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Auditor's Reputation and Auditor's Opinion on Stock Prices: Evidence from Indonesia's Main Board Index

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Abstract

This paper examines the effect of the auditor reputation and the auditor's opinion on the stock prices of the firm in the following year from Indonesia Main Board Index. This research aims to study the importance of the auditors' reputation and the opinion given to the value of the firm by their stock prices movements. Regression analysis was applied with control variable and year fixed effect to find out whether or not the reputation of the auditor and the opinion given by the auditor could affect the stock prices of the firm. The result shows that auditor's reputation does affect the stock prices in the following year, while auditor's opinion does not affect the stock prices of the firm in the following year.

Keywords Auditor Reputation, Auditor Opinion, Stock Prices

1. Introduction

One of the critical components for well-functioning capital market is the high-quality external auditing. Accounting literature has two principal core which drive auditors to deliver high quality result, they are litigation incentive and reputation incentive. On the litigation incentive perspective, when the auditors are liable for failures, they have an incentive to provide high-quality audit to refrain from litigation cost. On the reputation incentive perspective, auditors tend to maintain their reputation and avoid audit failure, because audit quality is valuable to clients. Audited financial statement is produced by an auditor and in the statement, there is also stated the opinion from the auditor. Therefore, auditor reputation and auditor opinion are crucial and important. How important this could be to the investor's attention? Investors are looking for the certainty of what will happen in the stock market.

Auditors are independent, but they work and brought the name of their public accounting firm. Yet, it is the clients who choose their auditors by ⁵ the auditor's size, industry expertise and the audit quality (Defond and Zhang, 2014). Client often finds some information about the auditor's reputation whether or not they work for the government, or is there any conflict of interest that connect to the auditor. In relying on their reputation, there are two things that could come after, the first one is ⁵ incentives to deliver a certain level of audit quality and avoid fraud and misreporting that could harm the firm (DeAngelo, 1981; Weber et al, 2008). In choosing their auditor, clients must have some consideration, because in the future it could also affect their firm, even their firm value. On the other side, from the view of the auditors perspective, accepting the offer from their client for engagement might also predict their future client and all the misconduct that could happen (Cook et al, 2020).

Many factors could affect stock market, whether showing abnormal return or the changes in the stock prices (Dopuch, et.al, 1986). These factors drag out sentiments on the stock market. Previous studies have mentioned the importance of auditor reputation on earnings management (Kanagaretnam, et.al, 2010), the price on the initial public offering (Beatty, 1989), even the government perspective on the critical report given by the auditors (Firth, 1990). Moreover, a study mention how market rely on the auditor's reputation for some information uncertainty (Billingsley & Schneller, 2009). ¹³ Information uncertainty is defined as ambiguity ¹³ concerning a firm's value (Zhang, 2006) ⁶ which also can be seen from the information provided in the financial statement and hopefully the higher the auditor's reputation, the more confident should investors be in the signal provided by a firm's financial statements.

¹¹ Accounting papers also mention about the announcement of the auditor opinion to the stock prices movements in the following day (Giuseppe & Giuseppe, 2015; Hoti et.al, 2012) and the information asymmetry as a result of the published auditor opinion (David, et.al, 2015), and audit report by the auditors hired on stock prices (Soltani, 2000). Even certain specific opinion given by the auditors could affect the stock prices (Dodd et.al, 1984; Varvara & Fedorova, 2020) and stock return (Flees

&Mouselli, 2022) of the firm in the following certain window days.

The purpose of this study is to find out the whether or not the auditor reputation and auditor opinion could affect the stock prices of the firms listed in the Main Board of Indonesia Stock Market. This paper enriches the literature in accounting on factors affecting stock prices in Indonesia Stock Market. Section II shows the literature review, section III shows the methodology used in this study, section IV shows the result of the regression and section V present the conclusion of this study.

