CHAPTER II

LITERATURE REVIEW

2.1. Theoretical Review

2.1.1. Agency Theory

Agency theory is a theory that explains the relationship between principle and agent. Sari and Puspaningsih (2018) stated that an agency relationship is a form of contract on which shareholder or principle give a command to management or agency to perform services on behalf of principle and give authority to an agent in terms of making the best decision for principle. Jensen and Meckling (1976) defined agency relationship as the contract between principle parties that persuade other parties in agent to perform management service in accordance with principle interest, including giving the decision making authority to the agent. Agency theory is the theory that examines the conflict between principle or shareholder and agent or management. An agent presents a financial report for its own interest, while principle expects the financial report describe the actual condition of the company (Robbitasari & Wiratmaja, 2013). In agency theory, there is a gap between the interest of principle and agent. The different intention of these parties is called information asymmetry. The main purpose of agency theory is to explain how those parties are able to design and determine contract that aims to minimize costs caused by asymmetric information and uncertainty condition (Hartadi, 2012).

Based on economic theory and contract theory, information asymmetry is a condition in which one party has more information or better information than the other (Hartadi, 2012). Auditing can decrease the agency risk created by the conflict of interest, such as information asymmetry between agency and principle (Watts & Zimmerman, 1983). Since there is a conflict of interest between principle and agent, an independent party is critical. Independent auditor plays a role as a mediator between agent and principle party (Wea & Murdiawati, 2015). That is why financial report should be audited by an independent auditor. Audited financial statements as the result of the accounting process are widely seen as a tool to decrease agency cost (Francis & Wilson, 1988). Auditing result is aimed to increase the information quality produced by the company. The value of an audit is expected to minimize the potential conflicts of both principle and agent interest.

In this research, agency theory is related to audit switching since management as an agent and shareholders as a principle have different interest. One of the concerns in agency theory is the problem of agency conflict, which can be minimized by implementing auditor switching. As it is well known that auditing is one of the assurance services that aims to improve the quality of information produced by a company (Budisanto, Bandi & Probohudono, 2017). When the information in financial statements has high quality, it will have value, which in turn reduce the conflict of interest. Auditor switching is critical since the company needs to maintain the quality of audit and auditor. High-quality audit is necessary too in order to reduce agency gaps (Budisanto, Bandi & Probohudono, 2017).

2.1.2 Auditing and Auditor

Generally, auditing is a systematic process to gain and evaluate evidence objectively with regard to the statements on economic activities and events, which aims to determine the conformity level between the statements and established criteria and deliver the result to interested users (Mulyadi, 2009). From public accountant point of view, auditing is the objective examination of company or organization financial report for the purpose of determining whether the financial report is presented fairly in all material aspects, financial position and company or organization result (Mulyadi, 2009). It is know to all, auditing activity is necessary for companies as it will bring about accurate, reliable, and trusted report required by management and reports users. The common way to get reliable information is to require independent audit so the information used in decision making is accurate and unbiased. According to Christiawan (2002), since there is a conflict of interest between management and financial report users, financial reports need to be audited. There are three reasons why financial report auditing is necessary; (1) the information in financial report has substantial economic consequences in decision making, (2) expertise is often needed in preparation and verification of information in financial reports, (3) using financial report cannot directly verify quality information of financial reports (Taylor & Glezen, 1997). Moreover, an auditing function can detect and disclose earning management and other variety of misconduct by business managers or controlling shareholders (Lin & Liu, 2010). Those factors indicate how necessary auditing in companies sustainability. According to Arens, Elder, Beasley, and Jusuf (2011), there are several types of audit, which are:

a. Financial statement audit

   It is an audit related to activities of obtaining data, evaluating the evidence regarding entity reports for the purpose of providing the opinion if the reports have been fairly presented in accordance with Generally Accepted Accounting Principle (GAAP) or *Prinsip Akuntansi yang Berlaku Umum* (PABU).

b. Compliance audit

   An audit related to the activity of obtaining and examining evidence to determine whether the financial activities or operational activities of an entity are in accordance with certain requirements, conditions, and specified regulations.

c. Operational audit

   An audit related to the activity of obtaining and evaluating evidence regarding the efficiency and effectivity of operational activities of an entity for achieving certain goals. Operational audit is often called as management audit or performance audit.

d. Forensic audit

   Forensic audit or usually called forensic accounting, is an accurate accounting for legal purpose. Forensic accounting is the application of investigative and analytical expertise for the purpose of solving the financial problems in accordance with the provision of court institutions (Hopwood et al., 2008).

