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Audit Committee and Audit Change: Empirical Evidence from the Emerging Market

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Abstract

This study aims to investigate the relationship between audit committee and audit change in listed Indonesia Company. We use four variables for audit committee that is independence, size, financial expertise and activity. Besides, this study also uses three control variables (ROA, LEV, and SIZE). By using the Binary Logit Model (BLM) with panel data for 654 observation, we find that all hypotheses are rejected which means that there is no role of audit committee in determining the audit change. However, big and company with the higher leverage is less likely to change audit firm. This finding has a practical and theoretical implication. For practical implication, regulator or government agent can increase the financial reporting quality by improving the role of audit committee by changing related mechanism.

Keyword; Audit committee, audit change, Indonesia listed company.

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1. Introduction

One of the most significant current discussions in corporate governance is the role of the committee. Board committee consists of the Audit, Risk, Remuneration and Nomination committee. In relation with the quality of financial reports, Audit committee has a significant role to determine the reliability of financial reports (McMullen, 1996). In addition, several countries have a regulation that public company has to have the audit committee, such as Indonesia. In fact, there is a specific regulation regarding to the number and independent of audit committee. Audit committee facilitates the communication with internal auditor, external auditor, management and board of directors (Cohen et al, 2004).

Auditor change refers to company changing its external auditor due to some reasons, such as accounting disagreement, auditor resigned, fee dispute, qualified audit opinion and etc. Many expert has argued why company change its external auditor (e.g. McMullen, 1996). He argues that management will search for new audit firm that agree about financial report and/ or disclosure decision. In addition, audit change is a signal from management. However, government agent also regulates auditor rotation. For example, Indonesia ministry of finance has released the regulation regarding to the audit rotation[2]. The audit firm only can audit the company financial report 5 years respectively and 3 years for auditor. Auditor change has been seen as mechanism to enhance the independent and audit quality (Ryken, Radich and Fargher, 2007). In addition, auditor change (or rotation) is an effort to reduce the "familiarity threat" to the acceptable level.

Zaitul and Hanim (2011) documented that there are 117 observations change the external auditor during 2006 to 2008[3]. Therefore, the research question arise why some company change its external audit. Research about the audit change has been largely done by many researchers, for example Carsello and Neal (2003), Hudaib and Coke (2005) and Robinson and Owens-Jackson (2009). However, previous study has very much focused on company characteristics as determinants. Study on the relationship between audit committee characteristic and auditor change are very limited, especially in Indonesia. In addition,

[2] No. 423/KMK.06/2008

[3] In their study, they use 218 companies for 2006 t0 2008

Indonesia has a different economic, business and culture systems. For example, Indonesia has unique corporate boards system. Even thought Indonesia follow the Continental Europe Board system but it has been adjusted in term of appointed and dismissal of board of directors. Therefore, this study would enrich the literature about the audit change and role of audit committee. Thus, this article aims to determine whether the audit committee characteristics affect the audit change prior mandatory regulation released by ministry of finance. The remaining of this paper is organized as follow. The next session discuss about the theoretical foundation and hypotheses development, followed by research methodology, finding and discussion, and finally conclusion and recommendation.

2. Theoretical foundation and hypothesis development

2.1. Audit Committee independence

Audit committee independence is a committee from outside of company. The role of audit committee independence to mitigate the agency problem has been argued by many experts. Klein (2002) claim that audit committee independence act independently in order to resolve the agency conflict. However, audit committee independence might be perceived not to be effective due to lack of accounting and finance knowledge (Paton & Baker, 1987). Previous study has reported that audit committee independence significantly associated with the audit change (Robinson and Owens-Jackson (2009). Based on the theoretical and previous study, we can conclude that audit committee independence significantly associate with the audit change.

H1 : There is a significant relationship between audit committee independence and audit change.

2.2. Audit Committee size

The significant of the audit committee size is from the dependence resources theory (Pierce & Zahra, 1992). Pierce & Zahra (1992) argue that bigger size audit committee will provide more diversity in skill and competency. This diversity contributes to the effective monitoring. However, the bigger number of audit committee is not monitoring effectively

due to the communication and decision making problem (Jensen, 1993). The number of audit committee is expected to improve the financial reporting quality and to have a significant role in determining the audit change. Thus, the next hypothesis is as follows

H2 : There is a significant relationship between audit committee size and audit change.

