THE IMPACT OF CLIENT IMPORTANCE ON EARNINGS MANAGEMENT AND GOING-CONCERN OPINION: EMPIRICAL EVIDENCE FROM INDONESIA

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Abstract

This study investigates the impact of client importance on auditor independence measured by accrual earnings management and going-concern opinion. Our research sample consists of 1,080 firm-years of observation from listed companies in the Indonesia Stock Exchange (IDX) with eight years of observation (2004-2011). With pooled OLS we found that client importance has a negative impact on accrual earnings management. We also found evidence that client importance has a positive impact on going-concern opinion. Collectively, our evidence suggests that although audit firms have economic dependence toward their clients, those audit firms can maintain their audit quality by keeping their independency toward their clients, reflected by the lower accrual earnings management and higher tendency of issuing going-concern opinion. Our results are robust by considering the results of our sensitivity tests that support the main results.

Keywords: audit quality, auditor independence, client importance, earnings management, going-concern opinion

Abstrak

Penelitian ini menguji pengaruh kepentingan klien terhadap independensi auditor yang diukur dengan manajemen laba berbasis akrual dan opini going-concern. Sampel penelitian terdiri dari 1.080 observasi dalam tahun-perusahaan dari perusahaan terdaftar di Bursa Efek Indonesia (BEI) dengan delapan tahun pengamatan (2004-2011). Dengan menggunakan pooled OLS, kami menemukan bahwa kepentingan terhadap klien (client importance) berpengaruh negatif terhadap manajemen laba akrual. Kami juga menemukan bukti bahwa kepentingan terhadap klien berpengaruh positif terhadap opini going-concern. Secara keseluruhan, temuan-temuan kami menyimpulkan bahwa walaupun Kantor Akuntan Publik memiliki kepentingan ekonomi terhadap klien, namun Kantor Akuntan Publik memelihara kualitas audit dengan menjaga tingkat independensi terhadap klien mereka, tercermin dari manajemen laba akrual yang lebih rendah, dan terdapat kecenderungan yang lebih tinggi dalam memberikan opini going-concern. Hasil studi ini robust setelah mempertimbangkan hasil dari pengujian sensitivitas yang mendukung pengujian utamanya.

Kata kunci: *kualitas audit, independensi auditor, kepentingan terhadap klien, manajemen laba, opini going-concern*

INTRODUCTION

The audit quality of public accounting firms has been criticized in the last decade, since they could not protect the interests of investors (Coffee 2002; 2003; Levitt 1998). This audit quality has been defined by various definitions. DeAngelo (1981), for example, defines audit quality as the joint probability that the auditor will find a breach in the client's accounting system, and report that violation. In this definition, audit

quality covers the dimensions of competence and independence. Fitriany (2011) suggests that a higher degree of compentence from auditors is not always be accompanied by a higher degree of independence. In terms of independence, audit quality can be measured from different aspects, i.e., economic dependence toward clients, the influence of client practices toward the propensity to meet earnings targets, corporate governance practices, the propensity to issue going-concern opinions, the conducted peer review, or other measure of independence (Bamber and Bamber 2009).

Due to the auditor-client relationship, auditors may have incentives to compromise with their clients depending on the auditors' economic interests on their clients (DeAngelo 1981; Reynolds and Francis 2001). The proposition that the auditors will report favorably to retain important clients is known as the economic bonding (DeAngelo 1981). The independence of auditors can be reflected in the extent to which auditors will tolerate opport u-nistic earnings management, and how likely the auditors will issue going-concern opinion (Herusetya 2012; Francis and Yu, 2009).

Most of prior studies found that economic dependence does not encourage larger clients to perform greater discretions in accrual-based earnings management (e.g., Reynold and Francis 2001; Francis and Yu 2009; Herusetya 2012). Some previous studies found evidence that auditor independence impaired when clients pay for non-audit services is relatively higher compared to the total fee (Frankel, Johnson and Nelson 2002). They found evidence of a positive association between client importance (i.e., the ratio of non-audit services to total fee) and the amount of discretionary accruals. While Chung and Kallapur (2003) found no evidence on the association between client importance and abnormal accruals.

