DOES THE PRESENCE OF FAMILY MEMBERS REDUCE AUDIT QUALITY?: EVIDENCE FROM FAMILY FIRM IN INDONESIA

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ABSTRACT
Our research aims to investigate family presence on audit quality. We use a total of 1,960 observations from 182 family companies listed on the Indonesia Stock Exchange. The research method that we use is explanatory research through logistic regression. The results of the study provide empirical evidence that the presence of the family, especially the founder as president director and family members who sit on directors and commissioners, is indicated to reduce audit quality. Our research also provides indications of a stronger entrenchment effect in reducing audit quality in family firms in Indonesia. Family companies in Indonesia tend to pay lower audit fees and use local public accounting firms. Our research has broad implications for two things. The first is for investors in investing, especially to assess the audit quality of family companies. Investors are also expected to assess audit quality as one of the considerations in making an investment. Second, for family companies in improving corporate governance and credibility by involving KAPs from Big4.

Key words: Audit quality, family members, logistic regression

INTRODUCTION

The issue of governance is a hot research issue that continues to be carried out among researchers. Several researchers have different arguments regarding the presence of families in the company. First, researchers agree that the presence of family in a company is an effective monitoring mechanism that increases company performance and creates an alignment effect. For example, Bertrand & Schoar (2006) stated that the presence of the family in the company boosted the credibility of the company, Behr & Güttler (2007) stated that the presence of the family encouraged access to external funding, Bunkanwanicha et al. (2013) and Santos et al. (2014) stated that the presence of family in a company can boost share prices in the capital market. But on the other hand, some researchers also agree that the presence of family in a company actually creates an entrenchment effect and reduces company performance. For example, Fan & Wong (2002) found that the entrenchment effect affects the quality of financial information, Guidara et al. (2016) stated that the entrenchment effect increases the cost of obtaining external funding, Rusmin, et al. (2011) found that the entrenchment effect decreases the quality of corporate governance. Our research seeks to investigate family presence in influencing audit quality. We used a total of 1,998 observations from 182 family companies listed on the Indonesia Stock Exchange.

Previous research provides empirical evidence of the relationship between family presence and audit quality which is still inconsistent. As an example of research conducted by Chen et al. (2007) found an indirect relationship between audit quality and family firms. Leung & Wang (2010) found that family firms in Hong Kong tend to pay low audit fees, thus reflecting low audit quality. Homayoun & Hakimzadeh, (2017) and Ho & Kang (2015) examine the involvement of the majority of families in companies and compare them to non-family firms. The results of the study show that family firms tend to pay smaller audit fees and tend to have lower audit quality. Khan et al. (2013) report the same for the context of family firms in Australia. Tahir et al. (2020) found that the presence of a family strengthens the entrenchment effect. Then research conducted by Al-Okaily (2020) found that family companies tend to pay high audit fees in times of crisis. This reflects poor audit quality in times of crisis. In contrast to these studies, Shahnaz and Javed (2017) found a positive correlation between family firms and audit quality.

Agency theory assumes that the manager is one of the parties that is indicated to be able to maximize his utility and prioritize the interests of the majority. Such conditions lead to information asymmetry and conflict of interest between majority and minority interests (Jensen & Meckling, 1976). Indonesia is a country with a high concentration of ownership. Based on a study conducted by Claessens et al. (2000) on family companies in Asia including Indonesia found that 84% of these companies are controlled or key management comes from the company. Therefore, his involvement can be identified as one of the factors that are thought to trigger the entrenchment effect and affect audit quality. We provide empirical evidence from the capital market in Indonesia to fill the debate among academics. The results of our research provide confidence that the presence of family in the company is indicated to reduce audit quality.

Our research has broad implications for two things. The first is for investors in investing, especially to assess the audit quality of family companies. Investors are also expected to assess audit quality as one of the considerations in making an investment. Second, for family companies in improving corporate governance and credibility by involving KAPs from Big4.

