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RELATED PARTY TRANSACTIONS AND AUDIT FEES IN AN OWNER DOMINANT CONTEXT

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Abstract

In a context where the presence of dominant shareholders is prevalent and where the audit function is monitored by market forces, we show a positive relationship between the amount of RPTs and audit fees. Our findings are consistent with RPTs increasing audit risk and consequently audit fees. Alternatively, our results are also consistent with the alignment effect on the demand for audit coverage, according to which as RPTs increase, controlling shareholders might also increase their demands for audit assurance to signal the value enhancing nature of RPTs.

1. INTRODUCTION

Accounting scandals of firms such as Enron, WorldCom, Adelphia and Tyco in the US and Vivendi or Parmalat in Europe have eroded public confidence in the financial reporting process and the audit function. In fact, in these financial scandals related party transactions (RPTs) seems to be a major problem. Although these transactions were supposedly conducted at arm's length, in practice, they benefit the principals involved (*e.g.*, managers, large shareholders or their relatives).

Accounting organizations have long expressed concerns about the potential consequences of RPTs in the capital markets (SFAS No. 57, 15, FASB 1982; ISA 550, IASB 2009). However, available empirical evidence has not reached a clear consensus on how harmful RPTs could be. Beasley, Carcello, and Hermanson (2001) analyze the cases in which the SEC (Security and Exchange Commission) sanctioned auditors for their association with fraudulent financial statements. The authors find that one of the most common reasons for sanction was the auditor's failure to recognize or disclose related party transactions or even the cooperation with the client to conceal this type of transactions. In a similar vein, other studies find that auditors consider related party transactions as one of the most important fraud risk factors (*e.g.,* Wilks and Zimbelman, 2004; Moyes, Lin, and Landry, 2005). On the contrary, Bell and Carcello (2000) evaluate a sample of 382 fraud and non-fraud audit engagements from a multinational audit firm. The authors conclude that the mere presence of related party transactions does not increase fraud risk. In a similar vein, Gordon, Henry, Louwers, and Reed (2007) note that although RPTs are listed as a fraud risk factor in the authoritative literature, they do not appear to be more common in companies committing fraud than in companies where fraud has not been detected. Hence, according to previous authors' reasoning, the presence of RPTs alone may not be a reliable indicator of fraud risk. Furthermore, Louwers, Henry, Reed, and Gordon (2008) examine 43 enforcement actions against auditors and conclude that audit failures in the presence of RPTs were more the result of a lack of professional skepticism and due professional care rather than a failure of the audit procedures themselves.

Despite this lack of consensus, there is no doubt that the audit function has an important role to play in the presence of RPTs. In this sense, external auditors play a critical role in validating the company financial information and, consequently, they are expected to

facilitate the operation of capital markets and promote the efficient flow of scarce human and financial capital to promising investment opportunities (Bushman and Smith, 2003). However, very little research has considered the auditors' response in the presence of RPTs (*e.g.*, Jiang, Lee, and Yue, 2010; Bennouri, Nephilid, and Touron, 2015). Furthermore, the empirical evidence on the effect of RPTs on audit fees is very recent and scarce and therefore, their results are far from conclusive (*e.g.*, Nan-wei, Nan, and Qiang, 2015; Habib, Jiang, and Zhou, 2015; Kohlbeck and Mayhew, 2017; Al-Dhamari, Al-Gamrh, Ku-Ismail, and Haji-Ismail, 2017).

In the current paper, we extend this body of research by investigating the relationship between RPTs and audit fees in a continental European setting. To fulfill this aim, we use a sample of Spanish listed firms over the period 2004-2014. We conduct our main empirical analysis by regressing audit fees on RPT values and controlling for a variety of audit fee determinants. Our results show a positive relationship between the amount of RPTs and audit fees. Our findings are consistent with the amount of RPTs increasing audit risk and consequently audit effort and/or audit risk premium (supply perspective). Alternatively, our results are also consistent with the alignment effect on the demand for audit coverage, according to which as RPTs increase, controlling shareholders might also increase their demands for audit coverage to signal the value enhancing nature of RPTs.

Our study makes several contributions. First, we contribute to the research on the consequences of RPTs (*e.g.,* Chang and Hong, 2000; Friedman, Johnson, and Mitton, 2003; Cheung, Rau, and Stouraitis, 2006; Lin, Liu and Keng, 2010; Lou, Wang, and Yuang, 2014) by showing that a higher amount of RPTs will come at higher audit costs in a continental European setting. Second, we also contribute to the substantial academic literature on audit pricing by showing that in the referred setting, RPTs is a determinant of external audit fees (*e.g.*, Simunic, 1980; Chan, 1993; DeFond, Raghunandan, and Subramanyam, 2002; Cameran, 2005; Choi, Kim, and Zang, 2010; Ellis and Booker, 2011; Wang, Sewon, Iqbal, and Smith, 2011). Third, we contribute to the little research on the auditor response to RPTs in firms controlled by dominant shareholders (*e.g.*, Jiang *et al*., 2010; Daie and Hasnan, 2012) and particularly to the recent and very limited empirical evidence on the effect of RPTs on audit fees in these firms (*e.g.*, Nan-wei *et al.*, 2015; Habib *et al*., 2015; Al-Dhamari *et al*., 2017). While Nan-wei *et al*. (2015) and Habib *et al*. (2015) focused on the Chinese context, and therefore in a setting where auditors struggle between compliance with the Guanxi code to preserve their reputation and an impartial assessment of the company's true and fair view,

