

The Effect of Industry Specialists and Non-Specialist Auditors on Audit Quality

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This study is aimed at analysing the influence of specialist auditors and non-specialist auditors listed in OJK on audit quality, due to OJK's new regulation POJK No 13/POJK.03/2017, concerning the use of public accounting services and public accounting firms in financial industry activities. Audit quality is measured using discretionary loan loss provision (DLLP). The population in this study is all financing companies listed on the Indonesia Stock Exchange in the period 2017–2018. A purposive sampling method was employed in this study to gain the research sample. The technique of Ordinary Least Square (OLS) Regression was employed for data analysis. The research findings reveal that specialist auditors have a positive effect on audit quality, while the OJK's auditor's have no effect on audit quality. The implication of this study is that OJK's regulation can't provide the higher audit quality which affects higher financial reporting quality.

Key words: *Audit quality, auditor specialist, auditor non specialist.*

Introduction

Research about audit quality started to develop when there was the scandal of Enron in 2002. In Indonesia, there were two scandal reports in 2019 when manipulation of financial statements conducted by PT Garuda Indonesia and PT Asuransi Jiwasraya occurred. PT Garuda Indonesia was suspected of manipulating profits by recording revenue from PT Mahata, but the payment has not yet been received. Whereas at PT Asuransi Jiwasraya, BPK announced that there was an accounting manipulation so as to produce false profit since 2006. This proves that there is still a lot of fraud committed by the companies, which indicates the low quality of audits.

According to Deangelo (1981) audit quality is the probability of an auditor in detecting and revealing violations committed by clients in their accounting system. The important thing in this definition is that quality audits are done by competent and independent auditors. Competence refers to the auditor's ability to find material misstatements in a financial statement, while independence refers to the auditors' courage in reporting the fraud. The auditor's competence will increase as the auditor extends to audit the client. The longer the auditor conducts audits on the same company, the more the auditor's understanding of the client's industry will increase. Thus, it will increase the auditor's ability to detect the possibility of misstatement by the client. The amount of experience an auditor has in conducting the same company audit ensures the auditor has special expertise or specialisation (Pramaswaradana and Astika, 2017).

This research is important because it is the first study to deal with industry specialist auditors toward audit quality, by classifying industry non-specialist auditors registered and non-registered in Financial Services Authority (OJK). This measurement was chosen because according to POJK regarding the procedures for using public accountant services, the institution that is overseen by the OJK must compile and present quality financial information. In addition, the Public Accountant and the Public Accountant Office provide support for Financial Services sector activities under the supervision of the Financial Services Authority and has an important role to assist the institution that is overseen by the FSA in preparing and presenting quality financial information. Therefore, using auditors affiliated with OJK is expected to be able to contribute more in improving audit quality.

Second, this research is done in a financial services company because there is a new regulation issued by OJK. The new OJK regulation Number 13/POJK.03/2017 is about the use of public accounting services and public accounting firms in financial services activities. In this regulation, it is stated that those who do financial service activities must use AP and KAP registered in OJK, and have competencies in accordance with the business complexity of those who carry out financial service activities. Whereas, AP and KAP that will provide services to those who do financial services must be registered in OJK. Previous research related to audit quality on earnings management in Indonesia was conducted at manufacturing companies Pramaswaradana and Astika (2017) and Nizar (2017). Research on all BEI companies was conducted by Fitriany et al. (2015) and in financial companies conducted by Siregar and Elissabeth (2018). Previous research conducted in Indonesia were limited to testing industry specialists.

This research aims to find out the quality that resulted from industry specialists and non-specialist auditors registered in OJK and non-industry specialists not registered in OJK. The results of this research can be taken into consideration by the FSA to evaluate the quality of audits produced by auditors who provide audit services to companies registered in the

Indonesia Stock Exchange. The results of this research can also give consideration to OJK in determining auditor's registration requirements, so that they can be more selective in choosing auditors.

