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An Overview on Contracting Theory and Agency Theory: Determinants of Voluntary Public Accounting Firms Switching

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Abstract

The objective of this literature study is to explore factors affecting voluntary Public Accounting Firm (PAF) switching according to contract theory associated and agency theory of Watts & Zimmerman (1986). PAF switching may occur due to regulations that require a company to do PAF switching, called as mandatory replacement, and due to the company's own wishes, called as voluntary PAF switching. The result of this study shows that 23.9% of companies voluntarily change their PAF because of managerial changes, financial distress, PAF Size, changes on Return on Assets, client size, and auditor's opinion. Contracting theory may explain researches in the field of auditing practices, such as auditor or PAF, related to auditor's reputation, professionalism, auditor environment, PAF size, and industry specialization. Large PAF has a brand image of having a better reputation than small PAF [36]. This is also supported by De Angelo (1981), who stated that large PAFs are preferred by clients because they are considered to be more independent than small PAFs. Agency Theory is often used in research in the field of auditing because information asymmetry is information gap between the interests of agents and principals. Therefore, an independent third party is needed, and the role of the auditor is only as the monitoring party.

Keywords: contracting theory, agency theory, Public Accounting Firm switching

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1. Introduction

Public Accountant is an independent party capable of bridging the interests of shareholders and management and providing an opinion about the fairness of financial statements [31]. The important role of public accountants results in competitions among PAFs (Public Accounting Firms) since companies move from one PAF to another [33]. Therefore, to maintain the independence of auditors from their clients, a regulation-governing public accounting service is required. Clients must switch PAF after a certain period [17].

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PAF switching in Indonesia is regulated by Decree of Ministry of Finance No. 423/ KMK.06/2002 and No. 359/KMK.06/2003 amended by Regulation of Ministry of Finance of Republic of Indonesia Number 17/PMK.01.2008 on Public Accounting Services. This Regulation states that the provision of general audit services for financial statements of an entity may be made by a same PAF for 6 consecutive fiscal years at the most and by the same auditor for 3 consecutive years at the most (article 3, paragraph 1). PAFs and Public Accountants can receive audit reassignments after one fiscal year (article 3, paragraphs 2 and 3) [37]. The regulation concerning the PAF switching must be obeyed by clients and Public Accounting Firms. PAF switching is rotation of independent auditors conducted by a company (client) for its financial report audit. It may be conducted due to a regulation, which is called as mandatory replacement, or due to the company's intention to change its PAF without being mandated by regulations, which is called as voluntary PAF switching. Voluntary PAF switching is the rotation made by the company before the time to do it is due [10, 33]. It might be caused by several reasons, one of which is dissatisfaction toward audit results. A company may determine its auditor for audit according to its own policy to obtain expected results. Determination of auditors or Public Accounting Firms is expected to get a fair opinion about the financial statements [34].

Researches on PAF switching was also conducted in Malaysia. They found that voluntary PAF switching is regulated in Malaysia by Malaysian Institute of Accountant (MIA). The regulation mentions that auditor rotation or change of partner is conducted after 5 (five) years [30]. Audit regulator in Singapore, the Accounting and Corporate Regulatory Authority (ACRA) and Register Public Accountants, requires that Public Accounting Firms must comply with the rules set by the Singapore Standards on Auditing (SSA), in which the replacement of auditors should be conducted within 5 years. The audit of firms listed in the Singapore Exchange (SGX) is controlled by ACRA through Singapore Standard Quality Control 1 (SSGC1) (ACRA, 2017). The regulation on voluntary PAF and auditor switching is expected to maintain the independence of auditors in improving the reliability of financial statements [33].

Researches related to auditing practice are based on contracting theory proposed by Watts & Zimmerman (1986), which mentions that accounting requires contracts made by a company. The contract is between professional auditors and management in conducting auditing activities to reduce corporate agency costs. In auditing research, contract theory has been widely used in auditing practice research. Watts and Zimmerman (1986) also stated that the size of public accounting firms determines independency. Therefore, larger PAFs have more clients and better brand image. Therefore, clients can determine their PAF by considering its size. The selection is expected to result in best opinions. Client's expectation to get the best opinion can be based on theories related to expectation. According to Ali Khasharmeh (2015) and Luypaert & Van Caneghem (2012), this voluntary PAF switching can occur due to several factors, including the factors of the company (financial difficulties, firm size and others), and the factors of auditor (PAF size, audit term (tenure), and auditor's opinion).