Past research also found the association between client importance and audit opinion issued by public accounting firms (e.g., Reynolds and Francis 2001; Craswell, Stokes and Laughton 2002; Chen, Sun and Wu 2010). Reynolds and Francis (2001) found that Big 5 did not treat larger clients with more compro-

mise than smaller clients based on the size of individual practice offices, i.e., by not reducing the propensity to issue going-concern opinions. Existing financial incentives were considered enough to motivate the auditors to be independent, despite the fact that the presence of economic dependence relationships was inherently in the auditor-client contract. Similarly, Craswell *et al.* (2002) found that fee dependence as a threat to auditor independence does not affect the likelihood of auditors to issue qualified audit opinions, both at national and local market levels.

The lack of evidence on the previous studies, which examined the associations between client importance, earnings management, and going-concern opinion are the main reasons of our study. The lack of past research on auditor independence in Indonesia, as measured by the economic dependence of auditors toward their clients will make some contributions to this study. First, Marchesi (2000) for example, found that audit quality in ASEAN countries was so compromise. But as the climate of audit environment in the United States has started to change since the corporate failure in 2001, which also gave impact to the legal and audit environment around the world including Indonesia[1] (Fargler and Jiang 2008; Chen *et al.* 2010), we expect to provide evidence on these associations. Secondly, past researches on audit quality were more dominated by the measurement of the competence dimension, for example, using the size of accounting firms (Big 4, etc) (Fitriany 2011; Siregar 2006; Francis 2004). Audit quality of the Big 4 firms in Indonesia may differ from the Big 4 firms in the United States who are under the Sarbanes Oxley Acts (Gordon *et al.* 2013). Our study contributes to the measurement of independence of the audit firms in Indonesia using a proxy of client importance which includes a sample of the Big 4 firms.

LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

Client Importance as a Measure of Auditor Independence

It was long been a suspicion that the auditors' financial interest toward their clients can greatly affect the auditor independence (Mautz and Sharaf 1961 in Chen *et al.* 2010). DeAngelo (1981) suggests that auditors' incentives to compromise their independence toward their client depends on the importance of a client to the auditor (client importance), i.e. the ratio of quasi rents specific to the client divided by the total number of quasi rents received by the auditor.

DeAngelo (1981) observed that if the percentage of the entire fee depends on one client used as a measure of audit quality (i.e., perceived independence with respect to that client) then the audit quality will decrease. The proposition that auditors will report favorably to retain important clients is known as economic bonding (DeAngelo 1981; Francis and Yu 2009), fee dependence, or economic dependence (Reynolds and Francis, 2001; Chen *et al.* 2010). It is probable that the greater the size of the clients in auditor's portfolio, the greater the incentive for the auditor to retain his clients, in which audit quality is likely to be compromised (Chen *et al.*2010).

Client Importance and Earnings Management

Since the corporate scandals involving auditors in the United States by the end of 2001 that gave birth to the Sarbanes-Oxley Act (SOX) of 2002, the change of audit environment is also felt through over the world, including Indonesia. The Indonesian Government issued various regulations concerning the audit services provided by audit firms. These regulations were expected to increase the competence and the independence of the auditors (Herusetya 2012).

Auditor independence can be reflected in the extent to which the auditor became more tolerant to the earnings management done by the clients. The higher the quality of the independence of the auditors, the lower the earnings management behavior was reflected. Previous research has examined the association between client importance and earnings management (e.g., Herusetya 2012; Reynolds and Francis 2001; Frankel *et al.* 2002; Chung and Kallapur 2003; Francis and Yu 2009).

Reynolds and Francis (2001) examined the association between client importance and audit outcome, i.e. total accruals and total discretionary accruals as measures of earnings quality. They suspect that the client importance (INFLUENCE variable) at the level of individual practice office can reduce auditor independence, but they found that Big 5 auditors did not treat larger clients more compromisingly compared to smaller clients.

With a sample of 6,568 U.S. firms-years observations for the period 2003 to 2005, Francis and Yu (2009) examined whether the larger offices of Big 4 auditors have higher audit quality. Using an INFLUENCE variable as a measure of the auditor's incentives with respect to a fee-dependence and used as a control variable, they found that larger Big 4 practice offices have a negative association with absolute abnormal accruals. Herusetya (2012) in his study used a composite measure of audit quality that covered the dimension of competence and independence, and client importance (CI) was one of the proxies used in the dimension of independence. By using a single proxy of CI, he found that CI has a negative association with the absolute discretionary accruals.

