

Political Connections, CEO Gender, and Audit Fees

Raysta Chrisanta Kandoli^a, Basuki^{b*}, ^{a,b}Department of Accountancy, Faculty of Economics and Business, Universitas Airlangga, Email: ^{b*}basuki@feb.unair.ac.id

This research examines the effect of political connections and CEO gender on audit fees. 390 observations of publicly listed companies on Indonesia Stock Exchange (IDX) were used for the period of 2016-2017. The ordinary least square regression analysis model was used to test the hypotheses. The results indicate that political connections can positively affect audit fees. Furthermore, political connections could affect audit fees both in above average sized-firms and below average size-firm. However, CEO gender did not affect the determination of audit fees.

Keywords: *Audit fees, Big four, CEO gender, Political connection*

Introduction

The Financial Services Authority in Indonesia, through Financial Services Authority Regulation No. 29/POJK.04/2016, requires companies listed on the Indonesia Stock Exchange to use professional services from external auditors and submit periodic audited financial statements. In this regard, OJK, through the Decree of the Chairperson of the Capital Market and Financial Institution Supervisory Agency Number: KEP-431/BL/2012 in item 2, letter e, point 16 also requires companies to disclose the amount of audit fees issued. Various risks within a company influences the determination of the amount of an audit fee for professional audit services. There is still little literature that discusses the relationship between the risk of political connections and the gender of board members and the determination of audit fees within a company. For this reason, this research will analyse the influence of CEO gender and political connections on the amount of audit fees paid to external auditors.

In the initial stages, before carrying out procedures in an audit engagement, an auditor will assess a company's risk (Ghosh & Tang, 2015). The higher the audit risk assessed by the auditor, the higher the audit effort needed to produce an appropriate audit opinion (Bedard &

Johnstone, 2004). Auditors tend to charge higher audit fees for companies that have high risks because auditors compensate for this by increasing their auditing effort (Cho et al. 2015; Bell et al., 2011).

One form of audit risk is inherent risk. Auditors charge higher audit fees if inherent risk is valued as high (Bliss, Muniandy, & Majid, 2007). Political connections within a company can provide positive and negative values for the company. Boubakri et al. (2012) found that companies in developing countries have strong incentives to use political connections to benefit from the government, thereby increasing company value. Political connections are often used to gain a competitive advantage. Politically connected firms gain privileged access to strategic resources with the help of politicians. They improve good relations with the government so that various forms of government coercion can be prevented. They also take advantage of the weaknesses of the institutional environment (Muttakin, Monem, Khan, & Subramaniam, 2015; You & Du, 2012). Political connections provide positive incentives for companies through better company performance and the likelihood of having a lower stock price crash risk (Harymawan et al., 2019a; Harymawan et al., 2019b). On the other hand, companies that have political connections are considered to have a higher risk. Consequently, auditors increase requested audit efforts and high-cost audits are charged (Wahab et al., 2011). In line with this, Ariningrum & Diyanty (2017) also show increased risk inherent in politically connected companies.

Gender equality is still a hot topic throughout the world. Grant Thornton's 2017 survey of 5,500 companies in 36 countries stated that Indonesia ranks second as a country with a high percentage of female involvement at the senior corporate level of 46%. As independent parties that provide assurance services for companies' financial statements, auditors need to consider whether the presence of women on boards of directors will influence a company's decisions. Female CEOs tend to be caring and less likely to make risky decisions (Faccio et al., 2016; Jakimow et al., 2019). Huang et al. (2014) explain that women are more conservative and risk-averse than men. Thus, companies with female CEOs need higher audit quality. We argue that the existence of higher audit quality is generally able to be obtained through an increase in audit effort and or assignment of auditors with higher quality, both of which are predicted to result in higher audit fees (Harjoto et al., 2015).

To analyse the relationships among political connections, CEO gender, and audit fees, we use 390 observations of firms listed on the IDX from 2016-2017. The hypotheses were tested using ordinary least square regression. The study finds that political connections can positively and significantly affect audit fees in both big companies and small companies. However, this research was unable to prove that CEO gender could affect audit fees.

