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Related Party Transactions and Audit Fees: Indian Evidence

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ABSTRACT

We examine the effect of related party transactions (RPTs) on audit fees in Indian public companies. RPTs can be used to manipulate financial statements or to transfer wealth between firms and their related parties, and the presence of RPTs increases audit risk. RPTs are relatively more important in India than in advanced economies, so we examine the association between RPTs and audit fees in the Indian setting. We find that audit fees increase by 3.58 percent moving from the first to third quartile of related party sales (RPS). The association between RPS and audit fees becomes prominent after the enactment of *The Companies Act of 2013*. Discussions with audit partners suggest that *The Companies Act of 2013* led to increases in audit effort. Our results provide information regarding the corporate governance environment in India and highlight the importance of separately analyzing different types of RPTs.

I. INTRODUCTION

Previous research documents that managers engage in earnings manipulation using related party sales (RPS) (Jian and Wong 2010) and that related party transactions (RPTs) are associated with lower stock returns (Kohlbeck and Mayhew 2010) and future restatements (Kohlbeck and Mayhew 2017). Thus, evidence from prior studies suggests that RPTs increase the risk to investors and creditors through the inefficient use of resources or through low-quality financial reporting. Therefore, it is reasonable to expect that RPTs should be associated with higher audit fees. However, prior evidence on this association is not consistent. For example, Kohlbeck and Mayhew (2017) find that firms engaged in RPTs in general pay lower audit fees, but subsequently restating firms with "tone at the top RPTs" pay higher audit fees. Some other studies on RPTs report mixed evidence on the association between types of RPTs and audit fees (Habib, Jiang, and Zhou 2015; Fang, Lobo, Zhang, and Zhao 2018).

This paper provides empirical evidence on the association between RPTs and audit fees in Indian public companies. It is motivated by the: (a) potential use of RPTs to manipulate the financial statements and transfer wealth between firms and related parties; (b) high audit risks associated with RPTs; (c) significant presence of RPTs in emerging economies, such as India; and (d) enactment of *The Companies Act of 2013* (*The 2013 Act*), which represented a major change in corporate governance in India.[1]

RPTs in Indian public companies gained a special significance after the important failure of Satyam in 2009. Subsequently, there was a major increase in interest from Indian policymakers to overhaul the financial disclosure standards, especially for RPTs. The Satyam fraud was a watershed event for Indian corporate governance due to its impact on the Indian market as a whole (Narayanaswamy, Raghunandan, and Rama 2012). This fraud highlighted

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[1] *The 2013 Act* was passed after the well-publicized failure of Satyam Computer Services Limited (Satyam), which was primarily due to RPTs. The statutory provisions related to RPTs in *The Companies Act of 2013* took effect on April 1, 2014.

the inadequate handling of RPTs by the board of directors and the auditors, and led to significant changes in laws and corporate governance regulations, particularly those related to RPTs (Narayanaswamy et al. 2012, 2015; OECD 2012, 2014; Brown, Daugherty, and Persellin 2014). The Indian government enacted *The 2013 Act* with the aim of increasing transparency and setting high standards of corporate governance. Thus, the Indian setting makes an interesting avenue to examine the association between RPTs and audit fees, and the effect of legal changes like those in *The 2013 Act* on this association.

India is currently ranked 5th globally in terms of Gross Domestic Product and is expected to be ranked 3rd by the end of the decade (World Economic Forum 2020; Aldrick and Goodman 2022; Shan 2022). It provides a good setting to examine our research questions because of the significant presence of RPTs among Indian companies.[2] Irregularities involving RPTs, such as undervalued transactions with related parties, circular transactions, diversion or siphoning of funds, occur frequently in India (OECD 2014). Insiders in emerging economies often find avenues through which to misuse RPTs for personal gain (Chauhan, Lakshmi, and Dey 2016) due to weak investor protection, poor law enforcement, inadequate disclosure, and financial opacity (Chakrabarti, Megginson, and Yadav 2008; Fan, Wei, and Xu 2011; Narayanaswamy et al. 2012). Therefore, RPTs are of significant concern to investors, regulators, and other stakeholders (SEBI 2020).