we provide novel evidence on the interactions between RPTs and audit fees in a setting where companies and auditors are monitored by market forces and not by regulators. Furthermore, while Al-Dhamari *et al*. (2017) accomplish their study in Malaysia and consequently under an institutional context where large firms are subject to an important government influence which also implies full control over the media (Sani, 2005) and where auditors' misconduct hardly has any consequences, our work is accomplished in a context where state ownership is practically non-existent and the economic activity show much less level of state influence. Furthermore, while Al-Dhamari *et al*. (2017) focus on one kind of RPTs, namely, related sales and purchases, our study analyze all RPTs committed by Spanish listed firms. Fourth, and contrary to most previous research in the area, we integrate both supply and demand based perspectives to show that the effect of RPTs on audit pricing is not straightforward, because in a continental European setting, RPTs might affect audit fees through their potential incidence on the supply of and the demand for audit coverage. This approach is important because according to Knechel and Willekens (2006) most prior research into audit fees has been based on a theoretical model, which treats audit fees as the by-product of a production function ignoring potential demand forces that may drive the level of the audit fee.

The rest of the paper is organized as follows. The second section reviews the theoretical background and develops the hypotheses. The third section presents the research method, the sample, and the descriptive statistics. In the fourth section, we present our main results and the robustness tests, while our final section provides the concluding remarks.

2. THEORETICAL BACKGROUND AND HYPOTHESES DEVELOPMENT

Previous studies have addressed the auditors' response to RPTs. Thus, Jiang *et al.* (2010) find that firms with high levels of intercorporate loans, a particular form of RPTs, are far more likely to receive a qualified audit opinion. Their results are consistent with the use of intercorporate loans as a tunneling vehicle and with auditors playing an active monitoring role. Furthermore, previous authors conclude that absent effective enforcement (by either regulators or informed investors) unclean audit opinions alone are insufficient to deter tunneling behaviour. In France, Bennouri *et al*. (2015) find that firms audited by Big 4 auditors report fewer related-party transactions. The authors argue that auditors influence managers to reduce the number of reported RPTs due to the accounting uncertainty surrounding RPTs reporting. They also find that the relationship between Big 4 auditors and the number of reported RPTs is less significant in a more transparent environment derived

from the adoption of IFRS standards, because auditors' role became less *important* in this setting. Many fewer studies have considered how RPTs affect audit fees. In a not yet published study, Nan-wei *et al*. (2015) study the relationship between RPTs and audit fees in China. Their results show a no significant relation between the two variables. Further analysis shows that RPTs implemented in the form of loans, guarantees and capital transfers are positively related to audit fees, while the purchase of goods and services show a no significant relation with audit fees. Moreover, Habib *et al.* (2015) document that the presence of RPTs increase audit fees in Chinese listed firms, thus supporting the conjecture that RPTs are seen as increasing audit risk. Further tests show a negative association between audit fees and RPTs involving sales and purchase of goods and services and a positive association between audit fees and RPTs related to intercorporate loans. According to previous authors' reasoning, while the usage of operational RPTs reduce audit risk, the opposite holds for the usage of inter-corporate loans. Recently, Kohlbeck and Mayhew (2017) show that RPTs are negatively related to audit fees. Previous authors' results are consistent with different explanations. First, with auditor's limited responsibilities for RPTs and second with RPT firms demanding lower quality audits, according with the literature on private control benefits and with insiders purchasing audits based on price rather than quality. Finally, Al-Dhamari *et al*. (2017) show that audit fees are higher for Malaysian firms that undertake RPTs.

As shown, the empirical evidence on the effect of RPTs on audit fees is very recent and scarce and their results are far from conclusive. Moreover, due to institutional differences the results from the previous studies might not be extrapolated to a continental European setting. Thus, Spanish civil-law-based legal system provides weak protection of minority shareholders' rights (*e.g*., Djankov, La Porta, Lopez-de-Silanes, and Shleifer, 2008; La Porta, Lopez-de-Silanes, Shleifer, and Vishny, 1998). The ownership structure of Spanish listed firms has been associated with the presence of controlling owners, generally families and banks, which have strong incentives to monitor the firm closely (*e.g*., La Porta, López-de-Silanes, and Shleifer, 1999; Faccio and Lang, 2002). Additionally, in Spain information asymmetries derived from the separation between ownership and control tend to be managed through private communication channels (Larrán, 2002; Bona, Pérez, and Santana, 2011; Desender, Aguilera, Crespí and García-Cestona, 2013) and therefore the importance of the audit function as a corporate governance mechanism aimed to solve information asymmetries derived from the separation between ownership and control decreases. However, in such a setting, the main agency conflict shifts into the potential

expropriation of minority shareholders by controlling owners (*e.g*., Shleifer and Vishny, 1997; La Porta, López-de-Silanes, Shleifer, and Vishny, 2000; Burkart, Panunzi, and Shleifer, 2003; Villalonga and Amit, 2006). Moreover, this latter agency conflict is aggravated by the relatively illiquidity of the capital market, which impedes minority shareholders from selling out when they perceive abuses by controlling owners, and by the weakness of the market for corporate control (De Miguel, Pindado, and de la Torre, 2004). Thus, following La Porta *et al*. (1998) in such a context, the use of RPTs as a tunneling device by the controlling shareholders is less likely to be effectively persecuted and penalized by ineffective enforcement mechanisms. Furthermore, according to the Global Competitiveness index 2015-2016 in the Spanish market, internal control mechanisms such as the board of directors lacks the necessary independence to act as effective control mechanism.

Previous institutional features not only affect the auditors' risk perception on the supply side, but they will also affect the demands for audit coverage (Choi and Wong, 2007). In this sense, when an owner effectively controls a firm, he/she also controls the reporting policies (Fan and Wong, 2002) and consequently the audit function. Thus, the Spanish setting provides an interesting framework to accomplish the current study by showing the importance of considering not only the auditors' risk perception as RPTs increase but also the controlling shareholder's incentives to increase the demands for audit coverage as RPTs increase.