In summary these findings conclude that even though the auditors have economic dependence on their clients, but the auditors do not encourage greater discretion in accrual-based earnings management[2]. In other words, the auditors do not provide greater tolerance to earnings management behavior for their important clients[3]. Based on the arguments given above, the hypothesis to be tested is:

H[1]: Client importance is negatively associated with earnings management.

Client Importance and Going-Concern Opinion

Auditor's independence can be reflected in the propensity to issue going-concern opinion. Auditor independence will decline if the auditor compromise not to report the financial condition of the clients related to going-

concern problems, because the auditor has economic dependence to the client (DeAngelo 1981; Reynold and Francis 2001).

Previous research found evidence on the association of client importance and audit opinion issued by public accounting firms (Reynolds and Francis 2001; Craswell *et al.* 2002; Chen *et al.* 2010)[4]. Reynolds and Francis (2001) found that Big 5 did not treat large clients with more compromise than the smaller clients. Reynolds and Francis (2001) found the size of individual practice offices of the Big 5 did not reduce the propensity to issue going-concern opinion. Existing financial incentives were considered enough to motivate the auditor to be independent, despite the fact that the presence of economic dependence relationships was inherently in the auditor and client contract. Similarly, Craswell *et al.* (2002) found that the fee dependence as a threat to auditor independence does not affect the likelihood of auditors to issue a qualified audit opinion, both at the national and local market levels.

Chen *et al.*(2010) conducted a study in China, and found that the level of auditor independence increase in line with the improvement of legal and regulatory environment. Chen *et al.* (2010) found that after 2001, when the legal and regulatory environment began to grow well in China, the tendency for clients to receive modified audit opinion (MAO) is higher compared to the period before 2001 (i.e., 1995-2000) for client importance measured by individual auditors. Similarly, Li (2009) found that after the period of SOX in the United States, higher audit fees and total audit fee ratio have a positive associ-

ation with the auditor's propensity to issue going-concern opinion. The findings of Li (2009) and Chen *et al.* (2010) provide additional evidence that in line with the improvement of the institutional and regulatory climate, the tendency of auditors to compromise in audit quality seems to decrease, given the risks of litigations and penalties for auditors are higher than the economic incentives they earned. Based on the above arguments, the hypothesis will be tested is:

H_2: Client importance is positively associated with the propensity to issue going-concern Opinion

RESEARCH METHODOLOGY

Population and Sample

Population of this research is all listed companies in IDX along the year 2004-2011. Sample selection is performed with the criteria as follows: a) Companies issued annual report each year, with the fiscal year ended at December 31, starting from year 2004 to 2011. b) Companies are fully operated from 2004 to 2011 and not included new listing (IPO) companies from 2004 to 2011. c) Companies are never delisted from IDX, discontinued its activities as well as merger. d) The sample does not include financial industries due to the classification of regulated industries (Balsam, Krishnan &Yang, 2003; Francis & Yu, 2009; Hermawan, 2009; Herusetya, 2012).

Based on the sample criteria, we obtained 135 final samples of company per year for 8 year-period (2004-2011), or 1,080 firm-years of observation[5] of pooled OLS data.

Table 1: Sample Description

Description	Total
Number of firm-years observation from listed companies at IDX for the year 2004-2011	4,560
Number of firm-years observation from financial industries	(1,144)
Total preliminary sample	3,416
Number of firm-years observation from new listing and delisted companies in 2004-2011	(1,440)
Number of firm-years observation with incomplete data in 2004-2011	(696)
Number of firm-years observation that does not meet the minimal observations in each industry per year	(200)
Total final sample (firm-years)	1,080
Total final sample (company)	135

Empirical Model

Client Importance and Earnings Management

Prior research used discretionary models to identify earnings management (Francis and Yu 2009; Reynolds and Francis 2001; Balsam *et al.* 2003). To test the association between client importance and accrual earnings management we use pooled-OLS of Model 1 as follows:

$$ABSDAC_{it} = \alpha_0 + \alpha_1\,CI_{it} + \alpha_2\,SIZE_{it} + \alpha_3\,CFO_{it} + \alpha_4\,LEV_{it} + \alpha_5\,LOSS_{it} + \alpha_6\,ABSTACC_{it} + \alpha_7\,SGRW_{it} + \varepsilon_{it} \quad\text{................................Model 1}$$

Hypothesis H_1 of this research can be formulated in statistical form as follows:
H_1: $\alpha_1 < 0$; the expectation for each variable control is: $\alpha_2 \neq 0, \alpha_3 < 0, \alpha_4 > 0, \alpha_5 < 0, \alpha_6 > 0, \alpha_7 > 0$. All variables are defined as in Table 2.

