

## THE EFFECT OF TENURE AND REPUTATION OF PUBLIC ACCOUNTING FIRM TOWARD AUDIT QUALITY: CASE OF MANDATORY ROTATION OF AUDITORS IN INDONESIA <sup>1</sup>

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**Abstract:** *The finance minister of Indonesia has issued a series of regulations governing the compulsory rotation of public accounting firms and auditors since 2003. It culminates with the issuance of finance minister regulation No. 17/Menkeu.01/2008, which limits the provision of auditing services to three years for auditors and six years for public accounting firms. This study is motivated by the issuance of the finance minister rules and the equivocal of research findings.*

*This study examines whether auditor tenure reduces audit quality in Indonesia. Further, this research investigates the effect of firm's reputation on audit quality. Using 455 firm-years in manufacturing industries listed in the Indonesian Stock Exchange, this research shows that audit tenure negatively affects audit quality. However, we find that reputation does not affect audit quality.*

**Key Word:** *Firm tenure, mandatory rotation, audit quality and firm reputation*

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## 1. Introduction

This research examines whether auditor tenure in a public accounting firm (KAP) reduces audit quality. This research will also test whether reputable KAPs are able to restrict earnings management by clients. The Enron case in the United States shocked many parties. The frauds committed by Enron involved a large public accounting firm of Arthur Anderson (AA) where many concerned parties saw auditors as the most responsible group. The lack of auditor independence is one of many factors that created the problem. AA had been assigned to audit Enron's financial reports for almost twenty years. Therefore, AA should have been very familiar with problems encountered by its client. Why was a large public accounting firm the size of AA not able to disclose the problem in Enron and why was it consciously or unconsciously involved in a conspiracy of Enron? This condition provokes a conjecture that excessively long auditor tenure will create a bond between clients and the auditors that jeopardizes their independence. The second conjecture is related to a question whether auditor's reputation is able to reinforce auditor's independence, which will generate a high quality audit.

Frequently, frauds committed by clients are associated with a lack of auditor independence. Accounting frauds can result from an auditor's commitment to deliver unqualified opinion persistently toward clients' fraudulent financial report (Moore et al., 2006). This attitude causes auditors to be trapped in his/her own way of thought, so the early decision to approve the client's illegal actions forces auditor to internalize commitment more deeply. When an auditor identifies its clients manipulating the financial report, the auditor does not reprimand them but instead legalize the clients' wrongdoing. Long auditor tenure is assumed to create a problem of a bias toward approving clients' inappropriate behavior. This commitment escalation is closely related to the action of low-balling to generate income for auditors in the future (Moore et al., 2006).

With the background mentioned above, the implementation of mandatory rotation is also theoretically because stipulation of mandatory rotation for auditors and KAP is expected to uplift auditor's independence either superficially or factually. Discussion on auditor's tenure is an attempt to avoid auditors from interacting too closely with clients so as it can jeopardize his/her independence. Restriction of tenure is also expected to cease commitment escalation of auditor toward the deception of the client. Studies on the association between mandatory rotation and auditor's independent attitude have not generated conclusive results, where some are supportive and some are not supportive.

Large public accounting firm (KAP) is frequently associated with good reputation. The research findings indicate that the size of the firm influences the audit quality. The size of public accounting firm implies the ability of the auditor to behave independently and professionally to the client, as they are less dependent on the client. Clients cannot influence auditor's opinion. Big public

accounting firms are more able to generate an opinion related to clients' bankruptcy (Lenox, 1999). The previous research used international and non international KAP as a proxy for auditor's quality that has positive correlation with the quality of earnings (Becker et al., 1998). In this study, auditor's reputation (auditors affiliated with international KAP) is used as a proxy for auditor's independence in audit engagements. Auditors affiliated with international public accounting firms/KAP will have a positive effect on audit quality measured with current accrual.

Problems that will be examined in this research are as follows

1. Whether the tenure of KAP will reduce audit quality
2. Whether the reputation of KAP will have influence toward audit quality
3. Whether the reputation of KAP will moderate the effect of KAP tenure toward audit quality

This study shows that the tenure of KAP has a negative and significant effect on audit quality, which is measured by current accruals (model 1, 2, 3 and 4). Reputation of KAP is significantly influential when it is tested as a single variable (model 2) and as moderator between tenure and audit quality (model 4). AGE variable (the duration of the firm registered in the Indonesia Stock Exchange) is not significantly influential toward audit quality. SIZE (the size of the firm) and CASH FLOW (operation cash flow) have positive influence toward audit quality at significance level of 1 percent (on every model).

## **2. Theoretical Review and Hypothesis Development on Auditor's Independence**

The core activity of auditing is verification (Antle, 1984). Verification is done through the financial report presented by management to the owner. This financial report requires confirmation. The need of confirmation of this financial report is due to the absence of verification, so that management has incentive providing information of false financial information. It is because financial report is used as measurement equipment of management performance. Direct observation to the financial report will produce high cost (Antle, 1984). One of many factors that emphasize the presence of audit service is independence. In doing verification, auditors should be independent. This research is a preliminary research to prove whether tenure and reputation of KAP will reduce or increase auditor's independence. Watts and Zimmerman (1981) argued that auditor should be obliged to maintain independence attitude; even in condition without regulation, self-monitoring may be adequate enough.

### *2.1. The History of Auditor Rotation*

Criticisms against accounting profession have reached the epidemic level for the very recent years (Hoyle, 1978). Many proposals have risen at the aim of improving this profession. One of the proposals by society is asking the public firms to conduct independent, periodic auditor rotation. Mandatory rotation have

been widely accepted and gained recommendations from different parties because it is expected to have significant influence on the practice of audit.

