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Related Party Transactions: Do They Matter to Auditors? Evidence from Audit Opinions in Indonesia

Arizona Mustikarini[1*]
[1]Faculty of Economics and Business, Universitas Gadjah Mada, Yogyakarta, Indonesia

ABSTRAK

I examine how independent auditors respond to the firms' related party transactions (RPTs), namely related party sales, purchases, receivables, and payables. I use Indonesian data where RPTs are profoundly prevalent. I predict that the nature of RPTs potentially leads to a higher risk of material misstatements, and thus, the auditor is likely to issue a modified audit opinion (MAO). The data is hand-collected from RPT disclosures in the annual reports from 360 observations during the financial year of 2011-2015. The data is analyzed using a logistic regression. Based on the analyses, I find that related party sales, purchases, and payables are positively associated with the issuance of an MAO. These results suggest that auditors respond to RPTs as high-risk transactions. However, I find no empirical support that RPT receivables are associated with MAO issuance. Findings from this study contribute to the literature by demonstrating that RPTs matter to auditors' decisions about opinion issuance. Results also suggest practical implications from this study. It is critical for auditors to have a comprehensive knowledge of the nature of RPTs conducted by audit clients, as RPTs are considered high-risk transactions.
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*Corresponding Author at Universitas Gadjah Mada, Yogyakarta, Indonesia
email: arizona.mustikarini(author#1)

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A. Introduction

IASB (2009) defines related party transactions (RPTs) as a transfer of resources, services, or obligations between related parties, regardless of whether a price is charged. RPTs have received stronger attention in the past decades, especially in Asian economies, where concentrated ownership structures and insider-controlled firms dominate (La Porta, Lopez-de-Silanes, & Shleifer, 2006). A large conglomeration and family-owned business contribute to the increasing number of RPTs (Utama & Utama, 2014). These firms are especially imposed by and have stronger economic incentives to exercise RPTs.

Literature suggests two competing views behind exercising RPTs. On the one hand, RPTs can be value-enhancing because business groups can utilize RPTs to share resources and knowledge (Al-Dhamari, Al-Gamrh, Ku Ismail, & Haji Ismail, 2018). By sharing them, business groups that have close interactions and perhaps better trust among themselves are able to reduce transaction costs and enhance tax benefits (Solikhah, Chen, Weng, & Al-Faryan, 2024; Williamson, 1973). Therefore, RPTs are seen as efficient contracts and transactions since they reduce uncertainties from information asymmetry in arm's length transactions (Fang, Lobo, Zhang, & Zhao, 2018). This view regards RPTs as not harming shareholders, but rather benefiting them. In this sense, RPTs are considered conventional transactions and are not conducted to manage earnings or expropriation (Kuan, Tower, Rusmin, & Van der Zahn, 2010). Instead, RPTs enable the firm to utilize its assets more efficiently because of lower transaction costs. Furthermore,

On the other hand, one may argue that RPTs are potentially abusive or value-decreasing, particularly in Asian economies. In these economies, the ownership structure concentrated in the founders or families as the controlling shareholders is pervasive (Claessens, Djankov, Fan, & Lang, 2002; Claessens, Djankov, & Lang, 2000). Controlling shareholders might use RPTs to extract private benefits through self-dealing or tunneling. Thus, they can arrange opportunistic transactions through RPTs, which benefit themselves at the expense of minority shareholders (Al-Dhamari et al., 2018). As such, RPTs may create agency problems type II, such as wealth transfer and expropriation, by controlling shareholders to non-controlling shareholders (Kohlbeck & Mayhew, 2017). Moreover, from the perspective of agency problems type I, opportunistic managers may structure their RPTs to manage their reported earnings (Abigail & Dharmastuti, 2022; Healy & Wahlen, 1999) for personal benefit or conceal expropriations (Djankov, La Porta, Lopez-de-

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Silanes, & Shleifer, 2008). In this perspective, RPTs serve as an opportunistic mechanism due to the conflict of interests between management and shareholders (Hasnan, Daie, & Hussain, 2016). Consequently, RPTs may be harmful and unfavorable means to shareholders.