The main variable in Model 1 is CI, and the coefficient α_1 is predicted negative and significant toward the absolute discretionary accruals (ABSDAC), which indicates that client importance has a negative association with accrual earnings management.

Table 2: Variable Descriptions

Model 1 and 2:		
ABSDAC	=	Absolute discretionary accruals scaled by lagged total assets, using Kothari et al. (2005) estimated model, computed cross sectionally each year for each industry
GCO	=	Dummy variable for going-concern opinion, equal to 1 if the company receive going-concern opinion in the current year; and 0 otherwise
CI	=	Client importance, as the ratio of audit firm's economic dependence toward its client
SIZE	=	Natural logarithm of total assets
CFO	=	Cash flow from operation of client i in year t scale by lagged total assets
LEV	=	Leverage ratio, defined as total liabilities divided by total assets at year end t
LOSS	=	Dummy variable for loss firm, 1 if firm i at year t report net loss; 0 otherwise
ABSTACC	=	Absolute value of total accruals of client i in year t
SGRW	=	Sales growth, defined as (sales t – sales t-1)/sales t-1
PRIORGC	=	Dummy variable, 1 if firm i receives going-concern opinion in the last year financial statements; 0 otherwise
CASH	=	Cash and cash equivalent
LLOSS	=	Dummy variable for prior year loss, 1 if firm i report net loss in t-1; 0 otherwise
Equation (1):		
TACC	=	Total accruals, defined as earnings before extraordinary items less cash flow from operation
A	=	Total assets
ΔREV	=	Change in firm's net revenue in year t
ΔAR	=	Change in firm's account receivables in year t
PPE	=	Property, plant and equipment
ROA	=	Firm's return on assets, defined as the ratio of net earnings deflated by total assets
ε_{it}	=	Residual errors
Subscript i,t	=	Identification for firm i and year t

To control other factors that affect absolute discretionary accruals, we include several variables in Model 1. Clients with larger size (SIZE) has less discretionary accruals, due to larger clients have more resources to maintain the sustainability of the entity (Becker, Defond, Jiambalvo and Subramanyam, 1998; Reynolds and Francis, 2001; Balsam *et al.* 2003). However, large companies have also higher market pressure to meet analysts' expectations (Barton and Simko 2002), thus having greater opportunities to perform earnings management (Tresnaningsih 2008). Therefore we do not predict the sign of SIZE coefficient. Higher level of sales would increase accruals but will reduce operating cash flows (Dechow, Sloan and Sweeney 1995), thus we expect a negative sign for CFO coefficient. Companies with the higher level of liabilities (LEV) have more incentives to deal with earnings management compared to the lower level of liabilities (Reynolds and Francis 2001; Balsam *et al.* 2003), therefore leverage (LEV) is predicted to be positively related to ABSDAC. Dechow and Schrand (2004), and Francis and Yu (2009) found a negative association of the company with net loss toward its accruals quality, therefore LOSS coefficient is predicted negative. ABSTACC, the absolute value of total accruals scaled by total asets t-1 is used to control the propensity to generate accruals, and is predicted to have positive relationship with ABSDAC (Balsam *et al.* 2003; Francis and Yu 2009). McNichols (2000), and Menon and William (2004) found evidence that sales growth has a positive association with abnormal accruals, due to high growth companies have higher discretionary accruals adjustment. We predict SGRW has a positive association with ABSDAC.

Client Importance and Going-Concern Opinion
Most prior research examined the propensity to issue going-concern opinion (e.g., Geiger, Raghunandan and Rama 2005; Reynolds and Francis 2001; Craswell *et al.* 2002; Francis and Yu 2009; Geiger and Rama 2006; Francis 2004). To test hypothesis H_2, we use logistic regression of Model 2 to identify the effect of client importance toward going-concern opinion:

$$GCO_{it} = \beta_0 + \beta_1 CI_{it} + \beta_2 SIZE_{it} + \beta_3 PRIORG\text{-}C_{it-1} + \beta_4 CASH_{it} + \beta_5 LEV_{it} + \beta_6 LOSS_{it} + \beta_7 LLOSS_{it} + \epsilon ....Model\ 2$$

The statistical form of the hypothesis H_2 of this research is as follows:
H_2: $\beta_1 > 0$; the expectation for each control variable is: $\beta_2 > 0$, $\beta_3 > 0$, $\beta_4 < 0$, $\beta_5 > 0$, $\beta_6 > 0$, $\beta_7 > 0$. All variables are defined as in Table 2.

