The effect of political connection and effectiveness of audit committee on audit fee

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ABSTRACT

This study analyzes the effect of political connection and effectiveness of audit committee on audit fee. This study uses the sample of non-financial companies listed on the Indonesia Stock Exchange (IDX) in 2015-2017. They were taken using a purposive sampling method. The total number of companies is 444 companies. The data were analyzed using SPSS 20 and the hypothesis testing was done using linear regression with a significance level of 5%. The F test indicates that the research model is stable and significant. The value of R square is 38.4%, indicating that there are other variables that can affect the model by 61.6%. The results of this study show that political connection has a significant positive effect on audit fee and the effectiveness of audit committee also has a significant positive effect on audit fee because audit committee wants a higher audit quality from the auditor.

1. INTRODUCTION

The capital market has developed very rapidly along with the intense business competition in Indonesia. According to the Financial Services Authority of the Republic of Indonesia (OJK), the capital market in Indonesia has become one of the investment destinations for foreign and domestic investors. OJK Regulation number 29/POJK/2016 states that companies whose shares are traded on the Indonesia Stock Exchange (IDX) should report their audited annual statements to OJK. The financial statements issued by the companies are a source of information for decision making for investors, creditors, debtors, management, and the government (Arnold et al., 2012). However, this financial statement—as a source of information and accountability to shareholders and stakeholders—must go through an audit process conducted by an external auditor (Lestari 2015).

The financial statements that the external auditors have audited can reduce conflicts between principals and agents (Jensen and Meckling, 1976). In order to reduce conflicts of interest, principals should monitor the procedures to oversee the performance of agents by employing external auditors.

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However, monitoring procedures can increase agency costs (Jensen and Meckling, 1976). Agency costs are costs incurred by the principal to carry out audit procedures on the company (Francis and Wilson, 1988).

External auditors, in carrying out audit procedures, must measure the risk of the company or client to be audited (Ghosh and Tang, 2015). Risk assessment is an analysis conducted by the auditor about relevant risks associated with the preparation of the company’s financial statements (Arens et al., 2014). The higher the audit risk assessed by the auditor, the higher the audit effort needed to produce an appropriate audit opinion (Bedard and Johnstone, 2004). Therefore, audit risk can determine how much the cost to be paid by the company which is measured by the amount of effort made by the auditor in conducting audit procedures. Inherent risk is one of the risks assessed by the auditor before conducting the audit process (Arens et al., 2014).

Companies that have political connections are associated with high inherent risk (Gul, 2006). Inherent risk is the risk of material misstatement assertions (Arens et al., 2014). In addition to being associated with inherent risk, companies that have political connections are also associated with a low level of transparency in financial statements, resulting in poor quality financial statements and risks of misstatement (Chaney et al., 2011; Srinidh et al., 2011; Walker and Reid, 2002; Yu and Yu, 2011). The higher the risk, the higher the efforts taken by the auditor in examining politically connected companies. Auditors are expected to provide appropriate opinions on financial statements with higher audit fees from connected companies as a return (Ariningrum and Diyanty, 2017; Gul, 2006; Khan et al., 2016; Tee, 2018; Wahab et al., 2011; Wahab et al. , 2009).

In addition to political connections within the company, there are other factors that can also affect audit fee, such as corporate governance. Corporate governance can be said to be good if it meets the standards applied to the Organization for Economic Co-operation and Development (OECD). Corporate governance is related to the supervisory function carried out by the board of commissioners by establishing committees under them, one of which is the Audit Committee.

Results of research conducted by Ghanem et al, (2016) and Collier and Gregory (2006) show that the effectiveness of audit committees has a positive effect on audit fees because the existence of an effective audit committee in a company is considered to provide a more objective supervision system. An effective monitoring system will generate demand for better audit quality and this will have implications for greater audit fees (Hay et al, 2006).