This study is motivated by the growing attention from regulators, investors, and the media due to the significant involvement of RPTs in numerous high-profile financial reporting scandals (e.g., Enron, WorldCom, Parmalat, Garuda).[1] Therefore, it is critical that all financial statement users, such as creditors, investors, managers, and government officials, understand the nature of RPTs for decision-making, especially auditors. As RPTs play a prominent role in financial reporting frauds, auditors receive heightened pressures to detect abusive RPTs.

As the independent examiners of the financial statements, external auditors are also imposed by the client's RPTs (Louwers, Henry, Reed, & Gordon, 2008). Auditors find RPTs to be a challenging area in an audit engagement due to the lack of transparency and the intricacy of the nature of RPTs (Levine, Fitzsimons, & Siegel, 1997). Auditors often see RPTs as red flags, which are potential indicators of audit risks. Research suggests that firms are likely to restate their financial statements after the disclosure of RPTs (Kohlbeck & Mayhew, 2017). On a similar note, from the perspective of internal auditors, research shows that besides clients imposing audit scope restrictions, RPTs are considered the second most effective red flag in identifying opportunities to commit fraud (Moyes, Lin, & Landry, 2005). Despite this, there is limited empirical evidence on how auditors actually respond to RPTs through their audit opinion issuance. Accordingly, this study aims to address this gap in the literature.

Most prior research examines RPTs and their relationship with earnings quality, accounting quality, and corporate governance (for example, El-Helaly, 2016; Elizabeth A Gordon & Henry, 2005; Elizabeth A. Gordon, Henry, & Palia, 2004; Hasnan et al., 2016; Utama & Utama, 2014; Wahab, Haron, Lee Lok, & Yahya, 2011; Yeh, Shu, & Su, 2012). However, research on the effect of RPTs on modified audit opinions (MAOs) is scarce (Fang et al., 2018).

Understanding the impact of RPTs on audit outcomes like MAOs using Indonesia as an empirical setting may be deemed appropriate. The Indonesian capital market is dominated by conglomeration firms, which provide opportunities to explore RPTs. In Indonesia,

[1] Hartomo (2019) reports that Garuda, the Indonesian state-owned airline, utilized 26 apparently non-contributing subsidiaries to allegedly facilitate harmful RPTs. These RPTs are primarily undergone via transfer pricing schemes.

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these firms have significant market capitalization (Claessens et al., 2002; Claessens et al., 2000). Therefore, I hypothesize that auditors are likely to issue MAOs to firms with higher related party transactions, i.e., sales, purchases, receivables, and payables.

To investigate the proposed hypotheses, the data is hand-collected from firms' annual reports combined with data from the Osiris database. All manufacturing firms listed in the Indonesian Stock Exchange (IDX) over the period 2011-2015 are included in this study. Accordingly, I gather 360 firm-year samples as the final observation. I use logistic regression to analyze the data.

Based on analyzing 360 firm-year observations during 5-year period, I report several key findings. First, auditors are likely to issue MAOs to firms with the magnitude of higher related party sales, purchases, and payables. However, I find no evidence of the relationship between RPTs receivables and MAOs. Overall, results suggest that RPTs in Indonesian firms are seen by auditors as heightened risks, and thereby, auditors respond to this risk by increasing the propensity of issuing a modified audit opinion communicated to the financial statement users.

This study provides several contributions to the auditing literature and practice. First, this study documents empirical evidence regarding how auditors respond to RPTs in the developing world. Prior research on this issue has been focused mainly on the more developed economies (e.g., Fang et al., 2018; Elizabeth A. Gordon, Henry, Louwers, & Reed, 2007). The results of this study contribute to the accounting literature by documenting how RPTs influence auditors' responses by issuing an MAO. Second, this study contributes to the debate on whether RPTs are efficient or abusive transactions. Kuan et al. (2010) find that RPTs of Indonesian firms do not necessarily suggest greater earnings management. However, from the perspective of auditors, this study indicates that Indonesian firms with related party sales, purchases, and payables are prone to higher audit risks, increasing the auditor's propensity to modify the audit report. Third, the results of this study provide practical implications for auditors. It is critical that auditors understand the nature and have a comprehensive knowledge of the nature of the client's RPTs, particularly in the audit planning and risk assessment because RPTs are considered a high-risk area that leads to a modification of audit opinion.