The main variable in Model 2 is CI, and we estimate the coefficient β_1 is positive and significant toward going-concern opinion (GCO), which indicates that client importance has a positive association with the propensity to issue going-concern opinion. Several control variables included in the Model 2 to control other factors that may affect audit firms to issue going-concern reports. Companies with larger size (SIZE) have greater resources and are more likely to survive compared to smaller companies (Francis and Yu 2009), therefore we predict variable SIZE has a negative association with GCO. Companies that received going-concern opinion on the previous year (PRIORGC) are more likely to receive going-concern opinion in the current year (Reynolds and Francis, 2001). CASH is a liquidity measure that is the sum of cash and cash equivalent, scaled by total assets. Companies with more liquid assets have more resources to deal with financial difficulties, therefore we expect CASH coefficient is negative. Companies with high debt levels (LEV) and experience net loss in the current year (LOSS) are more likely to fail and more likely to receive going-concern reports, therefore, we predict LEV and LOSS coefficients have positive associations with GCO (Francis and Yu 2009).

Operational Variables *Absolute Discretionary Accruals (ABSDAC)*
We use accrual model from Kothari, Leone and Wasley (2005) to measure the discretionary accrual which is as follows:

$$TACC_{it}/A_{it-1} = \alpha_0 + \alpha_1 (1/A_{it-1}) + \beta_{1i} (\Delta REV_{it} - \Delta AR_{it}/A_{it-1}) + \beta_{2i} (PP\&E_{it}/A_{it-1}) + \gamma_1 ROA_{it-1} + \epsilon_1 \dots\dots\dots(1)$$

Discretionary accruals equal the value of residual errors (ϵ) or the difference between total accruals and the fitted value of normal accruals, defined as $DA_{it} = (TACC_{it}) - NDA_{it}$ (Cohen, Dey and Lys 2008)[6]. The absolute value of discretionary accrual (ABSDAC) is used as a proxy of accrual earnings management by considering the possibility of positive and negative accrual earnings management (Myers, Myers and Omer 2003; Barton and Simko 2002; Cohen *et al.* 2008). All variables are defined as in Table 2.

Going-Concern Opinion (GCO)
GCO is a dummy variable (1; 0), equal to 1 if the auditor assumes that the company cannot survive within 12 months after the balance sheet date, and receive going-concern opinion; and 0 if otherwise (Geiger *et al.*2005).

Client Importance (CI)
Client importance (CI) examines the tendency of auditors having economic dependence that may reduce the auditor independence (e.g., Frankel *et al.* 2002; Craswell *et al.* 2002; Chung and Kallapur 2003; Chen *et al.* 2010). Following Chen *et al.* (2010), we use natural logarithm of total client assets as a proxy of economic dependence with the following measurements:

$$CI_{it} = SIZE_{it}/[\textstyle\sum_{i=1}^{n} SIZE_{it}] \dots\dots\dots 2$$

Where:
CI_{it} = client importance, as a measure of audit firm's economic dependence toward the client.
$SIZE_{it}$ = natural logarithm of client's assets.
$\sum_{i=1}^{n} SIZE_{it}$ = the sum of total assets (in natural logaritm) from n clients of certain audit firm.

Control Variables
We use control variables which have been used in the prior research as follows: company size (SIZE), cash flow from operation (CFO), leverage (LEV), net loss (LOSS), absolute value of total accruals (ABSTACC), prior year going-concern opinion (PRIORGC), cash and cash equivalents (CASH), sales growth (SGRW), prior year loss (LLOSS). See Table 2 for variable definitions.

RESULTS AND DISCUSSION
Descriptive Statistics and Correlations
The descriptive statistic of all operational variables can be seen on Table 3[7]. The mean of ABSDAC in Table 3, Panel A is 0.110 or 11.0% of the total assets, indicating the magnitude of accrual earnings management. The mean of GCO (Panel B) is 0.230 indicating that the average firm-years observation to receive going-concern opinion is 23.0%. The mean of CI is 0.239, indicating that the average proportion of audit firms' revenue per client is 23.9%. In Table 4, CI variable has a positive correlation with CGO at a significance level of 0.01, consistent with our prediction.

