

The Impact of Accounting Conservatism in Mediating Auditor Rotation and Audit Quality

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ABSTRACT

The research data were gathered from Public Accounting Firms (KAP) in Makassar City that consented to participate. A field research methodology was employed, with primary data collected through questionnaires distributed to 34 respondents. The data were then analyzed using Structural Equation Modeling (SEM) with Smart PLS software. The results indicate that auditor rotation has a positive and statistically significant effect on accounting conservatism. Additionally, the findings reveal that auditor rotation also significantly enhances audit quality, with accounting conservatism acting as a mediator in this relationship. This suggests that accounting conservatism plays a crucial role in strengthening the impact of auditor rotation on audit quality, providing valuable insights for both academic research and practical applications in the auditing profession.

INTRODUCTION

Rapidly advancing technology that continues to grow is capable of providing convenience and increasing competition among businesses in the era of globalization. Companies are required to prioritize high profits while striving to ensure the fairness of their financial statements. One of the efforts demonstrated by companies is using audit services to monitor their activities. To facilitate the stakeholders and management in ensuring the reliability of financial statements, the role of an independent and competent third party is necessary, hence the importance of the public accounting profession. Financial statements that are independently audited by public accountants are more trusted by the public. Auditors play a central role in efficiently functioning public markets through their contribution to financial statement reporting (Brigham and Houston, 2019).

Financial statements are reports that depict a company's financial status, performance, changes, and other aspects over a specific period as information for stakeholders who use financial reports in the decision-making process. Financial statements are expected to have the appropriate quality for decision-making. Therefore, the services of an independent party are required to audit these financial statements. This service is provided by an independent auditor through audit services. An audit is a structured review of a company's financial statements conducted by an objective third party by gathering and examining evidence in the financial reports to assess whether the financial statements are fairly presented or not (Irma et al., 2019).

Many studies show that the primary responsibility for producing accurate financial records does not rest solely with management and directors, but also raises questions regarding the standards and objectivity of external auditors in the audit process. This is because audited financial documents are products of public accounting firms (KAP), which means KAP plays a role in determining the quality of financial statements. Auditors play a crucial role in maintaining audit quality, oversight, and financial control by providing accurate and reliable information for decision-making (Nugraha, 2014). The public accounting profession is expected to deliver its services in accordance with established accounting standards, offer recommendations on documentation practices related to their work, and consider various factors to ensure high-quality audits.

In recent years, there have been numerous cases involving public accounting professionals related to audit quality. In Indonesia, many cases involve Public Accounting Firms. According to the official website of the Ministry of Finance (2018), the Financial Profession Development Center (PPPK) has conducted research and found evidence of violations of the standards set for the accounting profession. This pertains to the audit of the financial statements of PT Sunprima Nusantara Pembiayaan (SNP Finance), which was conducted by two public accountants. Financial Profession Development Center (PPPK) audited the Public Accounting Firm and the two auditors to ensure compliance. The audit findings concluded that auditors Merlina and Merlyana did not fully adhere to audit standards and professional standards when conducting a comprehensive audit of SNP Finance's financial statements. Based on these

findings, the Minister of Finance ordered a temporary suspension of Auditor Merlina and Auditor Merlyana Shamsul for 12 months, which included restrictions on providing audit services in the financial services sector (such as financial services and insurance services) and imposed administrative sanctions. This suspension was effective from September 16, 2018, to September 15, 2019 (keuangan.kontan.co.id).

Several studies have been conducted regarding the impact of audit rotation on audit quality, but the results are not always consistent. For example, research by Permatasari and Astuti (2019) revealed that audit rotation has a positive effect on audit quality, with each change in public accountants leading to improvements in audit quality. On the other hand, Suciana and Angelina (2018) argued that audit quality is not significantly affected by audit rotation. In relation to this topic, there are also differing views as shown by Ishak et al. (2016). They stated that audit rotation actually has a negative impact on auditing quality. Their research model used variations in auditor rotation, audit duration, and conservative accounting principles (Ishak et al., 2015). This model is somewhat different from that proposed by Georgakopoulos et al. (2011), who focused more on the rotation of Public Accounting Firms and their tenure (Georgakopoulos et al., 2011).

