CHAPTER I

INTRODUCTION

1.1 Background

Companies that are operating, need funds to take projects or investments in addition to their profits gained from operations. In funding the projects or investment, there are expenses related in financing the projects or investment (Gitman & Zutter, 2012). To cover the financing expenses, the companies obtain the fund from cost of capital whose choices in obtaining fund comes from cost of debt and cost of equity (Gitman & Zutter, 2012). Cost of equity is the rate of return that the investor expects to earn when undertaking the investment (Embong et al., 2012). Cost of equity is also defined as the expenses that the companies bear to obtain the fund for issuing shares (Meirina & Butar Butar, 2018). As the company's intention is not letting the market value of its share fall (Gitman, 2003). Thus, stable level of cost of equity needs to be maintained (Embong et al., 2012). Prior literature studies discovered that cost of equity will fall when the quality of information rises (Francis et al., 2004; Modigliani & Miller, 1958; Lambert et al., 2011). Companies' information that is obtained either directly or indirectly, has the possibility to affect every investment decision that is made by an investor. Asymmetric information arises as getting lesser information causes more difficulties for an investor to process the information than obtaining much more information (Bhattacharya et al., 2013). This implied that asymmetric information between management and investors leads the investors to face challenges in evaluating the investment quality.

Asymmetric information that arises in financial reporting, drives an opportunity for earnings management practice that is conducted by the managers (Utami, 2005). The asymmetric information leads to conflict between manager as the agent and shareholders as the principal, as the shareholders finds it difficult to fulfill both of their interests simultaneously (Scott, 2015). External auditors who act as an independent party for the company (client), are crucial in equipping the audit service which accommodate the quality and the reliability for the stakeholders of the company, as well as in supplying assurance that ensures the operations of the company have been operated with justice and with the compliance of applicable rules (Mayanda & Wardhani, 2015).

The role of external auditors comprises of three important audit function, such as : acting as monitoring role by monitoring managerial actions, taking information intermediary role in providing a better information environment and taking an insurance provider role in facilitating a secondary source of insurance to overcome corporate failures (Wallace, 1980). Instead acting as an insurance for covering the losses of investors, auditor is required to provide "reasonable assurance", functioning to ensure the financial statements are free from "material misstatement", since insurance role of auditing is not the primary role which consists of monitoring and information intermediary role (Fernando et al., 2010). Prior literature studied that external auditor in audit firm also plays an important role in documenting the evolving opportunistic earning management by acting as one of the gatekeepers of the stock market in providing assurance on the quality of public firms' financial reporting (Ronen & Yaari 2008). Through cutting the information asymmetry between users of financial statements and its preparers, the regulatory status of auditor is carried out by diluting the disadvantages of the separation of ownership and control (Jensen & Meckling, 1976). The agency costs which arise due to the presence of asymmetric information between managers and investors, are reduced by the mechanism of independent auditing (Jensen & Meckling, 1976). Audit service gives assurance on the reliability of financial statement (Jensen & Meckling, 1976). This implies that role of auditing that is taken by an auditor being employed in a public accounting firm (PAF) in providing assurance service, gives a reasonable assurance that leads to the higher quality of information, especially to shareholders. Auditor's role on maintaining independence, reduces the uncertainties that are faced by investors and the risks that are carried by investors (Titman & Trueman, 1986; Watts & Zimmerman, 1986). Reducing the risks means reducing the cost of equity (Watts & Zimmerman, 1986). Here, it is also implied that an unaudited financial statement doubts the quality of information being provided to the shareholders due to the presence of risk being carried by the investors.