Additionally, corporate governance practices in India differ from those in developed economies due to unique issues such as concentrated ownership and pyramidal business groups (Narayanaswamy et al. 2012; Armitage et al. 2017). Controlling shareholders own a significant stake in publicly listed Indian firms and, as such, heavily influence decision-making in these companies. This leads to unique agency conflicts between large (controlling) and small

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[2] As shown later, the relative magnitude of RPTs in India are much higher when compared to other countries, such as the United States of America (US) or China.

(minority) shareholders—i.e., the principal-principal problem (Young, Peng, Ahlstrom, Bruton, and Jiang 2008; Bhaumik and Selarka 2012)—rather than the conventional agency problems between managers and shareholders which are prevalent in developed countries (Jensen and Meckling 1976; Fama and Jensen 1983). Furthermore, in contrast to the US and other major economies, the Big 4 audit firms do not dominate the Indian audit market. Instead, the majority of Indian public companies are audited by non-Big 4 auditors (Narayanaswamy et al. 2012).

Using archival data from publicly listed Indian firms, we examine the effect of RPTs on audit fees. We use data from 2010 through 2019 and find that RPS are positively associated with audit fees after the implementation of *The 2013 Act*. We then examine whether the association between RPTs and audit fees differs for various types of firms, based on size, auditor type, and business group affiliation. Across all partitions, we find that RPS are associated with higher audit fees after the implementation of *The 2013 Act*. In addition, discussions with audit partners from two of the Big 4 accounting firms and two non-Big 4 accounting firms suggest that *The 2013 Act* increased audit effort for RPTs.

Higher audit fees can result from increased effort and/or higher risk premia. Because data about audit effort or audit report lag are not publicly available in Indian databases, we discussed our findings with audit partners from two of the Big 4 accounting firms and two non-Big 4 firms. In general, all of the audit partners indicated that *The 2013 Act* led to increased audit effort. Using a scale where 1 = very little or no increase in audit effort and 10 = very substantial increase in audit effort, the average response was 7.5 for the two Big 4 firms and 9 for the non-Big 4 firms.

Overall, the results are consistent with arguments presented in prior research that compares RPS to other RPTs. RPS are complex and more difficult to audit, requiring more significant effort (Kohlbeck and Mayhew 2017; Fang et al. 2018). Hence, auditors charge a

premium in the presence of these transactions because of the additional risk and additional effort, particularly after *The 2013 Act*. Our results align with findings reported in some prior studies. For example, Jian and Wong (2010) show that managers use RPS to prop up earnings and as a substitute for accrual-based earnings management, whereas Greiner, Kohlbeck, and Smith (2017) show that auditors charge a significant risk premium when earnings are manipulated.

Our results suggest that studies examining RPTs should distinguish between different types of RPTs, and that RPS are much more risky from an auditing perspective than other types of RPTs. Our results help to shed light on the corporate governance environment in India after *The 2013 Act*, and also highlight the fact that results and inferences from corporate governance and auditing settings based on data from developed countries must be applied with caution in the context of emerging economies.

The next section provides the background. This is followed by a discussion of related literature and by the research question. After describing the methodology and results, the paper concludes with a summary and discussion.

II. BACKGROUND

Corporate Governance in India

Corporate governance issues in India differ from those in advanced countries like the US, and also from those in China, due to unique organizational structures such as pyramidal business groups and concentrated ownership. Publicly listed Indian firms are characterized by significant ownership by controlling shareholders, who are typically family members or private entities controlled by the founding family. This ownership structure grants them considerable control over decision-making. In contrast, company stock ownership in the US and other advanced countries is widely dispersed, ensuring separation of ownership and control. In China, a majority of public companies are spinoffs from their parent state-owned enterprises,

with the state itself being the largest shareholder (Chan, Lin, and Mo 2006). As a result, Chinese public companies are subject to strong government influence. Narayanaswamy et al. (2012, 583-584) note:

> *The Indian approach to corporate governance, accounting, and auditing differs in many ways from the U.S. model (and the Chinese model). As such, the Indian context provides an important, unique setting for research. Yet, in contrast to China, empirical research related to governance / accounting / auditing in India is non-existent in the major accounting journals.*

Moreover, the affiliation of many Indian companies with business groups adds additional complexity and significantly influences their corporate governance practices. The controlling shareholders of business group-affiliated firms transfer a significant amount of wealth from firms with low cash flow rights to those with high cash flow rights (Bertrand, Mehta, and Mullainathan 2002). Additionally, Kali and Sarkar (2011) show that diversification in Indian business groups is motivated by tunneling, leading to the expropriation of minority shareholders.[3] Basu and Sen (2015) find that Indian business groups transfer capital efficiently between affiliated firms, but they act opportunistically when it comes to returning the capital to minority shareholders. In summary, concentrated ownership in the hands of families and the absence of strong government influence in Indian public companies distinguish India's corporate governance landscape from that of the US and China. These factors also highlight the importance of examining RPTs in the Indian setting.