Although mandatory rotation has been discussed for over 70 years and currently, has become the compulsory stipulation, the accounting profession has not yet come to an agreement. Professional accountants argue that this proposal will promote auditing cost for client, reduce audit quality and only give a little benefit.

Seidman is one of ex-president of American Institute of CPA (AICPA) argues that too often audit is directed for management interest rather than public interest. Seidman argues that public protection is an appropriate reason for the existence of auditor (Hoyle, 1978). The accounting profession should have been responsible for public. The firm's and management's satisfaction is an in satisfaction of public toward auditor. Public accountant profession should work to give satisfaction to the public (Hoyle, 1978).

Since 2003, Minister of Finance of the Republic of Indonesia has tried to issue Drafts of Public Accountant Regulation (RUUAP) that regulates mandatory rotation for auditors and KAP. But the mentioned draft is still under revision and has not been ratified yet. To fill the vacant regulations, Minister of Finance of the Republic of Indonesia issues some regulations, one of which is Regulation of Minister of Finance No. 17, 2008. In chapter 2, act 3, verse 1, such regulation states that the restriction of period for the provision of audit is three years for auditors and six months for KAP. This regulation reinforces the decree of Minister of Finance No. 359, 2003. These regulations have triggered long polemics among public accountants until today.

## *2.2. Argument for Mandatory Rotation Stipulation*

There are two fundamental arguments that support mandatory rotation, namely: (1) auditor's independence can be damaged by long-interaction with the firm managers; and (2) auditor's quality and competence are inclined to decrease significantly from time to time. According to the opinions of mandatory rotation supporters, the long-interaction with the firm's managers is the primary reason that threatens and damages auditor's independence. There are two practical problems that threaten auditor's actual capability to preserve his/her independent attitude upon executing audit, namely: 1) auditor should observe management recommendation to sustain the auditing task from year to year, and 2) the sustainability of auditing task causes members of KAP develop more personally close relationship to the management. The increasingly close relationship causes auditors to identify themselves to the management interest rather than public interest.

The second argument that is in favor of mandatory rotation for each five years is that this stipulation will encourage the enhancement of audit (AICPA, 1978; SEC, 1994). Their reasons are as follows: 1) a new approach will be brought into by the new KAP once every five years. Auditors who audit the same firm from year to year will be less creative in designing auditing procedure; 2) the enhancement of competitions among KAP will be based on the quality of

audit service; 3) auditors will not be dependent economically on client (economic independence), and 4) auditor rotation will enable KAP to supervise each other (Hoyle, 1978).

### 2.3. *Arguments Against the Stipulation of Mandatory Rotation*

Despite the many proposals for improvement, criticism, and mockeries raised to accounting profession, the change of mandatory rotation still must be evaluated carefully before implementation. Profession must determine the basic need of public, which serves as future improvement guidelines. This proposal must put into consideration all what is required by the user of financial report as the basis of the final decision. The benefits of every improvement proposal should be crosschecked with the possible risks arising from the proposals.

The statement that periodic rotation will improve audit quality should consider several things as the followings: 1) the complexity and size of modern firm do not support the implementation of short-term auditing; 2) auditors are no longer in the position of obtaining amnesty from the management. SEC request debates between the firm and auditor reported in form 8-K upon the change of auditor. It is an appropriate way to uplift auditor's independence. In September 1997, SEC proposed a regulation enlargement by asking all firms that change auditors to report the reason of the change and to show that commissioner agree with the change (Hoyle, 1978); 3) by asking for auditor rotation, congress will open its door to the possibility for the firm to "shop around for opinions". With the restriction of audit rotation, KAP or public accountant is doubted to have adequate knowledge details on the firm's business; and 4) the emergence of additional audit cost for client (Myers et al., 2003), and also for public. Mandatory rotation tends to develop deception problem for audit (Petty and Cagunesan, 1996) and litigation risks (Palmrose, 1986).

The debates on mandatory rotation should be ended and it is necessary to conduct objective study to find appropriate alternative. The accounting profession should secure a special-characterized stipulation than a guarantee with general characteristic. Be it a mandatory rotation, or not, is not the best method to ensure the achievement of auditing objectives (Hoyle, 1978). The emphasis that auditor mandatory rotation will give benefit to elevate audit quality has neglected the acceptance of preliminary assignment and the complexity of modern business. For Hoyle (1978) auditor rotation is simple, drastic step, but its benefits have not yet been examined and instead it will increase the auditing cost.

### 2.4. *The Influence of KAP Tenure toward Audit Quality*

The influence of KAP tenure toward the audit quality has long become debate (Mautz and Sharaf, 1961; AICPA, 1978; SEC, 1994). Debate on tenure is always closely associated with independence. Independence is a foundation for the accounting profession and an important asset for accounting. Hence, independence is a foundation for a reliable auditor's report (POB, 2000). Mautz and Sharaf (1961) argued that the biggest threat to the auditor's independence are

lethargy and honesty erosion that replaces neutrality - and objectivity (disinterestedness).

Tenure has close relation with the low-balling action done by auditor. In the perspective of economy, low-balling is an auditor's attempt to acquire a client by reducing the price of preliminary audit task in the hope of obtaining additional fee in the future (Simon and Francis, 1988; Ettrege and Greenberg, 1990; Deis and Giroux, 1996). Economic approach sees that independence and objectivity of auditor will be low in the early task of auditing. Dye (1991) argues that lowballing encourages auditor to create opinion that gives benefits to the client in the early period and this condition is utilized by the auditor to obtain earning expected by client in the next period.