Regarding auditing, the auditor also takes an important part in performing this activity. International Standard on Auditing 200 in International Auditing and Assurance Standard Board stated that an auditor is a person individually or group that conducts an audit, normally the engagement partner or other individuals of the engagement team, or, as applicable, the firm (International Auditing and Assurance Standard Board, 2009). Auditor independence is needed in auditing process. When an auditor is independent, he/she could obtain a reliable financial statement and detect misstatement committed by companies. Without the service of an independent auditor, management of a company will not be able to convince other parties that their financial statements are reliable. An auditor should not only prove and verify the fairness and completeness of the company financial statements but also monitor the management's financial performance in terms of company responsibilities (Imhoff, 2003). Moreover, an auditor should be able to detect and discover the manipulation of accounting numbers committed by the management and misconduct in terms of company regulation (Lin & Liu, 2010). These attempts are most likely to prevent a company from committing fraudulent acts. During an audit process, an auditor must often communicate or interact with the management to obtain necessary evidence and usually, auditor will request confidential data, thus auditor attitude is to recognize the importance of objective assessment and evidence obtained during an audit (Ardini, 2010). When a company has been audited by a certified public accounting firm, the firm will issue audit opinion. Based on Nasser et.al. (2006), an auditor is required to form and express an opinion in audit report as an unaffected bias observer, thus auditors are expected to prevent the situation that might cause other people conclude that auditors are not objective.

2.1.3. Auditor Switching

Auditor switching is the changes in the audit firm or auditor done by client or companies. In this research, auditor switching refers to the companies that change their auditor (certified public accountant) or the public accounting firm after the end audit period. Auditor switching is defined into two types, they are mandatory and voluntary auditor switching. These two types can be distinguished based on which party that becomes a concern. If auditor switching is done voluntarily, the main concern is on the client side. Meanwhile, if the company decides to do mandatory auditor switching, the concern is on the auditor side (Hudaib & Cooke, 2005). Auditor switching done by companies is to solve the independence issue in giving opinion on financial report because of the concern of audit tenure length. Auditor switching could happen when the auditor is dismissed by the company or the auditor resigns from an agreement. Dismissal issue comes from company initiative, while resignations are auditor decision (Schneider, 2015). Voluntary auditor switching, in general, focuses on matters such as pressuring authoritative auditors to issue clean audit opinions, brand name reputation, industry specialization, market power, and low-balling or price-gouging (Scott & Gist, 2013).

Auditor switching has received considerable attention from regulators, such as Securities and Exchange Commission (SEC) (1988). They stated the concern regarding auditor, that companies seek an auditor who is willing to support a proposed accounting treatment designed to enable a company to accomplish its reporting targets in spite of frustrating reliable reporting (Securities and Exchange Commission, 1988).

There are several concern and regulations related to auditor switching. The concern of Sarbanes-Oxley Act year 2002 about the close relationship between auditor and management focuses on the importance of auditing as important governance mechanism as a tool for shareholders to monitor management (Chan, Lin & Zhang, 2007). This indicates that independency is critical in auditor switching because companies can maintain outside party trust and reliability. This is strengthened through Government regulation no. 20 the year 2015 about Public Accountant Practice; in article 11 paragraph 1 about audit service provision of historical financial information toward the entity by the public accountant is limited to maximum 5 consecutive years. This limitation is for public accountant not public accounting firm. According to Budisanto, Bandi & Probohudono (2017) regarding on ASEAN countries, that Indonesia, Singapore, Laos have regulation of auditor switching in every 5 years, and Cambodia government regulate it every 3 years. On the other hand, Philippines, Malaysia, and Vietnam have no certain auditor switching rules.

