JAFA, 10(1), June 203, 13-21 P-ISSN: 1979-6862
DOI: 10.21512/jafa.v10i1.8904 E-ISSN: 2746-6019

EXTERNAL AUDITOR APPOINTMENT IN INDONESIAN STATE-OWNED ENTERPRISES: THE ROLE OF POLITICAL CONNECTION AND ACCOUNTING IRREGULARITIES

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ABSTRACT

This research investigates how political connections and accounting irregularities affect the auditor appointment decision in Indonesian state-owned enterprises. This research considers auditor choice and switching decisions as its dependent variables. Political connection is calculated as a percentage of the firm's board of directors and commissioners with political connections. Accounting irregularities are calculated with Beneish M-Score. Employing the 235 firm-year observations from 2014 to 2018 using logit regression, this research documents the following results: (1) Political connection has a significant negative influence on auditor choice. (2) Accounting irregularities have a weak significant negative influence on auditor choice. (3) Political connection has no significant influence on auditor switching. (4) Accounting irregularities have no significant influence on auditor switching.

***Keywords*:** *Political Connection, Accounting Irregularities, Auditor Choice, Auditor Switching, State-Owned Enterprises*

INTRODUCTION

One of the significant pillars of national development is the state-owned enterprises, as defined by Law Number 19 of 2003, which are business institutions whose all or most of their capital is held by the state through inclusion directly from the state's separated assets. State-owned enterprises take part in numerous fields dominating the citizen's livelihood to meet domestic needs and have an essential role in realizing the greatest prosperity of the people. However, state-owned enterprises have numerous issues that still need to be addressed; among others are the governance and financial reporting issues. Thereby, there is a need to study Indonesian state-owned enterprises and the issues regarding this topic, as this context becomes very interesting.

The primary responsibility of the external auditor is to provide an opinion on the fairness of the organization's financial reporting, such as the presentation of the financial position and results of operations for a period. The external auditor assesses whether the organization's financial statements are presented following generally accepted accounting principles, applied consistently from period to period. Users of financial statements use the external auditor's opinion to see how much the level of reliability of the financial statements presented by the organization. External auditors can see indications of fraudulent acts through items considered unusual or unreasonable, so based on these considerations, it is hoped that the external auditor can provide input on how to prevent financial statement fraud, as well as which the company should prioritize prevention efforts. Suggestions and input provided by external auditors are expected to provide benefits and minimize the risks posed.

Political connection is a phenomenon that also occurs in developing countries, including Asian countries and also in Indonesia, not just in developed countries. Some research (Claessens, Djankov,

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Fan, and Lang, 2002; Klapper and Love, 2004) have found that Asian countries are countries with concentrated ownership structures, lower public oversight and law enforcement, as well as lower minority shareholders protection, which leads to the considerations to have a political connection in order to achieve business goals.

Firms with the political connection may choose higher-quality auditors to signal outside parties that the firm is transparent (Susanne Preuss and Roland Konigsgruber, 2020). However, firms with political connections may also choose lower-quality auditors to cover up inappropriate acts committed (Susanne Preuss and Roland Konigsgruber, 2020). Moreover, the concern about political connections in Indonesia stems from the PT Krakatau Steel case. Main Director of Krakatau Steel Irvan Kamal Hakim said the political turmoil had pressured the company's performance. This is because Krakatau is vulnerable to fluctuations in the rupiah exchange rate against the dollar. Political sentiment is one of the causes of exchange rate fluctuations.

Furthermore, the Main Director of Krakatau Steel, Irvan Kamal Hakim, because Krakatau buys raw materials in dollars and sells them in rupiahs, the Company's performance is very depressed. Moreover, Krakatau's bookkeeping uses dollars. So, if the rupiah weakens, it will hurt the company.

