Impact of ISA 600 on market share and audit quality in Indonesia.

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Abstract

ISA 600 states that the auditor of the parent company (the group auditor) has full responsibility for all consolidated financial statements, including those of subsidiaries audited by other auditors (component auditors). This study aims to examine the impact of the implementation of ISA 600 on audit quality and market share in Indonesia, using mixed methods. The primary data were collected from FGD and questionnaires (244 respondents), while the secondary data were obtained from 1,062 firm years (2011-2016) of the parent company financial statements. The regression results show that the implementation of ISA 600 had a negative impact on audit quality. Additional testing found that the impact was greater when the group auditor was from a non-Big four firm. After ISA 600 implementation in Indonesia, many subsidiaries have switched to group auditors, which are usually Big 4 or Second-Tier, meaning small accounting firms have lost many clients. The questionnaires distributed to auditors and FGDs show consistent results. According to ISA 600, group auditors must supervise and inspect the component auditors' audit programs and working papers. In reality, however, group auditors do not want to bear the risk of supervising other auditors' work, so require subsidiaries to be only audited by them.

Keywords: ISA 600, Audit quality, Audit market share, Group auditor, Component auditor.

Accepted on April 02, 2019

Introduction

The financial scandals that have affected large companies such as Enron, Ahold and Parmalat have shown that there are problems and gaps in accounting and audit practices which are occurring even in large companies. Various parties began to realize the problem and voice their concerns about the importance of monitoring accounting and auditing practices in order to prevent similar problems which could harm companies or investors in the future. Auditing is a very important activity; quality of auditing is a guarantee of the quality of financial statements [1].

One of the causes of the financial scandals that have occurred in several large companies such as Parmalat in Italy and Royal Ahold in the Netherlands was the low quality of audit in subsidiaries [2]. Auditors at the parent company (the group auditors) relied too much on the work of auditors at the subsidiaries (the component auditors) without conducting sufficient reviews, meaning the lack of audit quality by the component auditors could not detected by the group auditors.

For this reason, the IAASB issued the International Standard on Auditing (ISA) 600, which regulates the responsibilities of group auditors towards component auditors. ISA 600 states that group auditors are fully responsible for all consolidated financial statements, including subsidiaries' financial statements audited by component auditors. In the previous audit standard (AU 543), this was not the full responsibility of group auditors. An impact of this rule is that the group auditor will choose to audit the subsidiary directly in order to minimize any risk that would be their responsibility. In ISA 600, the group auditor is responsible for the audit quality of subsidiaries (components), so they should direct and review the work of the component auditor. Therefore, ISA 600 requires the group auditor to communicate with component auditors about their work and is also responsible for obtaining sufficient and appropriate audit evidence regarding financial information relating to the components (subsidiary companies) and the consolidation process in order to express an opinion on the consolidated financial statements.

Research on this subject is still limited; one example is the work of Carson who found that audit quality in Australia was lower when it involved other auditors working as component auditors in group audits [2]. In the United States, Dee also found that audit quality decreases when component auditors are involved in group audits [3]. In Indonesia, ISA 600 has been adopted since 2013, but there is still little research related to it. Studies that have been conducted include that of Rahmansyah, who found that ISA 600 had a positive impact on audit quality, while Pati, and Izzati found that ISA 600 had a negative impact on audit quality [4-6].

This study aims to examine the impact of the implementation of ISA on audit quality and market share of small and large audit firms. The differences between this research and previous research are:

(a) previous research was conducted in developed countries, while this research was conducted in Indonesia, a developing country, where governance and law enforcement are still weak, thus affecting the regulator's supervision of public accounting firm [2]. This will cause the impact of ISA 600 to be different from that in developed countries;

(b) in calculating the audit market share, previous research only uses data from listed companies, whereas this study uses not only such data, but also those of non-listed companies, obtained from the Center for Financial Professional Development;

(c) this study not only uses secondary data from financial statements, but also primary data in the form of questionnaires distributed to external auditors of public accounting firms to find out their responses to ISA 600.