LITERATURE REVIEW

Agency Theory

Jensen & Meckling (1976), as cited in Mulyani & Munthe (2019), state that agency theory involves one or more individuals (principals) engaging a third party (agent) to act on their behalf, performing tasks on behalf of the principal. This may involve delegating decision-making authority to the agent. According to Suciana and Setiawan (2018), agency theory seeks to harmonize the interests of the principal and the agent within a contract to avoid conflicts of interest. The theory addresses conflicts of interest between managers, who act as agents, and shareholders, who are the principals. Managers might act in their personal interests rather than maximizing the company's value, leading to agency costs (Mulyani and Munthe, 2019). External auditors are considered capable of bridging the gap between clients and managers and minimizing such conflicts (Kap et al., 2013, as cited in Rafli and Amin, 2021). The auditor's responsibility is to issue an opinion on the accuracy of financial statements, ensuring they are free from material misstatements, thereby enhancing shareholders' trust in management. Additionally, auditors can improve public confidence in the activities and results of business entities.

Audit Quality

Audit quality is defined as the situation where auditors detect and report non-compliance with principles in the client's financial statements (Putri, 2020). According to Irma et al. (2019), audit quality reflects the auditor's ability to conduct audits in accordance with established standards, allowing them to detect and report errors and violations by the client. The results of an audit based on auditing standards contribute to the clarity of responses regarding audit quality (Berikang et al., 2018). The auditor's ability to assess the fairness of financial statements enhances audit quality and improves the quality of information conveyed by management to the owners (Anggina et al., 2021).

Accounting Conservatism

Conservatism in financial reporting refers to a cautious approach where companies recognize potential losses and liabilities as soon as they are identified, while being careful not to overstate assets or profits. This principle leads to the adoption of accounting practices that tend to report lower profits or asset values and higher liabilities (Watts, 2003, as cited in Andreas et al., 2017). The core principle of conservatism is to prevent overestimating a company's financial position, offering a more cautious view of its economic reality. By using conservative accounting methods, companies aim to avoid misleading stakeholders with overly optimistic financial statements. This approach helps mitigate the uncertainty of future events, such as market declines or unforeseen liabilities, enhancing transparency and reducing the risk of financial misstatements. As a result, conservative reporting fosters trust among investors and stakeholders. Under this concept, revenue recognition is slower, and expense recognition is quicker, which causes net income to appear lower. Furthermore, conservatism leads to financial reporting that is more pessimistic and reduces the optimistic outlook of report users (Ardina & Januarti, 2012, as cited in Andreas et al., 2017).

Accounting conservatism refers to the choice of accounting policies and estimates that keep the recorded amount of an asset significantly lower (Penman and Zhang, 2002, as cited in Andreas et al., 2017). Another model for applying conservative principles in accounting is choosing to expense research and development costs rather than capitalizing and depreciating them. The selection of depreciation methods that are consistently based on short estimates of the useful life of fixed assets demonstrates the implementation of conservative principles in financial reporting. In other words, depreciable assets are valued much lower than they should be because the company expends more on depreciation than the economic depreciation.

Audit Rotation

Audit rotation refers to the requirement for an entity or company to change its Public Accounting Firm (KAP). The length of the client-auditor relationship can impact the independence and accuracy of the auditor in performing audit engagements. The Enron scandal involving Arthur Andersen (AA) led to mandatory auditor rotation in Indonesia. The implementation of mandatory rotation aims to enhance auditor independence both in appearance and practice. This mandatory rotation is expected to have a significant impact on audit practices by maintaining auditor independence (Berikang et al., 2018). Therefore, audit rotation should comply with the regulations set forth in the Minister of Finance Decree No. 17/PMK.01/2008, issued on February 5, 2008, to avoid any special relationships between the auditor and the client that could affect audit quality. Auditor replacement audits are conducted every three years, and auditor tenure replacement audits are conducted.

