

Original Research

The Influence of Corporate Governance on the Relationship between Related Party Transactions and Audit Fees

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Abstract

The purpose of this study is to investigate the effect of corporate governance mechanisms on the relationship between related party transactions and audit fees. In this study, board size and duality role of CEO were selected as corporate governance mechanisms and their effect on the relationship between related party transactions and audit fees among 93 companies listed on the Tehran Stock Exchange in the 10-year period of 2011-2020 were investigated. For this purpose, three hypotheses were formulated to investigate this issue and research regression models were tested using the panel data method with the fixed effects approach. The results showed that there is a positive and significant relationship between related party transactions and audit fees. The results also indicate that corporate governance mechanisms (board size, CEO duality) have a negative and significant effect on the relationship between related party transactions and audit fees. In fact, the results indicate that auditors are increasing their audit efforts (reflecting audit fees) to address the risk associated with related party transactions. It also minimizes conflicts of interest, opportunistic behaviors of managers and, consequently, the risk associated with related party transactions by applying appropriate regulatory mechanisms.

Keywords: Related party transactions, audit fees, corporate governance.

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Introduction

Although the acquisition of corporate resources through related party transactions is common in developed countries, due to the weakness of foreign markets and the weakness of corporate governance, this phenomenon is more common in emerging economies. In many cases, related party transactions are inevitable and beneficial and are repeated throughout the company's operations cycle. But in special circumstances, it allows major shareholders or company managers to increase their personal interests at the expense of small shareholder (Hamidi & Sheri, 2012). The results of previous studies show that related party transactions can be related to agency theory, which refers to the role of management in the use of resources in its favor. Accordingly, related party transactions, which are often to the benefit of managers and to the detriment of shareholders, is a kind of use of resources to ensure the interests of managers. Managers or other affiliates can use their influence to gain personal advantage by engaging in such transactions and transfer wealth from the company to them. Such transactions can also reduce the reliability of financial statements and have a detrimental effect on the business value creation process in the long run (Aharony, Wang, & Yuan, 2010).

Auditing, as one of the corporate governance mechanisms, is usually proposed to reduce conflicts of interest in situations where agency problems prevail. The audit mission is to validate financial reporting and build trust for users of financial statements, and the auditor's economic interests are provided through fees. The characteristics of the auditor and the entity under consideration determine the audit fee. Characteristics of the unit under consideration; agency costs can affect audit fees by affecting the three descriptive factors of risk, volume and complexity of the operations of the entity under review. Auditors charge higher fees to cover risk for companies that are more likely to have agency problems. Also, corporate governance is one of the most important and fundamental pillars of any company that is tied to the agency problems. Good corporate governance can reduce the agency costs in financial reporting and in turn affect the volume of audit work and its risk and ultimately audit fees (Ben Ali & Lesage, 2012). In Iran, due to the nascent corporate governance debate and the process of privatization of some companies, the study of the issue of the change in corporate governance from the perspective of auditors who are responsible for accrediting financial statements, what effect on the severity of the agency problems, Seems to be a basic need. To find the answer to this question, an attempt has been made to examine the relationship between related party transactions and audit fees and the impact of corporate governance mechanisms, which is one of the important issues of the capital market, so that it can be determined on the one hand by determining the fee. Audit fees provide investors and creditors with important information about the severity of the agency problem of companies with different corporate governance structures, and on the other hand, auditors can identify these factors and price their services appropriately.

Literature review and development of hypotheses

Related party transactions are generally defined as "the transfer of resources, services, or liabilities between related parties regardless of whether or not the price is claimed." Related party transactions are a common feature of a business unit, as many companies operate through subsidiaries, special partnerships, and affiliates. Under such

circumstances, companies are able to influence the financial and operating policies of the company in which they have invested through control, joint control or considerable influence. Because related parties can make transactions with the company that are beyond the reach of non-related parties, contact with related parties will have a significant impact on the results and financial condition of the entity. In addition, the company's results and financial condition are affected by the mere existence of related parties (even if no transaction takes place) (Carlacia & Tudor, 2011). It can be said that related party transactions and, as a result, the possibility of opportunistic behavior of managers, is due to agency conflict. One of the basic assumptions of agency theory is that management uses the company's resources to its advantage to maximize its personal interests, and related party transactions, which are often to the benefit of managers and to the detriment of shareholders, are of this type. In addition to disrupting shareholder value creation, this management misconduct can also jeopardize the job security of managers. For this reason, in order to avoid the adverse effects of these transactions, the directors may distort the financial statements, which disrupts the value creation for the shareholders because it allows the owners to make informed decisions due to the presentation of distorted information (Matteo & Marco, 2014).

