

The Impact of Audit Quality on Auditor Litigation in Indonesia

Andi Agus¹ and Nurna Aziza²

¹STIEM Bongaya, Makassar, Indonesia

²Bengkulu University, Bengkulu, Indonesia

Abstract. This paper attempts to empirically examine the impact of audit quality on auditor litigation. This study considers a sample of 170 auditors working in public accounting firms using random survey methods. The main technique for analyzing data in Structural Equation Modeling (SEM) through AMOS IBM version 22. The test results show that the client pressure has a negative and significant effect on audit quality, while auditor quality has not negative and significant effect on auditor's litigation. The findings emphasize the disturbance of the client pressure aspects on auditors' during the audit. Audit quality in this study was not unable to reduce the potential for litigation.

Keywords: Client Pressure · Audit Quality · Litigation

1 Introduction

The auditor is legally responsible for the quality of audits produced or the auditor may be subject to lawsuits (litigation) to the low quality of audits produced [1]. This statement is following the United States Supreme Court decision that the auditor is legally responsible for losses resulting from misleading financial statements, even though the financial statements have been prepared following GAAP [2]. The statement reflects the auditor's high legal obligations over audit quality. Low audit quality has the potential to lead to capital market penalties and auditor litigation.

Cases of capital market penalty and auditor litigation can be seen in the case of Arthur Andersen in the United States [3], KMPG in the United States (AccountingWeb.com. December 14, 2006), and Chuo Aoyama in Japan [1]. Specifically, in Indonesia, a similar case can be seen in the case of KAP HTM, which did not reveal the profit inflation and the inventory value of PT. Kimia Farma. KAP JAS who made an audit error in the financial statements of PT. Great River International Tbk. KAP TSFB which did not reveal the profit markups of PT. Garuda Indonesia. These cases show the high capital market penalty and auditor litigation, the low quality of audits produced by the auditor, and the strong client pressure on the auditor to be involved in hiding the fraud committed by the client.

[4] The public accounting profession is a profession associated with stressful work. [5] Auditors are vulnerable to client pressure in a conflict about accounting issues. [6] Client pressure aims to prevent auditors from acting professionally when conflicts of interest arise between management and the auditor. Client pressure on the auditor at the time of the audit can negatively affect audit quality and increase the potential for capital

market penalties and auditor litigation. This paper empirically examines the influence of client pressure on audit quality and its impact on auditor litigation.

2 Literature Review and Hypothesis

2.1 Client Pressure and the Audit Quality

Users of financial statements, consider auditors vulnerable to client pressure [7]. Client pressure can be: (a) Personal pressures, such as granting luxury facilities to auditors when conducting audits [8] and providing guidance to clients [9], (b) Emotional pressures such as intimidation of dismissal and replacement of auditors [10], (c) Financial dependencies such as the provision of non-audit services [11] and large audit fees [12]. These three pressures can disrupt auditor independence and result in a decrease in audit quality.

[13], [14] Found that client pressure influences auditor decisions as a function of individual factors related to auditory sensitivity to client pressure. [15], [16], [17] Provide evidence that client pressure influences auditor behavior in carrying out audit tasks. Strong client pressure can cause auditor dysfunctional behavior in reaction to audit work environment factors that have an impact on deteriorating audit quality.

H1. Client pressure has a negative and significant influence on audit quality

2.2 Client Pressure and Litigation

Client pressure arises in situations of conflict between the auditor and the client. A conflict of interest causes management pressure, whether actual or perceived to prevent the auditor from acting independently and professionally [6]. [17] Define client pressure as pressure to follow client desires or influence auditors. Therefore, the client tries to influence the financial testing and reporting function by the auditor by pressing the auditor to take actions that violate the professional standards for public accountants, the professional code of ethics, and financial accounting standards.

Violations of the professional standards for public accountants, professional code of ethics, and financial accounting standards reduce the auditor's ability to find and disclose fraud and thus potentially lead to litigation. [18] Found that auditor litigation is related to the auditor's reporting back on the audited client's annual financial statements because the auditor did not reveal any errors, errors, or fraud. [19] Found that auditor litigation stems primarily from technical standard violations, failure to detect fraud or failure of disclosure that should be present in audit reports.

H2. Client Pressure has a positive and significant influence on litigation

2.3 Audit Quality and the Auditor Litigation

[20] Auditors improve audit quality to avoid litigation risk. [21] High audit quality decreases the auditor's mitigation potential. [22] High audit quality preserves the benefits of financial statements and avoids capital market penalties. [23], [24] High audit quality can increase the credibility of financial statements, investor confidence in

financial statements, client confidence in auditors, and avoid clients and auditors from capital market penalties and litigation from third parties who feel disadvantaged.

