

Narrow Diversification, Wide Diversification, and Auditor Switching on Audit Quality

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This study aims to analyse the effect of narrow diversification, wide diversification and auditor switching on audit quality. This study uses quantitative data types and secondary data sources to measure the variables studied. The population in this study is non-financial companies listed on the Indonesian Stock Exchange (IDX) for the year 2015-2017 with a sample of 1,055 companies. This study was tested using multiple linear regression analysis so that it requires testing of classic assumptions including normality, heteroskedasticities, and autocorrelation. T- test results with $\alpha = 0.05$ indicate narrow diversification and wide diversification are related to audit quality, while auditor switching is not related to audit quality.

Key words: *Audit quality, narrow diversification, wide diversification, auditor switching.*

Introduction

Audit quality is the likelihood that an auditor will find and report material misstatements in the client's annual reports. Audits are said to be of good quality if they meet the requirements or auditing standards (Watkins et al., 2004). The audit provisions and standards include that there are no errors in the presentation of financial reporting, one of which is that there is no element of manipulation. The elements of manipulation of these financial statements can be known through the existence of Discretionary Accruals (DA).

Several studies have proven that specialist auditors providing services to companies that are in accordance with their industrial specialisation, will result in higher audit quality. Audit quality produced by specialist auditors shows better results than non-specialist auditors because specialist auditors are able to detect errors and irregularities. Different levels of

ability from specialist and non-specialist auditors can be seen clearly in the early years of the auditor involvement in the client auditing process (Kartika Sari, 2018). Sarwoko and Agoes (2014) conducted surveys and interviews with 163 public accountants in Indonesia, and found that specialist auditors have a significant impact on the implementation of audit procedures used to detect fraud and can improve audit quality.

Specialisation has an important role in increasing effectiveness and efficiency. Industry specialisation refers to the accumulation of specialised knowledge gained from serving many clients in the same industry (Gul, Fung, & Jaggi, 2009). In line with previous studies conducted by Hao et al. (2016) shows the results that auditors who audit clients in the same field as their specialty have higher audit quality than auditors who audit clients in their non-specialised fields, because specialist auditors have sources, more specific industry knowledge, and incentives to limit clients act opportunistically. In contrast to Specialisation, non-specialisation has no connection with audit specialisation, because companies must engage in a new industrial world that is not their specialty. The auditor's performance in dealing with industries that are not his specialty will certainly not be as maximal as auditing the industries that he specialises in, so that it will affect audit quality. This non-specialisation area is then divided into Narrow Diversification and Wide Diversification.

Previous research conducted by Hao et al. (2016) stated that there are two possibilities when the public accounting firm takes the decision to diversify its client's industry, namely, conducting Narrow Diversification (narrow diversification) and Wide Diversification (broad diversification). Narrow Diversification has a narrow focus where public accounting firm audits several clients who are in one industry and approach their audit specialisation. Narrow Diversification allows the auditor to dig deeper knowledge gained from his new industry, so that it can increase the likelihood of the auditor to detect material misstatements and reduce the risk of audit failure. On the other hand, a public accounting firm can also audit various clients from new industries and not approach specialisation (Wide Diversification). Wide Diversification can increase company growth and profitability, but also provide higher risk and uncertainty in audit quality because of the lack of specialised knowledge held by the auditor. The auditor will obviously gain new experience and knowledge from the industry in his non-specialty field, but the auditor must start everything from zero to understand the client's industry type and company characteristics. A public accounting firm with Narrow Diversification produces better audit quality compared to a public accounting firm with Wide Diversification because the Narrow Diversification auditor has a higher level of expertise and knowledge compared to Wide Diversification.

