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The Role of Firm Ownership Type and Earnings Management on Auditor Choice and Audit Fee of Non-Financial Firms

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***Abstract*—In the past decade, there were cases questioning firm's auditor choice like Enron, Tyco International, and WorldCom. Auditor choice (big 4 vs non-big 4) is a proxy of audit quality which audit fee capable to be proxy too. The research purpose is to analyze the impact of firm ownership type and earnings management to auditor choice and audit fee of non-financial firms listed on the Indonesia Stock Exchange (IDX). This research employed quantitative approach using binary logistic regression for auditor choice and multiple linier regression, Ordinary Least Square method for audit fee. The research sample is 609 firms for auditor choice and 566 firms for audit fee. Our findings show that firm ownership and earnings do not have significant relationship with auditor choice but have significant relationship with audit fee. State owned firm is more likely to pay lower audit fee and firm with higher earnings management will pay higher audit fee. This study examines implications which are firm ownership type only divided to 2 categories (state owned firm and non-state-owned firm), time period of this research is limited for only 3 years (2015 – 2017), and limited control variables to explain the relationship between variables.**

Keywords—firm ownership type; earnings management; auditor choice; audit fee of non-financial firms; Indonesian stock exchange

I. INTRODUCTION

In accordance to agency theory, agency relationship is appeared when individual or group (principal) give order or job or authority in making decision to individual or group (agent) [1]. The difference between interest of principal and agent can cause of the conflict of interest in the company. According to Morck et al., there are two agency problems between managers and shareholders that can arise in the company which are divergence-of-interest problems and offsetting entrenchment problem [2]. Conflict of interest problem of the company could endanger its corporate governance. Good corporate governance. Good corporate governance improves the reliability and quality of financial statement [3]. Whereas, the reliability of financial statement decreases when company has bad corporate governance. Therefore, external auditor can help company to ensure the reliability of information in financial statement. The importance of external auditing is receiving considerable attention because of its function in this factor. According to Berle and Means, external audit is an important part to protect firm's corporate governance [4].

In the past decade, there was some cases that can be related to auditor choice. Some examples of the cases are from Enron (2001), Tyco International (2002), and WorldCom (2002). Those cases lead to arising question whether audit firm from big 4 is better than non-big 4. This paper will explain two of auditor relationship which are auditor choice and audit fee. There are many researches about the driver of auditor choice. There are two main approaches to explain it, which are the reduction in information risk that accrues as audit leads to more reliable reporting and high-quality auditing also improves the operational efficiency and effectiveness of a firm [5]. There also many researches about audit fee. Audit fees to external auditor are determined according to ownership structure of the client [6,7].

This research studies about the impact of two factors to auditor choice and audit fee. First factor in this research, firm ownership type which based on the prior research by Ghosh can be categorized into two types, state-owned firms and nonstate-owned firms [8]. Company which has government as shareholders is categorized as state owned firm and non-state-owned firm if otherwise. The second factor is earnings management which is proxied by discretionary accruals based on Jones model [9].

From past results, there were inconsistent findings about this topic. According to previous studies, Alfraih [10] and Ghosh [8] stated that the greater the level of government in the ownership structure, the lower the likelihood of the company to hire a big 4 auditor. However, study by Sarhan states that there is no statistically significant relationship between government ownership to auditor choice [11]. Prior research's finding by Ghosh is that firms having high discretionary accruals or high earnings management are less likely to be audited by domestic non-big 4 audit firms [8]. In contrary, Francis et al. argue that firm with high discretionary accruals has incentive to hire big 4 audit firm [12]. Nelson finds that government ownership in the company will lead to higher audit fee paid to external auditor [13]. Meanwhile, state-owned firms more likely to pay lower audit fee to external auditor [8]. However, referenced to Eshghalizdeh research result shows that between government ownership and audit fee does not have significant relationship statistically [14]. Nam also supports the statement that audit fee for higher earnings management more likely to be higher than firm with lower earnings management [15]. However, Chung and Kallapur [16] and Zhang and Xu [17] do not find any significant relationship between earnings management and audit fee. This research is conducted to research about the inconsistency of the result from prior researches and to answer a research question of whether firm ownership type and earning management has a significant impact to auditor choice and audit fee of non-financial firms listed on Indonesia Stock Exchange (IDX).