Hypothesis

This study includes two hypotheses concerning auditor rotation and the impact of audit rotation on audit quality, using accounting conservatism as a mediating variable. The proposed hypotheses are as follows:

The Effect of Auditor Rotation on Accounting Conservatism

The contract between the client and the audit firm or auditor can also be terminated according to the agreed terms, and auditor rotation can occur under other conditions. Generally, auditor rotation has two characteristics: mandatory and voluntary. Mandatory auditor rotation is the replacement of auditors at specified intervals according to client regulations and government rules where the auditor is located. In contrast, voluntary auditor rotation occurs at the initiative of the client and/or the auditor themselves.

Fransiskus et al. (2005), as cited in Georgakopoulos et al. (2011), found that better financial statement quality can be achieved by applying accounting conservatism, which ensures higher quality financial statements. Regarding auditor rotation, the conclusion is that the improvement in financial reporting quality after auditor rotation is due to increased accounting conservatism in financial reporting (Georgakopoulos et al., 2011; Ilyas et al., 2024). This is supported by research from Hamilton et al. (2005), which indicates that current reporting is more reliable compared to previous periods, leading to the completion of auditor rotation. Based on the provided description, the hypothesis to be tested is:

H1 : Accounting conservatism is positively and significantly affected by auditor rotation.

The Mediating Effect of Accounting Conservatism Positively Influences the Impact of Audit Rotation on Audit Quality

From the perspective of agency theory, rotation requirements reflect the existence of a business entity. This business theory is essentially intended to address questions related to business existence, the boundaries between business and market, organizational structure, the heterogeneity of business activities concerning performance, and other aspects. To enhance investor confidence and the trust of financial statement users, business entities also strive to improve the quality of audited financial statements. Therefore, business entities are inclined to change audit partners in order to gain the trust of financial statement users.

A study by Firth et al. (2012) reports that mandatory audit partner rotation has a significant impact. The post-Enron era has drawn attention to the development of the accounting industry, focusing on the independent behavior and qualifications of company auditors. As a result, lawmakers, regulators, and professional bodies agree on implementing audit rotation to maintain auditor independence. Limiting the engagement period through rotation can be seen as a step toward achieving a high level of audit quality. This restriction aims to reduce the likelihood of a strong bond developing between the auditor and the client, which could affect the auditor's objectivity.

H2 : Accounting conservatism positively and significantly mediates the relationship between auditor rotation and audit quality.

Research Conceptual Framework

The conceptual framework for this research is as follows:

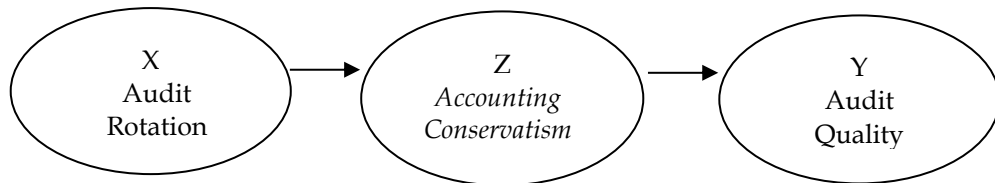


Figure 1. Conceptual Framework

METHODOLOGY

Population and Sample

The population in this study includes all auditors working at public accounting firms. Data will be collected from public accounting firms located in Makassar City and registered with the Indonesian Institute of Accountants (IAI) in the Makassar region. The sampling method used in this study is census sampling, as the entire population is used as the research sample (Sugiono, 2019).

Data Collection Techniques

Field research methods are used in this study. To collect field data, the research employs a method of distributing questionnaires to the research subjects. The field survey method involves using a list of statements that are answered directly by respondents. The questionnaires are distributed personally to auditors at public accounting firms in Makassar City.