Thus, available empirical evidence has considered that RPTs might constitute an important vehicle for minority shareholders' expropriation (*e.g.,* Friedman, *et al*., 2003; Gordon, Henry, and Palia, 2004; Cheung *et al*., 2006; Berkmana, Coleb, and Fu, 2009; Jian and Wong, 2010; Aharony *et al*., 2010; Johnson, La Porta, Lopez-de-Silanes, and Shleifer, 2013; Aharonya, Wang, and Yuan, 2014; Enriques, 2014). If RPTs are used by controlling owners as self-dealing transactions for minority shareholder's expropriation, they might also influence the supply of audit services (*e.g*., Whisenant, Sankaraguruswamy, and Raghunandan, 2003; Khalil, Magnan, and Cohen, 2008; Hope, Langli, and Thomas, 2010). Therefore, audit firms may conduct wider scope audits and/or charge a premium for clients having higher agency costs (*e.g*., Lyon and Maher, 2005). For example, audit firms may require materiality limits to be set at a lower level or they may insist on an increase in the number of audit hours.

In this sense, Simunic (1980) posits that audit fees could be broken down into audit effort and risk premium. Thus, the magnitude of agency conflicts might affect both, audit effort and

audit risk (*e.g.*, Barroso, Ali, and Lesage, 2016; Fan and Wong, 2005; Lafond and Roychowdhury, 2008). Therefore, auditors need to increase the scope of their audit for firms with high agency conflicts because of increased audit risk (inherent and/or audit risk) and auditor business risk (litigation risk) (*e.g.*, Khalil *et al*., 2008; Lafond and Roychowdhury, 2008). Houston, Peters, and Pratt (1999) investigate the conditions under which accounting choices influence the auditor's assessment of audit and litigation risk. Using an experimental design, previous authors find that the presence of accounting choices reflecting higher risk of accounting irregularities leads to higher litigation risk assessments and fee premiums. Thus, according previous reasoning, it is expected a positive relationship between the amount of RPTs and audit fees (supply perspective).

However, higher audit fees resulting from RPTs increasing audit risk can be attenuated by potentially lower demands for audit assurance by controlling shareholders when they use RPTs to tunnel resources outside the firm. In this sense, Knechel and Willekens (2006) consider that audit fees are dependent on the demand for external audit assurance, which is influenced by the risks faced by corporate shareholders and by the mechanisms employed to minimize these risks. Thus, if RPTs are used by controlling shareholders as an entrenchment vehicle, these shareholders will lower their demands for audit assurance. This way, controlling shareholders reduce the likelihood of auditors detecting their opportunistic behaviour as well as the associated penalties. In such a setting increasing the level of assurance (beyond the legal requirement) becomes an unwanted cost that is increasingly borne by the controlling shareholder, because it could undermine the controlling shareholders' ability to extract rents (Barroso *et al*., 2016) and consequently the use RPTs as a tunneling device. Therefore, according to the entrenchment effect on the demand for audit coverage, it is expected a negative relation between the amount of RPTs and audit fees.

From a different perspective, in Spain, controlling shareholders, mainly families and banks (*e.g.*, Cuervo, 2002; Faccio and Lang, 2002; La Porta *et al*., 1999), due to their large stakes and long investment horizons will view the company's health as an extension of their own well-being. This long-term horizon increases concerns about firms' reputation, which has a disciplining effect on their behavior discouraging minority abuse (*e.g.*, Agnblad, Berglöf, Högfeldt, and Svancar, 2001). Under this view, controlling owners are less likely to use RPTs to tunnel resources outside the firm, because this opportunistic behavior might potentially damage the controlling owner's reputation, wealth, and long-term performance.

Consequently, controlling owners might be more prone to use RPTs efficiently to reduce transaction costs and enhance internal resource allocation (*e.g*., Chang and Hong, 2000; Jian and Wong, 2010; Khanna and Palepu, 2000; Stein, 1997; Chen, Wang, and Li*,* 2012). Thus, for instance, controlling shareholders might use RPTs to create and internal capital market to optimize capital allocation (*e.g*., Stein 1997, Almeida, Kim, and Kim, 2015). Thus, available empirical evidence has documented that firms with greater agency problems embedded in ownership structure are more likely to increase audit quality to signal the market their good corporate governance practices (*e.g*., Gul, Tsui, and Chen, 1997; Francis, Richard, and Vanstraelen, 2009; Fan and Wong, 2005). Therefore, if RPTs are used by controlling shareholders efficiently to align controlling and minority shareholders' interests, the former will increase their demands for audit coverage. By increasing the level of assurance (beyond the legal requirement), controlling shareholders signal external investors the value-enhancing nature of RPTs. Consequently, due to this signaling effect, companies with RPTs may receive smaller share price discounts. In such a context, the reputational benefits arising from increasing audit scope outweighed their costs. Therefore, according to the alignment effect on the demand for audit coverage, the amount of RPTs will be positively associated with audit fees.