II. Theoretical Framework

A. The Agency Theory

According to Jensen and Meckling, agency theory is a relationship based on contract between the principal and agent which principal give job or order to the agent [1]. A company which has its own proportion of shareholders and management will has similar agency relationship. The shareholders in the company are playing a role as principal who give job or order to the agent and the management in the company is playing a role as agent who do the job given by its principal. there are problems that can appeared in agency relationship which called as agency problems. Conflict in interest problem is raised because of the different of desires or goals between principal and agent [18]. There are three assumption of human basic characteristics which are self-interest, bounded rationality, and risk averse [19]. Moreover, there is information asymmetry in agency relationship. Referenced from Panda and Leepsa, one of the causes of agency problem is from prevalence of information asymmetry in the company [20]. Landstorm believes that information asymmetry increases the threat of opportunism in the company [21].

B. Corporate Governance

Corporate governance is a system to direct and control a company to continue its existence and keep its responsibility to its stakeholders [22]. Corporate governance's purposes are making easier access of investment including domestic and foreign investment, getting cheaper cost of capital, making better decision to improve the company's performance, improving the confidence of stakeholders on company's performance and protecting board of directors and management from legal suing [23]. Corporate governance can be divided to the behavioral pattern and the normative framework [24]. The behavioral pattern when Corporate governance concerns in the actual behavior of corporation like the company performance, its growth, financial structure, efficiency and treatment to shareholders. The normative framework when corporate government concerns in the rules applied where the company is operated. The examples of the rules are legal system, judicial system, financial markets, and labor market. This research will explain about corporate governance in concern to the behav-ioral pattern whether there is behavior in the company that effect to decision making based on the type of shareholders and earnings management. There are five principles that have to be fulfilled in the companies according to *Pedoman Umum* Good Corporate Governance Indonesia, which are transparency, accountability, responsibility, independency, and fairness [25]. In result, a company need to protect is corporate governance to reduce the conflict in interest between principal and agent. Moreover, Berle and Means believe that external auditing is an important part that able to protect firm's corporate governance [4].

C. Audit

According to Arens, auditing is the accumulation and evaluation of information to determine whether the information given is in accordance to the established criteria and standard [26]. Referenced from International Standard on Auditing (ISA) 200, paragraph 3, the objectives of audit are to enhance the degree of intended user's confidence in financial statement by giving an opinion whether the financial statement prepared fairly. To conclude, auditing is to ensure whether the financial statement audited is free from material misstatement due to error or fraud. There are three types of audit which are operational audit, compliance audit, and financial statement audit [26]. This research is focused on financial statement audit of the company. Financial statement need to be assessed by public accountant (external auditor) because of their independency and objectivity to give assurance whether financial statement is free from material misstatement [27].

D. Auditor Choice

Gul et al. stated that auditor choice is seen as a function of demand side factors to identify client characteristics that influence the decision to choose its auditor [28]. Client has a right to choose which audit firms hired to be firm's auditor. According to Watts and Zimmerman, independent audits were demanded since eleventh century since the existence of English merchant guilds by a committee of guild members [29]. Firms with agency problem are more likely to demand external audit [30]. Companies make decision to auditor choice with the intention to reduce agency costs caused by several information asymmetries arising in a company's environment [31]. There are many researches about the determinant to choose external auditor like firm size, financial, leverage, total asset turnover, firm ownership, earnings management, international diversification, corporate governance, complexity and financial health [8,31,32]. Furtheremore, in this technological turbulence era, many companies have invested in technology, because it can increase the capability of company to gain benefit [33]. External auditor should have an awareness that focussing the audit strategies by using information technology is a wise choise to give the best audit performance.

In this research, auditor choice can be divided into two categories which are big 4 audit firms and non-big 4 audit firms [10,34,35]. Auditor choice is one of dependent variables in this research. Second dependent variables in this research is audit fee. The relationship between the dependent variables is that both of variables are proxy of audit quality.

E. *Audit Fee*

According to PP No 2 Tahun 2016, audit fee is a payment received by public accountant for giving an service audit to its client. Arens stated that audit fees are only given to CPA firms for audit service [26]. The amount of fees are varied and there are many studies conducted to understand about the drivers for audit fee. Some of characteristics that can affect the amount of audit fees paid to auditor are firm size, firm age, group affiliation, client's complexity, earnings management and ownership structure [8,36]. Referenced to PP No 2 Tahun 2016, audit fee can follow basic policies to calculate the amount of audit fee which are (1) the amount charged based on hourly charge for different level of auditor's staff, (2) policy on determining the price. It can be different with standard amount of audit fee, (3) the method for determining audit fee will be stated in engagement letter.