Data Analysis Methods

The statistical approach used to test the hypotheses in this study involves utilizing the SmartPLS software. After all the data has been collected, the subsequent data analysis consists of:

Partial Least Square

In this study, the data analysis utilizes Partial Least Squares (PLS). PLS is a type of Structural Equation Modeling (SEM) that focuses on component-based variance. According to Ghozali and Kusumadewi (2023), PLS is an alternative approach that shifts from covariance-based SEM to variance-based SEM. Covariance-based SEM is generally used to test causal relationships or theories, while PLS is more oriented towards predictive modeling. PLS is considered an effective analytical method (Ghozali and Kusumadewi, 2023; Ruslan et al., 2024), as it does not rely on many assumptions. For instance, the data does not need to be normally distributed, and the sample size does not have to be large. Additionally, PLS can also be used for theory confirmation and to explain the existence or absence of relationships between latent variables.

a. Measurement Model or Outer Model

In the Measurement Model (Outer Model) of Partial Least Squares (PLS), three crucial components are used to explain the relationships between indicators and their latent variables. These components are:

- 1) *Covergent Validity.*
- 2) *Discriminant Validity.*
- 3) *Composite Reliability.*

b. Structural Model (Inner Model)

Path analysis is used to test the structural model or inner model in the context of the conceptual model to observe the correlations among constructs. The significance value of R-squared is obtained from the research model. The assessment of the structural model includes using R-squared for dependent variables and evaluating the t-test and significance of structural path coefficient parameters (Ghozali and Kusumadewi, 2023).

RESEARCH RESULT

Outer Model Testing

Three criteria for evaluating a model using SmartPLS data analysis techniques include convergent validity, discriminant validity, and composite reliability.

a. Convergent Validity

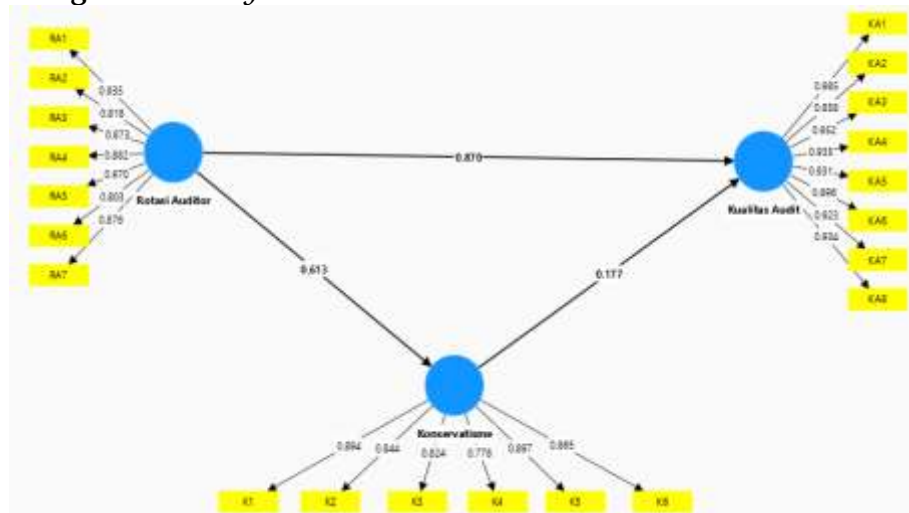


Figure 2. Factor Loadings

Figure 2 shows the results of the outer loading measurement test using SmartPLS for the indicators of auditor rotation, accounting conservatism, and audit quality variables. The figure indicates that RA1 to RA7, K1 to K6, and KA1 to KA8 are reflective indicators with factor loadings greater than 0.70. This means that all configuration indicators are valid. In conclusion, all indicators are valid for measuring the constructs of auditor rotation, conservatism, and audit quality.

b. Discriminant Validity Test

The basic principle of discriminant validity is that unrelated constructs should have low correlations with each other. One method to test discriminant validity for reflective indicators is by evaluating the cross-loadings of each indicator for each variable, where the loading values should be greater than 0.70 (Ghozali & Kusumadewi, 2023; Trisnawaty et al., 2024).

