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Auditor Retention: Auditor and Auditee Factors

Majidah,[1]* Dedik Nur Triyanto,[2] Erika Vivi Andriyani[3]

[1,2,3] Telkom University, Jl. Telekomunikasi, 40257, Bandung, Indonesia

ABSTRACT

Objective –This study aims to examine the influence of auditor and auditee factors on auditor retention.
Methodology/Technique – The analysis unit of this research is manufacturing firms that were listed on the Indonesian Stock Exchange between 2010 and 2014. Using purposive sampling, 54 companies, or 270 observations, were obtained. This research uses a logistic regression; there are 12 outliers in the data that disturb the regression model, hence, the final research data set was 258.
Findings –The result of the logistic regression analysis shows that auditee and auditor factors can simultaneously explain auditor retention by up to 4%. This partial effect shows that only audit quality affects auditor retention by 57.2%, at a level of significance of less than = 5%. Meanwhile, firm size affects auditor retention by 14.8%, at a significance level of less than = 10%.
Novelty –This research is unique because auditor retention and proxy of audit quality has never been investigated in previous studies.
Type of Paper: Empirical .

Keywords: Auditee Factors; Auditor Factors; Auditor Retention, Indonesia.

JEL Classification: M4, M42, M49.

1. Introduction

Accounting information or financial reports are used by employed to make business decisions (Majidah, Nazar, Muslih & Anggraeni, 2016). In order for the report to be useful for users, it must be audited by external auditors (Bagherpour, Monroe & Shailer, 2010). External auditors can provide guarantees for the quality of the auditee's financial reports, to increase stakeholder trust in the company (Ball & Shivakumar, 2012).

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* Corresponding author: Majidah
E-mail: majidah@ telkomuniversity.ac.id
Affiliation: Accounting Department, School of Economics and Business, Telkom University, Indonesia

To maintain the independence of external auditors, the assignment period of external auditors is limited by Government Regulation No 17/PMK/01/2008 concerning Public Accountant Services, where, in Article 3

Paragraph 1, it is stated that general audit services are provided for 6 six consecutive financial years by the Public Accountant Office (KAP) and 3 three consecutive financial years by external auditors. Auditor switching can occur where the auditee does not want to be audited by external auditors (auditee factor) or where the external auditor does not want to extend the audit time (auditor factor) (Ismail & Aliahmed, 2008; Lin & Liu, 2010).

This study uses auditor retention as the variable of how long the auditor is retained to conduct the audit service. Therefore, the viewpoint of auditor switching with auditor retention is contradictory. However, it is relevant in this study to refer to references on auditor switching. The motivation of this study is to test both auditor and auditee factors affecting auditor retention. This study examines manufacturing firms listed on the Indonesian Stock Exchange. This study is not limited to voluntary or mandatory auditor retention.

2. Literature Review

2.1 Agency Theory

The relationship between auditees and users of financial reports or stakeholders is associated with agency theory (Jensen & Meckling, 1976). The quality of information may be low or there may be information asymmetry between the management of an organization and the users of financial information if there is no examination to guarantee whether the information is qualified or not (Paramarini & Majidah, 2014). The auditor’s function is to guarantee the quality of information. Auditees and auditors who carry out their functions according to their duties can minimize the occurrence of voluntary auditor switching, which is able to reduce agency problems and maintain auditor independence.

2.2 Auditor Factors

2.2.1 Audit Opinion and Auditor Retention

Unqualified opinion has a positive influence on auditor switching (Hudaib & Cook, 2005). Auditees tend to dislike opinions from unqualified people (Salleh & Jasmani, 2014). In other words, unqualified opinions have a positive affect on auditor retention.

H1: Auditor opinions have a positive effect on auditor retention.

