CHAPTER II

LITERATURE REVIEW

A. Theoretical Framework

1. Agency Theory

Jensen and Meckling who were announced Agency Theory in 1976. Agency Theory explains the work relation or agency between two different parties, between owner and manager. Based on this theory, good relation between them is hardly found because conflict of interest. Potential problem which appear is information asymmetry.

Based on Rizqiasih (2010), agency theory focused to overcome problem when there is conflict of interest between principal and agent. This problem tends to asymmetry information between owner and manager, and conflict of interest. External auditor as outside party needed as a reviewer.

Based on Kayu (2012), owner and management activity are evaluated by financial performance that is reflected in financial statement. In agency theory, investor need auditor to verify information given by management. Conversely, management need auditor to legitimate their performance in a form of financial statement so that they deserve to get incentive. In the other hand, creditor needs auditor to make sure if their money is driven to activity that in accordance with agreement.

Controlling function that is done by auditor as an independent party, need a fee as an audit fee, thus it will influence determination of audit fee. In order to increasing assurance on financial statement, external auditor needs to test the quality of financial statement. Auditor is an intermediary party to eliminate asymmetry information between principal and agent.

2. Signaling Theory

Connelly et al (2011) revealed the theory of signals explaining the reason the company has a drive to provide its financial statement information to external parties because of the information asymmetry within the company. According to Raharja and Sari (2008), information asymmetry can occur because of small information differences that do not affect management, or significant differences that may affect management and stock prices. Reductions on information asymmetry that occurs can increase the value of the company, which is by providing a signal to external parties.

Signal theory suggests how companies should signal to users of financial statements about what has been done by the management to realize the wishes of the company owner. Signals may be promotions or other information that the company is better than other companies. Information can be provided through a published bond rating, which is expected to signal the company's financial condition and illustrate the possibility that it is related to the debt held (Kartikasari and Prabowo, 2010). This signal can be used as an auditor's consideration in assessing audit risk of the company and acceptance of audit assignment, and the amount of audit fee for their performance (Fachriyah, 2011)

3. Corporate Governance

Based on Forum for Corporate Governance in Indonesia (FCGI), corporate governance is a set of rules that regulate relationship between shareholder, manager, creditor, government, employee, and other internal and external interest that are related to right and obligation, in other word it is a system that regulate and control company.

Center for European Policy Studies (CEPS) defined corporate governance as a whole system of right, process and control, inside and outside management. Right is a whole stakeholder's right to influence management. Process is mechanism of stakeholder's right. Control is mechanism of stakeholder receive information that is needed about company activity. (Rizqiasih, 2010)

Based on that definition, important things about corporate governance are (Rizqiasih, 2010):

a. Balance relationship between General Meeting of Shareholders, commissioner and director, which is related to institutional structures and operational mechanism.

b. Fulfillment of company responsibilities as a business entity to stakeholder.

c. Shareholder's right to gain company information correctly in a specific time, right to decision making of strategic development, and get involved of company's profitability.

d. There is same treatment among shareholders, especially minority shareholder and foreign shareholder, in a form of widely relevant information.

4. Corporate Governance Principal

Based on Organization for Economic Cooperation and Development (OECD), there is four principals in corporate governance:

1. Fairness as a guarantor of the rights of shareholders and guarantors of the commitment of investors, so that there is good and careful management of all assets of the company, which is expected to realize the protection of the interests of shareholders honestly and fairly. Enforcement of the principle of fairness

requires the existence of legislation that is clear, firm, consistent and can be enforced.

2. Transparency requires the delivery of open, timely, clear and comparable information relating to the financial condition, company management and ownership of the company, so that it is expected to assist stakeholders in assessing the risks that may occur in conducting transactions with the company, as well as minimize the conflict of interest of various parties in management.
3. Accountability that explains roles and responsibilities, and supports efforts to ensure balancing the interests of management and shareholders, overseen by the board of commissioners. One form of implementation of this principle is the existence of effective internal audit practices as well as clarity of functions, rights, and obligations, powers, and responsibilities in the company's articles of association and company's achievement targets in the future. Implementation of this principle is expected to make clarity of functions, rights obligations, powers, and responsibilities between shareholders, board of commissioners, and directors.
4. Responsibility (responsibility) used to ensure compliance with rules and regulations that apply as a reflection of the compliance of social values, so that the company is expected to realize in operational activities often produce negative external impact on society due to company activities.

5. Corporate Governance Structure

According to Syakhroza (2003) the governance structure is "an organizational framework on how governance principles can be shared, executed, and controlled. The structure of governance is expected to support the running of organizational

activities in a responsible and controlled that is with the achievement of corporate governance in accordance with principles of corporate governance ".