The remainder of the paper proceeds as follows. In the second section, I review the literature and develop the hypotheses. Section 3 describes the research method. Section 4 presents the

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empirical results and provides discussions. The last section concludes the paper.

B. Literature Review and Hypothesis Development

RPTs are transactions between a firm and individuals or organizations related to the firm, such as managers, boards of directors, majority shareholders, and other affiliated firms (Al-Dhamari et al., 2018; Elizabeth A. Gordon et al., 2007). As stated in the International Accounting Standard 24, RPTs are defined as "transactions that transfer of resources, services, or obligations between related parties, regardless of whether a price is charged" (IASB, 2009). Research suggests that the implications of RPTs are particularly pronounced, especially in Asian economies like Indonesia, where concentrated ownership firms dominate the market (La Porta et al., 2006).

Literature insofar has discussed two competing views as to why agents exercise RPTs. On the one hand, under the efficient contract hypothesis, RPTs can increase the value of the firm by lowering transaction costs (Williamson, 1973). This is especially more pronounced in firms in developing countries like Indonesia. As a developing country, Indonesian firms may benefit from RPTs because a developing country usually exhibits several shortcomings in its market infrastructures, including underdeveloped capital and labor markets, a lack of information intermediaries, ineffective legal systems, and weak enforcement mechanisms (Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1998). These underdeveloped structures may prevent firms from acquiring information to obtain fair competition in the market, thereby enhancing transaction costs associated with businesses conducted at arm's length (Williamson, 1973). As such, agents of these firms are prone to relying upon mutual trust in the related party relationship to overcome these increased transaction costs due to market shortcomings. This notion is also similarly noted by Khanna and Yafeh (2007) who suggest that related-party relationship-based transactions especially provide the utmost advantages where legal and economic infrastructures are lacking. Furthermore, Solikhah et al. (2024) also find that RPTs optimize tax benefits where a strategy of leveraging RPTs results in significant tax savings at the business group level.

On the other hand, albeit the benefits of RPTs for firms in developing countries, agents of the firm may opportunistically use RPTs because they have stronger incentives to conduct earnings management and expropriation (Hasnan et al., 2016; Leuz, Nanda, & Wysocki, 2003). It has been established in the literature that controlling shareholders have more power over the minority shareholders to dominate the

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decision-making process about the firm's affairs which benefits controlling shareholders (Goergen, 2012). In this sense, RPTs are a convenient tool used by the agent to manipulate earnings or a "tunneling" mechanism to expropriate resources at the expense of minority shareholders (Al-Dhamari et al., 2018; Goergen, 2012). With underdeveloped market mechanisms and oversight, firms in developing countries are more prone to this opportunistic behavior that might lead to higher risks of aggressive earnings management (Shen & Chih, 2005).

Because of these risks, regulators put a heightened emphasis on the transparency of RPTs in financial reporting (IASB, 2009) and increase the role of auditors in detecting abusive RPTs through the issuance of International Standards on Auditing (ISAs) (IAASB, 2018, 2019). Research suggests auditors consider RPTs a higher-risk area to audit because of their potential for expropriation (Levine et al., 1997; Louwers et al., 2008), which may lead to fraudulent reporting (Moyes et al., 2005). As a response, auditors may issue a modification of audit opinion as a means to alert readers due to this heightened risk. Nevertheless, issuing an MAO due to RPT issues may pose detrimental effects on the auditor-client relationship (Mustikarini & Adhariani, 2022). Therefore, auditors may refrain from issuing an MAO, instead, they may charge higher audit fees to alternate this risk (Kohlbeck & Mayhew, 2017).

In an audit engagement, auditors are required by the auditing standard to assess risks of material misstatements as high for RPTs because of the accounting disclosure requirements (IASB, 2009), the lack of independence between related parties, and the opportunities RPTs provide to engage in fraudulent financial reporting (Elder, Beasley, Hogan, & Arens, 2020). Auditors assess RPTs not only in the testing phase; but starting from the planning phase where auditors understand the client's business and industry to determine the client's inherent risk (IAASB, 2019).