The remainder of this paper is structured as follows: Section 2 develops the research hypotheses. Section 3 describes the research design. Section 4 specifies the empirical results. Section 5 summarises the paper and presents concluding remarks.

Hypothesis Development

Political Connection and Audit Fees

Hawley and William (1996) show that political connections are categorised by the involvement of government in a company that is able to influence the company's performance. Companies can be categorised as having political connections if there are politically exposed people who hold important positions in them. Companies with political connections tend to get policy leeway related to the acquisition of government projects, increased company legitimacy, valuable resources controlled by the state, preferential access and exclusive information related to government policies (Goldman et al., 2009; Okhmatovskiy, 2010). Political connections are considered important, since when there are unstable political conditions, they can affect the business environment (Yaku et al., 2019).

Through its position, PEP can occupy strategic positions within a company. It is feared that it could potentially increase money laundering actions, such as corruption and bribery (FATF, 2012). The existence of political connections within a company is considered to be able to increase the political costs paid by the company. Ramsay, Stapledon, & Vernon (2001) show that the existence of political connections can lead to the exploitation of political donations to the government or other parties to help in making policies that are profitable for a company. In addition, the existence of political connections is also often associated with lower quality financial reporting due to lack of transparency (Chaney, et al., 2011). Because of this, companies with political connections are considered to have higher risks because their performance can change significantly if there is a change of political power (Leuz & Oberholzer-gee, 2006).

Based on audit pricing theory, the existence of political connections within a company is considered capable of increasing the inherent risk of the company. This increases the audit risk faced by the auditor, causing the auditor to need more audit procedures. The higher the audit risk assessed by the auditor, the higher the audit effort needed to produce an appropriate audit opinion (Bedard & Johnstone, 2004). Cho, et al. (2015) states that audit fees are an indirect measurement of audit efforts. In this study, it is argued that audit clients who are politically connected will have higher risks. This will encourage greater audit efforts and cause an increase in audit fees (Bell et al., 2001).

H1: Political connections affect audit fees.

CEO Gender and Audit Fees

Chief Executive Officer (CEO) is the highest-level executive position in a company that is responsible for making the most decisions related to overall company operations (Nowland, 2016). A CEO ensures that a company's operations are aligned with the objectives and direction set by the board of directors. One of the characteristics of a CEO that is considered to affect decision making is gender. Gender is a socially formed category that illustrates the definition of a culture of femininity and masculinity (Lott & Maluso, 2001). Gender differences cause differences in behaviour, mentality, and emotional characteristics. These are the results of socio-cultural constructs in the society that produce differences in leadership style, behaviour, and work attitude (Siahaan, 2017).

Differences among individuals due to gender or ethnicity tend to influence decision making (Harjoto et al., 2015). This is due to differences in preference for risk-taking between men and women, where men are more likely to dare to take risks than women. Women depend on men both socially and economically, so they are often doubtful in making decisions (Loukil & Yousfi, 2016). However, women play important roles and have good mindsets in supporting business and economics. There is now an increasing trend of women participating in business (Pulubuhu et al., 2019; Rafiki & Nasution, 2019; Dalimunthe, 2019). Companies managed by female CEOs make significantly less risky decisions when compared to similar companies led by male CEOs (Faccio et al., 2016).

Two arguments are presented in explaining the relationship between risk preference caused by gender differences and audit fees paid by companies. First, companies led by female CEOs will tend to make less risky decisions to maintain their reputation. Female CEOs need higher assurance and do not mind spending more money to get higher audit quality. Higher audit quality can be achieved by increasing audit effort and increasing the proportion of auditors who are experienced in an audit engagement. This increases the amount of audit fees (Harjoto et al., 2015; Huang et al., 2014). Second, female CEOs tend to avoid risks, so they build a strong internal control system within a company. The better the internal control of a company, the lower the risk control set by the auditor. This will potentially reduce the amount of audit fees that need to be paid by a company due to the audit effort that needs to be made by the auditor being reduced (Xiang, Qin, & Peterson, 2015).

H2: Female CEOs affect the amount of audit fees.