2.1.4. Audit Fee

Audit fee refers to some amount of money that a company spends to pay audit service by an audit firm. In accordance with Castro, Peleias, and Silva (2015), the value of an audit is on the perception of audited statements' users regarding auditor’s ability to detect errors or frauds in the accounting system and to prevent client pressures to reveal the errors and frauds. The calculation of auditor fees has sensitive matter; audit fee should reflect the agreement of both parties, which are audit firm and companies (client). The best method to charge auditor fees might use fixed cost or value (Castro, Peleias & Silva, 2015). However, this procedure may lead to excessive fees and will ruin client relationships. On the other side, when the audit fee is too low, it will put the auditor at loss. Indonesian Institute of Certified Public Accountant or *Insitut Akuntan Publik Indonesia* (IAPI) ruled in board regulation no. 2 the year 2016 about determination of financial statement audit service fee. It states that fee of audit financial statement service that is too low could raise a threat in form of personal interest that potentially cause disobedience or non-compliance with ethics code of Public Accountant profession (Indonesian Institute of Certified Public Accountants, 2016). Therefore, public accountants should make prevention by applying service fee for financial statement audit that is sufficient to perform an audit process.

2.1.5. Public Accounting Firm Reputation

Public accounting firm or audit firm refers to an entity that provides audit service and oversees auditors or certified accountants. In the 1960 era, there were 8 public accounting firms presented as a big accounting firm in the world. Gradually, the big eight turned into big six, big five, and now become big four. These changes happened because there was a merger between the big accounting firm and the collapse of a big accounting firm–Arthur Anderson audit firm. In this research, public accounting firm size is divided into big accounting firm and non-big 4 accounting firm. The big 4 accounting firms in Indonesia are:

a. Deloitte Touche Tohmatsu (Deloitte), affiliated with Hans Tuankotta Mustofa & Halim; Osman Ramli Satrio and friends; Osman Bing Satrio and friends.
b. Ernest and Young (EY), affiliated with Prasetyo, Sarwoko & Sandjaja; Purwanton, Surwoko & Sandjaja.
c. Kliynveld Peat Marwick Goerdeler (KPMG), affiliated with Siddharta Siddharta Widjaja
d. Pricewaterhouse Coopers (PwC), affiliated with Haryanto Sahari & friends; Tanudredja, Wibisana & friends; Drs. Hadi Susanto & friends.

This classification is in accordance with the amount of clients served by an accounting firm, the amount of partners or members joined, and total revenue gained in one period (Christiawan, 2002). Public accounting firm reputation that audits a company has an important influence on financial statement credibility to investors. Companies tend to choose a certified audit firm to increase financial report quality; hence it will upgrade company reputation to financial report users. Audit firm reputation may affect auditor change, since a large company usually uses big 4-audit firm as its independent auditor. Studies suggest that big four audit firms–Deloitte, PricewaterhouseCoopers, Ernst & Young, and KPMG usually have more capability of maintaining qualified independency than their small partners (Nasser et. al, 2006). Those audit firms usually provide several services to clients, thus it will reduce the dependence on particular clients.

2.1.6. Company Size

Company size can be described as the successfulness of firm financial condition. Size of a firm directly reflects the level of operational activity. A large company usually has more complexity rather than a smaller company. Company size is determined by total asset and regulated on OJK or *Otoritas Jasa Keuangan* that taken from the provision of Capital Market Supervisory Agency and Financial Institution or *Badan Pengawasan Pasar Modal* No. 11/PM/1997, which states developed company or small company is the firm that has a total asset not more than 50 billion rupiah. Company size scales can be measured from financial side by examining the total asset as stated before. Larger amount of total asset that a company has reflects how big the company is, and vice versa (Wea & Murdiawati, 2015).

