

# Impact of Family Ownership on the Firm's Abnormal Audit Fees

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**Abstract**— This study aims to examine empirical evidence of the effect of family ownership on negatives abnormal audit fee and positives abnormal audit fee. This study uses panel data of 733 observations of companies in Indonesia Stock Exchange (IDX) during the year 2012-2016, where 386 observations are companies that pay abnormal audit fee positives and 347 observations companies that pay abnormal audit fee negative. Regression results indicate that the family ownership level in the firm does not affect companies that pay negative abnormal audit fees but negatively affects the ownership of families who pay positives abnormal audit fee.

**Keywords**— *Family Ownership, Audit Fee, Abnormal Audit Fee*

## I. INTRODUCTION

The company's shareholding structure differs between developing and developed countries. Concentrated ownership commonly found in countries with emerging economies such as Indonesia. Stock ownership is said to concentrate if most of the shares are owned by a small number of individuals or groups so that shareholders have relatively dominant shares compared to others. The existence of concentration of ownership in a company can cause agency problem. In companies whose ownership concentrated in a family, there is a type II agency problem that is a conflict between majority shareholder and minority shareholder. The existence of this problem agency poses a threat to minority shareholders of the possibility of expropriation. [8] states that in family enterprises, there is a significant incentive to expropriate minority shareholders. The majority shareholder may use the company's control position to take personal advantage. Point out that the pattern of share ownership is a significant factor of low audit costs in Bangladesh [5]. The bigger agency problems that occur in the company will affect the auditor's inspection time that triggers a higher audit fee.

Explains that the audit fee consists of two types: regular fee and abnormal fee [2]. The standard fee is a set fee depending on the cost of the audit team, litigation risk, and average profit on audit engagement [10]. While the abnormal fee is an extraordinary cost for auditor-client relationship is determined not transparently based on agreement or negotiation between auditors with clients that can not be observed [2]. The abnormal audit fee is calculated based on the difference between the audit fee paid to the auditor for the audit work on the annual financial statements with the expectation of the standard audit fee to be charged. [1] found that there was no significant relationship between family

ownership of audit fees. However, [6] the cost of a positive abnormal audit is negatively related to the quality audit and implies that the audit cost premium is a significant indicator of the independence of the compromised auditor due to the auditor-client economic ties. The existence of discounted audit fees does not affect the reduced audit effort, so audit quality does not compromise when intense client bargaining occurs.

As far as the current researcher is concerned, no research has examined the effect of family ownership on abnormal audit fees, especially in Indonesia. Most studies examined the effect of abnormal audit fees on opinion shopping and audit quality. Besides, some researchers have examined the effect of concentration of ownership on audit fees. Khan [5] states that audit fees have a significant negative relationship with the sponsor and institutional ownership. Ben Ali & Lesage, [1] indicates that (1) there is a negative relationship between audit fees and government share ownership; (2) there is a positive relationship between audit cost and institutional ownership; and (3) there is no relationship between audit fees and family ownership. Therefore, the purpose of this article is to test based on an abnormal audit fee whether the audit fee paid to the auditor is above the standard (abnormal audit fee positives) or below the standard (and abnormal audit fee) audit level in the Indonesian context.

In the next discussion, this paper will explain the literature review and research methods in the second and third sections. While the results and conclusions discussed in the fourth and fifth.

## II. LITERATURE REVIEW

Family ownership is the ownership of the individual and the ownership of a private company (above 5%) that is not a public company, a country, or a financial institution [9]. Under this definition, a company with family ownership does not limit to a company that places members of its family in the position of CEO, commissioner, or other management positions. Companies with family ownership are the majority of the types of companies in Indonesia. [3] show that 68.7% of the company's shareholding in Indonesia concentrated in the family. Public companies in Indonesia have characteristics that are no different from companies in Asia in general. Companies in Asia are historically and sociologically corporate companies owned or controlled by families [3].

The family party, as the majority shareholder may use its degree of control to gain personal gain on the expenses incurred by minority shares. Companies with family ownership often have different interests between majority shareholders and minority shareholders. This difference of interest is due to the majority shareholder generally having a very high control over the company. Therefore, the tendency for expropriation for minority shareholders is considerable in family ownership.

