

## **CHAPTER II**

### **LITERATURE REVIEW**

#### **2.1. Literature Review**

##### **2.1.1. Agency Theory**

Agency theory is a concept which describes the contractual relationships between principals and agents. Basic agency paradigm was developed in the economics literature during 1960s to 1970s in order to determine the optimal amount of the risk-sharing among different individuals (Namazi, 2013). Agency theory is a set of proposition in governing a modern corporation which is typically characterized by large number of shareholders or owners who allow separate individuals to control and direct the use of their collective capital for future gains (Agarwal, Goel, & Vashishtha, 2014). Principals want to know all information including management activities, related to investments or funds in the company. This is done by requesting the accountability report from the agent (management). Based on that statement, the principal can determine the performance of the management (Kharismatuti & Hadiprajitno, 2012).

Principal and agent are having different interest. This different interest result in inappropriate decision making by the agent (Wanodya, 2013). In addition, there was tendency of management in performing some intentional action to mislead the principal. For this purpose, management tried to cover up their fraudulence acts to produce more reliable financial reports. The purpose of third party, here is the

auditor, is to examine this financial reports to find the manipulation (Kharismatuti & Hadiprajitno, 2012).

By the existence of agency theory, a third party may help to understand the conflicts of interest between principal and agent. The presence of third party is not expected to reduce the fraudulence activity in the financial system that might be done by the management. In fact, independent auditor as third party is expected to evaluate management performance, and then they will create relevant and useful information for principal decision making. Third party is monitoring the behavior of managers and ensuring that the agent acts in accordance to the principal interest. It means that auditors have an important role in the ratification of a company's financial statements. Therefore, the auditor must produce high audit quality then, it can reduce the misalignment that occurs between management and owners.

### **2.1.2. Audit Quality**

Quality is defined as conformance to the customer requirements. Quality is defined as good and acceptable when the output reaches the limits and close to the required target. Qualified audit can be obtained when it was done by competent and independent auditor. Audit procedure test should be done by capable auditor then reliable and relevant evidence can be obtained (Qi, Li, & Tian, 2015). The role of auditing is to reduce information asymmetry on accounting numbers and to minimize the residual loss resulting from managers opportunity in financial reporting (Soliman & Elsalam, 2012). Audit quality is every possibility where the auditor performing client's financial statements audit can find fraud or material

misstatement that occur in the client's accounting system then report in the audited financial statements with a guidance by Generally Accepted Auditing Standards (GAAS) and ethics code of public accountants (Saripudin et al., 2012). The detection aspect will give competitive reflection of auditors, while reporting is a reflection of the auditor's ethics or integrity, particularly independence (Wiwi Idawati, 2015). It is difficult to measure audit quality because there are no specific tool and parameter to objectively measure audit quality. A way to measure the auditor's quality work is through the quality of the decisions making. Auditor requires not only report on the fair presentation of financial statements but also report on internal control and on compliance with laws, regulations, and provisions of contracts or grant agreements (Cagle & Pridgen, 2015).

Auditors are required to produce a qualified financial report in their qualified working process because they were responsibilities of the report to the shareholders. Audit quality can be linked with conformity inspection with auditing standards. Audit standard is general guidelines for auditors in fulfilling the responsibility to conduct the auditor profession. Audit standard is useful to provide a framework in formulating interpretations (Kovinna & Betri, 2009). Auditor provides a good quality service to shareholder if they give independence, reliable, and relevance audit report. Audit quality is important because it will produce reliable financial statements as the basis for a decision (Febriyanti, 2014).

### **2.1.3. Competence**

Competence is one of the main qualifications required by the auditors to perform an audit truthfully. Competence is someone who has the knowledge and

skills which is demonstrated in audit experience (Agusti & Pertiwi, 2013). According to the competence principle, auditor is required to maintain the knowledge, expertise and professional skills (Wardhani et al., 2014). The main factors of competence are experience and knowledge. Experienced auditors will have a broader view on various things. Auditor's knowledge related to their education level. High-educated auditor would have more knowledge to find wider and more detail issue. Competence that should be owned by the auditors to ensure that audit value is generated.

In this study, competence is used to measure the auditor's audit quality. The auditor is subject that performs auditing directly related to the audit process to produce qualified audit quality. In performing audit, auditor requires knowledge about auditing (general and specific), knowledge about the audit fieldwork, and knowledge about accounting and industrial clients (Tjun, Marpaung, & Setiawan, 2012).

