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The Relationship between Business and the Audit Fee: Evidence from Indonesian Listed Companies

Andrivan Nindya Krisna[a], Amalia Rizki[b*], [a,b]Department of Accountancy, Faculty of Economics and Business, Universitas Airlangga, Indonesia. Email: [b*]amalia.rizki@feb.unair.ac.id

This research intends to obtain empirical evidence to determine the relationship between a business and the external audit service fee. Using the modified model from research of Simunic (1980), this research took balanced samples from 26 manufacturing firms listed on the Indonesian Stock Exchange (IDX) from the period 2014 to 2016 in order to represent the population of manufacturing firms listed in that time period. Using audit fees as dependent variable and firm size, audit complexity, audit risk, and Big-Four audit firms' premium, this research tried to find out the relationship between those variables, using multiple linear regression as the method to achieve that goal. The result of this research shows that there is a correlative relationship between firm size, audit complexity, audit risk, and 'Big-Four' audit firms' in regard to a premium positive and audit fee.

Key words: *Audit fee, firm size, audit complexity, audit risk, big-four audit firms' premium.*

Introduction

Stock exchange regulators globally require every registered firm to do an audit of their own financial statement. The New York Stock Exchange requires all its listed firms to submit an Auditor's Report, prepared by an external auditor, on an annual basis as a requirement for being listed on the stock exchange. The same goes for the Indonesian Stock Exchange. Audits by an external, non-vested auditor are required to show the firm's financial statement is true and fair, and consistent with its definitions. The definitions state that auditing is a systematic examination of the books and records of a business or organisation that ascertain or verify and report upon the facts regarding the financial operation and the result thereof (Montgomery, 1940). Since the failures of reporting in the Asian Financial Crisis in 1997/1998, and Enron's scandal at the end of 2001 concluded with the enactment of Sarbanes-Oxley act, the quality of audits required have been in greater demand.

Evidence of prior research suggests that bigger audit firms provide a higher quality audit because they have more expertise than the smaller audit firms whose clients usually came from larger firms with variety industries (O'Keefe and Westort, 1992). Therefore, it is important to impose limits on the provision of general audit services on the financial statements of an entity by the audit company by considering the client's equity between large, medium and small companies (Widyaningsih et al., 2019). Within the group of bigger audit firms, Big-N audit firms have been associated with better auditing service than the non Big-N. For example, audits for clients of Big-N result in less 'earnings management' than non Big-N audited clients (Becker et al., 1998). This higher quality of audit has resulted in higher fees (premium) for the client in comparison to their smaller competitor (Gonthier-Besacier and Schatt, 2007).

Other than being an audit by larger audit firm from Big-N, some other factors also affect the audit fee. Corporate governance is also found to be having an effect on the audit fee (Larasati et al., 2019). Based on observations of 1,022 firm-year of Malaysia's firms, research has found there is a positive and significant relationship between corporate governance and audit fees, which is consistent with the standard 'demand-side' explanation. Also, it is found that auditing in a politically-connected firm is perceived to be riskier, thus requires more auditor effort (Wahab et al., 2011).

Differences in how the board's oversight quality is being maintained also plays a role in determining the audit fees. A more expert, diligent, and independent board may demand a higher quality of audit to avoid legal liability (Gilson, 1990; Sahlman, 1990), protect its own reputation capital (Fama, 1980; Fama and Jensen, 1983; Gilson, 1990), and promote interest on shareholders. With greater demand of audit quality from firm boards, the firm will choose to engage with auditors from Big-N, as they are seen to provide the highest level of audit quality possible (Palmrose, 1988; Simunic and Stein, 1996). As mentioned before, an audit from Big-N audit firms will exhibit some amount of premium compared to the non Big-N competitor. Moreover, the Big-N forms will require more audit work than they usually provides because the client demanded due to prior reasons. This will further increase the audit fee for the client.

