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Labor Unions, Audit Fees, Internal Control and Audit Quality

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This research sought to discover the influence of union, audit fee and weakness of internal control on audit quality. This research was conducted at manufacturing companies listed on the BEI in the period 2013–16. Sources of data from this study were obtained from annual reports and financial statements of the company. The analytical technique used is ordinary least square regression using the help of SPSS18. The result of the analysis of this research shows that union labour and internal control have no significant effect on audit quality, while the audit fee significantly influence the quality of audit.

Keywords: *Audit fee, Audit quality, Internal control, Labour union.*

Introduction

Audit quality is a topic that has continued to develop in recent years (Behzadian & Nia, 2017; Choi, Kim & Zhang, 2010; David et al., 2008; Harymawan, Nasih & Noeraini, 2019; Hasibuan, Lubis, Hasyum & Sadalia, 2017; Jackson & Moldrich, 2007; Kalanjati, Nasution, Jonnergard & Sutedjo, 2019; Knechel & Vanstraelen, 2007; Widyaningsih et al., 2019). Several factors are known to be related to audit quality, such as external auditors (Kusumawati & Syamsuddin, 2018; Kusumawati, Syamsuddin & Sundari, 2017) and trade unions.

Workers cannot be under-estimated because companies use services and workers in carrying out their operational activities. The company's operational activities depend on the existence of these workers. When workers demand an increase in their wages, they tend to do so via demonstrations, strikes and other forms of protest that are certainly not liked by management. It is often reported that workers demonstrate with several demands. The most frequently heard topic of labour demonstrations is demands for wage increases. As reported at www.kupastuntas.com. hundreds of workers in Lampung demonstrated for an increase in wages (Kurniati, 2017). The company was PT. Fermentech Indonesia. The demand was for a 14.66 per cent increase in the nominal wage of workers, while company management



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considered this burden would be too heavy, so they offered a wage increase of 8.25 per cent. Workers who carry out these demonstrations are part of an organization or union, the Fermentech Indonesia Independent Workers Union.

A trade union is an organization created by company workers within the scope of the company and the region, aimed at defending the rights and interests of workers to improve the welfare of workers' lives. There are times when such a union is a threat to company management. The demand for wage increases is certainly not what management wants, so management holds back as much as possible so that there is no demand for wage increases. In negotiating with management related to labour wage contracts, workers use financial statements as material for consideration (Bryan, 2017). Financial statements are certainly not easily understood by lay workers, so there are several people in the labour union who are in control of financial statements for use as a consideration in negotiating. It can be said that labour unions are users of financial reports that come from internal companies.

Although trade unions are not directly related to the company's audit process, unions are known to like high-quality audits (Bryan, 2017). High audit quality is a guarantee that the financial statements truly reflect the financial state of the company, conditioned by its financial reporting system and some of its inherent characteristics (DeFond & Zhang, 2014). Conversely, company management prefers low-quality audits so it can have greater control over financial statements that will be published publicly including for the use of trade unions (Bryan, 2017).

Other internal factors that affect audit quality are internal controls, which involve the use of all company resources to improve, direct, control and oversee various activities, with the aim of ensuring that the company's goals are achieved. Adequate internal control will reduce the risk of management fraud. Weak internal control means internal control is unable to detect or reduce the risk of material error. Research conducted by Donelson et al. (2014), Jiambalvo (1996) and Skaife et al. (2013) found that weak internal control can support management to manipulate financial statements in ways that will benefit them. Of course, this will harm the users of the financial statements. As an independent party, the auditor is required to provide confidence that the company's audited financial statements have been fairly presented in accordance with financial accounting standards.

In addition to internal factors, external factors also affect audit quality according to Rahmina and Agoes (2011). One such factor is audit fees, which are in the form of money received by the auditor after performing their duties. Rahmina and Agoes (2014) show that high audit fees reflect good auditor expertise so the quality of the resulting audit will also be good. This study supports the research of Hoitash et al. (2007), who demonstrate statistically that there is a positive relationship between audit fees and audit quality.