According to previously considered arguments, the effect of RPTs on audit fees is an empirical question. Thus, the supply perspective and the alignment effect on the demand for audit coverage predict a positive relationship between the amount RPTs and audit fees. However, the entrenchment effect on the demand for audit coverage predicts a negative relationship between the amount of RPTs and audit fees. Therefore, we state our hypothesis as follows:

H1: The amount of RPTs affects audit fees

3. METHOD

The financial data are taken from Osiris database by Bureau van Dijk Electronic Publishing (BvDEP). We hand collect data about RPTs because this information is not publicly available. The sample comprises a non-balanced panel of 93 non-financial Spanish firms listed on the electronic market at the end of 2014. In our regression analysis, we apply the method developed by Hadi (1992) to eliminate outliers, which represent 6.5% of the total sample. As a result, we obtain an unbalanced panel of 89 companies (748 firm-year observations) for the period 2004-2014. Because disclosures of related party transactions

are incomplete and irregular in 2003, we exclude this year from our analysis. To alleviate the sample selection bias and to test whether there is some validity for the transaction costs theory all of the aforementioned firms have been included in the sample regardless of whether they have reported RPTs.

3.1. Variables definitions

Related-Party Transactions

Some previous studies have focused on specific RPTs such as acquisitions or sales of assets, lending or borrowing contracts, loan guarantees (*e.g*., Berkman *et al*., 2009; Friedman *et al*., 2003; Jiang *et al*., 2010; Al-Dhamari *et al*., 2017). Other studies provide a broader scope by considering a comprehensive set of RPT variables (*e.g*., Cheung *et al*., 2006; Kohlbeck and Mayhew, 2010; Peng, Wei, and Yang, 2011). Within this latter category, the authors usually use, together or separately, two classification criteria to group RPTs: (1) the related party of the transaction (Kohlbeck and Mayhew, 2017) and (2) the nature of the transaction (Kohlbeck and Mayhew, 2010; Habib *et al*., 2015).

Following the first criterion, some authors (Kohlbeck and Mayhew, 2010) group these transactions in: (a) transactions with directors, officers, shareholders or their affiliates and (b) investment (joint venture or other operations in which the company has a less than 100% that is not consolidated). Nekhili and Cherif (2011) group these operations in: (a) transactions between the main shareholders, directors or managers, and the companies with which they are affiliated (b) transactions with subsidiaries and associated firms.

In our study, information about RPTs is collected from annual corporate governance reports (CGR) published by the Spanish Security Exchange Commission over the period 2004-2014. The CGR includes RPTs with (1) significant shareholders, (2) directors and officers, and (3) affiliates (not included in the consolidation process). Because the third type of RPTs is practically non-existent, we focused on RPTs with blockholders, and directors and officers, which represent 95.20% of total RPTs reported by Spanish listed firms. Thus, our variable of primary interest (*RPT_TOTAL*) is the natural log of monetary value of all that transactions.

Dependent variable

Consistent with prior studies (*e.g*., DeFond, Francis, and Wong, 2000; Seetharaman, Gul, and Lynn, 2010; Eshleman and Guo, 2014; Kohlbeck and Mayhew, 2017), our dependent variable (*FEE*) is the natural log of external audit fees.

Control Variables

We include in our analysis a set of control variables commonly used in previous studies as potential determinants of audit fees. Thus, since controlling owners often use pyramidal structures to maintain tight control of a firm while committing low equity investment, creating, this way, a separation of ownership (cash flow) and control (voting rights), we have controlled in our empirical analysis the effect of ownership structure on the investigated relationship by including the controlling owner's voting-cash flow wedge (*DIVERG*).

Extant theory suggests that audit fees are a function of client complexity, audit risk and auditor production functions (*e.g*., Simunic 1980; Cameran, 2005; Stanley, 2011). In this sense, to proxy for audit complexity, we include the size of the auditee firm (*SIZE*), which is measured as the logarithm of firm's assets, because auditors of large companies have to spend more time and effort on testing and analyzing data and information (Simunic, 1980; Seetherman *et al*., 2002; Cameran, 2005). We also include a set of variables to control auditee firm's financial strength as proxies of audit risk: firm leverage (*LEV*), which is measured as the relationship between total debt and assets; losses (*LOSS*), a dummy variable that takes the value of 1 if the net income is negative, and 0 otherwise; *ROA* is net income divided by total assets; *CR* is the firm's current assets/current liabilities; *RECEIV* is accounts receivable divided by total assets; and *INVENTORY*, which is measured as the ratio of total inventory to total assets. In this sense, higher levered firms and firms reporting a loss are expected to increase audit risk (*e.g*., Simunic, 1980; Seetherman, *et al*., 2002; Gul, Chen, and Tsui, 2003; Kohlbeck and Mayhew, 2017). In the same line, Simunic (1980) consider receivable and inventory as "risky" balance sheet components, which evaluation is a complex task, requiring a forecast of future events. Contrary, a higher value of *ROA* and *CR* is expected to reduce audit risk, because a higher value of *ROA* reduce probability of financial failure (*e.g*., Simunic, 1980; Seetherman *et al*., 2002; Gul *et al*., 2003), while a higher value of CR reduces probability of a company to fail in its daily payment (Gul *et al*., 2003; Cameran, 2005; Kohlbeck and Mayhew, 2017). Additionally, since a qualified audit opinion may increase audit risk (*e.g*., Simunic, 1980; Gul *et al*., 2003; Habib *et al*., 2015), we include the variable audit opinion (*OPINION*), a categorical variable that takes the value of 0 for an unqualified opinion, 1 for unqualified opinion with explanatory notes, 2 for an qualified opinion with or without explanatory notes, and 3 for an adverse opinion, Previous researches have shown that differences in auditor production functions may also influence external audit fees (Simunic, 1980). Therefore, as in many previous studies (*e.g*., Simunic,

1980; Francis and Stoken, 1986; Seetherman *et al*., 2002; Gul *et al*., 2003; Cameran, 2005) to control the incidence of the audit firm size, we include the variable *BIG4*, which is a dummy variable that takes the value of 1 for firm-year observations audited by a Big 4, and 0 otherwise. The higher quality of the Big 4 audit firms' services may explain a positive relation between this variable and audit fees, however the existence of the scale economies may reduce audit fees. Finally, we include the variable *TENURE*, which is the natural log of the auditors' tenure in years, to control the effect of learning (*e.g*., Simunic, 1980; Cameran, 2005).