Pong and Whittington (1994) concluded that auditee size, complexity (measured by number of subsidiaries), Big-N effect (suggested by their premium), and low balling (tendency to cut fees to capture new audits) have an effect on the overall audit fees with auditee size, complexity, and Big-N effect (Big-Eight in this case) having a significant effect. Low balling has a persistent tendency toward affecting the audit fees, but it may be argued that low-balling takes place whenever a premium for cover set-up costs is not charged with a newly-appointed auditor. Similarly, Pong and Whittington (1994) and Thornton and Moore (1993) found that many empirical studies regarding the audit fees being associated with client's characteristics had been conducted in the U.S. (Simunic, 1980 and 1984, Palmrose, 1985 and 1988, Francis and Simon, 1987) and England (Francis 1984). They concluded that four variables are

positively associated with external audit fees: Client's firm size, internal control strength, business risk, and audit complexity.

Although much prior research regarding the audit fees factors has been done, the factors being investigated are not comprehensive and the variables are varied, and while essentially being the same, research done by Simunic (1980), Palmrose (1986), and Simon and Francis (1987) still uses the Big-Eight as opposed to Big-Four as the 'big auditor' factor. Also, the newer research done by Rusmanto and Waworuntu (2015) in Indonesia is using a model developed by Wu (2012), which is a model developed by Simunic (1980) modified to according to the Chinese institutional environment which focusing on corporate governance. These reasons motivates researcher to combine the factors that prior research had investigated, and renew the research using most recent data in Indonesia to make the result more relevant in Indonesia.

This research is aiming to represent a different population than the research of Rusmanto and Waworuntu, and other prior researchers, in order to accurately represent manufacturing firms during the period of 2014-2016, and the research is limited by the availability of firms that disclosed their audit fee expenses. The researcher has set the criteria of samples represented by the following questions: Is a manufacturing firm listed on the Indonesian Stock Exchange (IDX)? Have they disclosed their audit fee in 2014 until 2016 consecutively, and have they published their financial statements in the main currency of Indonesian Rupiahs (IDR)?

This research shows that there is a positive relationship between the firm size, with a firm's total assets acting as the measurement and the audit fee. This means that the bigger the firm's total asset value, the higher the fee the auditor will charge the auditee for their service. The more subsidiary a firm has, which implies the higher audit complexity, the higher the fee charged. The higher the ratio of inventory and receivable to total assets, which implies higher audit risk, the higher the audit fee charged. A company being audited by a Big-Four audit firm will have a higher audit fee.

This research contributes at the academic level by researching the significance of multiple factors that determine audit fees in Indonesia's market. It is renewing research using Big-Four auditors to make data more relevant and recent. This research also contributes to the practical level by helping managers of a firm to identify the factors that affects the amount audit fee in Indonesia. This research also provides information as a resource for audit firms to decide their audit fees and when employ after learning a client's characteristics.

The structure of this paper is as follows: Part 2 is literature review and hypotheses development; Part 3 is sample description and research variable; Part 4 is result and discussion; Part 5 is conclusions, limitations, and suggestions for future directions on from this research.

Literature Review

Theoretical Framework

The matters pertaining to agency theory have been explained by Jensen and Meckling (1976) and Fama (1980). Jensen and Meckling (1976) attempted to combine elements from the theory of agency, theory of finance, and theory of property rights to develop their own theory of the structure of a firm. In their research, Jensen and Meckling (1976) defined the agency relationship as follows:

"We define an agency relationship as a contract under which one or more persons (the principal(s)) engage another person (the agent), to perform some service on their behalf which involves delegating some decision-making authority to the agent (Jensen and Meckling, 1976:308)."

Jensen and Meckling (1976) inferred that if both parties – the principal and the agent - are utility maximised, there is a good reason that the agent will not always act in the best interest of the principal. Principal can limit the agent's divergence of interest by monitoring the activities of the agent and expanding some amount of incentive for the agent. In the agency relationship, it is very possible that there is a conflict caused by differences in interests between principals and agents (Agustia, Muhammad, & Permatasari, 2020; Mohammadi, Kardan, & Salehi, 2018; Bukit & Iskandar, 2009). In some situations the principal will pay the agent to expend resources (bonding costs), to ensure that the agent will not take actions that would harm the principal. Otherwise the agent will have to compensate the principal if such actions did take place. When the decision taken by the agent did not maximise the principal's welfare, the difference of principal's welfare in dollar amount was referred by Jensen and Meckling (1976) as residual loss. Thus, Jensen and Meckling (1976) define the costs of agency as the sum of (1) monitoring expenditure by the principal, (2) bonding expenditures by the agent, and (3) the residual loss.

