The Effect of Related Party Transactions and Political Connections on Audit Fee

Fitri Nurjanah*, Bandi, Payamta, Jaka Winarna

Universitas Sebelas Maret, Surakarta, Indonesia
Corresponding author. Email: fitrinurjanah@student.uns.ac.id

ABSTRACT

The purpose of this study is to present empirical data on the impact of related party transactions and political connection on audit fees. Using the Stata program, multiple linear regression analysis is employed in conjunction with descriptive statistics to test hypotheses. All non-financial companies listed on the Indonesia Stock Exchange between 2019 and 2021 make up the research population. This research uses a sample size of 125 companies. The research results show that political connections and related party transactions have a positive effect on audit fees. Companies that have high risk can increase the auditor's efforts in conducting audits so that they can increase audit efforts which results in high audit costs.

Keywords: *Audit Fees, Political Connections, Related Party Transactions.*

1. INTRODUCTION

Companies that have listed on the Indonesia Stock Exchange (BEI) must attach their financial reports. Financial reports reported to the IDX must be audited by an independent institution. The independent institution for auditing financial reports is a public accounting firm/auditor. In carrying out their duties, auditors must measure the complexity, size of the company and the risks the company has (Alkebsee et al., 2021).

Audit procedures carried out by external auditors must measure the level of risk possessed by the Company for which the audit procedure will be carried out (Ghosh & Tang, 2015) Risk assessment carried out by external auditors regarding risks in accordance with the preparation of financial reports (Arens et al., 2014). The audit efforts carried out by the auditor are in accordance with the risks the company has, if the company has high risks then the auditor in carrying out the audit is required to make more efforts so that the resulting opinion can reflect the company's condition. Audit risk is one that can determine the amount of audit received by the auditor which can be measured by the efforts and efforts made by the external auditor in carrying out his duties (Bliss et al., 2011). There are three audit risks including inherent risk, control risk, detection risk. Inherent risk is the vulnerability of an account balance or class of transactions to material misstatement. Related party transactions and political connections are considered a risk of material misstatement (Gul, 2006).

The company's political connections are used to achieve convenience in government affairs (Faccio, 2006). Since the reform era, entrepreneurs who have penetrated the world of politics have begun to emerge in Indonesia, including entrepreneurs who are running for mayor, governor, legislative members and some have founded political parties (Fernandez, 2018). The ombdusman of the Republic of Indonesia (ORI) reported data on 125 state officials holding concurrent positions as commissioners in State-Owned Enterprises (BUMN) (Setyawan, 2017). Fernandez (2015) a researcher at the Center for Strategic and International Studies (CSIS), predicts that entrepreneurs will continue to color the world of Indonesian politics for the next 10 years.

Companies with political connections have higher inherent risks compared to companies that are not connected (Gul, 2006). Inherent risk is the risk of an assertion being susceptible to material misstatement (Arens et al., 2014). Companies that have connections to politics are associated with low transparency so that it can have an impact on the company's poor financial reporting and is related to misstatements in the company's financial reports (Channey et al., 2011; Srinidh et al., 2011). Companies that are connected to politics have a high risk, so the efforts made by auditors in carrying out checks on the audit program are also higher. External auditors are expected to issue opinions that are in accordance with the financial statements in exchange for higher audit fees than companies that do not have political connections (Ariningrum & Diyanty, 2017; Harymawan et al., 2020; Nurjanah & Sudaryati, 2019; Tee, 2018; Wahab et al., 2009, 2011).

Transactions between an organization or persons connected to the corporation are referred to as related party transactions, or RPTs. Loan underwriting and asset sales and acquisitions are examples of related party transactions. Regarding RPT, there are two opposing viewpoints. Positively, company groupings may utilize RPT to share resources, lower transaction costs, and ultimately boost returns on assets, which can increase value. However, RPTs are frequently seen as unlawful because, among other things, dominating owners may exploit them opportunistically to further their own interests at the detriment of minority shareholders. In this scenario, holding firms or controlling owners could set up deals through connected parties in order to take advantage of personal advantages or transfer funds from minority shareholders to themselves.