Related Party Transactions in India

RPTs are transactions between a firm and related parties, such as controlling shareholders, directors, key management personnel, relatives, and entities under their control.

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[3] Tunneling occurs when affiliated firms shift wealth from those with low cash flow rights to those with high cash flow rights.

Emerging economies, such as India, are characterized by relatively higher incidence of RPTs (Chauhan et al. 2016; Li 2021). The involvement of RPTs in high-profile accounting frauds around the world has led to increased awareness among investors and regulators about the risks associated with RPTs.[4] The relative magnitude of RPTs in India is much higher (e.g., at approximately 20% of total assets for our sample) than those reported by prior studies examining RPTs in China.[5] Prior studies on RPTs in the US have not considered the magnitude (dollar value) of RPTs due to the limited availability of these data (Kohlbeck and Mayhew (2010, 2017), but anecdotally, the magnitude of RPTs in the US is much lower than in India or China.

In the aftermath of the Satyam fraud, a great deal of attention focused on how to improve the corporate governance environment in India, with a particular emphasis on the auditing and disclosure of RPTs. The regulatory framework around RPTs underwent significant changes after the enactment of *The 2013 Act* and SEBI's *Listing Obligations and Disclosure Requirements Regulations 2015* (*LODR*). *The 2013 Act*, *LODR*, and the *Indian Accounting Standard* (*Ind AS*) regulate the governance and disclosure of RPTs in Indian-listed companies. The above regulations require Indian-listed companies to disclose details of RPTs, such as the name of the related entity/individual, description of the relationship, amount, and nature of RPTs.

Prior to *The 2013 Act*, RPTs exceeding a specified threshold (specifically, the lesser of INR 1 billion or 10% of the company's turnover) required prior approval from the Government of India. However, companies were not required to disclose their justification for RPTs and

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[4] RPTs were involved in major accounting scandals such as Enron, WorldCom, Adelphia, and Tyco in the US (Gordon, Henry, Louwers, and Reed 2007), Schneider Rundenwerke, Parmalat, and Bermer Vulkan in Europe, and Kangsai Group and Baan Company in Asia (Bennouri, Nekhili, and Touron 2015).

[5] For example, Fang et al. (2018) report that for their sample of Chinese firms, RPTs are approximately 8.5% of total assets.

directors did not face penalties for non-compliance.[6] *The 2013 Act* marked a significant shift from a government approval-based regime to shareholder approval and disclosure-based regime.[7]

The 2013 Act requires disclosure about the justification for RPTs in the Annual Report. It prohibits companies from extending any loan/guarantee/security to its directors (or a person or entity in whom the director has an interest).[8] Moreover, RPT-related information must be submitted to the board for approval. However, arm's length RPTs (including loans) in the "ordinary course of business" are exempt from board approval and only require audit committee approval, whereas RPTs that are not at arm's length must be approved by shareholders. Additionally, similar to the Sarbanes-Oxley Act of 2002 (SOX) in the US, *The 2013 Act* increased liability for Indian auditors. It introduced monetary penalties, imprisonment for up to a year, and allowed class action suits against the auditors, thus increasing risk. Hence, we examine the effects of *The 2013 Act* on the association between RPTs and audit fees.

RPTs continue to be of interest to regulators in India. In November 2019, SEBI constituted a Working Group to review and recommend policies related to RPTs. The group submitted its report in January 2020 (SEBI 2020). Based on this report, SEBI widened the definitions and scope of related parties and RPTs.[9]

Auditing Related Party Transactions in India

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[6] Prior to *The 2013 Act*, Sections 297 and 314 of *The Companies Act of 1956* were relevant for RPTs. Government approval of RPTs was pro-forma and our discussions with an experienced audit committee director (who has served on many blue-ribbon commissions formed by Indian regulators) reveal that the director could not recall any instance of the government rejecting these requests.

