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Do Related Party Transactions Matter to Auditors? Evidence from Audit Opinion

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Abstract

The purpose of this study is to examine the effect of related party transactions (RPTs) on modified audit opinion (MAO). The nature of RPTs, in some circumstances, potentially lead to higher risk of material misstatement of the financial statements rather than transactions with third parties. Since material misstatements are related to the audit risk, therefore company will receive MAO from the auditor if their financial statements provide high audit risk indicated by high material misstatements. This study identifies RPTs from related party sales, related party purchases, related party receivables and related party payables. While MAO is described as audit opinion other than unmodified one. This study uses purposive sampling method by employing some criteria, which consist of 150 sample companies listed in Indonesian Stock Exchange from 2011 until 2015 obtained from Osiris database. Indonesian stock market is a unique setting for deeper understanding of RPTs as RPTs are common in the Asian region and conglomerate firms are still dominating the Indonesian market. Logistic regression analysis with STATA is used as the data analysis technique. The results show that the related party sales, purchases and payables have positive influence and are statistically significant at 5 percent level towards the issuance of MAO. However, related party receivables have no influence on MAO. It is implied that related party receivables are not considered as a high-risk for auditors. Further implication of this study is that it is critical for auditors to have comprehensive knowledge on the nature of RPTs of audit clients as RPTs are considered as a high-risk area. The auditing standards should put more emphasis on understanding the nature of RPTs particularly in the audit planning.

Keywords: MAO, RPTs, Related party sales, Related party purchase, Related party receivables, Related party payables, ROA, firm size, financial distress, public accounting firms.

1. INTRODUCTION

Related party transactions (RPTs) have attracted much attention in the past decades especially in Asian economies where concentrated ownership structure and insider controlled firms are dominating (La Porta, Lopez-De-Silanes, & Shiefer, 2006). Large conglomerates and family-owned businesses contribute to the increasing number of RPTs (Utama & Utama, 2014). Agency problems such as wealth expropriation by controlling shareholders to non-controlling shareholders may arise due to ownership structure concentrated in the founders or families as the controlling shareholders (Claessens et al., 2000, 2002). The nature of RPTs is critical to be understood by all financial statements users, such as creditors, investors, managers, and government for decision-making. Auditors as independent examiners of financial statements are also imposed by the clients' RPTs. RPTs can be value enhancing because business groups can utilize RPTs to share resources (Al-Dhamari et al., 2017). RPTs are indicated as efficient transactions because they fulfil economic demands of the company such as enhancing company's knowledge and expertise or providing alternative forms of compensation (Hasnan, Daie, & Hussain, 2016). These studies broaden the concept of transaction cost developed by Coase (1937) and Williamson (1977) that indicated RPTs might not be harmful but perhaps beneficial to shareholders. Moreover, Chien & Hsu (2010) argue that RPTs are ordinary transactions and are not

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conducted to manage earnings or expropriation. RPTs lead company to utilise its asset more efficiently because of a lower transaction cost. However, the competing arguments around RPTs see RPTs as abusive or a value decreasing because RPTs are used for personal benefits by shareholders through self-dealing controlling at the expense of minority shareholders. The majority shareholders or parent firms arrange transaction through RPTs to extract benefit for their own interests from minority shareholders to themselves (Al-Dhamari et al., 2017). RPTs are viewed as a conflict of interests between management and shareholders (Hasnan, Daie, & Hussain, 2016). Managers structure their RPTs to manage their reported earnings (Healy and Wahlen 1999) for their personal benefit or conceal such expropriations (Djankov et al., 2008). Hence RPTS are harmful and unfavourable to shareholders.

In terms of auditing RPTs, auditors find them to be challenging due to the lack of transparency and the intricate nature of RPTs (Levine, Fitzsimons, & Siegel, 1997). Auditors often see RPTs as red flags in audit. The American Institute of Certified Public Accounting also considers RPTs as a difficult area and a potential indicator for audit risks. Shareholders can potentially suffer losses because RPTs enable wealth transfer between company and its related parties (Kohlbeck & Mayhew, 2016). Hence, internal auditors rate RPTs as the second most effective red flag in identifying opportunities to commit fraud, after imposition of audit scope restriction by clients (Moyes, Lin, & Raymond, 2005). Kohlbeck & Mayhew (2016) argue that companies that issue restatement after disclosure of RPTs is consistent with the argument that RPTs serving as a red flag.