The research result on tenure and mandatory rotation indicates an equivocal finding. Mandatory rotation tends to reduce audit quality (Summer, 1998; Carcello and Nagy, 2004; Jackson et al., 2007; Myers et al., 2003; GAO, 2003; Ghosh and Moon, 2003; Geiger and Raghunandan, 2002; Manry et al., 2008). However, some researchers found out that auditor mandatory rotation is indeed required to elevate the audit quality (Vanstraelen, 2000; Casterella et al., 2003; Johnson et al., 2002). Mandatory rotation will enhance independence attitude of auditor (Copley and Doucet, 1993; Petty and Cagunesan, 1996; Brody and Moscové, 1998). The difference of results can be caused by factor of research design and different environment of country law.

Research done by Carcello and Nagy (2004) attempted to examine the correlation between the tenure of KAP with the deception of financial report. This research indicates finding that the deception of financial report is more possible to occur when auditor's tenure is short (three years or less). There is no evidence that supports idea that audit quality will increase when KAP is sustained. This result shows that auditor mandatory rotation can result in bad influence toward audit quality. This research attempts to extent the finding of Casterella et al. (2003) and Johnson et al. (2002). Johnson et al. (2002) finds out that absolute value of unexpected accrual (AVUA) is higher than early years of auditor assignment. There is no correlation between AVUA with audit tenure and upon medium auditor (4-8 years) compared with long-term tenure (more than 9 years). Audit quality becomes low upon auditor long-term tenure, so the failure of audit may more or less take place when auditor tenure is short (long) (Casterella et al., 2002). Auditor will adjust his/her audit to the manager's intention, so auditor is not completely independent. Mandatory rotation will enhance the independence of auditor or accountant (Copley and Doucet, 1993; Petty and Cagunesan, 1996; Brody and Moscové, 1998).

Parties that do not agree with the stipulation of mandatory rotation argue that the restriction of long-term relation between auditor and managers will reduce auditor's audit. Besides, this stipulation will cause a large switching cost and reduce audit quality. Objection on mandatory rotation stipulation is raised by GAO (General Accounting Office). The benefit of mandatory rotation can not cover the switching cost and other cost that take place upon auditing. Mandatory

rotation is required unless the stipulation of SOX in America is able to enhance audit quality (GAO, 2003).

The research Geiger and Raghunandan (2002) that auditor may issue common audit report exceptionally before client firm goes bankrupt. The bankruptcy of a firm could have been detected by auditor. The research outcome of Geiger and Raghunandan (2002) does not support the conjecture that long-term audit tenure will encourage deceptive audit report. Ghosh and Moon (2003) determines that absolute discretionary accruals and the action of earning management will decrease when auditor tenure is long. Myers et al. (2003) find out that auditor tenure has correlation with higher earning quality. They use absolute abnormal accrual an absolute current accruals as proxy of earnings quality. This research shows that audit quality is higher upon a longer-term tenure.

Casterella et al. (2002) in his working paper, concludes that audit quality is low when auditor tenure is long and low when auditor tenure is short. The search of Carcello and Nagy (2004) find a different result. The research result of Carcello and Nagy (2004) find out that fraud of financial report is more possible to occur upon long-term auditor tenure. This research result is consistent with argument that mandatory rotation can have bad influence toward audit quality.

Dopuch et al. (2001) conducts a research only to examine whether the stipulation of mandatory rotation to produce biased report that will give benefit to the managers. The presence of this retention stipulation is due to that auditor or KAP whose tenure is within the stipulated mandatory rotation period of time. This research is important, because this research result indicates that subject of the third category (rotation only) and the fourth category (rotation and retention) indicate the auditor's intention to produce a biased report (to the manager's intention) is lower.

The research of Manry et al. (2008) finds out that auditor's tenure has negative correlation with audit quality measured with accruals. This research is consistent with the research result of Geigher and Raghunandan (2002); Johnson et al. (2002); Myer et al. (2003); and Nagy (2005). Gunny et al. (2007) finds that auditor tenure has negative correlation toward audit deficiency and in obedience toward widely-accepted accountant principles (PABU).

There is another perspective of long tenure. Long audit tenure will encourage creating business knowledge for an auditor. This knowledge is used to design effective audit program and create a qualified financial report. If seen from the research result and logical reason raised is related to the correlation of tenure and audit quality, a proposition can be raised; audit quality will be higher if auditor tenure is longer. Based on this proposition, an alternative hypothesis can be arranged as follows:

**HI:** *Public Accounting Firm (KAP) with tenure higher than three years has negative influence toward the audit quality measured with current accrual.*

## *2.5. The Influence of KAP Reputation toward Audit Quality*

The research result indicates that the size of KAP will influence audit quality. The size of KAP indicates auditor's ability to develop independent attitude and execute audit professionally, because KAP is not economically dependent on the client. Client is not able to influence auditor's opinion, either. Big KAP is prone to giving opinion on the client's firm bankruptcy (Lenox, 1999). Internationally-affiliated KAP is used as proxy of KAP reputation. Reputable KAP explains auditor's independent attitude in executing the task of audit. Internationally-affiliated KAP will have negative influence toward audit quality measured with accrual (Becker et al., 1998). Earnings response coefficient of client audited by Big5 KAP is higher than non- Big5-KAP (Teoh and Wong, 1993).