Table 3: Descriptive Statistics for Regression Variables

Panel A: Model 1

	N	Minimum	Maximum	Mean	Std Deviation	Skewness
ABSDAC	1,080	0.000	2.319	0.110	0.168	5.843
CI	1,080	0.018	1.000	0.239	0.309	1.746
SIZE	1,080	6.339	18.849	13.574	1.687	0.129
CFO	1,080	-1.617	1.082	0.067	0.148	-1.639
LEV	1,080	0.000	5.025	0.543	0.512	3.736
LOSS	1,080	0.000	1.000	0.170	0.377	1.747
ABSTACC	1,080	0.000	2.465	0.101	0.154	6.047
SGRW	1,080	-2.418	453.055	0.582	13.79	32.819

Table 3

Panel B: Model 2

	N	Minimum	Maximum	Mean	Std Deviation	Skewness
GCO	1,053	0.000	1.000	0.230	0.424	1.255
CI	1,053	0.018	1.000	0.238	0.308	1.753
SIZE	1,053	6.339	18.849	13.590	1.689	0.122
PRIORGC	1,053	0.000	1.000	0.320	0.468	0.759
CASH	1,053	0.000	0.931	0.100	0.112	2.216
LEV	1,053	0.000	5.025	0.532	0.499	3.905
LOSS	1,053	0.000	1.000	0.170	0.372	1.805
LLOSS	1,053	0.000	1.000	0.190	0.394	1.568

All variables are defined as in Table 2.

Table 4: Pearson Correlations among Variables

Panel A: Model 1 (n=1,080)

	ABSDAC	CI	SIZE	CFO	LEV	LOSS	ABSTACC	SGRW
ABSDAC	1.000							
CI	0.039	1.000						
SIZE	-0.128***	-0.333***	1.000					
CFO	-0.134***	-0.124***	0.159***	1.000				
LEV	0.247***	0.134***	-0.197***	-0.184***	1.000			
LOSS	0.143***	0.123***	-0.209***	-0.191***	0.259***	1.000		
ABSTACC	0.914***	0.040*	-0.096***	0.002	0.253***	0.183***	1.000	
SGRW	0.014	-0.002	-0.022	0.051**	-0.034	-0.017	0.033	1.000

Panel B: Model 2 (n=1,053)

	GCO	CI	SIZE	PRIORGC	CASH	LEV	LOSS	LLOSS
GCO	1.000							
CI	0.154***	1.000						
SIZE	-0.165***	-0.341***	1.000					
PRIORGC	0.797***	0.130***	-0.161***	1.000				
CASH	-0.119***	-0.143***	-0.004	-0.112***	1.000			
LEV	0.309***	0.139***	-0.200***	0.226***	-0.146***	1.000		
LOSS	0.393***	0.135***	-0.196***	0.349***	-0.172***	0.258***	1.000	
LLOSS	0.413***	0.150***	-0.231***	0.360***	-0.147***	0.216***	0.543***	1.000

***, **, * significant at 0.01, 0.05, and 0.10 respectively. All variables are defined as in Table 2.

Test of Hypothesis 1 (H$_1$)

Hypothesis H$_1$ predicts a negative association between client importance (CI) and accrual-based earnings management (ABSDAC). Empirical result of Model 1 in Table 5 has adjusted R-square of 85.68% with F-stat 923.766 (prob < 0.01)[8]. The coefficient of CI (α_1) is -0.011 (t-stat = -1.303), negative but not significant at 0.10 with two-tailed test. However, the coefficient of CI is negative and significant at 0.10 with one-tailed test (critical value of t-stat = 1.28), consistent with our prediction.

Table 5: Regression of the Impact of Client Importance on the
Accrual-Based Earnings Managemen

Model 1

$$ABSDAC_{it} = \alpha_0 + \alpha_1\,CI_{it} + \alpha_2\,SIZE_{it} + \alpha_3\,CFO_{it} + \alpha_4\,LEV_{it} + \alpha_5\,LOSS_{it} + \alpha_6\,AB\text{-}STACC_{it} + \alpha_7\,SGRW_{it} + \varepsilon_{it}$$

Dependent Variable: ABSDAC

Independent Variable	Prediction	Coefficient	t-stat	p-value	VIF
C	?	0.076***	2.858	0.004	
CI	-	- 0.011	-1.303	0.193	1.137
SIZE	-/+	-0.004*	-1.916	0.056	1.191
CFO	-	-0.164***	-5.813	0.000	1.083
LEV	+	-0.001	-0.140	0.888	1.176
LOSS	-	-0.026***	-4.110	0.000	1.143
ABSTACC	+	1.006***	25.743	0.000	1.095
SGRW	+	-0.000***	-6.127	0.000	1.006
Adj R-squared (%)		85.68			
F-statistic		923.766			
Prob (F- statistic)		0.000			
n =1,080					

***, **, * significant at 0.01, 0.05, and 0.10, respectively in two-tailed tests; t-statistics are calculated using the Huber-White procedure to correct heteroscedasticity. All variables are defined as in Table 2.