2.1.7. Company Financial Distress

Financial distress is the condition of a company that is experiencing financial difficulties (Astrini & Muid, 2013). Financial distress has two concepts, first, it refers to the inability to pay obligations when due, second is when being bankrupt, the company asset exceeds its liabilities (Beaver, Correia, & McNichols, 2013). There are many companies have had negative net worth but as long as the company has an unrecognized intangible asset and has an ability to meet its obligations when due they are not considered in financial distress (Beaver, Correia & McNichols, 2013). Financial distress occurs when the company has higher liabilities rather than its assets. It indicates that the company has difficulties in paying its financial obligations. A study done by Astuti and

Ramantha (2014) revealed that financial distress that occurred in a company would affect client's decision in doing auditor switching. According to Wea and Murdiawati (2015), financial distress is measured by Debt to Equity Ratio. Higher DER ratio shows a total debt of company is bigger than total equity that it will lead to the increased liabilities to creditors. Clients with financial distress is inclined to change their old public accounting firm to the new one (Wea & Murdiawati, 2015). A company tends to do auditor switching since high audit cost will determine company's decision to change audit firm with lower audit cost.

2.2. Literature Review

The table below consists of several prior studies about auditor switching in Indonesia and other countries with several test variables and control variables, and diverse independent variables. It includes the result of researches, purpose, methodology and sample used.

Table 2.1 Previous Research Table

Authors	Research Purpose	Research Variable	Methodology and Sample	Result of Research
Wea & Murdiawati, 2015	Analyze the factors that affect voluntary auditor switching on manufacturing companies listed in IDX.	Dependent variable: auditor switching Independent variable: management changes, financial distress, KAP size, changes of ROA percentage, client size, and audit opinion.	Method: Logistic regression Sample: 630 manufacture companies	There is a significant influence of management changes, financial distress, KAP size, and client size toward auditor switching in manufacture companies. It revealed the changes in ROA percentage and audit opinion do not affect significantly auditor switching
Astrini & Muid, 2013	Find empirical evidence on the factors that affect the manufacturing companies listed on BEI.	Dependent variable: auditor switching Independent variable: auditor reputation, management changes, financial distress, accountant opinion, and audit tenure.	Method: Regression analysis Sample: 32 manufacture companies	This study found that audit tenure has a significant influence on auditor switching voluntarily. However, other variables such as auditor reputation, management changes, financial distress, and auditor opinion do not significantly influence auditor switching.

Table 2.1 Previous Research Table (continue)

Authors	Research Purpose	Research Variable	Methodology and Sample	Result of Research
Nasser, et. al., 2006	Examine one aspect of auditor-client of relationship, namely audit tenure and switching behavior, and factors affecting it.	Dependent variable: Audit tenure and audit switching Independent: book value of equity and market value of equity, client size, changes in total assets, changes in sales, audit firm type, changes in income from continuing operations in the two years preceding the audit change, financial distress, etc.	Method: Logistic regression Sample: 297 companies listed on Kuala Lumpur Exchange	It found that client size, client financial risk, the changes in a total asset, and interactive effects of the length of tenure before switching are significantly associated with audit switching. While, client growth, changes in operating income, and market value of equity were found not to be significant. Length of tenure of the big 4-audit firm is negatively related to audit switching.
Pawitri & Yadnyana, 2015	Analyze influence of audit delay, audit opinion, auditor reputation, and management change on auditor switching on real estate & property companies.	Dependent: auditor switching Independent: audit delay, audit opinion, audit reputation, and management changes.	Method: Regression analysis Sample: 27 real estate and property companies	The study found that audit delay, auditor reputation, and management changes influence voluntary auditor switching in real estate and property companies.