[7] Under *The 2013 Act*, Sections 177 (audit committee), 185 (loans to directors), 186 (loan and investment by the company), and 188 (related party transactions) are relevant for RPTs.

[8] *The Companies (Amendment) Act 2017* relaxed the restriction about RPT loans if the loans are utilized for the principal business activities.

[9] The revised *LODR* defines any person or entity either forming the promoter group or holding a 10% stake in the company as a "related party." This definition came into effect on April 1, 2023.

The 2013 Act requires auditors to comply with their responsibilities as described in *Standard on Auditing 550* (*Related Parties*).[10] As in the US, Indian auditing standards require auditors to identify related party relationships and RPTs.[11] Furthermore, auditors must evaluate and respond to the potential risk of material misstatements due to RPTs and identify fraud risk factors. Auditors are required to declare in the auditors' report that all RPTs comply with disclosure norms. In addition, *The 2013 Act* requires companies to file financial statements for all domestic and foreign subsidiaries.

One unique feature of the Indian audit market is that unlike in the US and many other developed economies, the Big 4 audit firms do not dominate the audit market. The Institute of Chartered Accountants of India (ICAI) prohibits Big 4 auditors from conducting audits in India under their internationally recognized names, such as KPMG, EY, PwC, and Deloitte; hence, the Big 4 audit firms engage in auditing activities in India by collaborating with domestic firms. Narayanaswamy et al. (2012) show that even in a sample of large Indian companies, the number of clients audited by Indian associates of the Big 4 is considerably lower than non-Big 4 auditors. As noted later, empirical data from our sample confirms the relative non-dominance of the Big 4 in the Indian audit market.

III. RELATED LITERATURE AND THE RESEARCH QUESTION

Alternate Perspectives on Related Party Transactions

There are two alternate perspectives on RPTs: the efficient contracting perspective and the shareholder expropriation perspective. Under the efficient contracting perspective, RPTs are necessary business transactions that "fulfill the rational economic demands" of the company (Gordon, Henry, and Palia 2004). Their superior information about a company and

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[10] *Standards on Auditing*, which are released by ICAI, are the Indian version of the International Standards on Auditing.

[11] The U.S. Public Company Accounting Oversight Board (PCAOB) in *AS 2410: Related Parties*, requires auditors to "obtain sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the financial statements."

willingness to share that private information could make RPTs efficient by optimizing internal resource allocation and reducing transaction costs (Khanna and Yafeh 2007; Ryngaert and Thomas 2012). Consistent with this view, prior research provides evidence of the transfer of cash from financially stronger firms to support financially constrained firms (Gopalan, Nanda, and Seru 2007; Buchuk, Larrain, Muñoz, and Urzúa 2014). Similarly, prior research provides evidence of a reciprocal relationship, also known as "co-insurance," among related parties (Fisman and Wang 2010; Jia, Shi, and Wang 2013).[12]

The shareholder expropriation perspective is that RPTs provide opportunities for controlling shareholders and directors to expropriate minority shareholders. Supporting this view, previous research documents that RPTs are used to manipulate earnings (Jian and Wong 2010; Lo, Wong, and Firth 2010) and transfer wealth between the firm and related parties (Johnson et al. 2000; Djankov 2008). RPTs can facilitate the expropriation of minority shareholders and tunneling of funds from a firm to controlling shareholders (Cheung, Rau, and Stouraitis 2006; Jiang, Lee, and Yue 2010; Lo et al. 2010).

In summary, RPTs can enhance value through efficient contracting or can be used for expropriation by controlling shareholders. The fact that the controlling shareholders occupy key management positions in most Indian firms makes RPTs an interesting area of research in the Indian setting (Chauhan et al. 2016; Armitage et al. 2017).

Related Party Transactions and Audit Risk

Challenges associated with identifying and disclosing RPTs can affect audit fees (Gordon et al. 2004).[13] In addition to increased audit risk and client business risk, increased

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[12] Research argues that greater efficiency in loan transactions could be due to their higher traceability compared to other RPTs (Jiang et al. 2010), better regulatory requirements in certain economies (Buchuk et al. 2014), or fear of the negative spill-over effect of default by a group firm on the rest of the business group (Gopalan et al. 2007). In contrast, RPS and related party purchases of goods, services, or assets could occur purely for commercial purposes.