The agency problem occurs because there are two interests that maximize each other's utility. Such conditions encourage information asymmetry because each party competes to obtain the best information (Jensen & Meckling, 1976). A concentrated ownership structure allows controlling shareholders to contribute in determining

decision making and determining policies in the company's operational activities. Controlling shareholders tend to use their high control for personal gain without regard to the interests of other shareholders (entrenchment effect). This condition creates conflict between controlling shareholders and non-controlling shareholders (Bhaumik & Selarka, 2012). According to La Porta, et al. (1999) ownership of a company will provide shareholders with two types of rights, namely cash-flow rights and voting/control rights. Cash flow rights are a shareholder's financial claim on the company, for example dividends on investment given to the company. Meanwhile, control rights are voting rights or control rights for shareholders to participate in determining company policy. Claessens et al. (2002) and Fan & Wong (2002) explain that shareholders who have higher control rights than their cash flow rights in pyramid ownership will cause an entrenchment effect. The entrenchment effect is the ability of the ultimate controlling shareholder to determine the company's operational policies according to his personal interests. Controlling shareholders can take advantage of their high control rights to take advantage of the company without incurring high costs or known as acts of expropriation. Actions of expropriation that can be carried out by the ultimate controlling shareholder can be in the form of actions to make transactions that benefit the ultimate controlling shareholder, related party transactions between companies that are under the same control by the ultimate controlling shareholder so as not to maximize profits, or decreasing dividend distribution to non-controlling shareholders (Claessens et al., 1999). The entrenchment effect will be worse when the controlling shareholder's control rights exceed their cash flow rights by using a pyramid ownership mechanism (Claessens et al., 2002). Pyramid ownership allows the ultimate controlling shareholder to carry out acts of expropriation because the ultimate controlling shareholder can take advantage of his high control rights for personal gain, but only bear a small portion of the costs resulting from the expropriation (Fan & Wong, 2002). King & Santo (2008) and Bozec et al. (2014) explained that the entrenchment effect has a higher negative effect on firm value in companies controlled by families.

Agency theory assumes that there are agency costs that arise as a result of information asymmetry (Jensen & Meckling, 1976). Information asymmetry in family companies allegedly arises due to family dominance in the company both sitting in key management and share ownership. As mentioned earlier, Claessens et al. (2000) found that family companies in Asia including Indonesia found that 84% of these companies were controlled or key management came from the company. Such conditions indicate the dominance of the family in the company. The domination of the family creates an entrenchment effect which is thought to greatly affect audit quality. Previous research has proven that the entrenchment effect is related to audit quality. Research conducted by Chen et al. (2007); (Leung & Wang, 2010); Homayoun & Hakimzadeh, (2017) and Ho & Kang (2015); Khan et al. (2013); Tahir et al. (2020) and Al-Okaily (2020) came to the conclusion that the presence of families in family companies can reduce audit quality. Their presence indicated that they prioritized family interests and information centered on family interests. In addition, these studies prove that family companies pay less fees than non-family companies. This reflects poor audit quality, especially during times of crisis. Based on this description, we formulate the research hypothesis as follows:

H1 = Founders as CEOs tend to reduce audit quality
H2 = Family representation tends to reduce audit quality
H3 = Family share ownership tends to reduce audit quality

METHOD

The sample in this study consisted of family companies listed on the Indonesia Stock Exchange from 2010-2020. The selection for 2012 to 2022 is based on the assumption that family companies have implemented IFRS accounting standards which are thought to affect audit quality. Samples were taken purposively based on research needs. Based on this method, 182 family companies and 1,960 observations were obtained with the following composition:

Table 1: Sample by Industry

No	Industry	Number of Companies	Number of Observations	Persentase
1	Infrastructure	13	132	7%
2	Consumption	20	217	11%
3	Manufacture	19	207	11%
4	Trading	58	618	32%
5	Mining	4	44	2%
6	Agriculture, Plantation, Forestry	12	131	7%
7	Property	27	294	15%
8	Others	29	317	16%
	Total	182	1.960	100%

Source: idx, (2022)

Our research sample was dominated by 58 trading companies with a total of 618 observations. An example of a family company belonging to a trading company is PT. Metrodata Electronics Tbk (MTDL) is engaged in selling various types of computers and other high-tech products. The ultimate controller of the company is the Ciputra family. Then the company that has the least number in this research sample is a mining company. An example of a family company belonging to a mining company is PT. Perdana Karya Perkasa Tbk (PKPK) is engaged in coal mining, construction and heavy equipment rental. The final controller of the company is Haryanto Sofian.