Table 2.1 Previous Research Table (continue)

Authors	Research Purpose	Research Variable	Methodology and Sample	Result of Research
				While other variables namely audit opinion did not significantly affect the voluntary auditor switching.
Bagherour, et. al., 2014	Investigate how auditor switching is affected by government influence, misalignment between a type of auditor (government vs. private), type of controlling shareholder (government vs. private), and misalignment between the authoritative auditor and imputed preference of managers in a market.	Dependent: auditor switching Test variables: government influence, misaligned, changes in management, type of audit opinion, discretionary accrual. Control variables: government ownership, audit opinion, size, loss, ROA, type of industry.	Method: Logistic regression Sample: Companies listed on Toronto Stock Exchange	The result found that government influence is negative and significant. It indicates that the existence of significant government influence will decrease auditor switching. The misaligned variable is positive and significant, which means private sector controlled companies with government auditor are more likely to do auditor switching. Changes in management, discretionary accrual, and audit opinion significantly positively affected auditor switching.

Auditor switching refers to the change of an auditor or public accounting firm (audit firm) conducted by the companies. There are several factors that can influence this action. Auditor switching decision may come from either company (client) side or audit firm itself. In this research, the factors that might affect auditor switching are audit fee, public accounting firm reputation, company size, and company financial distress. Auditor switching studies have been already studied in several countries with various types of variable, year period, and objects. According to Wea and Murdiawati (2015) that studied Indonesian manufacturing companies revealed there is a significant influence of public accounting firm size and company financial distress toward auditor switching. This result contrasts with the research by Astrini and Muid (2013), which stated that auditor reputation and company financial distress have no significant influence on auditor switching. Similarly, Nasser et. al. (2006) studied 297 companies listed on Kuala Lumpur stock exchange said that client financial risk is positively associated with auditor switching.

The financial position of the client may have an important implication on auditor switching decision. Companies that are insolvent and experience unhealthy financial condition potentially will involve auditors with high independency for the purpose of boosting the confidence of shareholders and creditors (Nasser et. al., 2006). The audit fee is one of the factors that influence auditor-switching decision (Astuti & Ramantha, 2014; Wijaya & Rasmini, 2015; Chadegani, Mohamed & Jari, 2011; Yendrawati, 2011). A company tends to change its auditor when the auditor fee is high; the company will seek another auditor with lower cost in order that the company will not be burdened down. The inclination of choosing lower audit fee is also due to similar service quality of each audit firm (Yendrawati, 2011). So, when management is not comfortable with audit fee, they tend to do auditor switching to find a better offer.

Public accounting firm reputation is defined as whether the audit firm is associated with big 4 accounting firms in Indonesia or not. Trisnawati & Wijaya (2009); Mardiyah (2003); Pawitri & Yadnyana (2015); Aprianti & Hartaty (2016); Gunady & Mangoting (2013); Yendrawati (2011) argued that audit firm size has a significant influence toward auditor switching. According to Mardiyah (2003), audit firm expertise is one of attributes in big audit firm service. The existence of expertise factor will determine the change of an auditor by the company, thus the company tend to choose larger audit firm. Big four public accounting firms are included in good reputation audit firm internationally since they have a widespread network around the world and have competent and experienced auditors (Aprianti & Hartaty, 2016). Thus, investors will more consider the financial statements audited by reputable auditors. Meanwhile, audit reputation does not affect companies to change their auditor in the research of manufacture companies listed in the stock exchange in ASEAN regions, including Indonesia, Malaysia, Philippine, Singapore, and Thailand (Budisantoso, Bandi & Probohudono, 2018). The reason is when a company has already been audited by the big four public accounting firm, it will not its switch audit firm as the firm has a high reputation. The investors will more consider the company with consistently–used audit firm. This result corroborates the research finding by

Sugiarti & Pramono (2016), audit firm size is not proven to influence a company to do auditor switching.

Company size has a positive impact on auditor switching (Astuti & Ramantha, 2014; Budisantoso, Bandi, & Probohudono, 2018). The more developed the company is, it tends to need better reputation auditor to increase its credibility to shareholders. Thus, large companies tend to have more complexity. High-quality auditor is considered more capable of doing audit processing in a large business as well as decreasing large information asymmetry because of large gap. This finding contrasts with Schwartz & Menon (1985); Wijaya & Rasmini (2015); Aprianti & Hartaty (2016); Chadegani, Mohamed & Jari (2011). Companies with a large number of the total asset will still use big four audit firm service to audit their financial statement, while a company with small total asset tends to switch auditor to non-big four-audit firm (Aprianti & Hartaty, 2016).