In response to several prior studies and recent cases on this particular issue, this research raises the concern of political connection as one of the determinants of Indonesian state-owned enterprises' auditor choice or switching. Another important issue to be addressed is accounting irregularities, which extended from research by Prayugi (2015) that analyzes the effects of fraud on auditor choice. Accounting irregularities are often associated with manipulating financial statements and usually aim to make attractive financial statements by deliberately manipulating financial information. A recent case was the polemic of PT Garuda Indonesia Tbk's annual financial report. Personal connections to top executive branch officials can matter greatly even in a country with strong overall institutions, at least during the acute financial crisis and heightened policy discretion (Acemoglu et al.,2016). Research result Babenko et al. (2020) find that employees contribute almost three times more to political candidates supported by their firm's CEO than to candidates not supported by the CEO. This effect persists around CEO turnovers, including plausibly exogenous turnovers caused by death or natural retirement. Further, this relation is stronger when CEOs explicitly advocate for political candidates.

From prior studies and several issues in Indonesia, this research stresses two main determinants of Indonesian state-owned enterprises' auditor appointment decisions: choice and switching. These determinants consist of political connections and accounting irregularities. This research is important considering how limited this research has been done in Indonesia, although the significance and benefits that this research may have. Therefore, research was conducted under the title "External Auditor Appointment in Indonesian State-Owned Enterprises: The Role of Political Connection and Accounting Irregularities."

State-owned enterprises are entitled to choose their own auditors. Most prior research argues that accounting firm size and reputation are the primary determinants of choosing and switching auditors. These are considered quality-related determinants. However, this paper wants to explore the auditor role in Indonesian state-owned enterprises with political connections since state-owned enterprises may choose non-big four accounting firms to conceal inappropriate acts because they provide lower-quality audits (Habib, Muhammadi, and Jiang, 2017).

In the Indonesian context, state-owned enterprises have several reasons that benefit them for choosing non-big four accounting firms (Guedhami et al., 2014). Firstly, state-owned enterprises with political connections tend to conceal financial statements in order to hide inappropriate activities. Consequently, managers tend to assign auditors who would be more willing to hide specific information about the firm in order to protect their political interests (La Porta et al., 1998; Fisman, 2001; guedhami et al., 2009). Secondly, increased transparency by choosing the big four accounting firms will hinder the ability of the controlling shareholders and political connections to take advantage of their power. Third, state-owned enterprises have the same opportunity to get credits from state-owned banks because of their political connection regardless of the lack of transparency from non-big four audits. These arguments imply that state-owned enterprises may have the incentives to hire acquiescent auditors or non-big four accounting firms with the aim of achieving political objectives (Guedhami et al., 2014). This may be caused by special treatment that politically affiliated firms may get from the policies issued

by the government. Thereby, choosing smaller domestic auditors can disguise this treatment as well as increase profits. This research suspects that state-owned enterprises with higher political connections in Indonesia tend to choose non-big four accounting firms.

Another issue is accounting irregularities, in accordance with research by Prayugi (2015) that finds that fraud affects the selection of auditors. This is associated with management actions that use accounting irregularities and accounting methods related to earning management, thereby resulting in attractive financial statements for the shareholders. Earnings management is one of many accounting irregularities, which refers to the choice of accounting methods that can generate more profits, such as accelerating or delaying expenses and costs issued by the firm until the next accounting period. Moreover, this is consistent with Chiang et al. (2011), which reveals that accounting irregularities such as earnings management negatively affect auditors' choices. Firms that commit fraud can be detected through the judgment and credibility of information contained in the financial statements. They have poor-quality financial statements and tend to choose smaller auditors with lower quality to conceal the actual firm's condition and performance. Based on the arguments above, this research suspects that motivated firms to conduct accounting irregularities may have a higher likelihood of choosing smaller auditors with lower quality to manipulate more profits.