Auditors are more likely to issue a modification of standard audit opinion (hereafter use modified audit opinion/MAO) when there is a likelihood of substantial misrepresentation in the financial statements, violation of audit quality and auditors' independence (Lin, Jiang, & Xu, 2011). MAO indicates that the quality of audit is higher along with the independence of an auditor (DeFond, Wong, & Li, 2000). Prior studies have shown that most of MAO issuance is due to related parties tunnelling and rent seeking activities provided by listed companies with strong incentives to engage in earnings management, which increase the probability of substantial misrepresentation in an annual report (Fan et al., 2008a, 2008b; Lin, Jiang, & Xu, 2011). Tunnelling mechanism refers to the expropriation activities conducted by controlling shareholders that occur in the subsidiaries or lower level to the parent company or higher level (Johnson et al., 2000). Hence, it is implied that MAO is issued as an auditors' response to the higher audit risks. MAO can be predicted by the firm size, leverage, profitability, solvency, default status, financial distress, or the probability of bankruptcy (Altman, Haldeman, & Narayanan, 1977; Habib, 2013; and Nyamboga et al., 2014). Public accounting firms (CPA firms) also contribute to MAO, the higher the size of the CPA firms, the more independence they will be. Hence, they provide MAO to the audit clients that experiencing financial distress (Mutchler, Hopwood, & McKeown, 1997). However, receiving MAO does not necessarily have a negative impact on the firms' value. After considering the cost and benefit of receiving MAO, some firms choose to receive it, because government may give some financing to the firms receiving MAO to boost their performance. Government may ease financing constraints and budget constraints as they are seen as a poor-performance firms (Lin, Jiang, & Xu, 2011).

Most of prior research examine the RPTs and its relationship between earnings quality, accounting quality, and corporate governance (Chien & Hsu, 2010; El-Helaly, 2016; Gordon & Henry, 2005; Hasnan, Daie & Hussain, 2016; Utama & Utama, 2010; Utama & Utama, 2014). Very little attention has been given to highlight the influence of RPTs on MAO (Fang et al., 2017). Indonesian market is used as the empirical setting for this study because Indonesia capital market is dominated by conglomerate firms, which have significant amount of market capitalization. As conglomerate firms are common in the Asian region, this unique setting will offer a deeper understanding on the RPTs and its influence towards MAO. This study contributes to existing literature on the determinants of MAO by showing that RPTs increase the likelihood of auditors issuing MAO. This paper uses related party sales, related party purchase, related party receivables, and related party payables as a measurement of firms' RPTs. Practical implications are inferred from the results of this study where it is critical from auditors to have a comprehensive knowledge on the nature of the RPTs of audit clients as RPTs are considered as a high-risk area. The auditing standards should put more emphasize on understanding the nature of RPTs particularly in the audit planning and risk assessment.

The remainder of the paper is organized as follows. Section 2 reviews the literature and develops hypotheses. Section 3 describes the research methods. Section 4 presents the empirical model and findings. And section 5 concludes the paper.

2. LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

2.1 Literature review

The primary function of audit is to add credibility to the financial statements by issuing independent opinion on the financial statements. Audited financial statements increase confidence of financial statement users because audit reduces the information risks contained in the financial information provided by the management and reduces information asymmetry between management and other stakeholders (Hayes, Dassen, & Schilder, 2011). MAO influences financial constraints and is resulted in information asymmetry (Lin, Jiang, & Xu, 2011). RPTs from family-ownership firms are likely to engage in earnings management for private gains, because there is a potential higher information asymmetry between family members and other shareholders (Hasnan et al., 2016). Firms can reduce information asymmetry by conducting specific types of goods and services of related party purchases and related party sales (Habib, Jiang, & Zhou, 2015).