Indonesian Institute of Certified Public Accountants (IAPI) has regulated the audit policy based on regulation number 2 of 2016 stating that the amount of member fees may vary depending on the risk of the assignment, the complexity of the services provided, the level of expertise required, the Public Accounting Office fee structure concerned, and other professional considerations. IAPI reported in 2016 that the application of regulatory mechanisms was not optimal to date. There were still many certified public accountants who did not disclose how they determined the amount of audit fees to be received. Considering that this regulation has not been implemented effectively in Indonesia, the determining factor of audit fees in Indonesia is still an interesting topic to study. Therefore, the purpose of this study is to provide empirical evidence of factors that affect audit fees, such as the existence of political connection in a company and the effectiveness of the Audit Committee.

2. THEORETICAL FRAMEWORK AND HYPOTHESIS

According to Li et al. (2008), the existence of political connection within a company can influence the company’s performance through policies that favor the company and ease in obtaining government projects. In order to get profit, the company can lobby to make policies that are profitable for them, where these activities require funds or resources the company has (Fisman, 2001; Johnson and Mitton, 2003). The company should provide resources in the form of donation to related parties in order to create policies. This should benefit the company to pose risks associated with the exploitation and manipulation of company resources, because the donation itself is not always through the approval of minority shareholders, thus triggering agency problems (Ramsay et al., 2001). Therefore, the existence of political connections in companies is often associated with a low level of transparency in financial statements that results in poor quality financial statements and risks of misstatements in financial statements (Chaney et al., 2011;
Srinidh et al., 2011; Walker and Reid, 2002; Yu and Yu, 2011).

Companies that have a higher risk are more likely to have material misstatements in the financial statements (Gul, 2006). The higher the auditor’s assessment of risks in the company including inherent risk, the higher the audit effort required by the auditor to audit the company. In addition, greater efforts cause auditors to feel that they need to charge large amounts of audit fees to the company (Gul, 2006). Therefore, politically connected companies are believed to pay greater audit fees than companies that are not politically connected (Ariningrum and Diyanty, 2017; Gul, 2006; Khan et al., 2016; Tee, 2018; Wahab et al., 2011; Wahab et al., 2009).

H1: Political connection within the company has a positive effect on audit fees

Indonesia implements a two-tier system in corporate governance. The highest organ of the company that has a supervisory function is the board of commissioners. To help carry out the supervisory function, the board of commissioners forms an audit committee. With regard to audit fees, there are two arguments that illustrate the effect of the effectiveness of the audit committee on audit fees.

The first argument is on the supply, seen through the auditor’s perspective. An effective audit committee can improve the quality of corporate governance. The auditor believes that inherent risk can be lower if the audit committee in the company is effective in carrying out its duties. This ultimately reduces the audit fees charged to the company (Wahab et al, 2011). The second argument is on the demand. As described by Hey et al. (2006), audit fees paid by companies are determined by companies as users. The effectiveness of the supervisory function is carried out by the Board of Commissioners and assisted by the Audit Committee. The company requests higher quality audit services and more thorough audit procedures. This can have implication for the high amount of audit fees charged by the auditor.

H2: The effectiveness of the audit committee has a positive effect on audit fees.

3. RESEARCH METHOD

The population in this study is all companies listed on the Indonesia Stock Exchange (IDX) period 2015-2017 except for financial companies. This research began in 2015 to coincide with the Indonesia President Jokowi’s administration. The type of data used in this study was secondary data taken from information presented in the Annual Report. A total of 444 companies were selected as research samples based on a purposive sampling technique with the criteria described on Table 1.

**Operational Definition of Variables**

The dependent variable of the study is audit fee which is defined as the amount of costs that each company must incur to finance the services of an external auditor who has conducted an audit of the financial statements of the company concerned. Audit fee is measured by the natural logarithm of audit fees contained in the financial statements.

The independent variables in this study are political connection and effectiveness of the audit committee. Political connection is defined as a condition in which one of the company’s leaders, such as the board of directors, the board of commissioners, or the majority shareholder (having a minimum share of 10%) is a member of the legislature, ministers, political party leaders or people related to the government. Political connection (POL) in this study is measured by a dummy variable, by giving a value of 1 for companies that have political connection and a value of 0 for companies that do not have political connection.

