	0.441	1	0.506	0.565
	Constant	22.916	1.550E4	0.000	1	0.999	8.962E9

5.5 Discussion

Hypothesis test results as presented in Table 4 indicate that audit opinions and management changes do not affect management decisions to switch the auditor, but the size of the public accounting firm evidently influence management to appoint another public accounting firm to audit its financial statements. It can be explained that the audit opinion did not affect managements desire to switch the auditor because public companies do not easily conduct opinion shopping to maintain the company's reputation in the eyes of investors nor avoid negative sentiments from market participants. Company sample data shows that overall the company's financial statements obtain an unqualified opinion. Management changes is a condition that is common in every public company. Logically, every time a change in management occurs, auditor changes will occur depending on the preference of new directors, but the results of this study indicate that management changes do not affect the behavior of auditor switching. It can be explained that the new directors cannot immediately switch the auditor without consulting with audit committees and must get approval from the general meeting of shareholders. The size of a public accounting firms can be categorized as small, medium, or large, which determined by the number of partners, auditors, clients, and also gross amount of audit and non-audit services income. Large public accounting firms are highly competitive as they are supported by number of auditors that are expert in their field, especially in certain business fields such as in the banking, insurance, oil and gas mining and other industries. An excellent audit quality is one of beneficiary traits of large public accounting firms, which also indirectly improves the quality of financial reporting. In order to maintain the integrity and consistency of good financial reporting, management need to cooperate with a well-known and good reputation large public accounting firms that can

provide a better financial statement, compared to previous auditor who might be disappointing.

6. CONCLUSIONS AND RECOMMENDATIONS

Auditor switch usually occurs before the end of the year based on several factors and consideration before appointing a successor auditor. The factors are audit opinions, the size of the public accounting firms and changes in management. The results of the study of the three factors indicate that the only factor that influence management decision to switch their auditors is the size of the public accounting firms, whereas the auditor switching does not affected by audit opinions and management changes. It is acceptable that size of public accounting firms affecting management decision to switch auditors. According to explanations above, large firms obviously have a reputation, resources, and global experience that are far better than small accounting firms. The results of this study also have several limitations. First, the result cannot be generalized simply because the study was only conducted on LQ45 public companies on the Indonesia Stock Exchange. Second, the number of samples and variables were limited. Third, it did not include non-public companies. Further research is needed to involve all public companies with a larger number of samples and add another variable such as audit fees, client financial conditions, and the level of competition among the public accounting firms.

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