International Standard on Auditing (ISA) 550 specifically provides background, explanation, and guidance on auditor's responsibilities and procedures on related parties when performing an audit of financial statements. ISA 550 expands on how ISA 315 (Revised)[1], ISA 330[2], and ISA 240[3] are applied in relation with the risks of material misstatements associated with related party relationships and transactions. ISA 550 specify the auditor's objective to recognize fraud risk factors, if any, arising from RPTs and transactions that are relevant to the identification and assessment of the risks of material misstatement due to fraud and to conclude that the financial statement are present fairly and nor misleading as they are affected by those relationships and transactions. Unlike arm's length assumption, related party is defined as a person or entities that control or have significant influence, and entities that have been controlled or affected, directly or indirectly through one or more intermediaries towards reporting entity (ISA 550). Related party is also defined as another entity together with a reporting entity that is under a common control through having common controlling ownership, owners who are close family members, or common key management.

As RPTs expose some additional risks to auditors, auditors tend to response in certain ways. Auditors are more likely to issue MAO when there is a likelihood of substantial misrepresentation in the financial report, violation of audit quality and auditors' independence (Lin, Jiang, & Xu, 2011). Most of MAO issuance is due to related parties tunnelling and rent seeking activities provided by listed companies with strong incentives to engage in earnings management, which increase the probability of substantial misrepresentation in the financial report (Fan et al., 2008a, 2008b; Lin, Jiang, & Xu, 2011). Hence, it is inferred that MAO is issued as an auditors' response to the higher audit risks.

Modification of audit reports is described as any forms of auditor's opinion of the financial statements other than unmodified one or clean opinion. MAO also includes unmodified reports with explanatory paragraphs that discuss about going concern assumption and significant RPTs. ISA 701[4] describes the auditor's report is modified in the following situations, 1) matters that do not affect the auditor's opinion means by adding an emphasis of matter paragraph, and 2) matters that do affect the auditor's opinion means opinion in particular opinion such as qualified opinion, adverse opinion, or disclaimer opinion.

2.2 Hypotheses development

RPTs have attracted much attention recently because, especially in Asian economics, many insiders controlled firm and ownership structure are dominating (La Porta et al., 2006). RPTs are transactions between a firm and individuals or organizations related to the company, such as managers, boards of directors, major shareholders, and affiliates (Al-Dhamari et al., 2017; and Gordon, Henry, & Reed, 2007). International Accounting Standard (IAS) 24 emphasizes the definition of RPTs as transactions that transfer of resources, services, or obligations between related parties, regardless of whether a price is charged. The implication of RPTs may be varied, positive or negative (Al-Dhamari et al., 2017). Some view RPTs as conventional transactions and are not necessarily conducted to manage earnings or to expropriate company's resources (El-Helaly 2016). Chien & Hsu (2010) argue that RPTs lead to lower transactions costs and enable firms to utilize their assets more efficiently. Not all RPTs are serving the interest of insiders and controlling shareholders (Ryngaert & Thomas 2012). RPTs are efficient transactions that rationally fulfil the economic demand of a firm. This view extends the concept that developed by Coase (1937) and Williamson (1977) about transaction costs, which indicates that

[1] ISA 315 (Revised), Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment.
[2] ISA 330, The Auditor's Responses to Assessed Risks.
[3] ISA 240, The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements.
[4] ISA 701, Communicating Key Audit Matters in the Independent Auditor's Report.

RPTs do not harm and may benefit the shareholders. The need of in-depth company knowledge and expertise or providing alternative forms of compensation are rationally fulfilled by RPTs.