<table>
<thead>
<tr>
<th>No</th>
<th>Sample Criteria</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Companies listed on the IDX</td>
<td>510</td>
<td>525</td>
<td>510</td>
</tr>
<tr>
<td>2</td>
<td>Financial Industry Company</td>
<td>(80)</td>
<td>(82)</td>
<td>(87)</td>
</tr>
<tr>
<td>3</td>
<td>The financial statements that cannot be accessed</td>
<td>(95)</td>
<td>(64)</td>
<td>(46)</td>
</tr>
<tr>
<td>4</td>
<td>Companies that do not disclose audit fees</td>
<td>(232)</td>
<td>(230)</td>
<td>(255)</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>103</td>
<td>149</td>
<td>192</td>
</tr>
<tr>
<td>Total Observation</td>
<td></td>
<td>444</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
The second independent variable is the effectiveness of the audit committee, defined as a committee that meets the requirements to protect the interests of shareholders to ensure that the financial reporting, internal control, and risk management are reliable, through efforts to carry out diligent supervision. The effectiveness of the audit committee is measured by the composite index (EFFAC5) confirmed with five characteristics. The five combined characteristics are: Independent Audit Committee (IAC), Audit Committee Expertise (ACEXP), Audit Committee Diligence (ACD), Size of Audit Committee (SAC), and Audit Committee Chair with Accounting Expertise (ACCHX). A score system is used where the dichotomous score of “1” or “0” is for each characteristic of an effective audit committee (Ali et al., 2018). After obtaining the value of the effectiveness score, the researcher ranked it by the score of the effectiveness of the audit committee in the company divided by the value of perfect score.

The control variables in this study are public accounting firms, return on assets (ROA), and company size. Public accounting firm is measured by dummy variable. Code 1 is given to companies that use big 4 public accounting services and code 0 is given to companies that use non big 4 public accounting services. ROA is measured using operating income after tax divided by total assets. Company size is measured using the natural logarithm of total assets.

The analysis techniques used include descriptive statistical analysis, classical assumption test, and hypothesis test (Ghozali, 2011). Descriptive statistical analysis contains information about the characteristics of research data in the form of minimum values, maximum values, mean values, and standard deviations. Hypothesis test is done using multiple linear regression analysis. The following is regression equation model in this study:

\[ \text{LAudFeeit} = \alpha_{0} + \beta_{1}\text{POLit} + \beta_{2}\text{EFFACit} + \beta_{3}\text{BIG4it} + \beta_{4}\text{ROAit} + \beta_{5}\text{SIZEit} + \epsilon_{it} \]

Note:
- \( \alpha_{0} \) = Constant
- \( \text{POL} \) = Political connection within the company
- \( \text{EFFAC} \) = Effectiveness of audit committee
- \( \text{BIG4} \) = Auditor big 4. Using dummy, 1 means audited by Big 4, and 0 means audited by other than Big 4

\[ \text{ROA} = \text{Return of asset} \]
\[ \text{SIZE} = \text{Company Size} \]
\[ \epsilon_{it} = \text{Error coefficient} \]

4. DATA ANALYSIS AND DISCUSSIONS

Results of Descriptive Statistics

Based on the descriptive statistics on Table 2, it indicates that the dependent variable of audit fee has an average value of IDR 775 million, which means that the average company in Indonesia in 2015 to 2017 was paid the total audit fee of IDR 775 million to the auditor. Based on the difference between the maximum and minimum values, the range on this variable is quite high, illustrating that the samples of companies in this study represent the nominal amount of audit fees from small to large. In addition, there are 307 companies that have political connections, or approximately 69.1% of the total sample. The results of this study also support the results of research conducted by Facchio. (2006) that there are more than 28% of companies in Indonesia that have political connection.

The independent variable of the effectiveness of the Audit Committee is measured by five characteristics, as used in the research conducted by Ali et al. (2018). The score of the effectiveness of audit committee for each company is divided by perfect score. The average value obtained is 0.8059. The result shows that the average sample company has a good score in the effectiveness of audit committee. The average value in the study conducted by Ali et al. (2018) is 4, with the ratio of 0.8 obtained from a score of 4 on the five characteristics of the effectiveness of the audit committee.