The object of research that will be used in this study is manufacturing companies listed on the Indonesia Stock Exchange in the period 2013–16. Manufacturing companies process goods and services into products that are ready for sale. The manufacturing industry tends to depend on its workers in its operational activities (labour based) compared with other industries. Manufacturing companies have more complex financial statement information than many other sectors.

The results of this study indicate that labour unions and internal control are not related to audit quality, but these results may only occur in manufacturing companies. This result contributes to providing additional literature related to audit quality in Indonesia. These results provide additional information that can be used as a basis for considerations for audit service users that the high audit fee might be a positive signal of the audit quality provided by the auditor.

The next section of this article presents a literature review and develops the hypotheses. This is followed by a description of the research sample and an examination of the research variables. A discussion of the results is then presented, and the final section outlines the conclusions of the research.

Literature Review and Hypotheses

According to Boynton and Johnson (2006), audit is a systematic process designed to objectively obtain and evaluate evidence about management assertions and economic events, with the aim of determining the degree of conformity between these assertions with predetermined criteria, as well as the delivery of results to interested parties. Meanwhile, according to Arens et al. (2012), the audit is the accumulation and evaluation of evidence and information to determine and report the level of conformity between the measured information with the specified criteria. This audit activity must be carried out by competent and independent parties. According to Boynton and Johnson (2006), the purpose of the audit is to express an opinion on the reasonableness of the financial statements in all material respects, the financial position, results of operations and cash flows in accordance with generally accepted accounting standards.

Several studies have been conducted on the influence of audit quality. In general, previous studies have related to management actions regarding earnings management. Examples include Bryan (2017), who conducted research into the effect of trade unions on audit quality and internal control. The research shows that trade unions have a positive effect on audit fees and negatively impact restatement and weaknesses in internal control. Rahmina and Agoes (2014) examined the effect of auditor independence, audit tenure and audit fees on audit quality, demonstrating that auditor independence is positively related to audit quality, audit



tenure does not have a significant impact on audit quality and audit fees have a positive and significant effect on audit quality.

In relation to internal control, Chen et al. (2012) found that audit quality was negatively and significantly related to the occurrence of internal control weaknesses. Foster and Shastri (2013) looked at the influence of internal control weaknesses on earnings management, showing that the weaknesses of internal control negatively affect audit quality. In this study earnings management shows the weakness of audit quality.

In terms of audit fees Serrano et al. (2017) examined the interaction between audit fees and audit quality, finding that audit fees have a significant positive effect on audit quality. Choi et al. (2011) examined the effect of audit firm size on audit quality and audit pricing. In this study, the results showed that the audit firm size had a significant positive effect on audit quality, which also depends on the quality of competent individuals – in this case, auditors who use their experience and apply integrity, objectivity and scepticism to making appropriate judgements supported by facts and circumstances at the time of the audit.

Labor Union and Audit Quality

The financial statements are prepared by the accounting department of a company, from the company's financial records for a certain period. Financial statements must be audited by external auditors to generate confidence that the financial statements have been presented fairly and can be trusted. This is due to possibility of conflicts of interest between internal parties and external parties. These have potential agency costs such as management decisions that cannot maximize shareholder interests (Bukit & Iskandar, 2009). The financial statements are used by internal and external parties of the company. Internal parties need financial statements as a measure of company performance for decision making to maximize profits, while external parties, including shareholders and creditors, also need financial reports to make decisions.

Workers also use financial statements. A trade union is an organization that represents workers in negotiating the issue of wages, working hours, conditions and other working conditions. Trade unions help workers to seek justice, and protect workers' rights and obligations. Workers also need information about the profitability and stability of the company to negotiate their wages. Financial statements have an important role in labour contract negotiations. When companies achieve high profits, workers want to increase their wages and if the company denies that they are earning high profits, workers can use financial statements to confirm the truth (Bryan, 2017). Management, on the other hand, tends to want low audit quality because it will give it greater power over the financial statements received by workers (Bryan, 2017). If the audit quality is low, then management has more power to



manipulate the financial statements by reducing existing profits to give them the upper hand in the negotiation process. Audit quality is very important for workers to ensure that the company's financial statements can be trusted.

