

CHAPTER I

INTRODUCTION

1.1 Background

Earnings Response Coefficient (ERC) is one way to measure earnings informativeness or earnings quality (Balsam et al., 2003; Dechow et al., 2009; Sun et al., 2011). ERC measures stock market responsiveness to unexpected earnings announcement. Earnings will give information to investors. If earnings information has more information content, the investor's response will be stronger. It can be seen through the value of ERC (Herusetya, 2012). Therefore, higher ERC value indicates higher earnings quality.

One thing that relates with earnings information and the reported financial statements is the role of external auditors from the public accounting firms that perform attestation service (Riyatno, 2007). In the attestation service, the auditor issues an opinion about the reliability of financial statements of a company based on the current accounting principle (Arens et al., 2012; Riyatno, 2007). Opinion issued by an auditor will add client's confidence towards information reported by the company.

The quality of audit done by public accounting firms can be measured by the size/reputation of the audit firms (Becker et al., 1998; DeAngelo, 1981; Reynolds & Francis, 2001; Teoh & Wong, 1993). Large public accounting firms (Big 4 companies) perform better audit quality compared to small public accounting firms (non Big 4), shown by higher value of ERC (Teoh & Wong,

1993). This happened because large public accounting firms have more resources and clients, so they are not dependent on one or a few clients only. In addition, the reputation of large public accounting firms has been considered good by the public, causing them to conduct audit more careful (Riyatno, 2007).

However, the accounting scandals that occurred in large companies in the United States such as Enron, WorldCom, Xerox, and Merck result in a decline of public trust, especially from investors, towards companies financial reporting in the capital market (Riyatno, 2007). The mistake was addressed to the public accountants who should act as public watchdog of financial information prepared by the companies. The same thing also happened in Indonesia, for the case of Telkom and Indofarma, which require earnings reassessment because the earnings management did not found by the previous auditor (Riyatno, 2007). Those companies were audited by large public accounting firms that have good reputation. Unfortunately, it did not guarantee that the company's financial statements reflect the company's true value (Riyatno, 2007).

The collapse of Arthur Andersen in the United States resulted in significant changes in the market of audit services, such as exceptional growth in the size of Mid Tier clients portfolios and encouragement to use Mid Tier companies as an alternative to Big 4 audit companies by regulators (Cassell et al., 2011). Mid Tier financial reporting credibility is improved and the audit quality is comparable to Big 4 post-Andersen (Cassell et al., 2011).

This research is investigating the impact of size/reputation of public accounting firms towards earning informativeness measured by ERC in the

context of Indonesia, through samples from public companies listed in Indonesia Stock Exchange (IDX) during the period of year 2004-2008. This study differs from prior research since limited research engages this topic in the context of Indonesia. Moreover, since Mid Tier companies are evolving, this research will also explore the quality of Mid Tier companies in Indonesia by examining how companies audited by Big 4 and Mid Tier differ in ERC.

Based on the arguments above, we want to examine the impact of size/reputation of public accounting firms towards earnings informativeness in Indonesian context and also the difference in ERC between companies audited by Big 4 and Mid Tier.

1.2 Problem Formulation

Based on the overview description on the background, the problem is specifically formulated as follow:

- 1) how is the impact of size/reputation of public accounting firms as a measure of audit quality towards earnings informativeness measured by ERC?
- 2) how is the difference in ERC between companies audited by Big 4 and Mid Tier?

1.3 Purpose of the Research

The objective to be achieved in doing this research is to give empirical evidence concerning the impact of size/reputation of public accounting firms as a

measure of audit quality against earnings informativeness and the difference in ERC between companies audited by Big 4 and Mid Tier.

1.4 Contribution of the Research

For the Researchers

This research is expected to give contributions for further research regarding the size/reputation of public accounting firms in audit quality. This research investigates not only the audit quality of Big 4, but also in Mid Tier and other non Big 4 and non Mid Tier. Therefore, it is expected to give contributions in giving some new evidence and develop measurement regarding the effectiveness of audit firm size/ reputation towards earnings informativeness. The results of this research should be of interest to researchers who are interested in investigating quality differences among various audit firms types.

For the Auditee

This research will give contribution to auditee in terms of knowing whether the audit quality of Big 4 differs with Mid Tier and other non Big 4 and non Mid Tier or not. The results of this research will give contributions to companies that are contemplating switching to Mid Tier audit firms.

For the Audit Companies

This research also gives contribution to audit firms so that they will know whether there is a difference in audit quality between Big 4 and non Big 4, and Big 4 and Mid Tier, so that they can be more cautious about their position in order to improve their audit quality.

1.5 Problem Limitation

Audit quality is influenced by several factors related to competency and independency such as the size/reputation of public accounting firms, client complexity, industry specialization, public accounting firm experience/tenure, client importance, the effect of the practice on reaching an earnings target, corporate governance practice, and the tendency to issue going concern audit opinion (Bamber & Bamber, 2009; Watkins et al., 2004). This research will only test the impact of size/reputation of public accounting firms towards earnings informativeness in order to compare the quality of audit between Big 4 and non Big 4, and also Big 4 and Mid Tier companies. In addition, there are five common measures of earnings quality, such as absolute discretionary accruals, small positive earnings, earnings persistence, timely loss recognition, and ERC (Sun et al., 2011). In this research, we will only use ERC as the measurement of earnings quality.

1.6 Writing Scheme

Chapter 1 Introduction

In this chapter, we will discuss about the background of the research, problem formulation, purpose of the research, contribution of the research, problem limitation and writing scheme.

Chapter 2 Literature Review and Hypothesis Development

In this chapter, we will explain about the theories related to this topic, such as the concept of auditing and the profession of public

accountant, the role of auditing in agency theory, auditing and signaling theory, audit quality, the size/reputation of public accounting firms, earnings quality, earnings informativeness, and previous research related to the topic and hypothesis development.

Chapter 3 Research Methodology

This chapter will discuss about the framework of empirical research model. Population, determination of sample, and source of data will also be discussed. It is also discuss in detail about empirical research model, operational variables, data analysis method, and additional testing used in the empirical testing model.

Chapter 4 Research Result Analysis and Discussion

This chapter will discuss about the result of each hypothesis testing model and the analysis of the research results, that is to know the impact of size/reputation of public accounting firms towards earnings informativeness and the difference in ERC between companies audited by Big 4 and Mid Tier.

Chapter 5 Conclusion, Implication and Recommendation

In this chapter, we will discuss about the conclusion from this research as a whole, implication for the researchers, auditee, and audit firms, and limitation of the research, as well as recommendation for the next research.