This result implies that the bigger the proportion of the economic dependence of audit firms toward their clients, the smaller the magnitude level of accrual earnings management. Our result gives interpretation that audit firms in Indonesia that have larger clients and bigger economic dependence to their clients, are less likely to allow earnings management behavior. This result is also consistent with previous research that found larger offices of Big 4 provides higher audit quality and have clients with less earnings management behavior (Francis and Yu, 2009).

Four control variables are significant in the expected direction (CFO, LOSS, ABSTACC, SIZE), and the other control variable is not significant at the 0.10 (LEV), or is significant in the opposite direction (SGRW).

Test of Hypothesis 2 (H₂)

Hypothesis H₂ predicts a positive association between client importance (CI) and going-concern opinion (GCO). Logistic regression in Model 2 (Table 6) has Cox and Snell R-square 53.70%, and Nagelkerke R-square 80.90% with the value of -2Log Likelihood 336.233[9]. The result of the test in Model 2 indicates that the coefficient of CI (β_1) is 1.218 (Wald test = 5.923), positive and significant at 0.05 with two-tailed test. This result implies that although the proportion of audit fee in audit firm's portfolio is bigger, audit firms can still maintain their independence, measured by the issuance of going-concern opinion. Our result is consistent with previous studies, which document that larger offices of public accounting firms are more likely to issue going-concern opinion, and give better prediction for financial distress in the upcoming period (e.g., Francis and Yu, 2009).

Five control variables are significant in the expected direction (SIZE, PRIORGC, LEV, LOSS, LLOSS) and the other control variable is not significant at the 0.10 (CASH).

Table 6: Logistic Regression of the Impact of Client Importance toward
Going-Concern Opinion

Model 2

$$GCO_{it}= \beta_0 + \beta_1\,CI_{it} + \beta_2\,SIZE_{it} + \beta_3\,PRIORGC_{it} + \beta_4\,CASH_{it} + \beta_5\,LEV_{it} + \beta_6\,LOSS_{it}$$
$$+ \beta_7\,LLOSS_{it} + \epsilon_{it}$$

Dependent Variable: GCO

Independent Variable	Prediction	Coefficient	Wald	p-value
C	?	-12.752***	25.499	0.000
CI	+	1.218**	5.923	0.015
SIZE	+	0.162*	2.743	0.098
PRIORGC	+	9.564***	28.244	0.000
CASH	-	0.049	0.002	0.969
LEV	+	1.900***	21.874	0.000
LOSS	+	0.836**	5.164	0.023
LLOSS	+	1.340***	14.015	0.000
-2Log Likelihood		336.233		
Cox & Snell R^2 (%)		53.7		
Nagelkerke R^2 (%)		80.9		
n =1,053				

***, **, * significant at 0.01, 0.05, and 0.10, respectively in two-tailed tests. All variables are defined as in Table 2.

Sensitivity and Robustness Tests

We use alternate measure of client importance (CI), i.e., client's sales instead of total assets to test the robustness of our main results. Conversely to the hypothesis result of H_1, we find no evidence of the association between client importance (CI) and accrual-based earnings management (ABSDAC) at 0.10 (not tabulated). The usage of client importance model using total sales as a proxy becomes sensitiveand do es not support the main result.

Sensitivity test for hypothesis H_2 using the same measure of client importance (CI) finds similar result as in the main test (Table 6) (not tabulated). Our result indicates that client importance (CI) has a positive association with going-concern opinion (GCO) at 0.05. The usage of the different measure of client importance (CI) in Model 2 is robust to all alternative test and support the main result. This result strengthens our main result and previous study (e.g., Francis and Yu 2009), which suggest that larger offices of audit firms are more likely to issue going-concern opinion rather than smaller offices.