[13] The American Institute of Certified Public Accountants (AICPA) terms RPTs "difficult to audit" because of the complexity involved in identifying related parties, reliance on managerial disclosure of RPTs, and difficulty in tracking RPTs (AICPA 2001).

audit effort associated with RPTs contributes to higher audit fees. Prior research shows that auditors account for audit and business risk (in the form of damaged reputation, litigation risk, etc.) when setting audit fees (Houston, Peters, and Pratt 1999; Johnstone 2000; Lyon and Maher 2005).

Previous research provides mixed evidence on the relation between RPTs and audit fees. Using US data, Kohlbeck and Mayhew (2017) show that RPTs are negatively associated with audit fees; however, the association is positive for subsequently restating firms with "tone at the top RPTs." Using data from China, Habib et al. (2015) show that operating RPTs, such as RPS and related party purchases of goods/services, are negatively associated with audit fees; however, non-operating RPTs, such as related party loans, are positively associated with audit fees. In contrast, Fang et al. (2018) find that related party asset sales are positively associated with audit fees in China but related party loans or non-asset sales are not significantly associated with audit fees.

RPTs can be of various types, such as loans given or borrowed, guarantees extended, sale or purchase of goods and services, sale or purchase of assets, etc. The audit risk associated with each type can differ because the motive behind transactions between related parties depends on the type of transactions and the counterparty (Kohlbeck and Mayhew 2017). Based on Fang et al. (2018), we broadly categorize RPTs as follows: RPS of goods and services, related party purchases of goods and services, related gross lending, related gross borrowings, related guarantees given, related guarantees taken, RPS of fixed assets and investments, and the related party purchases of fixed assets and investments. The following section discusses the audit risk associated with each type and the effect on audit effort.

Related Party Sales and Purchases of Goods and Services

Jian and Wong (2010) show that managers use RPS of goods and services as a substitute for accrual-based earnings management. Previous research shows that manipulating earnings

using RPS helps firms avoid reporting losses, boost earnings before initial public offerings or rights issues, and maintain listing status (Aharony, Wang, and Yuan 2010; Jian and Wong 2010;). Because manipulating earnings increases audit risk, earnings management significantly increases audit effort and fees (Schelleman and Knechel 2010).

Related party purchases of goods and services can also be used to prop up earnings by applying a discount on items purchased from related entities, reducing cost of goods sold. However, related party purchases pose a lower level of risk than RPS because the sale of goods and services immediately affects net income, whereas purchases affect net income only when later sales occur (Fang et al. 2018). Fang et al. (2018, 79) note that "there is greater room for the overstatement of sales than for the understatement of cost of goods sold because the latter cannot be zero." Jian and Wong (2010) find that only sales RPTs are significantly associated with earnings management, and the relation between purchase RPTs and earnings management is not significant. Based on the above evidence, we expect auditors to charge higher fees for RPS. We expect any association with audit fees to be weaker in the case of related party purchases.

Related Party Loans and Borrowings

Related party lending plays a significant role in the internal capital markets of emerging economies because these loans can be used to efficiently transfer funds to financially weaker firms (Gopalan et al. 2007; Fisman and Wang 2010; Buchuk et al. 2014). Conversely, loan RPTs are a potential channel for tunneling funds to related parties and are likely to influence audit risk. Apart from lower recovery and minimal interest payments, these loans carry a higher risk of default and a risk of siphoning off funds to controlling shareholders (La Porta, Lopez-de-Silanes, and Zamarripa 2003; Jiang et al. 2010; Fang et al. 2018). Hence, we expect loan RPTs to increase audit risk.

In contrast, related party borrowings are less likely to pose a serious threat because they put the funds of related parties at risk. However, Kohlbeck and Mayhew (2017) argue that borrowings from certain related parties, such as directors, officers, and shareholders, may be opportunistic and increase audit risk. Based on the above discussion, we expect a positive association between lending RPTs and audit fees, but we expect this association to be weaker for borrowing RPTs.

