Measurement Model of Public Companies' Audit Quality in Indonesia

Ida Rosnidah, Razana Juhaida Johari, and Rawi

***Abstract*—** Public or shareholders put a great hope on audit quality that can make the financial statements audited by the audit firms free from material misstatement caused by an error or fraud. Audit quality is also expected to provide confidence to investors in the capital market so that they can assess the company's performance more objectively. The objective of this current study is to identify factors that affect the measurement of audit quality by using the data from the Indonesia public companies. This study is designed to explore the measurement of audit quality of public companies related to various variables theoretically contribute to audit quality measurement. This study uses a two-stage evaluation process which involves the measurement and structural model analyses by using LISREL software. The findings offer a model of audit quality measurement that could be used as a guidance especially for the listed companies on the Indonesia Stock Exchange.

***Keywords*—**Audit procurement, audit fees, auditor's specialization, audit quality.

I. Introduction

GENERALLY, public or shareholders put a great hope on the audit quality to make the financial statements audited by the audit firms free from material misstatement caused by an error or fraud. The number of financial cases have resulted in the fact that audit quality is much questionable. DeAngelo [cited in Duff 2004] says that the quality of audit depends on two factors: (1) the ability of auditors to examine the accounts and identify errors or anomalies through their technical competence, and (2) their objectivity through their independence. Therefore, DeAngelo defines audit quality as the auditor's probability to detect and report errors or fraud in clients' accounting information systems.

These days, the support from empirical research related to the measurement of and influencing factors on the audit quality of public companies in Indonesia is relatively limited. Researches and publications on the quality of audits are mostly conducted in overseas that may bring their own culture and country's economic system on the researchresult. Some available researches and publications in Indonesia use six factors that affect the audit quality, namely the audit procurement, audit fee, auditor specialization in the clients' industries, the application of auditing standards, the application of quality control standards and the audit firms' size.

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However, so far the empirical evidence that justifies the validity of the influence of the six factors all together on the measurement of audit quality firms in Indonesia has not yet to be found. This research is conducted in order to find the factors that contribute to the measurement model of audit quality by using the listed public companies in Indonesia. The model may further serve as a guidance for public companies or stakeholders to select the audit firms that can provide the qualified audit services.

II. Literature Review & Hypothese Development

A. Entity and Agency Theory

According to Paton [1922 cited in Hendriksen, 2000:348], the company is considered as a separate economic unit that operates primarily for the benefit of equity holders. The agency theory proposed among others by Meckling [1976] considers that as an agent for shareholders the company management will act in full awareness for their own interests and the management will try to maximize their own welfare by minimizing various agency costs.

Furthermore, Meckling [1976] in the agency theory states that the company management must be monitored and controlled to ensure that the management is operated in full compliance with various rules and regulations. These efforts lead to what is referred to as agency costs. Agency costs include costs for monitoring by shareholders, the costs incurred by the management to generate transparent reports, cost of an independent audit and internal control as well as a variety of costs for the purpose of bringing together the interests of management and shareholders. Despite control and monitoring, the potential for the emergence of agency problems still exist, due to the separation of the management and ownership of the company particularly the issuer. Shareholders will ask the management's responsibility in managing the company. One form of accountability is through the financial statements. However, to reduce the risk of the fake information presented in the financial statements, it is necessary for the management to hire an independent external auditor to express an opinion on the fairness of financial statements.

B. Audit Quality

Audit quality, according to De Angelo [1981] is the auditor's probability to be able to reveal and report a violation in the client's accounting information system. In a fieldwork standard of financial audit [SPAP, 2001], it is stated that the auditor is responsible for being fully aware of characteristics and types of material errors in the audited material. Therefore, the auditor should give reasonable certainty in detecting errors in materials. Duff [2004] believes that audit quality is measured by two indicators: service and technical quality. Service quality is measured through five SERVQUAL dimensions, namely TERRA (Tangibles, Empathy, Reliability, Responsiveness and Assurance), while the technical quality is measured by two

factors identified by DeAngelo [1981], namely the competence and objectivity. Indicators developed from both the competence and objectivity include audit firms' reputation and capabilities along with partners and the audit team, the audit team's experience, skills, independence, and the ability of audit firms in providing non-audit services.

