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The Influence of Effective BOC on Choice of Auditor

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ABSTRACT

The role of board of commissioner in choosing an auditor has increased significantly as a result of 2008 global financial crisis of 2008. This paper examines whether the effectiveness of the BOC (BOC) affects the choice of an auditor. Past research related to the internal mechanisms of Good Corporate Governance (GCG) used the number of commissioners, the proportion of independent commissioners and the number of board meetings as indicators. However, this paper measures the effectiveness of board of commissioners (BOC) by conducting content analysis technique based on the level of independence of the commissioners, board activity, and the number of members, expertise and competence. A sample of 218 companies listed on the Indonesia Stock Exchange between 2013 and 2014 were selected. In this study, descriptive statistics and linear regression models were used for the purpose of revealing the significance of the variables. The results show that companies listed on the Indonesia Stock Exchange have an effective BOC in accordance with related administrative regulations. In addition, the effectiveness of the BOC has a positive effect on the choice of auditor.

Keywords: Auditor, Board of Commissioners, effective, good corporate governance, Indonesia

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INTRODUCTION

Background

The ASEAN Development Bank (ADB, 2014) revealed that Indonesian companies had poor corporate governance practices.

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The results of the Corporate Governance (CG) Scorecard in ASEAN between 2012 and 2013 places Indonesia in 5th place after Thailand, Malaysia, Singapore and the Philippines. Hence, it is clear that, Indonesian companies must improve their corporate governance practices, to enable them to compete with companies in Southeast Asia.

Based on agency theory, Good Corporate Governance (GCG) is essential for a company to avoid conflicts between managers and shareholders or investors (Jensen & Meckling, 1976). In addition, corporate governance allows related parties to ensure managers and other internal parties execute their duties to protect stakeholder interest (Sanda, Mikailu, & Garba, 2005). A company implements GCG in many ways, for instance, by presenting financial statements to the public to promote transparency in their dealings. These point to management accountability in resource allocation that they have entrusted to stakeholders (Elzan, Manzilathfiah, Pupung, & Harlianto, 2015). However, there is controversy surrounding how to properly obtain financial statements with a high-level of reliability.

Yesemin (2013) argues there is a substitution or complementary relationship between corporate governance and audit quality. Based on the substitution effect, Williamson (1983) states that better corporate governance mechanisms may replace higher quality external audits, hence, the need for qualified auditors will decrease. Otherwise, in accordance with the complementary relationship, better corporate governance mechanism will drive the need for more qualified auditors to ensure quality of financial reporting. In accordance with the insurance hypothesis, the company will consider being audited by a qualified auditor in any case to improve the quality of their reporting (Wallace, 2004). The insurance hypothesis also drives companies to choose big, well-known auditors (DeAngelo, 1981) to provide a fair and accurate financial report to investors. Stakeholders are more confident when the company is audited by a publicly trusted audit firm. Francis (2004) analyses the comprehensive prior theory and finds the Big Four auditors provide better assured services to their clients.

Independent auditors, one of the corporate governance external mechanisms, mitigate agency problems and reduce information asymmetry (Darmadi, 2016). Hassan, Hassan, Iqbal and Khan (2014) state that audits aim to achieve accountability within a company. Therefore, a high-quality audit is very important to corporate governance. Furthermore, independent auditors play a role in monitoring the relationship between managers and shareholders in order to minimise conflicts of interest that naturally occur between those parties (Elzan et al., 2015). Elzan et al. (2015) report that most auditors in Indonesia are cost focused instead of brand/quality focused. This is aggravated by the fact most companies in Indonesia place considerable weight on audit fee when choosing their auditor. This finding is consistent with that of Khan, Muttakin and Siddiqui (2015) in Bangladesh.