Different opinions about factors causing voluntary PAF switching are interesting discussed because researches in Indonesia and some other countries still show different results. Jessica (2014) in her research in 45 manufacturing companies listed in the Indonesia Stock Exchange found that 15.56% of the companies did voluntary PAF switching to big-four PAF without considering the time of changes. Other studies show that 23.9% of companies do voluntary PAF switching because of managerial changes, Financial Distress, PAF Size, changes on Return on Assets, client size, and auditor's opinion [37].

PAF switching also occurs in some countries in Southeast Asia, such as in Malaysia. 14% is influenced by modified opinion, and 72,5% is influenced by non-big-four PAF. The result of the research shows that there are influences of modified opinion and PAF size on voluntary PAF switching [30]. Another study was conducted in a period of 11 years on 297 companies listed in the Stock Exchange. It found that the change of auditors is caused by financial difficulties of the client and the type of accounting firm [25]. Meanwhile, a study examining 400 firms listed in Bursa Malaysia from 1990 to 2008 stated that there is a relationship between company complexity and auditor turnover (Nazrie, et.al, 2012).

One of the factors influencing PAF switching is financial distress experienced by the client company, which usually occurs due to the inability to pay debt as measured by Debt to Equity Ratio. The results of a research conducted in 2006-2010 in manufacturing companies listed in the Indonesia Stock Exchange indicate that PAF Size and managerial changes influence auditor rotation, while financial difficulties, public ownership, and changes in audit committee do not influence the rotation ([33]; Jessica, 2015). The results are different from the research of Suyono, et al. (2013), which examines 45 firms listed in the Indonesia Stock Exchange in 2012. The result suggests that financial condition, PAF competition level, and tenure influence auditor turnover, while firm size has no effect on PAF switching.

Another factor that influences voluntary PAF switching is firm size, which can be seen from total assets. Companies with large assets tend to look for a relatively large PAF because they want to get a better audit results. Thus, it can be concluded that the larger the size of the company, the more the likeliness to choose larges PAF in order to get better audit results and to improve the company's image [10].

PAF size also influences PAF switching. PAF size is an indicator used by companies to assess the quality of auditors. Most companies consider that larger PAFs have better auditor quality that smaller PAFs. Large PAF is an indicator of quality in audit assignments and opinion generation. Big-four PAFs are more qualified than non-big-four PAF [30, 33].

In addition, companies switch PAF for auditor opinion, from which they always expect to get an unqualified opinion. If they do not get the expected opinion, they tend to change their PAF. This might happen because companies want to get good opinion results, regardless of the real condition of the company. Auditor's opinion is one of the instruments that can be used to measure the condition of companies, from which the companies can attract investors to invest in them [10, 37].

2. Literature Review

2.1. Contracting theory

Watts & Zimmerman (1986) suggests that, in positive accounting research, theories of accounting practices and auditing practices have been developed through economic theory which asserts that it is assumed that there is always nonzero contracting and information costs. That is, company managers need cash flow to create policies in determining accounting procedures and political policies for corporate activities. The need to contract between manager and shareholders (outside shareholders), according to Jensen & Meckling (1976), in fact, is not a contract between the company with them but as agency relations. That is, the principal assigns or delegates to the agent (manager) to make a decision. Thus, in the contracts, managers are seen as agents, and shareholders are seen as principals. It can be said that the role of accounting and auditing is very close in the theory underlying it. Watt & Zimmerman (1986) stated that, in order to reduce agency costs, a contract is required to monitor the company, namely auditing. The need for accounting monitoring and explanations in auditing practice can be explained in contracting theory. The examples are explanations related to the independency of auditor, the existence of auditor's professionalism, and the size of Public Accounting Firm. Researchers usually use this theory to predict a company with its professionalism when auditor is not required by law.