[3] Auditors who produce low audit quality are reflected in the legal case or litigation faced. [25] Litigation or lawsuits that have befallen the auditor mostly stems from issues of published financial statements. The main cause is low audit quality or audit failure. [26] Audit failures occur when auditors submit audit opinions that are not appropriate because they do not meet established audit standards. [1] Auditors are legally responsible for the quality of audits produced or auditors may be subject to litigation for the low quality of audits produced.

H3. Audit quality has a negative and significant influence on auditor litigation

2.4 Mediation Effects of Audit Quality

During the audit, the auditor is faced with various pressures that might affect the attitudes, behavior, and actions of the auditor. When the auditor understands his professional responsibilities, the auditor may choose to act ethically to obtain a positive work assessment. When the auditor is stressful, the auditor may act unethically to produce low audit quality. [20] Explain that financial statements containing material misstatements are generally seen as low audit quality.

[27], [28] The potential risk of litigation is triggered by the potential inherent in the company related to the unmet interests of investors and creditors. Stakeholders' interests are; (a) There is a guarantee that the financial statements do not have material misstatements and do not commit fraud [29], (b) The financial statements are free from management interest bias and are neutral for the interests of various user groups, present important information, and contain as much possible relevant data [30]. This can be interpreted that stakeholders have a high interest in audit quality and can sue the auditor if they feel disadvantaged by accounting information that results from low audit quality.

H4. Audit quality mediates the effect of client pressure on the auditor litigation

3 Methodology

The data used in this study are primary data obtained from the results of questionnaire surveys on respondents, namely auditors who work in the Public Accounting Firm (KAP) registered at the IAI-KAP Directory in 2013. The population of the study is the auditor who works for KAP in Indonesia. Based on the 2013 IAI-KAP Directory, there were 409 KAP in all regions of Indonesia [31]. The sampling technique was carried out with nonprobability sampling techniques, namely purposive sampling with the type of judgment sampling with certain criteria.

The minimum sample size for SEM analysis with the Maximum Likelihood estimation method is 100 to 200 [32]. The number of samples used in this study is 220 samples, which means the number of samples has exceeded the sufficient number of samples in SEM analysis. The number of samples in this study was 170 auditors who worked in public accounting offices in several major cities in Indonesia. Survey method by sending questionnaires to respondents who are used to collect data about; client pressure, audit quality, and auditor litigation.

The main technique for analyzing data is a structural equation modeling (SEM). Data processing is done using the Statistical Package for Social Science (SPSS) application program version 22 and Analysis of Moment Structure (AMOS) version 22.

4 Result

4.1 Normality Test

The normality test in SEM analysis is intended to determine the normal distribution of research for each variable. Normality evaluation is carried out using the criterion of critical skewness value, data is said to be normally distributed if the value of the critical ratio skewness value is below the absolute price of 2.58 [32], while [33] States that the value of C.R multivariate below 8 is acceptable and the analysis can still be continued as long as all indicators have a C.R kurtosis value $-2.58 < z < 2.58$.

The results of the normality test show that the research data is normally distributed because the univariate C.R skewness values of all variables have been in the interval of $-2.58 < z < 2.58$ so it can be concluded that the data analyzed has met univariate normality, furthermore, the multivariate C.R value has also been being in the range of $-2.58 < z < 2.58$ so that multivariate can be declared normal, thus it can be concluded that the research data also fulfills the assumption of multivariate normality.

4.2 Tes the Validity of Exogenous Constructs

Exogenous construct validity test is done by looking at the value of the Loading Factor of each indicator in the exogenous construct. In this test, the indicator is declared valid if it has the value of Loading Factor > 0.5 , while the exogenous construct reliability test is done by calculating the AVE value and C.R exogenous construct. In this test, the exogenous construct is declared reliable if the AVE model > 0.5 and C.R model > 0.7 . Moreover, the results of structural model estimates show that model modification has a probability above 0.05, thus, the model has been used properly to test the hypothesis in this study.

4.3 Goodness of Fit Indices

Goodness of fit is done to evaluate the suitability of the model by examining various criteria. A model is said to be fit if the matrix covariance of a model is the same as the data matrix covariance. Evaluation of goodness of fit is to assess whether the data to be processed meets the assumptions of structural equation models. Three basic assumptions must be met to be able to use structural equation models, namely: (1) Independent data observation, (2) Respondents taken randomly, (3) Have a linear relationship. Before the data is processed, it is necessary to test whether there are data outliers and the assumption the normality of data.

Table 1. Goodness of Fit.

Index	Cut-off value	Results	Information
Chi-square	170,809	233,168	Marginal
Significance Probability	≥ 0.05	0,00	Marginal
CMIN/DF	≤ 2.00	1,64	Good
TLI	≥ 0.90	0,96	Good
GFI	≥ 0.90	0,90	Good
AGFI	≥ 0.90	0,84	Marginal
RMSEA	≤ 0.08	0,06	Good

Based on the test results, the Chi-square value is 233,168, the significance probability of 0,000 is considered marginal because it is below the cut-off value nilai 0.05, CMIN / DF 1,64 (≤2,00), TLI 0,955 (≥0.90), GFI 0,90 (≥0.90), AGFI 0,84 (≥0.90), and RMSEA 0,06 (≤0.08). Based on these results, the model in this study is fit.