Other than Jensen and Meckling (1976), Fama (1980) attempted to explain the matters of agency theory. However, Fama (1980) is focussed more on how the separation of ownership and control could work efficiently. Fama (1980), based on model constructed, argued that by revision of wages by the managerial labour market, the managerial incentive problems – where agents would take initiatives to take more on the job than is agreed in a contract – would be resolved. Managers and principals are both parties who want their respective interests to be implemented (Fitri et al., 2019; Lubis, Rustam, & Muda, 2017).

A notable example of when the agency problem took place, when the agent tried to maximize its own benefit to such an extreme degree, is the Enron scandal of 2001. Many Enron's

executives were proven guilty of misleading the board of directors in regards to debts of billions of dollars from failed projects and deals. Arthur Andersen, its engaged auditor, also proven to be guilty by illegally destroying documents relevant to the investigation, and as a result, its license was voided, effectively closing the business. In this example, the principals were being misled by the agents who were hiding the debts of the company. This resulted in the skyrocketing of the agency costs.

Hypotheses Development

Auditee Firm Size and Audit Fee

The firm size refers to how big the firm is, with assets of the firm as the indicator (Lutfi, Nazwar, & Muda, 2016; Arifuddin, Hanafi & Usman, 2017). With the increase of firm assets , the auditor will have to spend more time and effort in making sure that their work is accurately representing the actual condition of the firm. The effort made by the auditors may be in the form of acquiring more samples to be tested, distributing more letters of confirmations to vendors, acquiring more detailed information regarding the internal control systems, among many other examples. These kinds of effort made by the auditors will inevitably demand higher compensation for the auditor for their work in the form of salary. By paying ahigher salary to the auditors, audit firms will charge the audit fee higher than the auditee firm with lesser assets.

From all of the research that has been done in the past, all have not failed to include the factors of auditee size when calculating its effect toward audit fee. Although the measurement of audit size can be measured several ways, e.g. using total assets, sales, or turnover, all of the previous research has found that auditee size is a significant factor when determining the audit fee. Pong and Whittington (1994) and Rusmanto and Waworuntu (2015) argued that auditee size is the fundamental determinants of audit fee. Based on the preceding explanation, the researcher proposes hypothesis as follows:

H1: The is a relationship between Auditee firm size and the audit fee

Audit Complexity and Audit Fee

Similar to the auditee firm size, the complexity of an audit of a firm will affect the audit fee from the engagement in order to ensure the quality of the audit. Complexity of an audit includes how many subsidiaries the auditee has, how many industries the auditee operates in, and how big the ratio of foreign asset is compared to total asset of auditee. However, different to the firm size, the main concern of the auditors regarding the complexity is the difficulty of the audit, rather than the bulk effort that is required to complete an audit according to auditors' standards. Within a firm which is considered to be "complex", the decision centre is more

numerous than the "simple" one, and they all needed to be monitored by the auditors. To compensate for the difficulty of an audit, auditors will charge a higher audit fee toward the auditee.

Simunic (1980), in his research, did include the factors of audit complexity and expanded it into three variables (SUBS, DIVERS, and FORGN) for measurement. The result showed that all of those three variables significantly affect the audit fee. Francis (1984) also tried to factor in the audit complexity when determining the audit fee, but because of limitation of publicly available data, he only managed to use the number of subsidiary variables (equivalent with SUBS). Francis (1984), similar with Simunic (1980), obtained results that suggested that the audit complexity is a significant factor that affected the audit fee. Based on the preceding explanation, the researcher proposes an hypothesis as follows:

H2: There is a relationship between Audit complexity significantly and the audit fee

Audit Risk and Audit Fee

The risk of the audit in this context refers to the ratio of both total receivable and total inventory compared to the total assets at the year end. Both of the receivable and inventory accounts are "risky" because they require a precise judgement to determine the accurate value of those accounts. Regarding the receivable, auditors are required to predict and evaluate the auditee prediction pertaining the reasonable amount that the auditee may collect in the future. Regarding the inventory, auditors are also required to predict and evaluate the auditee prediction pertaining the value of inventory in the future, considering many factors. This "risky" prediction will force the auditor to charge an audit fee that corresponds to the ratio of both receivable and inventory account.