Literature Review and Hypothesis Development

The impact of the full responsibility established by ISA 600 has led group auditors to prefer to directly audit component companies' financial statements [4]. This indicates a possible shift of audit work from component to group auditors in order to minimize risks arising from other auditors' work. The subsidiary companies that were previously audited by other audit firms will therefore be audited by the group auditor. Carson found that the implementation of the revised ISA 600 in Australia significantly reduced the extent of involvement of unaffiliated component auditors, while there was no change in the use of network auditors (affiliated auditors) as component auditors [7].

In Indonesia, the auditing of the group company's financial statements is generally undertaken by large audit firms, while subsidiaries of the group are normally audited by smaller audit firms because of their lower fees. This shift from component to group auditors will lead to a decrease in the market share of small audit firms. Therefore, it is expected that the audit market share of small audit firms will decrease following the implementation of ISA 600. Based on this argument, this study hypothesizes that:

H1a: The market share of small accounting firms will decrease after the implementation of ISA 600.

H1b: The market share of large accounting firms will increase after the implementation of ISA 600.

Working with other auditors as component auditors in group audit can pose several challenges, such as coordination and communication between the parent auditors (group auditors) and component auditors [7]. Ineffective coordination and communication will increase the asymmetric information between the group auditor (principals) and various component auditors (agents), which might lead to a decrease in group audit quality. Lead auditors must therefore be able to satisfy themselves that the use of components auditors will not impair audit quality. ISA 600 requires the group engagement partner (lead auditor) to be responsible for supervising and monitoring component auditors to ensure that they are in compliance with auditing standards. Following the implementation of ISA 600, group auditors will face greater audit risk and also greater responsibility for obtaining sufficient and appropriate audit evidence. The implementation of ISA 600 will also encourage group auditors to ensure that any audit work conducted at the component level is in accordance with procedures and quality. Therefore, it is expected that audit quality will increase after the implementation of ISA 600.

Based on ISA 600, group auditors are prohibited from referring to the work of other component auditor and are required to review the work of other auditors. This indicates that group auditors are responsible for directing and re-evaluating the work of component auditors and should ensure that audit work undertaken at the component level is in accordance with audit standards, so that the overall audit of the consolidated financial statements is of high quality. The implementation of ISA 600 is thought to have improved audit quality as: 1) the increased risk after implementation of ISA 600 has made group auditors more careful in monitoring and evaluating the work of component auditor; and 2) ISA 600 sets out issues that need to be considered and acted on by group auditors when more detailed work by other component auditors is involved, but not yet regulated by previous audit standards. This is to ensure that the component auditor conducts high quality work. Therefore, if any error or problem occurs in the work of the component auditor, it should be detected when the group auditor reviews their performance. Based on these arguments, the study hypothesizes that:

H2: The implementation of ISA 600 will increase audit quality.

Research Methodology

Two types of data source are employed: primary and secondary data. The primary data were obtained from questionnaires distributed to auditors in Indonesia, which included the Big 4, second tier, and small accounting firms. The questions included: 1) whether clients of the component auditor had moved to the parent auditor because of the implementation of ISA 600; and 2) what the opinion of the auditor was regarding ISA 600 and what aspects needed to be improved in relation to its implementation. The respondents were auditors who held the position of assistant manager to audit partners. Out of the questionnaires distributed, 244 were returned.

The secondary data were obtained from the financial statements of companies listed on the Indonesian Stock Exchange that make consolidated financial statements. Furthermore, for companies that do this, a search was made of the names of their subsidiaries. We then looked for the names of the accounting firms and their audit partners based on data from the Ministry of Finance (P2PK). The study period was from 2011 to 2016.

To test hypotheses 1a and 1b, market share was defined as the market share of audit services with clients of all the subsidiaries of listed companies making consolidated financial statements. The first step to measure market share involved data collection regarding the name of the subsidiary company from all the listed companies in Indonesia. The data were then grouped based on the name of the accounting firm, and the market share was then calculated from each of the accounting firms with the formula of the number of clients divided by total clients in the industry. The sample was 191 parent companies with a total number of subsidiaries of 1,205 (equal to 7,230 firm years). The market share was divided into three groups: the Big 4, second tier and small. The audit market share was measured by observing the proportion of subsidiary clients in the three groups who had experienced a decrease or increase in the period before and after SA600 implementation.