In general, RPTs can be categorized into related party sales and purchases of goods and services, as well as related party lending and borrowing (or related party receivables and payables) (Fang et al., 2018). Related sales and purchases of goods and services typically occur as part of regular business operations and are among the most common types of RPTs. Although related party sales and purchases may be used to lower transaction costs (Williamson, 1973) and are not intended for earnings manipulations (Kuan et al., 2010), there is some evidence that related party sales of goods and services could be used opportunistically to manage earnings upwards (Aharony, Wang, & Yuan, 2010). Furthermore,

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Barokah and Sari (2024) find that related party sales for cross-border transactions are significantly associated with the increased of tax avoidance activities for Indonesian manufacturing firms. Hence, it suggests that related party sales pose higher risks of material misstatements for auditors. This highlights a potential additional risk for revenue recognition (Elder et al., 2020).

Due to a number of high-profile instances of fraudulent financial reporting involving misstatements in revenue recognition, IAASB (2018) requires auditors to consider revenue recognition as a presumed fraud risk. Specifically, misstatements in revenues have a direct impact on firms' net income and profitability. Meanwhile, misstatements in purchases do not directly impact net income. They go through misstatements in the cost of goods sold beforehand. Due to the risks of material misstatements, accordingly, the following hypotheses are proposed:

H1: Firms with higher related party sales are more likely to receive a modified audit opinion.

H2: Firms with higher related party purchases are more likely to receive a modified audit opinion.

Related party receivables (lending) and related party payables (borrowing) are other forms of RPTs. Research suggests that receivables from related parties serve as a "tunneling" mechanism that erodes firm value. Unlike related party sales, related party receivables do not directly affect net income numbers. Nonetheless, the realization of related party receivables may be problematic because they usually allow lower or even zero interest rates and no guarantees or collateral (La Porta, Lopez-de-Silanes, & Zamarripa, 2003). Consequently, these transactions are likely to default and be written off as bad debts in the long run, and thereby, affecting the net income numbers. Because of the above likelihood, there is a potential that related party receivables may be overstated and provide higher risks of material misstatements. Thus, the following hypothesis is proposed:

H3: Firms with higher related party receivables are more likely to receive a modified audit opinion.

Related party payables (borrowing) serve as an alternative if external financing is more expensive or less accessible in the financial market (La Porta et al., 2003). Under the efficient contract hypothesis, a firm can secure a loan at a better, perhaps lower, interest rate from a related party compared to an arm's length transaction. This may lead to lower financial constraints, hence increasing the accounting and stock market performance (Khanna & Palepu, 2000). Regardless of this advantage, research also suggests that firms with a higher level of related party compared to

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third-party arm's length borrowing are associated with a lower expansion of real investments, decreased operational performance, and eventually lower market valuation (Thapa, Rao, Farag, & Koirala, 2020). In the long run, related party payables may pose significant risks to firms' going concern which can impact auditors' assessment of the client's going concern. Based on the above discussion, the following hypothesis is proposed:

H4: Firms with higher related party payables are more likely to receive a modified audit opinion.

C. Research methods

In this study, I use firms in the manufacturing industry listed on the IDX for the period of five years (from 2011 to 2015). This industry is deemed appropriate for examining the relationship between RPTs and modified audit opinions because manufacturing firms engage quite substantially in sales and purchase activities (Jian & Wong, 2010). Furthermore, using the Indonesian context for this study, Indonesian listed firms are dominated by manufacturing-type firms (Rusmin & Evans, 2017).

I use a purposive sampling method based on the following criteria. Initially, I identified all manufacturing firms that were consistently listed on the IDX during the 2011–2015 period and gathered 150 firms. Data for this study, including RPTs and auditor opinions, were hand-collected from companies' annual reports. Accordingly, I removed fifteen firms that had not publicly published their financial reports on IDX and delisted firms. Then, I removed 63 firms with incomplete data and information about RPTs, audit opinions, or other data about control variables. I gathered 72 firms as my final firm samples. With the five-year period, I finally obtained panel data of 360 firm-year observations as the final sample for this study.