The structure of corporate governance in this study includes the involvement of independent commissioners, audit committees, and majority shareholders within the company.

a. Independent Commissioner

The Jakarta Stock Exchange through the Indonesia Stock Exchange regulation in 2000 has governed the existence of an independent commissioner, where the listed company must have an independent commissioner proportionately equal to the number of shares owned by minority shareholders, with a minimum of 30% of all members of the board of commissioners (Princess and Main, 2014).

According to the National Committee on Governance Policy (2006), the board of commissioners as corporate organs is tasked and collectively responsible for supervising and advising the directors, and ensuring that companies implement good corporate governance.

The Jakarta Stock Exchange (2000) states several criteria for independent commissioners:

1. Independent Commissioners have no affiliation relationship with majority shareholder or controlling shareholder in the company.
2. The independent commissioner has no relationship with the director and or other commissioners within the company.
3. The independent commissioners shall not be duplicated in another company affiliated with the listed company concerned.

4. Independent commissioners must understand the laws and regulations in the capital market.
5. An independent commissioner is proposed and selected by a minority shareholder who is not a controlling shareholder in the General Meeting of Shareholders (GMS).

b. Audit Committee

Toha (2004) in Rizqiasih (2010) explains that the audit committee is a committee formed by the board of commissioners of the company to assist in conducting the necessary inspection on the implementation of the function of the board of directors in executing, managing the company, and performing important functions related to the financial reporting system conducted by management and independent auditors.

According to the National Committee on Governance Policies (2006), the audit committee is responsible for assisting the board of commissioners to ensure that the financial statements are fairly presented in accordance with generally accepted accounting principles, the company's internal control structure is well implemented, internal and external audits are carried out in accordance with apply, and follow-up findings of the audit results implemented by management. In addition, the audit committee processes the candidates of the external auditor including the remuneration to be submitted to the board of commissioners.

The purpose of the establishment of audit committees, among others:

1. In the financial statements, the audit committee carries out independent oversight of the financial reporting process and the conduct of external audits, although the board of directors and board of commissioners are responsible for

the preparation of the financial statements and the external auditor is responsible for the external audit of the financial statements.

2. In risk management and control, the audit committee remains in charge of providing independent oversight of risk management and control processes, although directors and board of commissioners are primarily responsible for risk and control management
3. In corporate governance, the audit committee carries out independent oversight of the corporate governance process, although directors and board of commissioners are responsible for implementing corporate governance. The audit committee aims to oversee the implementation of financial statement audits and assess the quality of the auditor's work and the fairness of audit fees provided by the external auditor, this affects the determination of the audit fee.

6. Business Complexity

Complexity associated with the complexity of transactions that exist in the company. The complexity of client operations is an important variable in determining the amount of audit fees. The complexity of a company's operations can lead to higher audit costs because more audit work is needed so that more time will be required and automatically higher costs will be charged to clients (Cameran, 2005).

According to Widiasari (2009), variables of complexity are mostly large medium-sized enterprises that almost have transaction complexity problems. Therefore, this study uses a branch of the company as an indicator of complexity, given the complexity of audit services provided that is a complex measure of whether or not transactions owned by clients of public accounting firms to be audited.

Business with diversified operations such as branches and operations abroad is more complicated, so audit work is also difficult. Group companies with many subsidiaries are associated with extra work done by auditors in checking the consolidated financial statements that ultimately lead to higher audit costs.

7. Business Risk

Business risk is risk where clients will fail to achieve their goals related to the reliability of financial statements, efficiency and effectiveness of operations, as well as compliance with law and government (Arens, 2000:303)

Fachriyah (2011) states that in order to receive audit assignments, the auditor should consider the company's business risks that are reflected from the client company's audit risk.

Simunic (1980) and O'Keefee et al. (1994) in Kartikasari and Prabowo (2010) explains credit ratings related to audit business risk. The credit rating relates to bond risk, ie repayment of long-term debt maturing, interest payments, and dividends, reflected in the company's bond rating. The rating of bonds tries to measure the default risk of issuers in their inability to meet their financial obligations. Thus, a bad rating of a bond signifies a high risk of the company.

a. Bond Rating

Fachriyah (2011) defines the bond rating as the risk scale of all traded bonds, which shows how secure a bond is for investors. This is evident from the company's ability to pay interest and repayment of loan principal. Kartikasari and Prabowo (2010) define credit ratings as an opinion of credit worthiness of obligors against certain financial obligations, certain levels of financial obligations, or certain financial programs.

According to Standard & Poor's Rating Service, ratings range from AAA for best quality debt, to D for the worst quality debt. Ranking is based on the quantitative and qualitative information that the credit rating agency obtains from its access to information of a company, as well as the consideration of creditors, insurers, or other forms of credit increase to liabilities.