Audit quality is defined as the capability of an auditor to detect the client's breach on financial reporting and the capability to report the violation of financial reporting (DeAngelo, 1981a). The capability of an auditor to detect the client's misstatement or violation of financial reporting is the competence dimension of audit quality (DeAngelo, 1981a). Meanwhile, the independence dimension of audit quality is the ability of an auditor to report the client's breach of financial reporting (DeAngelo, 1981a). In past study, it is found that the high audit quality is also crucial in boosting the capital market developments in developing or emerging markets (Michas, 2011). High audit quality leads to a rise in the transparency, the accuracy and the reliability of financial information and a reduction of risk information whose consequence is a decrease in the cost of equity (Boone et al., 2008). In supporting this literature, the intention of achieving high audit quality is to restrict opportunistic behaviour on implementing earnings management, leading to a reduction of material misstatement of financial reporting that is being made by the company so that the possibility of misleading financial information can be cut (Herusetya, 2012a). Moreover, past study found that the necessity of audit quality and the independence of auditor are profoundly crucial in dealing with the issue of asymmetric information (Becker et al., 1998). Hence, audit quality is essential to ensure the quality of financial information for both external and internal purpose of decision making. However, public auditing firm has received numerous critics in this latest decade, specifically since Enron Scandal occurred, due to the failure in protecting the investors' interests (Jenskin et al., 2006). Moreover, the critics of public auditing firms validate the need to consider audit quality that is brought by auditors.

Most studies on audit quality concluded the research based on the proxy using earnings quality, thus audit quality is difficult to be observed (Becker et al., 1998; Balsam et al., 2003; Gul et al., 2009). Due to the multidimension characteristics of audit quality, many researchers stated that there is no single specific characteristic that represents audit quality entirely (Bamber & Bamber, 2009; Francis, 2004). The multidimension characteristic of audit quality's measurement consists of independence and competency dimension (Herusetya, 2012a). Cost of equity capital is utilized as an alternative measurement for audit quality in a later stream of study (Fernando et al., 2010). Both direct and indirect research on audit quality has majorly used the audit firm size which is affiliated with Big 4 (e.g. Siregar & Utama, 2006; 2008; Sanjaya, 2008) or audit firm with industry specialization (e.g. Herusetya, 2009; Mayangsari, 2004) as the proxy to measure audit quality. These audit quality's measurements are under independence dimension of audit quality (Fernando et al., 2010).

In this paper, the writer is going to utilize one of the proxies of audit quality which is audit tenure whose effect to be examined with the alternative audit quality proxy which is cost of equity. Audit tenure is defined as the period of audit that is expressed as the number of year by which the client retains the particular audit service and audit service is provided to the client's company (Myers et al., 2003). Audit tenure is classified into two perspectives. One of them is at the viewpoint of a partner (an auditor) which is referred as partner tenure. The other perspective is at the viewpoint of an audit firm or public accounting firm (PAF). There are still few amount of studies on utilizing partner tenure as the proxy of audit quality (Carey & Simnett, 2006; Chen et al., 2008; Chi & Huang, 2005). The results on the effect of partner tenure towards the audit quality are still mixed. Carey & Simnett (2006) discovered that the longer partner tenure, the higher the auditor's leniency which deteriorates an auditor's independence, resulting in a reduction of audit quality. Another result proved that a fall in audit quality if a partner is retained to provide an audit service for the client for five years (Chi & Huang, 2005). However, Chen et al. (2008) discovered that longer partner tenure raises audit quality.

Azizkhani et al. (2013) conducted research on the effect of partner tenure towards cost of equity in Australia. This study found out that there is a non-linear relationship between partner tenure and *ex-ante* of cost of capital in the circumstance when the partners are being employed in non-Big 4 audit firms before the partner rotation mandated and a rise in cost of equity occurs when partner rotation policy is imposed (Azizkhani et al., 2013).

There are mixed findings on effect of audit firm tenure on cost of equity. Previous studies discovered that there is a negative effect of audit firm tenure on cost of equity (Boone et al., 2008; Jensen & Meckling, 1976; Watts & Zimmerman, 1986). Longer audit firm tenure allows the auditors to gain specific knowledge on industry, indicating the rise of auditor's capabilities of detecting client's misstatement on financial reporting so a rise of client's integrity on disclosing the financial info to the users occurs; leading to a reduction of information risk which leads to a decrease in the firm's cost of equity (Boone et al., 2008; Geiger & Raghunandan, 2002; Myers et al., 2003). However, audit firm tenure affects cost of equity positively on cost of equity of the client. Some studies argued that long audit tenure deteriorates the independence dimension of audit quality in auditing the client's company (Geiger & Raghunandan, 2002; Shockely 1981; Garcia-Blandon et al., 2020).