CONCLUSION

Our study investigates the independence of auditors measured by the client importance, and reflected in the accrual-based earnings management and going-concern opinion. The main result of our study finds a negative association between client importance and accrual-based earnings management. Our evidence implies that audit firms with larger clients and with more economic dependence to their clients are less likely to allow earnings management behavior. This result is consistent with previous studies that suggest that larger audit firms, like Big 4 with more expertise and ability to detect earnings management behavior are less likely to allow earnings management rather than smaller audit firms (Francis and Yu 2009; Reynolds and Francis 2001).

Our second main test finds that client importance has a positive association with going-concern opinion. This evidence implies that although the proportion of client dependence is bigger, public accounting firms can maintain their independence measured by the

issuance of going-concern opinion. Our result is consistent with the previous studies (e.g., Reynolds and Francis 2001) and robust to other sensitivity tests that support the main test result. The combine results indicate that client importance as a measure of auditor independence has a negative association with earnings management and has a positive association with going-concern opinion.

This research has some limitations: (i) the conclusions drawn in this study should be conducted with caution, because we use only single measure of auditor independence, i.e., the client importance. There are some other measurements, such as the influence of client practices toward the propensity to meet earnings targets, and corporate governance practices (Bamber and Bamber 2009); (ii) accrual-based earnings management is the only measure of earnings management used in this study. Previous research documented several other earnings management techniques, such as real earnings management, and classification shifting (e.g., Cohen and Zarowin 2010; Fan *et al.* 2010).

We recommend for further study to use the composite measure of independence. Herusetya (2012) for example, the use composite measures of audit quality from the dimension of competency and independence. In order to reflect the different aspect of earnings management, we also recommend to examine the other tools of earnings management, such as real earnings management and classification shifting (Cohen and Zarowin 2010; Graham *et al.* 2005).

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[1] For example, the Indonesian Government issued a number of regulations concerning the independence and competence of auditors and audit firms, such as: KEP-310/BL/2008 regarding "The Independence of Accountant Providing Services in the Capital Markets in 2008"; and The Act No. 5 for the Public Accountants in 2011.

[2] Recent research found that public listed companies not only did accrual-based earnings management, but also real-based transactions (e.g., Cohen and Zarowin, 2010; Graham, Harvey, and Rajgopal, 2005; Chi, Lisic & Pevzner, 2011; Challen and Siregar, 2011). Other research found other earnings management tools, such as classification shifting (Fan, Barua, Cready & Thomas, 2010).

[3] Frankel et al. (2002) found evidence of a positive association between client importance, i.e., the ratio of non-audit services fee to total fee and the amount of discretionary accruals. The findings and methodology used by Frankel et al. (2002) were questioned by many researchers. Chung and Kallapur (2003) for example, found that the association of the ratio of non-audit to total fee and absolute abnormal accruals are less robust, because it did not include control variable of each industry.

[4] Francis and Yu (2009) for exception, found no evidence of the association between economic dependence and auditor's going-concern opinion.

[5] Our sample consist of 53.33% from manufacture industry (basic and chemical industry, consumer goods, and miscellaneous), 32.59% from trade, service & investment, and 14.07% from property & real estate industry.

[6] For accrual model used, our study requires a minimum of 15 observations for each type of industry each year (Chi et al., 2011; Cohen et al., 2008).

[7] All continuous data are winsorized to avoid outliers using 2 standard deviations from the mean, so that the data is spread over an area of 95.45% (Acock, 2008). All variables in Table 3, Panel A and B have low standard deviation except for SGRW.

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[8] We test for multicollinearity problem and found that all variables have small value of VIF (below 1.50). The tolerance (TOL) value of all variables are also close to 1.00, indicating that there are no multicollinearity problem (Gujarati, 2003; Nachrowi and Usman, 2006). While the test for heteroscedasticity indicates that there is a problem with heteroscedasticity, but we treat using the Huber-White procedure to correct heteroscedasticity in order to get estimated coefficient from robust variance-covariance (Wooldridge, 2009).

[9] We eliminate 27 outliers out of 1080 firm-years observation to obtain robust standard errors. We also test whether there is a multicollinearity problem in our empirical model, and found that all independent variables have VIF value below 1.50, indicating that there is no multicollinearity problem (Gujarati, 2003). Our logistic regression has $Chi^2 = 3.930$ (p > 0.10) for Hosmer and Lemeshow test, indicating that the data and model used are fit.