2.3. Audit Committee financial expertise

Audit commitee financial expertise refers to audit commitee members who have the financial expertice. Most of capital market required the audit commitee to have the financial expertice. For example in Indonesia, one of audit committe members must have the accounting and financial expertice. Most of study conclude that the existence of audit commitee financial expertice associated with the quality of financial report. For example, Abbot et al (2004) documented the relationship between audit commitee financial expertice and accounting quality (in term of financial restatement). Robinson and Owens-Jackson (2009) also found the significant relationship between audit committee financial expertise and audit change.

H3 : There is a significant relationship between audit committee financial expertise and audit change

2.4. Audit Committee Activity

Audit committee activity is one of determinants of quality of financial report. It is usually measured by frequency of meeting, meeting duration etc (Hsu, 2007). In addition, Adam (2000) states that frequency of audit committee meetings can measure the level of real monitoring and control. Further, Abbot et al (2004) argue that more frequency of audit committee meeting would make them more informed and knowledgeable about accounting and auditing issues. Previous studies investigating the effect of the audit committee activity on accounting quality has been largely done (see for example, Lin et al., 2006; and Saleh et al., 2007) but little on audit change. However, Robinson and Owens-Jackson (2009) investigated

this relationship. Based on the theoretical reasons and previous study, the next hypothesis offers as follow.

H4: there is a significant relationship between audit committee activity and audit change.

3. Sample, data and model

This study aims to investigate the relationship between audit committee independence, size, financial expertise and activity, and audit change. This study uses the 218 companies (44.9% of total population) for three years. Therefore, the number of observation is 654 companies-years. For this research, we use the secondary data from multiple sources, such as annual report, Indonesia Capital Market Directory, company website and other sources. Moreover, there are three group variables here: audit change (dependent variable), audit committee (independent variables) and control variables (ROA, LEV and SIZE). Audit change is categorical variable which measured by 1 if company change its audit firm and 0 otherwise. Audit committee independence is measured by ratio of number of audit committee independence over the total audit committee members (Hsu, 2007). In addition, total number of audit committee is used to measure audit committee size (Abbot et al, 2004). Further, audit committee financial expertise is measured by using the proxy offered by Hsu (2007). And the number of meeting held in a year is proxy for audit committee activity (Lin et al., 2006). However, Return on asset (ROA) and debt to asset (LEV) are proxy for profitability and leverage. In addition, company size indicate the big or small company which measured by total asset. The research model is as follow,

$$\mathbf{AC}_{it} = a + \beta_1 ACI_{it} + \beta_2 ACS_{it} + \beta_3 ACFE_{it} + \beta_4 CA_{it} + \beta_5 ROA_{it} + \beta_6 LEV_{it} + \beta_7 SIZE_{it} + e \quad ..(1)$$

The data is analyzed by using the logit model due to the dependent variable is a dummy variable. Therefore, the logit model procedure is applied to this study.

4. Result and Discussion

Total sample of this study is 218. This sample is much more adequate due to the minimal sample is 10 to 20 time of the number of variables (Sekaran, 2003). In this case, the minimal sample is around 80 companies. Therefore, the number of observation is 654 company-years. The table 4.1 shows the descriptive statistics.

Table 4.1
Descriptive Statistic

No	Variables	Descriptive Statistic before Outlier Test (n=654)			
		Min	Max	Means	SD
1	ACI (%)	0.00	100.00	45.34	23.96
2	ACS (person)	1.00	8.00	3.21	0.74
3	ACFE (%)	0.00	100.00	52.70	26.01
4	ACA (x)	1.00	96.00	3.31	10.23
5	ROA (%)	-130.00	62.20	3.65	13.19
6	DAR (%)	0.00	238.00	53.31	29.78
7	SIZE (billion)	0.40	57929.00	5696.15	12489.51
8	AC	0.00	1.00	0.18	0.38

Note; ACI is audit committee independence, ACS is audit committee size, ACFE is audit committee financial expertise, ACA is audit committee activity, ROA is return on asset, DAR is debt to asset ratio, SIZE is company size, and AC is audit change.