The rating of bonds is used to evaluate the ability and willingness of obligors in fulfilling financial commitments when they are due. This type of valuation can help the issuer in determining the structure of debt issuance (interest rate, term, credit increase). The rating of debt instruments is also useful for investors to compare various issuers and debt problems when making investment decisions and managing portfolios (Norden and Weber, 2004).

Indonesia has a bond rating agency, PT.PEFINDO. The methodology used by PT. PEFINDO in the rating process for the corporate sector is similar to the Standard & Poor's Rating Service method, which includes three major risks of assessment. In addition, comparative analysis of similar competitors in industry is also performed.

According to Ashbaug-Skaife (2006) in Kartikasari and Prabowo (2010), companies with poor credit ratings, signify a high liquidity risk. This may affect the auditor's judgment on client's audit risk that impacts the audit process procedures by the Firm and determines the audit fee for their performance.

8. Audit Fee

According to Agoes (2012), the Audit fee is a service reward that depends on the assignment, the complexity of the audit service, the level of expertise required to perform the service, the corresponding public accounting firm cost structure and

other professional considerations. Indicators used in the audit fee measurement are the assignment risk, the complexity of the services provided, the cost structure of the public accounting firm and the size of the audit office that provides audit services

Halim (2005) states that an audit fee is an income earned by auditors with a large amount varies depending on several factors in audit assignment, such as: client company size, audit service complexity faced by auditor, audit risk faced by client auditor, and name of Public Accounting Firm conducting services audit.

Simunic (2006) states that the audit fee is determined by the size of the company being audited (client size), audit risk (on the basis of current ratio, quick ratio, D / E, litigation risk) and audit complexity (subsidiaries, foreign listed). The determination of the audit fee has been arranged based on the decree of the Chairman of the Indonesian Institute of Certified Public Accountants on July 2, 2008 Number KEP / 24 / IAPI / VII / 2008, as a guide for all Members of the Indonesian Institute of Certified Public Accountants in determining reasonable remuneration for professional services as public accountant .

Establishment of fees for audit services must be reasonable in accordance with the dignity of the public accounting profession, and in appropriate amounts in accordance with the applicable professional standards of the public accountant. Remuneration services that are either too low or significantly lower than those imposed by the auditor or accountant of the predecessor or advocated by any other auditor or accountant may cast doubt on the ability and competence of members in applying the applicable standards (Rizqiasih, 2010).

High auditing fees are often associated with high auditor quality. The accuracy of the information generated by the auditor over the financial statements depends on the quality of the auditor. It can be assumed that higher quality auditors

will impose a higher audit fee. In the initial share sale, qualified auditors are expected to provide a more appropriate estimate to potential investors about the company's cash flow in the future. In equilibrium conditions, the owner has an incentive to choose a qualified auditor, in the hope that the resulting information can convince investors, so that the stock price becomes high.

Entry into ISA that fully adopts Risk Based Audit approach in the process of auditing work, impact on the existence of quality audit and produce reliable information (Suryanto, 2013). This makes public accounting firm audit method and process undergo significant changes, thereby impacting the amount of audit fees on the auditor's performance.

B. Previous Research and Developing Hypotheses

1) Existence of Independent Commissioner and Audit Fee

Independent Commissioners are members of the board of commissioners who are not affiliated with the directors, other members of the board of commissioners and controlling shareholders, and are free from any business relationship or other relationship that may affect their ability to act independently or act solely for the benefit of the enterprise (Law Number 40, 2007).

Hazmi (2013) found a negative relationship between the existence of independent commissioners to audit fees. The board of commissioners has the primary responsibility to oversee the company's financial reporting process. They should also assess the quality of organizational governance and ensure that the organization has, for example, effective accounting practices, internal control and risk management, and audit functions. The supervision of an independent board of commissioners will have an impact on good financial reporting. This can reduce the risk assessment

done by the auditor, so the audit fee will decrease

From that research above can be concluded that the more the board of commissioners is independent, the audit fee is lower. Thus, hypotheses proposed in the study are as follows:

H_1: Proportion of independent commissioners negatively effect on audit fee.

2) Size of Board of Commissioners and Audit fee

Beasley (1996) states that the total board of commissioners will influence the possibility of fraud in the financial statements significantly. This is in line with Jensen's research in Hazmi and Sudarno (2013) who argue that organizing and co-ordinating a large board of commissioners will have difficulty.

Hazmi and Sudarno (2013) found that companies with large boards of commissioners will have a high demand for internal control and are required to have high audit quality from external auditors, resulting in large fees. Chandra M.O (2006), also has the same result of research.