Contracting theory is used to describe researches in auditing practice, such as about auditor or Public Accounting Firm (PAF) in terms of auditor's reputation, professionalism, auditor environment, PAF size, and industry specialization. PAFs with larger brand image are considered to have a better reputation compared to smaller ones because the former is considered to have a reputation in maintaining their quality and independence. Smaller PAFs have no added value because they are considered to be still under client pressure [36]. This is also supported by De Angelo (1981), who stated that larger PAFs are preferred by clients because they are considered to be more independent than smaller ones.

A research related to audit using contract variables has also been done by Chow (1982) to predict and explain the selection of PAF on a sample of 1926 companies, regardless the companies were audited or unaudited by professional auditors. The variables used in the study are: 1) firm size, measured by market value of equity and book value of debt; 2) capital structure, as measured by book value of debt, and 3) total debt. Chow explained that companies whose debt-to-equity ratios are high tend to be audited more. The result of the research is that all independent variables are predicted to be significant. This is consistent with contracting theory that, which can support the potential for predicting auditing practices.

2.2. Agency theory

In general, research in the field of auditing is built from the discipline of economics, psychology, and law. This field of auditing is considered as a discipline that ignores theory, but some previous studies have used agency theory as their theoretical basis for explaining the need for auditors as a bridge between the interests of agents and principals (Sila, 2016). Agency theory explains agency relationship that emerge from the contract between agent and principal, in which the agent perform tasks for the interest of the principal. The difference of interest between agent as the management of the firm and the principal as the owner of capital can occur in the carrying out of agency relationship [16]. Principal as the owner of the capital provides a mandate or authority to the agent to undertake and take decisions for the operational activities of the company based on agreements or contracts that have been agreed upon by both parties. The mandate is granted to the agent to carry out the operations of the company in accordance with predetermined limitations. To ensure good operational activities of the company, control from principals is needed because agent will humanly seek for personal gain over his work. Since principal also has an interest in the operations of the company, the relationship between agent and principal often creates a conflict of interest. This conflict occurs because each individual tries to get his own advantage, which can lead to information asymmetry, the information difference between agent's interest and principal's interests. Financial statements prepared by management as the agents lead to information asymmetry due to differences of interest. Therefore, an independent third party, the auditor, is required, so the financial statements is fair and accountable [12].

Theoretical evidence of voluntary PAF switching is based on agency theory, a theory that deals with contractual relationships between agents (management) and principals (shareholders). The principal, as the owner of the capital, gives trust to the agent to manage the assets of the company, and the agent has the obligation to provide reports on the development of the company in each period. However, the relationship between them in the company's operational activities creates a conflict, so a third party, namely independent auditor, is needed [22].

2.3. Indonesian government regulation on public accounting firm or auditor switching

Pratini & Astika (2013) stated that the Government of Indonesia through the Decree of Ministry of Finance No. 359/KMK.06/2003 requires companies to voluntarily change PAF that has been assigned for 5 consecutive years. Wea & Murdiawati (2013) stated that the decree was updated by Regulation of Ministry of Finance No. 17/PMK.01/2008 on Public Accountant Services, in which article 3 paragraph 1 states that the provision of general audit services for financial statements of an entity may be made by a same PAF for 6 consecutive fiscal years at the most and by the same auditor for 3 consecutive years at the most. Later in Article 3, paragraph 2 and 3 state that Public Accounting Firm and Public Accountant may receive reassignment after 1 fiscal year. Therefore, auditors shall maintain their quality and independency, as governed by Regulation of Ministry of Finance. In audit assignment, auditors can have a good relationship with the assigning company (the client) if they have been cooperating for a long time. Through the regulation of Ministry of Finance, Public Accounting Firms must change clients within a certain time limit. According to Putri (2015), Regulation of Ministry of Finance No. 17/PMK.01/2008 does not necessarily bind the effective behavior of PAF (auditor) in maintaining its independency. In practice, PAF switching follows the rules stipulated by the Government, yet there is also PAF switching not following the time specified in the regulation.

