

The Power of Political Connections: Review on the Impacts of Audit Committee and Corporate Governance

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Abstract

In this paper, the study summarizes the major studies addressing on the power of political connections that have impacts on the role of audit committees and corporate governance in the companies. The question addressed by this paper is how the political connections and audit committee role may influence the corporate governance variables as reflected in audit fees and corporate governance behavior through auditor's assessment process. This is what has been lacking in the literatures. This paper is an attempt to identify the gaps and contribute to the political connections and corporate governance literature by showing the political connection influences on audit committee especially in an economy in which the government has coercive power in the firms. In the different context, the paper provides avenue to potential research to understand firm's agency conflicts between the majority shareholder and the management as well as political connections that providing external resources to the firms affect auditor's decision on audit fees, audit plan and assessment process and audit opinions.

Keywords: audit committee, corporate governance, political connections

1. Introduction

This paper summarises the major studies addressing on the role of audit committees on corporate governance variables, namely audit quality and corporate governance behaviour and highlighting the need to consider the power of political connections that potentially affect the role of audit committee in the companies. The aim of audit committees is to improve organisational governance in all types of organisations, whether they are public listed companies or private companies. Audit committees are known as one type of monitoring mechanism, which aim to provide assurance on financial and compliance issues through increased accountability and the efficient use of resources. Over the past decade, the role of

audit committees has become increasingly significant as high profile corporate scandals, such as Enron and WorldCom, have caused chaotic problems for the credibility of corporate governance. The need for more audit committees has been given attention through the combination of legislation and support through best practice guidelines, while in the post-Sarbanes Oxley Act (SOX) era, the key responsibilities of audit committees have the potential to influence operations, strategy and firm performance (Karim et al. 2015 and Lisic et al. 2019). The issues concerning audit committees and corporate governance have been highlighted in many prior studies to improve financial reporting and audit quality (Neal et al. 2009; Cohen et al. 2004; Krishnan and Visvanathan 2007; Peasnell et al. 2000; Turley and Zaman 2007; Jamil and Nelson, 2011; De Vlaminck and Sarens 2015; Lisic, 2019, Muslih, 2020). The lack of competency among audit committee members may contribute to a company's financial distress (Simpson and Gleason 1999) and hence, the effectiveness of the audit committee is among the key issues in companies in financial distress. In addition, audit committee independence is argued to be negatively associated with the going concern of financially distressed firms (Neal et al. 2009; Muslih, 2020). It is expected, therefore, that good characteristics of audit committees are associated with good company financial performance, which in turn is negatively associated with financial distress. Financial distress can normally be related with those companies which have government guarantees to support them financially (Muslih, 2020). However, research on the effectiveness of audit committees in relation to the connections with government and politicians is lacking in the literature. Thus, it is warranted to further investigate these issues in the current paper.

2. Political Connections and Audit Committee

As a general definition, political connection is a kind of bonding between the managers' personal connections and those of government officials. While other studies, Gomez and Jomo (1999), Johnson and Mitton (2003) and Abdul Wahab et al. (2009) defined political connections as the firms having an individual who has connections with the key government officials. On the other hand, Faccio et al. (2006a) identified a firm as connected through a minister or head of state when the politician or a close relative (son or daughter) holds the office and is a large shareholder or senior officer. Similarly, political connections also defined as connections with individual who have power in the government (Belkaoui, 2004), through state ownership of enterprises (Bushman et al. 2004 and Nee et al. 2007) and through golden (special) shares held by government (Hanousek et al, 2007).

There are polemical debates in the existing literature with regards to politically connected firms, especially in emerging economies, as there is much evidence which has been extensively documented with regards to the appointment of well-connected individuals to directorships (Faccio et al. 2006; Gomez and Jomo 1997). This is because the rationale behind the appointments of connected individuals is subject to controversy. According to the Jamil (2017), in reference to the emerging economies, a politically connected board should have the necessary authority, competencies and objectivity to carry out its function of monitoring the management. However, according to various authorities, this potentially leads to conflicting goals and thus an increase in the level of complexities. Menozzi et al. (2014) provide evidence that politically connected directors dominate board organisation and performance in

network industries as they need to pursue a social mission and be subject to social control.