Generally, a company will consider various things before selecting a public accounting firm. Based on the framework of good governance, companies should prioritise the quality of the auditor during the selection process. There have been extensive studies on the effect of corporate governance mechanisms on auditor quality, in China (Leung & Cheng, 2014; Lin & Liu, 2009) and Bangladesh (Karim, Zijl, & Molah, 2013; Khan et al., 2015) while in Indonesia, Maharani (2012); Markali and Rudiawarni (2012); Trisnawati and Hermawan (2013); Putra (2014). These studies used a proxy of board size, family ownership, capital ownership and audit committee effectiveness as a mechanism for the implementation of corporate governance. Meanwhile, the effectiveness of corporate governance focuses on internal mechanisms, such as the effectiveness of board of commissioners. This study attempts to address the limitations of previous studies (Putra, 2014; Lin & Liu, 2009) that only use the size of the board of commissioners (BOC) as a measurement when it is unable to completely describe the performance of the board as a whole. Other measurements that are commonly used in previous research include the proportion of independent commissioners in a company (Marakali & Rudiawarni, 2012).

Most studies measure audit quality by using a dummy variable (Karim et al., 2013; Lin & Liu, 2009; Maharani, 2012; Markali & Rudiawarni, 2012). Nevertheless, this study uses the auditor's rankings to measure auditor quality. All public accounting firms (PAF) in Indonesia, both international and local affiliated, are ranked according to their revenue. Firm size is measured based on annual income earned for services provided to audited enterprises. This measurement refers to the study of DeAngelo (1981) which describes the correlation of audit quality and PAF, the bigger the PAF, the higher the perceived audit quality.

Agency Theory

Agency theory is frequently associated with corporate governance. Suhartati (2013) states that agency theory is important in understanding of corporate governance. Jensen and Meckling (1976) define managers as the agent and the shareholders as the principal. Shareholders therefore delegate decision-making to the manager as agent. Conflicts between the agent and principal gives rise to agency problems. Jensen and Meckling (1976) argue that agency problems eventually lead to agency costs. Agency cost include monitoring costs, bonding cost, and residual losses. Monitoring costs represent expenditures used to control the divergent activities of agents, for example, audit fees, budgetary constraints and operating regulations.

Corporate Governance

Corporate governance is a popular good governance concept and is widely applied in the management of modern organisations. According to Hasan and Butt (2009), corporate governance is defined as the philosophy and mechanisms related to value creation for shareholders. Abor (2007) states that corporate governance refers to how companies should run, organise and regulate the management. In this case, corporate governance will contribute to the goodwill of the company and an increase in trust of the investors. Meanwhile, Rocca (2007) defines corporate governance as a system for making decisions that can be used by the company to solve any conflicts that occur between existing stakeholders. Corporate governance mechanisms include internal and external controls that monitor management activity, corporate policies, the implementations and decisions of companies, their agents/ branches, and affected stakeholders. Internal corporate governance can be achieved by implementing monitoring activities and taking corrective actions, for example, using the board of commissioner, internal auditors, managerial ownership, and remunerations. External corporate governance controls on the other hand come from outside of the company, and include the use of the government regulations, debt covenants, media pressure and competition.

How BOC influences the choice of an Auditor

In Indonesia, the structure of BOC is based on a two-tier system, like in Europe. This system consists of the board of directors that manages the company and the BOC responsible for supervising the management of the company. As its duty is to monitor company activities, the BOC is an effective internal control mechanism of corporate governance. It plays an important role in providing reliable financial reports of the companies. The existence of a BOC influences the quality of their financial reporting. It is also used to measure fraudulent statements by managers. Furthermore, Suhartati (2013) argues that in the selection of public accounting firms, commissioners may establish audit committees to assist in their duties and functions and to provide credible financial statements. The commissioner should be responsible for selecting a qualified and independent auditor. According to Putra (2014), a company with a larger number of commissioners is most likely to choose one of the top 10 auditors. Lin and Liu (2009) find a positive and significant relationship between the number of supervisory board members and the selection of a high-quality auditor. This finding is consistent with previous studies (Maharani, 2012; Markali & Rudiawarni, 2012) which found independent commissioners positively affect the choice of high-quality auditors. From the above, the following hypothesis is proposed:

Ha: The effectiveness of the BOC has a positive effect on the choice of auditor.