Tabel 1. Cross loading

	Konservatisme	Kualitas Audit	Rotasi Auditor
K 1	0.894	0.627	0.546
K 2	0.844	0.621	0.524
K 3	0.824	0.612	0.546
K 4	0.778	0.541	0.482
K 5	0.897	0.639	0.546
K 6	0.865	0.577	0.479
KA 1	0.662	0.985	0.970
KA 2	0.753	0.858	0.795
KA 3	0.600	0.952	0.962
KA 4	0.726	0.935	0.918

KA 5	0.575	0.931	0.919
KA 6	0.805	0.896	0.821
KA 7	0.569	0.923	0.936
KA 8	0.600	0.934	0.919
RA 1	0.543	0.890	0.935
RA 2	0.590	0.808	0.818
RA 3	0.536	0.860	0.873
RA 4	0.525	0.844	0.882
RA 5	0.662	0.985	0.970
RA 6	0.413	0.783	0.803
RA 7	0.482	0.844	0.876

Source: PLS Output, 2024

The results presented in Table 1 show that the cross-loading values indicate that each construct's indicator values exceed the values of the other constructs, with cross-loading values greater than 0.70. This indicates that all constructs or latent variables have good discriminant validity.

c. *Composite Reliability Test*

Reliability testing aims to determine whether a survey can effectively measure the indicators of a variable or construct. Measurement instruments, such as questionnaires, must produce consistent and stable data to be considered reliable. A construct is deemed to have an adequate level of reliability if the values of Composite Reliability (CR) and Cronbach's Alpha exceed the threshold of 0.70 (Nunnally, 1996, in Ghozali and Kusumadewi, 2023). Additionally, the Average Variance Extracted (AVE) is used as an evaluation tool to assess the reliability of scores on latent variable components. This method provides a simpler approach compared to composite reliability testing. According to recommendations by Fornell and Larcker (1981, in Ghozali and Kusumadewi, 2023), an acceptable AVE value should exceed 0.50, indicating that the majority of the variance in the indicators can be explained by the latent construct.

By meeting these criteria, the measurement instruments can be assured of sufficient quality to support the validity and accuracy of further analysis. Employing robust reliability tests ensures that research results are not only consistent but also dependable for making relevant interpretations and decisions. In the future, researchers can use these criteria as a foundation for developing more accurate measurement tools or refining indicators to better align with specific research contexts.

Table 2. Results of Cronbach's Alpha, Composite Reliability, and AVE Testing

	Cronbach's alpha	Composite reliability (rho_a)	Composite reliability (rho_c)	Average variance extracted (AVE)	Ket
Rotasi Auditor	0.951	0.956	0.960	0.777	Reliabil
Konservatisme	0.923	0.926	0.940	0.725	Reliabil
Kualitas Audit	0.977	0.978	0.980	0.860	Reliabil

Source: PLS Output, 2024

The findings presented in Table 2 demonstrate that the Cronbach's Alpha values for the variables meet acceptable standards, reflecting the reliability of the measurement instruments. Furthermore, the Composite Reliability (CR) values for all variables surpass the minimum required threshold of 0.70, indicating robust internal consistency across the constructs. In addition, the Average Variance Extracted (AVE) values for all configurations are greater than 0.50, which confirms that a substantial proportion of the variance in the observed variables is accounted for by the underlying constructs. These results collectively indicate that the measurement tools used in the study exhibit both high reliability and validity, ensuring the consistency and stability of the data collected.

This level of reliability implies that the statements and items included in the instruments effectively measure the intended constructs without significant measurement errors. Consequently, the instruments provide a solid foundation for further analysis and interpretation, contributing to the overall robustness of the research findings. Future studies could build upon these validated measures to explore additional dimensions or refine the existing constructs for even greater precision.