C. Audit Procurement

The audit procurement emerges from the need of external audit services. Requests for external audit services are part of the agency costs arising from the separation of the ownership and management of the company. The problem is that it is difficult for management to obtain the desired audit quality at a reasonable cost. As a result, the quality of the external audit for most organizations is not optimal in the eye of General Accounting Office [GAO, 1986], and the cost of audit services for various organizations becomes higher than that if the required set of information is available for the selection of auditors. General Accounting Office [GAO, 1987] and the American Institute of Certified Public Accountants [AICPA, 1987] agree that the solution for this problem is through improved procurement process of audit services.

The main focus of the procurement process is quality. Jensen and Payne [2003] believe that when a manager has a high level of agency costs, they would prefer to implement procurement mechanism designed well and can help him/her to identify and acquire a qualified external auditor at the reasonable cost. Through a multi-dimensional model of the audit procurement process, Jensen and Payne [2003] prove that a good mechanism of the procurement process include First, the procurement procedure to obtain information about the audit firms and the cost of audit services. Second, personal characteristics of the implementer of audit service procurement process. Third, the characteristics of organization in which decisions of the audit services procurement are made. This will improve the quality of the audit in the reasonable price. Then the derived hypothesis is:

H1: Audit Procurement affects audit quality.

D. Audit Fee

The Indonesian Accounting Code [SPAP, 2001], regulated some matters relating to the reward for professional services. In practice, the phenomenon of client scramble among public accountants have long colored audit services trade, and this it is closely related to the fee matter [Meidawati, 2001]. The calculation of the audit fee is only based on negotiations with the client. Clients may force a public accountant to issue opinions they desire. Whereas, the opinions should be based on the collection of competent and sufficient evidence for the auditor in order to give an opinion on the fairness of the clients financial statements. Formulation of derived hypotheses is as follows:

H2: Audit fee affects quality audit.

E. Auditor's Specialization in the Client's Industries

The importance of an understanding of the client's business and industry as well as knowledge about the operation of the company is very important to enable an adequate audit as it is said by Arens, Elder & Beasley [2008:199]. Understanding of the client's industry is also required under the PSA 67 [SA Section 318] in the Public Accountants Professional Standards / SPAP [2001:318]. There are three main reasons why it is important to get a good understanding of the client's industry. First, many industries have unique accounting rules auditors must understand to evaluate whether the client's financial statements in accordance with Financial Accounting Standards (IFRSs). Second, the auditor should be able to identify risks in the industry that will affect the determination of an acceptable audit risk or audit firms in the industry can be justified.Third, there is an inherent risk that is essentially the same for all clients in the industry. The risk understanding helps the auditor in identifying the inherent risks of the client. Derived hypothesis is:

H3: Auditor's specialization in the client's Industries affects the audit quality.

F. Auditing Standards

Auditing standards cover professional qualities of the independent auditor and his/her judgment used in the audit process and in the arrangement of audit reports. Auditing standards that have been established and approved by the Indonesian Institute of Accountants consist of ten standards that can be grouped into three major groups: general standards, work standards in the field and reporting standards. Derived hypothesis is:

H4: Auditing standards affect the audit quality.

G. Quality Control Standards

As auditing standards, quality control standards are also included in the Indonesian Public Accountant Professional Standards (SPAP). Quality control standards codification consist of: (i) SPM Section 100: Quality Control System of Audit Firms; (ii) SPM Section 200: Policy Formulation and Quality Control Procedures; and (iii) SPM Section 300: Implementation and Reporting Standards of Quality Review. Quality control should be applied by any audit firm in all audit services, attestation, accounting and review, and consultation whose standards have been set by Indonesian Accountant Association [Indonesian Accountant Association, SPAP, 2001: 16000.1]. Quality Control Systems of audit firms include quality control policies and procedures, responsibility determination, communication and monitoring [IAI, SPAP, 2001: 17000.1]. Derived hypothesis is:

H5: Quality Control standards affect the audit quality.