2.2.2 Audit Quality and Auditor Retention

Audit quality is an important factor in selecting auditors to maintain company reputation (Vanstraelen & Shelleman, 2017). KAPs with a good service reputation with the Public Accountant Office will result in qualified audits, meaning auditees will not switch their auditors (Jackson & Moldrich, 2008; Firth, Rui & Wu, 2012). Therefore, audit quality has a positive effect on auditor retention. The audit quality will be proxied with the earnings surprise benchmark (Carey & Roger, 2006). If profits exceed the earnings surprise benchmark, the auditors will be unable to disclose indications of window dressing, meaning that the audit is not qualified. However, the losses exceed the earnings benchmark, the auditors will be unable to disclose the indication of ‘taking a bath’, leading to unqualified audits. Qualified audits refers to an audit where the reported profits or losses do not exceed the earnings benchmark.

H2: Audit quality has a positive effect on auditor retention.

2.3 Auditee Factors

2.3.1 Financial Distress and Auditor Retention

Financial distress is a condition in which a company experiences financial difficulties (Cohen, Costanzo & Rossi, 2017). Companies that experience financial difficulties are more likely to replace their auditors (Chen, Chang & Yen, 2005; Hudaib & Cook, 2005; Khasharmeh, 2015), because new auditors will increase the trust of the company, and enable the company to obtain more funds for its operations (Chadegani & Chadegani, 2011).

H3: Financial distress has a negative effect on auditor retention.

2.3.2 Firm Size and Auditor Retention

Big companies typically have complex management structures. In this situation, increasing supervision of management can potentially overcome agency problems by retaining qualified auditors (Carcello, Hermanson, Neal & Riley, 2002; Salehi & Alinya, 2017). Hence, big companies are more likely to retain qualified auditors to minimize agency costs (Nasser, Wahid, Nazri & Hudaib, 2006).

H4: Firm Size has a positive effect on auditor retention.

3. Research Methodology

The unit of analysis in this study is manufacturing firms listed on the Indonesian Stock Exchange between 2010 and 2014. Based on a purposive sampling method, 54 companies, or 270 observations, were obtained. The results were analyzed using a logistic regression because the dependent variable use a nominal scale. The definitions of the operational variables are described in Table 1.

Table 1. Operational Variables

No	Variable	Indicator	Scale
Auditor Factors			
1.	Audit Opinion	Unqualified Opinion =1 Besides Unqualified Opinion=0	Nominal
2.	Audit Quality	Earnings Surprise Benchmark; μ-σ<ROA< μ+σ; qualified= 1 ROA>μ+σ; unqualified =0 ROA<μ-σ; unqualified =0	Nominal
Auditee Factors			
3.	Financial Distress	Debt to Equity Ratio	Ratio
4.	Firm Size	Ln Total Assets	Ratio
5.	Auditor Retention	Not switching auditors ≥2 years Auditor Retention=1 Non Auditor Retention=0	Nominal

Note: The model of logistic regression in this study is: as follow: Logistic (AudRet)=β0+ β1AudOp+ β2AudQua+ β3FinDis+ β4Firm size.

4. Results

4.1 Descriptive Statistic

Table 2. Descriptive Statistic of Variables with Nominal Scale

Audit Opinion			**Audit Quality**			**Auditor Retention**		
AuditOP	**Freq.**	**Per cent**	**AuditOP**	**Freq.**	**Per cent**	**AudReten**	**Freq.**	**Per cent**
Unq.Op	229	88.76%	AudQuality	165	63.95%	AudReten	178	68.99%
Others	29	11.24%	AudUnQuality	93	36.05%	NonAudRet	80	31.01%
Total	**258**	**100.00%**	**Total**	**258**	**100.00%**	**Total**	**258**	**100.00%**

Table 2 presents the results of the descriptive statistic. From the 270 samples, there are 12 outliers that are excluded from the statistical analysis, thus, the final data set is 258. Table 2 shows that 88.7% of manufacturing firms obtained unqualified opinions, 63.95% of audits are qualified and auditor retention is at 69%. For additional interpretation, 24.81% of companies obtained unqualified opinions. This has the potential for window dressing or taking a bath. On the other hand, 19.77% of the companies that obtained unqualified opinions switched auditors.