Several researches have examined whether audit quality measured with brand name auditor has positive correlation with audit quality. Becker et al. (1998) and Reynolds and Francis (2000) argue that qualified auditor (international KAP) can detect earnings management because of their adequate knowledge and can prevent opportunistic earnings management by client. Becker et al. (1998); Francis et al. (1999); and Reynolds and Francis (2000) find out that international KAP-affiliated client has lower accrual level than non-international KAP affiliated client. Such elaboration arouses the following alternative hypothesis:

**H2:** *Internationally-affiliated KAP has negative influence toward audit quality measured with current accrual.*

The examination outcome of KAP tenure's influence toward audit quality is equivocal, either at the level of significance or correlation direction. It is probably caused by other variable that moderate the previous correlation (Hartono, 2004, p. 143). KAP long tenure will increase the knowledge of KAP/auditor about the firm business so that they are able to design a better audit program. This tendency will be stronger when audit is carried out by big KAP with high reputation. International KAP has high reputation because of its economic ability and high knowledge to prevent opportunistic actions of earnings management by client (Becker et al., 1998; Reynolds and Francis, 2000). Therefore, raises a conjecture that reputable KAP (Internationally-affiliated KAP) with long tenure will enhance audit quality. This explanation provokes an alternative hypothesis, as follows:

**H3:** *Internationally-affiliated KAP with audit tenure of more than three years has negative influence toward audit quality measured with current accrual.*

### **3. RESEARCH DESIGN**

This research aims to investigate if audit quality remains sustainable well upon audit long tenure. This research is ex-post facto, meaning that this research



is conducted by investigating facts that have occurred using archival data available.

3.1. *Research Samples*

This research sample employs financial report of firms registered at Indonesian Stock Exchange with the following criteria: a) should not belong to financial industry; b) expelling too young firms, those with less or equal three years; c) expelling firms that do merger and acquisition because of the difficulty of accrual identification and the possibility of not giving any influence to this research (Collins and Hribar, 2002); d) financial reports of firms at Indonesian Stock Exchange 1996-2005. The data is taken from financial reports publicized by Indonesian Stock Exchange.

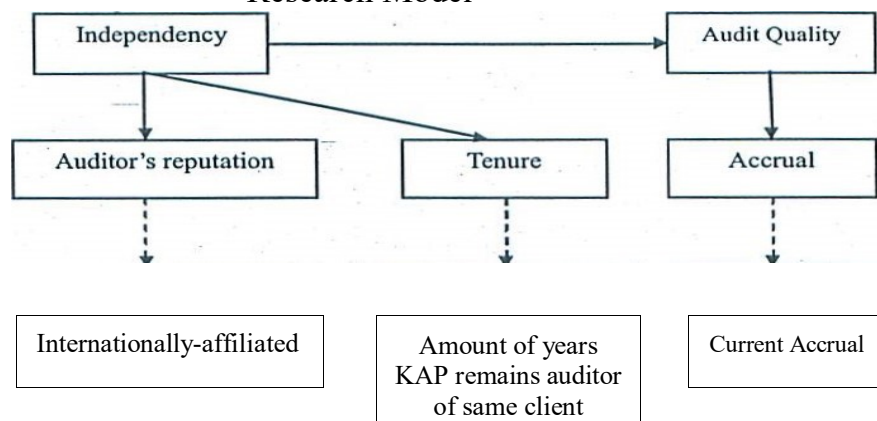
The year of 1996 is chosen because in 1996 reports of cash flow were available and presented better by public firms. PSAK No. 2, on the cash flow obliges public firms to present cash flow from the late 1995 (IAI, 2004:2.1-2.23), but possibly not all the firms that presented financial report well in that year. Finally, the research samples can be obtained fro 455 year firms. This amount consists of 151 firms with long tenure and 304 firms with short tenure. The detailed description of the research data will be elaborated on table 1 , 2, and 3.

3.2. *Research Model and Variable Measurement*

Auditor Independence is an important assumption that bases the existence of auditor in auditing service. Tenure is one of triggering factors for actions that can reduce auditor independence. A conjecture develops that the longer the auditor's tenure, the more possible for auditors to commit action that reduces his/her independent attitude. This conjecture arouses the stipulation of mandatory rotation.

The research model employed in this research is similar to the model used by Myers et al. (2003), but Myers et al. (2003) did not examine auditor reputation variable measured with types of KAP (internationally-affiliated or not). Based on such elaboration it can be described in a research model as follows:

Figure 1.  
Research Model



Research model on Figure 1 above can be written in the form of regression equation as follows:

$$\text{CURRENTACCRUAL} = \alpha_0 + \delta_1\text{TENUR} + \delta_2\text{REPU} + \delta_3\text{UMUR} + \delta_4\text{UKUR} + \delta_5\text{ALIRKAS} + \varepsilon \quad (1)$$

**Note:**

- Akrulancar* : The level of accrual measured with current accrual  
*Tenur* : The amount of year KAP remains to audit the same client; as dummy variable, long tenure (more than three years) valued 1, and short tenure (less than three years) valued 0.  
*Repu* : Types of KAP whether internationally-affiliated KAP or not: as dummy k variable, digit 1 is for Internationally-affiliated KAP, and 0 for non-internationally-affiliated KAP.  
*Umur* : The length of period of firm registered at Indonesian Stock Exchange.  
*Ukur* : The size of Firms measured with total net of sale.  
*AlirKas* : The cash flow of operation activity