H. Audit Firm Size

Arens, Elder and Beasley [2008:46] categorize 4 size of audit firms into the big four: international firms, national firms, regional and large local firms, and small local firms. The four big international firms include Deloitte & Touche, Ernst & Young, PricewaterhouseCoopers and KPMG. These firms come to the big four due to the billion dollars of their net revenue, thousands of partners, and tens of thousands of professionals with offices spread across the United States and around the world. The national accounting firms include those who have branches in almost all major cities in the country. Regional accounting firms include those who have more than 50 professional employees. Finally, local audit firms have only one office with less than 25 professionals. Derived hypothesis is:

H6: Audit Firm Size affects the audit quality.

III. RESEARCH METHODOLOGY

A. Data Collection

Both primary and secondary data are used in this research that include the perseption of issuers on the audit qualitysand various theoretical and empirical resources related to the measurement of audit quality. In order to answer the research questions, data were acquired in two

different ways. The primary data was collected by distributing the questionaires booklet to the listed companies on the Indonesian Stock Exchange. While for the secondary data, the data was collected from textbooks, research journals, articles, database and important data collected from issuers' annual reports included in Indonesian Stock Exchange Fact Book 2012.

B. Research Sample

The research chose the population of company issuers listed in Indonesia Stock Exchange 2011. According to Indonesian Capital Market Directory 2011, the number of listed issuers reaches 393 companies. From this number, the sample taken for the study reached 198 issuers. The sampling technique used was probability technique that give the same chances for all populations to be choosen. To be more detailed, the sampling technique is random sampling in which the researcher chose the sample in a random way. The minimal sample determined for this research used Slovin formula (Umar, 2005:78)

IV. FINDINGS

A. Data Analysis Techniques

This research is designed to test measurement model of audit quality using multiple relationship model involving a number of variables and information acquired in a simultaneous way. This leads to the use of Structural Equation Modeling (SEM) as data analysis techniques. SEM is one of the multivariate models that combines both path and factor analysis to empirically examine both the measurement and the structural model built upon a particular theoretical study. Some other terms of the SEM include Latent Variable Analysis, Covariant Structural Analysis and Linear Structural Relationships (LISREL) [Hair et al. 2006: 711].

B. Data Description

TABLE I.
DESCRIPTION OF RESEARCH DATA

Item	Category	Frequency	Percentage
Sex	Male	140	71
	Female	58	29
	Total	198	100
Age	Less than 26 years	3	2
	26 until 35 years	35	18
	36 until 50 years	90	45
	More than 50 years	70	35
	Total	198	100
Education	Diploma (D3)	13	7
	Undergraduate	120	61
	Master	55	28
	PhD	10	5
	Total	198	100
Working Experience	Less than 3 years	8	4
	3 until 5 years	20	10
	6 until 10 years	130	66
	More than 10 years	40	20
	Total	198	100
Possition	CEO	9	5
	Director	20	10
	Manager	140	71
	Others	30	15
	Total	198	100

C. Research Results

This section presents the research results obtained from the distribution of questionnaires to the respondents as the main source of data. The questionnaire consisted of 151 questions and 7 variables studied. The number of samples in this study were 198 public companies in Indonesia. Before the data from the questionnaires were further analyzed, the researchers conducted a validity and reliability test to prove whether the measuring instruments used have a validity and reliability to measure what is supposed to be a measuring function, that is to test whether the questionnaires have carefully and precisely measured what to measure in this study.

