

THE EFFECT OF BOARD INDEPENDENCE, CORPORATE COMPLEXITY, POLITICAL CONNECTION, COMPANY SIZE, AND COMPANY RISK ON AUDIT QUALITY WITH AUDIT FEE AS MEDIATING VARIABLE

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ABSTRACT

This study aims to examine the effect of board independence, corporate complexity, political connection, company size, and company risk on audit quality with audit fee as mediating variable. The total of 122 observations were used to test the hypotheses. Secondary data were obtained from the annual report published by the companies. WarpPLS 7.0 is used to analyze the data. The results show that board independence has no effect on audit fee, corporate complexity has no effect on audit fee, political connection has negative significant effect on audit fee, company size has a positive significant effect on audit fee, company risk has a negative significant effect on audit fee, audit fee has a positive significant effect on audit quality, and audit fee can partially mediate the relationship between company size and audit fee.

Keywords: client attribute, audit fee, audit quality

JEL classification: M42

INTRODUCTION

The separation of ownership between principal and agent creates agency problems. In order to reduce

these problems, agency cost is incurred. Audit fee is a type of agency cost. Audit fee is an important topic to study because the amount of audit fee is one of the determinants of financial statement reliability.

Audit services are used to improve the quality of financial statements as a form of responsibility of managers to shareholders. Good quality financial reports can be obtained with good audit quality. However, in reality the audit fees issued by companies are often not comparable to the audit quality received (Gao, Qi, Xu, & Zhu, 2019; Salehi, Tarighi, & Safdari, 2018). This is proven by the many cases relating to public accounting firms with international networks that basically charge high audit fees. The cases are related to the poor audit quality provided by the accounting firm. The audit quality in question is the auditor's ability to find material misstatements and report them (DeAngelo, 1981).

The inconsistent results (Gao et al., 2017; Ganesan *et al.*, 2018) regarding the relationship between audit fee and audit quality motivate the author to conduct further research on the relationship between these variables. The author also wants to examine the factors affecting audit fee especially in developing countries. Therefore, the purpose of this study is to examine the factors influencing audit fee and see the effect of audit fee on audit quality. This study also examines the mediating role of audit fee on the relationship of factors affecting audit fee and audit quality.

The model in this study as a whole refers to

the research of Gellings (2017) which examines the mediating role of audit fee on the relationship between IFRS implementation and audit quality. The results of the study found that audit fee is able to mediate the effect of IFRS implementation on audit quality. The difference between this research and Gellings (2017) is that the author changes the independent variables in the research model that are adapted to the conditions in Indonesia.

The board of commissioners has an important role in the company. The board of commissioners acts as a bridge between shareholders and company management. Appointment of auditors and determination of audit fees are also determined by the board of commissioners based on the recommendation of the audit committee. The presence of an independent commissioner enhances the oversight function carried out by the board of commissioners. Research on the relationship of board composition, audit fees, and audit quality has been widely studied in other countries, especially in developed countries (Carcello, Hermanson, Neal, & Riley, 2000; Nehme & Jizi, 2018; O'Sullivan, 2000). However, this research is still limited in Indonesian literature. Therefore, this study has the motivation to expand the research literature on the influence of board independence on audit fees and audit quality, especially in developing countries. The results of this study will contribute to them to determine the mechanism of corporate governance related to the composition of board members more precisely to reduce agency costs and add literature on the relationship of the board of commissioners, audit fees, and audit quality.

Indonesia is in the top 10 crony capitalism countries (The Economist, 2016). Crony capitalism is an economic term that states that the success of a business depends on the close relationship between businessman and the government. Inconsistent results were found in the relationship between political connections and audit fees. Several studies have found that political connections are positively related to audit fees (Nurjanah & Sudaryati, 2019; Primasari & Sudarno, 2013; Wea, 2019). These results are not supported by another research (Pradana & Purwanto, 2016). Therefore, the author is motivated to re-examine the relationship between political connections and audit fees. This research contributes to the government in formulating policies relating to corporate political

relations and for auditors to consider this factor when determining audit risk and conducting audits.