H1: There is a positive relationship between trade unions and audit quality.

Audit Fee and Audit Quality

The audit fee is a service fee in the form of money obtained by the auditor after performing his duties. Often higher audit fees indicate auditor professionalism and also the auditor's good reputation. Agoes (2014) defines audit fees as wages requested by external accountants to clients for auditing services. Hoitash et al. (2005) argue that the aggregate audit fee is the sum of all costs borne by the auditor. There are variations in the amount of costs, depending on the size of the auditee and how complex the audit process is (Lyon & Maher, 2005). This is further corroborated by Turley et al. (2008), who state that three factors contribute to the determination of audit costs: complexity, client size and related risks. Audit fees reflect the costs of efforts made by public editors and risk litigation (Choi, 2009). Rahmina and Agoes (2014) say that auditors from the Public Accountant's Office are not allowed to negotiate with clients about their wages because it can damage the image of the profession. Rahmina and Agoes (2014) and Serrano et al. (2017) both found a positive relationship between audit fees and audit quality. This means that the higher the audit fee, the more likely it is that the auditor will produce high audit quality.

H2: There is a positive relationship between audit fees and audit quality.

Internal Control and Audit Quality

Internal control is a very important element in a company. The internal control mechanism is designed so that the interests of managers and shareholders can proceed accordingly (Sari et al., 2018). Internal control is a system created by the company to oversee the running of its operational system and minimize fraud. Internal control, according to the Institute of Internal Auditors (quoted in Moeller, 2005), means, 'Any action taken by management, the board, and other parties to manage risk any increase the likelihood that established objectives and goals will be achieved. Management plans, organizes, and directs the performance of sufficient actions to provide reasonable assurance that objectives and goals will be achieved.' This includes actions taken by management, the board and interested parties to manage risk in order to achieve the stated objectives. Management's role is to plan, organize and direct performance so that goals can be achieved. Internal control is influenced by commissioners, management and other members, who provide adequate guarantees for the achievement of objectives related to operations, reporting and compliance.



According to Bryan (2017), 'material weaknesses in internal control over financial reporting are associated with lower earnings quality and greater uncertainty in earnings'; this means weaknesses in internal control of financial statements are related to low labour costs and labour wage uncertainty. Where weaknesses of internal control exist, internal control is not able to detect or reduce the risk of material error. In SOX Section 404 Sarbanes-Oxley 2002 asks management to report internal controls in the financial statements.

Every good company has a control system that has been designed to reduce the risk of fraud. With good internal control, the possibility of fraud is reduced; however, there are times when internal control designed by the company cannot reduce the risk of fraud. This is called the weakness of internal control. When linked to financial statements, good internal control can improve the quality of audits produced by auditors. Chen et al. (2011) and Bryan (2017) prove that quality of audits produced is negatively related to the weaknesses of internal control. Managers tend to increase or decrease the company's profits in the financial statements under certain conditions that benefit the company, a process called earnings management. Though financial statements are also used by other parties for decision making, this is easy for management to do if internal control weaknesses are still high.

H3: There is a positive relationship between internal control and audit quality.

Research Design

Sample and Source of Data

This study uses data from manufacturing companies listed on the Indonesia Stock Exchange in 2013–16. The method used in sampling is purposive sampling. Total companies sampled were 153 companies. The data used in this study are secondary data, namely the companies' annual reports, available from the Indonesia Stock Exchange website at <http://www.idx.co.id>.