Validity testing used the product moment correlation (validity index) in which the statement item is considered valid if correlation coefficient of the statement item constitutes 0.30 [Barker et al, 2002:70]. The reliability testing used Alpha Cronbach method and considered reliable if the reliability coefficient is greater than 0.70 [Barker et al, 2002:70]. Validity and reliability test of each questionnaire found that three statements: number 33, 36 and 56 on the variable of quality control standards were invalid. Based on the validity test results, the three invalid statement items were set aside in the subsequent analysis. In addition, the reliability values of seven variables have already meet the minimum suggested threshold, that is greater than 0.70.

D. Data Normality Results

The use of estimation method of maximum likelihood in structural equation modeling requires data to distribute in multivariate normal. Therefore, prior to the data processing, the researchers conducted data normality testing using Chi-square test. The chi-square value is 100.294 with a p-value of 0.000. Due to the fact that p-value is less than 0.05, it can be concluded that the manifest variable data (indicators) have no a multivariate normal distribution. Because the normality test results show that the data are not a multivariate normal distribution, as Raykov and Marcoulides [2006: 30] believe when the data are not normally distributed, estimation method used is the Satorra-Bentler robust maximum likelihood.study.

E. Goodness of Fit Test's Results

Goodness of fit test was performed to know whether the model has been appropriately obtained in describing the relationship between the variables under study so it can be categorized into a good model. Goodness of fit test in structural equation modeling models can be based on several criteria of goodness of fit test as presented in the following Table II.

The results of absolute goodness of fit shows that the acquired models meet the criteria of goodness of fit at the size of the RMSEA (0.046 <0.08) and SRMR (0.045 <0.080). Thus, it can be concluded that the estimation result are accepted. In other words, empirical models obtained are still in accordance with the theoretical models.

TABLE II.
GOODNESS OF FIT TEST

Dimensions of Goodness of Fit	Value Result of Estimation
Chi-Square	239,77 (p-value = 0,0003)
RMSEA	0,046*
GFI	0,896
AGFI	0,859
RMR	0,045*
SRMR	0,045*
NFI	0,952*
CFI	0,986*
IFI	0,986*
RFI	0,941*

F. Measurement Model

Measurement model is a model that links between latent and manifest variables. In this study, there are seven latent variables and twenty one manifest variables. The latent variables of the audit procurement consist of 3 manifest variables, the audit fee consists of two manifest variables, auditors' specialization in the clients' industries consist of one manifest variable, auditing standards consist of three manifest variables, standards of quality control consists of nine manifest variables, the audit firm size consists of one manifest variable and the audit quality comprises two manifest variables. Goodness of fit test concluded that the model is acceptable meaning that the model obtained can be used to test the research hypothesis proposed. Using the estimation method of robust maximum likehood obtained full model path diagram of factors that affect the audit quality as shown in Figure I.

Through weighting factors listed in Figure I, it can be seen in the latent variable of audit procurement (ξ_1) that PPJA1 (procurement process) indicator is the most powerful in reflecting the latent variables of the audit. On the contrary, PPJA2 (personal characteristics of those implementing audit services procurement) indicator show the weakest in reflecting the latent variables of the audit procurement. Furthermore, in the latent variable of audit fee (ξ_2), BJA1 (clients' characteristic) indicator is more strongly in reflecting the latent variables of the audit fee than BJA2 (audit firm size) indicator.

In the latent variables of the application of auditing standards (ξ_4), PSA2 (standard of field work) indicator is most On the contrary, PSA1 (general standards) indicator shows the weakest in reflecting the latent variable of the strongly in reflecting the latent variables of the application of auditing standards. Then, in the latent variable of quality control standards (ξ_5), SPM6 (promotion) indicator shows the most powerful in reflecting the latent variable of quality control