To answer hypotheses 1a and 1b, a test was conducted of market share differences in the three groups before and after the application of ISA 600. It was predicted that after implementation, there would be a decrease in the market share of small accounting firms and an increase in that of large firms (the Big 4 and second tier).

To answer hypothesis 2, the study used parent company data. Employing the purposive sampling method, the sample comprised 1,062 firm years. Hypothesis 2 was tested with the following measurement models:

$$ABS_{DAC_{it}} = \alpha_1 + \alpha_2 ISA600_{it} + \alpha_3 CONC_{it} + \alpha_4 BIG4_{it} + \alpha_5 LEV_{it} + \alpha_6 GROWTH_{it}$$
$$+ \alpha_7 LOSS_{it} + \alpha_8 ROA_{it} + \alpha_9 AGE_{it} + \alpha_{10} SIZE_{it} + \alpha_{11} CFO_{it} + \varepsilon_{it} \qquad -(1)$$

Further analysis was made of Big 4 and non-Big 4:

$$ABS\_DAC_{it} = \alpha_1 + \alpha_2 ISA600_{it} + \alpha_3 CONC_{it} + \alpha_4 LEV_{it} + \alpha_5 GROWTH_{it} +$$
$$\alpha_6 LOSS_{it} + \alpha_7 ROA_{it} + \alpha_8 AGE_{it} + \alpha_9 SIZE_{it} + \alpha_{10} CFO_{it} + \varepsilon_{it} \qquad -(2)$$

ABS_DAC=Absolute Discretionary Accrual, as a proxy for audit quality;

CONC=Audit Market Concentration based on total clients;

ISA 600: Dummy, 1 for the year before ISA 600 implementation (2011-2012) and 0 for the period after ISA 600 implementation (2013-2016);

LEV: Total debt divided by total assets;

SIZE: Size of the company calculated by the natural logarithm of total assets;

ROA: Return on assets;

GROWTH: Growth based on PBV;

CFO: Operating Cash Flow;

AGE: Number of Years Company listed on the IDX;

D_LOSS: 1 if the company recorded losses, 0 if no losses recorded;

BIG 4: 1 for companies audited by Big 4 audit firm, 0 for other firms.

Audit quality was measured using absolute discretionary accruals (ABS_DAC) according to McNichols model, and following previous studies conducted by Becker, Myers and Larcker and Richardson, in which the higher the ABS_DAC value, the lower the audit quality [8].

Results and Discussion

ABS_DAC=Absolute Discretionary Accrual, as a proxy for audit quality;

CONC = Audit Market Concentration based on total clients;

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Table 1 shows the descriptive statistics of all the variables for the study samples. There were a total number of observations of 1,062 in the 6 year period, namely 2011-2016. The average value of discretionary accruals is 0.0715, while the standard deviation value is 0.1149. A standard deviation value higher than the average value indicates that the discretionary accrual data is very scattered and varied. The independent variable of the study is ISA 600 in the form of a dummy variable. The sample is given a value of 1 if ISA 600 has been implemented (2011-2012) and a value of 0 if not implemented (2013-2016). The dummy percentage of ISA 600 with a value of 1 has a frequency of 66.67%, meaning that 66.67% of the research data were taken in the period after the implementation of ISA 600, and 33.33% taken before implementation.

Of the 1,062 samples examined, the Big 4 dummy variable has a value of 42.94%, meaning that the number of companies audited by the Big 4 is quite high. In addition, from the descriptive statistics table, the sample companies audited by the Big 4 have on average lower leverage and lower discretionary accruals. However, the firms audited by the Big 4 have higher performance (ROA), higher growth, and higher operating cash flows compared to the sample companies audited by firms other than the Big 4.