On the contrary, RPTs can be viewed as a value-decreasing transaction. Al-Dhamari et al. (2017) argue that RPTs are often regarded as abusive, because it can be used opportunistically by self-dealing controlling shareholders to extract private benefits at the expense of minority shareholders. In this case, controlling shareholders have a role as parent firms that arrange transactions through related parties to extract private benefits or divert a company's resources from minority shareholders to themselves. Hasnan, Daie, & Hussain (2016) argue that RPTs are harmful and unfavourable transactions to shareholders RPTs because it indicates as an agency conflict between the management and the shareholders. Management has the incentive to manage earnings for their private gain or possibly conceal such expropriation (Gordon & Henry, 2005).

Auditors issue MAO because there is a substantial misrepresentation present in financial statement. Related party tunnelling and corporate rent seeking activities provide listed companies with strong incentives to engage in earnings management that leads high volume of misrepresentation in annual report (Fan et al., 2008a, 2008b; and Lin, Jiang, & Xu, 2011). RPTs have relationships between material misstatements due to fraud and error and audit risks. For instances, shareholders may potentially incurred losses because RPTs enable wealth transfer between firm and related parties. Managers used RPTs to manage earnings and to boost firm's performance. Moyes, Lin, & Raymond (2005) also argue that internal auditors rate RPTs as a second most effective red flag identifying opportunities to commit fraud, after the client imposed audit scope restriction.

Related party sales and purchases are considered as major resources in earnings management. A firm may receive an increasing amount of fund due to increase the level of sales and reduce the cost of purchasing. Hence, it will result in a large profit (Aharony, Wang, & Yuan, 2010). Related party sales and purchase of goods and services are the most frequent RPTs and occur in normal business operation. Fang et al. (2017) argue that related party sales of goods and services lead to the higher audit risks since there is a greater room for overstatement sales and understatement of cost of goods sold. Related party receivables (lending) and related party payables (borrowing) are other forms of RPTs. Borrowing from a related party firm is one of the solutions if external financing is less developed (Fang et al., 2017). Related party payables could lessen the financial constraint, hence it leads to the increment of accounting and stock market performance. While related party receivables (lending) could destroy the firm's value due to tunnelling mechanism that lending from listed firm to related parties. Lending carries lower interest rate and is more likely to default and lower recovery rates (Fang et al., 2017). The insiders could overstate the book value of related party receivables if they have expropriation motives and an intention to default loan. Based on above discussion, the following hypotheses are developed (stated in alternative form):

H1: Auditors are likely to issue a modified audit opinion to firms with higher related party sales.
H2: Auditors are likely to issue a modified audit opinion to firms with higher related party purchase.
H3: Auditors are likely to issue a modified audit opinion to firms with higher related party receivables.
H4: Auditors are likely to issue a modified audit opinion to firms with higher related party payables.

3. RESEARCH METHODS

3.1 Research design

Data analysis method that used in this research is include in quantitative data analysis. The analytical tool used in this research is logistic regression model, with evaluation of regression results using descriptive statistics and logistic regression analysis. The four hypotheses are tested using the following logistic model of modified audit opinion:

$$MAO_{it} = \alpha_0 + \alpha_1 RPSALES_{it} + \alpha_2 RPPURCHASE_{it} + \alpha_3 RPRECEIVABLES_{it} + \alpha_4 RPPAYABLES_{it} + \alpha_5 ROA_{it} + \alpha_6 SIZE_{it} + \alpha_7 DISTRESS_{it} + \alpha_8 BIGFOUR_{it} + \varepsilon_{it} \quad (1)$$

where,

Dependent variable
MAO a dummy variable equals to 1 if a firm receives a modified audit opinion, and 0 otherwise.

Tested variables
RPSALES sum of sales of goods and services to related parties scaled by total net sales.

RPPURCHASE	sum of purchases of goods and services from related parties scaled by total net purchase.
RPRECEIVABLE	amount of inter-corporate lending from the company to its related parties.
RPPAYABLE	amount of inter-corporate borrowing by the company from its related parties.

Control variables

ROA	ratio of firm's net income to its total assets.
SIZE	natural logarithm of the total year-end asset.
DISTRESS	ratio of firm's total liabilities to its total assets.
BIGFOUR	a dummy variable equals to 1 if a firm is audited by big-four accounting firm, and 0 otherwise.