2. Literature Review

2.1 Auditor Reputation

Public accounting firm has certain characteristics and unique method to make their worker keep up with the workplace reputation. Thus, frequent evaluation needs to be done, with specific benchmark, expectation on time budget, workpaper completeness and maintaining relationship with clients as an aspect of reputation development (Ferris et.al, 2003). A positive reputation generally provides power for individuals within an organization (Pfeffer, 1992). Reputation is a social construct, it is not creating a legitimate power, but concerning the organization through the position given (Zinko et.al, 2007). A common situation faced by the auditors is about choice, whether or not to complete the social group expectation, the standard to maintain performance or the needs of the clients. This reputation catches investor's attention and build their trust, believing that the company will choose the best candidate as their auditor.

H1: Auditor's reputation affects stock prices in the following year.

2.2 Auditor Opinion

Auditor opinion is a product from the work of auditors on the financial statement of a certain company. Previous study mention that there is an instant market reaction after the audit report disclosure (Kim, 2012). There are unqualified audit reports, qualified audit reports and modified audit reports. There is a different reason on why the auditors conclude their work with these reports. Unqualified audit report issued when the financial statement produced accordingly with the accounting, standard known as GAAP. Qualified audit reports are usually issued due to some violation of GAAP such as IFRS, IFRS for SMEs, when there is some limitation, or material misstatement. Modified audit reports issued when there is a change in accounting method, when there is going concern or emphasis on a specific matter. This report is used to draw attention to some important accounting issue.

Accounting literature review mention the importance of auditor opinion. Altman and McGough (1974) studied the bankrupt companies receiving "going concern opinion". Deakin (1977) mention that almost 15% of bankrupt companies had received "going-concern" opinion. Dodd et al (1984) and Elliott

(1982) both agree to state that companies with qualified opinions undergo longer period of audit than companies that receive unqualified opinions.

H2: Auditor's opinion affects stock prices in the following year.

2.3 Stock Prices

Stock prices moves every day. ¹ Today's closing price and tomorrow's opening price could be affected by many factors. When there are changes of the boards or the CEO, when there are some legal issues on the company, or even when the CEO involve in some scandals or achievements, that kind of news could move the stock prices of the company.

There are two opinions on whether stock prices could be affected by auditor opinions. Tahinakis et al (2010) mention that audit opinion does not influence investor's decision. Moradi et al (2011) conclude that qualified audit opinion does not affect stock prices. Anvarkhatibi, et al (2012) state that ¹¹ there is no significant relationship between audit opinion and stock price. Current research by Muslih and Amin (2018) shows that audit opinion does not significantly affect stock price movements.

On the other side, previous studies mention that auditor reports could affect stock prices (Dodd et.al, 1984), Hoti et al (2012) shows the same result on auditor's opinion affect stock prices movement. Some previous papers mention abnormal return in association with the announcement of the qualified auditor opinion. This opinion is not the best opinion given to the firm.

H3: Auditor's reputation and auditor's opinion affect stock prices in the following

2.4 Tables

Tables should be displayed in the middle. Table numbers should run consecutively. Details of font type and spacing of table titles, table text and data, notes, and sources are shown below. Notes and sources are positioned below the table. Tables should be clear and neatly prepared in a form suitable for immediate reproduction.

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3. Methodologies

3.1 Research Model

3.1.1 Auditor's Reputation and Stock Prices

Following previous literature, we study the changes in the stock prices by using these estimations partially:

$$\text{StockPrice}_{i,t+1} = \beta_0 + \beta_1 \text{DUMMY}(\text{AuditorRep})_{i,t} + \beta_2 \text{FSize}_{i,t} + \varphi t + \varepsilon \quad (1)$$

where:

StockPrice is the adjusted closing price of the firm i in year t . DUMMY(RepA) is the dummy variable of Auditor's Reputation, 1 if the auditors handling the firm is from BIG4, 0 otherwise. We use FirmSize from the natural logarithm of total asset as control variable. For controlling unobserved factors of a firm, we use a fixed effect model to control the time fixed effect by using year dummies (φt) to capture factors which affect all firms at the same time. All variables that need to be winsorized are winsorized at 1% and 99%.