Table 3. Descriptive Statistics of Variables with Ratio Scale

	N	Minimum	Maximum	Mean	Std. Deviation
FinDistress	258	-10.34	9,47	1.0455	1.87977
FirmSize	258	25.08	31.70	27.9764	1.58860
Valid N (listwise)	258				

Table 3 shows that the average financial distress that is proxied with debt to equity ratio is 1.0455 less than the standard deviation of 1.8797. This means that the financial risk of manufacturing firms is varied. Meanwhile, the average firm size, that is proxied with Ln Total Assets, is of 27.976 higher than the standard deviation of 1.588. This means that the size of manufacturing firms listed on the Indonesian Stock is relatively equal in terms of total assets.

4.2 Logistic Regression Analysis

Table 4. Model Summary

-2 Log likelihood	Cox & Snell R Square	Nagelkerke R Square
312.116a	.028	.040
a. Estimation terminated at iteration number 4 because parameter estimates changed by less than .001.		

The value of nagelkerke R square is 0.04, meaning the auditor and auditee factors are able to describe auditor retention by up to 4%.

Table 5. Hosmer-Lemeshow Test

Step	Chi-square	df	Sig.
1	4.860	8	.772

The Hosmer-Lemeshow Test, shown in Table 5, describes a significance level of 0.772 > 5%, meaning that the auditor and auditee factors affect auditor retention simultaneously.

Table 6. Variables in the Equation

		B	S.E.	Wald	df	Sig.	Exp(B)
Step 1a	AuditOP	.084	.427	.039	1	.844	1.088
	AuditQuality	.572	.281	4.134	1	.042	1.771
	FirmSize	.148	.088	2.844	1	.092	1.160
	FinDistress	.044	.073	.365	1	.546	1.045
	Constant	-3.814	2.489	2.348	1	.125	.022

Note: a. Variable(s) entered on step 1: AuditOP, AuditQuality, FirmSize, FinDistress.

Table 6 shows that only audit quality partially affects auditor retention with a β coefficient of 57.2% and a significance level of 0.042 <α=5%. Meanwhile, firm size affects auditor retention with a β coefficient of 14.8%, and a significance level of 0.092 < α=10%.

5. Discussion

The results of the logistic regression statistical analysis indicate that the main determinant factor of auditor retention is audit quality, which is proxied by the earnings surprise benchmark. This shows that qualified auditors are retained in the company according to the audit period, in accordance with government regulations (five years for audit firm). Audit quality can also reduce agency conflict as it is based on the quality of earnings reflected in the earning surprise benchmark, so that the audit opinion provided is consistent with the actual condition of the company. Meanwhile, although the significance level is more than 5% (less than 10%), firm size is also a determinant factor of auditor retention. Big companies with a larger management base tend to maintain their auditors in accordance with the engagement period to minimize agency costs.

6. Conclusion

Based on the descriptive statistics, unqualified opinion, audit quality and auditor retention dominate the data of manufacturing firms listed on the Indonesian Capital Market. The results of the analysis show that audit quality is the main determinant factor of auditor retention. This indicates that qualified auditors are maintained in the company without ignoring the independence of auditors, namely, not exceeding the maximum engagement period in accordance with the regulations. Firm size is another determinant factor of auditor retention, although the effect is not strong. The novelty of this study is the use of the proxy of audit quality with the earnings surprise benchmark associated with auditor retention. Future research may wish to continue this study in a different industry and examine auditor retention with an engagement period of three to five years.

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Case Processing Summary

Case Processing Summary

Unweighted Cases[a]		N	Percent
Selected Cases	Included in Analysis	258	100,0
	Missing Cases	0	,0
	Total	258	100,0
Unselected Cases		0	,0
Total		258	100,0

a. If weight is in effect, see classification table for the total number of cases.