Related Party Guarantees Given and Taken

Similar to related party lending and borrowing, related party guarantees can significantly influence audit risk. Loan guarantees for the debt taken by related parties could substantially increase the company's business risk due to the potential risk of default (Berkman, Cole, and Fu 2009; Chen, Arnoldi, and Na 2015). Consequently, related party guarantees can influence audit risk. Similar to related party borrowings, company loans that are guaranteed by related parties, such as directors, officers, and shareholders, may be opportunistic. Additionally, guarantees obtained from related parties can indicate poor financial condition of the company, which may affect audit risk.

Related Party Sales/Purchases of Assets and Investments

Cheung, Qi, Rao, and Stouraitis (2009) show that listed firms acquire assets at a higher price than "fair" value (i.e., in similar arm's length transactions) from related parties but sell at a price lower than fair value. This suggests that the acquisition and sale of assets can increase audit risk and require greater audit effort. However, Fang et al. (2018) argue that because these transactions affect net income but do not have any impact on operating income, firms are less likely to prefer them when attempting to manipulate earnings. Hence, audit risk associated with RPS and related party purchases of assets/investments is expected to be lower than other RPTs.

Research Question

Transactions between related parties could require greater audit effort because the auditor mitigates risk through increased effort. Additionally, an auditor could charge a premium for accepting the risk originating from RPTs. Because RPTs are a convenient tool that managers can use for opportunistic purposes, such as manipulating earnings or transferring wealth between related entities, we expect auditors to exert more effort and levy higher risk premia, leading to higher audit fees. These arguments suggest a positive association between RPTs and audit fees. However, as discussed in the prior section, the extent of the association between RPTs and audit fees need not be uniform across all types of RPTs. Thus, our research question, which we test using a sample of Indian public companies, is:

RQ: Is there a significant association between various types of RPTs and audit fees?

IV. METHOD

Data

We obtain necessary data for Indian companies listed on National Stock Exchange (NSE) from the Auditors Database, maintained by PRIME Database Group, and from Prowessdx maintained by the Centre for Monitoring Indian Economy (CMIE).[14] Most public companies in India use an April 1 through March 31 reporting period. For expositional convenience, we refer to the fiscal year ending on March 31, 20XY+1 as "year 20XY." Our sample covers 2010 (i.e., following the Satyam failure) through 2019. Following prior research, we remove financial (National Industrial Classification [NIC] codes 64-69) and utility (NIC codes 35-38) firms from the sample.

The above procedure yields a sample of 7,950 firm-year observations from 1,238 unique firms. We find that approximately 9 percent of the sample does not report RPTs. Because these non-RPT reporting firms may be inherently different from those with RPT

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[14] These databases, equivalent to Compustat in the US, are a primary source of data for academic research in India (Bertrand et al. 2002; Gopalan et al. 2007).

disclosures, we delete these observations. Our final sample consists of an unbalanced panel of 7,232 firm-year observations from unique 1,174 firms.

Empirical Model

We use the following regression model to examine the relation between audit fees and RPTs in Indian firms.

$$LNAF_{it} = \beta_0 + \beta_1 RPT\_SALES\_Rs_{it} + \beta_2 RPT\_PURCH\_Rs_{it} + \beta_3 RPT\_LOANS\_Rs_{it}$$

$$+ \beta_4 RPT\_BORROWINGS\_Rs_{it} + \beta_5 RPT\_GUARGIV\_Rs_{it}$$

$$+ \beta_6 RPT\_GUARTKN\_Rs_{it} + \beta_7 RPT\_FAINVSALES\_Rs_{it}$$

$$+ \beta_8 RPT\_FAINVPURCH\_Rs_{it} + \beta_9 SIZE_{it} + \beta_{10} WORKING\_CAPITAL_{it}$$

$$+ \beta_{11} LEV_{it} + \beta_{12} QUICK_{it} + \beta_{13} ROA_{it} + \beta_{14} BIG4_{it} + \beta_{15} INITIAL_{it}$$

$$+ \beta_{16} JOINT\_AUDIT_{it} + \beta_{17} CSO_{it} + \beta_{18} BG_{it} + \beta_{19} IO_{it}$$

$$+ Industry\ Fixed\ Effects + Year\ Fixed\ Effects + error \qquad (1)$$

The variables are defined as follows:

LNAF = Natural logarithm of audit fees paid to the auditors;

RPT_SALES_Rs = Square-root of the ratio of RPS of goods and services to total assets;

