

**THE AUDITOR TENURE AND THE QUALITY OF AUDIT:
MANDATORY AUDIT FIRM ROTATION AND AUDIT
QUALITY**

**Evidence from the Manufacturing Firms Listed in Indonesia
Stock Exchange (IDX)**



SKRIPSI

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By:

SYLFIANDY N

ID Num. 04153055



**ACCOUNTING DEPARTMENT
FACULTY OF ECONOMICS
ANDALAS UNIVERSITY**

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ABSTRACT

The Auditor Tenure And The Quality Of Audit: Mandatory Audit Firm Rotation And Audit Quality Evidence From The Manufacturing Firms Listed In Indonesia Stock Exchange (Idx)

Sylfiandy N

This study assesses whether mandatory audit firm rotation effect audit quality. Audit firm rotation reflects by the auditor tenure and quality of audit by quality of earning. Quality of earnings reflects by discretionary accrual, based on previous research that uses accruals to proxy for the quality of earnings. Further, if audit quality is thought of as constraining extreme management decisions in the reporting of financial performance, these results suggest that mandatory rotation may lead to lower audit quality. In this research the value of discretionary accruals are divided into three, absolute, negative, and positive discretionary accruals. Negative discretionary accruals show a positive relationship with Auditor Tenure and the rest of variables. Which mean auditee more conservative with the auditors that have been long relationship with them. Auditees tend to be more careful and choose to decrease their income that result in negative discretionary accruals. Positive discretionary accrual shows negative relationship with absolute value of Discretionary accruals. It means that the longer auditor tenure the lower positive discretionary accruals. In sum, there is negative relationship between Absolute Discretionary Accruals and Auditor Tenure. It means that the higher number the companies retained the same auditor (longer tenure) the lower the value of absolute discretionary accruals. The lower value of Absolute discretionary accruals reflects the higher earning quality. Or with simple conclusion, audit quality is increase as the auditor tenure increase

Keywords: auditor tenure, earnings quality, audit quality, mandatory rotation

CHAPTER I

INTRODUCTION

1.1 Background

The collapse of Enron and its auditor, Arthur Andersen, quickly led regulators worldwide to consider different mechanism for enhancing auditor independent. Particular attention has been given to aspects of the auditor-client relationship that could impact on auditor independence, whether in fact or in appearance. The auditing profession has traditionally opposed the implementation of any mandatory regulatory requirement for audit firm to rotate after a given period of tenure. A system of mandatory audit firm would require companies to rotate their audit firm, hereafter called auditor, periodically. Listed companies in Italy and Brazil are require to rotate their auditor every nine and five years respectively (Jackson et al 2006). Tempo online (April 16th 2007) record Singapore required its bank to rotate their external auditor every five years since 2003; in the same year South Korea stated auditor rotation is mandatory. Came along in the next year (2004) Lithuania also settle a mandatory auditor rotation for its public companies.

Indonesia listed companies at Februari 5, 2008, required to rotate their independent auditor every six years. This is the new policy since before they were required to rotate every five years. The first rule that required companies to rotate their auditor can be found in *Keputusan Menteri Keuangan Republik Indonesia Nomor 423/KMK.06/2002 tentang Jasa Akuntan Publik 30 September 2002*. It required companies to rotate their auditor every five years. But this rule

not yet implemented until 2004. A one year tolerance was given by the regulator and 2003 is considered as the transition year. At 2003 companies that have retained the same auditor for five or more years in a row still allows to use services of the same auditor until the years ended 2003. Furthermore explained in the *Keputusan Menteri Keuangan Republik Indonesia Nomor 359/KMK.06/2003 tentang Jasa Akuntan Publik 21 Agustus 2003*.

Recently the Indonesian Ministry of Finance, Sri Mulyani Indrawati published a new rule of public accountant in Indonesia. The policy is founds in the *Peraturan Menteri Keuangan (PMK) No. 17/PMK.08/2008 5 Februari 2008* about public accountant services. The new policy is the consummation of previous policy that was considered no longer sufficient with the recent condition (*Keputusan Menteri Keuangan (KMK) No. 423/KMK.06/2002 and KMK No. 359/KMK.06/2003*). One of many reasons that require the establishing of this policy was there are some changes in the association of public accountant. Before, each public accountant was grouped in the association called *Ikatan Akuntan Indonesia-Kompartemen Akuntan Publik*. But now, they are grouped under the *Institut Akuntan Publik Indonesia*.

These rotation issue comes to the surface because society have lost their trust on the public accountant profession. The requirement to rotate auditors is an attempt to reduce the threats to auditor independence largely arising from familiarity. The concern is that over the long term, the auditor becomes too close to the client and loses his or her "honest disinterestedness". For example, auditor independence can decrease as friendships develop, the auditor becomes too closely identified with the interests of client management, the audit plan becomes

CHAPTER V

CONCLUSION AND LIMITATION

5.1 Conclusions

This research investigates whether mandatory audit firm rotation effect audit quality. Audit firm rotation reflect by the auditor tenure and audit quality by quality of earning. Overall, this research found that there is a negative relationship between absolute discretionary accruals and auditor tenure. It means that the higher number the companies retained the same auditor (longer tenure) the lower the value of absolute discretionary accruals. The lower value of absolute discretionary accruals reflects the higher earning quality. Or with simple conclusion, audit quality is increase as the auditor tenure increase (H1-rejected; H2-accepted).

The main issue that comes up with this auditor rotation problem is that the worried about the independent of auditors if the companies retained the same auditor with no limitation tenure can cause an audit quality reduction. But, in fact independence is not the only issue that needs to put in consideration. For example, audit quality is lower in the early years of the auditor-client relationship. Audit quality is alleged to be lower in the early years of the relationship because the auditor is unfamiliar with the client's business, operations, systems, controls, and accounting policies.

Those in favor of a mandatory change of the audit firm often defend their view by claiming that audit quality deteriorates as audit tenure increases because the relationship between the auditor and the client becomes too strict and the

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