Theoretical Background and Hypothesis Development

Agency Theory

Agency theory was developed by Jensen and Meckling (1976). Agency theory discusses management interests and the interests of shareholders that are often incompatible, that can lead to conflict. This conflict can happen because managers tend to prioritise their personal interests rather than the interests of shareholders (self-interest). This happens because of the asymmetry of information between managers and owners. To minimise this, supervisory tools or means are needed to limit the behavior of managers who can harm the company. In the context of this agency theory, the auditor plays a role as a means of monitoring in order to align the interests of managers and company owners. Stewardship hypothesis in the research of Watts and Zimmerman (1986) explains that auditing is needed to examine the honesty and reliability of financial statements made by managers and as a tool to monitor contracts between managers and owners.

Audit Quality

Audit quality is the probability of an auditor in detecting and revealing violations committed by clients in their accounting system (Deangelo, 1981). Audit quality plays an important role in presenting the opinion of financial statements because the results of the auditor's report will be used as consideration in making decisions by users of financial statements (Siregar and Elisabeth, 2018). The auditor's competence will increase as the auditor extends to audit the client. The longer the auditor conducts audits on the same company, the more the auditor's understanding of the client's industry will increase. Thus, it will increase the auditor's ability to detect the possibility of misstatement by the client. The amount of experience an auditor has in conducting the same company audit makes the auditor have special expertise or specialisation (Pramaswaradana and Astika, 2017).

Auditor Specialists

Industry specialist auditors are a product of differentiation strategy of accounting firms to distinguish themselves from competitors, to fulfill client demands in producing better quality financial reporting and to compete only in aspects of price-cost strategy (Kharuddin et al., 2019). Industry specialist auditors are auditors who obtain training, knowledge, and expertise concentrated in one industry (Kamath et al., 2018, Solomon et al., 1999). Auditors gain industry knowledge through indirect experience, namely by following training, then supplemented by

focused direct experience, such as working exclusively on audit engagements in certain industries (Solomon et al., 1999). Industry specialist auditors include industry-specific knowledge and expertise through sustainable audit practices, extensive human capital investment, and superior information technology (Kwon et al., 2017).

The Effect of Industry Specialist Auditors on Audit Quality

Industry specialist auditors have more knowledge about certain industries than industry non-specialist auditors. This expertise is obtained by studying business processes between clients while providing audit services to clients in the same industry (Balsam et al., 2003, Kamath et al., 2018). This expertise makes audit services produced by auditors of higher quality because they use appropriate audit procedures to the industry to reduce the possibility of misstatement (Kwon et al., 2017). Industry specialist auditors can improve efficiency and effectiveness in determining the reliability and estimation of clients' financial statements so that auditors will have the ability to detect mistakes that are usually made by clients in the industry. Thus, industry specialist auditors usually make fewer mistakes than non-auditors (Fitriany et al., 2015, Solomon et al., 1999). According to these arguments, the following hypothesis is formulated as follow:

H1: Audit quality produced by Industry specialist auditors is higher than the audit quality produced by industry non-specialist auditors.

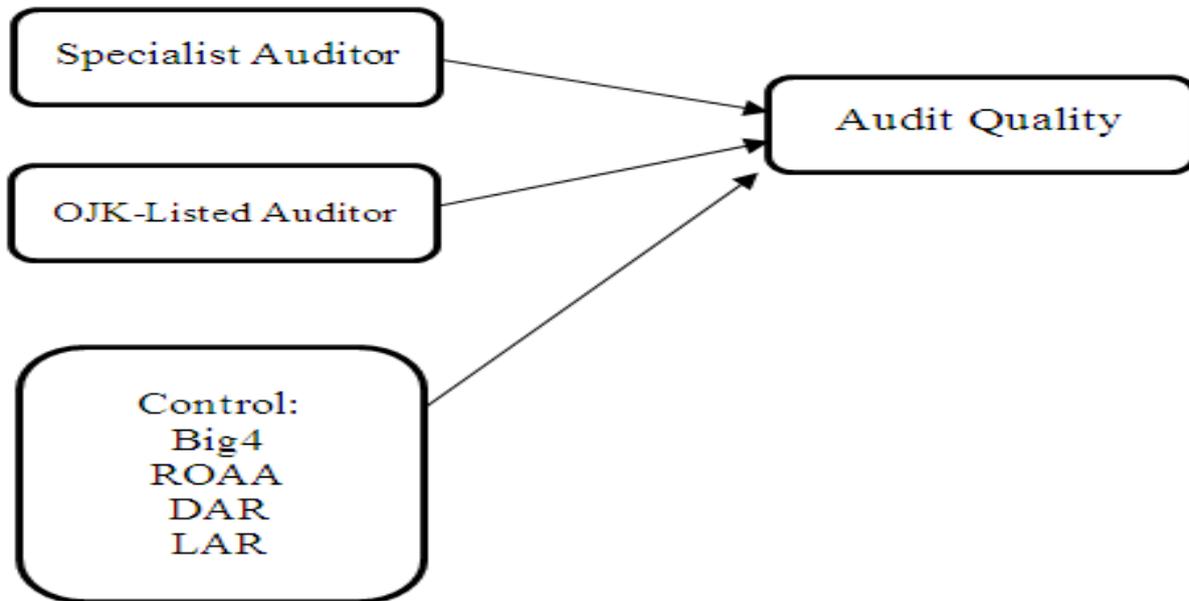
The Effect of Non-Specialist Auditors Registered in OJK toward Audit Quality