Methods

Sampling and Data

The initial sample consisted of 860 observations of all companies listed on the Indonesia Stock Exchange (IDX) for the period of 2016–2017. We exclude companies with SIC 6 codes

that are included in the financial sector industry. The financial services and insurance sectors were excluded from this study because they have different risk characteristics from the non-financial sector (Alsaeed, 2006). Observations with missing data were also excluded. After eliminating the data, 390 observations remained. The data was obtained through financial statements from the official website of the Indonesia Stock Exchange (www.idx.co.id) or through their respective websites.

Variable Definition

Measurement of Political Connections

The independent variable in this study is political connection. A company is said to be politically connected if there is direct ownership by the government of at least 10% of total ownership, so that the government can influence the company's performance. In other words, companies with political connections are BUMN/BUMD companies listed on the Indonesia Stock Exchange. In addition to government ownership, political connections can also be seen with the presence of politically exposed persons (PEPs) who hold important positions in a company. Bank Indonesia Regulation Number 19/10/PBI/2017, article 1, number 12 states that PEP covers three categories:

1. A foreign PEP is a person who is given the authority to perform an important function (prominent function) by another country;
2. A domestic PEP is a person who is given the authority to perform an important role (prominent function) by the state; and
3. People who are given the authority to perform important functions (prominent functions) by international organisations.

The Financial Action Task Force (FATF, 2012) states that a person can be said to be a foreign PEP and a domestic PEP if he/she serves:

1. as the head of state or head of government,
2. as a senior politician,
4. in senior government,
5. in justice,
6. in the military,
7. as a senior executive of a state-owned company,
8. as an important politician, or
9. as a party clerk.

A person can be said to be a PEP because of their involvement in an international organisation if that person serves as a senior member of management or other equivalent

position, such as director, vice director, and other equal positions. Political connections (PCON) are measured using a dummy variable, where the number 1 is given for companies that have political connections and the number 0 for companies that do not have political connections.

Measurement of CEO Gender

Gender is a category formed by the social environment that reflects cultural definitions of femininity and masculinity (Lott & Maluso, 2001; Meier-Pesti & Penz, 2008). CEO gender is measured using a dummy variable, where companies that have female CEOs will be given a value of 1. Meanwhile, companies that have male CEOs will be given a value of 0.

Measurement of the Dependent Variable

Audit fees are a number of costs that must be paid by each company for the professional services of financial statement audits that have been carried out by external auditors. Duellman, et al. (2015) state an audit fee is a remuneration paid by a client to an auditor for audit services provided. Data is measured using natural logarithms and symbolised by Ln_FEE.

Measurement of Control Variables

Based on previous research (Hay et al., 2006; Castro, Peleias, & Silva, 2015; Chaney & Shivakumar, 2004; Larasati et al., 2019; Mohammadi et al., 2018), the control variables in this study include company size (FSIZE), Leverage (LEV), Company profitability (ROA), and public accounting firm size (BIG4). Firm size (FSIZE) is an important variable that is one of the determinants of the number of audit fees (Hay et al., 2006). Large companies tend to want quality audit work and be able to increase the value of their companies (Arifuddin et al., 2017). Large companies require more effort to audit, so audit fees charged by external auditors to large companies are higher than audit fees for smaller companies.

Leverage (LEV) is the ratio of total corporate debt divided by total company assets (Simamora & Hendarjatno, 2019). The leverage ratio is used to describe the client's risk faced by the auditor. Higher leverage illustrates higher financial risk in a company. Leverage has a positive effect on audit fees (Castro, Peleias, & Silva, 2015). When a client has high business risk, the audit risk faced by the auditor is higher, so the auditor will charge higher audit fees to the riskier company. Return on assets (ROA) is one of the ratios used to measure a company's profitability. ROA is the ratio of income before interest and taxes divided by total assets. The higher the profitability of a company, the more likely the company is to choose an auditor with an excellent reputation to get a higher audit quality. This can give a positive signal to outsiders that the company has a good performance (Chaney & Shivakumar, 2004). BIG 4 is a variable that shows the size of the audit firm that carries out professional audit services at the company. If the company is audited by a large audit firm or Big 4 public

accounting firm (KPMG, Ernst & Young, Pricewaterhouse Coopers, Deloitte), then a dummy indicator is given with a value of 1. Meanwhile, a value of 0 is given if the company is not audited by an audit firm that includes Big 4.