Auditors need to understand the characteristics of client companies in conducting the audit process. The characteristics to be tested in this study are corporate complexity, company size, and company risk. Indonesia is a country with high company complexity. Indonesia also has companies of various sizes and risks. The size and risk of the company also determines the scope, complexity, and time of the audit which will affect audit fees and audit quality. The inconsistent results regarding the relationship of these variables also provides motivation for the author to conduct further research. Based on the explanation above, this study aims to examine the effect of board independence, corporate complexity, political connections, company size, and company risk on audit quality with audit fee as mediating variable.

LITERATURE REVIEW

Agency Theory

Agency theory was first introduced by Jensen and Meckling (1976). This theory explains the agency relationship between principal and agent in which the agent is responsible to the principal. Therefore, the principal trusts the agent for the decision-making process. Agency problem arising from this is how to make agents act in the interests of principals.

The Effect of Board Independence on Audit Fees

Independent commissioners are considered as good corporate governance because they are not under the authority of the corporate hierarchy so that the supervision conducted is independent and objective. As we know, an independent board expects understandable and reliable financial reporting by proper supervision and internal control. Therefore, it can increase the reliability of accounting reports and reduce audit risk. Peasnell et al. (2000) prove the existence of a negative relationship between earnings management and board members from outside the company.

Based on the explanation above, it can be concluded that when a company implements GCG, the risk of the company in committing financial fraud is low so that audit risk is also low. When audit risk is low, audit testing is not so extensive that the auditor does

not require a long audit time and high effort, therefore, the formulated hypothesis is:

H1: Board independence has a negative effect on audit fees

The Effect of Corporate Complexity on Audit Fees

Corporate complexity raises agency problems namely information asymmetry. Information asymmetry occurs when the agent knows more information about the company than the principal. Corporate complexity in this study is seen from whether the company has a subsidiary or not. The information asymmetry in this case occurs because the principal does not have access to individual subsidiary information. The Principal can only see the reports about subsidiaries in the annual report presented by the parent company. Often, these consolidated reports are not made transparently. Therefore, services are needed to ensure that the company’s financial statements are presented in accordance with the actual situation.

When the auditor discovers that the company carries out related party transaction activities or the company has many subsidiaries, the auditor will face complicated work. The auditor will have difficulty in determining the reasonableness of the financial statements presented. To decide on the reasonableness of the financial statements, the auditor requires a longer audit process and time which will increase the audit fee. This is consistent with the study conducted by Wea (2019) which concluded that the level of complexity of the company has a positive effect on audit fees, therefore, the hypothesis formulated is:

H2: Corporate complexity has a positive effect on audit fees

The Effect of Political Connection on Audit Fees

The literature on crony capitalism and political protection says that political connections in companies are caused by severe agency problems, namely the opportunistic behavior of the company’s managerial position (Boubakri, Guedhami, Mishra, & Saffar, 2012). Companies with political connections can ignore market discipline, accountability, and transparency in corporate transactions by not seeking financing from the capital market because the government can influence banks to provide very competitive financing levels (Chaney, Faccio, & Parsley, 2011). Companies

with political connections are more risky because these companies are considered to operate inefficiently and often have too much debt (Bliss & Gul, 2012). Based on the description above, the author concludes that companies with political connections have high audit risk and thus require a longer audit process and time that can increase audit fees, therefore, the hypothesis formulated is:

H3: Political connections have a positive effect on audit fees

The Effect of Company Size on Audit Fees

Large companies have more activities than the small ones. Therefore, the auditor needs more detailed audit procedures to analyze the data given the size of assets and liabilities on the balance sheet of large companies (Xu, 2011). This could result in increased time and effort to audit such large companies and the number of audit teams that would have an impact on increasing audit fees. This idea is supported by the research conducted by Musah (2017). The study found that company size had a significant positive effect on audit fees. Based on this explanation, the hypothesis formulated is:

H4: Company size has a positive effect on audit fees

The Effect of Company Risk on Audit Fees

The more risks involved in audit work, the greater the responsibility that deserves a higher pay for compensating external auditors for taking such risks. The risk of a higher client company causes more effort by the auditor to reduce the risk of litigation in the future. Studies conducted by (Sun & Liu, 2011) show that clients with high levels of risk will force external auditors to carry out audit procedures effectively. Therefore, financial risk must be included in the audit program to determine the “red signal” that indicates the possibility of fraud. In addition, (Firth, 1997) found that a higher level of client risk will increase the auditor’s efforts which have an impact on more audit fees. Therefore, the accounting firm must do detailed work to complete or moderate the risks, so the hypothesis formulated is:

H5: The risk of client companies has a positive effect on audit fees

The Effect of Audit Fees on Audit Quality

Previous studies conducted by Palmrose (1986)

showed that accounting firms charge higher audit fees for better audit quality. The company will put financial pressure on auditors to provide good audit quality because the audit fee is also high (Ghafran & O’Sullivan, 2017). Studies conducted by (Ganesan et al., 2019; Mulyani & Munthe, 2018) produce a significant positive effect between the relationship of audit fees to audit quality. Based on this explanation, the hypotheses formulated are:

H6: Audit fee has a positive effect on audit quality.

The Effect of Board Independence, Corporate Complexity, Political Connection, Company Size, and Company Risk To Audit Quality With Audit Fees As Mediating Variable

Companies with good corporate governance expect good audit quality to find fraud to ensure the sustainability of the company and as a form of accountability to shareholders. Therefore, the better corporate governance in the form of effectiveness of the board of commissioners, the higher audit quality is expected. Corporate complexity also requires high audit quality so that the findings obtained cover the entire company. The auditor must use more effort and a long time to audit companies with a high level of complexity. This is expected not to reduce audit quality so that auditors can continue to find material misstatements in complex companies.

Politically connected companies tend to have high audit risk because the company gets certain

privilege from the relationship (Faccio et al., 2006). High audit risk requires high audit quality in order to detect fraud. Therefore, it can be said that companies want high audit quality. Large company size and high company risk require high audit quality. High audit quality is needed because of the wide audit scope, the large amount of audit time required, and the extra audit effort. High quality audit is expected to be able to find material misstatements in large and high-risk companies.

In order to get a good audit quality, the company is willing to pay a certain amount of costs. The company expects the amount of audit fees incurred in proportion to the audit quality obtained. The higher the costs incurred, the higher the audit quality is expected. Research on the effect of audit fees as a mediating variable has been investigated by Gellings (2017). The research proves that audit fees can mediate the effect of IFRS adoption on audit quality. Based on the description, the hypotheses formulated are:

H7a: Audit fees mediate the effect of board independence on audit quality

H7b: Audit fees mediate the effect of corporate complexity on audit quality

H7c: Audit fees mediate the effect of political connections with audit quality

H7d: Audit fees mediate the effect of company size with audit quality

H7e: Audit fees mediate the effect of company risk with audit quality

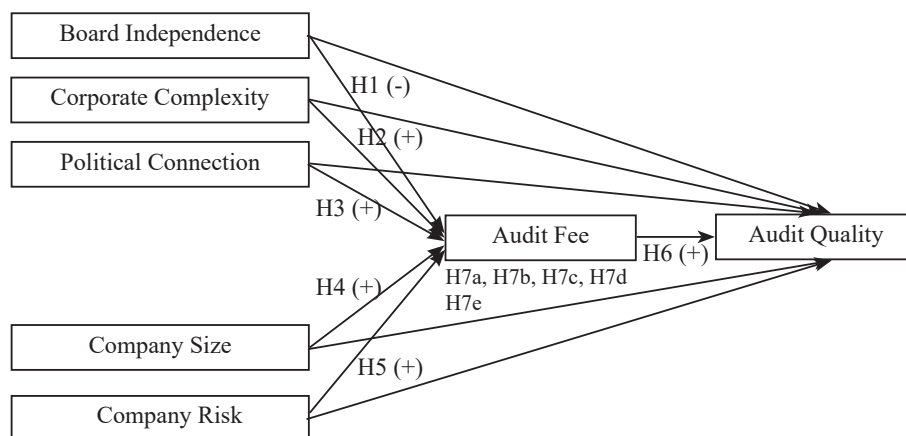


Figure 1
Research Model

Research Variables

Variabel	Pengukuran
Board Independence (BOARD)	$\frac{\text{Independence Commissioners}}{\text{Total of Board of Commissioners}}$
Corporate Complexity (KOMP)	0: Companies with no subsidiaries 1: Companies with subsidiaries
Political connection (KPOL)	0: Companies with no political connection 1: Companies with political connection
Company size (SIZE)	Total asset
Company risk (RISK)	Debt to total asset ratio (DAR)
Audit fee (AUFEE)	The nominal value of audit fee
Audit quality (KUAL)	$AWCA_{i,t} = \frac{WCA_{i,t-1}}{S_{i,t-1}} \times S_{i,t}$ $WCA = \frac{(\text{Current Asset} - \text{Cash} \& \text{Cash Equivalents}) - (\text{Current Liabilities} - \text{Short Term Debt})}{S_i}$ Si = Total Sales

Research Sample

The sample selection method in this study uses a purposive sampling method with the following criteria 1) Companies other than service and financial companies listed on the Indonesia Stock Exchange from 2015 – 2018; 2) Companies that publish annual reports for the period 2015 - 2018 on the IDX website and company website; 3) Companies that issue annual reports on audited results; 4) Companies that use December 31 as the end-year close book they can be compared 5) Companies that disclose the amount of audit fee and other required information in the annual report and 6) Companies that do not use foreign currencies in their

financial statements.

Data Source

The author used data from annual reports of manufacturing companies in the period of 2015-2018 obtained through the Indonesia Stock Exchange website and company website.

RESULTS

Based on the results of the sample selection in this study conducted using the purposive sampling method, the number of samples used are 35 companies which can be seen in the table below.

Table 1
Sample Selection

Samples	2015	2016	2017	2018
Number of companies listed on the IDX	568	583	620	677
Number of manufacturing companies	146	145	161	163
Companies that do not disclose audit fee information	(105)	(96)	(112)	(114)
Financial statements that do not use rupiah currency units	(14)	(14)	(14)	(14)
Number of companies sampled	27	35	35	35
Total data for 2015 - 2018		132		
Data outliers		10		
Total final data		122		

Source: data processed, 2020

Descriptive Statistics

Descriptive statistical data shows minimum, maximum, mean and std. deviation:

Table 2
Descriptive Statistics

Variable	N	Minimum	Maximum	Mean	Std. Deviation
BOARD	122	0,25	0,8	0,42378	0,11407
KOMP	122	0	1	0,77	0,422
KPOL	122	0	1	0,35	0,480
SIZE	122	159.563.931.000	49.068.650.213.000	5.494.297.241.057	7.782.650.474.358
RISK	122	0,03873	1,01949	0,42105	0,20527
AUFEE	122	96.800.000	15.000.000.000	1.453.062.798	2.491.989.626
KUAL	122	583.724.367	2.005.999.974.559	225.609.288.324	358.411.534.736
VALID N (Listwise)	122				

Source: data processed, 2020

Model Testing

Table 3 shows the results of the R-square estimation:

Tabel 3
R-Square Score

Exogenous Variable	R ² Score
AUFEE	0,552
KUAL	0,661

Source: data processed, 2020

This value indicates that the audit fee is explained by its exogenous variables namely board independence, corporate complexity, political connection, company size, and company risk of 55.2%, while 44.8% is explained by variables outside this study. While audit quality is influenced by its exogenous variables of 66.1%, while 33.9% is explained by other

variables not included in this study.