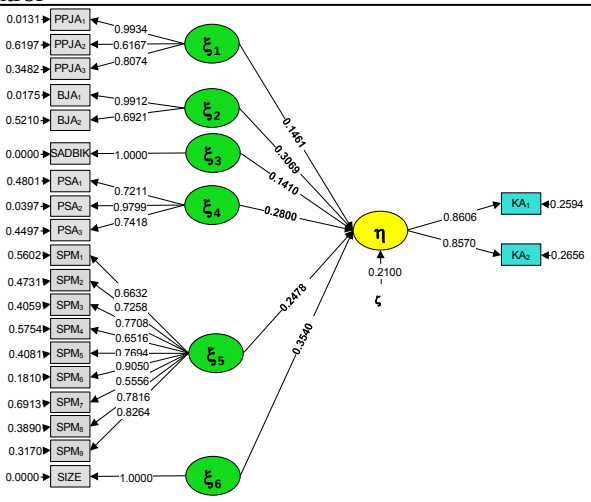

Fig. 1. Standardization Coefficient of Structural Equation Modelling

standards. On the contrary, SPM7 (inspection) indicator is the weakest in reflecting latent variables of quality control standards. Finally, the latent variable of quality audit (η), KA1 (technical quality) indicators shows more powerful in reflecting the latent variable of audit quality than KA2 (service quality) indicator.

The next step of the analysis is to testing the degree of conformity of indicators used to measure the audit procurement, audit fee, auditor's specialization in the client's industry, auditing standards application, quality control standards, the audit firm size and the audit quality through construct reliability and variance extracted approach. The test results for each indicator of the latent variables are described in the Table III.

TABLE III.
CONSTRUCT RELIABILITY & VARIANCE EXTRACTED

Manifest Variables	Weighting Factors						
	ξ_1	ξ_2	ξ_3	ξ_4	ξ_5	ξ_6	η
Construct Reliability	0,8563	0,8403	1,0000	0,8602	0,9170	1,0000	0,8489
Variance Extracted	0,6730	0,7307	1,0000	0,6768	0,5554	1,0000	0,7375

G. Structural Model

Structural model is a model that links the exogenous latent variable to the endogenous latent variables or endogenous variables relationship with the other endogenous variables. Here is a summary of the values used in the structural model (Table IV). Based on the value of the determination coefficient (R-Square) it is known that the audit procurement, audit fee, auditor's specialization in clients' industries, the application of auditing standards, quality control standards and audit firm size jointly have 79.0% influence on the audit quality. While the remaining 21.0% is the influence of other factors beyond the six exogenous variables under study.

TABLE IV.
SUMMARY OF STATISTICAL TEST RESULT

Path	Coefficient	T_{count}*	R^{2}-Square
$\xi_1 \rightarrow \eta$	0,1461	2,9211	0,7900
$\xi_2 \rightarrow \eta$	0,3069	5,6718	
$\xi_3 \rightarrow \eta$	0,1410	2,5498	
$\xi_4 \rightarrow \eta$	0,2800	5,1296	
$\xi_5 \rightarrow \eta$	0,2478	4,3562	
$\xi_6 \rightarrow \eta$	0,3540	6,9286	

After the path coefficients are calculated, the next step to prove whether the audit procurement, audit fee, auditor's specialization in clients' industries, the application of auditing standards, quality control standards and audit firm size have significant influence either simultaneously or partially on the audit quality is through hypothesis testing.

H. Hypotheses Testing

Hypothesis testing is conducted through F-test statistics with the condition of rejecting Ho if F_{count} is greater than F_{table}, or accepting Ho if F_{count} is less than or equal to the F_{table}. Through the value of the determination coefficient (R2) F value can be calculated with the following formula. Table V presents the results of each hypothesis testing.

$$F_{count} = \frac{(n\text{-}k\text{-}1)R^2_{Y_1(X_1,\ldots,X_6)}}{k(1\text{-}R^2_{Y_1(X_1,\ldots,X_6)})}$$

TABLE V.
SUMMARY OF HYPOTHESES TESTING

Hypothesis	Results
H1: Audit procurement affects audit quality	Accepted
H2: Audit fee affects quality audit	Accepted
H3: Auditor's specialization in the client's Industries affects the audit quality	Accepted
H4: Auditing standards affect the audit quality	Accepted
H5: Quality control standars affect the audit quality	Accepted
H6: Audit firm size affect the audit quality	Accepted

I. Discussionsof the Results

- Audit Procurement affect the Audit Quality

Audit procurement partially affects the audit quality of public companies in Indonesia. Audit procurement directly affects by 2.13% on audit quality, and indirectly has 4.35% influence. In total, audit procurement provides 6.48% influence on the quality of audits of public companies in Indonesia. These results support the results of the study of Jensen and Payne [2003] and Rosnidah [2008].