An abnormal audit fee is a difference between a factual audit fee (the fee paid to the auditor for a financial statement audit) with rational audit fee expectations charged for the audit engagement. The factual fee audit consists of two parts, namely: (1) a standard fee reflecting the auditor's work costs, litigation risk and average profit and (2) an abnormal audit fee determined from the agreement between the auditor and the client. Standard fee audits are generally determined by the size of the client firm, client complexity, and client-specific risk while the abnormal fee audit determined by factors observed in specific agreements or agreements between the auditor and the client [2]. An Auditor may receive an audit fee that is higher or lower than the standard fee. A higher audit fee is called positives abnormal audit fee while a lower audit fee is called a negative abnormal audit fee. The high low abnormal audit fee influenced by the economic dependence of the auditor (economic bonding) on the client and the bargaining power.

The agency theory states that the existence of different interests between shareholders and management will make it difficult for shareholders to believe in decisions taken by management. Besides, shareholders also have less information so that there is a difference in information owned by shareholders and management (information asymmetry). Given the information asymmetry as well as the assumption that shareholders and management are those who want to maximize their interests, so shareholders are confident that management will act on its behalf. Agency conflicts that occur between management and owners can overcome by the increasing ownership of management within the company. This is because management that has significant amounts of equity in the company will tend not to do something that keeps their stock price down. Also, when the right cash flow right increases in the hands of the controlling shareholder, it will cause increased financial incentives so that it will align its interests with the company or non controlling shareholder (alignment effect) [4].

However, [8] says that family ownership with a percentage of more than 33% tends to make greater expropriation than non-family companies. The expropriation of minority shareholders did by transferring the wealth or free cash flow to enrich themselves and sacrifice the interests of minority shareholders. The increased likelihood of expropriation by controlling shareholders may cause the inherent risks faced by the firm to become higher. Therefore the required audit effort will be more significant. The higher the audit effort, the total the audit cost will increase, and Choi [2] also states that the controlling shareholder will choose a low-quality auditor to cover the expropriation measures since local or low-quality auditors are considered cheaper, expropriation then the company will tend to pay lower audit fees.

In addition to family companies, shareholders participate in overseeing the company, thereby reducing the conflict

between shareholders and corporate managers (agency problem type I). Family control is crucial to monitor the performance of the company. Supervision by shareholders is considered to be very useful in activities carried out by management and financial reporting processes [5]. Also, according to Diyanty [4], the increase in cash flow rights in the hands of a controlling shareholder will cause increased financial incentives and will ultimately align its interests with the company or non controlling shareholder (alignment effect). The alignment of interests between the controlling shareholder with the company or non-controlling shareholder (effective alignment) and the existence of adequate supervision will reduce the inherent risk to the company so that it can reduce the audit effort so that it will result in lower-paid audit fee [5]. This is consistent with that oversight of company performance can be overcome by concentrated shareholdings in order to decrease inherent risk, audit risk, and ultimately lower audit fees paid.

Therefore, due to the adequate supervision of the shareholders of the family will decrease the conflict of agency, the opportunistic actions undertaken by management will decrease and the alignment of interests between the controlling shareholder with the company or non controlling shareholder then the company will pay the audit fee under standard ( abnormal audit fee negatives) because it is not necessary to negotiate or bargain to cover the opportunistic actions undertaken by the company. This is in line with the argument [7] who found that family ownership would reduce corporate earnings management. Therefore the hypothesis is stated below.

H<sub>1</sub>: Family ownership positively affects negative abnormal audit fees.

According to Wang [8], family ownership with a percentage of more than 33% tends to do greater expropriation. The existence of the Entrenchment Effect on family ownership is related to low earnings reporting quality since the majority of shareholders have the opportunity to make earnings management. This happens because of agency problems in the form of controlling shareholders who make policies or corporate decisions for their interests. According to Claessens, [3], the negative impact of entrenchment is worse when the controlling shareholder exercises control through a cross-hold mechanism or pyramid proprietary mechanism so that the controlling shareholder has control over the right to cash flow. This may result in the controlling shareholder being able to direct the company's policies according to personal interests without being liable for losses incurred by the policy [3]. Claessens, [3] also add that the increase in control rights and cash flow rights positively correlated with the level of expropriation of non controlling shareholders.

The expropriation of minority shareholders by transferring wealth or free cash flow to enrich themselves at the expense of minority shareholders' interests. The increased likelihood of expropriation by controlling shareholders may cause the inherent risks faced by the firm to become higher. Therefore the required audit effort will be more considerable. The higher the audit effort, the total Audit fees will increase.