Investors view RPT as one of the main reasons for companies to restate financial statements. If the external auditor believes that transactions with related parties have potential risks in material presentation, the company charges high fees to compensate for the risk and effort. what they need to do to untangle the transaction and provide assurance that the RPT is not damaging. There are still few studies that have conducted research on the influence of related party transactions on audit fees. Research by (Habib et al., 2015) shows that audit fees paid are higher for companies involved in related party transactions in China.

The research gap from previous research is the use of companies that have inherent risks, namely related party transactions and politically connected companies, on audit fees. Research Habib et al, (2015) examine related party transactions on audit fees then research related party transactions on audit fees with the role of internal control (Al-Gamrh et al., 2017a). Therefore, researchers are interested in examining the influence of risky companies on audit fees.

2. LITERATURE REVIEW

2.1. Related Party Transactions

According to PSAK 7 IAI Regardless of whether there is a fee involved, a related party transaction is any transfer of assets, liabilities, or services between the reporting company and a related party. Related party transactions can be agreements or business arrangements between parties who are not independent of each other for certain purposes. Individuals, family members with joint or total control, people with a great deal of influence, and important employees of the parent company or the reporting entity are examples of related parties to the reporting entity. Put differently, a connected party is a party that is seen to be able to control another party or to have a large amount of decision-making influence over another party.

2.2. Agency Theory

According to agency theory, the connection between the principle and the agent is one that develops as a result of a mutually agreed-upon agreement between the two parties to do activities that serve the principal's interests (Jensen & Meckling, 1976). The agency relationship between the two parties does not allow for conflicts to arise in the delegation of work, the problems faced are differences in interests between the principal and the agent so that the expected results are not in accordance with the agreed goals.

Principals need monitoring procedures for their agents to reduce agency conflicts that occur. Auditors are needed as independent parties to mediate in these conflicts of interest. These monitoring practices have the potential to raise agency costs; one example of an agency cost is the cost of audit fees, which are incurred when third parties conduct audit processes (Jensen & Meckling, 1976).

2.3. Hypothesis Development

Related party transactions have attracted a lot of attention among financial reporting and auditing, especially after the many financial scandals that have occurred throughout the world. In theory, related party transactions have two points of view. The first point of view is related party transactions related to*efficiency-enhancing theory* which states that transactions with related parties are used by business groups as a way to allocate resources better and can reduce transaction costs (Al-Gamrh et al., 2017b). In addition, related parties with in-depth knowledge and experience of company activities can provide services to the company more effectively (Gordon & Henry, 2005).

The second point of view statesRelated party transactions can give rise to agency issues, where related party transactions can cause losses due to failure experienced by the company due to opportunistic actions (Kohlbeck & Mayhew, 2010). Significant related party relationships can have an influence on the company's financial position and profit and loss. Debates about linked party transactions in financial statements: It is the auditor's duty to point up related party transactions if there might be a serious misrepresentation risk. According to Kohlbeck & Mayhew (2010), linked party transactions can be interpreted as a warning sign that raises risk and requires auditors to put in more work when reviewing financial reports in order to form a suitable conclusion. (Simunic, 1980b) formulate that audit costs are influenced by the size of the auditee, the complexity of the audit and the company's risks. Related party transactions are one of the particular factors that external auditors take into account while conducting the audit process in relation to audit risk. Thus, the audit process requires time and effort from auditors, which affects audit expenses (Habib et al., 2015; Al-Gamrh et al., 2017).

H1: related party transactions have a positive effect on the amount of company audit fees.

(Li et al., 2008) revealed that the existence of political connections in a company can influence the company's performance, through leniency regulations/policies and ease in obtaining government projects. To gain profits, companies lobby to create policies that are profitable for the company where this activity requires funds or resources owned by the company (Fisman, 2001; Johnson & Mitton, 2003). Donations of company resources, which are used to develop profitable policies for affiliated parties, can carry risks associated with the exploitation and manipulation of those resources because minority shareholders may not always approve of the donations, which can lead to agency issues (Ramsay et al, 2001). Thus, political ties inside an organization are frequently linked to a lack of openness in financial reports, which lowers the quality of financial reports and increases the possibility of financial report fraud (Channey et al., 2011; Srinidh et al., 2011).