The question addressed by this paper is how the political connections and audit committee role may influence the corporate governance variables as reflected in audit fees and corporate governance behaviour through auditor's assessment process. This is what has been lacking in the literatures. Prior literature reveals that a number of studies have examined the relationship between political connections and their impact on the improvement of corporate governance. A number of studies examine corporate political connections within a country, Fisman (2001) for the case of Indonesia, Johnson and Mitton (2003) and Jamil (2018) for the case of Malaysia, Ferguson and Voth (2008) and Niessen and Ruenzi (2010) for the case of Germany, and Agrawal and Knoeber (2000) for a sample of outside directors in the United States. A review of the literature reveals that a number of prior studies that have examined the relationship between political connections and their impact on the development of a firm's performance have extended to examination of the quality of accounting information (Ball et al. 2003; Chaney et al. 2011), of corporate bailouts for politically-connected firms (Faccio et al. 2006), of the performance of connected firms (Johnson and Mitton 2003; Leuz and Oberholzergee 2006), of political favouritism in relation to access to finance (Faccio et al. 2006; Mian and Khwaja 2004) and of the value of such connections (Fisman 2001). In addition, the current paper is consistent with (Chizema et al. 2015), which investigated the impact of politically connected directors despite their being more sophisticated and successful in gaining board seats. A politically connected board has at least one director who is a former politician, including being a Member of Parliament, a minister or any other senior government appointee, or an officer in a state owned enterprise (Faccio et al. 2006).

Of particular interest related to politically connected firms, other than having the traditional agency cost, they also have to bear the costs of catering to the interests of the political party/entity to which they are affiliated (Micco et al., 2007). The risk is that to preserve and serve this political relationship, members of the management who produce financial reports may manage earnings to serve the interests of their political allies at the expense of other stakeholders, such as the shareholders and creditors. This consideration is likely to affect an auditor's perception of a connected firm's business risk. Hence, the suggestion by Gul (2006) that political connections affect audit fees: politically connected firms seemed to be associated with higher audit risks and consequently were charged higher audit fees.

In expanding operational definition used by Faccio et al. (2006a) which is 'a politically connected board has at least one director who is a former politician, including being a Member of Parliament, a minister or any other senior government appointee, or an officer in a state owned enterprises', the study taken into account audit committee members who are senior government officer (SGO) and politician (POL) as main variables to explore the impacts of corporate governance variables and corporate governance behaviour. Audit committees are now a common feature of corporate governance in many countries. Widely promoted since the publication of the Cadbury Report (1992), audit committees are now expected, and in some cases required, to exercise oversight over financial reporting and auditing. Research on audit committees suggest that independence, expertise and meeting frequency are important determinants of their effectiveness and that their connections with

management and stakeholders can affect their monitoring role. A potentially important aspect that can affect audit committee monitoring behaviour is inclusion of members on audit committees who are politicians or senior government officers. Therefore, it provides avenue for future research to conduct study in examining the power of political connections on audit committee in corporate governance variables and corporate governance behaviour.

3. Corporate Governance Variables: Audit Quality

Audit effort is one of the alternatives for measuring audit quality, which is known as something unobservable and intangible. Due to its complex nature, prior researchers have tried to find various measurements to represent audit quality, such as audit opinion (Fan and Wong 2001; DeFond et al. 2000; Chen et al. 2001), auditor size (DeAngelo 1981); Big Eight/non Big Eight firms (Palmrose 1986) and also audit fees (O'Sullivan 2000). The Big Four audit firms are among the identifiable brand names of audit firms, which imply brand reputation and better audit quality. This has been elaborated further by Clarkson and Simunic (1994), explaining that audit quality and auditor quality become synonymous. However, with contradictory findings, Balsam et al. (2003) argue that auditor quality is inherently unobservable and no single auditor characteristic can be a proxy for it. It is understandable that the auditor potentially detects any material error that is directly linked to audit effort through amount of time, scope, coverage and resources. Caramanis and Lennox (2008) tested the effect of audit effort in terms of hours worked on audits in Greece. However, this approach is difficult to apply due to the unavailability of large datasets of audit hours. A more common proxy for audit effort is linked to the amount of audit fees paid. If the level of conflict is high between management and owners, then there may be greater demand for audits to be of high quality (Watkins et al. 2004). Consequently, this suggests that more effort may be expended and more costs (audit fees) may be incurred by the firm in ensuring this high quality audit (Simunic 1980; Craswell et al. 1995; Ferguson and Stokes 2002). Moreover, O'Sullivan (2000) found an association between audit fees and audit quality, whereby low audit fees must cause low quality, and Palmrose (1986) provided evidence that high quality auditors charge high audit fees. Therefore, it is more accurate to study audit quality through audit effort, which is indicated by audit fees that may provide a very useful and comprehensive understanding of audit quality.