There may be possibilities that political connections and accounting irregularities may also influence auditor switching, given the similar arguments for auditor choice. In other words, the firms may switch to auditors with lower quality audits, which can help conceal their inappropriate activities, have lower transparency to achieve political goals, or collude with others to share the same political gains. Thus, based on the arguments of how different levels of political influence, as well as accounting irregularities, may affect Indonesian state-owned enterprises to switch their external auditors, this paper also wants to analyze the effect of both variables on auditor switching.

METHODS

The object of research utilized in analyzing auditor appointment decisions, namely auditor choice, and switching, is all Indonesian state-owned enterprises with a research period of 2014-2018. There is a total population of 115 Indonesian state-owned enterprises. Factors that will be examined are political connections and accounting irregularities. These factors are chosen as research objects to examine whether political connections and accounting irregularities affect auditor appointment decisions on Indonesian state-owned enterprises during 2014-2018. The sampling method is purposive sampling, which is a method that studies the entire population intending to obtain a representative sample based on specified criteria; thus, the criteria for sampling are as follows:

1. All state-owned enterprise has been listed on the IDX, and non-listed state-owned enterprises for 2014 to 2018.
2. The state-owned enterprise has complete audited financial statements for the period 2014 to 2018.
3. The financial statements have all necessary data, such as names of the board of commissioners and directors, all financial data for Beneish M-Score calculation, and names of auditing firms, auditors, and audit partners' characteristics.
4. State-owned banks and insurance services enterprises are excluded from the research regarding different industry characteristics and regulations.

The dependent variable in this research is auditor appointment, namely auditor choice, and switching. Auditor choice is measured using a dummy variable: (1) is when a state-owned enterprise chooses a Big Four accounting firm, and (0) otherwise. Auditor switching is also measured using dummy variable (1) is when a state-owned enterprise switches its auditor, and (0) otherwise. This research utilizes two dependent variables; political connection is the percentage of political connection the top officials (boards of directors and boards of commissioners) have, and accounting irregularities are calculated using Beneish M-Score. For control variables, I choose the auditor's characteristics (age, gender, tenure), firm size, and leverage.

The analytical tool utilized in this study is binary logistic regression analysis with SPSS (Statistical Product and Service Solutions). Furthermore, the analytical method utilized is a logit or binary logistic regression analysis method because the dependent variable is a dummy measured variable. The tests that will be carried out are descriptive statistical test, correlation test, and logit regression test (hypothesis testing) that consists of the overall model fit test and wald test, the goodness of fit, and classification matrix. This research separates each independent variable and dependent variable into four different models, as follows:

Model 1a : Auditor Choice = α + β1(PCON) + β2(AGE) + β3(GENDER) + β4(TENURE) + β5(SIZE) + β6(LEV) +ε

Model 1b : Auditor Choice = α + β1(BENEISH) + β2(AGE) + β3(GENDER) + β4(TENURE) + β5(SIZE) + β6(LEV) +ε

Model 2a : Auditor Switch = α + β1(PCON) + β2(AGE) + β3(GENDER) + β4(TENURE) + β5(SIZE) + β6(LEV) +ε

Model 2b : Auditor Switch = α + β1(BENEISH) + β2(AGE) + β3(GENDER) + β4(TENURE) + β5(SIZE) + β6(LEV) +ε

In which: PCON = political connection; BENEISH = Beneish M-Score or accounting irregularities; AGE = audit partner's age; GENDER = audit partner's gender; TENURE = audit tenure; SIZE = firm's size; LEV = leverage; ε = error; α = Constanta; β1, β2, β3, β4, β5 = the values of the regression coefficients.

ANALYSIS

Hypothesis testing using the Walt test is carried out by entering each independent variable one by one (political connection and Beneish M-Score) into both models (auditor choice and auditor switching). This test aims to determine each independent variable's effect on the dependent variables.