Methodology

This study uses multiple linear regression analysis using STATA 14.0 software. To test Hypothesis 1 and Hypothesis 2, the following regression models were used:

$$\text{LN_FEE} = \alpha + \beta_1\text{PCON} + \beta_2\text{CEO} + \beta_3\text{FSIZE} + \beta_4\text{LEV} + \beta_5\text{ROA} + \beta_6\text{BIG4} + e$$

In this study, we expect a positive coefficient on PCON to be negative, while the coefficient of CEO is still an open question. LN_FEE is audit fee; α is a constant; β_1 - β_2 is the regression coefficient of the independent variable; PCON is a political connection; CEO is the CEO gender; FSIZE is a company size; LEV is the leverage ratio; ROA is return on assets; BIG4 is the company's external auditor and e is an error.

Result and Discussion

Descriptive Statistics and Univariate Comparisons

Table 1 shows the distribution of samples by industry. The most observational samples came from industries with SIC 2 code, which was 26.67%, while the least observation samples came from industries with SIC 8 codes, which was 2.31%. Table 2 shows the descriptive statistical results for the mean values, minimum values, and maximum values for each variable. Based on the table, the average natural logarithm of an audit fee paid by a company to an external auditor is 20.485 and the median value is 20.465. Political connection (PCON) is an independent variable that indicates a political relationship that is owned by a company. Based on the table, PCON has an average value of 0.744. This means the number of companies that have political connections is 74.4% of the total study sample. CEO gender has an average value of 0.054, which means companies that have female CEOs constitute 5.4% of the total study sample. The BIG4 variable shows the number 0.444, which means 44.4% of the total study sample were companies that use professional audit services from the Big Four Public Accounting Firms. LEV shows an average value of 0.545 and a mean value of 0.471. In the table, it can be seen that the average value of the ROA variable is 0.035. The size of the company varies from 17,379 to 26,412.

Table 1: Sample Distribution Based on Industry Classification

SIC	<i>Freq.</i>	<i>Percentage(%)</i>	<i>Cum.</i>
0	13	3,33	3,33
1	77	19,74	23,08
2	104	26,67	49,74
3	65	16,67	66,41
4	68	17,44	83,85
5	30	7,69	91,54
7	24	6,15	97,69
8	9	2,31	100,00
Total	390	100	

Table 2: Descriptive Statistics

	Mean	Median	Minimum	Maximum
Ln_Fee	20.485	20.465	17.660	24.501
Pcon	0.744	1.000	0.000	1.000
Ceo	0.054	0.000	0.000	1.000
Big4	0.444	0.000	0.000	1.000
Lev	0.545	0.471	0.036	20.714
Roa	0.035	0.034	-2.084	1.120
Fsize	22.016	22.071	17.379	26.412

Table 3 shows the results of the Pearson correlation test. The Pearson correlation test results show a significant positive relationship with a correlation coefficient of 1% between PCON and LN_FEE. This shows that an external auditor considers the political connections of a company as one of the factors that influences the external auditor to set a higher audit fee. BIG4 and FSIZE also showed a positive relationship with audit fees with a significance level of 1%. The level of profitability (ROA) also shows a positive relationship with audit fees, but with a significance level of 5%. Thus, if there is an increase in these variables, it will affect higher audit fee levels. CEO and LEV variables do not have a significant relationship to audit fees.

Table 3: Pearson Correlation

	Ln_Fee	Pcon	Gender	Big4	Lev	Roa	Fsize
Ln_Fee	1.000						
Pcon	0.468*** (0.000)	1.000					
Ceo	0.062 (0.221)	0.010 (0.844)	1.000				
Big4	0.566*** (0.000)	0.276*** (0.000)	0.039 (0.448)	1.000			
Lev	0.017 (0.742)	0.060 (0.237)	-0.024 (0.638)	-0.048 (0.343)	1.000		
Roa	0.102** (0.044)	0.004 (0.935)	-0.005 (0.928)	0.173*** (0.001)	-0.710*** (0.000)	1.000	
Fsize	0.721*** (0.000)	0.491*** (0.000)	-0.001 (0.980)	0.404*** (0.000)	-0.019 (0.703)	0.089* (0.078)	1.000

p-values in parentheses * $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$

Table 4 shows the results of the independent t-test based on the political connection variable. Table 4 shows that companies with political connections pay higher audit fees compared to companies without political connections. In Table 4, it can be seen that companies that have political connections are larger in size compared to companies that are not connected by politics.