Choi [10] states that the controlling shareholder chooses a low-quality auditor to cover the expropriation measures that this does because the local auditor is more comfortable

to influence or negotiate than the large auditor (KAP BIG4). However, due to the negotiation to cover the opportunistic action taken, then the company will pay the audit fee above average (abnormal audit fee positives) to the local auditor. Therefore the hypothesis is:

H<sub>2</sub>: Family ownership positively affects positives abnormal audit fees.

**III. METHOD**

The research method used in this study is a quantitative empirical study. This research conducted by using all companies listed in Indonesian Stock Exchange (BEI) in 2014-2016 except companies financial sector. This research is unbalanced panel because not all companies consistently disclose the amount of audit fee in its annual report. The total population in this study was 2103 firm-years, but the sample used was 386 firm-years for positive abnormal audit fee model and 347 firm-years for negative abnormal audit fee model. This study measures the abnormal audit fee of the residual audit fees. Calculation of abnormal audit fee to Choi [10] with the following formula.

$$AFEE = \beta_0 + \beta_1 LNTA + \beta_2 NBS + \beta_3 NGS + \beta_4 INVREC + \beta_5 EMPLOY + \beta_6 LOSSLAG + \beta_7 LEVE + \beta_8 ROA + \beta_9 LIQUID + \beta_{10} BIG4 + \beta_{10} SHORT\_TEN + \beta_{10} BTM + \beta_{11} CHGSALE + \varepsilon$$

Where: AFEE = natural logarithm of audit fee, LNTA = natural logarithm of total asset, NBS = natural logarithm above 1 plus number of business segment, NGS = natural logarithm above 1 plus number of geographical segment, INVREC = preparation and receivable together with asset, EMPLOY = the square root of the employee, LOSSLAG = 1 starts the Net Income period t-1 negative, 0 others, LEV = leverage (total liabilities share total assets), ROA = return on assets (average net income - total assets total ), LIQUID = current assets divided by current liabilities, BIG4 = 1 auditor of BIG4 Public Accountant Firm, 0 others, SHORT\_TEN = 1 audit in first or second audit period, 0 others, BTM = book-to-market rate, CHGSALE = sales a year ago divided by total assets of the current year.

The demand for audit services tends to increase according to firm size, leading to a positive relationship between audit fee rewards and firm size. The existence of LNTA and EMPLOY variables are entered to control the size of the company. The rewards of audit services tend to be higher for clients with more complex business operations. The INVREC variable is entered as a proxy to control client business complexity. These variables are expected to have a positive coefficient on audit fee rewards [10].

The existence of the LOSSLAG, LEV, LIQUID, and ROA variables is included as a proxy to control the characteristics of the client's business risk. When the auditor imposes a high cost on the client's business risk, it predicted that LOSSLAG and LEV variables have a positive coefficient on audit fees, while ROA and LIQUID have negative coefficients. The existence of BIG4 variables aims to be able to capture the effect of different audit quality on the level of the audit fee. The positive coefficient of the BIG4 variable means that there is a premium audit fee for high audit quality, which is represented by BIG4.

The SHORT\_TEN variable is included to control the cost disconnect at the beginning of the audit engagement. The CHGSALE and BTM variables were included to control the growth of the company, the higher demand for audit services required by companies with high growth rates compared to low-growth firms [10]. High sales growth has a positive indication of abnormal audit fees

The research model used to test the first hypothesis (H1) is as follows Eq. (1) also, for the second model used in testing the second (H2) and third (H3) hypotheses are as follows Eq. (2).

$$NegABFEE = \beta_0 + \beta_1 \%FAM + \beta_4 SIZE + \beta_5 ROA + \beta_6 LEV + BIG4 + \beta_8 LOSS + \varepsilon \dots \dots \dots (1)$$

$$PosABFEE = \beta_0 + \beta_1 \%FAM + \beta_4 SIZE + \beta_5 ROA + \beta_6 LEV + BIG4 + \beta_8 LOSS + \varepsilon \dots \dots \dots (2)$$

NegABFEE is a negative abnormal audit fee estimate, PosABFEE is an abnormal estimate of positives audit fee, and FAM is calculated based on the number of family ownership percentage of the firm. This study uses control variables: firm size (SIZE) measured from Logartima natural on total assets, return on assets (ROA) measured Logartima natural over total asset leverage (LEV), loss (LOSS) measured from ratio of current assets divided by current liabilities, auditor (BIG4) is measured by 1 if auditor of big four public accountant firm, 0 others.