As an effort to answer the proposed hypothesis, we formulate a research model referring to the theory and research variables used as follows:

$$AQ_{it} = \beta_0 + \beta_1 CEOFounder_{it} + \beta_2 FamRepre_{it} + \beta_3 FamOwner_{it} + \beta_4 SIZE_{it} + \beta_5 ROA_{it} + \beta_5 Firmage_{it} + \varepsilon$$

AQit is audit quality, CEOFounderit is a founder who still serves as president director, FamRepreit is a representation of family members in management and directors, FamOwner is family ownership either directly or indirectly. Sizeit, ROAit and FirmAgeit are control variables that affect audit quality. The selection of these control variables has been used by previous researchers to control company characteristics that affect audit quality.

The initial step taken was to download the financial reports and annual reports of family companies listed on the Indonesia Stock Exchange for the period 2010 to 2020. Then they were inputted manually into the Excel program. At this stage, the writer tabulates and determines each variable proxy. After each proxy value is determined, then the author prepares to perform data processing through the eviews program. The data collected is panel data. Using panel data has several advantages. Hsiao (2005) argues that panel data provides a larger number of observations so as to increase the degree of freedom, have large variability and reduce collinearity between independent variables so as to produce efficient econometric estimates. Then, panel data can provide a better inference solution than cross section. After the data was prepared in the eviews program, the authors then performed multivariate testing via logistic regression.

Referring to previous research by Tahir et al. (2020) measurement of audit quality can be carried out using an auditor selection proxy. Big4 Auditor is the largest public accounting firm based on partner network, revenue and has a reputation for auditing large companies in the world, especially companies belonging to the Global Fortune 500 (Teoh & Wong, 2014). Therefore, companies that choose Big4 auditors as auditors represent their audit quality. We use a dummy variable with the number 1 if the company uses auditors from Big4 and number 0 if the company does not use Big4 auditors.

Referring to Berrone et al. (2012) family involvement in the company can be seen through 3 aspects. First, share ownership involving family members, either directly or indirectly. Second, the founder who still serves as president director and the three family members who sit on the board of directors or management. To measure family ownership, referring to previous studies such as Gao et al. (2020), we use the percentage of shares owned by families either directly or indirectly. Representation in the family is measured through the involvement of family members who sit on the board of directors and commissioners. We trace family involvement by looking at the blood and marriage relationship of each member who sits on the board of directors and commissioners. Then we look at the percentage of the number of members sitting on the board of directors and commissioners. Measurement of the founder as president director using a dummy variable. We use the number 1 if the founder is still the president director of the family company. Point 0 if the founder does not serve as president director. We tracked the president directors who served during the observation period and determined their role in the founding of the company.

Control variables consist of company size, ROA and company age. The size of the company is measured through the natural logarithm of total assets of company i in year t. ROA is measured through a comparison of net profit with total assets of company i in year t. The age of the company is measured from the time the company was founded or operates commercially until the end of the observation period.

RESULTS AND DISCUSSION

Univariate Testing

This research went through several stages. First we tabulated data for founders as president directors. We are tracking company founders who still serve as president directors. Then we tabulated for family involvement. We traced family members who sit on the board of directors and commissioners to their wives, children and grandchildren. Then we also tracked the family's share ownership, both directly and indirectly. Table 2 represents the univariate test by means of the maximum values, minimum values and standard deviations. Table 3 represents the correlation test between variables

Table 2. Descriptive Statistic

	AUDIT	FOUNDER	FAMINVOL	FAMOWER	SIZE	ROA	FIRMAGE
Mean	0.345345	0.265265	0.234134	0.413313	9.117167	-0.011962	30.48549
Median	0.000000	0.000000	0.200000	0.400000	9.300000	0.000000	30.00000
Maximum	1.000000	1.000000	0.700000	0.970000	11.50000	6.400000	99.00000
Minimum	0.000000	0.000000	0.000000	0.000000	0.000000	-24.50000	0.000000
Std. Dev.	0.475600	0.441585	0.174791	0.280805	1.527583	0.763194	13.30831
Observations	1998	1998	1998	1998	1998	1998	1998