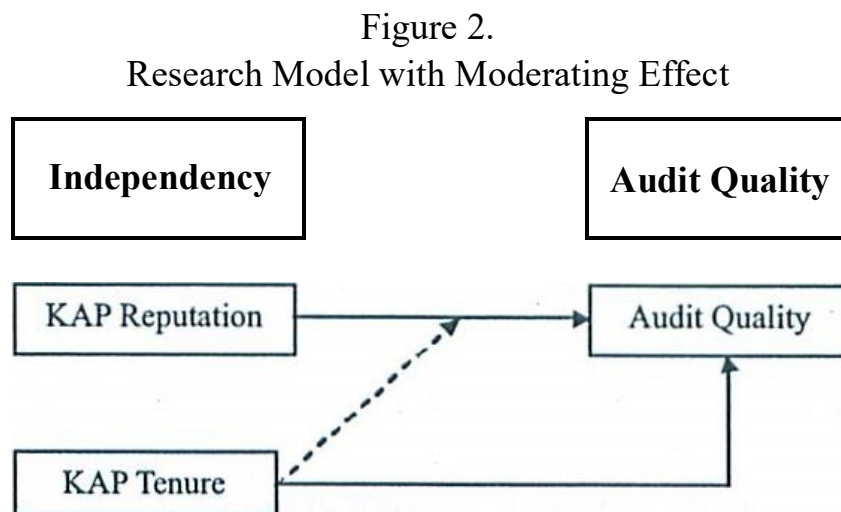
Like explained above, there is possibly a moderating correlation between KAP tenure with audit quality by KAP reputation, so the research model in equation (1) above, can be rewritten as follows:

$$\text{CURRENTACCRUAL} = \alpha_0 + \delta_1\text{TENUR} + \delta_2\text{REPU} + \delta_3\text{TENUREPU} + \delta_4\text{UMUR} + \delta_5\text{UKUR} + \delta_6\text{ALIRKAS} + \varepsilon \quad (2)$$

**Remark:**

*TENURREPU*: moderating variable is a moderating interaction between Tenure and Reputation variables.

Research Model (2) above can re-described on Figure 2 below:



The dependent variable is audit quality. Audit quality is current accrual. (Jones model) is calculated by the following formula:

$$\text{CURRENTACCRUAL} = (\Delta AL - \Delta KAS) - (\Delta LL - \Delta LJP) \quad (3)$$

Remark :

$\Delta AL$  : *Change of current asset;*

$\Delta Kas$  : *Change and equivalence of Cash;*

$\Delta LL$  : *Change of current liability;*

$\Delta LJP$  : *Change of short-termed draft debt and long-termed debt that will due*

This research examination especially has relation with sign-test and the significance of influence of TENURE and REPU coefficient variable toward the AUDIT QUALITY variable. If argument for mandatory rotation is true, Tenure variable is expected negative. But, on the contrary, if argument against mandatory rotation is true, Tenure coefficient variable is expected positive. Other than that, the researcher also examine whether reputable KAP has negative correlation with audit quality measured with accruals. There are controlling variables included in this research, namely: the age of firm, the size of firm, and net operation cash flow.

### 3.3 *The Measurement of Controlling Variable*

The firm's AGE (UMUR) is used as controlling variable because the firm's accrual will be different when the life cycle of the firm is long (Anthony and Ramesh, 1992; Dechow et al., 2001). The firm's AGE is measured with the length of being registered at Indonesian Stock Exchange. The firm's AGE (UMUR) is expected to enhance audit quality. MEASURE variable is measured with net sale value. Big client tends to have more stable accrual than small client (Dechow and Dichev, 2002). Big client tends to have ability to influence auditor's opinion. There fore, MEASURE (UKUR) variable is expected to have positive influence toward audit quality measured with accrual. Cash flow is included in controlling variable in this research because high operation cash flow reflects the firm's high performance, so operation cash flow has positive correlation with audit quality (Sloan, 1996). CASH FLOW (ALIRKAS) variable is expected to negatively influence audit quality measured with accrual.

#### 4. RESEARCH RESULT

##### 4.3 Descriptive Statistics

Table 1 explains the average value of each research variables. On that table, the group of KAP with short tenure has an average of current accrual value bigger than those with long tenure. Client with long tenure has an average of lower debt value, lower sale value, and lower operation cash flow than client audited by short-termed KAP.

Table 1  
The Description of Tenure-Based Data Groups

TENURE	CURRENT ACCRUAL	TOTAL ASSET'	TOTAL DEBT	SALE	OPERATION CASH FLOW
SHORT	141613179	2538856518	1562998095	5026093950	249648624
N	304	304	304	304	304
LONG	-76498676	1524507093	1246631859	1003186446	120130463
N	151	151	151	151	151

On table 2, it is indicated the description of data group based on the types of KAP; local or affiliated KAP. Based on table 2, clients who assign internationally affiliated KAP reaches a bigger number than those who assign local KAP/nonaffiliated KAP. Local KAP at the average, produces higher current accrual, lower debt policy, lower sale value, and lower operation cash flow than client with affiliated KAP. It is almost compliant with the conjecture that affiliated KAP will produce a better audit quality than non-affiliated KAP. Besides that, affiliated KAPs generally audit relatively big firms, which have high sale rate and high operation cash flow too. Table 2 explains that clients would prefer affiliated KAP than local KAP to audit their financial report.