Companies that have a higher risk have a greater possibility that material misstatements will occur in the financial statements(Gul, 2006). The more risks the auditor evaluates in the firm, including inherent risks, the more work the auditor will need to put into the audit of the organization. Furthermore, increased effort makes auditors believe they must bill the organization for a higher amount of audit fees (Gul, 2006). Consequently, it is thought that politically linked corporations pay higher audit fees than politically unconnected companies (Ariningrum & Diyanty, 2017; Harymawan et al., 2020; Nurjanah & Sudaryati, 2019; Tee, 2018; Wahab et al., 2009, 2011).

H2: political connections within the company have a positive influence on audit fees.

3. METHOD

All manufacturing businesses listed between 2019 and 2021 on the Indonesia Stock Exchange (BEI) comprise the population of this research. Secondary data from the material in the Annual Report is used in this study. Using the following criteria, a number of firms were chosen as study samples using purposive sampling approaches.

3.1. Variable operational definition

The amount that each firm must pay to fund the services of an external auditor who has audited the financial accounts of the company in question is known as audit fees, and it is the dependent variable of the research. The financial statements' natural logarithm of audit fees is used to calculate audit fees.

Related party transactions, which are any transfers of assets, liabilities, or services between the reporting company and related parties, whether or not a fee is involved, make up the first independent variable. These exchanges between an organization and its own management, directors, primary owners, or affiliates may be intricate economic dealings. Related party ties may be determined by looking at more than just the formal structure of the relationship (Wong et al., 2015). RPT Sales can be formulated as follows (see Equation 1).

$$\text{RPT Sales} = \frac{\text{Related party sales}}{\text{Unrelated party sales}} \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots (1)$$

The second independent variable is political connection, which is defined as the presence of a government official, minister, member of the legislature, or other high-ranking political party official among the company's leaders, i.e., the board of directors, board of commissioners, and majority shareholder (holding at least 10% of the company's shares). In this study, political connections (POL) are quantified using a dummy variable, wherein firms with political ties are assigned a value of 1, while those without are assigned a value of 0 (Faccio, 2006). The research control variables are company size, sales growth and leverage.

Company sizecalculated using the total amount of assets owned by a company indicating the size of a company. In this research, company size is proxied by the book value of the company's total assets as done by (Gama and Rodrigues, 2013). Sales growth is measured by proxy for net sales growth as in previous research (Gama and Rodrigues, 2013). An rise in sales from year to year or occasionally is referred to as sales growth. As stated by Rodriguez and Gama (2013). A company's capacity to employ money or assets with a fixed cost (fixed cost funds or assets) to raise the amount of revenue (return) for business owners is referred to as leverage.

The analysis techniques used include descriptive statistical analysis and hypothesis testing. The minimum, maximum, average, and standard deviation values of research data are among the features of the data that descriptive statistical analysis provides information on. Testing the first hypothesis uses mixed linear regression analysis using the Stata 14 test tool as follows (see Equation 2):

$$\text{AudFeeit} = \alpha 0 + \beta 1\text{RPT\_SALESit} + \beta 2\text{POLit} + \beta 3\text{SIZEit} + \beta 4\text{GROWTHit} + \beta 5\text{LEVit} + \varepsilon\text{it} \ldots\ldots\ldots\ldots (2)$$

Information:

Dependent variable:

AudFee: Audit costs incurred by go-public entities (Simunic, 1980a) (Data source: Annual report)

Independent variable:

POL: 1 for companies with political connections and 0 otherwise (Faccio, 2006) (Data source: Annual report)

RPT_SALES: Related party transactions of company i year t (Data source: Annual report)

Control Variables:

GROWTH: Company growth i year t (Data source: Annual report)

LEV: Operating income after tax divided by total assets (Data source: Annual report)

SIZE: Natural logarithm of total assets (Data source: Annual report)

4. DISCUSSION RESULT

4.1. Descriptive Statistics Results

The dependent variable in this study, audit fees, has an average value of 21,00284 rupiah, or IDR 940 million, as can be seen in the descriptive statistics table below. This means that the average company in Indonesia paid audit fees amounting to IDR 9400 million to the auditor from 2019 to 2021. The range of maximum and minimum values for this variable is quite high, showing that the sample of companies in Indonesia paid audit fees amounting to IDR 9400 million.