A. Auditor Choice and Political Connection

TABLE 1 WALD TEST MODEL 1A

							95% C.I.for EXP(B)	
	B	**S.E.**	**Wald**	**df**	**Sig.**	**Exp(B)**	**Lower**	**Upper**
PCON	-8.179	4.047	4.085	1	.043**	.000	.000	.781
AGE	-.026	.020	1.657	1	.198	.974	.937	1.014
GENDER	-.694	.562	1.524	1	.217	.500	.166	1.503
TENURE	.424	.130	10.659	1	.001***	1.528	1.185	1.970
SIZE	.026	.066	.151	1	.697	1.026	.901	1.169
LEV	-.306	.127	5.772	1	.016***	.737	.574	.945
Constant	.194	2.019	.009	1	.923	1.214		

Note: *, **, *** are significant at 10, 5, and 1 percent, respectively.

Source: Results of Data Processing with SPSS, 2020

Based on the binary logistic regression test above, the binary logistic regression obtained for model 1a will be as follows:

CHOICE = 0.194 - 8.179 PCON - 0.026 AGE – 0.694 GENDER + 0.424 TENURE + 0.026 SIZE – 0.306 LEV

Based on Table 1 above, the intercept of 0.194 can be interpreted as *CHOICE* will have a value of 0.194 if the other independent variables have a value of 0. The estimated coefficient of -8.179 can be interpreted that *CHOICE* will have a value of -8.179 if the *PCON* has a value equal to 1, and other independent variables are constant or can be interpreted as an increase in *PCON* by one will increase *CHOICE* by -8.179. Meanwhile, a negative sign (-) indicates an opposite relationship between *PCON* and *CHOICE*. The negative coefficient of -8.179 suggests that state-owned enterprises with higher political connections are less likely to assign big four accounting firms. Consequently, it can be concluded that the Wald value of *PCON* is 4.085 with 0.043 significance.

Furthermore, the significance value of 0.043 is smaller than the significance level of 0.05 (5%), thereby signifying that political connection significantly affects auditor choice. Therefore, the first hypothesis can be accepted. For the control variables, *AGE*, *GENDER*, and *SIZE* do not significantly affect auditor choice. This is concluded by the levels of significance that are greater than. On the other hand, *TENURE* and *LEV* have a significant effect on auditor choice due to their significance value being smaller than the significance level of 0.01 (1%).

B. Auditor Choice and Accounting Irregularities

TABLE 2 WALD TEST MODEL 1B

							95% C.I.for EXP(B)	
	B	**S.E.**	**Wald**	**df**	**Sig.**	**Exp(B)**	**Lower**	**Upper**
BENEISH	-.216	.128	2.873	1	.090*	.805	.627	1.034
AGE	-.028	.020	1.967	1	.161	.972	.934	1.011
GENDER	-.705	.567	1.544	1	.214	.494	.163	1.502
TENURE	.352	.124	8.103	1	.004***	1.422	1.116	1.811
SIZE	.051	.064	.626	1	.429	1.052	.928	1.194
LEV	-.329	.131	6.279	1	.012**	.720	.556	.931
Constant	-.827	2.062	.161	1	.688	.437		

Note: *, **, *** are significant at 10, 5, and 1 percent, respectively.

Source: Results of Data Processing with SPSS, 2020

Based on the binary logistic regression test above, the binary logistic regression obtained for model 1b will be as follows:

CHOICE = -0.827 – 0.216 BENEISH - 0.028 AGE – 0.705 GENDER + 0.352 TENURE + 0.051 SIZE – 0.329 LEV

Based on Table 2 above, the intercept -0.827 can be interpreted as *CHOICE* will have a value of -0.827 if the other independent variables have a value of 0. The estimated coefficient of -0.216 can be interpreted that *CHOICE* will have a value of -0.216 if the *BENEISH* has a value equal to 1, and other independent variables are constant or can be interpreted as an increase in *BENEISH* by one will increase *CHOICE* by -0.216. Meanwhile, a negative sign (-) indicates an opposite relationship between *BENEISH* and *CHOICE*. This suggests that state-owned enterprises with accounting irregularities are less likely to assign big four accounting firms.