(Habib, Jiang, & Zhou, 2015) believe that according to the agency theory, related party transactions increase concerns; this is because managers reduce the profitability and reliability of financial statements by improper transfer of wealth, reducing the effectiveness of contracts designed to reduce agency conflict and ultimately the loss of corporate shareholders. In this context, the issue of auditing transactions with related parties is complex and the inability of auditors to identify these transactions is one of the shortcomings of the audit. The American Institute of Certified Public Accountants offers three reasons why auditing related party transactions is difficult. First, these transactions are not easily identifiable; second, the auditor relies on the principal and major shareholder to identify related party and related party transactions; and third, these transactions are not easily traceable under the company's internal controls (AICPA, 2001).

(Hope, Longhli, & Wayne, 2010) state that the severity of the agency conflict increases audit working hours. Investors expect companies to hire better quality auditors from companies whose ownership structure shows signs of agency conflict. On the other hand, in order to satisfy the capital market, the management hires reputable auditors. Also, (Habib, Jiang, & Zhou, 2015) state that the auditor's effort is measured by the audit service fee, and the larger the agency problem, the more work is done to ensure that there is no fraud or significant error. Required in the financial statements; Therefore, auditing costs will be higher. Therefore, it is assumed that the level of audit fees reflects the auditor's understanding of the need for more work in situations where the issue of agency is more severe. Corporate governance is a mechanism to achieve the company's goals through the management of the company's affairs, which ensures that the interests of all shareholders, including major and minor shareholders, are protected (Hajiha & Akhlaghi, 2015). One of the corporate governance mechanisms is the management structure of the company which has been studied in this research.

(Chien & Hsu, 2010) believe that corporate governance mechanisms change related party transactions from opportunistic to efficient transactions and the independence of the

board of directors' plays a moderating role in these transactions. (Srinivasan, 2013) in its research concluded that there is a significant negative relationship between related party transactions and company performance. Also, the number of transactions with related parties in companies audited by large corporations was lower than in other companies. (Oktorina & Wedari, 2015) found that management ownership, audit committee actions, firm size, liquidity ratio and profitability ratio affect audit fees. Institutional ownership, free cash flow, and market value at book value, on the other hand, do not have a significant effect on audit fees. (Al-Gamrh, 2018) in its research concluded that transactions with related parties reduce the quality of financial reporting and as a result increase audit risk, which ultimately leads to an increase in audit fees. (Abdul Rasheed, Iqbal Thonse, & Mallikarjunappa, 2021) in a study examined the impact of transactions with related parties on audit risk. In their study, the researchers concluded that the new rules regarding related party transactions increase the complexity of these transactions, increase audit costs, and ultimately increase audit risk.

In view of the above, the present study seeks to find an answer to the question of whether related party transactions affect audit fees or not? Also, can the management structure influence this possible relationship? In this regard, three hypotheses are stated as follows:

H1: Related party transactions have a significant impact on audit fees.

H2: The size of the board has a significant effect on the relationship between related party transactions and audit fees.

H3: CEO duality has a significant effect on the relationship between related party transactions and auditing fees.

Methodology

Due to the impossibility of controlling all relevant variables, this study cannot be a kind of purely experimental research, but according to the analysis of past information, it is considered a quasi-experimental research. Also, due to the fact that the results obtained from this study solve a specific problem or issue, it is applied in terms of purpose and regression correlation analysis in terms of method. For data analysis, in the descriptive statistics section, data analysis was performed using central indicators such as mean and median and scatter indices of standard deviation. Also, the pooled data regression model has been used to test the hypotheses. F test is used to choose between the methods of hybrid regression patterns and panel data pattern with fixed effects. If the combined data method is chosen in the F test, it is done, but if the panel data method with fixed effects is chosen, it is necessary to perform the Hausman test as well. Hausman test is used to determine the use of fixed effects pattern versus random effects pattern (Aflatouni, 2014).