Simunic (1980) hypothesised that the audit risk affects the audit fee. Using variables of REC and INV as proxy for the risk of the audit, Simunic (1980) concluded that the risk of the audit affects the audit fee significantly. Francis (1984) intended to test the same factor, but, instead of percentage of receivable and inventory in assets, he used percentage of assets in current assets, quick ratio, equity to debt ratio, and month-of year-end instead. The result suggested that audit risk is a significant factor that affects audit fee, similar to Simunic (1980). Based on the preceding explanation, the researcher proposes the hypothesis as follows:

H3: There is a relationship between Audit risk and the audit fee

Big 4 Audit Firms' Premium and Audit Fee

The Big-Four audit firms are the "big name" in the audit world. They are trusted by many firms and financial statement users to be reliable and to present the value of a firm as accurately as possible. Because of this, many firms use the Big-Four audit firm service and the big-four audit firms have now gained the power to charge a higher audit fee compared to non-Big-Four firms. They may do so because their consumers believe that the services they provide are the best and this has become the standard audit service. By not using a Big-Four service, consumers may believe that the financial statements are not reliable, thus decreasing the trust upon the auditee. In regards to the existence of the Big-N audit firms' premium, Simunic (1980) argued that, with the exception of Price Waterhouse & Co. audit firm, Big-Eight audit firms' average fees were less than their non-Big-Eight competitor for both "large" and "small" auditee, as measured by their sales. However, the research of Palmrose (1986) suggests a different conclusion. Palmrose (1986) concluded that Big-Eight audit firms charge more for their audit works than their non Big-Eight competitor, with Palmrose who tried to explain this difference in his appendix A. Francis and Simon (1987) tried to test this difference using a "small" market sample and came up with a similar conclusion to Palmrose (1986). Pong and Whittington (1994), and Campa (2013), also tried to test the existence of Big-N premium in U.K. market. They both obtained evidence that suggested that a Big-N premium did exist. Based on the preceding explanation, the researcher chose to accept the Palmrose explanation and the majority of prior research, and proposes hypothesis as follows:

H4: There is a significant relationship between Big-Four audit firms' premium and the audit fee

Research Design

Sample and Source of Data

The population of this research is all of the listed manufacturing firms on the Indonesian Stock Exchange (IDX). The full list has been provided on the IDX website (www.idx.co.id). In choosing the samples for this research, the researcher uses purposive sampling (deliberate sampling). In this research, the researcher obtained all of the data necessary - external audit fees (proxy of audit fees), total assets at year-end (proxy of auditee firm size), the number of subsidiary of firm (proxy of audit complexity), the total inventories and total receivables at year-end (proxy of audit risk), and the auditor in engagement (proxy of Big-Four audit firms' premium) - from the audited financial statements of respective firms and Orbis. The audited financial statements are published in either a firm's own website or through the website of the Indonesian Stock Exchange (www.idx.co.id). However, to obtain the ratios of auditee's

inventories and receivables to total assets at year-end, the researcher hd to calculate them manually after obtaining the data.

Operational Definition and Variable Measurement

The dependent variable used in this research is audit fee. Audit fee is defined as a fee a company pays an external auditor in exchange for performing an audit. We decided to use only the audit fees which resulted from the engagement of audit between the auditee and the audit firm as the dependent variable as a sole proxy of audit fees because the audit department in Indonesia has not been fully developed, thus making it almost impossible to obtain the necessary data. That being said, it is also not possible to obtain the data for external audit fees of every single listed firm. Because of the "voluntary disclosure" policy on the audit fee in Indonesia, the number of firms that has listed their own audit fee on their financial statement is limited.

The independent variables used in this research are auditee firm size, audit complexity, audit risk, and big-four audit firms' premium. Auditee firm size is measured as the natural logarithm of the firm's total assets at year-end (variable name lnASSETS). We used the number of subsidiaries of a firm (variable name SUBS) as a sole proxy of audit complexity. However, in the application of audit risk proxy in this research, we prefer to follow Francis and Simon's (1987) study, which combined both the ratio of inventories and ratio of receivables to total assets at the year's end (variable name INVREC). The dummy variable of Big-Four audit firms' premium is valued as 1 if the auditor is a member of Big-Four audit firms and 0 if the auditor is not a member of Big-Four audit firms.