Table 2.  
Description of Auditor-Based Data Groups

AUDIT FIRM	TOTAL ASSET	CURRENT ACCRUAL	TOTAL DEBT	SALE	OPERATION CASH FLOW
LOCAL KAP	1374563219	101675856	813950151	1330317576	187698087
	155	155	155	155	155
AFFILIATED	2629852179	52464496	1790768527	4910714967	216465594
KAP	300	300	300	300	300

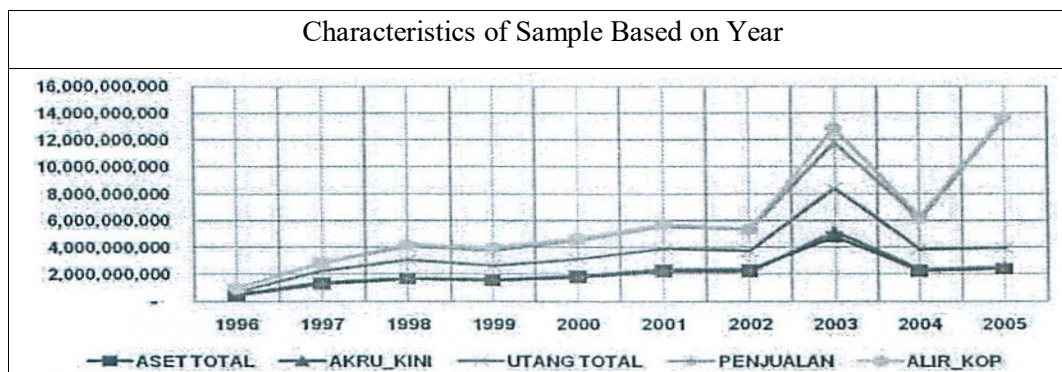
Table 3, explains client data group based on the period of implementation mandatory rotation stipulation in Indonesia. Non-rotation stipulation period ended in 2002, whereas rotation stipulation period started in 2003 until today. On table 3, it is seen that client in the non-rotation period has average of higher positive current accrual, higher operation cash flow, higher net sale value, and higher debt value than KAP client in the period of mandatory rotation.

Table 3.  
Description of Data Group Based on Rotation Stipulation

PERIOD	TOTAL ASSET	CURRENT ACCRUAL	TOTAL DEBT	SALE	OPERATION CASH FLOW
NON-ROTATION	2,472,549,425	166673298	1,562,076,090	5,388,676,177	257,859,841
N	273	273	273	273	273
ROTATION	1,796,741,536	(76937933)	1,301,901,423	1,144,533,616	129,874,424
N	182	182	182	182	182

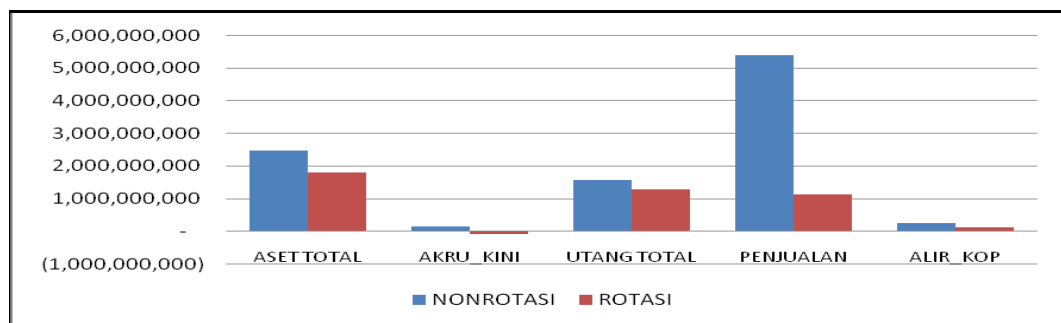
Picture 3 explains that there is an average increase of current accrual value, operation cash flow, debt, sale and total asset from 1996 until 2003. All variables tend to have the same pattern. In 2003, all variables increased and decreased again in 2004. Starting from 2003, a very extreme increase for all variables, including current accrual variable occurred. From 2004 until 2005 there was no increase, nor decrease for the total asset variable, accrual and debt. But the sale value and operation cash flow increased starting from 2004. According to the researcher's conjecture, one of those that triggers the increase and decrease of current accrual value of client in 2003 and 2004 is client's and KAP's response toward the change of policy in relevance with the mandatory rotation stipulation in 2003. In 2003, a quite hike of operation cash flow, and sale value took place. It is perhaps due to the increasingly-improving economic condition in that year.

Figure 3.  
Pattern of Current Accrual, Total Asset, Cash Flow, Sale And Total Debt Variables



Picture 4 explains the pattern of variables in the period of mandatory rotation and non-rotation. In the period of non-mandatory rotation the average of higher value of asset, current accruals, total debt, sale, and operation cash flow than in the period of rotation. It means that stipulation of mandatory rotation is effectively able to reduce the management's intention to carry out an accrual based earning management.

Figure 4.  
Pattern of Variables for Rotation and Non-Rotation Period  
Characteristics of Sample Based on Year



#### 4.2. The Test Result of Mean Equation

The test result of mean equation on AKRULANCAR (current accruals) variable for two group of tenures (short and long) and two groups of auditors (local and affiliated KAP) indicates the t-test and F-statistic value each 6,23 and 38,82 with significant level less than 1% for tenure (TENUR) variable. It means that the average of current accrual value for short and long tenure is significantly different. REPU (reputation) variable indicates t-test and F-statistic each 1,36 and 1 with the level of significance of more than 10%. This test result indicates that local KAP and affiliated KAP are statistically significantly indifferent.