3.2. Descriptive Statistics

Table 1 (Panel A) reports the amount of audit fees and RPTs in euros per year of Spanish listed firms. As we can see, audit fees show a growing trend throughout the whole period, while the largest amount of RPTs occurred in 2005-2006. It is worthwhile noted that while the general trend regarding the audit fee variable is a continuous growth, it experienced an important decrease in 2013.

Table 1 (Panel C) shows that audit fees are positively correlated with RPTs. Furthermore, *BIG4*, *SIZE*, *LEV* and *TENURE* present high positive correlation with audit fees, while *CR*, *INVENTOR*, *LOSS*, *OPINION* show a negative correlation. Finally, Panel D presents a formal test conducted to ensure that multi-collinearity is not present in our regressions. Thus, we calculate the Variance Inflation Factor (VIF) for each independent variable included in the estimated models. The highest VIF value is 1.44, which is well below 5 (the value indicating that multicollinearity might be present) (Studenmund, 1997). Therefore, we conclude that multicollinearity is not a problem in our sample.

Table 1. Descriptive Statistics and Correlation Matrix

Panel A. Descriptive data on RPTs and audit fees

	2004	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*	*2011*	*2012*	*2013*	*2014*
FEE (thousands of euros)	1023	1231	1501	1634	1706	1722	1923	1929	1991	1798	1960
RPT (thousands of euros)	187	634	652	244	308	310	401	555	468	274	404

Panel B. Descriptive Statistics

Variables	***Mean***	***SD***	***Median***	***Min***	***Max***
FEE	6.17	1.53	6.07	2.89	10.33
RPT_TOTAL	0.03	0.08	0.00	0.00	0.76
DIVERG	3.84	6.83	0.00	0.00	35.73
BIG4	0.92	0.26	1.00	0.00	1.00
SIZE	13.41	1.92	13.29	9.06	18.51
ROA	0.02	0.08	0.02	-0.34	0.37
CR	1.29	0.59	1.16	0.19	4.43
RECEIV	0.15	0.12	0.12	0.00	0.67
INVENTORY	0.09	0.10	0.05	-0.02	0.56
LOSS	0.22	0.41	0.00	0.00	1.00
OPINION	0.10	0.35	0.00	0.00	3.00
LEV	0.66	0.19	0.67	0.13	1.33
TENURE	2.00	0.89	2.19	0.00	3.33

Panel C. Correlation Matrix

	1.FEE	2.RPT_TOTAL	3. DI VERG	4.BIG4	5.SIZE	6.ROA	7.CR	8.RECEIV	9.INVENTORY	10.LOSS	11.OPINION	12.LEV
2.RPT_TOTAL	0.05*											
3.DIVERG	0.03	0.06**										
4.BIG4	0.28***	-0.05	-0.00									
5.SIZE	0.69***	0.12***	0.03	0.25***								
6.ROA	0.00	-0.01	0.03	0.04	0.23***							
7.CR	-0.26***	-0.03	0.01	-0.08**	-0.13***	-0.02						
8.RECEIV	-0.04	-0.03	-0.05*	0.06**	-0.09***	0.13***	0.00					
9.INVENTORY	-0.34***	-0.10***	-0.17***	-0.08**	-0.29***	-0.05*	0.39***	0.10***				
10.LOSS	-0.06**	-0.02	0.01	-0.11***	-0.37***	-0.10***	-0.04	-0.14***	-0.06**			
11.OPINION	-0.12***	0.03	-0.06**	-0.21***	-0.15***	0.01	-0.00	0.00	-0.01	0.10***		
12.LEV	0.12***	0.00	0.02	-0.03	0.00	0.68***	-0.25***	0.06**	-0.31***	0.17***	0.15***	
13.TENURE	0.23***	-0.08***	0.00	0.27***	0.11***	-0.06*	0.04	0.20***	0.03	-0.04	-0.17***	-0.06**

FEE_{it}: natural log of total audit fees of the firm *i* in year *t.; FEE_{it-1}*: natural log of total audit fees of the firm *i* in year *t-1. RPT_TOTAL_{it}*: related party transactions divided by total assets of the firm *i* in year *t*. $DIVERG_{it}$: measures the degree of divergence between the dominant owner's voting and cash flow rights. $BIG\ 4_{it}$: dummy variable that takes the value of 1 for firm- year observations audited by a Big 4, and 0 otherwise. $SIZE_{it}$ is the natural logarithm of the market value of equity of the firm *i* in year *t*. ROA_{it} is net income divided by total assets. CR_{it}: current assets divided by current liabilities; $RECEIV_{it}$: accounts receivable divided by total assets; $INVENTORY_{it}$: total inventory divided by total assets; $LOSS_{it}$: dummy variable that takes the value of 1 if net income is negative, and 0 otherwise; $OPINION_{it}$: categorical variable that takes the value of 0 for an unqualified opinion, 1 for unqualified opinion with explanatory notes, 2 for an qualified opinion with or without explanatory notes, and 3 for an adverse opinion. LEV_{it} is total debt in year *t* divided by total assets. $TENURE_{it}$: natural log of the auditor's tenure in years.