Table 2 shows the change in market share (to test hypotheses 1a and 1b). It can be seen that the implementation of ISA 600 led to the market share of the Big 4 to increase from 38.17% to 43.03% (an increase of 4.85%). Second tier firms also experienced an increase in market share, from 36.64% to

Table 1. *Statistic descriptive (After Winsorize).*

Variable	Full Sample				Big 4				Non Big 4			
	Mean	Std Dev.	Min	MAX	Mean	Std Dev.	Min	MAX	Mean	Std Dev.	Min	MAX
Abs_Dac	0.0715	0.1149	0.0002	16.475	0.0708	0.1249	0.0003	16.475	0.0719	0.1067	0.002	15.87
Share	0.0378	0.0178	0.0158	0.0846	0.0418	0.019	0.0158	0.0846	0.0349	0.0162	0.0158	0.0846
Lev	0.5169	0.3999	0.0025	880482	0.4905	0.2443	0.0025	19.834	0.5367	0.4844	0.0085	88.483
Size (billion)	2983610	50.319	10158	254432140	6928436	39.385	10194	254432140	1582544	44.478	10158	97099
ROA	0.0553	0.3578	-109.653	11.891	0.0929	0.1398	-11.067	11.891	0.0269	0.4559	-109.653	0.6145
Growth	28.963	16.158	-32.827	1.609.987	35286	48.978	-29.388	454.808	24.204	79.452	-32.827	1.609.987
CFO	0.0678	0.1039	-0.615	0.673	0.0715	0.1089	-0.3444	0.673	0.065	0.0999	-0.615	0.5736
Age	0.0678	0.1039	0	35	145.658	84.284	0	35	140.545	76.758	0	34

Dummy Variable	Percentage		Percentage		Percentage	
	1	0	1	0	1	0
ISA 600	66.67%	33.33%	67.32%	32.68%	66.17%	33.83%
D_Loss	16.76%	83.24%	15.13%	84.87%	17.99%	82.01%
Big 4	42.94%	57.06%				
N-Observation	1062		456		606	

Table 2. *Change in market share.*

Market Share	Before ISA 600	After ISA 600	Difference	Effect
MS_BIG 4	38.17%	43.03%	4.85% ***	Increase
MS_SECOND TIER	36.64%	38.34%	1.70% **	Increase
MS_SMALL Accounting Firm	25.19%	18.63%	(6.56%) ***	Decrease
N: 7,230 subsidiary company firm years				
*** significant at level of 1%; ** significant at level of 5%				

38.34% (an increase of 1.74%). The increase in market share of the Big 4 and second tier was accompanied by a decrease in small accounting firms' market share, from 24.19% to 18.63 (a decrease of 6.56%). With regard to these increases and decreases, statistical tests were conducted to establish whether they were significant or not. The statistical test results show that the increase in market share of the Big 4 is significant at the 1% level that of the second tier is significant at 5%, with the decrease in small accounting firms' market share is significant at 1%.

The results indicate that the application of ISA 600 in Indonesia led to a shift of clients from small to Big 4 and second tier firms, with the highest percentage of transfers to the Big 4. They also confirm that many subsidiaries which had previously been audited by small firms had moved to the audit firm of its parent company, mainly large ones (Big 4 and second tier auditors). This result is consistent with Carson who found that the implementation of ISA600 significantly reduced the extent of involvement of component auditors from unaffiliated auditors. Carson also found that compared to other auditors, Big 4 and large non-Big 4 auditors were more (or less) likely to involve network (or unaffiliated) auditors [7]. The implementation of ISA 600 meant that the auditor group was responsible for the work undertaken by the component auditor. Group auditors are required to evaluate the accuracy of audit procedures performed by component auditors and are prohibited from referring to component auditors unless there are laws that require it.

According to ISA 600, group auditors are responsible for directing and evaluating the work of the component auditor. Based on this, to support efficiency and effectiveness, many group auditors prefer to take over the audits of their subsidiaries that had previously been audited by another firm. Another issue that might be the cause of the change of auditor of a subsidiary company following its parent company is because the auditor of the parent company obtains additional clients and audit fees.

