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# The Effects of Corporate Governance on Audit Quality: An Empirical Study of Non-Financial Companies Listed on the Idx (2020-2022)

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A B S T R A C T

This study aims to examine the effects of corporate governance on audit quality. Board size, independent commissioners, institutional ownership and financial literacy of the audit committee are independent variables in this study. The dependent variable in this study is audit quality. Control variables are also involved in this study, which include firm size and firm age. The logistic regression analysis method was used in this study. All data used was obtained from the annual reports of non-financial companies listed on the Indonesia Stock Exchange for 2020-2022. A total of 936 samples were selected using a purposive sampling method. The study results show that board size and financial literacy of the audit committee have a significant positive effect on audit quality. Independent commissioners and institutional ownership also have a positive effect but not significant on audit quality. These findings may indicate that increasing the board size and the presence of audit committee members who have accounting knowledge can improve audit quality in the company

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## INTRODUCTION

To ensure that financial statements comply with established standards, an audit of the financial statements must be conducted (Mulyadi, 2002). Audited financial statements play a significant role in maintaining relationships with stakeholders who do not have direct access to verify the information, as explained in Agency Theory (Bansal & Sharma, 2016). Audit quality is considered a key factor in ensuring the credibility of financial information (Beasley et al., 2000). Efforts to prevent potential misstatements in financial statements can be made through the audit process, but not all misstatements can be identified. Misstatements in financial statements can affect the audit quality, as explained by Mardijuwono & Subianto (2018).

Attention to audit quality continues to increase, especially with the emergence of cases of auditor violations during audits. One such case involves the public accountant Kasner Sirumapea during the 2018 financial statement audit of PT Garuda Indonesia Tbk. At that time, PT Garuda Indonesia Tbk committed fraud in its financial statements, but the auditor failed to detect it due to violations of auditing standards (SA 315, SA 500, and SA 560) by the auditor, which affected the opinion of the Independent Auditor's Report. Additionally, the audit firm had not optimally implemented a quality control system regarding external consultations. Besides this case, the Report to the Nation (RTTN) by ACFE in 2020 and 2022 found that external audits only accounted for 4% of detected fraud in companies. This finding indicates that of all the reported fraud cases, only a small portion was uncovered through the external audit process.

Audit is one of the various mechanisms used in corporate governance (Coffee Jr, 2002). The role of corporate governance is to protect the company from potential financial fraud and audit failures in the future by implementing structures, regulations, and processes designed to ensure transparent, accountable, and responsible management. Audit quality can be influenced by several corporate governance proxies (Puwanenthiren & Sivarajah, 2022).

## LITERATURE REVIEW

### Agency Theory

According to agency theory, agents will prioritize their personal interests, which may conflict with the interests of the principal (Ghozali, 2020). Consequently, agency theory suggests control strategies to address these conflicts, such as monitoring manager performance through the implementation of corporate governance and involving audits (Abu Afifa et al., 2023). According to the agency theory literature, companies that implement good governance practices are able to encourage management to provide more comprehensive information for the benefit of investors or shareholders (Elmarzouky et al., 2023). This study used agency theory because it encompasses aspects of corporate governance practices that play a role in enhancing control and preventing fraudulent actions by management, while emphasizing the importance of high audit quality in protecting stakeholder interests (Knechel, 2016). According to Alawaqleh & Almasria (2021), audit quality is a critical requirement in addressing agency issues.

**Corporate Governance**

According to Puwanenthiren & Sivarajah (2022), corporate governance plays a crucial role in protecting companies from potential financial difficulties in the future. Corporate governance involves a series of provisions that manage the relationships among various stakeholders in the company, such as management, creditors, shareholders, and others. This includes the rights and obligations of stakeholders, making corporate governance a system for managing and overseeing business operations (Widani & Bernawati, 2020). Corporate governance involves methods and systems used by those concerned with the overall success of the company to protect their interests (Aljifri & Moustafa, 2007). The ultimate goal of corporate governance is to maximize long-term value for shareholders, and the optimal implementation of corporate governance practices has greater potential for excellence compared to competitors (Khanchel, 2007).