4. RESULTS

4.1. Main test results

We estimate our regression using a panel data procedure, namely, Generalized Method of Moments (GMM). The GMM procedure allows us to address potential endogeneity problems by using the right-hand-side variables in the model lagged two to six times as instruments; the only exceptions are the year and industry effects variables, which are considered exogenous. The original Arellano and Bond (1991) approach can perform poorly, however, if the autoregressive parameters are too large or the ratio of the variance of the panel-level effect to the variance of the idiosyncratic error is too large. Drawing on Arellano and Bover (1995), Blundell and Bond (1998) develop a system GMM estimator that addresses these problems by expanding the instrument list to include instruments for the level equation. In this paper, we use the system GMM approach to estimate our models.

The consistency of GMM estimates depends on both an absence of second-order serial autocorrelation in the residuals and on the validity of the instruments. To check for potential model misspecification, we use the Hansen statistic of over-identifying restrictions. We next examine the m2 statistic developed by (Arellano and Bond, 1991) to test for the absence of second-order serial correlation in the first-difference residual. Finally, we conduct three Wald tests, specifically, a Wald test of the joint significance of the reported coefficients (z1), a Wald test of the joint significance of the time dummies (z2) and a Wald test of the joint significance of the industry dummies (z3).

To test our Hypothesis, we estimate the following model:

$$FEE_{it} = \alpha_o + \alpha_1 FEE_{it-1} + \alpha_2 RPT\_TOTAL_{it} + \alpha_3 DIVERG_{it} + \alpha_4 BIG4_{it} + \alpha_5 SIZE_{it} + \alpha_6 ROA_{it} + \alpha_7 CR_{it} + \alpha_8 RECEIV_{it} + \alpha_9 INVENTORY_{it} + \alpha_{10} LOSS_{it} + \alpha_{11} OPINION_{it} + \alpha_{12} LEV_{it} + \alpha_{13} TENURE_{it} + \eta_k + \lambda_j + \varepsilon_i \quad \textit{Eq1}$$

where ηk and λj control for industry and year effects, respectively.

Model 1 (Table 2) reports results on the effect of RPTs on audit fees. Particularly, Model 1 shows a positive and statistically significant effect of RPTs on audit fees, the coefficient on RPTs is 0.562 (t-statistic 3.38). These results indicate that the presence of RPTs may increase audit fees. The results are consistent with the supply perspective according to which an increase in the amount of RPTs might increase audit risk and consequently audit effort and/or audit risk premium. Alternatively, our results are also consistent with the alignment effect on the demand for audit coverage, according to which as RPTs increase,

controlling shareholders might also increase their demands for audit coverage to signal the value enhancing nature of RPTs.

Regarding the control variables, the results are consistent with our expectations. Thus, Table 2 shows that audit fees are positively associated with Big4 audit firms (0.660; t-statistic 5.25), firm size (0.160; t-statistic 7.05), opinion (0.258; t-statistic 4.88), and firm leverage (0.929; t-statistic 6.44).

Table 2. Related-Party Transactions and Audit Fees

Model 1:

$$FEE_{it} = \alpha_o + \alpha_1 FEE_{it-1} + \alpha_2 RPT\_TOTAL_{it} + \alpha_3 DIVERG_{it} +$$
$$+\alpha_4 BIG4_{it} + \alpha_5 SIZE_{it} + \alpha_6 ROA_{it} + \alpha_7 CR_{it} + \alpha_8 RECEIV_{it} + \alpha_9 INVENTORY_{it} +$$
$$+\alpha_{10} LOSS_{it} + \alpha_{11} OPINION_{it} + \alpha_{12} LEV_{it} + \alpha_{13} TENURE_{it} + \eta_k + \lambda_j + \varepsilon_i$$

	Model 1
FEE_{it-1}	0.485***
	(15.50)
RPT_TOTAL_{it}	0.562***
	(3.38)
$DIVERG_{it}$	-0.014
	(-3.78)
$BIG4_{it}$	0.660***
	(5.25)
$SIZE_{it}$	0.160***
	(7,05)
ROA_{it}	-0.474
	(-1.56)
CR_{it}	-0.003
	(-0.11)
$RECEIV_{it}$	-0.140
	(-0.41)
$INVENTORY_{it}$	-0.070
	(-0.19)
$LOSS_{it}$	0.016
	(0.30)
$OPINION_{it}$	0.258***
	(4.88)
LEV_{it}	0.929***
	(6.44)
$TENURE_{it}$	-0.000
	(-0.04)
Constant	0.130

	(0.29)
Year effect	*Yes*
Industry effect	*Yes*
Hansen	59.87
	(0.657)
m2 test	-1.00
	(0.318)
z1 test	61.80***
z2 test	14.77***
z3 test	20.76***

FEE_{it}: natural log of total audit fees of the firm *i* in year *t.; FEE_{it-1}*: natural log of total audit fees of the firm *i* in year *t-1. RPT_TOTAL_{it}*: related party transactions divided by total assets of the firm *i* in year *t*. *$DIVERG_{it:}$* measures the degree of divergence between the dominant owner's voting and cash flow rights. *$BIG\ 4_{it}$*: dummy variable that takes the value of 1 for firm- year observations audited by a Big 4, and 0 otherwise. *$SIZE_{it}$* is the natural logarithm of the market value of equity of the firm *i* in year *t*. *ROA_{it}* is net income divided by total assets. *CR_{it}*: current assets divided by current liabilities; *$RECEIV_{it}$*: accounts receivable divided by total assets; *$INVENTORY_{it}$*: total inventory divided by total assets; *$LOSS_{it}$*: dummy variable that takes the value of 1 if net income is negative, and 0 otherwise; *$OPINION_{it}$*: categorical variable that takes the value of 0 for an unqualified opinion, 1 for unqualified opinion with explanatory notes, 2 for an qualified opinion with or without explanatory notes, and 3 for an adverse opinion. *LEV_{it}* is total debt in year *t* divided by total assets. *$TENURE_{it}$*: natural log of the auditor's tenure in years.
Hansen is the test of over-identifying restrictions, under the null hypothesis that all instruments are uncorrelated with the disturbance process. *m2* is the statistic test for lack of second-order serial correlation in the first-difference residual. *z1* is the Wald test of the joint significance of the reported coefficients. *z2* is the Wald test of the joint significance of the time dummies. *z3* is the Wald test of the joint significance of the industry dummies.
***,**,*: Statistically significant at p .01, p .05 and p .10, respectively.
In parentheses, t-statistics based on robust standard errors.