#### **2.1.4. Independence**

Independence means audit that is free of restrictions that could significantly limit the scope and effectiveness of the review or the later reporting of resultant findings and conclusions (Aji, 2012). Independence is mental attitude which are free from intervention, not controlled by the other party, and not depend on others. Independence will lead auditors to honesty by looking at the facts and the existence of the objects. After that, it will help them in making up their opinion (Tjun et al., 2012). The independence itself has four important factors namely audit tenure, pressure from clients, peer review, and non-audit services (Agusti &

Pertiwi, 2013). High independence will create high audit quality. Auditor must be aware of the various pressures, some obvious some subtle, which tend to influence auditor attitude and thereby erode slowly but sure about their independence (Brooks, Cheng, & Reichelt, 2012).

Independence can be divided into two parts, which are independence in fact and independence in appearance which including the mental of independence skill that required in auditors (Kovinna & Betri, 2009). Independence in fact is auditor's ability to be free, fair, and objective in conducting the audit. While independence in appearance is independence is seen from interested parties in the company who know the relationship between auditor and client.

Auditors will be considered as not independent if they have high level of satisfaction, lack of innovation, and lack of strong audit procedures. The suspicious situation is when auditors have long-standing relationships and emergence of excessive confidence to clients (Wibowo & Rossieta, n.d.). The auditor is expected to be independent from the management staff of the company being audited (Adeyemi, Okpala, & Dabor, 2012).

#### **2.1.5. Due Professional Care**

Due professional care is an important act that should be had by auditor in conducting their work to achieve high audit quality. Due professional care involves two aspects, namely professional skepticism and confidence adequately (Martini, 2011). The auditor should maintain an attitude of professional skepticism during the inspection process. That was because the audited financial

statements may not be reliable when the auditor is no longer able to maintain professional skepticism. Auditors should use professional judgment and maintain professional skepticism in planning and performing audit. It is to recognize the circumstances that might exist that would cause the material misstatement in financial statements (Coppage & Shastri, 2014).

Using due professional care thoroughly and carefully will give adequate confidence in the auditor's opinion. It will make financial statements free from material misstatement, whether caused by fraud or error (Wiratama & Budiarta, 2015). In addition, auditors are required to have sufficient confidence in the evaluation of audit evidence. Based on Febriyanti (2014) there are some indicators to measure due professional care. First is using the precision and skill in work, responsibility, competence and carefully. Second, auditors should not disclose information obtained in the auditing process to third parties, either in oral or in writing, except for certain purposes as part of the procedure.

#### **2.1.6. Auditor Ethics**

It is important for an auditor to uphold behavior in performing their task. Ethics is critical attitude in individual or society to realization the morality to maintain people to do the activity (Tarigan et al., 2013). Accountant has responsibility for maintaining the highest standards of ethical behavior to their organization and profession. Accountant has responsibility to maintain their integrity and objectivity (Aprianti, 2010). Accountant ethic code is behavior norms that control the relations between public accountant and their clients.

In doing their professionalism, auditor is having realistic perspective. Related to ethics, standards and principles are inherent in the auditor (Kovinna & Betri, 2009). Ethical principle is the basic framework for the ethical rules that will control the service implementation professionally. There are some ethics principles that must be obey for auditor based on IAI such as integrity, objectivity, responsibility, public interest, competence and carefulness, secrecy, professional attitude, and standard technique (Tarigan et al., 2013).

Ethics is a characteristic that would differentiate one profession to the others. It will function as an attitude control device. In ethics, a profession has high moral commitment that generally poured in specific rule and become guidance for used user. These rules in performing a profession are called ethics code. It must be fulfilled and adhered by the user (Wanodya, 2013). This ethics code should be used in examination combining with the principle.

## **2.2. Theoretical Framework**

The research with a topic of competence, independence, and due professional care cannot be considered as a new topic. The existence of the research must be continued in order to update the consistency result of the theory and previous studies. Some previous studies are used by researcher as a basis for their current study by researcher. Those studies established in either domestic (local studies) or foreign (overseas studies).

Bawono & Singgih (2010) conducted a research about independency, due professional care, accountability, and experience which were influence the auditor

and the audit quality: study in KAP “Big Four” in Indonesia. This study used simple random sampling which was conducted by determination of samples counted with Slovin formula. Data analysis was conducted using multiple regression analysis. The result proved that independency, due professional care and accountability has significant influence on audit quality partially. However, the experience variable has no influence on audit quality. This study also proved that independence was dominant factor which was influence audit quality.