The study population consists of all companies listed on Tehran Stock Exchange during the period from 1391 to 1400. Taking into account the following restrictions for the companies, a sample (93 companies) was selected: 1- In terms of increased comparability, the fiscal period ended March. 2- Do not change the financial year during the period. 3- During the period under review, the trading symbol is not out of exchange.

4- Because to calculate the market value of the entity, stock market value is required, the companies during the period should work constantly, and their shares have been traded without interruption significantly. 5- The sample does not include financial intermediation companies, investments, leasing companies, banks and insurance companies; because the nature of the assets of these companies is different.

Research variables

Dependent variable

Audit Fee: The dependent variable is the audit fee, which is measured based on the natural logarithm of the auditor's fee. The reason for using natural logarithms in calculating audit fees is to homogenize the fees of large and small companies.

Independent variable

Related Party Transactions: Amount of these transactions from the total amount of related party transactions (purchase of goods and services from related party + sale of goods and services to related party) disclosed in the accompanying notes to the annual financial statements of the surveyed companies divided by the total assets at the beginning of the period The company is obtained (Habib, Jiang, & Zhou, 2015).

Moderating variables

Board size: Board size is the total number of board members of the company

Duality role of CEO: This variable is a virtual variable, so that if the CEO is also the chairman of the board of directors, the value is one and otherwise the value is zero.

Control variables

Size: The natural logarithm of the total assets of Company *i* is defined in year *t*.

ROA: Represents the return on assets of Company *i* in year *t* and is obtained from the ratio of operating profit to total assets.

Loss: If the company is unprofitable; Equivalent to one and otherwise equivalent to zero. This variable is intended to control the companies that have declared losses.

Research models

To test the research hypotheses, a multivariate regression model was used. Therefore, the research hypotheses are examined based on the following models:

Model (1):

$$AF = \beta_0 + \beta_1 RPT + \beta_2 SIZE + \beta_3 ROA + \beta_4 LOSS + \varepsilon$$

Model (2):

$$AF = \beta_0 + \beta_1 RPT + \beta_2 BS + \beta_3 (RPT * BS) + \beta_4 SIZE + \beta_5 ROA + \beta_6 LOSS + \varepsilon$$

Model (3):

$$AF = \beta_0 + \beta_1 RPT + \beta_2 DUAL + \beta_3 (RPT * DUAL) + \beta_4 SIZE + \beta_5 ROA + \beta_6 LOSS + \varepsilon$$

Research Findings

Descriptive Statistics

Descriptive statistics of research variables are presented in Table (1).

Table (1): Results of descriptive analysis of research data

Std. dev	Min	Max	Med	Mean	Obs.	Symbol	Variable
0.748	4.431	8.117	5.914	5.958	930	AF	Audit fee
0.217	0.0108	0.951	0.028	0.113	930	RPT	Related party transactions
0.359	3	9	5.032	5.032	930	BS	Board size
0.298	0	1	0	0.22	930	DUAL	Duality of CEO
0.851	4.721	8.010	5.954	6.185	930	SIZE	Size
0.138	-0.104	0.730	0.211	0.226	930	ROA	ROA
0.249	0	1	0	0.074	930	LOSS	Loss

As can be seen in Table 1, the mean and median of most variables are close to each other. Examination of quantitative results of descriptive statistics of research variables shows that the mean and standard deviation of the dependent variable of audit fees are 5.958 and 0.748, respectively, and the mean and standard deviation of the independent variable of related party transactions in companies in the sample. It is about 0.113 and 0.028, in relation to the control variables, it should be said that the average loss in listed companies is about 7%, which indicates that a high percentage of the companies under review are profitable. In addition, the average firm size and rate of return on assets of the companies in the sample are 6.185 and 0.226, respectively.

Test hypotheses

Before fitting the models, in order to determine the use of panel data method with fixed effects versus pooled data method, F-test should be performed on research models. The results of the F-test for research models are shown in Table (2).

Table (2): F-test results for research models

Accepted model	Prob.	Statistic	Research model
Fixed effects model	0.000	63.232	Model 1
Fixed effects model	0.000	62.345	Model 2
Fixed effects model	0.000	62.351	Model 3

According to the statistics and error level of the F-test and rejection of the H0 hypothesis for research models, the Hausmann test should also be performed to select the model of panel data with fixed effects or panel data with random effects. The results of the Hausman test are shown in Table (3).