4.2. Sensitivity analysis

In order provide robustness to our results, we extend our analysis in two ways. First, in Model 2 we test the sensitivity of our main model by considering the influence of the information environment and the accounting uncertainty on the external auditor's attitude, by including only the years after the adoption of the International Financial Reporting Standards (2005-2014). Second, we expand our models by adding some additional variables that were considered in some previous studies, although its inclusion has been less frequent. Thus, in Model 3 we add the variable *FOREING*, to control for foreign sales, and *CRISIS*, to control for the effect of the financial crisis. In this sense, according to previous research, the evaluation of foreign sales is complex and requires higher levels of inspection (Desender *et al*., 2013), while the changes in economic conditions induced by the

economic crisis may affect audit fees (*e.g.,* Alexeyeva and Svanström, 2015). Overall, our findings are consistent with the previous results shown in Table 2 (Model 1).

Table 3. Sensitivity Analysis Related-Party Transactions and Auditor Fees

Model 2:

$$FEE_{it} = \alpha_o + \alpha_1 FEE_{it-1} + \alpha_2 RPT\_TOTAL_{it} + \\ + \alpha_3 DIVERG_{it} + \alpha_4 BIG4_{it} + \alpha_5 SIZE_{it} + \alpha_6 ROA_{it} + \alpha_7 CR_{it} + \alpha_8 RECEIV_{it} + \\ + \alpha_9 INVENTORY_{it} + \alpha_{10} LOSS_{it} + \alpha_{11} OPINION_{it} + \alpha_{12} LEV_{it} + \alpha_{13} TENURE_{it} + \eta_k + \lambda_j + \varepsilon_i$$

Model 3:

$$FEE_{it} = \alpha_o + \alpha_1 FEE_{it-1} + \alpha_2 RPT\_TOTAL_{it} + \alpha_3 DIVERG_{it} + \\ + \alpha_4 BIG4_{it} + \alpha_5 SIZE_{it} + \alpha_6 ROA_{it} + \alpha_7 CR_{it} + \alpha_8 RECEIV_{it} + \alpha_9 INVENTORY_{it} + \\ + \alpha_{10} LOSS_{it} + \alpha_{11} OPINION_{it} + \alpha_{12} LEV_{it} + \alpha_{13} TENURE_{it} + \alpha_{14} FOREIGN_{it} + \alpha_{15} CRISIS_t + \eta_k + \lambda_j + \varepsilon_i$$

	Model 2	**Model 3**
FEE_{it-1}	0.435***	0.443***
	(10.83)	(9.66)
RPT_TOTAL_{it}	0.452***	0.500***
	(2.99)	(2.44)
$DIVERG_{it}$	-0.013***	-0.007**
	(-3.81)	(-1.97)
$BIG4_{it}$	-0.013***	0.560***
	(-3.81)	(3.79)
$SIZE_{it}$	0.231***	0.160***
	(9.70)	(4.10)
ROA_{it}	-0.499**	0.443
	(-2.52)	(1.05)
CR_{it}	-0.044	-0.136**
	(-1.21)	(-2.32)
$RECEIV_{it}$	-0.031	-1.459***
	(-0.09)	(-3.16)
$INVENTORY_{it}$	-0.072	0.124
	(-0.20)	(0.22)
$LOSS_{it}$	0.151***	0.310***
	(3.06)	(3.18)
$OPINION_{it}$	0.268***	-0.010
	(4.21)	(-0.14)
LEV_{it}	1.063***	0.561**
	(6.95)	(1.92)
$TENURE_{it}$	-0.021	-0.082**
	(-0.84)	(-2.05)
$FOREIGN_{it}$		0.806***

		(4.28)
$CRISIS_{it}$		-0.120*
		(-1.83)
Constant	-0.437	0.960
	(-1.33)	(1.61)
Year effect	*Yes*	*Yes*
Industry effect	*Yes*	*Yes*
Hansen	62.99	47.02
	(0.548)	(0.632)
m2 test	-0.48	-0.80
	(0.632)	(0.424)
z1 test	211.09***	24.78***
z2 test	26.99***	6.19***
z3 test	16.83***	10.63***

FEE_{it}: natural log of total audit fees of the firm *i* in year *t.;* FEE_{it-1}: natural log of total audit fees of the firm *i* in year *t-1.* RPT_TOTAL_{it}: related party transactions divided by total assets of the firm *i* in year *t*.; $DIVERG_{it}$ measures the degree of divergence between the dominant owner's voting and cash flow rights. $BIG\ 4_{it}$: dummy variable that takes the value of 1 for firm-year observations audited by a Big 4, and 0 otherwise. $SIZE_{it}$ is the natural logarithm of the market value of equity of the firm *i* in year *t*. ROA_{it} is net income divided by total assets. CR_{it}: current assets divided by current liabilities; $RECEIV_{it}$: accounts receivable divided by total assets; $INVENTORY_{it}$: total inventory divided by total assets; $LOSS_{it}$: dummy variable that takes the value of 1 if net income is negative, and 0 otherweise; $OPINION_{it}$: categorical variable that takes the value of 0 for an unqualified opinion, 1 for unqualified opinion with explanatory notes, 2 for a qualified opinion with or without explanatory notes, and 3 for an adverse opinion. LEV_{it} is total debt in year *t* divided by total assets. $TENURE_{it}$: natural log of the auditor's tenure in years.