Structural Model Testing or Inner Model

The intrinsic model (intrinsic relationships, structural model, and content theory) illustrates the correlations between latent variables according to content theory. For example, constructs are assessed using R-squared values for latent dependent variables. When evaluating constructs using PLS, begin by reviewing the R-squared for each latent dependent variable. This interpretation is similar to regression analysis. Changes in R-squared values can help assess the direct impact of independent latent variables on dependent latent variables, provided the effect is significant (Ghozali and Kusumadewi, 2023).

Testing the Coefficient of Determination (R-Squared)

Table 3. R-Squared Values for Constructs

	R-square	R-square adjusted
Konservatisme	0.376	0.356
Kualitas Audit	0.976	0.974

The data presented in Table 3 reveals that the R-squared values for the variables of conservatism and audit quality are 0.376 and 0.976, respectively. These figures indicate differing levels of explanatory power, with conservatism showing a moderate level and audit quality demonstrating a very strong level of explanatory capability. Specifically, the R-squared value of 0.376 for conservatism implies that 37.6% of the variability in conservatism can be attributed to the influence of auditor rotation. This suggests that while auditor rotation plays a significant role, a substantial portion 62.4% of the variance in conservatism is driven by other factors not included in the scope of this research.

In contrast, the R-squared value for audit quality, which stands at 0.976 or 97.6%, reflects a much stronger relationship. This high percentage indicates that the variability in audit quality is predominantly explained by the combined effect of auditor rotation and conservatism, leaving only a minor portion 2.4% – accounted for by variables outside the parameters of this study. These findings highlight the varying degrees of impact and interconnectedness among the examined variables, providing valuable insights into the dynamics between auditor rotation, conservatism, and audit quality. Further exploration of the unexamined factors could deepen the understanding of these relationships and offer a more comprehensive perspective.

Hypothesis Testing Results

The evaluation of the proposed hypotheses was conducted using the inner model (structural model) approach. This involves examining the path coefficients and the t-values for statistical significance. The significance parameters help detail the connections between various research variables. The criterion for accepting or rejecting hypotheses is based on p-values, with the significance level set at $p < 0.05$.

1. Direct Effect

Table 4. Hypothesis Testing Based on Path Coefficient

Hipotesis 1	Original Sampel	T Statistik	P value	Ket
Rotasi Auditor -> Konservatisme	0.613	4.528	0.000	Signifikan

Source: PLS Output, 2024

Table 4 indicates that the auditor rotation variable has a significance level of 0.000 or $\text{sig} < 0.05$. The parameter coefficient of +0.613 reflects a positive impact on the dependent variable. This is the reason why H1 is accepted, and it is concluded that auditor rotation has a positive and significant impact on conservatism.

2. Indirect Effect

Table 5. Hypothesis Testing Based on Specific Indirect Effect

Hipotesis 2	Original Sampel	T Statistik	P value	Ket
Rotasi Auditor -> Konservatisme -> Kualitas Audit	0.108	2.599	0.009	Signifikan

Source: PLS Output, 2024

The results presented in Table 5 show that the auditor rotation variable has a significance level of 0.009, which is less than 0.05 (Sig < 0.05). The parameter coefficient of +0.108 indicates a positive relationship with the dependent variable. Based on this, H2 is accepted, suggesting that auditor rotation has a positive and significant effect on audit quality, with conservatism playing a mediating role. This implies that the relationship between auditor rotation and audit quality is influenced by the conservatism variable, which acts as an intermediary.

DISCUSSION

The Effect of Auditor Rotation on Conservatism

Research has shown that the conservatism variable is positively and significantly affected by auditor rotation. A higher level of auditor rotation will increase conservatism. During auditor rotation, this encourages clients to avoid fraud in preparing financial statements and to be more cautious in choosing the financial reporting methods to be used. This results in higher quality audit reports. The agreement between the client and the public accounting firm or auditor can be terminated based on a mutually agreed contract, which includes changes or auditor rotation. Generally, there are two types of auditor rotation: mandatory and voluntary. Mandatory auditor rotation involves changing auditors after a specified period determined by the government where the client and auditor are located. In contrast, voluntary auditor rotation occurs at the initiative of either the client or the auditor themselves.