The research independent variable is political connection which is measured using a dummy variable of 1 if the company is politically connected and 0 otherwise. The results of the research showed that 78 companies had boards of commissioners and directors connected to politics with a percentage of 64.4%. Companies that are not connected to politics are 47 with a percentage of 37.6%. Table 1 show the descriptive statistics of this research.

Table 1. Descriptive statistics

	Obs	Minimum	Maximum	Mean	Std. Deviation
AudFee	125	18.72079	29.98535	21.00284	1.62932
RPTSales	125	.0000856	48.81927	2.170316	6.797472
SIZE	125	25.79861	33.32018	29.27334	1.55173
GROWTH	125	-.4913413	.8540818	.1116456	.1920888
Lev	125	.1092341	7.501407	1.138788	1.081708
Valid N (listwise)	125				
Dummy Variables					
Variable	%Score1	%Score0	total%		
POL	(78) 62.4%	(47) 37.6%	(125) 100%		

Table 2. Multiple linear regression

Variable	Audit fees			
	Coef	Std. Err	t	P>t
POL	1,419,725	0.273503	5.19	0,000***

Table 2. Multiple linear regression (cont.)

Variable	Audit fees			
	Coef	Std. Err	t	P>t

RPTSales	0.03581	0.019645	1.82	0.071*
GROWTH	-0.11461	0.682331	-0.17	0.867
SIZE	0.039027	0.091258	0.43	0.67
LEV	-0.28213	0.12364	-2.28	0.024**
_cons	194,352	2,589,358	7.51	0,000
F	0			
Adj-R2	0.2584			
R2	0.2886			
N	125			

*t*statistics in parenthesis. * $p < 0.1$, * $p < 0.05$, ** $p < 0.01$

4.2. The Influence of Political Connections on Audit Fees

Based on Table 2 on this research model show that the results are consistent with the first hypothesis which states that political connections have a significant positive effect on audit fees. The significance level is 5% (0.019 < 0.050), so H1 is accepted. The prevalence of political ties within the organization is thought to raise the inherent risk of the corporation, which explains the research's findings (Gul, 2006). Companies with political clout can assist with government-related issues (Channey et al., 2011), and connected companies can lobby for policies that are profitable for their companies.

Politically connected businesses will conceal the political donation process, which will reduce financial report openness. Low transparency can result in poor quality of financial reports and the risk of misstatements in financial reports (Channey et al., 2011; Srinidh et al., 2011). In return for larger audit fees, auditors are required to offer relevant views on financial accounts. Auditors are expected to provide appropriate opinions on financial statements in exchange for higher audit fees from connected companies (Ariningrum & Diyanty, 2017; Harymawan et al., 2020; Nurjanah & Sudaryati, 2019; Tee, 2018; Wahab et al., 2009, 2011).

This outcome is also consistent with the Audit Pricing Theory viewpoint, which holds that while deciding the appropriate audit fees, auditors must consider the risks the organization faces. The amount of effort auditors put forth to complete audit processes is indicative of this. According to theory and empirical findings, politically connected corporations pay greater audit costs than non-connected companies, indicating that politically connected companies have higher inherent risks (Gul, 2006).

4.3. The influence of related party transactions on audit fees

The results of research conducted on this research model show that the results are consistent with the second hypothesis which states that related party transactions have a significant positive effect on audit fees. The significance level is 10% (0.070 < 0.050), so H2 is accepted. The explanation of the results of this research shows that related party transactions in related financial reports can be used as a red flag which can increase risk so that auditors in examining financial reports use more effort in order to produce an appropriate opinion. The second point of view states that Related party transactions may result in agency problems, whereby the firm may suffer losses as a result of opportunistic acts that lead to failure (Kohlbeck & Mayhew, 2010). The financial standing and profit and loss of the firm may be impacted by significant related party ties. Debates about linked party transactions in financial statements: It is the auditor's duty to point up related party transactions if there might be a serious misrepresentation risk. According to Kohlbeck & Mayhew (2010), linked party transactions can be interpreted as a warning sign that raises risk and requires auditors to put in more work when reviewing financial reports in order to form a suitable conclusion.