Based on this table, an average of 34% of family companies in Indonesia have used auditors from Big4. This percentage is still relatively small and reflects the lack of audit quality of family companies in Indonesia. Several family companies that have used Big4 auditors consistently for the last 10 years are PT Astra Agro Lestari Tbk. The company uses the auditors Tanudiredja, Wibisana, Rintis & Rekan in 2019. The auditor is one of the Big4 PricewaterhouseCoopers Public Accounting Firm network. Then the average founder as president director is 26%. This reflects that some of the founders still serve as president directors. For example PT Argha Karya Prima Industry Tbk. The company was founded by Private Wilson as one of the founders and has consistently served as president director for the last 10 years or so. However, looking at these figures, 74% of family companies are not held by the founder as president director. Then the average family share ownership of 41% dominates family companies, with a maximum of 97% of the company owned by the family. For example PT. Sinar Mas Agro Resources and Technology Tbk. 97% owned by the Widjaja family. The average size of the company is 9.11 with a maximum value of 11.5. The average company performance in the form of negative ROA is 0.011. Thus, in the last 10 years, the average family company has suffered losses. The maximum value of the company's performance is 6.4 percent. This figure is quite low when compared to non-family companies. Then the average age of the company reached 30 years with the longest age of 99 years. Looking at the average age, it can be concluded that family companies in general have reached the growth stage. This is consistent with the founder's data as president director. The average family company has been delegated to the children, sons-in-law or grandchildren of the company founders. Then the family company with the longest life is PT. Jaya Agra Wattie Tbk. The company was founded in 1921 which is engaged in agribusiness, covering planting, manufacturing, shipping and sales as well as managing the operational business activities of its subsidiaries which have plantations and factories for processing plantation products, especially rubber, palm oil and other plantation products.

Table 3: Correlation Matrix

	AUDIT	FOUNDER	FAMINVOL	FAMOWER	SIZE	ROA	FIRMAGE
AUDIT	1.000000						

FOUNDER	-0.162213	1.000000					
	0.0000***	-----					
FAMINVOL	-0.132837	0.199878	1.000000				
	0.0000***	0.0000	-----				
FAMOWER	-0.012050	0.030465	0.162646	1.000000			
	0.0590**	0.1734	0.0000	-----			
SIZE	0.262779	0.030289	0.051310	0.171621	1.000000		
	0.0000***	0.1760	0.0218	0.0000	-----		
ROA	0.075813	0.032005	-0.005196	0.048130	0.047067	1.000000	
	0.0007***	0.1527	0.8165	0.0315	0.0354	-----	
FIRMAGE	0.108705	-0.016216	0.076870	0.121560	0.333007	0.021047	1.000000
	0.0000***	0.4688	0.0006	0.0000	0.0000	0.3471	-----

Based on the matrix correlation table, we conclude that all significant independent variables are related to the dependent variable. The correlational relationship indicates that there is no perfect relationship between variables. It is known that the highest relationship is 16% contributed by the founder variable as president director. In addition, the control variable that has a high correlation is the size of the company. This result also implies that the research model is free from multicollinearity.

Multivariate Testing

This test aims to determine the effect of family involvement on audit quality. The main question we want to answer is whether family involvement can reduce audit quality. We performed a series of logistic regression tests through the Probit binary with the following results:

Table 4: Multivariate Testing

	Dependent = Audit Quality	
Variable	Coefficient	Prob.
C	-6.327064	0.0000***
FOUNDER	-0.469338	0.0000***
FAMINVOL	-0.330190	0.0864**
FAMOWER	0.003636	0.9740**
SIZE	0.639248	0.0000***
ROA	0.184799	0.0106***
FIRMAGE	0.004437	0.0664**
McFadden R-squared	0.114008	
Obs	1.998	
LR Statistics	360.3203	
Prob	0.000***	

Source : idx (2022)

Based on the tests above, model testing shows that the research model is a model that meets the goodness of fit with a significance level of 1%. Then the McFadden R-squared shows a lift of 11% of the variables that are determined to influence the dependent variable. The rest is influenced by other variables outside the research. The test results also provide empirical evidence that family involvement which we proxies through the founder as president director, and family involvement in the composition of directors and commissioners is proven to reduce audit quality. Both of these variables are significant at the 1% and 10% level with a negative coefficient direction. The results of this test conclude that the 1st and 2nd hypotheses are proven in this study, while the 3rd hypothesis is not proven. We suspect that the third hypothesis is related to share ownership which is difficult to detect, especially in indirect ownership. Some family businesses have indirect controls that are difficult to detect with the ultimate controller. Then the control variables consisting of company size (SIZE) and financial performance (ROA) proved to have a significant effect on improving audit quality. Both of these variables are significant at the 1% level with a positive coefficient direction. Meanwhile, company age (FirmAge) has an effect on the 10% level in a positive direction.