- Audit fee affects Audit Quality

Audit fee partially affects the audit quality of public companies in Indonesia. Audit cost directly affects by 9.42% on audit quality and because of its association with other independent variables it has 7.10% indirect influence. In total, audit fee has 16.52% influence on the audit quality of public companies in Indonesia. These results support the research of Neni [2001] and Rosnidah [2008].

- Auditor's Specialization in the Client's Industries affects Audit Quality

Auditor specialization in the client's industry partially affects the audit quality of public companies in Indonesia. Auditor's specialization in the client's industry directly affects by 1.99% on audit quality, and because of its association with other independent variables it has 5.41% indirect influence. In the overall specialization, Auditor's specialization in the client's industry affects by 7.40% on audit quality public companies in Indonesia. The results support the research of Jensen and Payne [2003], Duff [2004] and Rosnidah [2008].

- Auditing standards affect the Audit Quality

The Application of auditing standards partially affects the audit quality of public companies in Indonesia. Application of auditing standards has 7.84% direct influence on audit quality, and because of its association with other independent variables it has 7.77% indirect influence. In total, the application of auditing standards has 15.61% influence on the audit quality of public companies in Indonesia. The result supports the research of Agoes [2003].

- Quality Control standars affect Audit Quality

Quality control standards partially affect the audit quality of public companies in Indonesia. Quality control standards provide 6.14% direct influence on audit quality, and because of its association with other independent variables it has 7.81% indirect influence. In total quality control standards provide 13.95% influence on the audit quality of public companies in Indonesia. The result supports the research of Agoes [2003].

- Audit Firm's Size affects Audit Quality

Firm size partially affects audit quality of public companies in Indonesia. Firm size directly affects by 12.53% on audit quality, and because of its association with other independent variables it has 6.51% indirect influence. In total the firm size has 19.04% influence on the audit quality of public companies in Indonesia. The result supports the research Rosnidah [2010].

J. Conclusions & Limitations

Basically, the results of this study revealed that audit procurement, audit fee, auditor's specialization in client's industries, the application of auditing standards, quality control standards and audit firm's size jointly have a significant effect on the audit quality of public companies in Indonesia by 79%. Through the weighting factor of latent variable of audit procurement i.e. procurement process, client's characteristics, fieldwork standard, quality control and promotion appeared to be the most powerful indicator in reflecting the latent variable of audit procurement. On the contrary, the personal's characteristics of those implementing audit services procurement showed the weakest indicator in reflecting the latent variable of audit procurement. Instead, the general standard showed the weakest indicator in reflecting latent variables of the application of auditing standards. Whereas, the audit inspection is the weakest indicator in reflecting the latent variable of quality control standards. Finally, the latent variable of audit i.e. technical quality showed a stronger indicator in reflecting the latent variables of audit quality of quality of service indicator.

In conclusion, the study indicates that the audit procurement, audit fee, auditors' specialization in clients' industries, the application of auditing standards, the application of quality control standards and the audit firm size affect either simultaneously or partially on the audit quality of public companies in Indonesia. Thus, the measurement model of audit quality of public companies in Indonesia according to the results of this study can serve as a guide for issuers in selecting a qualified audit firm. There is one main limitation of this study as it only involves companies listed in the Indonesia Stock Exchange, the findings could not be generalized to another developing countries. The further study is expected to include data from other developing countries such as Malaysia and also to involve the audit firms as the object of the study.coefficient

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