The Wald value of *BENEISH* is 2.873 with 0.090 significance. Moreover, the significance value of 0.090 is smaller than the significance level of 0.10 (10%), thereby signifying that there is weak evidence that Beneish M-Score affects auditor choice. Based on this significance test in this Wald test, the hypothesis is accepted based on a 1% significance level, in which state-owned enterprises with accounting irregularities are more likely to assign non-big four accounting firms. Furthermore, the odd ratio value of 0.805 suggests that the increase in *BENEISH* will increase the tendency of state-owned enterprises to choose big four accounting firms by 0.805 times higher than state-owned enterprises that have not experienced an increase in *BENEISH*. Just like model 1a, *AGE*, *GENDER*, and *SIZE* do not significantly affect auditor choice. This is concluded by the levels of significance that are greater than alpha. On the other hand, *TENURE* and *LEV* have a significant effect on auditor choice. This is because their significance values are smaller than the significance level of 0.01 and 0.05, respectively.

C. Auditor Switching and Political Connection

TABLE 3 WALD TEST MODEL 2A

							95% C.I.for EXP(B)	
	B	**S.E.**	**Wald**	**df**	**Sig.**	**Exp(B)**	**Lower**	**Upper**
PCON	-.779	4.777	.027	1	.870	.459	.000	5344.494
AGE	.004	.025	.031	1	.861	1.004	.956	1.055
GENDER	1.365	1.191	1.315	1	.252	3.917	.380	40.410
TENURE	-19.602	2028.448	.000	1	.992	.000	.000	.
SIZE	.124	.086	2.087	1	.149	1.132	.957	1.341
LEV	-.055	.122	.207	1	.649	.946	.745	1.201
Constant	14.786	2028.450	.000	1	.994	2640065.202		

Source: Results of Data Processing with SPSS, 2020

Based on the binary logistic regression test above, the binary logistic regression obtained for model 2a will be as follows:

SWITCH= 14.786 – 0.779 PCON + 0.004 AGE + 1.365 GENDER - 19.602 TENURE + 0.124 SIZE – 0.055 LEV

Based on Table 3 above, the intercept 14.786 can be interpreted as *SWITCH* will have a value of 14.786 if the other independent variables have a value of 0. The estimated coefficient of -0.779 can be interpreted that *SWITCH* will have a value of -0.779 if the *PCON* has a value equal to 1, and other independent variables are constant or can be interpreted as an increase in *BENEISH* by one will increase *SWITCH* by -0.779. Meanwhile, a negative sign (-) indicates an opposite relationship between *PCON* and *SWITCH*. This suggests that state-owned enterprises with higher political connections are less likely to switch auditors.

Consequently, it can be concluded that the Wald value of *PCON* is 0.027 with 0.870 significance. Furthermore, the significance value of 0.870 is greater than the significance level of 0.05 (5%) and thereby signifying that political connection is not associated with Indonesian state-owned enterprises' decision to switch their auditors. Therefore, the second hypothesis cannot be accepted. In addition, the odd ratio value of 0.459 indicates that the increase in *PCON* will increase the tendency of state-owned enterprises to switch their auditor by 0.459 times higher than state-owned enterprises that have not experienced an increase in *PCON*. For the control variables, *AGE*, *GENDER*, *TENURE*, *SIZE*, and *LEV*

do not significantly affect the auditor switch. This is concluded by the levels of significance that are greater than alpha.