#### 4.3. The Test Result of Classical Assumption

This research attempts to examine the influence of tenure and KAP reputation variable toward audit quality using statistic instrument of ordinary Least Square (OLS). Therefore, it is necessary to do classical assumption test. The test result is not appropriate to apply OLS as test instrument in this research. The value of probability of Jarque Bera has the level of significance of less than 1 0/0. It means that residual value in this research does not have normal distribution. The test result of Breusch-Godfrey Serial Correlation LM-Test indicates that the value of F-statistic of 1,038 and insignificant. It means that autocorrelation does not take place. The test result of White Heteroscedasticity Test indicates the value of F-

statistic of 9,452 and significant at level less than 1%. It means that this research consists of heteroscedasticity. However, this test result of linearity using Ramsey Reset Test indicates that value off-statistic is 0,773 with level of significance of 5%. Therefore, this model is linear. Based on the result of assumption test above, technique of OLS is less possible to be used in this research. That is why statistic instrument that can anticipate the shortcoming of this classic assumption, especially heteroscedasticity, that is, generalized method of moment. This instrument does not require assumption of a strict normality, heteroscedasticity, multicollinearity, and autocorrelation. Other than that this research does not have interest with model of prediction and forecast of occurrence, but rather has relation with the sign test coefficient variable of KAP tenure and reputation.

Table 4 shows the level of correlation between variables in this research. There are two variables with very high correlation (of more than 0,8), so that possibly it contains multicollinearity. Those variables are Debt and Asset T, as well as Tenure and Period.

Table 4  
Correlation among Variables AKR LANCAR (Current Accrual), AUDITOR, UMUR (Age), ALIRKAS (Cash Flow), and JUALNET (Net sale)

	CURR ACCR	OP-CASHF	TOTAL ASSET	SALE	KAP	PERIOD	TENUR E	AGE	DEBT
CURRACCR	1.000000								
OP-CASHF	0.186982	1.000000							
TOT ASET	0.293996	0.719348	1.000000						
SALE	0.162204	0.043181	0.111388	1.000000					
KAP	-0.063797	0.012970	0.115527	0.044038	1.000000				
PERIOD	-0.326455	-0.059645	-0.064292	-0.053960	0.520632	1.000000			
TENURE	-0.280940	-0.058017	-0.092753	-0.049163	0.477046	0.863172	1.000000		
AGE	0.122640	0.018472	0.033507	0.027131	-0.187368	-0.371364	-0.371637	1.000000	
DEBT	0.289432	0.657631	0.934142	0.096584	0.147996	-0.040747	-0.047624	0.011047	1.000000

#### 4.4. The Test Result of Multivariate Regression

In this univariate test other factors are included, so that it might influence the current accrual distribution. Therefore, it is necessary to conduct a multivariate test. It is done by applying the equation model 1, above. The statistic instrument used for multivariate test is generalized method of moment (GMM). Statistic test will use the whole data samples from 1996-2005. The result of multivariate regression test with CMM is presented on table 5:

Table 5.  
The Test Result of Multivariate Regression (GMM)

INDEPENDENT VARIABLE	MODEL 1	MODEL 2	MODEL 3	MODEL 4 MODERATION EFFECT
C	1,25E+08 (4,698)***	60182513 (2,104)**	1,27E+08 (4,567)***	90003449 (2,868)***
TENURE	-1,71E+08 (-6,352)***	-	-1,69E+08 (-6,375)***	-1,17E+08 (-3,723)***
REPU	-	-49253156 (-1,705)*	-5486563 (-0,226)	62734040 (1,786)*
TENREPU	-	-	-	-1,31E+08 (-2,636)***
AGE	-2081408 (-1,306)	-527952 (0,319)	-2036102 (-1,241)	-824981 (-0,471)
SIZE	0,001 (12,919)***	0,0011 (20,988)***	0,001 (12,753)***	0,001 (13,405)***
CASHFOP	0,033 (2,923)***	0,034 (2,631)***	0,032 (2,782)***	0,0367 (3,248)***
J-statistic	0,0465	0,108	0,0466	0,034
R <sup>2</sup>	0,115	0,052	0,114	-0,125
Adjusted R <sup>2</sup>	0,107	0,044	0,104	-0,113
Durbin Watson	1,819	1,698	1,817	1,843

The test using model 1 on Table 5 indicates that TENUR (tenure) coefficient is negative-signed and statistically influential significantly toward CURRACC (current accruals) at level of less than 1 percent. This result shows that the longer the auditor tenure will is the higher ability an auditor has to restrict accrual action by management. SIZE and CASHFOP (cash flow) variables have significant influence toward audit quality at level of less than 1 percent. AGE variables does not influence significantly toward audit quality. The result of J-test indicates significance at level less than 5 percent. Therefore, test with model 1 is valid.

The test using model 2 on Table 5 shows that REPU (reputation) variable coefficient is negative-signed and statistically influential significantly toward audit quality at level of less than 10 percent. This result indicates that international affiliated KAP has the ability to restrict action of earnings management by client. SIZE and CASHFOP (cash flow) variables have significant influence toward audit quality. The result of J-test shows significance at level 10 percent. Thus, test with model 2 is less valid.

Test with model 3 on Table 5 indicates that TENURE variable coefficient is negative-signed and statistically significant toward audit quality at level less than I percent. This result indicates that long KAP tenure will enhance audit quality. REPU (reputation) variable does not significantly influence audit quality when tested simultaneously with TENURE variable. SIZE and CASHFOP (cash flow) variables have significant influence on the



audit quality at level less than 1 percent. AGE variable is not significantly influential to the audit quality. The result of J-test indicates significance at level less than 5 percent. Thus, test with model 3 is valid.