Data analysis is begun by checking the outlier. We use the Grubb test procedure to detect and remedy the outlier data (Grubb, 1969). Out of nine variables, three variables is free from outlier, that are ACFE, LEV and AC. Other variables are remedied by using the Grubb's procedure. The next analysis is normality test. We utilize the Kurtosis and Skewness to detect normality. In addition, transformation is applied if variables are not normal. Tolerance value of kurtosis and skewness is + 1 and – 1 (Owusu-ansah, 2006). The result of detection and remedy for normality is presented below.

Table 4.2
Normality Test and Transformation

Variable	Skewness		Kurtosis		Transformation	Skewness		Kurtosis	
	Stat	SE	Stat	SE		Stat	SE	Stat	SE
aci	1,26	0,1	0,64	0,19	inverse	-0,52	0,1	-0,112	0,19
acs	1,68	0,1	3,67	0,19	normal score*	-0,94	0,1	1,76	0,19
acfe	0	0,1	-0,44	0,19	none needed	0	0,1	-0,44	0,19
aca	2,19	0,1	5,16	0,19	Logarithma	0,32	0,1	0,35	0,19
roa	0,63	0,1	4,98	0,19	normal score*	-0,01	0,1	-0,19	0,21
dar	0,47	0,1	0,96	0,19	none needed	0,47	0,1	0,96	0,19
size	2,77	0,1	7,22	0,19	Logarithma	-0,48	0,1	0,24	0,19
ac	1,67	0,1	0,78	0,19	dummy				

*The data were transformed by computing normal scores using Van der Waerden's transformation defined by the formula r/(w + 1), where w is the sum of the case weight and r is the rank ranging from 1 to w.

To analyze data, this study uses a panel data using the e views software. Further, the first step is testing the feasibility of the model. In this case, we use the Hosmer and Lemeshaw test and the result show that the model is feasible. H-L test is 5.9210 with the significant value of 0.6561 which is greater than 0.05. Therefore, we can conclude that there is no significant difference was found between the classifications of the observed and predicted. Thus, the model is fit and can proceed to next procedure. To regress data, binary logic model (BLM) use with option of quadratic hill climbing. To describe How far the independent variables could explain the dependent variable use the McFadden R-Square. In addition, McFadden R Square is 0.0206; meaning that independent variables can explain only 2.06% and the rest is from other variables which are not included in this study.

Table 4.3
Regression Result

No	Variables	Coefficient	Standard Error	Z statistic	Probability
1	C	-0.315595	0.903094	-0.349460	0.7267
2	ACI	0.072492	0.120015	0.604025	0.5458
3	ACS	0.097926	0.190369	0.514400	0.6070
4	ACFE	-0.493788	0.403361	-1.224.183	0.2209
5	ACA	0.389336	0.399273	0.975114	0.3295
6	ROA	-0.150657	0.114050	-1.320.978	0.1865
7	DAR	-0.753993	0.391793	-1.924.468	0.0543*
8	SIZE	-0.229681	0.124053	-1.851.466	0.0641*

Note: AC is dependent variable, * Significant at 10%

Table 4.3 indicates the regression result. All hypotheses are rejected, meaning that there is no role of audit committee characteristic in determining the audit change in Indonesia listed company prior 2009. However, two variables control is significantly negative associated with the audit change, which is leverage and company size. It means that big and company with higher leverage is less likely to change the audit firm. This finding is contrast to previous study done by Robinson and Owens-Jackson (2009). In addition, this result does not also confirm the premise that audit change aims to increase the financial reporting quality and therefore, audit committee should have contribution to the financial reporting quality.

5. Conclusion

The role of audit committee in determining the financial reporting quality is prevalent in agency theory. One of their roles is change audit firm to get higher quality of financial report. However, there is a limited study on relationship between audit committee and audit change, especially in Indonesia. Based on the 218 company for three years and using the binary logic model for panel data, we find that there is no role of audit committee in determining the audit change. This finding is contrast to the previous study, such as Robinson and Owens-Jackson (2009), agency theory. However, this finding have a practical contribution in the sense that audit committee role in Indonesia setting must be improve by changing the certain mechanism regarding to audit committee. The future researcher could continue this study by selecting other relating audit committee variables as determinants of the audit change.

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