Methodology

This research uses descriptive analysis as a means to provide the overview of the data obtained. We also test the data using the classical assumption tests, as a requirement when using regression to analyse data. The analysis used in this research is the multiple linear regression analysis using IBM SPSS Statistic 20. Having explained various tests that will be used, the researcher developed a model of multiple regression to be used in this research as follows:

$$FEE_i = \alpha + \beta_1 lnASSETS_i + \beta_2 SUBS_i + \beta_3 INVREC_i + \beta_4 BIG4_i + \varepsilon_i$$

Result and Discussion

Descriptive Statistics

The descriptive statistic of variables is presented on Table 4.1. Of all observations, the standard deviation of the audit fee spent is 7,360,343,043 rupiahs. The average audit fee spent is

2,884,170,325 rupiahs, and the median is 672,500,000 rupiahs. The average firm's total assets is 12,465,568,514,432 rupiahs, and the median is 2,194,059,348,260 rupiahs.

Table 1: Descriptive Statistics

	Mean	Median	Min	Max	Std. Dev.
FEE (th)	2884170	672500	99595	40000000	7360343
ASSETS (mil)	12465569	2194059	268891	261855000	33861513
SUBS	6.8205	2.5	0	34	8.7174
INVREC	0.3859	0.4	0.0773	0.9	0.1919
BIG4	0.3590	0	0	1	0.4828

Pearson Correlation

Correlation between audit fee and its dependent variables (firm size, audit complexity, audit risk, and Big-Four audit firms' premium) is explained in Table 2.

Table 2: Pearson Correlation

	FEE	ASSETS	SUBS	INVREC	BIG4
FEE	1.000				
lnASSETS	.820***	1.000			
	(.000)				
SUBS	.846***	.817***	1.000		
	(.000)	(.000)			
INVREC	-.035	-.356***	-.112	1.000	
	(.380)	(.001)	(.165)		
BIG4	.633***	.434***	.343**	-.085	1.000
	(.000)	(.000)	(.001)	(.230)	

This table (Table 2) shows the Pearson Correlation test results with *t > 1,645, ** t > 1,960, *** t > 2,326, significance at 10%, 5% and 1%.

Firm Size and Audit Fee

The firm size measures how big the firm's assets, and relates it to its effect toward the audit fee. The result from the Table 3 shows that there is a positive relationship between the firm size audit fee under the significance level of 5%. Basing on this result, the researcher thus can accept H1. This finding on firm size effect toward audit fee is consistent with many prior research findings. Simunic (1980), Francis (1984), and Palmrose (1986), among others, have revealed that firm size indeed has an effect on audit fee, very significantly. As a pioneer in the

research on the audit fee determinant, Simunic (1980) stated that firm size is closely related to possible loss exposure, where flawed asset valuation in financial statements resulted in lawsuits, more often than in accounting flow measure. Another reason Simunic (1980) mentioned, is that the audit process is a sampling-based process. This means that the increase in a firm's total asset will increase the number of elements that made up the whole population of the total asset. Thus, the sample size required to properly sample the asset will increase accordingly, at a diminishing rate. This, in addition to the increase in possible loss of exposure toward auditor incentivises auditing firms to increase their audit fee, in a hope to compensate their loss exposure and huge sample size.

Table 3: Multiple Regression

Model	Unstandardized Coefficients		t	Sig.
	B	Std. Error		
(Constant)	9.463	2.053	4.609	0.000
ASSETS	0.337	0.072	4.675	0.000
SUBS	0.073	0.012	6.205	0.000
INVREC	1.312	0.332	3.954	0.000
BIG4	0.988	0.129	7.653	0.000

Table 4: Coefficient of Determination Table

R	R Square
0.943	0.889

Audit Complexity and Audit Fee

The number of subsidiaries defines the complexity of the audits in this research. The p-value of SUBS variables suggests that there is relationship between the number of subsidiaries and the audit fee significantly. This means that audit complexity does have effect toward audit fee. Thus, in regard to the hypothesis developed, the researcher accepted hypothesis H2, while rejecting Ho. The outcome of hypothesis H2 is in line with Simunic (1980), and Hassan and Naser (2013). The reasoning behind the effect of the number of subsidiaries, according to Simunic (1980) is because the increase in decentralisation and diversification is parallel with the increase loss exposure. Thus, the increase in loss exposure results in the increase in audit fee. Similar to Simunic (1980), Hassan and Naser (2013) stated that firms with several subsidiaries are considered to be more complex than those with few or no subsidiaries. The greater number of subsidiary means that an auditor requires more audit time and expertise to ensure the accuracy of the financial statement.