Results of Multiple Linear Regression Analysis

The hypotheses in this study were tested using multiple linear regression analysis. Before doing the multiple linear regression analysis, the researchers conduct classical assumption test consisting of data normality test, heteroscedasticity test, and the multicolinearity test. The classical assumption test was conducted to find out whether the research data are normally distributed, and free from heterokedasticity and multicolinearity. This research model is feasible to do multiple linear regression analysis because it has passed the classical assumption test.
In Table 3, it shows that the value of adjusted $R^2$ is 0.384, which means that variations in the variables of political connection and the effectiveness of the audit committee are able to explain the dependent variable of audit fees by 38.4%, while the remaining 61.6% is influenced by other factors outside the research model that are not selected as dependent variables. Furthermore, the F test shows a significance value of 0.000, indicating that the independent variables and control variables significantly affect the dependent variable.

### Table 2

**Descriptive Statistics**

<table>
<thead>
<tr>
<th></th>
<th>N</th>
<th>Minimum</th>
<th>Maximum</th>
<th>Mean</th>
<th>Std. Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fee</td>
<td>444</td>
<td>17.66</td>
<td>28.4696</td>
<td>20.4696</td>
<td>1.15451</td>
</tr>
<tr>
<td>Committee</td>
<td>444</td>
<td>.40</td>
<td>1.00</td>
<td>.8059</td>
<td>.14178</td>
</tr>
<tr>
<td>RoA</td>
<td>444</td>
<td>-.46</td>
<td>1.85</td>
<td>.0475</td>
<td>.13989</td>
</tr>
<tr>
<td>Asset</td>
<td>444</td>
<td>19.30</td>
<td>31.88</td>
<td>28.7188</td>
<td>1.74163</td>
</tr>
<tr>
<td>Valid N (list-wise)</td>
<td>444</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Dummy Variable**

<table>
<thead>
<tr>
<th>Variable</th>
<th>%Score1</th>
<th>%Score0</th>
<th>total%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Political Connection</td>
<td>(307) 69.1%</td>
<td>(137) 30.9%</td>
<td>(444) 100%</td>
</tr>
<tr>
<td>Effectiveness of Audit Committee</td>
<td>(246) 35.4%</td>
<td>(198) 44.6%</td>
<td>(444) 100%</td>
</tr>
</tbody>
</table>

Source: Data Proces

### Table 3

**Statistics Test**

<table>
<thead>
<tr>
<th>Variables</th>
<th>Coefficients</th>
<th>t-statistic</th>
<th>Sig</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constant</td>
<td>13.869</td>
<td>17.355</td>
<td>.000</td>
</tr>
<tr>
<td>Political Connection</td>
<td>.324</td>
<td>.130</td>
<td>.001</td>
</tr>
<tr>
<td>Effectiveness of Audit Committee</td>
<td>-.597</td>
<td>-1.965</td>
<td>.050</td>
</tr>
<tr>
<td>Public Accounting Firm</td>
<td>.776</td>
<td>8.321</td>
<td>.000</td>
</tr>
<tr>
<td>RoA</td>
<td>.700</td>
<td>2.262</td>
<td>.024</td>
</tr>
<tr>
<td>Asset</td>
<td>.226</td>
<td>8.336</td>
<td>.000</td>
</tr>
<tr>
<td>F-test</td>
<td>.000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Adjusted $R^2$</td>
<td>.384</td>
<td></td>
<td></td>
</tr>
<tr>
<td>N</td>
<td>444</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Data Proces

In Table 3, it shows that the value of adjusted $R^2$ is 0.384, which means that variations in the variables of political connection and the effectiveness of the audit committee are able to explain the dependent variable of audit fees by 38.4%, while the remaining 61.6% is influenced by other factors outside the research model that are not selected as dependent variables. Furthermore, the F test shows a significance value of 0.000, indicating that the independent variables and control variables significantly affect the dependent variable.