3.1.2 Auditor's Opinion and Stock Prices

Following previous literature, we study the changes in the stock prices by using these estimations partially:

$$\text{StockPrice}_{i,t+1} = \beta_0 + \beta_1 \text{DUMMY}(\text{AuditorOp})_{i,t} + \beta_2 \text{FSize}_{i,t} + \varphi t + \varepsilon \quad (2)$$

where StockPrice is the adjusted closing price of the firm i in year t . DUMMY(OA) is the dummy variable of Auditor's Opinion, 1 if the opinion is Unqualified, 0 if the opinion is other than Unqualified. We use FirmSize from the natural logarithm of total asset as control variable. For controlling unobserved factors of a firm, we use a fixed effect model to control the time fixed effect by using year dummies (φt) to capture factors which affect all firms at the same time. All variables that need to be winsorized are winsorized at 1% and 99%.

3.1.3 Auditor's Reputation and Auditor's Opinion on Stock Prices

Following previous literature, we study the changes in the stock prices by using these

estimations simultaneously:

$$\text{StockPrice}_{i,t+1} = \beta_0 + \beta_1 \text{DUMMY}(\text{AuditorRep})_{i,t} + \beta_2 \text{DUMMY}(\text{AuditorOp})_{i,t} + \beta_3 \text{FSize}_{i,t} + \phi t + \varepsilon$$

(3)

where StockPrice is the adjusted closing price of the firm i in year t . DUMMY(RepA) is the dummy variable of Auditor's Reputation, 1 if the auditors handling the firm is from BIG4, 0 otherwise. DUMMY(OA) is the dummy variable of Auditor's Opinion, 1 if the opinion is Unqualified, 0 if the opinion is other than Unqualified. We use FirmSize from the natural logarithm of total asset as control variable. For controlling unobserved factors of a firm, we use a fixed effect model to control the time fixed effect by using year dummies (ϕt) to capture factors which affect all firms at the same time. All variables that need to be winsorized are winsorized at 1% and 99%.

3.2 Research Data

In this paper, we study the firms listed in the Main Board Index of Indonesia Stock Market. We use panel data taken from annual report of the firm for the period of 2016-2020. Main Board Index consist of large firms with a good track record. The total number of samples is 200 firm-year observation since the sample need to meet the criteria of consistency listed in the Main Board Index for the whole period of observation. Table 2 shows the variable definition of all variables used in this paper.

Variables	Abbreviation	Measurement
Stock Price	StockPrice	The adjusted closing price of firm i at time $t+1$
Auditor Reputation	AuditorRep	Dummy variable. 1 if the auditors handling the firm is from BIG4, 0 otherwise of firm i at time t .
Auditor Opinion	AuditorOp	Dummy variable. 1 if opinion is Unqualified, 0 if the opinion is other than Unqualified of firm i at time t .
Firm Size	FSize	Natural logarithm of total asset from firm i at time t

Source: Authors' text

The result of the descriptive statistics and frequencies are shown in Table 3. Stock Price are shown in IDR Rupiah and Size is shown in billion.

Table 3: Descriptive Statistics of Variables in the Model

Variable	N	Min	Max	Mean	Std. Deviation
StockPrice	200	105	12,872	1661.35	2008.098
Firmsize	200	29	34	30.69	1.227

Source: Calculated by Authors

Table 3 shown that on the Main Board Index, for the year 2016-2020 the minimum stock price is IDR 105 and the maximum price is IDR 12,872. The mean of the adjusted close price is IDR 1,661.35. The size of the firms is in between 29 to 34 billion Rupiah with the mean of 30.69 billion Rupiah.

Table 4: Frequencies of Dummy Variables in the Model

Variable	Dummy	Frequency	Percent
RepA	0	76	38
	1	124	62
<i>Total</i>		200	100
OA	0	28	14
	1	172	86
<i>Total</i>		200	100

Source: Calculated by Authors

Table 4 shown the frequencies of dummy variables used in this paper. From 200 firm-year observation of Main Board Index in Indonesia Stock Market, there are 38% firms handled by non BIG4 CPA firm, while 62% of them are handled by BIG4 CPA firm. As for the Audit Opinion, 86% of the sample got the Unqualified opinion and only 14% firms given opinion other than Unqualified.