Audit quality is influenced by various other factors, including the change of auditors of public accounting firms (Widyaningsih et al., 2019; Jackson et al., 2015) and female audit engagement partners (Harymawan & Nasih, 2019). The auditor change (auditor switching) is

the change of auditor or public accounting firm made by the client company (Hasbi et al., 2017). The choice of a public accounting firm is a very important decision for the life of a company and the decision to change auditor or public accounting firm should not be underestimated (Davidson III et al., 2005). Auditor switching can be divided into two, namely, mandatory (mandatory) or voluntary (voluntary). Mandatory auditor switching is a change of auditors made by the client company due to government policies governing the time period of the public accounting firm auditing a company (Peranian and Mimba 2018). In 2017 OJK issued regulation no. 13 / POJK.03 / 2017 concerning the Use of Public Accountant Services and Public Accounting Firms in Financial Services Activities states that those who carry out financial service activities are obliged to limit the use of audit services to the annual historical financial information from the same public accountant for a maximum of three consecutive book years. Restrictions on the use of services from public accounting firm depend on the results of the audit committee's evaluation of the potential risks of using services from the same public accounting firm in a row for a long period of time.

Voluntary auditor switching occurs because there are factors on the part of the client that cause some changes including changing the auditor to improve the company's reputation to external parties. Williams (1998) argues that companies decide to do auditor switching when the company's contractual environment changes, when the company wants more effective auditors or different services, when the company wants to improve its image, or to reduce audit costs. Auditor switching, which occurs for one of these reasons, generally indicates that these companies are involved in greater earnings management (Davidson III et al., 2005). Earnings management can be detected using discretionary accruals, therefore large earnings management signifies high discretionary accruals too, so that it is positively related to audit failure (Geiger and Raghunandan, 2002). Audit failures are indicated due to management's freedom of action while quality audits should be able to limit management's movements to manipulate financial statements (Sopian, 2015).

An auditor who is bound with a client company for a long time can lead to a special relationship that results in the loss of auditor independence as a third party, so the results of the audit will be biased. The loss of independence encourages the auditor to give an unqualified opinion on the company's financial statements that actually contain material misstatement (Leensen, 2016). Auditor switching is a way that can be used to maintain auditor independence so that it can produce higher audit quality (Peranian and Mimba, 2018).

This study uses a sample of companies engaged in all non-financial industry sectors which are listed on the Indonesian Stock Exchange (IDX). The period of annual financial statements used were issued by the company in the year 2015-2017. The results showed that showing narrow diversification and wide diversification had a relationship with audit quality, whereas auditor switching was not related to audit quality.

The structure of this paper is as follows: Part 2 is literature review and hypotheses development; Part 3 is sample description and research variable; Part 4 is result and discussion; Part 5 is a conclusion with limitations and suggestions of this research.

Literature Review

Theoretical Framework

Jensen and Meckling (1976) describe agency relationships as a contract whereby one or more people perform several services that involve the delegation of authority and decision-making representatives which are left to the agents. Principal is a shareholder who has economic resources, while the agent can be referred to as management who has a role in managing and controlling economic resources owned by the principal. In agency relationships, there may be conflicts that occur due to differences in interests between agents and principals (Agustia, Muhammad, & Permatasari, 2020; Lubis, Rustam, & Muda, 2017; Bukit & Iskandar, 2009). Principals and agents try to maximise their respective benefits (Fitri et al., 2019).

Agency theory overcomes problems contained in agency relationships because the main purpose of this theory is to discuss problems that occur between several parties who work together but have different goals (Eisenhardt, 1989 in Hartadi, 2012). Problems that can arise in the agency relationship include a difference in objectives between the shareholders and management. These different goals can encourage management to take deviant actions in their own interests and manipulate them to make it appear that management has acted in accordance with the wishes of shareholders. These actions make it difficult for shareholders to ascertain whether management has done its job properly. Another problem that can arise in agency relationships is that there are differences in attitudes towards risks that arise. This difference in attitude makes shareholders and management unilateral in making decisions. Shareholders and management who have aligned goals and attitudes will make management present their company's financial statements in their true state without manipulation. Financial statements that are of a good quality will have an impact on the audit quality produced by the auditor (Radianti, 2017).

Based on the problems that arise between the principal and agent, a third party is needed as a mediator from both parties. The role of the third party that is the auditor is as an assistant to shareholders in monitoring the behaviour of managers and ensuring managers act in accordance with the interests of shareholders. Differences in interests between the principal and agent will have a negative impact if not properly aligned by the auditor. Auditors are those who are considered capable of bridging the interests of the principal and the manager as a form of accountability of the manager to the principal. The task of the auditor is to provide

an opinion on how reasonable the financial statements are that are provided by the manager whose reliability can be seen from the audit quality produced by the auditor (Radianti, 2017).