The next model evaluation used is Q-square predictive relevance based on R² of each endogenous variable. R1 is the R-square of the audit fee. R2 is the R-square of audit quality. The value of Q-square predictive relevance is:

$$Q2 = 1 - (1-R1)(1-R2)$$

$$Q2 = 1 - (1 - 0,552)(1 - 0,661)$$

$$Q2 = 1 - (0,448)(0,339)$$

$$Q2 = 1 - 0,1587$$

$$Q2 = 0,8413$$

Based on these calculations, the Q2 value obtained was 84.13% which means that the model has a predictive value of 84.13%. This figure shows that the variable board independence, corporate complexity, political connection, company size, and company risk are able to explain the audit fee and audit quality

Table 4
Goodness of Fit

Result	P-value	Criterion	Conclusion
APC = 0,261	<0,001	<0,05	Accepted
ARS = 0,607	<0,001	<0,05	Accepted
AVIF = 1,436		<5, ideal <3	Accepted

Source: data processed, 2020

of 84.13%, while as much as 15.87% are explained by variables not in this study. Thus, this model can be said to be good. The following Table 4 shows the goodness of fit results:

Based on this table, this research model can be said to be fit so that this data can be used for hypothesis testing.

Table 5
Hypothesis Testing Results

Path	P-value	Path Coefficients
BOARD → AUFEE	0,099*	-0,014
KOMP → AUFEE	0,080*	0,124
KPOL → AUFEE	0,017**	-0,186
SIZE → AUFEE	<0,001**	0,677
RISK → AUFEE	0,011**	-0,200
AUFEE → KUAL	0,014**	-0,192
BOARD → AUFEE → KUAL	0,366	0,022
KOMP → AUFEE → KUAL	0,354	-0,024
KPOL → AUFEE → KUAL	0,287	0,036
SIZE → AUFEE → KUAL	0,019**	-0,130
RISK → AUFEE → KUAL	0,273	0,038

Source: data processed, 2020

**Significant < 0,05

*Significant < 0,10

DISCUSSION

Board independence does not affect audit fees. This is because there is no need for a large board of commissioners to determine audit fees. Corporate complexity does not affect audit fees. This result proves that the existence of subsidiaries does not mean that the company is complex. Political connections have a significant and negative impact on audit fees. This relationship can occur because there is a close relationship between managerial parties who have political connections and auditors. Company size has a significant and positive effect. This result proves that large companies require extensive audits so that it has an impact on increasing audit fees. Company risk has a negative impact on audit fees. This means that auditors must carry out extensive and detailed testing to reduce company risk so that it has an impact on increasing audit fees. Audit fees have a significant and positive effect on audit quality. This is because the auditor has sufficient financial resources to conduct the audit process properly. Audit fees only

mediate the effect of company size on audit quality. This is because to test large companies with good audit quality, the auditor must have financial resources to achieve this so that the audit fee increases. Company size also has a significant and negative direct effect on audit quality. This proves that the size of the company can have a negative impact on audit quality if it is not balanced with sufficient resources.

CONCLUSION AND RECOMMENDATION

Conclusion

This research is conducted to see the effect of board independence, corporate complexity, political connections, company size, and company risk on audit quality with audit fees as mediating variables. The analysis was performed using SEM PLS with the WarpPLS 7.0 analysis tool. This research resulted in 3 accepted hypotheses and 8 rejected hypotheses. There are many factors affecting audit fees. These factors are divided into three broad categories, namely client attributes,

auditor attributes, and engagement attributes. This research focuses on client attributes. Insight of these factors is useful for getting better negotiations regarding audit fees.

Limitations

This research has been carried out in accordance with scientific procedures, but this study still has the following limitations 1) There are only a few companies that disclose audit fees on financial reporting; 2) Proxy for audit quality in this study can only be used in manufacturing companies; and 3) Political connection variabel is assessed subjectively by looking at the managerial profiles listed in financial reporting and other online media.

Recommendation

The author provides the following suggestions 1) Future studies can find other sources to obtain audit fee information; 2) Future studies can add other variables both from the auditor attribute and engagement attribute with a longer period; 3) Further research can re-examine variables related to the composition of the board of commissioners and their effect on audit fees. For example, does the board of commissioners who have accounting backgrounds have an impact on the demands of the auditor, thereby increasing the audit of the fee; 4) Further research can re-examine corporate complexity variables using different proxies such as related party transactions, number of branch offices, whether the company conducts transactions with foreign currencies and whether there are subsidiaries abroad; 5) Future studies can re-examine company risk variables with other proxies such as whether the company has a loss; 6) Future studies can re-examine audit quality with different proxies that allow the use of companies from all sectors; and 7) Future studies can use control variables.

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