### The Effect of Political Connection on Audit Fee

The results of research conducted using this model are consistent with the first hypothesis which states that political connection has a significant positive effect on audit fee. The level of significance is 5% (0.001 < 0.05). Thus, the first hypothesis (H1) is accepted. It can be concluded that the existence of political connection in a company can increase the inherent risk of a company (Gul, 2006). Politically connected companies can help government-related affairs (Faccio, 2006), and the connected companies can lobby policies that benefit their companies.

Companies that have political connections will cover the process of political contributions which will result in low transparency in the financial statements. Low transparency can result in poor quality of financial statements and risk of material misstatement in financial statements (Chaney et al., 2011; Srinidh et al., 2011; Walker and Reid, 2002; Yu and Yu, 2011). The higher the risk, the higher the efforts taken by the auditor in examining politically connected companies. Auditors are expected to provide appropriate opinions on financial statements, and as a return they will get higher audit fees from connected companies (Ariningrum and Diyanty, 2017; Gul, 2006; Khan et al., 2016; Tee, 2018; Wahab et al., 2011; Wahab et al., 2009).
The result of this study is also in line with the perspective of the Audit Pricing Theory which states that the auditor determines the audit fees to be charged because they must consider the risks that the company has. This can be reflected in the number of efforts made by auditors to carry out audit procedures. Politically connected companies have a high inherent risk (Gul, 2006). It is also in line with the theory and empirical results that politically connected companies pay higher audit fees than unconnected companies.

The Effect of the Effectiveness of Audit Committee on Audit Fee

The results of this study show that the effectiveness of the audit committee has a positive effect on audit fee, with the significance level of 5% (0.050 < 0.05). For that reason, the second hypothesis (H2) in this study is accepted. It can be explained that, in practice, audit fees are seen not only from the auditor’s perspective as an audit service provider, but also from the client’s perspective that plays a role in determining the audit fees to be paid (Hey et al., 2006). Client requests determine the audit fees paid because the client wants an audit conducted by a higher quality auditor, thus causing the audit fees charged to be higher.

Companies that have effective audit committees will encourage the companies to get better audit quality. The companies do this to maintain their reputation and protect themselves from legal responsibilities that might occur in the future due to the low level of supervision that the companies do (Carcello, Hermanson, Neal, & Riley, 2002). Demand for better audit quality and wider audit coverage will make the company pay a higher audit.

The results of this study support the argument of demand-side theory which states that the higher the level of the effectiveness of supervision conducted by the Audit Committee to assist the Board of Commissioners in overseeing management, the higher the demand for better audit quality. The demand for high audit quality will in turn affect higher audit fees charged by auditors (Carcello, Hermanson, Neal, & Riley, 2002).

5. CONCLUSION, IMPLICATION, SUGGESTION, AND LIMITATIONS

This study aims to analyze the effect of political connections and the effectiveness of the audit committee on audit fees. Based on the first hypothesis testing, it provides evidence that the existence of political connection in the company significantly affects audit fees. Politically connected companies are considered to have a higher risk than other companies that do not have political connections. Consequently, auditors will increase the audit effort required, thus resulting in the high audit fees charged (Aringgrum and Diyanty, 2017; Gul, 2006; Khan et al., 2016; Tee, 2018; Wahab et al., 2011; Wahab et al., 2009). Based on the second hypothesis testing, it is found that the effectiveness of the audit committee has a significant effect on audit fees. This result supports the argument of demand-side theory which states that an effective audit committee will conduct oversight. The audit committee will ask the auditor to conduct good quality audits which will have implications for the high audit fees charged (Carcello, Hermanson, Neal, & Riley, 2002).

The limitations in this research include: 1) there is only a small number of companies that disclose audit fees in their annual reports; 2) in Indonesia, there are still no reliable sources that show someone’s political relationship, so the researchers only use online media as information to find out someone’s political relationship.

This study recommends that, for further study, the researchers should add variables that have an effect on audit fees. In addition, this study also suggests that further research find more accurate sources for one’s relationship with politics.

REFERENCES