PAF switching is a policy undertaken by the government to maintain the independency of auditor from client. Countries in Southeast Asia, or ASEAN, have also created policies directed to maintain the independency of auditors. In Malaysia, according to Won, Teng, et al. (2014) PAF switching is compulsory if the PAF has been auditing the same client for more than 5 years. This rule is set by Malaysia Institute Accountant (MIA) on Professional Ethics, Conduct and Practice, section 290.151 [30]. The PAF switching is also required in Singapore if a company has more than a 5-years cooperation in audit assignment [40]. Ginting & Fransisca (2014) found that audit fee influences PAF switching, while PAF size, client size, and opinion does not influence PAF switching in companies listed in Bursa Malaysia. Borja (2015) examined PAF switching in property firms, financial institutions and energy sector in the Philippines, in which the results suggest that auditor turnover is influenced by PAF size and credibility of financial statements. Based on the several researches above, PAF switching in some ASEAN countries is also caused by various factors.

2.4. Voluntary public accounting firm switching

PAF switching is the replacement of auditor or PAF by client, which can be mandatory or voluntary. Compulsory PAF switching is based on time limit stipulated by Regulation of Ministry of Finance of the Republic of Indonesia Number 17/PMK.01/2008 regarding Public Accounting Services. The regulation states that clients who have used the service of the same PAF for six consecutive years are required to do a PAF switching [29]. By doing so, it is expected that auditors' independence can be maintained because they are the third party that can give trust to financial information users (Agoes, 2004).

A previous research on PAF switching done by Salleh & Jasmani (2014) found that 156 companies listed in the Malaysian stock exchange in the year of 2003-2012 stated that non-big-four PAFs tend to give qualified opinion and that auditor's opinion does not affect PAF switching. A research conducted in Indonesia by Suyono & Yi (2013) found that PAF size does not influence voluntary PAF switching. Woo & Koh (2010), in their research in Singapore, stated that firms that are audited by small PAFs tend to voluntarily switch PAF and that companies with high leverage tend to do PAF switching. Therefore, it can be concluded that auditor's opinion and PAF Size do not affect voluntary PAF switching

3. Conclusion

Some countries through regulatory agencies have implemented mandatory PAF switching. The phenomena are interesting to study because there are many factors that may affect the company's decision to do voluntary PAF switching. Factors that influence voluntary PAF switching might be from client's side as well as auditor's side. Won et al. (2014), through their research conducted in Malaysia, stated that the factors of voluntary PAF switching from auditor's side are the complexity of auditor's task and the auditor's risk level and that the factors from client's side are ownership level, auditor's fee, and going concern opinion. The results show that risk level, ownership level, auditor's fee, and auditor's opinion significantly influence voluntary auditor switching. The factor for auditors, i.e. PAF size, and the factor of clients, i.e. managerial changes, support the hypothesis that PAF size and management turnover influence auditor rotation. Studies conducted by Hudaib & Cooke (2005), Poels (2011), Sihotang (2014), Khasharmeh (2015), Suyono & Yi (2013) state that competition between PAFs, audit fees, and auditor's qualified opinion influence client's decision to do PAF switching and that the client's financial condition, PAF size, and managerial changes do not influence PAF switching. Another study show different results. Nasser et al. (2006), in their study in 297 companies listed in the Kuala Lumpur Stock Exchange over a period of 11 years, found that voluntary PAF switching is significantly related to the financial difficulty level of clients and PAF types; that is, companies with financial difficulties tend to switch PAF in order to get a better opinion. Big-four PAFs tend to generate qualified opinion if a company is experiencing financial difficulties.

All of those studies use agency theory as their theoretical basis, which, according to the authors, is not a purely agency theory in terms of the role of agents and principals; it is limited to the role of auditors as monitoring parties. This literature study found that theory that is based on appropriate research in auditing practice is contracting theory, which states that the role of independent auditors is monitoring the relationship between principals and agents, which requires a contract between management and the shareholders because monitoring will always be followed by cost payment. This is mentioned in contracting theory.

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