Hypotheses Development

Narrow Diversification and Audit Quality

Casterella et al., (2004) say that industry specialisation is basically a differentiation strategy that gives auditors an advantage to compete with competitors. In contrast to the differentiation strategy, the diversification strategy classifies client industry memberships with the aim of increasing company growth and profits by attracting clients from new industries or markets. Narrow diversification has a narrow focus by having several clients in the same industry. Narrow diversification can have a positive effect on performance due to differences in markets and product areas that can be used by auditors to increase knowledge (Rumelt, 1974).

Hao et al., (2016) found that narrow diversification allows auditors to add deeper knowledge about their industry, thereby increasing the possibility of detecting material misstatements and reducing the risk of audit failure. Auditors who have many clients in the same industry will have better knowledge and understanding of the company's internal controls, the company's business risks, and audit risks in the industry. Narrow Diversification enables auditors to audit client industries that have similarities so that they can better use their knowledge and abilities. This can increase the likelihood of auditors to detect material misstatements and reduce the risk of audit failure. Detection of material misstatements and the low risk of audit failure make audit quality even higher because it is free from management manipulation. Based on the description above, the hypothesis is formulated as follows:

H₁: Narrow diversification has a relationship with audit quality

Wide Diversification and Audit Fee

Zhao and Luo, (2002); Boz et al., (2013) argue that narrow diversification is superior to wide diversification because wide diversification can frustrate business. This business failure is caused by the difficulties experienced by the company in applying experience to unknown new market conditions. Wide diversification in an industry has a broad focus by having various clients from different industries (Hao et al., 2016). Diversification that is too wide has a negative impact on performance due to lack of knowledge to develop competence (Palepu, 1985).

Hao et al., (2016) found that wide diversification poses a risk of uncertainty in audit quality because of the lack of knowledge held by the auditor. The greater risk of uncertainty makes

audit quality lower because there are indications that auditors fail to detect material misstatements in the financial statements. Based on the description above, the hypothesis is formulated as follows:

H₂: Wide diversification has a relationship with audit quality

Auditor Switching and Audit Fee

Substitution of auditors or public accountants (APs) conducted by the client company, has been regulated by the Financial Services Authority No.13 / POJK.03 / 2017 concerning the Use of Public Accountant Services and the Public Accountant Office in Financial Services Activities states that those who carry out service activities finance must limit the use of audit services to annual historical financial information from the same public accountant (AP) for a maximum of three consecutive financial years. Restrictions on the use of services from public accounting firm depend on the results of the audit committee's evaluation of the potential risks of using services from the same public accounting firm in a row for a long period of time.

The obligation of rotation in the perspective of agency theory illustrates the existence of the company. Companies whose ownership is spread and owned by the public are trying to increase the level of trust of investors and users of financial statements by trying to improve the quality of audited financial statements so that they are of good quality. One of the reasons companies do auditor switching is to gain the trust of users of financial statements (Hasbi, 2017). The trust of users of these financial statements can be obtained by performing auditor switching to improve audit quality. According to Espahbodi (1991) in Wijayani and Januarti (2011) said that the auditor's relationship with the same client in a long period of time will affect its independence. Auditor independence will affect audit quality because the mental attitude and opinion of an auditor can be affected if he has a personal relationship with his client (Nasser et al., 2006).

Center (2008) in Suparlan and Andayani (2010) said that a company that makes the decision to replace or retain its auditor is strongly influenced by the company's image. Companies tend to want to improve their audit quality in order to gain the trust of investors and the public by replacing auditors. Change of auditors is considered to increase auditor independence, resulting in higher audit quality (Mahindrayogi and Suputra 2016). Based on the description above, the hypothesis is formulated as follows:

H₃: Auditor switching is related to audit quality

Research Design

Sample and Data Source

The population used in this study is companies engaged in all non-financial industrial sectors which are listed on the Indonesian Stock Exchange (IDX). The period used was of annual financial statements issued by the company in 2015-2017. Total observations obtained were 1055 observations. Data was obtained from the Indonesian Stock Exchange website (www.idx.co.id) and analysed with the help of SPSS software.