Aqmalia (2014) conducted a research about the effect of competence and independence to the audit quality with auditor ethics as moderating variable, which it was an empirical study on public accountant in Surakarta and D.I. Yogyakarta. By using moderated regression analysis, the result concluded that competence and independence have positive and significant influence on audit quality partially. The auditor ethics has positive and significant influence on the interaction of all the independent variables (competence and independence) to audit quality partially.

Kharismatuti & Hadiprajitno (2012) conducted a research in BPKP DKI Jakarta about the effect of competence and independence to audit quality with auditor ethics as moderating variable. This research used moderated regression in order to analyze the data. The result showed that competence has positive influence on audit quality partially, even though it was insignificant, whereas independence has positive and significant influence on audit quality partially. The result also showed that the interaction between competence and auditor ethics has



significant but in negative influence on audit quality. Therefore, the less interaction of auditor ethics and auditor competency will result in better audit quality. The interaction between independence and auditor ethics has positive and significant influence to audit quality. Therefore, the more interaction of auditor ethics and auditor independency will result in better audit quality.

Hardiningsih & Oktaviani (2012) conducted a research about the effect of due professional care, ethics, and tenure to audit quality. The multiple regression analysis was used to measure the used variables. The result showed that due professional care and ethics have positive and significant influence on audit quality partially whereas tenure variable has no influence on audit quality.

Saputra (2012) conducted a research about the effect of competence and independence to audit quality with auditor ethics as moderating variable on public accountant in Middle Java and D.I. Yogyakarta. This study used moderated regression analysis. The result showed that competence and independence were positively and significantly influences on audit quality partially. The result also showed that auditor ethics has positive and significant influence on the interaction of competence to audit quality. It is also shown that auditor ethics has positive and significant influence on the interaction of independence to audit quality. Therefore, competence and independence variable are strengthened by the auditor ethics as moderating variable.

Wanodya (2013) conducted a research in BPKP Yogyakarta about the influence of competence, independence, and experience to audit quality with

auditor ethics as moderating variable. The data were analyzed using Moderated Regression Analysis (MRA). The study showed that competence and experience has positive significant influence on audit quality partially. However, independence has negative influence on audit quality. The result also showed that interaction between competence and auditor ethics has positive influence on audit quality partially. In addition, the interaction between independence and auditor ethics has positive influence on audit quality. Interaction between experience and auditor ethics has positive influence on audit quality. Therefore, variables of competence, independence, and experience are strengthened by the auditor ethics as moderating variable.

Kurnia et al., (2014) conducted a research about the influence of competence, independence, time pressure, and auditor ethics to audit quality. This study used multiple regression analysis. The result concluded that competence, independence, and auditor ethics have positive and significant influence on audit quality partially. Whereas time pressure has negatives influence on the quality of audit.

Satiti (2016) conducted a research about the effect of independency, work experience, due professional care, and accountability to audit quality with auditor ethics as moderating variable, on public accountant in Surakarta and D.I. Yogyakarta. The data were analyzed by using Moderated Regression Analysis. The result showed that independence, work experience, due professional care, and accountability has no influence on audit quality partially. Moreover, the independency, work experience, due professional care, and accountability has

influence on audit quality after being moderated by auditor ethics. It can be concluded that the auditor ethics as moderating variable is strengthen the independent variables.

From the several previous studies above, there are some inconsistent results. Therefore, this study aims to re-test the influence of competence, independence, and due professional care to audit quality with auditor ethics as moderating variable which will use BPKP Yogyakarta as the case study.

### **2.3. Hypothesis Formulation**

#### **2.3.1. Competence and Audit Quality**

Based on the agency theory explanation, it is implied that third party will help principal to communicate their desire to management. Third party must have good skill, knowledge, and experience to solve the problem in a company and to deliver useful information for principal. Knowledge and experience or another capability needed by auditor include in one component called competence.

Competence makes auditor becomes more sensitive and able to evaluate the decision making, and then they will make useful information and decision that can be used by the user. Main standard (SA part 210 in SPAP 2001) in Tjun et al. (2012b) stated that audit must be done by a person or group that have capable skill and standard technical training as an auditor. Competence is a qualification that needed by auditor to do audit properly. Competence measures auditor's audit quality with considering some factors of competency. Competent auditor will provide better audit quality.

The research of Aqmalia (2014), Saputra (2012), Wanodya (2013), and Kurnia et al. (2014) found that competence has positive and significant influence on audit quality. It means that high competence will result in high audit quality. Then, the hypothesis can be shown as:

H1: Competence has positive influence on audit quality.