**Audit Quality**

Audit quality, according to Davidson & Neu (1993), encompasses the auditor's ability to identify and disclose errors and manipulations in financial statements. The quality of audit is determined by the auditor's competence and professionalism, which are acquired through sufficient knowledge, skills, and experience in the field of auditing. Corporate governance practices, as mentioned by Puwanenthiren & Sivarajah (2022), influence the level of audit quality by ensuring transparency and honesty in financial and operational reporting. Effective internal monitoring and control systems are also crucial components of corporate governance, helping to identify and manage operational risks, thereby reducing the potential for errors or fraud that could affect audit quality (Knechel, 2016). According to Qawqzeh et al. (2021), there is a high interaction between corporate governance mechanisms and the function of external audit quality. These two components complement each other and have a close relationship. Effective corporate governance mechanisms strive to achieve higher levels of external audit quality. At the same time, external auditors are expected to enhance corporate governance mechanisms (Wan Abdullah et al., 2008).

**Hypotheses Development**

***1. Board Size***

In agency theory, when the interests of investors and management are not aligned, and investors have limited information to accurately transmit management behavior, agency problems will arise (Ghozali, 2020). The emergence of this agency problem causes agency costs (Jensen & Meckling, 1976). A large board size can reduce agency costs, which in turn can increase audit quality (Puwanenthiren & Sivarajah, 2022). A large board of directors allows for a more transparent and objective decision-making process, so that board decisions are based on a broader perspective and can reduce risk bias and conflicts of interest. This transparency can create a more effective control environment that can help auditors minimize the risk of material errors in financial statements (Beasley et al., 2000). Likewise, the results of research from Alawaqleh & Almasria (2021), board size significantly affects audit quality. A larger board size indicates more resources and capabilities to rely on in assisting the audit. Auditors can obtain audit evidence with the help of the board of

directors. Top management of the company and regulators can consider this criterion seriously to improve the quality of financial reporting and auditing (Alawaqleh & Almasria, 2021). The first hypothesis for examine the effect of board size on audit quality is as follows:

H1: Board size has a significant positive effect on audit quality.

***2. Independent Commissioner***

According to previous research, increasing independent representation can improve the quality of the audit process in various aspects. According to Puwanenthiren & Sivarajah (2022), independent commissioners have strong knowledge or valuable information about audit quality so that the existence of an independent board can produce more optimal audit choices and support companies in attracting quality resources. Auditors can discuss issues that arise during the audit process with independent board members who are not influenced by management. Research from Al-Hamadeen et al. (2021) found that a large proportion of independent commissioners has a significant positive impact on audit quality proxies. These findings indicate that increasing the proportion of independent members in the board of commissioners can increase effective supervision so as to avoid agency conflicts and information asymmetry problems, which will ultimately improve audit quality. Independent commissioners can carry out supervisory duties more objectively and comprehensively. With more effective supervision and reduced information asymmetry, external auditors will have more accurate access and information when conducting audits (Al-Hamadeen et al., 2021). The second hypothesis for examine the effect of independent commissioners on audit quality is as follows:

H2: Independent commissioners have a significant positive influence on audit quality.

***3. Institutional Ownership***

Odudu et al. (2018) reported a negative effect of institutional ownership on external audit quality. A large amount of share ownership is unable to effectively monitor actions in the company (Sofyaningsih & Hardiningsih, 2011). Investors may not have full access to the information held by managers so that control over good decision-making related to audits is difficult (Sofyaningsih & Hardiningsih, 2011). On the other hand, Qawqzeh et al. (2021) revealed that institutional ownership improves audit quality. Institutional investors are interested in choosing high-quality auditors in order to obtain reliable information to increase wealth. The third hypothesis for examine the effect of institutional ownership on audit quality is as follows:

H3: Institutional ownership has a significant positive effect on audit quality.