Table (3): Hausman test results for research models

Accepted model	Prob.	Statistic	Research model
Fixed effects model	0.000	112.496	Model 1
Fixed effects model	0.000	123.114	Model 2
Fixed effects model	0.000	141.156	Model 3

As can be seen in Table (3), the results indicate that the panel data method with fixed effects is the preferred method for research models. Therefore, to estimate the research models, the panel data method with fixed effects has been used.

Test the first hypothesis

To test the first hypothesis, model (1) has been used. The results of the first hypothesis test are given in Table (4).

Table (4): Results of the first hypothesis test

$AF_{it} = \beta_0 + \beta_1 RPT_{it} + \beta_2 SIZE_{it} + \beta_3 ROA_{it} + \beta_4 LOSS_{it} + \varepsilon_{it}$				
Prob.	t-statistic	St. error	Coefficient	Variable
0.000	-4.807	0.805	-3.882	C
0.000	5.719	0.016	0.079	RPT
0.000	10.885	0.061	0.623	SIZE
0.268	1.124	0.330	0.369	ROA
0.028	2.198	0.113	0.251	LOSS
0.464				Adj. R-Square
1.789				Durbin-Watson
11.850				F-Statistic
0.000				Prob. (F-Statistic)

According to the obtained F-statistic for the model which is equal to 11.850 and also its error level which is equal to (0.000), it can be said that it has a high significance at the 95% confidence level in the whole model. Also, according to the adjusted coefficient of determination obtained for the model, which is equal to 46.4%, it can be said that the independent and control variables explain about 46% of the changes of the dependent

variable, respectively. According to the Durbin-Watson statistic obtained for the model, which is equal to 1.789, it can be said that there is no first-order autocorrelation between the residuals of the model. In addition, the probability associated with the assumption of zero, based on the relationship between related party transactions and the audit fee, is equal to 0.0000, therefore, the null hypothesis is not rejected at the 5% error level. The variable coefficient of related party transactions is 0.079. Considering the significance of the variable coefficient of related party transactions and its positives, it can be concluded that there is a positive and significant relationship between transactions with dependents and auditing fees.

Test the second hypothesis

To test the second hypothesis, model (2) has been used. The results of the second hypothesis test are given in Table (5).

Table (5): Results of the second hypothesis test

$AF_{it} = \beta_0 + \beta_1 RPT_{it} + \beta_2 BS_{it} + \beta_3 (RPT * BS_{it}) + \beta_4 SIZE_{it} + \beta_5 ROA_{it} + \beta_6 LOSS_{it} + \varepsilon_{it}$				
Prob.	t-statistic	St. error	Coefficient	Variable
0.000	-4.759	0.903	-4.273	C
0.000	6.846	0.014	0.087	RPT
0.0038	-2.927	0.438	-1.251	BS
0.0003	-3.636	0.036	-0.141	RPT*BS
0.000	10.628	0.067	0.679	SIZE
0.1869	1.329	0.339	0.449	ROA
0.0508	1.968	0.115	0.216	LOSS
0.473				Adj. R-Square
1.780				Durbin-Watson
12.222				F-Statistic
0.000				Prob. (F-Statistic)

According to the obtained F-statistic for the model which is equal to 12.222 and also its error level which is equal to (0.000), it can be said that it has a high significance at the 95% confidence level in the whole model. Also, according to the adjusted coefficient of determination obtained for the model, which is equal to 47.3%, it can be said that the independent and control variables explain about 47% of the changes of the dependent variable, respectively. According to the Durbin-Watson statistic obtained for the model, which is equal to 1.780, it can be said that there is no first-order autocorrelation between the residuals of the model. Also, the probability related to the null hypothesis, based on the effect of board size on the relationship between related party transactions and auditing fees, is equal to 0.003, so the null hypothesis is not rejected at the 5% error level. Also, the coefficient of the variable of related party transactions * the size of the board of directors is -0.141 and due to the significance and negativity of this coefficient and its change compared to the variable coefficient of related party transactions (from 0.087 to -0.141), it can be concluded that the size of the board reduces the positive relationship between transactions with related party and the audit fee. In fact, according to the change

of the above mentioned coefficients, it can be understood that the size of the board of directors modulates the relationship between related party transactions and the audit fee.

Test the third hypothesis

To test the third hypothesis, model (3) has been used. The results of the test of the third hypothesis are given in Table (6).