### **2.3.2 Independence and Audit Quality**

The existence of agency theory as a third party that can help to solve the problem or conflict between principal and agent. Hopefully, the independent character of an auditor could help them in detecting fraud that might be done by manager. An independent auditor should be able to evaluate the management performance to provide the relevant information for principal's decision-making. The auditor independency has fundamental impact on financial arrangement, for example as explained by Dantas & Medeiros (2015), an auditor who gives a reliable opinion can help the decision maker to arrange the future financial report. In conducting an audit and issuing examination result, an independent auditor must be in accordance with the facts, then the performance of auditors will increase and the trustworthy information will be resulted. The more independent the auditor, the better audit quality and responsibility will be resulted (Febriyanti, 2014). Independency must be owned by auditor because it was an absolute requirement for better audit quality.

Research conducted by Aqmalia (2014), Kharismatuti & Hadiprajitno (2012), Saputra (2012), and Kurnia et al. (2014) shown that independence also has

positive and significant influence on audit quality. Then, the hypothesis can be shown as:

H2: Independence has positive influence on audit quality.

### **2.3.3 Due Professional Care and Audit Quality**

Due professional care is an important act that needs to be owned by every public accountant in conducting his professional work as an auditor in order to achieve a high audit quality. By using agency theory, auditor as a third party must be professionally and carefully implemented the auditor ethics in their work. They should be alert to any fraud, error, and conflicts of interest possibilities. This could minimize the material misstatement in the management financial report that will be reported to the principal. Auditor use professional skepticism and lean to due professional care likely to succeed in resolving cases of fraud in financial report (Hardiningsih & Oktaviani, 2012).

Accuracy and precision requires the auditor to conduct professional skepticism, which it is an attitude that requires the auditor to think critically about the audit evidence exists with an evaluation of the audit evidence, and carefully in conducting inspection (Febriyanti, 2014). The auditor should maintain an attitude of professional skepticism during the audit process. If auditor fails in applying professional skepticism, it may result in bad quality of audit opinion. Based on the previous research, due professional care has influence to audit quality.

Research conducted by Bawono & Singgih (2010) and Hardiningsih & Oktaviani (2012) found that the due professional care has positive and significant

influence on audit quality partially. From those previous researches, it can be concluded that high professionalism of auditor will give better audit quality. It can take the hypothesis as:

H3: Due professional care has positive influence on audit quality

#### **2.3.4 Competence, Auditor Ethics, and Audit Quality**

Competence is considerable expertise that explicitly can be used to perform an audit objective. According to general standards, auditors are required to have sufficient audit competence in their profession, meet the technical qualifications, and experience in industrial sector that was involved his client (Tjun et al., 2012). Audit quality is essential to ensure that the professional accountant fulfill their responsibilities to investors, governments, and other parties who rely on the credibility of the audited financial statements with upholding the ethics (Kharismatuti & Hadiprajitno, 2012). Based on agency theory, it is implied that the third party will help to solve the problem between management and principal. The problem is occurred because the difference urges and interest between them. Third party must have knowledge and experience supported by their profession ethics to solve the problem. With that, the task of third party will be easier and more understandable.

Competence can be measured based on their education and experience. High education will develop auditor's ethical standard understanding. High audit quality can measure the auditor's ethics and competency. Thus, the auditor competency should be supported with the auditor ethics.

Research conducted by Saputra (2012) and Aqmalia (2014) stated that auditor ethics has positive and significant influence on the interaction of competence to audit quality partially. If the auditor ethics influence on the interaction of competence to audit quality is increasing, then the audit quality will be increase. Based on the logic and previous studies above, it can take the hypothesis as:

H4: Auditor ethics has positive influence on interaction of competence to audit quality.

### **2.3.5 Independence, Auditor Ethics, and Audit Quality**

Independence is one of important role in auditor. An independent auditor will not be affected by external obstacles during examinations. Auditors in performing their duties, they should be able to maintain an independent skill in providing services in facts and in professional manner (Tarigan et al., 2013). Agency theory, as explained before, is the way of contractual relationships between principals and agents. Agency theory reflects that third party solves the problem between agent and principal. By implementing agency theory, it is implied that third party helps agent to provide relevant information to principal based on facts and procedure. Third party are required to take decisions independently and based on auditor ethics.