Variable Definition and Data Measurement

The dependent variable in this study is audit quality. Audit quality in this study defines the results of the entire audit process carried out by an auditor. DeAngelo (1981) defines audit quality as the probability of auditors finding and reporting material errors contained in financial statements. Quality audit in this study uses proxy discretionary accruals (DAC). The researchers used discretionary measures of accruals in tests for earnings management and market efficiency (Kothari et al., 2005). Most studies of this kind use the Jones model (Jones, 1991) or the modified Jones model (Dechow et al., 1995) to measure discretionary accruals. In line with the research of Hao et al. (2016), this study modifies the study by Kothari et al. (2005) by adding the variable return on assets (ROA), which is in the Jones model into the Kothari model to measure discretionary accruals. Total accruals will be measured first before measuring DAC.

Total accruals are divided into two components, namely discretionary and nondiscretionary with the following stages:

- a. Total accruals are measured by a modified Jones model:

TAC (Total Accrual) = net income – cash flow from operating

- b. Estimated value of accruals is calculated by the OLS (*Ordinary Least Square*) regression equation:

$$TAC_t / A_{t-1} = \beta_0 + \beta_1 (I/A_{t-1}) + \beta_2 ((\Delta REV_{i,t} - \Delta AR_{i,t}) / A_{t-1}) + \beta_3 (PPE_{i,t} / A_{t-1}) + \beta_4 (ROA_{i,t} / A_{t-1}) + \epsilon_{i,t}$$

- c. Non-discretionary accruals (NDA) are calculated as follows:

$$NDA_t = \beta_1 (I/A_{t-1}) + \beta_2 ((\Delta REV_{i,t} - \Delta AR_{i,t}) / A_{t-1}) + \beta_3 (PPE_{i,t} / A_{t-1}) + \beta_4 (ROA_{i,t} / A_{t-1})$$

- d. Calculating Discretionary Accruals

$$DAC_t = (TAC_t / A_{t-1}) - NDA_t$$

Notes:

TAC_t = Total Accruals of company i in period t

A_(t-1) = Total assets of company i at the end of year t-1

REVI,t = Change in company revenue i at the end of the year t

ARI,t = Changes in company receivables i from year t-1 to year t

PPE = Fixed assets (gross property plant and equipment) in the company t

ROA = Return on assets, calculated as the ratio of company income i, years t and t-1

NDA_t = Nondiscretionary Accruals in year t

DAC_t = Discretionary accruals of the company i in period t

This study has three independent variables, including: narrow diversification, wide diversification, and auditor switching. Narrow diversification in this study is defined as a public accounting firm that audits several clients in the same industry and approaches its specialisation. Detection of material misstatements can reduce the risk of audit failure. Low risk of audit failure makes audit quality higher because the auditor can detect management fraud in the financial statements (Hao et al., 2016). In this study, narrow is measured using measurement industry auditor specialisation. This study measures auditor specialisation by using the market share measure by calculating the total assets owned by the client. This measurement method using the auditor's assumption is the result of his experience conducting audits of large business volumes in an industry (Gul, Fung, & Jaggi, 2009). Narrow diversification will be given a value of 1 if the auditor has a SPECC percentage of $\geq 10\%$ - $\leq 30\%$ and a value of 0 if vice versa (Reichelt & Wang, 2009).

$$SPECC = \frac{\text{Number of public accounting firms' clients in the industry}}{\text{Number of emitents in the industry}} \times \frac{\text{Average of public accounting firms' clients' assets in the industry}}{\text{Average of emitents' assets in the industry}}$$

In this study wide diversification was measured using measurement industry auditor specialisation. This study measures auditor specialisation by using the market share measure by calculating the total assets owned by the client. This measurement method using the auditor's assumption is the result of his experience conducting audits of large business volumes in an industry (Gul, Fung, & Jaggi, 2009).

Wide diversification will be given a value of 1 if the auditor has an SPECC of $\leq 10\%$ and a value of 0 if vice versa (Mayhew & Walkins, 2002). Auditor switching in this study was measured using a dummy variable, which would be given a value of 1 or 0. A value of 1 would indicate a change in public accountants (AP) by a client company and a value of 0 would be given when the client company did not make a change of AP in the 2015 - 2017.