D. Auditor Switching and Accounting Irregularities

TABLE 4 WALD TEST MODEL 2B

	B	S.E.	Wald	df	Sig.	Exp(B)	95% C.I.for EXP(B)	
							Lower	Upper
BENEISH	.101	.160	.404	1	.525	1.107	.809	1.513
AGE	.003	.025	.019	1	.890	1.003	.955	1.054
GENDER	1.429	1.194	1.433	1	.231	4.175	.402	43.326
TENURE	-19.629	2022.966	.000	1	.992	.000	.000	.
SIZE	.126	.086	2.181	1	.140	1.135	.960	1.342
LEV	-.071	.124	.327	1	.567	.931	.730	1.189
Constant	14.961	2022.968	.000	1	.994	3144586.115		

Source: Results of Data Processing with SPSS, 2020

Based on the binary logistic regression test above, the binary logistic regression obtained for model 2b will be as follows:

SWITCH= 14.961 + 0.101 BENEISH + 0.003 AGE + 1.429 GENDER - 19.629 TENURE + 0.126 SIZE – 0.071 LEV

Based on Table 4 above, the intercept 14.961 can be interpreted as *SWITCH* will have a value of 14.961 if the other independent variables have a value of 0. The estimated coefficient of 0.101 can be interpreted that *SWITCH* will have a value of 0.101 if the *BENEISH* has a value equal to 1, and other independent variables are constant or can be interpreted as an increase in *BENEISH* by one will increase *SWITCH* by 0.101. In comparison, the positive sign (+) indicates a direct relationship between the *BENEISH* and *SWITCH*. This positive coefficient suggests that state-owned enterprises with accounting irregularities are more likely to switch auditors.

The wald value of *BENEISH* is 0.404 with 0.525 significance. Moreover, the significance value of 0.525 is greater than the significance level of 0.05 (5%) and thereby signifying that Beneish M-Score is not associated with Indonesian state-owned enterprises' decision to switch their auditors. Thereby, the fourth hypothesis cannot be accepted. Furthermore, the odd ratio value of 1.107 suggests that an increase in *BENEISH* will increase the tendency of state-owned enterprises to switch their auditors by 1.107 times higher than state-owned enterprises that have not experienced an increase in *BENEISH*. Just like model 2a, *AGE*, *GENDER*, *TENURE*, *SIZE*, and *LEV* do not significantly affect auditor switch. This is concluded by the levels of significance that are greater than alpha.

CONCLUSIONS

This research analyzes the influence of political connections and accounting irregularities on Indonesian state-owned enterprises' auditor appointment decisions, namely auditor choice and switching.

Based on the results of the analysis and the discussion carried out, several conclusions are obtained, as follows:

1. Political connection has a significant negative effect on auditor choice because Indonesian state-owned enterprises with higher political connections are more likely to assign non-big four accounting firms for political reasons and gains. This is consistent with findings by prior studies in which state-owned enterprises have the incentives to appoint non-big four accounting firms with the aim of achieving political objectives.
2. Accounting irregularities have a weak significant negative effect on auditor choice because Indonesian state-owned enterprises with higher Beneish M-Score or likelihood to conduct accounting irregularities are more likely to assign non-big four accounting firms to conceal their inappropriate acts. This is also aligned with numerous prior studies that found that accounting irregularities negatively influence auditor choice because big four accounting firms tend to assist in reducing accounting irregularities. Thus, firms that conduct accounting irregularities are more likely to choose lower-quality auditors.
3. Political connection is not associated with the Indonesian state-owned enterprises' decision to switch their auditors. Even though there is little evidence of an association between the two variables, prior studies found that state-owned enterprises with political advantages have less tendency to switch to big four accounting firms. Therefore, it can be said that using dummy variables may not be sufficient to analyze the association between both variables.
4. Accounting Irregularities are not associated with the Indonesian state-owned enterprises' decision to switch their auditors. Even though there is little evidence of an association between the two variables, the negative relationship is aligned with several findings that state that the higher the likelihood of accounting irregularities exist, the more frequently auditor switching is conducted. Thus, it can be said that this result can be promising, and the statistical power and sample size of this research may not be sufficient to analyze the association.

Practical Implications

External audits helping managers to provide a basis for assessment, assisting managers in reporting weaknesses control within the company and providing advice to managers and directors regarding solutions for more efficient, timely, and relevant company operations for management in making decisions to increase company profitability.

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