(Simunic, 1980a) formulate that audit costs are influenced by the size of the auditee, the complexity of the audit and the company's risks. Related party transactions are one of the particular factors that external auditors take into account while conducting the audit process in relation to audit risk. So auditors need time and effort to carry out the audit process and this has an impact on audit costs (Habib et al., 2015; Al-Gamrh et al., 2017).

5. CONCLUSION

The objective of this study is to ascertain the empirical findings about the impact of related party transactions and political affiliations on audit fees. Testing the first hypothesis revealed that the presence of internal political ties inside the organization positively impacted audit fees. Politically linked businesses are thought to be riskier than non-politically connected businesses, which means that auditors will need to put in more work during the audit and demand more audit costs as a result (Ariningrum & Diyanty, 2017; Harymawan et al., 2020; Nurjanah & Sudaryati, 2019; Tee, 2018; Wahab et al., 2009, 2011).

The second test examines the effect of related party transactions on audit fees. Based on the results of testing the second hypothesis, it was found that related party transactions have a positive effect on audit fees. Companies that have related party transactions can cause losses due to failures experienced by the company due to opportunistic actions (Kohlbeck & Mayhew, 2010). This can increase audit efforts in conducting audits so that the audit costs incurred will be high.

This study has two limitations: firstly, very few businesses still reveal audit fees in their annual reports; secondly, there are currently no trustworthy sources in Indonesia that reveal a person's relationship with politicians; as a result, we can only learn about someone's political relationship through online media. Potential avenues for further study include the use of moderating variables related to corporate governance, such as an audit committee or an independent board of commissioners, which can provide effective oversight to reduce the risks facing the firm.

REFERENCE

Al-Gamrh, R. A. A. B., Ismail, K. N. I. K., & Ismail, S. S. H. (2017a). Related party transactions and audit fees : the role of the internal audit function. *Journal of Management & Governance*. https://doi.org/10.1007/s10997-017-9376-6

Al-Gamrh, R. A. A. B., Ismail, K. N. I. K., & Ismail, S. S. H. (2017b). Related party transactions and audit fees : the role of the internal audit function. *Journal of Management & Governance*. https://doi.org/10.1007/s10997-017-9376-6

Alkebsee, R. H., Tian, G. L., Usman, M., Siddique, M. A., & Alhebry, A. A. (2021). Gender diversity in audit committees and audit fees: evidence from China. *Managerial Auditing Journal*, *36*(1), 72–104. https://doi.org/10.1108/MAJ-06-2019-2326

Arens, A. A., Elder, R. J., & Beasley, M. S. (2014). *Auditing and assurance services (15 edition ed.)*. pearson education Inc.

Ariningrum, I., & Diyanty, V. (2017). *The Impact of Political Connections and the Effectiveness of Board of Commissioner and Audit Committees on Audit Fees The Impact of Political Connections and the Effectiveness of Board of*. *11*(4), 53–70. https://doi.org/10.14453/aabfj.v11i4.5

Bliss, M. A., Gul, F. A., & Majid, A. (2011). Do political connections affect the role of independent audit committees and CEO Duality? Some evidence from Malaysian audit pricing. *Journal of Contemporary Accounting and Economics*, *7*(2), 82–98. https://doi.org/10.1016/j.jcae.2011.10.002

Channey, paul K., Facio, M., & Parsley, D. (2011). The quality of accounting information in politically connected firms. *Journal of Accounting and Economics*, *51*(1), 58–76.

Faccio, M. (2006). Politically connected firms. *American Economic Review*, *96*(1), 369–386. https://doi.org/10.1257/000282806776157704

Fernandez. (2018). Para pengusaha di balik partai politik/Interviewer: T.Hadiyantono. *KONTAN.Co.Id*.

Fisman, R. (2001). Estimating the Value of Political Connections. *The American Economic Review*, *19*(4), 1095–1102.