Our research is in line with previous studies by Chen et al. (2007); (Leung & Wang, 2010); Homayoun & Hakimzadeh, (2017) and Ho & Kang (2015); Khan et al. (2013); Tahir et al. (2020) and Al-Okaily (2020). Research conducted by Chen et al. (2007) on family firms in Japan found that auditors have low bargaining power when dealing with family firms. The results of his research also show that audit quality does deteriorate when an auditor faces clients who are controlled by their families. Then the latest research was conducted by Al-Okaily (2020) in the context of a family company in Beirut. The results of the study found that family firms in Beirut pay lower audit fees than non-family firms. The two research contexts are consistent with family firms in Indonesia. The preference for using local audits by family firms in Indonesia proves low audit quality within family firms.

Our research is also in line with the agency theory put forward by (Jensen & Meckling, 1976). Agency theory assumes that the presence of the founder's family as president director, as well as family members who sit in the composition of commissioners and directors as well as family share ownership is indicated to cause an entrenchment effect. This effect arises due to indications of information asymmetry between companies owned by families and investors, both equity investors and debtholders. Most likely this asymmetry arose because the family company kept information from outsiders in such a way that the interests of the family could be safeguarded. In addition, there is a strong suspicion that the governance of family companies is still not well developed. This conjecture is in line with research conducted by Cline & Williamson (2016). According to him, developing countries like Indonesia are still weak in the quality of regulations, corruption control, political stability, rule of law, accountability, and government effectiveness can implement corporate trust as a substitute for supervision from the government.

Sensitivity Analysis

We conducted a sensitivity analysis to see how far the application of IFRS is sensitive to the effect of family presence on the cost of debt. Therefore, we developed a research model involving the application of IFRS as a dummy variable as follows:

$$AQ_{it} = \beta_0 + \beta_1 CEOFounder_{it} + \beta_2 FamRepre_{it} + \beta_3 FamOwner_{it} + \beta_4 SIZE_{it} + \beta_5 ROA_{it} + \beta_5 Firmage_{it} + \beta_6 IFRS_{it} + \varepsilon$$

The following table represents the results of sensitivity analysis testing. Based on the table it can be concluded that the application of IFRS is sensitive to the influence of family involvement on audit quality. This conclusion is drawn from the significant IFRS variable at the 10% level. The results of this test provide broad implications for the application of IFRS which must be followed by auditor selection preferences, especially in improving audit quality.

Table 5: Sensitivity Analysis

	Dependent = Audit Quality	
Variable	Coefficient	Prob.
C	-6.314720	0.0000***
FOUNDER	-0.473382	0.0000***
FAMINVOL	-0.324326	0.0924*
FAMOWER	0.014965	0.8936
SIZE	0.646880	0.0000***
ROA	0.180190	0.0130**
FIRMAGE	0.004728	0.0513**
IFRS	0.118509	0.1053*
McFadden R-squared	0.140691	
Obs	1.998	
LR Statistics	362.3494	
Prob	0.0000***	

CONCLUSION

Our research seeks to investigate family presence in influencing audit quality. We used a total of 1,998 observations from 182 family companies listed on the Indonesia Stock Exchange. The results of our study provide empirical evidence that the presence of both the founder's family as president director and family members who sit on the board of directors and commissioners is proven to reduce audit quality. Then our research also provides support for agency theory and entrenchment effects that occur in countries in Asia such as Indonesia. Our research is also extended through a sensitivity analysis to see the sensitivity of IFRS implementation to the effect of family involvement and the cost of debt. The research results provide empirical evidence that family involvement which we proxies through the founder as president director, and family involvement in the composition of directors and commissioners is proven to reduce audit quality. In other side, we conclude that the application of IFRS is sensitive to the influence of family involvement on audit quality.

Our research has weaknesses. First, our research has not investigated the characteristics of other family firms other than the founder as president director, family members sitting on the board of directors and family share ownership. Second, our research ignores industry characteristics and regulatory changes that affect audit quality. Third, our research has not succeeded in proving family ownership in influencing audit quality. Family share ownership is difficult to identify, especially ownership through other entities. However, we assess that there are indications of a fairly strong entrenchment effect due to the concentration of shareholding in family companies in Indonesia, the majority of which are owned by controlling shares within one family. For further research, we suggest strengthening the test by involving the characteristics of other family firms and involving industry characteristics and regulatory changes that affect audit quality.

Our research has implications for two things. The first is for investors in investing, especially to assess the audit quality of family companies. Investors are also expected to assess audit quality as one of the considerations in making an investment. Second, for family companies in improving corporate governance and credibility.

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