Hansen is the test of over-identifying restrictions, under the null hypothesis that all instruments are uncorrelated with the disturbance process. *m2* is the statistic test for lack of second-order serial correlation in the first-difference residual. *z1* is the Wald test of the joint significance of the reported coefficients. *z2* is the Wald test of the joint significance of the time dummies. *z3* is the Wald test of the joint significance of the industry dummies.

***,**,*: Statistically significant at p .01, p .05 and p .10, respectively.

In parentheses, t-statistics based on robust standard errors.

5. CONCLUDING REMARKS

Related party transactions have played a major role in the collapse of several large companies; awaken the interest in corporate governance issues and particularly in the audit function. Outsiders rely on accounting information to make economic decisions and the audit function provides confidence on accounting information by reducing uncertainty and risks. Gaining a detailed understanding of RPTs is important for the auditor's risk evaluation. In this sense, previous studies have revealed that auditors consider RPTs in their risk assessment process (*e.g*., Bennouri *et al*., 2015; Nan-wai *et al.,* 2015; Habib *et al.*, 2015, Al-Dhamari *et al*., 2017). However, the audit function might also be affected by demand forces (*e.g*., Carcelo, Hermanson, Neal, and Riley, 2002; Abbott, Parker, Peters, and Raghunandan, 2003; Knechel and Willekens, 2006) and consequently, RPTs could affect the demands for audit coverage (*e.g*., Fan and Wong, 2005; Tsai and Wang, 2016; Kohlbeck and Mayhew, 2017). On this basis, the current work examines the relation between RPTs and audit fees in continental European setting. By adopting an integrated theoretical approach, which combines supply and demand forces, we find a positive relation between the amount of RPTs and external audit fees. We attribute these findings to RPTs increasing audit risk and consequently audit effort and/or audit risk premium (supply perspective), or alternatively, to RPTs creating a demand for audit coverage to signal the value enhancing nature of RPTs (demand perspective).

We contribute to the existing literature in several ways. First, we add to the scarce empirical evidence on the influence of RPTs on audit fees. In this sense, consistent with Habib *et al.* (2015) and Al-Dhamari *et al*. (2017), we show a positive effect of RPTs on audit fees. However, unlike previous studies that attribute their results to RPTs increasing audit risk (supply perspective), the current work uses an integrated theoretical approach that considered not only supply but also demand forces to provide novel evidence on the effect of RPTs on audit fees. Moreover, while previous studies focus on Asian economies, we focus on a continental European setting and therefore on a context where state ownership is not prevalent and the economic activity and the audit function show lower levels of state intervention. Additionally, our results on a positive effect of RPTs on audit fees are in contrast with the ones in Kohlbeck and Mayhew, (2017) who find lower audit fees by RPT firms in the US. However, the results from previous studies might not be extrapolated to continental Europe because institutional differences and different audit traditions might shape in a different way not only auditors' litigation and reputation concerns but also insiders' demands for audit coverage. Thus, some proven incentives that help maintain high audit quality present in countries with a long auditing tradition, reputation loss and litigation risk, for instance, seem to be weak in the Spanish

case (Ruiz-Barbadillo, Gómez-Aguilar, De Fuentes-Barberá and García-Benau, 2004). Thus, the consideration of the demand forces that could affect the relation between RPTs and audit fees becomes particularly relevant in the Spanish case because, as the litigation environment weakens, auditors might have incremental incentives to accommodate to clients' need (Hwang and Chang, 2010). In such settings, the benefits of acquiescing to client request could outweigh the potential penalties (Choi *et al*., 2010; Simunic, 2005).

Second, we also add to the studies that investigate how the firms' agency conflicts between majority and minority shareholders might affect the audit function (*e.g*., Fan and Wong, 2005; Khalil *et al*., 2008; Ben and Lesage, 2013). Thus, we contribute to previous literature by showing that RPTs affect audit fees in a context where the legal system do not provide strong protection to outside shareholders (*e.g*., Djankov *et al*., 2008; La Porta *et al*., 1998) and where the enforcement mechanisms in place are weak (La Porta *et al*., 2000).

Our work provides some important implications. Thus, understanding how external audit fees are affected by the amount of RPTs provides potential benefits to investors. Standards setters may also find our evidence useful when developing standards concerning the role of auditors in the presence of RPTs.

One major limitation of the current study lies in the fact that it is unclear whether higher audit fees are the result of the supply of higher audit coverage due to higher auditor's risk perception or a result of the demands for higher audit coverage by controlling shareholders as RPTs increase. Furthermore, regarding the supply perspective, we do not know whether higher audit fees reflect more audit work as RPTs increase or only risk-premium. We encourage further research in this direction. Second, inferences apply only to listed Spanish firms. Extending the study to other institutional settings and exploring how different categories of RPTs could affect audit fees would provide a potential avenue for future research. Thus, finance transactions might not offer controlling shareholders the same opportunities to tunnel resources outside the company as those RPTs closely related to the firm's core operation. In this sense, Kohlbeck and Mayhew (2017) posit that the closer the transaction is to core operations the more likely it is to be a business-rather than a tone-related transaction. Finally, we have not considered interactions between audit and non-audit services as RPTs increase. Despite these limits, our study aims at improving our understanding of the complex relationships between RPTs and audit fees.

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