There are several arguments for the use of audit fees as proxy to measure audit effort. Prior studies suggest that higher audit fees are associated with greater audit effort (Simunic 1980; Palmrose 1986; Craswell et al. 1995; Ferguson and Stokes 2002). According to Craswell et al. (1995), the development of the reputation of an auditor's brand name and industry specialisation consumes a higher cost and thus results in higher audit fees. The evidence shows that clients are willing to pay a premium fee on these auditors' reputations in order to have a better quality of service. In the same vein, Palmrose (1986) noted that the Big Eight auditors charged higher audit fees for two reasons: they indicate (1) higher audit quality or (2) monopoly pricing. The finding suggested that the Big Eight auditors were consistent as providers of higher quality of audit after the audit fees variable was substituted by audit hours. Craswell et al. (1995) and Ferguson and Stokes (2002) claim that the brand name of industry specialist auditors earns additional fee premiums over non-specialist brand name auditors,

which indicates a higher audit quality differentiation among them. However, the present paper notes the limitation that audit fees are an imperfect measure of audit quality. Audit fees are also not necessarily an accurate indicator for audit effort as the appropriate measure for audit effort is the number of audit hours. However, Deis and Giroux (1996) provide some empirical evidence that audit fees and audit hours are significantly related to audit quality in their analysis of three important attributes: audit fees, audit hours and audit quality. Hence, it seems reasonable that more audit hours will lead to higher audit fees and promote a higher audit quality.

3.1 The Role of Audit Committees in Maintaining Audit Quality through Audit Fees

Audit quality is not something that can be directly examined, and it is difficult to measure. There are many prior studies that have used different measures in quantifying audit quality. High quality auditors are more likely to be able to detect issues that arise within firms, such as accounting irregularities and financial misstatements, and will issue opinions in a relevant manner. The current paper uses audit fees as the determinant of audit quality. This is because one of the current motivations is for research to largely investigate the roles of boards and audit committees in their financial oversight responsibilities. This has also been emphasised through regulatory bodies, as in July 2002 following the securities commission (SEC) requiring audit committees to be responsible for the audit fees paid to the auditors. Thus, this paper is distinctive from prior literature by investigating politically connected audit committees and how this may influence the level of audit fees.

There are numerous studies relating to audit fees and how they tend to vary with complexity, size, governance and riskiness (Gul and Tsui 2001; Hay et al. 2008). Haniffa et al. (2006) and Tsui et al. (2001) assumed that better corporate governance would reduce audit effort since there would be less need for inherent control. Audit effort refers to the audit fee which, in the current literature on auditing, is supported by the theory of supply and demand. Audit fees are a significant part of monitoring costs, since the auditor needs to ensure that the board of directors is fulfilling the shareholders' interests (Haniffa et al. 2006). In other words, a strict control and governance environment will reduce the auditor's assessment and the extent of audit procedures, which will reduce the audit fees. In contrast, the demand for better corporate governance will require the auditor to play its role efficiently by better auditing and internal control. This will demand good governance by higher quality of audit services and higher audit costs. This is supported by Carcello et al. (2002), Abbott et al. (2003), Fan and Wong (2005) and Goodwin-Stewart and Kent (2006). Prior literature has investigated in relation to independent boards, including audit committees, and has found that they demand greater audit effort (Carcello et al. 2002; Zalailah et al. 2006). Furthermore, independent directors need to protect their reputation by improving the level of monitoring, thus leading to better financial performance. Empirical evidence in Abbott et al. (2003) and Lisic et al. (2019) refers to audit committee effectiveness by assuming that audit committee independence and expertise has a positive association with audit fees. Given the significant value of the relationship between politics and business, it is important to examine how audit fees are influenced by audit committee characteristics. To date, there is no study which has directly assessed the political connections with audit fees in relation to audit committee effectiveness

and corporate governance mechanisms.

3.2 The Gap on Politically Connected Audit Committee and Audit Fees

Prior studies of Bedard and Johnstone (2004) demonstrated supply side audit risk model to posit theoretical relationships between political connections, corporate governance practises and audit fees. In which the situation is where the auditors take the corporate governance practises and the influence of political connections of the client firm into account and exert more (less) effort and hence charge more (less) fees depending upon they perceive the risk. In contrast to this supply side or risk based perspective, several studies have adopted a demand side perspective that argues a stronger corporate governance practises and strong political influences and audit fees may be positively related. Thus, more independent directors on the board or audit committee and stronger political connections may demand higher quality audits that lead to greater audit effort and higher audit fees. However, it can be seen from the evidence that is based on this demand side argument is somehow cause to problems. The current paper proposes to the future research to use different variables and types of corporate governance practises in which comes from varying regulatory environments. As a main focus of this paper is on the influence of political connections and audit committee, thus the limitations of the demand side arguments are even more pronounced given that audit committee have becoming emerged as reliable mechanism to improve corporate governance.