METHODS

The populations in this study comprised companies listed on the Indonesia Stock Exchange between 2013 and 2014. The sample size of 218 companies are described in Table 1.

Table 1
Sample selection

No	Criteria	2013	2014	Total
1	Company listed in Indonesia Stock Exchange	528	528	1.056
2	Company that did not disclose data regarding the research (Incomplete data)	(391)	(348)	(739)
3	Outlier data*	(38)	(61)	(99)
Total of analysis unit		99	119	218

*Base on z-score test with z score = 3.00 – 4.00 (Hair, 1998)

Dependent Variable: Auditor's Choice

The measurement of audit quality remains a debatable issues (Ianniello, Mainardi, & Rossi, 2013). DeAngelo (1981) describes audit quality as the auditor's ability to detect anomalies (errors or fraud) and reports them to the public in an audit report. Previous studies have used income/accounting firm size as the proxy of auditor quality (Farag & Elias, 2011; Hoitash, Markelevich, & Barragato, 2007; Karim et al., 2013; Lin & Liu, 2009; Nazri, Smith, & Ismail, 2012; Solikhah, 2016). This research measures auditor quality based on the accounting firm's annual income. This measurement refers to DeAngelo (1981) who states that audit quality can be drawn from an auditor's firm size as the bigger the accounting firm, the higher the audit quality. Maharani (2012) reveals that larger public accounting firms as measured by their revenue, will have a higher audit quality. Annual income data of the public accounting firm is obtained through the Financial Professional Development Centre of the Ministry of Finance of the Republic of Indonesia.

Independent Variable: The Effectiveness of Board of Commissioners

To determine the effectiveness of the board of commissioners, this paper adopts a list of statements (checklist) developed by Trisnawati and Hermawan (2013) which includes: independence, commissioners' activities, the number of commissioners', expertise and competencies that have been adapted to the conditions in Indonesia. The statement list consists of 17 statements using three categories of assessment, excellent (given a score of 3), good (given a score of 2) and poor (given a score of 1). There are six statements relating to board independence; six statements relating to board activities; one statement regarding board size and four statements relating to board expertise and competency.

Data Analysis Technique

Data was analysed using a descriptive statistical technique, while the hypothesis was analysed using ordinary least squares. Before the data was analysed using OLS, it was tested using a classical assumption consisting of normality, multicollinearity, heteroscedasticity and autocorrelation. The data has met all requirements, so the regression model has satisfied the best linear un-bias estimation.

RESULTS

Table 2
Auditor's choice by Indonesian listed companies 2013 - 2014

No	Criteria	Frequent	Percentage
1	Audited by Big 4 auditor	129	59.1%
2	Audited by Non-Big 4 auditor	89	40.8%
Total		218	100%

From the results presented in Table 2, a high quality of PAF which is categorised as the Big 4 PAF is selected by most companies listed on the Indonesian Stock Exchange. There were 59.1% companies in any given year that chose one of the Big 4 PAFs and this was greater than non-Big 4 PAF (40.8%). This indicates most companies in Indonesia select high quality PAFs to audit their financial information. The table below is a descriptive statistical analysis of auditor choice and the commissioners' effectiveness scores in the companies listed on the Indonesian Stock Exchange (2013 and 2014).

Table 3
Statistic descriptive of variable

Variable	N	Mean	Maximum	Minimum	Standard Deviation
Auditor choice	218	343,183,351,421	748,727,984,280	1,813,325,816	275,396,386,070
The effectiveness of board of commissioners	218	39.47	49	29	4.03

Auditor Quality

In this paper, auditor quality was measured using PAF's annual revenue. The Big 4 accounting firms in Indonesia have an average revenue above 300 billion Rupiah per annum. Table 3 shows that the income received by large PAFs and small PAFs in Indonesia varies considerably.