Ghosh, A. Al, & Tang, C. Y. (2015). Assessing financial reporting quality of family firms: The auditors’ perspective. *Journal of Accounting and Economics*, *60*(1), 95–116. https://doi.org/10.1016/j.jacceco.2015.03.002

Gordon, E. A., & Henry, E. (2005). *Related Party Transactions and Earnings Management*.

Gul, F. A. (2006). Auditors’ response to political connections and cronyism in Malaysia. *Journal of Accounting Research*, *44*(5), 931–963. https://doi.org/10.1111/j.1475-679X.2006.00220.x

Habib, A., Jiang, H., & Zhou, D. (2015). Related-Party Transactions and Audit Fees: Evidence from China. *Journal of International Accounting Research*, *14*(1), 59–83.

Harymawan, I., Putra, F. K. G., Ekasari, W. F., & Sucahyati, D. (2020). Are independent commissioners able to mitigate higher audit fees in politically connected firms? Evidence from Indonesia. *International Journal of Innovation, Creativity and Change*, *11*(8), 24–43.

Jensen, C., & Meckling, H. (1976). Theory of the firm: Managerial behavior, agency costs and ownership structure. *Journal of Financial Economics*, *3*, 305–360.

Johnson, S., & Mitton, T. (2003). *Cronyism and capital controls : evidence from Malaysia $. 67*, 351–382.

Kohlbeck, M., & Mayhew, B. W. (2010). Valuation of firms that disclose related party transactions. *Journal of Accounting and Public Policy*, *29*(2), 115–137.

Li, H., Meng, L., Wang, Q., & Zhou, L. A. (2008). Political connections, financing and firm performance: Evidence from Chinese private firms. *Journal of Development Economics*, *87*(2), 283–299. https://doi.org/10.1016/j.jdeveco.2007.03.001

Matias Gama, A. P., & Rodrigues, C. (2013). The governance-performance relations in publicly listed family controlled firms: an empirical analysis. *Corporate Governance: The international journal of business in society*, *13*(4), 439-456.

Nurjanah, F., & Sudaryati, E. (2019). The effect of political connection and effectiveness of audit committee on audit fee. *The Indonesian Accounting Review*, *9*(2), 227. https://doi.org/10.14414/tiar.v9i2.1848

Ramsay, I., Stapledon, G., & Vernon, J. (2001). Political donations by Australian companies. *Federal Law Review*, *29*(2), 179-221.

Setyawan. (2017). Ombudsman: 222 Komisaris BUMN Rangkap Jabatan. *Cnn Indonesia*.

Simunic, D. A. (1980a). The Prici Theoryw- and rEviden ~ ce of Audt Nervices : *Journal of Accounting Research*, *18*(1), 161–190.

Simunic, Dan. A. (1980b). The Pricing of Audit Service: Theory and Evidence. *Jurnal of Accounting Research*, *18*(1), 161–190.

Srinidh, B., Zhang, H., & Zhang, T. (2011). Transparency in politically connected firms: Evidence from private sector firms in China. *City University of Hong …*.

Tee, C. M. (2018). Family firms, political connections and audit fees: evidence from Malaysian firms. *Managerial Auditing Journal*, *33*(6–7), 613–632. https://doi.org/10.1108/MAJ-06-2017-1585

Wahab, E. A. A., Zain, M. M., & James, K. (2011). Political connections, corporate governance and audit fees in Malaysia. *Managerial Auditing Journal*, *26*(5), 393–418. https://doi.org/10.1108/02686901111129562

Wahab, E. A. A., Zain, M. M., James, K., & Haron, H. (2009). Institutional investors, political connection and audit quality in Malaysia. *Accounting Research Journal*, *22*(2), 167–195. https://doi.org/10.1108/10309610910987501

Wong, R. M. K., Kim, J., & Lo, A. W. Y. (2015). Are Related-Party Sales Value-Adding or Value-Destroying? Evidence from China. *Journal of International Finance Manangement & Accounting*, *26*(1), 1–38. https://doi.org/https://doi.org/10.1111/jifm.12023