Article 4 Law Number 21 Year 2011 regarding Financial Services Authority (OJK) states that OJK is established with the aim to ensure all activities in the financial services sector are carried out in an orderly, fair, transparent, accountable manner. This is also to realise a financial system is growing in a sustainable and stable manner, and able to protect the interests of consumers and society. In realising this goal, one of the efforts undertaken by the OJK is to issue new regulations namely OJK Regulation Number 13/POJK.03/2017 about the procedures for using public accountant services. Institutions overseen by the OJK must compile and present quality financial information, such as using Public Accountants (AP) and Public Accounting Firms (KAP) registered in OJK. Likewise, AP and KAPs that provide services to those who carry out financial services must be registered in OJK. This is on the grounds that AP and KAP as supporting financial service sector activities under OJK's supervision play an important role to assist institutions overseen by OJK to compile and present quality financial information. Based on these arguments, the following hypothesis is formulated:

H2: Audit quality produced by industry non-specialist auditors registered in OJK is higher than audit quality produced by industry non-specialist auditors non-OJK.

Conceptual Framework

Figure 1. Conceptual Framework



Research Method

Population and Sample

Population used in this research is all entities in the financial services industry which are registered in the Indonesia Stock Exchange. This research examines the independent variables during the last two years, 2017 to 2018, with the expectation that it can provide actual results. This research uses data pooling. It is a combination of data in the form of time series for 2 years and cross section data. The sampling method uses purposive sampling with the following criteria: companies registered in the financial services industry on the Stock Exchange in 2017-2018 and companies that publish complete financial statements. Thus, it obtains 132 samples.

Dependent Variable Measurement

Dependent variable in this research is audit quality. This research uses DLLP as proxy of audit quality. The DLLP value used in the analysis is an absolute value, where the magnitude of the DLLP shows low audit quality. DLLP in this research uses the model of Kanagaretnam dkk. (2004). In determining DLLP, the first step taken is to determine the estimated NDLLP with the model below:

$$LLP = \alpha_1 + \beta_1 NPL_{t-1} + \beta_2 \Delta NPL_t + \beta_3 \Delta TL_t + \epsilon_1 \quad (1)$$

In equation (1), the independent variable explains the NDLLP component. Therefore, the discretionary component (DLLP) is obtained from the residual value.

In which:

- LLP = loan loss provision is divided by beginning loan
- NPL = non-performing loan is divided by beginning loan
- Δ NPL = deviation of nonperforming loan is divided by beginning loan
- Δ TL = deviation value of loan is divided by beginning loan
- NDLLP = non-discretionary loan loss provision
- DLLP = discretionary loan loss provision

Independent Variable Measurement

Industry specialist auditors are defined as industries that have a bigger market than their competitors in certain industries (Neal and Riley Jr, 2004). Industry specialist auditors are generally determined based on industrial market share. The market share is calculated using different metrics, such as audit fees, total assets, and sales revenue (Garcia-Blandon and Argiles-Bosch, 2018). The audit specialisation in this research is measured using the model by Fitriany et al. (2015) with the formula below :

$$SPEC = \frac{\text{Number of clients in the industry}}{\text{All companies in the industry}} \times \frac{\text{Client's average assets}}{\text{All companies's average assets}}$$

Auditors are considered industry specialists if they dominate market share more than 10. Furthermore, it is measured using a dummy in which the auditor included in the category of industry specialists is given a value of 1 and non-industrial specialists are given a value of 0.