This study employs a logistic regression model to test the predicted hypotheses. Logistic regression is a special form of regression analysis where the dependent variable is categorical or dichotomous (binary). Logistic regression is utilized to test the probability occurrence of the dependent variable that can be predicted by independent variables (Gujarati, 2003).[2] Accordingly, I use the following model to test the hypotheses:

[2] Using data panel estimation with a logit model as shown in Model (1), Gujarati (2003) argues that it is unnecessary to consider the deviation of classical assumptions, such as autocorrelation symptoms, heteroskedasticity, and multicollinearity. This approach is similar to prior research using an audit opinion model by Fang et al. (2018).

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$$MAO_{it} = \alpha + \beta_1 RPSALES_{it} + \beta_2 RPPURCHASES_{it} + \beta_3 RPRECEIVABLES_{it} + \beta_4 RPPAYABLES_{it} + \beta_5 ROA_{it} + \beta_6 SIZE_{it} + \beta_7 LEV_{it} + \beta_8 BIG4_{it} + \varepsilon_{it} \quad (1)$$

where, *MAO* is the modified audit opinion, coded 1 if a firm receives a modified audit opinion in year *t*, 0 otherwise. Following Al-Dhamari et al. (2018) and Fang et al. (2018), I include the following RPT categories as test variables. First, *RPSALES* is measured by the sum of sales of goods and services to related parties scaled by total net sales of firm *i* in year *t.* Second, *RPPURCHASES* is calculated by the sum of purchases of goods and services from related parties scaled by the total net purchase of firm *i* in year *t*. Third, *RPRECEIVABLES* is the sum of inter-corporate lending from firm *i* in year *t* to its related parties scaled by its total assets. Lastly, *RPPAYABLES* is the sum of inter-corporate borrowing by firm *i* in year *t* from its related parties scaled by its total liabilities.

I also control several variables for an audit opinion model, as shown by previous studies (e.g., Banimahd & Vafaei, 2012; Chen, Chen, & Su, 2001; Fang et al., 2018; Habib, 2013). Chen et al. (2001) find a significant relationship between receiving MAOs and financial profitability. Hence, I use *ROA* to control firms' performance, measured by the ratio of net income to total assets of a firm *i* in year *t*. I include *SIZE* to control the firm's size, as smaller firms are most likely to obtain modified opinions (Habib, 2013). *SIZE* is measured by the natural logarithm of the total year-end assets of firm *i* in year *t*. Following Banimahd and Vafaei (2012), I include financial leverage (*LEV*) to control MAO as research shows that the propensity of firms receiving modified opinions is higher for firms with higher financial distress (Desai, Kim, Srivastava, & Desai, 2017). *LEV* is the ratio of total liabilities to total assets of firm *i* in year *t*. Finally, to control governance and auditor effect (Habib, 2013), I include a dummy variable, *BIG4*, coded 1 if firm *i* in year *t* is audited by a Big4 auditor and 0 otherwise.

D. Results and Discussion

Table 1 reports the descriptive statistics of the sample. On average, there 48% of firms received MAOs, suggesting a good distribution of the audit opinion data. *RPSALES* has a mean value of 20.06, meaning that, on average, related party sales comprise 20.06% of the total sales. The *RPSALES* has a minimum value of -6.30 because a firm has a related party sales return. The mean value of *RPPURCHASES* is 17.22, suggesting that related party purchase comprises 17.22% of the total purchase on average. *RPRECEIVABLES* and *RPPAYABLES* have a mean value of 4.72 and 8.85, respectively, suggesting that the proportion of related party receivables of its total assets is 4.72%, and the ratio of related

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party payables to total liabilities is 8.85%, on sample's average. Overall, *RPRECEIVABLES* show the lowest ratio level than other RPTs—*RPSALES*, *RPPURCHASES*, and *RPPAYABLES*.

Firms in the sample data have, on average, 7.09% profitability performance, measured by *ROA*. The mean value of *SIZE* is IDR 10.41 billion, and the mean of *LEV* is 50.26% suggesting that about fifty percent of the total assets of the firms are financed by liabilities. Lastly, Big4 auditors represent 38% of the sample data.