RPT_PURCH_Rs = Square-root of the ratio of related party purchases of goods and services to total assets;

RPT_LOANS_Rs = Square-root of the ratio of related party loans to total assets;

RPT_BORROWINGS_Rs = Square-root of the ratio of related party borrowings to total assets;

RPT_GUARGIV_Rs = Square-root of the ratio of related party guarantees given to total assets;

RPT_GUARTKN_Rs = Square-root of the ratio of related party guarantees taken to total assets;

RPT_FAINVSALES_Rs = Square-root of the ratio of RPS of assets and investments to total assets;

RPT_FAINVPURCH_Rs = Square-root of the ratio of related party purchases of assets and investments to total assets;

SIZE = Natural logarithm of total assets (measured in millions of Indian rupees);

WORKING_CAPITAL = Total working capital divided by total assets;

LEV = Total debt divided by total assets;

QUICK = Current assets minus inventories divided by current liabilities;

ROA = Net income divided by total assets;

BIG4 = 1 if the firm is audited by one of the Big 4 accounting firms, 0 otherwise;

INITIAL = 1 if it is a first-year audit (initial year audit), 0 otherwise;

JOINT_AUDIT = 1 if more than one statutory auditor audits the firm, 0 otherwise;

CSO = The proportion of controlling shareholders' ownership;

BG = 1 if the firm is affiliated with a business group, 0 otherwise; and

IO = The proportion of institutional ownership.

Our dependent variable is the natural logarithm of audit fees (*LNAF*). Our independent variables are various types of RPTs: RPS of goods and services (*RPT_SALES_Rs*), related party purchases of goods and services (*RPT_PURCH_Rs*), related gross lending (*RPT_LOANS_Rs*), related gross borrowings (*RPT_BORROWINGS_Rs*), related guarantees given (*RPT_GUARGIV_Rs*), related guarantees taken (*RPT_GUARTKN_Rs*), RPS of fixed assets and investments (*RPT_FAINVSALES_Rs*), and the related party purchases of fixed assets and investments (*RPT_FAINVPURCH_Rs*). We take the square-root of the ratios because the distributions of the raw measures are right-skewed.

We control for factors that could influence audit fees, such as firm size, audit complexity, firm-specific factors, auditor characteristics, and ownership characteristics. We use the natural logarithm of total assets as our measure of client size (*SIZE*). We account for audit risk and audit complexity of clients by including total working capital as a proportion of total assets (*WORKING_CAPITAL*) as a control variable. We control for firm-specific factors such as leverage (*LEV*), liquidity (*QUICK*), and profitability (*ROA*). Additionally, audit fees

paid by clients are likely to be higher if the auditor is one of the Big 4 accounting firms (*BIG4*) or jointly auditing the client with another statutory auditor (*JOINT_AUDIT*). We also control for initial year audits (*INITIAL*). In emerging economies, organizational forms such as concentrated ownership and business groups are prevalent (Khanna and Palepu 1999; Khanna and Rivkin 2001). These organizational forms exercise significant control over managerial decision-making and can influence audit fees. Hence, we include controlling shareholders ownership (*CSO*) and business group affiliation (*BG*). Because institutional investors play a significant role in corporate governance (McCahery, Sautner, and Starks 2016), we control for institutional ownership (*IO*). Finally, following prior research (Kohlbeck and Mayhew 2017; Fang et al. 2018), we include industry and year fixed effects and cluster the standard errors by firm.

V. RESULTS

Descriptive Statistics

Table 1 reports descriptive statistics for our sample of 7,232 observations from 1,174 firms. Panel A presents the continuous variables, which are winsorized at the 1st and 99th percentiles. In untabulated results, we find that total RPTs are approximately 20 percent of total assets; as noted previously, this is much higher than numbers reported in studies using data from China.

Panel B presents the mean values of the binary variables. RPS (purchases) are present in approximately 79 (75) percent of the observations. Furthermore, 49 (26) percent of the observations disclose related party loans (borrowings) to (from) related parties. Related party guarantees given or taken are much less frequent (present in 21 and 6 percent of observations, respectively). Almost 20 percent of observations report selling assets and investments to related parties, and 44 percent of observations purchase assets and investments from related parties.