**IV. RESULTS**

The results of the first hypothesis (H<sub>1</sub>), the effect of family ownership on negative abnormal audit fees seen in Table 1:

Table 1. Family ownership and negative abnormal audit fees

Var	Predict	Coef.	Prob	Sign. (5%)
FAM	(+)	0,02641	0,452	
SIZE	(+)	-0,0356	0,0245	**
ROA	(+)	0,1977	0,216	
LEV	(+)	-32,702	0,127	
BIG4	(-)	-0,9105	0,4645	
LOSS	(+)	0,2456	0,01	**
Obs				347
Adjusted R <sup>2</sup>				0.1359
F-Stat				5.48

In the first hypothesis (H<sub>1</sub>), we found that the level of family ownership in the firm did not have a significant effect on companies paying a lower than usual (negative abnormal audit fee) fee. It does not prove the research hypothesis (H<sub>1</sub>) that the family ownership allows the company to pay the audit fee below standard (negative abnormal audit fee). This result reinforced by Ali & Lesage [1] stating that there is no relationship between family ownership and audit fees.

In addition, due to the adequate supervision of shareholders of the family can reduce the conflict of the agency, the opportunistic actions undertaken by management will decrease and the alignment of interests between the controlling shareholder with the company or non controlling shareholder then the company will pay the

audit fee below standard (abnormal negative audit fee) because there is no need for negotiation or bargaining to cover the opportunistic actions the company undertakes.

However, family ownership with a large percentage of ownership can trigger agency problem II, which is between the major shareholders and the majority shareholder (expropriation). The Entrenchment Effect states that the risk of expropriation is appropriate may improve the audit fee imposed. This is because of the higher possibility of expropriation by controlling shareholders can lead to inherent risks faced by firms becoming higher. Therefore, to cover the expropriation actions undertaken, the company negotiates with the auditor so that the audit fee paid becomes above normal (abnormal audit fee positives). This can lead to an insignificant family ownership effect on audit fees. Besides, this result attributed to the fact that there are still many companies with family ownership that have not disclosed an audit fee to the company.

However, for family companies that pay audit fees above average (positives abnormal audit fee), there is a negative effect with the coefficient of -0.0823 against the abnormal audit fee positives. The effect is significant at the 1% level. This is inconsistent with the research hypothesis (H2). This finding is in line with the research of Khan, Muttakin, & Siddiqui [5] where family ownership will lower the audit fee. This finding is consistent with the alignment effect argument in which significant family ownership will provide control over the company. The existence of large family ownerships will mitigate agency conflicts that may occur because either the family shareholder of the company or minority shareholder has a harmonious goal, i.e., for the sustainability of the company going forward. Also, adequate supervision improves the company's internal control and suppresses opportunistic action opportunities. Therefore, with adequate supervision, the ownership of families who pay the audit fee above regular (abnormal audit fee positives) becomes cheaper. Table 2. show us the family ownership and positives abnormal audit fees.

Table 2. Family ownership and positives abnormal audit fees

Var	Predict	Coef.	Prob	Sign.
<b>FAM</b>	(+)	-0,0823	0,0735	**
<b>SIZE</b>	(+)	-0,0426	0,135	
<b>ROA</b>	(+)	0,1834	0,039	**
<b>LEV</b>	(+)	0,1107	0,0605	*
<b>BIG4</b>	(-)	-0,9105	0,4645	
<b>LOSS</b>	(+)	0,0049	0,0705	*
Obs				386
Adjusted R <sup>2</sup>				0.1359
F-Stat				5.48
***significant 1%; **significant 5%; *significant 10%				

## V. CONCLUSION

The purpose of this study was to test the influence of family ownership on abnormal audit fee empirically. The sample in this study is but the sample used is 386 firm-years for positive abnormal audit fee model and 347 firm-years for negative abnormal audit fee model from 2012 until 2016 so that observation of this research amounted to 733 observations.

We found that family ownership in the firm did not have a significant effect on companies paying abnormal negative audit fees. However, for the family company negatively affect the company that pays the audit fee above average (abnormal audit fee positive). This is due to the effective monitoring of the family to improve the internal control of the company and can reduce the chance of opportunistic actions taken. Limitations of this study are first, not many family companies, especially in Indonesia that reveal the amount of audit fee in the company's annual report. Secondly, this study uses only the percentage of family shareholding; therefore, the next research is expected to use other measurements to get different results.

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