***4. Financial Literacy of Audit Committee***

Several studies have found that the proportion of accounting experts on the audit committee has an impact on audit quality. Bruynseels & Cardinaels (2014) revealed that the proportion of financial experts on the audit committee has a positive impact on the demand for audit effort, as measured by audit fees. Higher audit fees can indicate greater audit effort, resulting in increased audit quality (Ghafran & O'Sullivan, 2017). Research conducted by Puwanenthiren & Sivarajah (2022) also shows that there is a significant positive relationship

between financial literacy of the audit committee and audit quality. An audit committee with a high proportion of accounting experts is valuable because it shows support for the auditor. The extensive accounting expertise on the audit committee can be more effective in reviewing and understanding financial statements, as well as in communicating with external auditors. Constructive communication between the audit committee and external auditors helps solve problems more efficiently. Conversely, the results of research conducted by (Ghafran & O'Sullivan, 2017), the level of non-accounting expertise has a more positive impact on audit quality than the level of accounting expertise members on the audit committee. This is because the non-accounting expertise in audit committee members can bring different and diverse perspectives to the audit process. The fourth hypothesis for examine the effect of financial literacy of audit committee on audit quality is as follows:

H4: Financial literacy of audit committee has a significant positive effect on audit quality.

## METHODOLOGY

The study focuses on non-financial companies listed on the Indonesia Stock Exchange during the 2020-2022 period which are the research samples. The non-financial sector covers various fields, such as manufacturing, retail, mining, agriculture, industry, and others. Based on Puwanenthiren & Sivarajah (2022), financial companies have a high level of regulation and extensive use of leverage that will distort the results, so non-financial companies were chosen as the objects of this study. The recency of data related to research on the effect of corporate governance on audit quality that has been carried out previously is the reason for choosing this research period. Purposive sampling is the method chosen by the researcher as the basis for determining the sample. The criteria or requirements set for the selection of this sample are as follows:

1. Non-financial companies listed on the IDX in 2020.
2. Non-financial companies have not been delisted from 2020-2022.
3. Non-financial companies publish complete annual reports from 2020-2022.
4. Non-financial companies publish financial reports using the rupiah currency.
5. Non-financial companies have complete variable data needed in 2020-2022.

The research data was obtained from the annual reports of non-financial companies listed on the IDX in 2020-2022. The sources for obtaining data are the official website of the Indonesia Stock Exchange, the websites of each company, and Bloomberg Diponegoro University. The study involved a series of statistical tests to process the collected data, including descriptive analysis and logistic regression. SPSS version 29 was used as a statistical tool for analysis and testing this research. For the measurement of each variable is described in table 1.

Table 1. Variables Measurement

| Variable | Measurement | Reference |
|---|---|---|
| KA | Dummy variable, value 1 for Big 4, value 0 for Non-Big 4 | Puwanenthiren & Sivarajah (2022) |
| UD | Number of board of directors in the company | Puwanenthiren & Sivarajah (2022) |
| KI | The number of independent commissioners divided by the total number of board of commissioners | Puwanenthiren & Sivarajah (2022) |
| INSOWN | The number of institutional investor's shares divided by the number of shares outstanding | Qawqzeh et al. (2021) |
| LKKA | Number of audit committee financial experts divided by the number of audit committees | Ghafran & O'Sullivan (2017) |
| SIZE | The natural logarithm of a company's assets | Puwanenthiren & Sivarajah (2022) |
| AGE | The natural logarithm of the total years the company has been established | Puwanenthiren & Sivarajah (2022) |

## RESULT AND DISCUSSION

### Descriptive Statistics

Descriptive statistics is an analysis method that can provide a summary of data related to the uniqueness of each variable, where in this study the variables are audit quality, board size, independent commissioners, institutional ownership, financial literacy of audit committee, firm size and firm age. The uniqueness of each variable is reflected in the smallest value, the largest value, the average value, and the standard deviation value. However, for dummy variables, frequency is used to describe the data. This test is shown in table 2 and table 3.