Table 3 shows the results for H2, the impact of the implementation of ISA 600 on audit quality. The regression results show that ISA 600 has a positive effect on discretionary accruals, which means that the implementation of ISA 600 decreases audit quality. This finding is not consistent with the hypothesis that proposes that ISA 600 has a positive effect on audit quality. The results indicate that the objective of ISA 600 to improve audit quality has not been achieved (H2 is therefore not proven). The results are also consistent with Carson in Australia, who found no evidence that the implementation of ISA 600 increases audit quality [7]. In addition, Pati and Izzati found that implementation of ISA 600 decreased audit quality in Indonesia [5,6]. This finding indicates that such implementation has a limited effect on audit quality. This might be because the implementation

Table 3. *Regression result.*

Variable	Prediction	Dependent Variable: ABSDAC					
		Full Sample		Big 4		Non Big 4	
		Coefficient	Significance	Coefficient	Significance	Coefficient	Significance
ISA 600	H2: -	0.0571	0.0000***	0.027	0.0230**	0.0624	0.0005***
CON	H3: +/-	-0.4895	0.0810*	-0.2627	0.397	-0.4306	0.327
LEV	+/-	0.0349	0.213	0.089	0.0890*	0.0077	0.791
SIZE	+/-	-0.0201	0.136	-0.0981	0.0050***	-0.0022	0.787
ROA	-	0.2532	0.0030***	0.2072	0.033	0.3592	0.0075***
GROWTH	+	-0.0031	0.0285**	-0.0068	0.0000***	-0.0003	0.406
CFO	-	0.0113	0.3275	0.0224	0.284	0.0078	0.4065
D_LOSS	+/-	0.0426	0.0010***	0.0189	0.288	0.0632	0.0005***
BIG 4	-	-0.0288	0.0800*				
AGE	-	-0.0136	0.0000***	0.0036	0.211	-0.0178	0.0010***
CONST		0.2208	0	0.0416	0.491	0.2595	0.002
Prob > F		0		0.0004		0.0012	
R-Square		0.1178		0.2024		0.1238	
N-Observe		1062		456		606	
Dep var: DAC							

of ISA 600 is not consistently understood and applied as intended [9]. This is also supported by Barret, who found that inter-office instructions are not necessarily interpreted or completed by the component as intended [10].

This may happen because after the implementation of ISA 600, many subsidiary companies changed their auditor to that of its parent company auditor (group auditor). After the implementation of ISA 600 in Indonesia, many subsidiary company auditors were changed to group auditors. Full responsibility of the Group Auditor makes the Group Auditors prefers to conduct audits directly on subsidiary companies rather than supervise and inspect the working papers of another auditor. With the implementation of ISA 600, earnings management has increased because the parent and subsidiary are audited by the same firm. In the context of this study, with the adoption of ISA, many auditors in subsidiaries have moved to the same auditor as the parent auditor, thus causing the parent auditor to be too dependent on the component auditor, which is also the same accounting firm. If the component auditor comes from a different accounting firm, the auditor will conduct an audit more carefully, knowing that the paperwork will be reviewed by another auditor. On the other hand, the main auditor will also conduct a detailed review of subsidiaries' working papers, because the component auditors are different from the parent ones, making the parent auditors more careful.

Table 3 also presents the results of additional testing by dividing the sample into parent companies audited by the Big 4 and those audited by the non-Big 4. They show the same results as the main test. The coefficient of the ISA 600 variable is the same, significantly positive to DAC or significantly negative to audit quality. However, the magnitude of the coefficient in the sample of parent companies audited by the non-Big Four (0.0624) is higher than the Big 4 (0.0270). This means that decreased audit quality is more pronounced in parent companies audited by the non-Big 4 compared to those audited by the Big 4. This may be because:

1) Implementation of ISA 600 causes the component auditor to move to the parent auditor, leading to overload for the parent auditor, thereby reducing audit quality (in the second tier there are fewer human resources than in the Big 4;

2) The Big 4 have a reputation that must be maintained, so they will try to maintain the level of their audit quality.

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D_LOSS: 1 if the company recorded losses, 0 if not; BIG 4: 1 for companies audited by Big 4 audit firm, 0 for other firms.