Hypotheses testing used in this study is logistic regression analysis, because the dependent variable is indicated as a categorical or dichotomous variable (binary). This regression analysis has a better classification level than other models and it is not sensitive to the number of samples that are not in the same frequency.

3.2 Sample

This study uses 150 manufacturing firms listed in Indonesian Stock Exchange (IDX) over the period 2011-2015. The data is taken from OSIRIS database and the websites of respective firms. Table 1 shows the sample selection methods used in this study.

Table 1. Sample Selection Methods

Criteria	Number of firms
Active and listed manufacturing firms in IDX	150
Delisted firms and unavailable audited financial statements	(15)
Incomplete information in the audited financial statements	(63)
Total firms	72
Year of observations (2011-2015)	5
Final observations	360

4. RESULTS AND ANALYSIS

The following is the output table of STATA for descriptive in descriptive statistics along with its interpretation. Table 2 shows the number of observations, mean, standard deviation, minimum and maximum value of each variable.

Table 2. Descriptive Statistic Results

Variable	Observation	Mean	Std. Dev.	Minimum	Maximum
OPINION	360	0.48	0.50	0	1
RPSALES	360	20.06	27.64	-6.30	100
RPPURCHASE	360	17.22	23.07	0	99.18
RPRECEIVABLES	360	4.72	10.96	0	95.72
RPPAYABLES	360	8.65	18.48	0	99.59
ROA	360	7.09	10.45	-28.83	52.57
SIZE	360	21.71	1.52	18.59	26.23
DISTRESS	360	50.26	21.21	8	129.21
BIGFOUR	360	0.38	0.49	0	1

The mean of *OPINION* is close to 0.48, it represents good distribution of data around receiving clean opinion or MAO. The *RPSALES* variable has minimum value of -6.3 because one company record related party sales based on sales return. The mean of *RPSALES, RPPURCHASE, RPRECEIVABLES,* and *RPPAYABLES* is 20.06, 17.22, 4.72, and 8.65 respectively. It means on the average, the companies commit related party sales, related party purchase, related party receivables, and related party payables of 20 percent, 17 percent, 4.7 percent, and 8.6 percent.

Table 3 is the output of logistic regression with audit opinion as a dependent variable and RPTs as independent test variables. The control variables employed in the model are *ROA*, *SIZE*, *DISTRESS*, and *BIGFOUR*. The main parameter to be observed from the regression result is likelihood ratio that reflected by Prob>chi2, Z-stat that reflected by P>|z|, and goodness of fit that reflected by Pseudo R2.

Table 3. Logistic Regression Results

Number of observations = 360
Prob > chi^2 = 0.0000
Pseudo R^2 = 0.6494

OPINION	Expected Sign	Coefficient	Std. Error	z	P>|z|
RPSALES	+	0.853081	0.0224369	3.80	**0.000**
RPPURCHASE	+	0.1095373	0.0180186	6.08	**0.000**
RPRECEIVABLES	+	0.1570921	0.1060832	1.48	0.139
RPPAYABLES	+	0.0673991	0.0219457	3.07	**0.002**
ROA	-	-0.0448968	0.0263068	-1.71	0.088
SIZE	-	-0.2350553	0.1434675	-1.64	0.101
DISTRESS	+	-0.0000279	0.0107117	-0.00	0.998
BIGFOUR	+	1.252922	0.4325522	2.90	0.004
cons	+	1.381766	3.113778	0.44	0.657

The logistic regression results show that the Pseudo R^2 is 0.6494. It indicates that in the model independent variables describe the dependent variable in the amount of 64.94 percent and the rest is explained by other factors. The likelihood ratio (Prob > chi^2) tests whether all coefficient slope of independent variables regression simultaneously affect the dependent variable. Table 3 shows that with confidence level of 95 percent and Prob > chi^2 statistics probability is 0.0000 or H_0 is rejected, it means simultaneously independent variables affected dependent variable.