The Effectiveness of the Board of Commissioners

The effectiveness score of the BOC in the sample companies has a maximum value of 49 and minimum value of 29 (Table 3). The average score is 39.47. The maximum score is 51, so the average score of BOC effectiveness of the sample is 77%. This research also creates a distributional table to categorise the effectiveness score of the board of commissioners. Table 4 shows the frequency analysis of the effectiveness scores between 2013 and 2014. Based on Indonesian regulation of the board of commissioners, most companies (60.6%) have met the requirements of existing legislation in Indonesia in terms of quantity, independence, activity and competence. As an internal mechanism of governance, the BOC carry out their roles and responsibilities as controls for the activities of the company.

Table 4
Frequency analysis of commissioners effectiveness score

No	Interval	Criteria	Frequency	Percentage
1.	17 - 28	Less effective	0	0%
2.	29 - 40	Effective	132	60.6%
3.	41 - 52	Very effective	86	39.4%
Total			218	100%

Table 5
Ordinary least square results

	Model	Unstandardised Coefficients		Standardised Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	-1,534,416.657	154,648.145		-9.922	.000
	Comis_Board	38,225.004	4,184.904	.559	9.134	.000

a. Dependent Variable: Auditor Choice

In Table 5, the regression equation is:

AUD_{it} = $-1{,}534{,}416.657 + 38{,}225.004\ COM_{it} + e_{it}$

AUD_{it} = Choice of auditor, measured by the accounting firm's annual income

COM_{it} = Effectiveness of BOC, measured using a checklist that includes board independence, board activities, board size, board expertise and competence.

DISCUSSION

An analysis using OLS showed the effectiveness of the commissioners has a positive effect on the choice of the auditor, thus the hypothesis is accepted. More effective commissioners will drive the company to choose a better qualified PAF. This finding is consistent with that of Suhartati (2013) who states that there is a positive and significant correlation between the effectiveness of the BOC and audit quality. According to the agency theory, there may be a conflict between the principal and agent (known also as an agency problem). In this case, agency problems can be avoided by evaluating the agent's performance. This can be achieved through the use of internal mechanisms of corporate governance. Furthermore, the implementation of corporate governance by internal mechanisms can be achieved by establishing a board of commissioners.

The BOC have a duty to its stakeholders as well as possess the authority to monitor all management activities and oversee the implementation of policies adopted by the management. As an internal mechanism of corporate governance, the BOC is expected to minimise agency problems between the board of directors and the shareholders. To effectively monitor activities, competent commissioners are essential, such as those with considerable experience in the field and those who have educational backgrounds in the same area. In addition, the number of commissioners is important, Lin and Liu (2009); Maharani (2012); Markali and Rudiawarni (2012); Putra (2014) found that the number of commissioners will affect the selection of qualified external auditors. Therefore, the BOC will run effectively.

If the BOC is effective, they will call for transparent financial reporting to minimise information asymmetry that may occur between management and shareholders. Audit services by high quality public accounting firms is needed to create and align corporate information, particularly those related to financial statements. In addition, choosing BOC qualified public accountant firm is the duty of the Board. This encourages management to produce reliable information and to be accountable to its stakeholders.

CONCLUSION

The results show that companies listed on the Indonesian Stock Exchange in 2013 and 2014 have an effective BOC in accordance with the administrative regulations. This paper concludes that a more effective BOC will encourage the company to choose a more qualified public accounting firm. Moreover, a measurement model of commissioners' effectiveness score is dynamic, thus future research is expected to employ an adapted model with the new regulations. Further research may also consider using board performance BOC to measure the effectiveness of each commissioner, as the performance of the council goes beyond merely obeying the rules of quantity and independence. This paper contributes to a better understanding of an aspect of internal governance mechanisms to improve the quality and reliability of financial reporting. To the regulator, this paper may contribute as consideration in creating policy related to good corporate governance in Indonesia.

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