Ideally, a demand side perspective argues that stronger corporate governance practices and strong political influences may demand a higher quality of audit, leading to a greater audit effort and higher audit fees. These demand side theories contend that there is a positive relationship between corporate governance and audit fees (Goodwin-Stewart and Kent 2006). Audit committees that have politicians and or senior government officers, as members are likely to be associated with higher audit fees. First, the demand for higher audit effort is likely to stem from the audit committee members being keen to protect their reputation and demonstrate their oversight of financial reporting and auditing. Members of audit committees who are politicians or who are senior government officers may raise issues with external auditors during their meetings, which may in turn affect the audit scope and be reflected in higher audit fees. Second, audit fees are also affected by assessment of audit risk (Choi et al., 2008; Gul, 2006; Simunic et al., 2008). From the perspective of auditors, corporate governance guidelines and auditing standards require auditors to assess the tone at the top as part of the audit planning process. Auditors' evaluation of risk is likely to take into consideration the strength of corporate governance in a firm as well as any political connections of members, and in turn auditors may exert more effort and hence charge more fees if they perceive the risk as high. Auditors are expected to exercise more audit effort to investigate any accounting irregularities if management incentive to misreport are perceived to be high. This additional effort is likely to be reflected in higher audit fees. This is consistent with the view that auditors may charge extra fees to clients with a higher risk (Dye 1993; Bedard and Johnstone, 2004).

4. Corporate Governance Behaviour: Auditor's Assessment Process

This paper enhances our understanding of the obscure side of the work of auditors – the

leeway they have in performing their duties. This aspect remains almost unexplored by researchers, because it is difficult to have access to both external auditors and internal auditors, and because their work remains confidential for strategic reasons (Neu et al. 2013). This is necessary because role conflicts are at the core of their practices in planning the scope and plan of an audit (Vinten and Van Peursem 2005; Norman et al. 2010; Jamil, 2018) and may have an impact on the roles that they ultimately play within the organisation (Roussy 2013). The paper tries to further explore to what extent political connections may influence the auditor's assessment process and what they are confronted with in their practice throughout the audit process. Nor do we know how they manage themselves when such conflicts happen. This paper is highlighting the gap in the literature on the relationship political connections with audit committee and audited managers, because conflicts arise between all these organizational actors. Moreover, this paper is illustrating how political connections may influence the auditor's coping behaviour and affect their ability to perform their governance duty. There has been a lack of academic research on how politically connected companies may affect audit quality or the audit assessment process. The political connections of firms may potentially lead to an increase in complexity of the auditor's assessment process. There are many factors that auditors must consider, such as personnel policies and procedures, the board's profile and background, and corporate governance information of the firm (Messier Jr and Austen 2000). Prior research by Agrawal and Knoeber (2012) has shown that larger political donations are associated with poorer corporate governance and that donations are indicative of agency problems within a firm. The study specifically found that firms with larger boards, and CEOs who also chair the board, are associated with larger donations. Thus, these political donations may potentially increase the auditor's assessment process.

Auditors are required to make independent judgements about financial statements from an ethical perspective. Given the complexities of human nature and the involvement of political connections, it can be ethically difficult for the auditor to conduct the assessment process. A review of the audit literature has revealed that there are not many studies that have examined how auditors conduct their assessment process when political connections are involved. The auditor's assessment process may potentially involve the audit plan, audit scope and procedures, ethical action or aspects of behaviour in how the auditor responds to ethical situations. For instance, Falk et al. (2000), using an experimental approach, found that when auditors were faced with the prospect of losing a client, they were more likely to compromise their independent judgement. Similarly, Ponemon and Gabhart (1990) found that auditors with low moral development appeared to be more willing to underreport time. These studies therefore show that contextual factors (client pressure) may influence auditors' ethical actions. There are also studies on the factors that may influence auditors in conducting the audit process for such instances (Shafer et al. 2001; DeZoort and Lord 1997; Thorne and Hartwick 2001; Trompeter 1994). The factors that are mentioned in these studies are individual characteristics, internal factors in firms, client company factors and regulatory factors. The present paper thus tries to establish if political connections can be among the contextual factors that may influence the auditor's assessment process.