The results from the logistic regression show that *RPSALES, RPPURCHASE,* and *RPPAYABLES* are statistically significant at the 5 percent level (P>|z| < 5%). The positive coefficient of *RPSALES, RPPURCHASE,* and *RPPAYABLES* are as hypothesized. Based on the results, H_1, H_2, and H_4 are supported. Consistent with prior studies (e.g., Fang et al., 2017), related party sales and related party purchase is subjects to management discretion on selling and purchasing goods to manage the net income. Lin, Jiang, & Xu (2011) also argue that RPTs, including related party payables, should be supervised because RPTs are one of the indicators of earnings management. RPTs increase the probability of substantial misrepresentation in the audit report, hence it leads to higher probability to modify the audit opinion.

While *RPRECEIVABLES* is not statistically significant at the 5 percent level because the value of P>|z| is 13.9 percent. It means that H_3 is not supported and H_0 is accepted, even though the direction of H_4 is as expected. This result is supported by Kuan et al. (2010) showing that amongst RPTs, related party receivables of Indonesian manufacturing firms are statistically lower than other RPTs (related party sales, related party purchase, and related party payables) and are likely to have more assurance in the collection of credit provided based on stable and long-term relationships developed among related party members. Gorczynska (2011) also argues that manufacturing firms have better level of account receivables turnover ratio and average collection period especially in food and beverages sector. Manufacturing firms have efficient credit policies that ensure fast collection, hence it can be inferred that the related party receivables pose a lower audit risk than other RPTs.

The control variables for *BIGFOUR* is positive and statistically significant at the 5 percent level, and is consistent prior studies (DeFond, Wong, & Li, 2000; and Kaklar, Kangarlouei, & Motavassel, 2012). Big accounting firms would issue modified audit opinion if necessary because they ignore the client pressure. Big-four firms also have greater independence and are likely to detect accounting irregularities. Other control variables which are *ROA* and *SIZE* are statistically significant at the 10 percent level. Both directions are as expected. Prior studies (Rafizadeh, 2016 and Rudhkani & Jabbari, 2013) support the negative relationship between MAO and ROA. Habib (2013) also argue that smaller firms are more likely to receive MAO than bigger firms. Other control variables of *DISTRESS* is not statistically significant at the 10 percent level, however the coefficient of regression is as expected. Consistent to prior research (Lin, Jiang, & Xu, 2011; and Yati, Yuniarta, & Sinarwati, 2017), financial distress measured by debt ratio is not the only data to be accounted for when auditors issue an opinion.

5. CONCLUSION

The objective of this study is to investigate how RPTs affects the issuance of MAO. The nature of RPTs, in some circumstances, potentially lead to higher risk of material misstatement of the financial statements rather than transactions with third parties. Since material misstatements are related to the audit risk, therefore company will receive MAO from the auditor if their financial statements provide high audit risk indicated by high material misstatements. In this study, MAO acts as a dependent variable and is classified as opinion other than unmodified opinion which includes, unmodified opinion with explanatory paragraph, qualified opinion, adverse opinion, and disclaimer opinion. The independent variables used in this study are measured by RPTs, which includes the related party from sales, purchase, receivables, and payables. The control variables used are ROA, firm size, financial distress and big-four accounting firms.

The results of this study indicate that RPTs from sales, purchases, and payables result in issuance of MAO. However, related party receivables are suggested as a non-high-risk transaction that leads to issuance of MAO. This variable is not considered as a high-risk for auditor to issue modified audit opinion. Consistent with a study by Kuan et al. (2010), it shows that related party receivables of Indonesian manufacturing firms are statistically lower than other RPTs. Furthermore, Gorczynska (2011) argues that manufacturing firms have a better level of account receivables turnover ratios and average collection period particularly in food and beverages sector. Therefore, it can be inferred that the related party receivables carry a lower audit risk than other RPTs. Some practical implications are provided in this study. First, it is critical that auditors have comprehensive knowledge on the nature of the RPTs of audit clients as RPTs are considered as a high-risk area. Second, the auditing standards should consistently put more emphasis on understanding the nature of RPTs particularly in the audit planning stage.

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