Operational Definition and Variable Measurement

The dependent variable in this study is audit quality, which is the magnitude of the possibility of the auditor finding and reporting violations of earnings management practices in the client's accounting reporting system. Several proxies can be used to measure audit quality, one of which is earnings management. Earnings management occurs when management uses valuations in financial statements and the preparation of transactions into financial statements that give the wrong understanding for users of financial statements about the company's economic performance or to influence other factors that depend on financial statements (Healy & Wahlen, 1999). This study uses one of the Modified Jones Model earnings



management measurement models to measure audit quality. The steps that must be taken in measuring earnings management with this model are:

1. Determine the total value of accruals which is the difference between net income and operating cash flow.

$$TA_{it} = NI_{it} - CFO_{it}$$

2. Determine the value of nondiscretionary accruals with the Jones Model (1991).

$$TA_{it} = \beta_0 + \beta_1(REV_{it} - REC_{it}) + \beta_2 PPE_{it} + \varepsilon$$

To scale the data, all the variables above are divided by the assets of the previous year.

3. Total accruals are the sum of discretionary accruals and nondiscretionary accruals. To calculate discretionary accruals is to subtract total accruals with nondiscretionary accruals.

$$DA_{it} = TA_{it} - NDA_{it}$$

Notes:

TA: total accruals company i in the period t

NI: net income company i in the period t¹

CFO: operating cash flow company i in the period t

NDA: estimation of *nondiscretionary accruals* company i in Period t

DA: *discretionary accrual* company i in the period t

REV: change in net sales company i in the period t

PPE: *property, plant dan equipment* company i in the period t

REC : receivables in the period t minus receivables in the period t-1.

The first independent variable in this study is the labour union. Trade unions represent a large number of workers who work in companies under the union. Workers or company workers are generally associated with certain goals. Bryan (2017) found that trade unions are useful in the negotiation process with management, and that they are positively related to audit quality. The stronger a trade union, the more a company will demand better audit quality. Union variables are dummy variables. If the company does not have the union listed on the annual report, it is given a score of 0 and if the company has the union listed on the annual report then it is given a score of 1.

The next independent variable is audit fee, which is the amount paid by the auditee in return for audit services performed by the auditor. In this study, the audit fee is the amount paid by the auditee listed in the financial statements during the audit observation period.

Internal control oversees various management activities to reduce the risk of fraud. In this study, internal control is measured based on the occurrence of internal control weaknesses in the company. According to Ge et al. (2005), control weaknesses are closely related to restructuring, so the weakness of internal control in this study is assessed from whether in the



notes to the auditor's financial statements reveal debt restructuring. Weaknesses in internal control occur when the internal control system cannot reduce the risk of material error. Weaknesses of internal control use dummy variables. If the auditor does not disclose the weaknesses of internal control in the financial statements of the audit results, it is given a score of 0 and if the auditor discloses weaknesses of internal control in the financial statements then given a score of 1.

The size of the audit firm was used as a control variable in this study. According to Minister of Finance Regulation No. 17 / PMK.01 / 2008, a public accountant firm is a business entity that has obtained permission from the minister as a forum for public accountants to provide their services. The Big-Four Audit Firm is internationally proven by the quality of its auditors. DeAngelo (1981), in research that uses the Big Four and Non-Big Four Audit Firms to proxy the size of the audit firm, shows that Big-Four Audit Firm auditors tend to have better audit quality than other firms.

Methodology

To address the hypotheses, multiple linear regression analysis was used. Before conducting multiple linear regression analysis, researchers must first test the classic assumptions. This research was conducted with the help of SPSS20. The regression equation (1) used is:

$$\text{Audit_quality}_{i,t} = \beta_0 + \beta_1 \text{Laborunion}_{it} + \beta_2 \text{AFEE}_{it} + \beta_3 \text{IC}_{it} + \beta_4 \text{BIG4}_{it} + \varepsilon$$

Table 1: Variable definition

Variables	Definition
Dependent:	
Audit_quality	Total accruals are reduced by nondiscretionary accruals.
Independent:	
Labourunion	Dummy variable 1 if the company has a union which is stated in the company's annual report and 0 otherwise.
AFEE	Natural logarithm of Audit fees
IC	Dummy variable 1 if the auditor discloses weaknesses of internal control in the company's financial statements and 0 otherwise.
Control	
BIG4	Dummy variable, 1 if the financial statements are audited by an audit firm BIG4 and 0 otherwise.