Auditors registered based on Financial Services Authority (OJK) Number 13/POJK.03/ 2017 concerning the Use of Public Accountant Services and Public Accountant Firms in Financial Services Activities Article 3 paragraph 1 is an auditor given permission by OJK to conduct audit services on financial institutions under the auspices of the OJK. Non-industry specialists registered in OJK are auditors categorised as non-audit specialists who obtain licenses from OJK, evidenced by the STTD owned by the auditors. Whereas, non-OJK industry specialists are auditor's categorised as non-industry specialists but do not get licenses from OJK. Variable of industry non-specialist auditors registered in OJK are measured using a dummy, in which industry non-specialist auditors registered in OJK are given a value of 1 and a value of 0 for non-OJK.

Data Analysis Method

Hypotheses testing was conducted using Ordinary Least Square (OLS) regression analysis. The regression equation employed in this research is as follows.

$$(H1) \text{ Audit Quality} = \alpha + \beta_1 \text{Specialis} + \beta_2 \text{BIG4} + \beta_3 \text{ROAA} + \beta_4 \text{DAR} + \beta_5 \text{LAR} + \varepsilon \quad (2)$$

In which:

Audit Quality	= Audit Quality
Specialist	= Industry specialist and Non-Specialist Auditor
BIG4	= Industry use KAP BIG4 and Non BIG4
ROAA	= Return on Average Assets
DAR	= Debt to Assets Ratio
LAR	= Loan to Assets Ratio

An additional test was conducted by examining whether the quality of audits produced by non-specialist OJK industry auditors is higher than those of non-OJK industry non-specialist auditors. Auditors categorised as non-OJK industry specialists are given a value of 1 and 0 for non-OJK industry non-specialist auditors. The regression model used to test the second hypothesis is

$$(H2) \text{ Audit Quality} = \alpha + \beta_1 \text{OJK-LISTED} + \beta_2 \text{BIG4} + \beta_3 \text{ROAA} + \beta_4 \text{DAR} + \beta_5 \text{LAR} + \varepsilon \quad (3)$$

In which:

Audit Quality	= Audit Quality
Specialist	= non-specialist OJK and Non-OJK Auditor
BIG4	= Industry that use KAP BIG4 and Non BIG4
ROAA	= Return on Average Assets
DAR	= Debt to Assets Ratio
LAR	= Loan to Assets Ratio

Results and Discussion

Descriptive Statistics

Table 1 below presents descriptive statistic test result and dependent variable - audit quality, independent variables - specialist auditors, and control variables - big4, ROAA, DAR, LAR.

Table 1: Statistic descriptive

Variable	Min	Max	Mean	Std. Deviation
AQ	-0,3191	0,1063	0,0000	0,0519
SPEC	0,0000	1,0000	0,4015	0,4921
BIG4	0,0000	1,0000	0,5455	0,4998
ROAA	-2,6766	0,5536	-0,0024	0,2416
DAR	0,0137	1,0025	0,7765	0,1482
LAR	0,0004	0,9740	0,5824	0,2194

This table shows the descriptive statistical results of the research variables used in this research. This research uses a sample of companies registered with the financial industry on the Stock Exchange in 2017-2018 with a total sample of 132. Source: Processed by the Author

Table 1 presents descriptive statistics from variables used in this research. For the dependent variable, the audit quality (AQ) of financial services companies in Indonesia registered IDX/BIE as measured using the DLLP method has an average of -0.0000 with a range of values of -0.3191 to 0.1063. For independent variables, the audit specialist variable (SPEC) is a dummy variable with an average value of 0.4015. This means that only 40.15% of financial service companies in Indonesia are registered on the IDX/BEI using specialist auditors. Furthermore, we divide specialist variable into OJK non-specialist and Non-OJK.