Saputra (2012) stated that independence interaction with ethics which was done by auditor to client might be happened while doing audit. The conflict between the auditor and the client related to the independence occurs because of pressure from clients. It could happen because different opinion between them.

The auditor independency could be influenced by the conflict that occurred between auditor and client because of their different opinion. In other way, client could decrease the auditor independency by making social group between client and auditor. Auditors will not be impartial to the client if the client is giving pressure on their work. The worst scenario that could happen is the ability of client to replace the auditor when their request was not fulfilled. In consequently, auditor must hold their auditor ethics to be an independent auditor. High independence level of auditor will increase the audit quality.

The previous research by Saputra (2012), Aqmalia (2014), and Satiti (2016) shown that auditor ethics has positive influence on the interaction of independence to audit quality. Higher auditor ethics influence on the interaction of independence to audit quality is estimated higher for audit quality. Based on the logic and previous studies above, it can take the hypothesis as:

H5: Auditor ethics has positive influence on interaction of independence to audit quality.

### **2.3.6 Due Professional Care, Auditor Ethics, and Audit Quality**

Auditors have a responsibility to be carefully professional in audit process. Auditors should have sufficient knowledge to identify the indicators, if material misstatements are existed (Moyes et al., 2006). One of the objectives of regulatory body in Accountants and Auditors Association is to improve the quality of auditing profession (Sawan & Alzeban, 2015). The existence of agency theory was helping the third party to understand the conflicts of interest arising between



principal and agent. Third party will use due professional care and ethics during the duty to avoid from fraud to minimize the interest conflict among of them. If third party use due professional care and ethics properly, the audit quality will be increased.

An ethics code is a comprehensive statement of the values and principles which should guide the daily work of auditors (Auditing Standard Committee, 2001). Ethics is needed by auditor to confront any problem. It is because auditor as a professional will use ethics to make sure that every step done by auditor was already correct and trusted. Auditor with due professional care will always consider the standard and ethics. Without due professional care and ethics, the audit quality is difficult to be determined and the result will not be effective.

Researchers conducted by Satiti (2016) shown that auditor ethics has influence on the interaction of due professional care to audit quality partially. Due professional care has relationship with auditor ethics. If auditor upholds high auditor ethics, the audit quality will increase. Based on above explanation, it can take the hypothesis as:

H6: Auditor ethics has positive influence on interaction of due professional care to audit quality

## 2.4. Research Model

Based on the theoretical review, theoretical framework and previous researches are described above. The research model can be seen in the figure below:

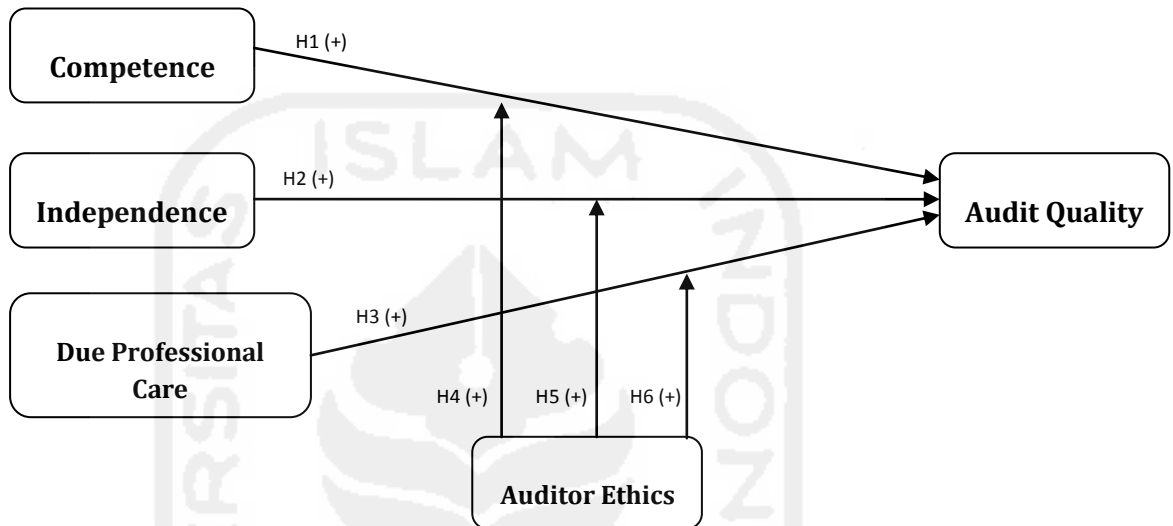


Figure 2.1 Research Model