Table (6): Results of the second hypothesis test

$AF_{it} = \beta_0 + \beta_1 RPT_{it} + \beta_2 DUAL_{it} + \beta_3 (RPT * DUAL_{it}) + \beta_4 SIZE_{it} + \beta_5 ROA_{it} + \beta_6 LOSS_{it} + \varepsilon_{it}$				
Prob.	t-statistic	St. error	Coefficient	Variable
0.000	-5.941	0.816	-4.854	C
0.000	7.378	0.015	0.117	RPT
0.0002	-3.789	0.409	-1.554	DUAL
0.000	-4.506	0.026	-0.157	RPT*DUAL
0.000	11.658	0.063	0.708	SIZE
0.1469	1.453	0.336	0.489	ROA
0.0715	1.804	0.118	0.201	LOSS
0.486				Adj. R-Square
1.873				Durbin-Watson
12.456				F-Statistic
0.000				Prob. (F-Statistic)

According to the obtained F-statistic for the model which is equal to 12.456 and also its error level which is equal to (0.000), it can be said that it has a high significance at the 95% confidence level in the whole model. Also, according to the adjusted coefficient of determination obtained for the model, which is equal to 48.6%, it can be said that the independent and control variables explain about 48% of the changes of the dependent variable, respectively. According to the Durbin-Watson statistic obtained for the model, which is equal to 1.873, it can be said that there is no first-order autocorrelation between the residuals of the model. Also, the probability related to the null hypothesis, based on the effect of board size on the relationship between related party transactions and auditing fees, is equal to 0.000, so the null hypothesis is not rejected at the 5% error level.

Also, the coefficient of the variable of related party transactions * the duality role of CEO is -0.157 and due to the significance and negativity of this coefficient and its change compared to the variable coefficient of related party transactions (from 0.117 to -0.157), it can be concluded that the CEO duality reduces the positive relationship between transactions with related party and the audit fee. In fact, according to the change of the above mentioned coefficients, it can be understood that the duality role of CEO modulates the relationship between related party transactions and the audit fee.

Discussion and Conclusions

The purpose of this study is to investigate the relationship between related party transactions and audit fees and the impact of corporate governance mechanisms on this

relationship in companies listed on the Tehran Stock Exchange. For this purpose, three hypotheses were developed to investigate this issue and the available data were analyzed. According to the theoretical foundations, there is a positive relationship between some of the concepts of risk and audit fee. In fact, the characteristics of the unit under consideration; agency costs can affect the audit fee by influencing the three descriptive factors of risk, volume and complexity of the operations of the entity under review. Auditors charge higher fees to cover risk for companies that are more likely to have agency problems, and according to agency theory, related party transactions increase concerns; because managers reduce the profitability and reliability of financial statements by improper transfer of wealth. This reduces the effect of contracts designed to reduce agency conflict and ultimately the loss of corporate shareholders, which increases risk. Therefore, in determining the audit fee, the auditors consider the risk characteristics of their client and offset the related risks through higher fees. In other words, auditors are demanding higher audit fees due to greater efforts to reduce the risk associated with related party transactions. As a result, it was expected that the relationship between related party transactions and audit fees is a positive. The results of the first hypothesis confirm this and are in accordance with the research findings conducted by (Habib, Jiang, & Zhou, 2015).

Also, the results of the second hypothesis showed that the size of the board modulates the relationship between related party transactions and audit fees because of the existence of a higher board size, corporate management to focus on economic performance and avoid opportunistic behaviors. This result is in accordance with the research of (Habib, Jiang, & Zhou, 2015) and (Chien & Hsu, 2010). In addition, the results showed that the duality role of CEO of companies moderates the relationship between related party transactions and audit fees, which is consistent with the findings of (Habib, Jiang, & Zhou, 2015), (Oktorina & Wedari, 2015) and (Chien & Hsu, 2010).

This study has limitations such as non-adjustment of financial statement items due to inflation and also lack of control of some factors affecting the results of the study, including the effect of variables such as economic factors, political conditions, global economic situation, laws and regulations that may be effective in examining relationships. Also, due to incomplete data of some companies, 930 observations were examined. The findings of this study expand the literature on audit risk-related areas as determinants of audit pricing that audit firms respond to in assessing their risk. Considering the results of testing the research hypotheses on the impact of related party transactions on audit fees and the impact of corporate governance mechanisms on this relationship, it is suggested that auditors take this point into account in their decisions to audit business units.

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