Table 2. Descriptive Statistics

| Variable | N | Minimum | Maximum | Mean | Std. Deviation |
|---|---|---|---|---|---|
| UD | 936 | 2 | 12 | 4,31 | 1,966 |
| KI | 936 | 0,200 | 0,750 | 0,421 | 0,100 |
| INSOWN | 936 | 0,008 | 0,980 | 0,624 | 0,235 |
| LKKA | 936 | 0,250 | 1,000 | 0,534 | 0,262 |
| SIZE | 936 | 20,993 | 33,455 | 28,403 | 1,745 |
| AGE | 936 | 1,386 | 4,710 | 3,296 | 0,623 |

Source: Output SPSS 29, 2024

Table 3: Descriptive Statistics of Dummy Variables

| | | Frequency | Percent |
|---|---|---|---|
| KA | Non-Big 4 | 668 | 71,4 |
| | Big 4 | 268 | 28,6 |
| | Total | 936 | 100,0 |

Source: Output SPSS 29, 2024

Table 2 and table 3 shows the number of sample data used in each variable as many as 936 data. Table 2 shows descriptive statistics on the size of the board of directors, independent commissioners, institutional ownership, financial literacy of the audit committee, size and age of the company. The average of board size is 4.31 and the standard deviation value is 1.966. The results show that the variable of board size has a smaller standard deviation than the mean (1.966 < 4.31) which can be concluded that the distribution range of the independent commissioner variable is low. The average of independent commissioners is 0.421 and the standard deviation is 0.1. The results show that independent commissioners have a standard deviation lower than the mean (0.100 < 0.421) which can be concluded that the distribution range of independent commissioner variables is low. The average of institutional ownership is 0.624 and the standard deviation is 0.235. The results show that institutional ownership has a lower standard deviation than the mean (0.235 < 0.624) which can be concluded that the distribution range of the independent commissioner variable is low. The mean of financial literacy of audit committee is 0.534 and the standard deviation is 0.262. The results show that the financial literacy variable of the audit committee has a lower standard deviation than its mean (0.262 < 0.534) which can be concluded that the distribution range of this variable is low.

Table 3 shows the results of descriptive statistics of audit quality. Measurement of audit quality with dummy variables. Based on the table, the results show that 668 samples used auditors from non-Big 4 audit firm to audit their companies with a percentage of 71.4%. In addition, companies audited by Big 4 auditors were 268 samples out of a total of 936 samples with a percentage of 28.6%. This shows that the percentage of auditor use from non-Big 4 audit firm is greater than the use of auditors from Big 4 audit firm in the selected samples.

**Logistic Regression**

The binary logistic regression method is a method used in analyzing research data. Before conducting logistic regression analysis, a multicollinearity test will be carried out. If the data is proven to have no multicollinearity, then the test can be continued. Logistic regression analysis includes several tests, which are the overall model fit test, Hosmer and Lemeshow's goodness of fit test, determination coefficient test, classification matrix and hypothesis testing.

***1. Multicollinearity Test***

The results of the multicollinearity test show that the research data does not experience multicollinearity, as shown in the test results of each research variable having a VIF result of less than 10. The multicollinearity test produces a VIF value of board size with a number of 1.710. Independent commissioners have a VIF of 1.030. The institutional ownership variable has a VIF of 1.031. The audit committee financial literacy variable has a VIF of 1.233. Meanwhile, the company size control variable has a VIF of 1.463. The company age variable has a VIF of 1.161. The results of the multicollinearity test are in table 4.

Table 4. Multicollinearity Test

| Variable | VIF |
|---|---|
| UD | 1,710 |
| KI | 1,030 |
| INSOWN | 1,031 |
| LKKA | 1,233 |
| SIZE | 1,463 |
| AGE | 1,161 |

Source: Output SPSS 29, 2024

**2. *Overall Model Fit Test***

According to table 5, the value of -2LogL before the independent variable was entered was 1121.006. After the independent variable was entered, it was seen that the value of -2LogL became 284.847. In both values, there was a decrease in the value of -2LogL of 836.159. This decrease indicates that there is a match between the model and the data.