F. *Firm Ownership Type*

Firm ownership type can be defined by looking at ratio of share ownership in the company. According to Ghosh, firm ownership type can be divided in to two categories which are state owned firm and nonstate-owned firm [8]. Referenced to The Organization for Economic Co-operation and Development (OCDE), firm can be defined as state owned enterprises when the state has a participation in ownership [37]. Abramov et al. study about the state ownership regardless of the government ownership's size as long as the government has part of ownership of the company [38]. In addition, according to Claessens et al. shareholders who control over 5% of the votes has a significant control rights of companies [39]. In this study, the writer defined state-owned firms as firm in which government has a part of ownership in the company regardless of the size of the ownership. The company in which government does not have any part of ownership is categorized as non state-owned firms in this research.

G. *Earning Management*

Earnings management is manager's choice of accounting policies or actions that affect earnings to achieve some specific reported earnings objective [40]. In addition, Setiawati and Na'im stated that earnings management is management's intervention at financial reporting process for their own benefit [41]. According to Watt and Zimmerman, there are three factors that can motivate earnings management which are (1) bonus plan hypothesis, (2) debt covenant hypothesis, (3) political cost hypothesis [31]. Bonus plan hypothesis is when Management has tendency to choose accounting method that maximize their bonus. In result, earnings management is done by management to increase its profit by choosing accounting method which will increase their bonus received. Debt covenant hypothesis is when earnings management is done because the manager wants to avoid overruling debt contract. Manager make high earnings to reduce the possibility of overruling the debt contract and to maintain its reputation to its creditors. Political cost hypothesis is because the magnitude of political cost is highly dependent on firm size which means that bigger company increase the probability of manager to defer current year's earnings to next year's earnings to decrease its earnings. If company's earning is high, government will take action for example, increase its tax income, implement antitrust policy, etc.

H. *Hypothesis Development*

There are many indicators in choosing external auditor for a company. Many studies explain that auditor choice can be decided based on audit risk, audit complexity, and audit quality [42,43]. State owned firm can be defined as one of firm ownership type which has a political connection [35]. Moreover, Faccio and Claessens et al. believe that firm with political connection has easier access to credit or loan [39,44]. Therefore, state owned firms does not need to hire good audit quality because the financing for its capital can be done without credible financial statement [45]. According to Kitindi et al. and Kim, the credibility of financial statement influences the lending decision [46,47]. According to those statements, the hypothesis is:

> H1. Non-big 4 audit firms are more likely to be associated with state-owned firms.

State owned firm capable to reduce its audit risk [48]. Audit risk can be reduced because state owned firm has incentive to monitor the quality of management's reputation in the company which means that the company is monitored carefully so there is less conflict in interest between shareholders and management [48,49]. Referenced to Alzoubi, agency theory proposed that monitoring mechanism possibly help in aligning the interest of management and investors and reducing the conflict in interest and its opportunistic behavior. Moreover, audit risk has significant relationship with audit fee [50-52]. Client wilth high audit risk has to pay higher audit fee because auditor has to increase audit effort to audit the client. According to Caramanis and Lennox, audit hours can reflect the audit effort by auditor [53]. Therefore, increased audit effort also increases the audit evidence needed and quality of human resource in auditing the company. According to those statements, the hypothesis is:

> H2. Audit fees are likely to be lower for state-owned firms.

Auditor has insurance role to promote transparency information provided in the financial reporting [54]. Information transparency improve earnings quality of the company. Therefore, greater transparency information in financial reporting will reduce earnings management of the company. High audit quality which is proxied by auditor choice (big 4 audit firms) able to constrain the earnings management [49,55,56]. Earnings management is done by the management for their own benefit. In result, they do not want auditor to detect its earnings management. According to those statements, the hypothesis is:

> H3. Non-big-4 audit firms are more likely to be associated with firms having higher earnings management.