Table 4: Independent t-Test Based on Political Connection

	Politically connected	Non-politically connected	Coef	t-value
Ln_Fee	20.808	19.549	1.259***	10.438
Lev	0.582	0.436	0.146	1.184
Roa	0.035	0.034	0.001	0.081
Fsize	22.466	20.713	1.753***	11.101

t statistics in parentheses

* $t > 1.65$, ** $t > 1.97$, *** $t > 2.59$

Table 5 shows the results of the independent t-test based on the CEO Gender variable. Table 5 shows that there are no significant differences in the level of audit fees, leverage, profitability, and company size between companies led by male and female CEOs.

Table 5: Independent t-Test Based on CEO Gender

	<i>Firm with Female CEO</i>	<i>Firm with Male CEO</i>	Coef	t-value
Ln_Fee	20.791	20.467	0.323	1.227
Lev	0.438	0.551	-0.112	-0.471
Roa	0.032	0.035	-0.003	-0.090
Fsize	22.008	22.017	-0.009	-0.026

t statistics in parentheses

* $t > 1.65$, ** $t > 1.97$, *** $t > 2.59$

Political Connection and Audit Fees

Table 6 presents the results of testing the analysis of hypothesis 1. It can be seen in the first column that PCON has a coefficient of 0.295. The test results show a positive direction with a significance of 1%. It can be concluded that the existence of political connections in a company is proven to have a positive and significant effect on audit fees. These results are consistent with the initial hypothesis of this study: Companies with political connections will pay higher audit fees compared to companies without political connections.

Following the results of the regression analysis that has been carried out, it is evident political connections owned by companies have a significant positive effect on audit fees. These results indicate that both government ownership in a company and the presence of politically exposed persons (PEPs) who hold strategic positions in a company can affect the audit risk assessment by external auditors. This is then able to influence the determination of the audit fee level. The results of this study are consistent with previous research conducted by Ariningrum & Diyanty (2017). Companies with political connections have inherently higher risks, so external auditors need to exert more audit effort to collect audit evidence. This ultimately makes audit fees higher. The results of the study are also consistent with the research of Tee et al. (2017). Companies with political connections will increase monitoring activities to reduce the risk of material financial misstatements. Companies will require auditors to carry out higher quality audits that lead to increased audit fees.

CEO Gender and Audit Fees

Table 6 presents the results of testing the analysis of hypothesis 2. The CEO variable shows the direction of the positive effect on the level of audit fees with a coefficient of 0.187 (not significant). Based on this, it can be seen that the existence of a female CEO in a company is not related to the level of audit fees.

Table 6: Regression Results

	(1)
	LN_FEE
Pcon	0.295***
	(3.13)
Ceo	0.187
	(1.13)
Big4	0.718***
	(9.41)
Lev	0.080**
	(2.11)
Roa	0.408
	(1.19)
Fsize	0.418***
	(12.01)
_Cons	10.947***
	(13.83)
R ²	0.637
N	390

t statistics in parentheses

* $t > 1.65$, ** $t > 1.97$, *** $t > 2.59$

This result is different from the research of Harjoto et al. (2015) and Huang et al. (2014), who found a relationship between CEO gender and the amount of audit fees paid to external auditors. However, the existence of a woman is considered not to have a significant influence on a company's financial performance. Pletzer et al. (2015) state that if other diversity factors, such as age, experience, or education are not taken into account, the effect of gender on a company's financial performance is not statistically significant. There are still many other factors that need to be investigated that might have an effect on the relationship between women's representation in the composition of company boards and companies' financial performances.