From the above research can be concluded that with the higher size of the board of commissioners then the company will pay a higher fee because the auditor will be required to have a good audit quality and takes a longer time. So the hypotheses proposed in the study are as follows:

H_2: Size of board of commissioners positively effect on audit fee

3) Size of Board of Commissioner’s Meeting and Audit fee

Independent board of commissioners who are separate from the management have a duty to oversee management performance, including overseeing financial

reporting. With the high intensity of board of commissioners meeting, the corporate governance function in the company has been running well so that this will reduce the risk assessment by external auditors that will also impact the reduction of audit fees (Chandra M.O, 2016).

Hazmi and Sudarno (2013) found negative relationship between size of board of commissioners meeting and audit fee. besides, based on Chandra M.O (2016) also found negative relationship between number of meeting and audit fee. The more meeting held, the more controlling done by board of commissioner. When there is control, fraud can be mitigated thus it will lead to lowering audit fee.

From the above research can be concluded that with the high intensity of meetings conducted by the board of commissioners, the audit fee paid will be low. This is because the high proportion of meetings will increase the board of commissioner's persistence, the effectiveness of the board of commissioners and the benefits with shareholders so as to enhance the supervision of financial statements that will reduce the auditor's responsibility.

H_3: Proportion meeting of board of commissioner negatively effect on audit fee

4) Size of Audit Committee and Audit fee

The Blue Ribbon Company (1999) found a negative relationship between the number of audit committees and audit fees. The larger number of audit committees will increase the credibility of the company's financial statements. With good financial reporting quality is expected to reduce the workload that must be done by external auditors and result in low audit fees.

Besides, Hazmi and Sudarno (2013) also found negative relationship between size of audit committee and audit fee. From several studies above can be concluded that the

more the number of audit committees, the audit fee is lower. So the hypotheses proposed in the study are as follows:

H_4: Audit committee size negatively effect on audit fee

5) Audit Committee Expertise and Audit fees

The existence of an audit committee is regulated through the Circular Letter of Bapepam Number SE-03 / PM / 2002 (for public companies) and the Decree of the Minister of SOEs No. KEP-103 / MBU / 2002 (for SOEs). The Audit Committee consists of at least three people, chaired by an independent commissioner of the company with two external people who are independent and master and have an accounting and financial background (Nugraheni, 2013).

Blue Ribbon Company (1999), this study argues that a larger number of audit committees will improve the quality of the company's financial statements resulting in low audit fee. Hazmi and Sudarno (2013) research also prove that higher audit committee who has accounting skill and background could lesser the external auditor workload and tend to decreasing audit fee.

From that researches, can be concluded that audit committee size have negative effect to audit fee. So the hypotheses proposed in the study are as follows:

H_5: Audit Committee expertise negatively effect on audit fee

6) Business Complexity with Audit Fee

Complexity in business according to Cameran (2005) is related to the complexity of transactions that exist in the company. The complexity of the company can come from the number of subsidiaries, the number of branches and the presence of business

operations abroad. The number of subsidiaries will provide a complex task to the auditor in conducting the audit process, so it will take longer and cost more.

This is also supported by research conducted by Xu (2011) which resulted in the conclusion that the number of subsidiaries positively affects audit fees. Sharma (2008) also uses a subsidiary in its research and found significant results on audit fees.

The more complex the client, the harder it will be to audit and will take longer. This results in higher audit fees. Based on the above description, hypotheses can be formulated:

H_6: Business complexity positively effect on audit fee.

7) Business Risk and Audit Fee

Fachriyah (2011) states that to accept the assignment, the auditor should consider business risks as reflected from the client company's audit risk.

Kisgen (2006) stated that there is a relationship between credit ratings and liquidity risk. Simunic (1980) explains that credit ratings may reflect business risks. The rating of a bond tries to measure the risk of default issuers in its inability to meet its financial obligations, which may affect the amount of audit fees that must be incurred. Firms with poorer credit ratings, indicate a higher risk of corporate liquidity, thus enhancing the auditor's assessment of clients' audit risk.

Kartikasari and Prabowo (2010) and Siskawati (2017) found a positive influence of bond ratings on audit fees. A high credit rating will provide a large audit of bonds to the Firm that audits the financial statements. This credit ranking information assists the auditor in auditing a company's funding cycle regarding the audit risk to be faced.

From the above research can be concluded that the higher the business risk, the audit fee is greater. This is because, the higher the business risk that is reflected in the

worsening of the company's bond rating, making the auditor establish higher audit risk, which in turn can increase audit fees. So the hypotheses proposed in the study are as follows:

H_7: Business risk positively effect on audit fee

C. Research Model

This research consists of dependent variable, independent variable, and control variable. Independent variables of this research are existence of independent commissioners, size of board of commissioner, size of board of commissioner’s meeting, size of audit committee, audit committee expertise, business complexity, and business risk. Dependent variable of this research is audit fee. Control variable of this research is firm size. The research model is showed by Picture 2.1:

Picture 2.1
Research Model