To ascertain whether there is a relationship between audit quality, narrow diversification, wide diversification, and auditor switching, this study includes several control variables that have been tested in previous studies related to audit quality. Company size (SIZE) is a company that is grouped into several groups including large, medium and small companies. The size of the company is measured using the natural logarithm of the total assets owned by the company (Irawati, Maksum, Sadalia, & Muda, 2019; Arifuddin, Hanafi, & Usman, 2017; Suwito and Herawaty, 2005). LagLOSS is a loss that occurred at the company in the previous year. LagLOSS is useful for controlling financial conditions, because companies that have difficult financial conditions are more likely to manage their income (DeFond & Jiambalvo, 1994). LAGLOSS is valued 1 if the company reported a loss in the previous year, and 0 vice versa. Leverage (LEV) is a ratio that represents a company's debt to assets. Leverage on reflects the incentive to manage income to avoid violating debt agreements (DeFond and Jiambalvo, 1994). Leverage is measured using total liabilities divided by total assets (Simamora & Hendarjatno, 2019; Sejati & Prasetyaningrum, 2019).

Research Method

To be able to answer the hypothesis of this study using Multiple Linear Regression Analysis. The classic assumption test which consists of a normality test, a multicollinearity test, a heteroskedasticity test, and an autocorrelation test are also performed. This regression equation is used to test a hypothesis whose formula is as follows:

$$AQ = \alpha + \beta_1 NARROW + \beta_2 WIDE + \beta_3 SWITCH + \beta_4 LOGAT + \beta_5 LagLOSS + \beta_6 LEV + \varepsilon$$

Result and Discussion

Descriptive Statistics

Based on Table 1, there were 463 samples (43.9%) of companies that did not change auditors, while 592 samples (56.1%) of companies did change auditors.

Table 1: Descriptive Statistics

Variable	N	Minimum	Maximum	Mean	Std. Deviation
AQ	1055	-0.194256	-0.000933	-0.05944841	.043951690
SIZE	1055	22.65897	33.32018	28.6629198	1.62672217
LEV	1055	.000258	.999261	.46111506	.215027284
Valid N (listwise)	1055				

Narrow Diversification and Audit Quality

Based on the results of the study, it can be seen that narrow diversification has a relationship with audit quality. In accordance with the hypothesis that in this study that narrow diversification is associated with audit quality. The results of this study support previous research conducted by Hao et al. (2016) which states that narrow diversification has an influence on audit quality. A public accounting firm that audits several clients in the same industry has a higher audit quality than public accounting firm that audits clients not in the same industry. Narrow diversification enables the auditor to have more ability and experience in an industry so as to increase the possibility of detecting material misstatements and reducing the risk of audit failure. This low level of material misstatement and risk of audit failure can increase the higher audit quality because auditors can minimise the possibility of management committing fraud. Stewardship agency theory explains that principals with agents are described by the relationship between management and auditors in the audit process. Principals will appoint auditors who specialise in getting high audit quality.

Table 2: Multiple Linear Regression Results

Independent Variable	Regression Model		
	β	t	Sig.
(Constant)	0.824	3.346	0.001
NARROW	-0.123	-2.857	0.004*
WIDE	-0.127	-2.963	0.003*
SWITCH	-0.011	-0.480	0.631
SIZE	0.026	3.209	0.001*
LagLOSS	0.098	3.493	0.000*
LEV	-0.258	-4.553	0.000*
R square	0.043		
F statistic	7.819		
F Sig	0.000		

Wide Diversification and Audit Quality

Based on the results of the study, it can be seen that wide diversification has a relationship with audit quality. In accordance with the hypothesis that in this study that wide diversification is related to audit quality. Wide diversification tends to reduce audit quality because public accounting firm tends to have a broad focus in the client's industry. The results of this study support previous research conducted by Hao et al. (2016) that wide diversification is related to audit quality. Wide diversification is contrary to specialisation, wide diversification makes the auditor does not have in-depth knowledge of the business and industry of the client, does not understand the course of the company's operations, and does

not yet know the specific rules regarding accounting and audit procedures that are suitable for the industry. Stewardship agency theory explains that Principals tend to appoint auditors who specialise in getting high audit quality, because non-specialist auditors are considered not to master business conditions, company risk, capability, and in-depth knowledge of the company.