The inconsistency of the test result for direction and level of significance of REPU (reputation) variable encourages the writer to examine whether there is a moderating correlation between TENURE variable and AUDIT QUALITY by REPU (reputation) variable (model 4). Test with model 4 on Table 5 indicates that TENURE variable coefficient is negative-signed and is statistically influential significantly toward the audit quality at level less than 1 percent. REPU (reputation) variable has significant influence at level less than 10 percent toward audit quality, but negative-signed. TENREPU (interaction between tenure and reputation variable) indicates significant coefficient value at level less than 1 percent. SIZE and CASHFOP (cash flow) variables have significant influence toward audit quality at level less than 1 percent. AGE variable does not have significant value toward audit quality. The result of J-test shows significance at level less than 5 percent. Thus, test using model 4 is valid. Therefore, alternative hypothesis 1 and 3 are successfully supported, but do not successfully support alternative hypothesis 2.

Long KAP tenure will have significant influence in elevating audit quality measured with level of current accrual. This finding supports an argument that the longer the tenure, KAP will have more knowledge and experience to design a good and right audit procedure. Reputation (REPU) variable despite its significant influence is relatively low and is positive-signed.

The design of stipulation that regulates auditor/KAP must be based on research result. Stipulation that regulates auditor and KAP should have been able to increase auditor independence superficially (in appearance) or factually (in fact). The restriction of auditor tenure is an attempt to avoid such close interaction between auditor and client that it will disturb his/her independence. Regulation can not regulate how closely auditor/KAP makes interaction with client. It is only auditors, who know exactly what is going on, so the regulation is within the auditors themselves; an uncompromised independent attitude.

Argument for mandatory rotation state that auditor independence will be damaged by the long-term relation with managers and will encourage the enhancement of audit quality (AICPA 1978; SEC 1994) is not proven in this research. The conjecture that long auditor's tenure will reduce audit quality is not proven in this research. This research result even shows contradictory things; that long auditor tenure does not reduce audit quality. This is proven

through TENUR (tenure) variable coefficient, which is negative-signed and is significant at level less than 1 percent. There are some reasons that underlie this conclusion. First, the long auditor tenure even will create sufficient knowledge for auditor/KAP to execute the task of auditing professionally. Second, the long auditor tenure even will produce lower cost. The sufficient knowledge of auditor/KAP will make auditors more meticulous.

This research result shows that internationally-affiliated KAP has positive influence toward the level of current accrual and is significant at level less than 10 percent. This research implies that being affiliated with international KAP is aimed more at marketing strategy to attract client. This research result indicates that internationally-affiliated KAP has the ability to moderate the influence of TENUR (tenure) toward KUALITAS AUDIT (audit quality). This result is shown by TENREPU variable, which is statistically influential significantly at level less than 1 percent. Therefore, when auditor tenure is short, affiliated KAP is less able to enhance audit quality.

## **5. CONCLUSION, IMPLICATION AND SUGGESTION**

### *5.1. Conclusion*

This research result indicates that TENUR (tenure) variable has negative and significant influence toward KUALITAS AUDIT (audit quality) variable. REPU (reputation) variable has significance of more than 5% and positive-signed. Therefore, hypothesis 1 is successfully supported, whereas hypothesis 2 fails being supported. REPU (reputation) variable can have significant influence and negative-signed upon the interaction with TENUR (tenure) variable. Therefore, hypothesis 3 can successfully be supported.

### *5.2. Implication*

This research has implication on policy. This research result indicates that the stipulation of mandatory rotation should not have been necessary in Indonesia. But this conclusion is not true at all. It is because there are still many other factors that have not been included in this research. Aspect of law enforcement, culture and the poor application of Good Corporate Governance (GCG) encourage us to be more careful in drawing conclusion in this research. This research is only valid for this research design. Audit quality can be measured with other more appropriate measurement than only using accrual level. Personally, I support the regulation of public accountant. This research gives theoretical and practical implication that a stipulation to regulate profession should be carefully arranged with consideration of the

research result and other's opinion, especially in relevance with such profession. The government in this case is not guilty, because IAI (in this case, IAPI) should have been more actively involved and have initiated to regulate itself, before being regulated by public (government). The accounting profession should have shown good initiative and started to improve themselves. One thing to bear in mind is the problem of Enron is not the biggest and the last problem, because the biggest problem has not yet revealed itself. This research result indicates that long auditor tenure reduces audit quality measured with current accruals. It does not suggest that regulation of auditor or KAP is not required. Auditors without regulation will be dangerous. But when the government arranges regulation in relevance with the profession of public accountant, it would be better to put into considerations some other more spacious aspects. For example, it is very difficult for auditors to understand the complexity of client's business in short time.

### 5.3. *Suggestion*

There are three important things to do to improve this research, namely: a) research samples, b) research method and c) measurement of audit quality. This research samples are public firms in manufactured industry. Firms for financial industry are expelled from samples. The following research can compare the influence of auditor's tenure and reputation toward audit quality in different types of industry. Besides that, the next research can be done using more complete panel data. In the perspective of research, this research can be done with another approach, like experimental approach. This approach can give answers to the auditor's and client's behavior in relevance with action of low-balling in short term, and auditor's independence upon long tenure. The measurement of audit quality can be done with other proxy with consideration of a more appropriate definition of audit quality. Besides, this research uses the subject of KAP (public accounting firm), the next research can employ the subject of auditor.

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