There are many studies researched about the determinant of audit fee. Some studies find that there is a negative relationship between audit fee and firm performance [48,57]. Based on research by Gill et al., earnings management has significant adverse relationship to firm performance [58]. Alali stated that earnings management is related to high inherent risk and accounting estimates [59]. Auditor who audit client with high earnings management need to get more audit effort which means audit hours, experience staffs, collect more evidence in which that will increase the cost of audit. If the client has high earnings management, external auditor need to keep caution to the risk and result in higher audit fees [59]. According to Schelleman and Knechel, auditors increase their audit effort if there is higher presence earnings management [60]. According to those statements, the hypothesis is:

H4. Audit fees are higher for firms with higher earnings management.

III. Research Method

This study is explanatory research which is to identify and explain about the impact of firm ownership type and earnings management to auditor choice and audit fee of non-financial firms listed on Indonesia Stock Exchange (IDX) for the period of 2015 – 2017. This study also explain cause and effect relationship between independent variables to dependent variables.

A. Population and Sampling

The population of this research is non-financial firms listed in Indonesia Stock Exchange (IDX) for the period of 2015 – 2017. The sampling technique used is non-probability sampling with judgmental sampling in which the sample does not have the same probability to be included. There are limitations implemented by writer to determine of sample used which are (1) all of non-financial firms publicly listed in Indonesia, (2) annual report and financial statement for the period of 2015 - 2017 are published completely, (3) reporting period of annual report and financial statement are ended in December 31 every year, (4) the annual report states the auditor relationship with the company (auditor choice and audit fee). For hypothesis 2 and 4, the samples should pass classic assumption test which in this research, 43 firms are outlier. From table 1 , it shows that the number of samples used for auditor choice testing which are hypothesis 1 and 3 was 609 firms and for audit fee which are hypothesis 2 and 4 was 566.

TABLE I. Sample Selection

Description	2015	2016	2017	Total
All companies listed in Indonesian Stock Exchange (IDX) during 2015 – 2017	517	534	584	1.635
Companies in finance sector	-86	-89	-90	-265
Companies that does not publish annual report and financial statement	-13	-14	-14	-41
Companies that the reporting period does not ended on December 31 every year	-2	-2	-2	-6
Companies that does not provide information about auditor relationship (audit fee)	-230	-230	-254	-714
Companies that fulfilled the criteria for hypothesis 1 and 3	186	199	224	609
Outlier	-9	-19	-15	-43
Companies that fulfilled the criteria for hypothesis 2 and 4	177	180	209	566

B. Measurement Variables

This research uses secondary data for all variables which can be obtained from company's annual report and financial statement on IDX's website. Earnings management, audit fee, total assets, company's age, total subsidiaries, return on asset (ROA), leverage ratio, tangible ratio, and current ratio use ratio scale. Auditor choice, firm ownership type, and business group, overseas, and opinion use nominal scale and dummy variable. Firm ownership type will be valued as 1 if the firm is state owned firm and 0 if otherwise. Auditor choice will be valued as 1 if firm is audited by non-big 4 audit firm and 0 if otherwise. According to Ghosh, Earnings management can be calculated using discretionary accruals based on Jones model [8,9].

IV. Results

Tables 2 and 3 shows the result for multiple regression for hypothesis 2 and hypothesis 4. Both hypothesis 2 and 4 is accepted because its significant value is lower 0,1. Firm ownership type has significant negative relationship with auditor choice with significant value of 0,0565. This result align with research by Ghosh which is state owned firms more likely to pay lower audit fee [8]. Liu and Subramaniam find that audit fees paid by state owned firm firms is lower than non-state owned firms because there is informal and invincible government guarantees that can decrease firm's audit risk assessment [61]. In addition, state owned firms has incentive to monitor the quality of management's reputation in the company which can reduce conflict in interest in the company [48]. Audit effort given to firm with less audit risk would be lower. In result, audit fees for state owned firms based on audit effort by auditor will be lower.