Result of Model Analysis

The Effect of Industry Specialist Auditor on Audit Quality

Table 2 shows test result of industry specialist auditor variable toward audit quality. From this table, it can be seen that the variable industry specialist auditor has a significant effect toward audit quality ($t = -1.88450$ and $p < 0.1$). This is consistent with hypothesis (H1) which states that the audit quality produced by industry specialist auditors is higher than the audit quality produced by industry non-specialist auditors. Industry specialist auditors have more knowledge and experience compared to industry non-specialist auditors. This knowledge and ability will be used by auditors to improve competence in finding misstatements so as to improve the quality of audits produced.

In relation to agency theory, if shareholders want a monitoring tool to monitor the behavior of managers, they can use the services of a specialist auditor. This research supports previous research conducted by Fitriany et al. (2015) in which industry specialist auditors affect audit quality. Furthermore, further tests were done by classifying industrial non-specialist auditors into two categories, OJK industry non-specialist auditors and non-OJK industrial non-specialist auditors, to be tested in hypothesis (H2).

Table 2: Regression Result

Variable	Spec-NonSpec			OJK-Non-OJK		
	Predict	Coef	Prob	Predict	Coef	Prob
SPEC	-	-0,026	-1,8450*	+	0,018	0,834
BIG4	+	0,033	2,3838**	+	0,049	1,9726*
ROAA	+	0,000	0,021	+	0,000	0,011
DAR	+	0,076	2,2418**	+	0,090	2,0346**
LAR	+	0,008	0,362	+	0,007	0,190
Observation		132			79	
R-Squared		0,100			0,142	
Prob		0,020			0,045	

*** significance at 1%, ** significance at 5%, * significance at 10%

The Effect of OJK Non-Specialist Auditors on Audit Quality

Test result of non-specialist auditors registered in Financial Services Authority (OJK) toward audit quality is presented in Table 2 column 6. The results show that the industry specialist auditor registered in OJK variable has no significant effect toward audit quality ($t = 0.834$ and $p > 0.1$). This is not in accordance with hypothesis (H2) which states that audit quality produced by industrial non-specialist auditors registered in OJK is higher than audit quality produced by non-OJK industry non-specialist auditors. Both registered and non-OJK auditors have almost the same audit quality.

The result of the research shows that the regulation issued by OJK of OJK Regulation Number 13/POJK.03/2017 regarding the use of public accounting services and public accounting firms in financial services activities fails to regulate auditors to provide quality financial information. This is evident from the low quality of audits produced. In this regulation, it is stated that those who carry out financial service activities are obliged to use AP and KAP that are registered in OJK and have competencies in accordance with the business complexity of those who do financial service activities. However, evidence from the regression coefficient of the second hypothesis testing result is not significant, the competencies possessed by auditors registered with OJK are as low as the competencies possessed by non-OJK auditors. In relation to agency theory, auditors registered in OJK can't be considered by shareholders when they want to supervise the manager's performance.

Conclusion

This research aims to find out the effect from industry specialist auditors by considering auditors registered in Financial Services Authority (OJK) according to new OJK regulations No. 13/POJK.03/2017, concerning the use of public accountant services and public accounting



firms in financial service activities. The results show that industry specialist auditors have higher audit quality compared to industry non-specialist auditors. Furthermore, this research finds that the audit quality produced by industrial non-specialist auditors registered is OJK is almost the same as the audit quality produced by industrial non-specialist OJK auditors. This shows that OJK regulations can't be used as a consideration in selecting quality auditors. Although this is the first time research has tested OJK auditors, this research has several limitations. The low significance in the testing of industry specialist auditor variables supports previous research which states that market share is an incomplete measurement of industry specialist auditors. Future research can be carried out with different audit quality proxies and industry specialist auditors in order to provide additional evidence on this topic. This research has important implications for regulators and shareholders to be more discerning when selecting quality auditors.

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