4.4 Hypothesis Testing

Hypothesis testing is done by testing the level of significance aimed at testing whether there is a significant effect of endogenous variables on endogenous variables. The hypotheses built in this test are as follows:

Ho: There is no significant effect of exogenous variables on endogenous variables.

Ha: There is a significant effect of exogenous variables on endogenous variables.

With a significant level of 0.05, Ho will be rejected if the significant value (P)<0.05 and C.R>1.96, whereas if the value is significant (P)>0.05 and C.R<1.96 then Ho is not rejected.

Table 2. Regression Weights.

Variabel			Hipotesis	C.R.	p	Estimasi	Ket
CP	→	AQ	H1 (-)	-2,047	0,041*	-0,167	Accepted
CP	→	AL	H2 (+)	3,553	0,000*	0,437	Accepted
AQ	→	AL	H3 (-)	1,314	0,189	0,156	Rejected
CP → AQ → AL			H4	<i>Indirect effect = (-0,167) (0,156)</i> = -0,0261 < 0,437 Non significance			Rejected
<i>Note: AL: Auditor Litigation; AQ: Audit Quality; CP: Clien Pressure</i>							

Based on the results of statistical calculations, the value of p-value influence the client pressure variable on audit quality (CP → AQ) is significant (0,041*) with C.R marked negative at -2,047. Therefore, the p-value obtained <0.05 and C.R is positive and >1.96. The implication is that client pressure has a negative and significant effect on audit quality, the stronger the client pressure, the lower the audit quality. So, the first hypothesis is accepted.

Furthermore, the second hypothesis analyzes the positive influence of client pressure on auditor litigation. The results of the statistical test show the value of p-value the effect of the client pressure variable on auditor litigation (CP → AL) is significant (0,000***) with C.R marked positive at 3,553. Because the value of the p-value obtained <0.05 and C.R is positive and the absolute value is C.R>1.96. Thus, client pressure has a positive and significant influence on auditor litigation, the stronger the client pressure, the higher the auditor litigation. This means that the second hypothesis is accepted.

The third states that there is a negative influence of audit quality on auditor litigation. The test results show the value of p-value the influence of audit quality variable on auditor litigation (AQ → AL) is not significant with C.R positive sign of 1,314. Because the p-value obtained >0.05 and C.R is positive and the absolute value is C.R<1.96. This means that auditor quality does not have a negative and significant effect on auditor litigation. Poor audit quality is not the cause of auditor litigation in Indonesia. So, the second hypothesis is rejected.

The third hypothesis The fourth hypothesis analyzes the role of audit quality mediating client pressure on auditor litigation. Based on the path analysis shows the estimated value of the direct effect of client pressure on auditor litigation is higher by 0.437 compared to through audit quality (indirect effect) of -0.0261 namely (-0.167) x (0.156), but the probability value of the influence of client pressure on auditor litigation (direct effect) is significant at 0,000 below 0.05. Likewise, the indirect effect of client pressure on audit quality is significant (0.041 <0.05) and audit quality on auditor litigation is not significant (0.189 > 0.05). Thus, the results of the study indicate that audit quality has not been proven to mediate the effect of client pressure on auditor litigation. This means that client pressure cannot cause the auditor to potentially cause auditor litigation even though the auditor produces low audit quality.

5 Conclusion

The results revealed that there was a negative and significant influence of client pressure on audit quality. The next finding is that audit quality does not have a negative and significant effect on auditor litigation. Furthermore, in the relationship between client pressure and litigation, the findings also reveal that client pressure has a positive and significant influence on auditor litigation. The theoretical implication of this finding is that the stronger the client pressure, the lower the audit quality. The stronger the client pressure, the higher the auditor litigation potential. While audit quality does not have a negative and significant effect on auditor litigation. To examine the effect of auditor quality mediation variables in the relationship between client pressure and litigation, the statistical results show that audit quality does not mediate the effect of client pressure on auditor litigation. Theoretically, the stronger the client pressure, the lower the audit quality which will encourage high auditor litigation.

This finding emphasizes aspects of client pressure on the auditor. The findings show that the client pressure experienced by the auditor at the time of the audit reduces audit quality. The stronger the client pressure, the lower the audit quality. Auditors who experience client pressure can behave dysfunctionally by ignoring integrity and objectivity in conducting audits. The findings also show that client pressure increases

the potential for auditor litigation, but audit quality does not mediate the effect of client pressure on auditor litigation.

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