TABLE II. Estimation of Parameter and Interpretation

	B	Sig.	Exp(B)
FOT	.434	.145	
DA	.342	.229	*.0565
SIZE	-.750	***.000	*.0945
AGE	-.120	.485	***.000
BUGROUP	.705	**.049	**.0005
OVERSEAS	-.237	.237	**.003
SUBSIDIARIES	.011	*.072	*.079
OPINION	-.116	.927	.403
ROA	-6.121	***.000	.3685
LEVERAGE	.145	.724	.343
TANGIBLE	-1,047	**.026	***.000
CURRENT	-,215	.687	.1045
Constant	22.466	***.000	.4825

TABLE III. Multiple Linier Regression Result

Variable	Unstandardized Coefficients	t	Sig.	Sig./2
(Constant)	7.973	11.354	.000	.000
FOT	-133	-1.588	.113	*.0565
DA	.101	1.317	.189	*.0945
SIZE	.409	16.974	.000	***.000
AGE	.167	3.485	.001	**.0005
BUGROUP	.274	2.742	.006	**.003
OVERSEAS	.080	1.412	.158	*.079
SUBSIDIARIES	.000	.246	.806	.403

Table 3. Cont.

Variable	Unstandardized Coefficients	t	Sig.	Sig./2
OPINION	.128	.336	.737	.3685
ROA	.118	.404	.686	.343
LEVERAGE	.465	4.128	.000	***.000
TANGIBLE	-.161	-1.257	.209	.1045
CURRENT	-.006	-.044	.965	.4825

Earnings management has significant positive relationship with audit fee with significant value of 0,0945. This research align with Ghosh [8] and Moradi et al. that there is a positive relationship between DA and AUFEE [62]. There is important role from DA in earnings management in which its high inherent risk will increase its audit fee. Moreover, Arens stated that high inherent risk and DA relates to accounting estimate in which that there is a need to use more time, experience to collect more evidence and review to audit the company [63]. High DA means auditor need more resources to be able audit its client correctly, from human resources to audit cost. The resources needed for audit will make the cost of audit higher to accommodate.

The result for control variables varied. SIZE, LEVERAGE have positive significant relationship with AUFEE at 0,001 level. AUCH has significant negative relationship with AUFEE at 0,001 level. AGE and BUGROUP have significant positive relationship with AUFEE at 0,05 level. OVERSEAS has significant positive relationship with AUFEE at 0,1 level. SUBSIDIARIES, OPINION, ROA, TANGIBLE, and CURRENT does not have significant relationship with AUFEE.

V. Discussion

This research studies about the determinant of auditor choice and audit fee based on non-financial firms listed on Indonesia Stock Exchange (IDX) for period of 2015 – 2017. This research proved that there is information asymmetry between management and shareholders based on the existence of earnings management. This shows that agency theory is relevant to this research. There is agency problem that need to be reduced by hiring audit firm to audit firm's financial statement.

In this research, it is concluded that firm ownership firm ownership type has positive correlation but insignificantly to auditor choice because of the way company choose its auditor choice which firm ownership type is not one of the main variables used for determinant of auditor choice. However, firm ownership type has negative and significant impact to audit fee. It means that state owned firms are more likely to pay lower audit fee audit fee because state owned firms have privilege to has easier access to financing. In result, firm with government ownership can get help to reduce the financial distress easier. In addition with state owned firm which has monitoring incentive to its firm performance. This will reduce audit risk and lower audit fees for audit service.

While, earnings management also does not have significant relationship with auditor choice because the quality of detecting earnings management between big 4 audit firm and non-big 4 audit firm. However, earnings management has significant and positive relationship with audit fee which means that firm with higher earnings management pays higher audit fee. High earnings management will increase the accounting estimate which means the audit will more time and skills to audit the client. Therefore, more resources needed to audit the company will increase the audit fee paid.

However, there are research limitations. Information of audit fee is not mandatory on all firms which limit the number of samples used in this research. This research also only divides firm ownership type to 2 types which are state owned firm and non-state owned firm. This research does not consider other type of firm ownership type. Time period of this research is limited for only 3 years which from 2015 – 2017. This makes the result of the research does not relfect the relationship of independent variables and dependent variables fully. Lastly, the research only used limited control variables to explain the relationship between independent variables and dependent variables.

For future research, the researcher suggests some recommendations. First, adding more category of firm ownership variable in the research. Second, extending time horizon of this research. Last, adding more control variables to increase the ability of the variable to explain the relationship between independent variables and dependent variables.

VI. Conclusion

This study extends the agency theory by providing empirical evidence that firm ownership and earnings do not have significant relationship with auditor choice but have significant relationship with audit fee. State owned firm is more likely to pay lower audit fee and firm with higher earnings management will pay higher audit fee.

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