Due to limited research of partner tenure on the cost of equity and inconsistent results on audit firm tenure on cost of equity, the writer would like to research more audit firm tenure and partner tenure which are categorized as proxies of the audit quality and how they affect cost of equity which is an alternative proxy of audit quality. The writer wishes to contribute the research in ASEAN countries, as there are certain differences in this research, as follow : (1) the effect of partner tenure on cost of equity in emerging countries including ASEAN countries, have not been discovered (2) Most studies relating to the effect of partner tenure and audit firm tenure on cost of equity are conducted in Western developed countries, while the writer's research conducts research in ASEAN countries (3) Inconsistent findings on the effect of both partner tenure and audit firm tenure on cost of equity . In response of these distinctions between the writer's research and the past studies, the writer wishes to examine whether both partner tenure and audit firm tenure, significantly affect the client's cost of equity capital. In conclusion, this thesis takes the title of "**THE EFFECT OF PARTNER TENURE AND AUDIT FIRM TENURE ON COST OF EQUITY**."

1.2 Problem Statement

Based on the background presented above, it is required to understand whether the length of auditor conducting audits and the length of each audit firm provide audit service could decrease or increase the client's cost of equity capital . To discover whether the partner tenure and audit firm tenure reduces or raises the client's cost of equity, writer defines research problems as follows:

1. Does partner tenure has significant effect on the client's cost of equity ?
2. Does audit firm tenure has significant effect the client's cost of equity ?

1.3 Objective of the Study

In composing the objective of the study, writer holds on to the problem statement. The following are the objective of the study:

1. Prove empirically that partner tenure significantly affects client’s cost of equity
2. Prove empirically that firm tenure significantly affects client’s cost of equity

1.4 Purpose of the Study

Based on the research objectives, the results of this study are expected to be useful for:

1. Companies

   This research is expected to provide recommendations for companies in Malaysia, Philippines and Thailand to consider the factors that may have impacts on cost of equity.

2. Academics

   This research is expected to add insights and help next researchers as a reference for further examination regarding the impacts of the length of partner tenure on cost of equity of the companies

3. Investor

   This research is expected to become a source of information that may help investors in their decision-making process when planning to invest in a firm.

4. Regulators

This research is expected to take part when the regulator considers enforcing or revising policy regarding the partner tenures, especially for regulator in Malaysia, Philippines and Thailand.

1.5 Scope of the Study

This research focuses on public listed retail companies listed in Malaysia, Philippines and Thailand, this is a comprehensive study of industrial-sector companies listed on Malaysia, Philippines and Thailand stock exchange. Examining the impacts of length of partner tenure on the firm's cost of equity.

1.6 Systematic Discussion

The research paper systematically divided into 3 chapters as follows:

Chapter I INTRODUCTION

This chapter will discuss subchapters including background, problem statement, objective of the study, the purpose of the study, scope of the study as well as systematic discussion.

Chapter II THEORETICAL FRAMEWORK AND HYPOTHESIS DEVELOPMENT

This chapter will discuss about related literature review, conceptual framework, and hypothesis development.

Chapter III METHODOLOGY

This chapter will state what method of research is being used. It will also include the population, sample and source of data, the empirical model, operational variable definition, method of data analysis and test of classical assumption

Chapter IV RESULT AND DISCUSSION

This chapter will discuss the result and empirical findings in the research in relation to the impacts of length of partner tenure on the firm's cost of equity.

Chapter V CONCLUSION

This chapter consists of conclusion and suggestion from the result and discussion preceding this chapter, along with recommendations for future research.