Result and Discussion

Descriptive Statistics

The management of this descriptive statistical data was carried out on 127 companies for four years (2013–16). Results (output) in the form of minimum, maximum, average (mean), and standard deviation are shown in Table 2.

Table 2: Descriptive statistics

	N	Min.	Max.	Mean	Std. dev.
Audit_quality	127	-0.96779	-0.00357	-0.4238892	0.25075423
AFEE	127	18.36939	23.24900	20.2662745	1.11069641
Laborunion	127	0	1	0.49	0.502
IC	127	0	1	0.18	0.387
BIG4	127	0	1	0.49	0.502

Table 3 shows that from the sampled companies, 48.8% (62) of them had trade unions mentioned in their annual report, while for companies without unions these figures were 51.2% (65 samples).

Table 3: Frequency distribution of labour unions

	Frequency	%
Do not have labour union	65	51.2
Have labour union	62	48.8
Total	127	100.0

Table 4 shows that companies that gave rise to internal control weaknesses were 18.1% or 23 samples, while the companies that did not bring up internal control weaknesses in their financial statements were 81.9%, or 104 samples.

Table 4: Frequency Distribution of Internal Control

	Frequency	%
Do not raise internal control weaknesses	104	81.9
Raise internal control weaknesses	23	18.1
Total	127	100.0



Based on Table 5, the percentage of companies that use Big-Four audit firm services amounted to 48.8% with a total of 62 samples, while the percentage of companies using non Big-Four audit firm services amounted to 51.2% with a total of 65 samples.

Table 5: Frequency distribution of audit firm

	Frequency	%
Non BIG 4	65	51.2
BIG 4	62	48.8
Total	127	100.0

Labor Unions and Audit Quality

Table 6 shows an R^2 value of 0.069 and an adjusted R^2 value of 0.039. That is, the independent variable in the form of labour unions, audit fees, internal control weaknesses with control variables namely AUDIT FIRM size related to audit quality as the dependent variable of 3.9%. The remaining 96.1% are related to other factors. The correlation coefficient (R) of 0.263 means that the relationship between the independent variable and the dependent variable is directly proportional (positive).

Table 6: Model summary

Model	R	R^2	Adjusted R^2
1	0.263	0.069	0.039

Table 7: T-test results (Partial)

Coefficients ^a						
Model	Unstandardized coefficients		Standardized coefficients	t	Sig.	
	B	Std. error	Beta			
(Constant)	-1.654	0.497		-3.330	0.001	
Audit_quality	0.047	0.045	0.093	1.029	0.306	
AFEE	0.062	0.025	0.277	2.460	0.015	
Laborunion	-0.014	0.058	-0.022	-0.244	0.808	
IC	-0.115	0.055	-0.231	-2.093	0.038	

The first hypothesis of this study is that trade unions are positively related to audit quality. A trade union is a collection of employees that forms an organization, which acts in the interests and for the welfare of the employees. The company union is expected to be able to urge the company to give workers rights and welfare. This can be seen from demonstrations, strikes



and other activities that can threaten the company's survival. According to Bryan (2017), trade unions tend to demand good audit quality from a company because the union can analyse the continuity of its work through the financial statements. From the financial statements, workers can determine the right time to negotiate with management regarding wage increases. The results of the regression coefficient on trade unions are negative, and the results of hypothesis testing indicate that trade unions have no relationship with audit quality.

In this study, no relationship was found between trade unions and audit quality in manufacturing companies listed on the Indonesia Stock Exchange. This is likely due to the influential role of labour in Indonesia. The company has not paid too much attention to the aspirations of workers. In this study, the labour movement therefore did not have an effect on audit quality. This result contradicts the previous hypothesis, and contradicts the results of the research of Bryan (2017) and Hilary (2006), who found significant positive results between trade unions and audit quality.

Audit Fee and Audit Quality

The second hypothesis of this study is that audit fees are positively related to audit quality. The regression coefficient value of the audit fee shows positive, and the results of the hypothesis test indicate that the audit fee has a significant positive relationship with audit quality. An increase in audit fees will cause an increase in audit quality. Conversely, a decrease in audit fees will cause a decrease in audit quality.