Auditor Switching and Audit Quality

Based on the results of testing in this study, it shows that auditor switching is not related to audit quality. In line with previous research conducted by Leensen (2016) who found that auditor switching has no relationship with audit quality. Auditor switching does not have any impact on audit quality because basically auditors are required to comply with their professional code of ethics and the auditor's job is to evaluate the company's financial statements so that there are no material misstatements in them so as to produce high audit quality. Auditor switching that is often done tends to have a negative impact on audit quality because in the first year of turnover, the auditor has little knowledge about the condition of his new client's company. In contrast (Hasbi, 2017) found that auditor switching is related to audit quality because auditor switching can increase auditor independence and provide greater incentives for auditors to reject pressures from their new client companies.

Based on agency theory, auditor switching must be done considering the existence of OJK Regulation No.13 / POJK.03 / 2017 regarding the Use of Public Accountant Services and Public Accountant Offices in Financial Services Activities, namely public accountants providing audit services for a maximum of 3 consecutive financial years. The existence of this regulation is to maintain auditor independence to assess the fairness of financial statements, but in reality, auditor switching has no relationship with audit quality.

Based on the results of this study, it can be seen that company size has a relationship with audit quality. Large companies are considered far better in managing company conditions in terms of management and operations, so as to produce good audit quality. The results of this study are consistent with research conducted by Kafabih and Adiwibowo (2017) which shows that company size influences audit quality on auditing company financial statements in a positive direction, because audit quality obtained by large companies tends to be better. Based on agency theory, the greater the size of the company, the principal expects an increase in the performance of company management in order to be better and the results of financial statements that are better and more transparent. Financial statements that have good quality can help auditors in producing high audit quality.

Based on the results of this study, LagLOSS has a relationship with audit quality. Companies that suffered losses in the previous year, tend to want to improve the state of the company in

the following year by not doing earnings management so that the audit quality is higher. Agency theory prioritises the delegation of authority from the principal to the agent. Agents are required to always be transparent in managing the company. Through financial statements, agents can show the form of accountability for their performance (Wahyuningtyas, 2010). In the financial statements can be seen profit and loss in the current year and the previous year, so when the company suffered a loss in the previous year, the company tends to want to gain investor confidence in the following year by increasing audit quality.

Based on the results of this study, it can be seen that leverage has a relationship with audit quality. Increased leverage can reduce the value of audit quality. The results of this study are in line with Anas et al. (2018) who found that leverage affects audit quality because the higher the level of leverage, the higher the level of discretionary accruals which results in lower audit quality. Agency theory reveals that the higher the level of corporate leverage, the cost of monitoring (monitoring costs) will be high also because the company has an obligation to disclose financial information in truth (Jensen and Meckling, 1976).

Conclusion

Conclusions that refer to the formulation and objectives of this study indicate that narrow diversification and wide diversification have a relationship with audit quality. Narrow diversification means public accounting firm has a narrow industry focus, making the auditor's capabilities and experience more in an industry so that it can increase the possibility of detecting material misstatement and reducing the risk of audit failure. This low level of material misstatement and risk of audit failure can increase the higher audit quality. Wide diversification tends to reduce audit quality because public accounting firms have a broad focus in the industry of its clients. Wide diversification means the auditor does not have in-depth knowledge of the client's business and industry, lacks understanding of the course of the company's operations, and does not yet know the specific rules regarding accounting and audit procedures that are suitable for the industry. In contrast to narrow diversification and wide diversification, auditor switching has no relationship with audit quality because auditors are required to comply with their ethical codes of conduct and the auditor's job is to evaluate the company's financial statements so there are no material misstatements in them so as to produce high audit quality.

This study cannot use other more precise measurements to measure narrow diversification and wide diversification which can be grouped through the SIC code. In the future, higher quality research results are expected by adding variables that have significant links to audit quality such as audit tenure, public accounting firm size, financial client size and health, audit fees, and audit committees.

Acknowledgement

This paper is derived from Fitri Rachmadini's Undergraduate Thesis at the Faculty of Economics and Business, Universitas Airlangga, Surabaya, Indonesia. We are also grateful for the comments and insights from Yuanita Intan Paramitasari and Nadia Klarita Rahayu.

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