Table 1. Descriptive Statistics

Variable	N	Mean	SD	Min	Max
MAO	360	0.48	0.50	0.00	1.00
RPSALES	360	20.06	27.64	-6.30	100.00
RPPURCHASES	360	17.22	23.07	0.00	99.18
RPRECEIVABLES	360	4.72	10.96	0.00	95.72
RPPAYABLES	360	8.65	18.48	0.00	99.56
ROA	360	7.09	10.45	-28.83	52.57
SIZE	360	10.41	27.69	0.12	246.35
LEV	360	50.26	21.21	8.00	129.21
BIG4	360	0.38	0.49	0.00	1.00

Table 1 reports the descriptive statistics for the sample of 360 firm-year observations for the period 2011–2015.

To test the hypotheses, I run the logistic regression model and present the results in Table 2. I begin my analysis by including only the test variables, which are *RPSALES, RPPURCHASES, RPRECEIVABLES,* and *RPPAYABLES,* as the independent variables, as shown in Column 1 of Table 2. In that specification, I find that *RPSALES* ($b = 0.09$, $SE = 0.02$, $z = 4.24$, $p = 0.000$), *RPPURCHASES* ($b = 0.11$, $SE = 0.02$, $z = 6.88$, $p = 0.000$), and *RPPAYABLES* ($b = 0.07$, $SE = 0.02$, $z = 3.23$, $p = 0.000$) are positively associated with *MAO* and significant at the 1% level, as hypothesized.Meanwhile, *RPRECEIVABLES* ($b = 0.19$, $SE = 0.11$, $z = 1.76$, $p = 0.077$) is positively significant at a 10% level.

Column 2 of Table 2 reports the results when I include both year and firm fixed-effect in the logistic regression model. Consistent with the model in Column 1, I find that the coefficients of *RPSALES* ($b = 0.10$, $SE = 0.02$, $z = 4.29$, $p = 0.000$), *RPPURCHASES* ($b = 0.11$, $SE = 0.02$, $z = 6.69$, $p = 0.000$), and *RPPAYABLES* ($b = 0.08$, $SE = 0.02$, $z = 3.64$, $p = 0.000$) are positive and

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significant at the 1% level, while *RPRECEIVABLES* (b = 0.19, SE = 0.11, z = 1.77, p = 0.077) is positive and significant at a 10% level.

Table 2. Logistic Regression Results

	Column 1 ***MAO*** **Coeff. (z-stat.)**	**Column 2** ***MAO*** **Coeff. (z-stat.)**	**Column 3** ***MAO*** **Coeff. (z-stat.)**
RPSALES (H1)	0.088***	0.101***	0.097***
	(4.24)	(4.29)	(3.93)
RPPURCHASES (H2)	0.113***	0.108***	0.104***
	(6.88)	(6.69)	(5.80)
RPRECEIVABLES (H3)	0.183*	0.193*	0.172
	(1.77)	(1.77)	(1.52)
RPPAYABLES (H4)	0.069***	0.084***	0.087***
	(3.23)	(3.64)	(3.55)
ROA			-0.037
			(-1.37)
SIZE			-0.212
			(-1.47)
LEV			-0.000
			(-0.01)
BIG4			1.375***
			(3.15)
Constant	-3.630***	-2.901***	1.474
	(-9.39)	(-4.77)	(0.48)
Year Fixed-effect	No	Yes	Yes
Firm Fixed-effect	No	Yes	Yes
Prob > chi-square	0.0000	0.0000	0.0000
Pseudo R-square	0.6203	0.6322	0.6623
N	360	360	360

Table 2 shows logistic regression results for the impact of RPTs on MAOs. Column 1 reports the results when no control variables and fixed effects are included in the model. Column 2 reports the results when year and firm fixed effects are included. Column 3 reports the full model when all control variables and fixed effects are included in the estimation.
* and *** indicate statistical significance at the 10 and 1 percent levels, respectively.

Finally, Column 3 of Table 2 reports the full model and more comprehensive results after including all control variables and fixed effects. I remain to find a significant and positive relationship between *RPSALES* (b =

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0.10, *SE* = 0.02, *z* = 3.93, *p* = 0.000), *RPPURCHASES* (*b* = 0.10, *SE* = 0.02, *z* = 5.80, *p* = 0.000), *RPPAYABLES* (*b* = 0.09, *SE* = 0.02, *z* = 3.55, *p* = 0.000), and *MAO,* as predicted. *RPRECEIVABLES* shows a positive coefficient to *MAO* (*b* = 0.17, *SE* = 0.11, *z* = 1.52, *p* = 0.128); however, the marginal significant effect disappears in the full model.