Table 5. Overall Model Fit Test

| -2LogL | |
|---|---|
| Block Number = 0 | 1121,006 |
| Block Number = 1 | 284,862 |

Source: Output SPSS 29, 2024

**3. *Hosmer and Lemeshow's Goodness of Fit Test***

Table 6 shows the results of the Hosmer and Lemeshow Goodness of Fit Test, where the chi-square gets a number of 2.087 and the significance level gets a number of 0.978. This means that the significance number is greater than 0.05 (0.978 ≥ 0.05), the null hypothesis is accepted. The conclusion of the test is that there is no significant difference between the regression model and the research data. The research regression model is able to predict its observation values so it is considered good.

Table 6. Hosmer and Lemeshow's Goodness of Fit Test

| Step | Chi-square | df | Sig. |
|---|---|---|---|
| 1 | 2,087 | 8 | 0,978 |

Source: Output SPSS 29, 2024

**4. *Determination Coefficient Test***

As seen in table 7, the test shows the results of the Nagelkerke R Square determination coefficient of 0.846. The results indicate the ability of independent variables including board size, independent commissioners, institutional ownership, and financial literacy of audit committee in effecting the audit quality variable has a strength of 84.6%. The results of this test also show that there is a percentage of factors other than the independent research variables that affect the dependent variable by 15.4%.

Table 7. Determination Coefficient Test

| Model Summary | | | |
|---|---|---|---|
| **Step** | **-2 Log likelihood** | **Cox & Snell R Square** | **Nagelkerke R Square** |
| 1 | 284.862[a] | 0,591 | 0,846 |

Source: Output SPSS 29, 2024

### *5. Classification Matrix*

As seen from table 4.8, the results reveal the model's ability to predict the audit firm that audits the company is 94.4%. The analysis results show that out of 666 samples, the total sample predicted that the company would choose a non-Big 4 audit firm audit service was 641 with an accuracy percentage of 90.7%. The results also show that 243 out of 270 company samples chose a Big 4 audit firm service with a precision percentage of 90.7%.

Table 8. Classification Matrix

| **Observed** | | **Predicted** | | |
|---|---|---|---|---|
| | | **KA** | | **Percentage Correct** |
| | | **Non-Big 4** | **Big 4** | |
| KA | Non-Big 4 | 641 | 27 | 96,0 |
| | Big 4 | 25 | 243 | 90,7 |
| **Overall Percentage** | | | | 94,4 |

Source: Output SPSS 29, 2024

### *6. Omnibus Test of Model Coefficients*

Table 9 shows the results of the significance figure obtained at 0.000. The results show a significance figure smaller than 0.05. This means that it is concluded that all independent variables together with control variables have a significant influence on the dependent variable simultaneously.

Table 9. Omnibus Test of Model Coefficients

| | **Chi-square** | **df** | **Sig.** |
|---|---|---|---|
| Step 1 | 836,144 | 6 | 0,000 |

Source: Output SPSS 29, 2024

### *7. Wald Test*

Wald test is a test that aims to test whether the independent variables are partially able to effect the dependent variables. Based on table 10, the board size (UD), which is an independent variable, produces a significance value of 0.000 with a Log of odds value of 1.454. Based on these results, it is known that significantly, the board size (UD) has a positive effect on audit quality, so H1 is accepted. The test results are also supported by previous studies, namely Puwanenthiren & Sivarajah (2022) who found that board size has a significant effect on audit quality. A larger board of directors usually includes members with diverse backgrounds and expertise. This diversity allows the board to better handle complex issues, including audit and internal control issues (Puwanenthiren & Sivarajah, 2022).