4.1 The Gap of Politically Connected Audit Committees and Auditor Assessment Process

Auditors and their politically connected clients often encounter situations in which professional standards allow for different judgements related to accounting matters. For instance, it may be argued that both parties generally benefit from a strong, long term relationship with the other, in which auditors might gain valuable client specific knowledge that may aid them to conduct their audit effectively, and clients avoid the costs associated with switching auditors. Therefore, it is in both parties' interests to resolve, through discussion and negotiation, whenever possible, when they have a dispute. According to Johnstone and Muzatko (2002), it is very important for both the auditor and the client's management to have negotiations in order to present a representationally faithful view of the client's financial status. Due to political power and pressure, it can be assumed that in the process of expressing an opinion on the client's financial statements, a certain amount of conflict between the auditor and the client's management could possibly arise. According to Gibbins et al. (2000), during the resolution process, the client's management is likely to attempt to persuade the auditor to accept its own position. The influence of political connections may have an effect on the auditor's assessment process, as it builds upon the basis of the client's sources of power. Thus, Murnighan and Bazerman (1990) point out when negotiating with the client, the auditor is faced with incentives to cooperate and incentives to compete. Strong corporate governance is needed in a company's structure in order to assist the auditor to resist the political power that can pressure them in planning their audit. A corporate governance structure is an institutional mechanism applied at the level of every company to provide assurance to third parties that an auditor's integrity and independence are being preserved. This includes board of directors and audit committee involvement in establishing and maintaining the auditor client relationship in overseeing the conduct of an audit. Appropriately, a stronger governance mechanism should provide a neutral and a well-informed buffer to the auditor and management, even though political connections exist. The interactions investigated in the present paper show how political connections have become a contextual factor affecting the auditor's assessment process through audit disputes, audit negotiations, the ability of the auditor to withstand political pressure and the strategy of re-engineering their audit scope and plan.

Most of the previous studies were concerned with how political connections may have effects on audit fees and financial reporting quality, so there is much room for the notion that more research needs to be carried out on how the auditor's assessment process may be potentially adversely affected by such connections. Thus, additional evidence can be provided on this issue in order to reduce the frequency of conflicts in the audit context as well as to manage the phenomenon in a constructive manner which, in turn, could benefit all parties with a stake in ensuring effective corporate governance.

6. Discussion and Concluding Remarks

This paper has reviewed prior studies that have provided an understanding of the concept of audit committee, political connections, audit fees and auditor's assessment process. The audit committee have been widely studied but there is still limited evidence on the concept of audit

committee who are politically connected and the measurement of political connections has been recognised in prior studies through 1) political ties or connections between the company and politicians or individual have power in government agencies or ministry; 2) the presence of politicians on boards; 3) government shares owned of the company. From the earlier discussion, it can be seen that much work has investigated the relationship between audit committees and the external auditors. There are lacking studies exploring the impact of politically connected audit committee with audit fees and from prior literatures of the audit committees and audit fees the findings are mixed. The prior findings show both positive and negative impacts depending on both the jurisdiction and time period being studied. On the other hand, it is importance to see prior literatures on how the auditor conduct the audit assessment process and it is believed that political connections may potentially affect the way audit being conducted. It is very importance to see the role of corporate governance as a control mechanism and how auditor can maintain their credibility in conducting the audit. This paper is an attempt to identify the gaps and contribute to the political connections and corporate governance literature by showing the political connection influences on audit committee especially in an economy in which the government has coercive power¹ in the firms. Most prior research examines the impact direct political connections of shareholder itself. However, by demonstrating that public companies benefited the political connections with their audit committee, this paper suggests that political connections are playing a greater role in audit fees and auditor's assessment process than previously documented. This paper proposes some new points to the emerging literatures by examining how political connections affect the audit committee effectiveness and corporate governance as a whole. In the different context, the paper provides avenue to potential research to understand firm's agency conflicts between the majority shareholder and the management as well as political connections that providing external resources to the firms affect auditor's decision on audit fees, audit plan and assessment process and audit opinions. Analysing audit fees allow the researcher to use this quantifiable measure to capture the quality of corporate governance mechanism in the firms. In addition, further investigation on the corporate governance and political behaviour provide in depth explanation for the researcher to understand the role of audit committee as a whole.

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¹ Coercive power is the authority or power that is dependent on fear, suppression of free will, and/or use of punishment or threat, for its existence.

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