All three models in Table 2 show a goodness-of-fit model with *Prob* > *chi-square* statistically significant ($p < 0.001$), indicating that all coefficient slopes of independent variables regression simultaneously affect the dependent variable. Moreover, the *Pseudo R-squares* in Columns 1, 2, and 3 of Table 2 show an increasing value of 62.03%, 63.22%, and 66.23%, suggesting that the full model in Column 3 of Table 2 has the highest value of independent variables describing the variation of the dependent variable. The goodness-of-fit analysis above implies that H1, H2, and H4 are supported. Even though in Columns 1 and 2, *RPRECEIVABLES* has a positive and marginal significance of a 10% level, however, to mitigate Type I error (false positive), it is inferred that H3 is not supported.

In summary, overall results suggest that auditors perceive related party sales, purchases, and payables of Indonesian firms as higher audit risks, thereby increasing the likelihood of a modified audit opinion issuance. Auditors alert financial statement users to the possibility of earnings management and/or risks of expropriation from related party sales, purchases, and payables through audit opinions.

In a similar note on related party sales, Fang et al. (2018) find that auditors' likelihood to issue MAOs is higher when Chinese firms report higher related party sales; however, this is not the case for related party purchases. Unlike Fang et al. (2018), this study demonstrates that auditors in Indonesia deem to communicate the possibility of expropriation risk from related party purchases and payables as they eventually affect the net income numbers.

With regard to the related party receivables, this study finds that there is no relationship with auditors' issuance of MAOs. La Porta et al. (2003) suggest that related party receivables/lending could manifest moral hazard problems of controlling shareholders by exercising extortion at the expense of minority shareholders. However, they provide empirical evidence using the Mexican banking industry. The results of this study differ from La Porta et al. (2003)

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as it utilizes Indonesian manufacturing firms.

Indonesian firms may have more assurance in the collection of credit provided based on stable and long-term relationships developed among members (Kuan et al., 2010). Specifically, manufacturing firms have a lower ratio level of related party receivables than other RPTs like related party sales, purchases, and payables; and a better level of account receivable turnover ratio and average collection period (Gorczyńska, 2011). These firms may have established efficient credit policies to ensure quicker collections. Because of the higher receivable turnover, the risks of material misstatements from uncollectible and overstated related party receivables are decreasing, thus unrelated to the issuance of an MAO.

E. Conclusion

The purpose of this study is to investigate how RPTs, namely related party sales, purchases, receivables, and payables, influence the likelihood of auditors issuing a modified audit opinion. The nature of RPTs, in some circumstances, potentially leads to a higher risk of material misstatements of the financial statements rather than arms-length transactions with third parties. Auditors who assess heightened material misstatements are likely to modify their audit report if the audit client refuses to accept and adjust the proposed audit adjustments. This modified audit opinion may also serve as an alert from auditors to the financial statement users about certain risks in the audit client.

Overall, the results of this study indicate that RPTs from sales, purchases, and payables are positively associated with the issuance of an MAO. However, related party receivables of Indonesian manufacturing firms are not associated with the issuance of MAOs as auditors may not perceive these transactions as a high risk.

This study is subject to some limitations that readers should interpret carefully. First, although investigating the relationship between related party transactions and the issuance of a modified audit opinion does not require the most recent data, as also shown by prior research (e.g., Fang et al., 2018), there is some potential that this relationship might change with the current empirical data. This is especially because the recent data might be strongly affected by the financial crisis due to the pandemic (Amabel & Herusetya, 2023; Fidiana, Yani, & Suryaningrum, 2023). Therefore, using data that is not affected by significant events like financial crises, as has been utilized in this study, is deemed appropriate. Second, I do not identify the modified audit opinions that specifically discuss

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RPTs. Nevertheless, empirical evidence from this study demonstrates the high value of *Pseudo R-square* > 60% (see Table 2) indicating that test variables might well explain the current dependent variable used.

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