To ascertain the opinion of the auditors on the implementation of ISA 600, a questionnaire was distributed to them in August 2018 through Google Forms, and also at a PPL event (training) in Surabaya. 244 questionnaires are return, with the majority of respondents stating that 59.43% of their clients which were subsidiaries had moved to the audit firm that audited the parent company. The majority of respondents (41.39%) said that the audit fees of the clients which had moved to group auditors after the implementation of SA 600 were quite high. Reasons for the subsidiary to move to the group auditor were because the group auditor did not want to bear the audit risk of another audit firm (38.87%), or because of the client's interpretation of ISA 600 (25.82%). The majority of respondents (63%) stated that only a small number of clients really understood ISA 600, while the majority (44%) did not agree with the implementation of ISA 600, stating that it could result in small audit firms' clients moving to big audit firms. The steps given that could be taken by the government to ensure that ISA 600 meets its target of improving audit quality are:

1) Give clearer information to all auditors regarding the purpose of applying ISA 600 (40%);

2) Provide clearer socialization to auditees regarding the purpose of applying ISA 600 (35%);

3) Supervise ISA 600 implementation (20%);

4) Other reasons (5%).

The focus group discussion was attended by two partners of the Big 4, five partners of second tier firms, and eight from small audit firms. Those from small audit firms said that they were devastated by the enactment of ISA 600 because many of their clients had moved to the accounting firm that audited the parent company, which had requested this as it was following ISA 600 requirements. Since the implementation of ISA 600, small audit firms had lost many clients, including small ones which were in fact not of usual interest for the Big 4. This has resulted in them not being able to survive. A Big 4 auditor stated that they could not do anything about the situation, because with ISA 600 the parent auditor was responsible for all companies, including the subsidiaries audited by other firms. Small accounting firms could perhaps increase their audit quality, so that the Big 4 could trust handing over their clients audited by another firm [8,11-14].

Conclusion

The research has found that there has been a shift in the auditor's subsidiary company (component auditor) from small audit firms to the Big 4 and second tier. The differential tests showed that the change was significant, with the Big 4 and second tier experiencing an increase in market share, while small audit firms have experienced a decline. This result is evidence that after the implementation of ISA 600 in Indonesia, many subsidiary auditors have been changed to group auditors. This is possibly because large accounting firms are trying to minimize the risks that must be borne from work undertaken by other parties. They assume that when another auditor is involved as a subsidiary auditor (component), the group auditor will face the risk that the audit conducted by component auditor is of low quality, which will have an impact on the audit quality of group financial statements (parent company). This is undesirable for the client.

The results of the study also show that the implementation of ISA 600 has had a negative effect on audit quality. This negative influence is greater in the parent company groups audited by the Big 4 compared to those audited by non-Big 4. This shows that ISA600 implementation has not been effective in improving audit quality in Indonesia. In addition, it is also evidence that the parent auditor is too dependent on the work of the component auditor, who is the parent auditor's affiliate. In the context of this study, because the component auditor is also the parent auditor, this means the parent auditor becomes too dependent on the component auditor from the same accounting firm. If the component auditor comes from a different accounting firm, the audit process will be conducted more cautiously, in the knowledge that the working papers will be reviewed by the parent auditor. On the other hand, the parent auditor will also make more detailed reviews, because any differences between the component and parent auditors mean the parent auditor must be more careful.

The questionnaires distributed to the auditors show consistent results. According to ISA 600, subsidiary companies do not need to always be audited by the group auditor; they may still be audited by another accounting firm, but the group auditor must supervise and inspect the subsidiary's audit program and working papers. However, it seems that the group auditors do not want to bear the risk. The implication of this study is that regulators should introduce regulations to protect small accounting firms from negative impacts of ISA 600. They need to socialize that with ISA 600, the subsidiary should not always be audited by the group auditor.

The application of Isa 600 does not aim to move all audit work to one auditor who is a group auditor. ISA 600 aims to improve audit quality with supervision by the group auditor on component auditors. However, the application of ISA 600 has an impact on the shift of auditors that audit the subsidiaries to the group auditor because the group auditor does not want to bear the audit risk. So that this study found no evidence that the application of ISA had an impact on increasing audit quality.

Therefore there needs to be some regulations so that the implementation of ISA can achieve its objectives to improve the quality of the audit. The group companies and their affiliates must be audited by different audit companies and the group auditors ensure that the audits performed on the subsidiaries meet audit standards.

Limitations

The limitation of this study is that it only uses the absolute discretionary accruals (ABS_DAC) of McNichols to detect earnings quality as a proxy of audit quality. Future research could use other models, such as the Kasznik model, that of Kothari or the Modified Jones Model for comparison.

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