Public companies are required to use the services of an independent auditor to audit their financial statements. This is because the financial statements of public companies are used for the benefit of many parties, such as for consideration in decision making. The audited financial statements must therefore have a good audit quality because it will involve the interests of many parties. In return for financial statement audit services that have been carried out by independent auditors, the company provides compensation in the form of an audit fee to the designated audit firm. The amount of the audit fee is based on the agreement between the company and the audit firm. High audit fees indicate high audit quality because the higher the audit fee, the greater the independent auditor's effort will be in conducting audit activities so that the resulting audit quality will be better. High audit fees also indicate a good level of auditor professionalism so that the quality of the resulting audit will be good. The results of this study are in accordance with the hypotheses carried out at the beginning and in accordance with the research of Rahmina and Agoes (2014) and Serrano et al. (2017), who found that audit fees have a significant positive effect on audit quality.



Internal Control and Audit Quality

The third hypothesis is that internal control is positively related to audit quality. The results of the regression coefficient on internal control showed negative, and the results of the hypothesis test showed that the appearance of internal control weaknesses was not related to audit quality – that is, internal control is not related to the increase or decrease in audit quality.

Theoretically, internal control should be positively related to audit quality. Every company must have its own internal controls, but sometimes internal controls that have been designed in this way fail to the risk of fraud. This is called internal control weakness. According to Chen et al. (2011), the presence of internal control weakness shows that the audit quality is getting worse. The better the audit quality of the company, the more the occurrence of internal control weakness will be reduced.

Empirically, the results show that internal control weaknesses are not related to audit quality. This can be caused because even though the company has a weak internal control system, the company management does not necessarily make earnings management if there is no intention to do so. So even though there is a great opportunity to commit fraud, if employees have good integrity and professionalism, then earnings management will not occur.

The results of this study are not in accordance with the previous hypothesis, and do not support the research findings of Bryan (2017), Chen et al. (2011), Chan et al. (2008) and Lashgari et al. (2015), who all found a significant negative effect between weaknesses in internal control on audit quality.

Control Variables

The results of the regression coefficient values on the audit firm size are negative, and the results of the hypothesis test show that audit firm size is negatively related to audit quality. This test means that the greater the size of the audit firm, the more the audit quality will be reduced. This is assessed based on whether the audit firm is included in the Big-Four audit firms – namely Deloitte, Pricewaterhouse Coopers, Ernst & Young and KPMG.

According to Rahmina and Agoes (2014), the Big-Four audit firms tend to have good audit quality because they want to maintain their reputations. However, this study found a negative influence between audit firm size and audit quality. According to De Angelo (1981), Big-Four audit firms will certainly have more clients compared with other audit firms, which can cause the concentration of auditors to split audited financial statements so that the resulting audit quality is not optimal. The results of this study contradict the initial hypothesis and also



contradict the research of DeAngelo (1981), Muliawan and Sujana (2017) and Choi et al. (2010), who found a significant positive relationship between audit firm size and audit quality. The results of this study also do not support research from Nindita and Siregar (2012), who did not find an effect between audit firm size and audit quality.

Conclusion

This study aimed to examine the relationship between trade unions, internal audit, audit fees and audit quality. Analysis and discussion have been conducted on the hypothesis that by using a sample of manufacturing companies listed on the Indonesia Stock Exchange in the period 2013–16. This study showed that labour unions and internal control had no relationship with audit quality. On the other hand, evidence was found that audit fees are positively related to audit quality. This proves that a high audit fee is accompanied by an increase in audit quality.

This study only uses one sector listed on the Indonesia Stock Exchange (IDX) as the object of research, namely the manufacturing sector. In addition, the study period used also consisted of only four years (2013–16). We suggest future research to add other variables that can affect audit quality. Further research is also recommended to expand the sample variables in order to involve companies from other industrial sectors so that the sample studied can be expanded and research results can be more easily generalised.

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