According to Wijaya and Rasmini (2015); Astuti and Ramantha (2014); Trisnawati and Wijaya (2009); Sugiarti and Pramono (2016); Faradila and Yahya (2016); Yendrawati (2011) company financial distress does not affect a company to do auditor switching. The larger the leverage ratio that company has, the bigger the probability of financial risks. Consequently, the company with high financial risks is inclined to choose bigger audit firm, with the expectation that the audit firm has better ability to analyze current situation and increase the credibility of audit report compared to small audit firms (Trisnawati & Wijaya, 2009). A company will not conduct auditor switching when there are financial difficulties due to the concern of shareholder's perception. A company that conducts auditor switching not within the time specified of regulation will evoke shareholder's negative responses (Sari & Puspaningsih, 2018).

On the other hand, auditor switching is influenced by company distress (Mardiyah (2003); Chadegani, Mohamed & Jari (2011); Djamalilleil (2015); Gunady & Mangoting (2013). The condition of client company that has the possibility of bankruptcy will improve the objectivity and carefulness of the company's auditor. In this condition, the company will tend to change auditors. Another reason is the company no longer has the ability to pay audit fee charged by audit firm due to decreased financial capacity (Yendrawati, 2011).

2.3. Hypothesis Formulation

The variables used in this research are audit fee, public accounting firm reputation, company size, and company financial distress. These variables have probability that will affect auditor switching.

2.3.1. The Influence of Audit Fee on Auditor Switching

Agency theory is a contract between agency and principle; agent will have the authority to make the best decision for principle (Jensen & Meckling, 1976). The audit fee is one of the concerning problems in determining the suitable auditor for a company. In relation to audit fee, management as an agent will determine the best cost that they will spend for an audit firm. Encouragement to do auditor switching is caused by several factors; the audit fee that is relatively high offered by the audit firm to a company and there is no agreement on audit fee amount. Agent and principle have a different interest in determining audit fee.

Management as an agent tends to choose lower audit fee to relieve their financial condition. Meanwhile, shareholders as principal usually intend the company to be audited by the big four-audit firm, which charges high fee. Thus, this factor has a probability to influence auditor switching. Based on previous research, audit fee has a significant influence on auditor switching positively (Astuti & Ramantha, 2014; Wijaya & Rasmini, 2015; Chadegani, Mohamed & Jari, 2011; Yendrawati, 2011). Thus, a hypothesis is proposed as follows:

H1: *Audit fee has a positive influence on auditor switching*

2.3.2. The Influence of Public Accounting Firm Reputation on Auditor Switching

Larger audit firm is considered to be able to maintain the independence of their auditor better rather than smaller audit firms since they provide the range of service to clients in the larger number (Budisantoso, Bandi, & Probohudono, 2018). Big audit firms are generally considered to provide high-quality audit and good reputation in business environment. This factor has encouraged companies to maintain the independency and the good impression of the companies (Naseer, et. al., 20016). According to agency theory, agency and principle have the same goal to maximize company value, thus agency will act in accordance with principle interest (Jensen & Meckling, 1976). In this case, principle will encourage a company to keep using big four-audit firm as its auditor, and agent will be in favor with it. Thus, a hypothesis is proposed as follows:

H2: *Public accounting firm reputation has a negative influence on auditor switching*

2.3.3. The Influence of Company Size on Auditor Switching

A principle expects a company to have big financial result, while agent should perform well to gain company value and make the best decision for the company. Company size is a scale that can be classified as big or small regarding company's finances. As citied in Palmrose (1984), the larger the companies, the higher the probability of agency conflict happens and this might increase demand for quality-differentiated auditors (Nasser et al., 2006). It indicates that larger companies tend to do auditor switching because of complex operational activities (Sari & Puspaningsih, 2018). In addition, a company with bigger financial operational has a lower probability of doing auditor changes rather than a small company to maintain their independency. The shareholders in large company will be more convinced if the management hire audit firm affiliated with big four as the auditor. According to previous research, company size has a positive influence on auditor switching (Astuti & Ramantha, 2014; Budisantoso, Bandi, & Probohudono, 2018). Thus, a hypothesis is proposed as follows:

H3: *Company size has a positive influence on auditor switching*

2.3.4. The Influence of Company Financial Distress on Auditor Switching

Financial distress is defined as the condition of a company that is experiencing financial difficulties and has the possibility of bankruptcy (Astuti & Ramantha, 2014). The uncertainty in business that occurs in distressed companies may lead to auditor switching (Astrini & Muid, 2013). In other words, a company can potentially do an auditor switching when it is experiencing financial distress. Nevertheless, auditor switching may harm company's reputation. Management as an agent will prefer to do auditor switching to save their company because of the decreasing financial ability to pay audit fee (Djamalieli & Sari, 2015). Meanwhile, principle tends to demand the company to continue to use current auditor or audit firm. According to Hudaib and Cooke (2005); Chadegani, Mohamed & Jari, 2011; Djamalilleil 2015; Gunady & Mangoting (2013), company financial distress has a significant influence on auditor switching. Thus, a hypothesis is proposed as follows:

H4: *Company financial distress has a positive influence on auditor switching*

2.4. Research Model

This research examines impact of several factors, such as audit fee, pubic accounting firm reputation, company size, and company financial distress toward auditor switching. The study will prove whether those factors influence auditor switching positively or negatively. From the hypothesis formulation above, it can be illustrated by the figure down below:

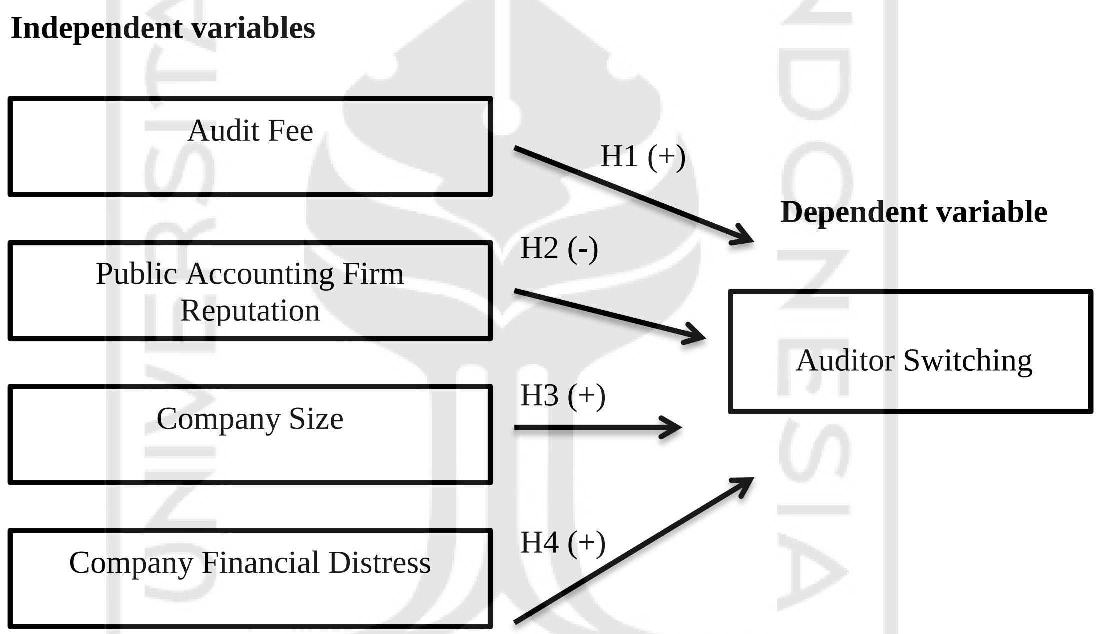

Figure 2.2 Research Framework