4. Research Result

4.1 The Relation of Auditor's Reputation on Stock Prices

Tabel 5. Auditor's Reputation on Stock Prices

	Stock Prices			
		1	2	
Constanta	1521.5***	4.29	-5255.6	(-1.50)
<i>RepA</i>	808.3***	2.79	719.0*	2.47
<i>Firm Size</i>			223.9	-1.94
Year Fixed Effect	Yes		Yes	
N	200		200	
Adjusted R-Square	0.027		0.041	

Source: Calculated by Authors

Table 5 shows the regression analysis between Auditor's Reputation and Stock Prices in two

models from formulas number 1. Model 1 represent the regression without control variable and Model 2 represent the full regression including control variable dan the year fixed effect. The result shows that Reputation Auditor positively affect stock prices with or without the control variable. Empirically, this shows that whatever is the size of the firm, when the firm handled by reputable auditors, in this study represented by BIG4 audit firm, does help increase the stock prices in the following year. *t* statistics in parentheses * $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$ indicate the regression coefficient significantly different from zero at the 10%, 5% and 1% levels, respectively.

4.2 The Relation of Auditor's Opinion on Stock Prices

Table 6. Auditor's Opinion and Stock Prices

	Stock Prices			
	1	2		
Constanta	1351.7***	2.77	-6314.6	-1.79
<i>OA</i>	705	1.71	626.9	1.53
<i>Firm Size</i>			253.7*	2.19
Year Fixed Effect	Yes		Yes	
N	200		200	
Adjusted R-Square	0.003		0.022	

Source: Calculated by Authors

Tabel 6 shows the regression analysis between Auditor's Opinion and Stock Prices in two models from formulas number 2. Model 1 represent the regression without control variable and Model 2 represent the full regression including control variable dan the year fixed effect. The result shows that Auditor Opinion does not affect stock prices with or without the control variable. Empirically, this shows that whatever is the size of the firm, whatever the opinion given by the auditors does not help increase nor decrease the stock prices in the following year. *t* statistics in parentheses * $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$ indicate the regression coefficient significantly different from zero at the 10%, 5% and 1% levels, respectively.

12 4.3 The Relation of Auditor's Reputation and Auditor's Opinion on Stock Prices

12 Table 7. Auditor's Reputation and Auditor's Opinion and Stock Prices

	Stock Prices			
	1		2	
Constanta	1195.0*	2.46	-5414.3	-1.54
Dummy_Rep	724.3*	2.4	644.0*	2.13
Dummy_OA	416.3	0.98	380.9	0.9
Firm Size			219.3	1.89
Year Fixed Effect	Yes		Yes	
N	200		200	
Adjusted R-Square	0.027		0.04	

Source: Calculated by Authors

4 Tabel 7 shows the regression analysis between Auditor's Reputation and Auditor's Opinion on Stock Prices in two models from formulas number 2. Model 1 represent the regression without control variable and Model 2 represent the full regression including control variable dan the year fixed effect. The result shows that in Model 1 and Model 2 only Auditor's Reputation affect the stock prices while the Auditor Opinion does not affect stock prices with or without the control variable. Empirically, this shows that the reputation of the auditors is more important than the opinion given, since the reputation does affect the changes of the stock prices in the following year. ¹ *t* statistics in parentheses * $p < 0.10$, ² ** $p < 0.05$, *** $p < 0.01$ indicate the regression coefficient significantly different from zero at the 10%, 5% and 1% levels, respectively.

5. Conclusion

This study aims to study whether or not the auditor reputation and the auditor opinion given to the firms could affect the stock prices of the firm in the following year. The result shown that partially, the auditor reputation does affect the stock prices for the following year. While auditor's opinion did not affect the stock prices in the following year. Simultaneously tested, both variables tested does affect the stock prices in the following year by 5%. Empirically, we need to find more factors that could affect the stock prices in the following year since it can be affected by many more factors. This paper state that auditor reputation does matter and contribute to the investor's attention. A firm which handled by BIG4 auditors has higher stock prices than firms that are handled by second tier auditors. Thus, this paper is limited to the firms listed on the main board index. On the other side, main board index represents various industries which means the result could represent firms in Indonesia. Moreover, some of the firms listed in the main board index also handled by non BIG4 auditors. Even though not every firm could be handled by reputable auditors which represented by BIG4 auditors, the opinion given still

matters the most and in the case of the firms listed in the main board index in Indonesia Stock Market, auditor opinion does not affect stock prices in the following year.

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