Francis et al. (2005), as cited in Georgakopoulos et al. (2011), show that accounting quality improves with conservatism, meaning financial statements become more reliable. This relationship with auditor rotation suggests that the improvement in financial statement quality following auditor rotation is indicated by increased accounting conservatism in the financial statements (Georgakopoulos et al., 2011). This study is supported by findings from Hamilton et al. (2005), which indicate that auditor rotation leads to more conservative reporting. Georgakopoulos et al. (2011) argue that limiting the duration of audits is necessary to address the weakened auditor independence revealed by the Enron scandal. Long contract durations are considered one of the factors that could reduce financial statement quality due to lower audit quality (Georgakopoulos, G., I. Sotiropoulos, K. Z. Vasileiou, 2011).

The Effect of Auditor Rotation on Audit Quality through Conservatism

Research provides evidence that auditor rotation has a positive and significant effect on audit quality when mediated by accounting conservatism. In other words, auditor rotation not only directly affects audit quality but also impacts it indirectly through the influence of conservatism. This mediation effect highlights the importance of conservatism as a factor that strengthens the connection between auditor rotation and the improvement in audit quality. These findings underscore the need for further investigation into the mechanisms through which auditor rotation and conservatism interact to shape the overall effectiveness of audit practices. Such insights could provide valuable guidance for policy-makers and practitioners seeking to enhance the quality and reliability of audits within organizations.

Increased auditor rotation contributes to improved audit quality by leveraging the principle of conservatism. This relationship highlights the importance of regular auditor rotation as a mechanism to uphold rigorous audit standards and foster greater accountability in financial reporting. By encouraging conservative accounting practices, auditor rotation ensures that financial statements provide a more accurate and prudent representation of a company's financial position.

To enhance the confidence of investors and other stakeholders who rely on financial statements for decision-making, business entities continuously seek to improve the quality and credibility of audited financial reports. This involves not only adhering to professional audit standards but also adopting practices that reduce the risk of bias or complacency, such as rotating audit partners or audit firms. Such measures help maintain auditor independence and objectivity, which are critical to delivering reliable audit outcomes. As a result, companies implement changes in audit partners or engage new auditors periodically to strengthen stakeholder trust. This proactive approach not only aligns with regulatory requirements in some jurisdictions but also signals a commitment to transparency and good corporate governance. Ultimately, these practices contribute to building and maintaining the confidence of financial statement users, ensuring that the organization is viewed as a trustworthy and reliable entity in the market.

Another perspective supporting mandatory rotation is that it can enhance independent behavior, which in turn can improve audit quality, albeit at the cost of significant portfolio exposure to certain large clients. By increasing auditor independence, the audit quality standards applied can be safeguarded from deterioration due to errors made by non-independent auditors (Gietzman, 2002, as cited in Faisal, 2019). A study by Siregar et al. (2012) found that audit partner rotation had a negative impact before mandatory auditor rotation rules were introduced but had a positive effect once the audit firm rotation rules were implemented. This indicates that companies adhering to audit partner rotation rules have higher quality compared to audit firms that do not follow the rotation rules.

Research by Firth et al. (2012) concludes that mandatory audit partner rotation has a significant impact. The period following the Enron scandal has brought significant attention to the development of public accountants, focusing on the objectivity and quality achieved by audit firms. Therefore, legislators, regulatory authorities, and professional bodies have agreed to mandate auditor rotation to maintain auditor objectivity.

CONCLUSIONS

Based on the data collected and the hypothesis testing conducted using SmartPLS, the conclusions of this study are as follows:

1. Conservatism is significantly and positively affected by auditor rotation. The more frequent the auditor rotation, the higher the level of conservatism.
2. Accounting conservatism positively and significantly mediates the relationship between auditor rotation and audit quality. Increased auditor rotation leads to improved audit quality through conservatism.

ADVANCED RESEARCH

Still conducting further research to find out more about the Impact of Accounting Conservatism in Mediating Auditor Rotation and Audit Quality.

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