Audit Risk and Audit Fee

The measurement of audit risk is defined by the ratio of inventory and receivable ratio to total assets. Referencing to the regression output, the p-value of inventory and receivable ratio does have a significant effect toward audit fee. This means that the audit risk has an effect on audit fee, thus the researcher agrees to accept H3. This outcome is in accordance withSimunic (1980), and Gonthier-Besacier and Schatt (2007). According to Simunic (1980), the inventory is considered to be a risky subject, which in order to be audited properly, confirmation and observation procedure is recommended. Furthermore, the audit of this subject requires forecasting for future events. Gonthier-Besacier and Schatt (2007) added that a relatively strong involvement of the most experienced and expensive auditor is required to audit inventory.

Big-four Audit Firms' Premium and Audit Fee

The Big-Four audit firms' premium is based on whether firms are audited using the Big-Four service. The variable BIG4 is a dummy variable with the value of "1" when the observation is using Big-Four service and "0" when it did not. From the regression result, the Big-Four audit firms' premium has a p-value that suggests its' effect toward the audit fee is significant. According to this, thus, the researcher chooses to accept H4. This result is in line with the result of Francis (1984) and Palmrose (1986), but not with Simunic (1980). Both Francis (1984) and Palmrose (1986) have tried to explain the difference. In this research, the researcher chose to agree with the explanation provided by Francis (1984). Francis (1984) suggested that the difference between his research and the research of Simunic (1980) is because Australian firms voluntarily chose to contract a higher priced audit from large accounting firms. They do so because they believe that by contracting a higher priced audit, a higher quality audit will be delivered. In regards to a study into the U.S. market by Simunic (1980) and a study into the British market by Taffler and Ramalinggam (1982), Francis (1984) stated that the study in the U.S. conducted by Simunic (1980) offered weak evidence of the existing economies of scale in the U.S. market. The possible interpretation of those studies, plus one conducted by Francis (1984) himself in Australia market, is that there exists a scale of economies in the U.S. market which offsets higher prices, in relation to product differentiation, whereas in the British and Australian markets, the scale of the economies did not exist comparably.

Conclusion

The purpose of this research is to determine the factors that are influencing audit fees. To determine the factors, this research used the audit fee as the dependent variable, and firm size, audit complexity, audit risk, and Big-Four audit firms' premium as the independent variables. This research shows that there is a positive relationship between the firm size, with firm's total asset acting as the measurement and the audit fee. This means that the bigger the firm's total

asset value, the higher fee the auditor will charge toward the auditee for their service. This research shows the audit complexity have a positive relationship with the audit fee. This means that the more subsidiary a firm has, which implies the higher audit complexity, the higher the fee that will be charged. This research shows that there is a positive relationship between the audit risk and audit fee. This means that the higher the ratio of inventory and receivable to total assets, which implies higher audit risk, the higher the audit fee that will be charged. This research shows the Big-Four have a positive relationship between audit firms' premium and audit fee. We conclude that being audited by Big-Four audit firms will increase the audit fee.

This research has some limitations. Some firms in Indonesia do not disclose their amount of audit fee. This is because in Indonesia, the disclosure of audit fee is not required by authorities. This research has limited the number of samples according to the number of firms that disclose their audit fee. Many of independent variables used in prior research are unsuitable because of limitability of data in Indonesia. The disparity between big firms and small firms is huge, which makes the data abnormal. To solve this problem, the researchers removed some firms from the observation.

To improve the research in a similar field in the future, the researchers conclude with some suggestions based on the research limitation. Future researchers should use samples from a country which requires their firm to disclose the audit fee to expand the research sample whenever possible. Future researchers should consider to make some addition or change to the independent variables. Future research may also separate the sample base into "big firms" and "small firms".

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