The second independent variable, independent commissioner (KI), produces a significance of 0.780 with a Log of odds of 0.448. Based on these results, the independent commissioner (KI) variable has a positive but insignificant effect on audit quality because the resulting significance figure is higher than 0.05. The findings can be concluded as unable to support the second hypothesis which assumes that independent commissioners have a significant positive effect on audit quality, so H2 is rejected. The test results are also supported by the studies of Makni et al. (2012) and Puspaningsih & Faza Sabella (2017) which found that independent commissioners do not have a significant effect on audit quality. This means that the number of independent members in the commissioners is not able to influence the level of audit quality in the company. From this conclusion, it can be said that independent commissioners are not a factor that can influence audit quality. This finding supports the idea that independent commissioners are recognized as parties who are able to ensure reliable financial reporting, so that audit quality is not greatly influenced by which auditor the company chooses, because the main focus is on protecting the interests of shareholders (Makni et al., 2012).

Institutional ownership (INSOWN), which is the third independent variable, produces a significance of 0.186 with a Log of odds of 0.845. Based on these results, the significance value of the test results of 0.186> 0.05 indicates that institutional ownership has a positive but insignificant effect on audit quality. Based on the test, it is concluded that it is unable to support the third hypothesis which assumes that independent commissioners have an effect on audit quality, so H3 is rejected. In line with the findings of this study, Khasharmeh et al. (2017) and Puspaningsih & Faza Sabella (2017) found that institutional ownership has a positive but insignificant effect on audit quality. This means that the percentage of institutional share ownership is unable to influence the level of audit quality in the company. A high percentage of institutional ownership cannot guarantee a high level of audit quality either. From this conclusion, it can be said that institutional ownership is not a factor that can influence audit quality. Institutional investors prioritize short-term performance and maximizing personal interests (Makni et al., 2012).

According to table 10, financial literacy of audit committee (LKKA) is significant at a probability of 0.000 with a Log of odds value of 6.884. Based on the test results, it can be seen that significantly, the financial literacy of audit committee has a positive effect on audit quality, so H4 is accepted. In line with the results of this study, Puwanenthiren & Sivarajah (2022) revealed the findings of a significant positive influence of financial literacy of audit committee members on the quality of the resulting audit. According to him, expertise in accounting and finance opens up opportunities for the audit committee to more effectively understand the company's financial statements so that it will improve the quality of the audit process.

Table 10. Wald Test

| | | B | Sig. |
|---|---|---|---|
| Step 1[a] | UD | 1,454 | 0,000 |
| | KI | 0,448 | 0,780 |
| | INSOWN | 0,845 | 0,186 |
| | LKKA | 6,884 | 0,000 |
| | SIZE | 0,198 | 0,074 |
| | AGE | -0,198 | 0,521 |
| | Constant | -18,066 | 0,000 |

Source: Output SPSS 29, 2024

## CONCLUSIONS AND RECOMMENDATIONS

The research conducted is to test the effect of corporate governance, which is proxied by the variables of board size, independent commissioners, institutional ownership, and financial literacy of the audit committee, on audit quality. Agency theory and previous studies are the basis for generating hypotheses, which then from the results of the test produce empirical evidence. The population of the study was non-financial companies listed on the Indonesia Stock Exchange in 2020-2022. With purposive sampling as the basis for determining the sample, 936 samples were selected, then analyzed using the logistic regression method. Based on the test results, all corporate governance variables have a positive effect on audit quality. The board size and financial literacy of the audit committee have a significant positive effect on audit quality, while independent commissioners and institutional ownership have a positive but insignificant effect on audit quality. The results show that corporate governance practices can affect audit quality and provide confidence that effective supervision and management in the company have a positive impact on the audit process carried out. Companies can focus on developing corporate governance practices so that companies can improve the quality of the audits they carry out.

## FURTHER STUDY

This research related to the effect of corporate governance on audit quality has limitations. The limitation is that the measurement of audit quality using a dummy variable, namely a value of 1 for big 4 audit firm and a value of 0 for non-big 4 audit firm, has become less relevant over time because there have been cases of fraud from big 4 audit firm and the increasing development of non-big 4 audit firm (Rahayu et al., 2020). Based on the limitations that arise, researchers expect improvements and developments in further research to complement this research. The development that the author can suggest for future research is to apply different measurements for audit quality, such as going concern audit opinions, Audit Quality Metric Score (AQMS), or other relevant audit quality measurements.

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