Control variables, such as BIG4 and FSIZE, have a positive and significant effect on audit fees, with a significance level of 1%. The coefficient values of each variable are 0.718 and 0.418, while the ROA and LEV variables show no significant effect on audit fees. R2 value indicates a value of 0.637. Regarding this value, the audit fee regression model in this study consists of independent variables in the form of PCON and CEO, and control variables such as ROA, LEV, BIG4, and FSIZE. This represents 63.7% of the overall audit fee model. This means that there are still other variables not examined in this study that are also determinants of audit fees to an extent of 36.3%.

Additional Analysis

We employ additional analysis by separating our samples into several subsamples based on company size (FSIZE). Table 7 shows the regression results for a sample with a company size above the average ($> 22,016$). Table 6 shows the regression results for samples with below-average company size ($< 22,016$).

Table 7: Regression Analysis Results: Political Connection and Audit fees with Sub-samples Based on FSIZE $> 22,016$ (mean)

	(1)
	LN_FEE
Pcon	0.526 ^{***}
	(2.78)
Gender	0.272
	(0.88)
Big4	1.052 ^{***}
	(7.97)
Lev	1.044 ^{***}
	(5.27)
Roa	0.989
	(1.52)
_Cons	19.531 ^{***}
	(47.08)
R2	0.354
N	198

t statistics in parentheses

* $t > 1.65$, ** $t > 1.97$, *** $t > 2.59$

In Table 7, the coefficient of PCON shows a value of 0.526, which is statistically significant at the 1% level. The PCON coefficient shows a positive direction towards LN_FEE. In Table 8, the PCON coefficient shows a value of 0.603, which is statistically significant at the 1% level. The PCON coefficient in Table 6 shows positive results for LN_FEE. In the two sub-samples based on company size, PCON showed a positive relationship with audit fees, PCON also has a positive effect on LN_FEE. This indicates that political connections can influence the determination of audit fees in both small and large companies.

Then, testing is done on Sub Samples based on BIG4. In Table 7, PCON did not affect LN_FEE in the company audited by KAP BIG4. This means that the presence or absence of political connections does not affect the determination of the audit fee level by KAP BIG4. This may occur because BIG4 Audit Firm is more competence in handling various types of

clients including clients with political connections when compared to non-BIG4. BIG4 does not set a higher audit fee level for risks that may arise from clients who have political connections. Whereas in Table 8, for non-BIG4 audit firm, PCON has a positive and significant effect on LN_FEE. That is, non-big four KAPs set higher audit fee levels for companies with political connections.

Table 8: Regression Analysis Results: Political Connection and Audit fees with Sub-samples based on FSIZE < 22,016 (mean)

	LN_FEE
Pcon	0.603***
	(5.67)
Gender	0.306
	(1.56)
Big4	0.978***
	(10.10)
Lev	0.048
	(0.86)
Roa	0.487
	(0.88)
_cons	19.915***
	(109.60)
r2	0.505
N	192

Conclusion

The results of this study indicate that political connections have a positive and significant effect on audit fees. Meanwhile, the CEO gender variable does not significantly influence audit fees. Furthermore, we find that political connections have a significant effect on audit fees for both large and small companies.

A positive relationship between PCON and audit fees indicates that political connections can influence audit risk assessments by external auditors and are then able to influence the amount of audit effort and lead to higher audit fees. The results support the argument that companies with political connections have inherently higher risks. Consequently, external auditors need more audit effort to collect audit evidence that ultimately causes audit fees to be greater. On the other hand, an increase in audit fees for companies that have political connections can also be caused by an increase in monitoring activities within companies to reduce the risk of material financial misstatements. Companies will tend to require auditors to carry out higher quality audits that lead to increased audit fees.



This study did not find a relationship between CEO gender and audit fees. This can occur because the presence of gender is considered not to make a significant difference in performance and risk within companies. In addition, Pletzer et al. (2015) states that if other diversity factors such as age, experience, or education are not taken into account, the effect of gender on a company's financial performance is not statistically significant. This means that there are still many other factors that need to be investigated to analyse the relationship between women's representation in the composition of company boards and company financial performance.

The limitation of this study is that the differences in the relationships between political connections originating from government ownership of companies and political connections originating from the presence of politically exposed persons in companies were not examined. Based on this, we suggest future research examines political connections by seeing the influence of each political connection criterion on audit fees. In further research gender variables can be combined with other variables to carry out multivariate analysis.

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