Transactions that are more likely to be expropriative, such as sales, lending, and guarantees given, are significantly higher than purchases, borrowings, and guarantees obtained.

Big 4 auditors audit 28 percent of observations in our sample. Although this proportion is much lower than those reported in the US or other developed countries, it is similar to proportions reported by prior studies using Indian data (e.g., Narayanaswamy et al. 2012). This figure confirms that the Big 4 auditors do not dominate the Indian audit market. In addition, 14 percent of observations are initial-year audits. This is primarily because mandatory auditor rotation was required by *The 2013 Act* for the first time during our sample period. More than one auditor audited approximately 7% of sample observations. Finally, consistent with prior research on Indian companies (e.g., Manos, Murinde, and Green 2012), more than half of the observations are affiliated with business groups.

Panel C reports yearly values of RPTs (based on the square root of the ratio of RPTs to total assets). These values are constant over the sample period so it appears that *The 2013 Act* did not have a significant impact on the relative magnitude of RPTs. In unreported results, we observe that in the last three years of our sample period, auditor characteristics differ from previous years. In 2017, 2018, and 2019, the proportion of clients with a Big 4 auditor was more than 30 percent, compared to an average of 26 percent in previous years. Additionally, initial year audits (*INITIAL*) rose to 64.9 percent in 2017, compared to a range of 5-10% in other years.[15] This is explained by the fact that *The 2013 Act* provided a five-year transition period for mandatory auditor rotation.

Regression Results

Panel A in Table 2 reports the results from regression analyses examining the effects of RPTs on audit fees. To address potential heteroskedasticity and autocorrelation problems,

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[15] To test the sensitivity of our findings to this change, we exclude the year 2017 from our sample and re-estimate the regression. Our inferences remain qualitatively similar to those reported.

we cluster the standard errors by firm. The overall model is statistically significant at p < 0.01, and the adjusted R^2 is 72 percent.

In model (1), we find that the coefficient on *RPT_SALES_Rs* is positive and significant (coefficient = 0.16, t-statistic = 3.61). The regression estimate indicates that when the value of RPS moves from the first quartile (0.02) to the third quartile (0.24), audit fees increase by 3.58 percent on average.[16] This is consistent with prior research that shows that firms engage in earnings manipulation activities using RPS of goods/services, increasing audit risk (Greiner et al. 2017). Transactions with greater risk require more audit effort because auditors mitigate risk through increased effort, resulting in higher audit fees. Our paper is the first to show an association between RPS and audit fees in the Indian context.

The coefficient on *RPT_PURCH_Rs* is not significant in the regression. Auditors likely consider these transactions as innocuous.

The coefficient on *RPT_LOANS_Rs* is positive and statistically significant (coefficient = 0.32, t-statistic = 4.24). The regression estimate indicates that when the value of loan RPTs moves from the first quartile (0.00) to the third quartile (0.12), this is associated with 3.91 percent higher audit fees.[17] Similarly, the coefficient on *RPT_FAINVPURCH_Rs* is positive and statistically significant. In contrast, the coefficients on *RPT_BORROWINGS_Rs*, *RPT_GUARGIV_Rs*, *RPT_GUARTKN_Rs*, and *RPT_FAINVSALES_Rs* are not significant.

Turning to the control variables, consistent with prior research, firm size and working capital are positively associated with audit fees. Leverage is negatively associated with audit fees, indicating that audit risk is lower for clients with higher debt in their capital structure. This is consistent with the literature on the monitoring role of debt (Gul and Tsui 2001). We find that liquidity (quick ratio) is negatively associated with audit fees, indicating that clients

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[16] $(e^{0.16 \times [0.24 - 0.02]} - 1) \times 100\% = 3.58\%$

[17] $(e^{0.32 \times [0.12 - 0]} - 1) \times 100\% = 3.91\%$

with greater liquidity pose a lesser audit risk. Audit fees are higher for firms audited by the Big 4 and by multiple statutory auditors. Finally, firms affiliated with business groups and those with high levels of controlling shareholders and institutional ownership pay higher audit fees.

Panel B presents the F-test results for differences in the coefficients in model (1) (Panel A). Overall, the results indicate that *RPT_SALES_Rs* and *RPT_LOANS_Rs* are the primary types of RPTs that heighten audit risk and hence lead to higher audit fees. In addition, the coefficients on *RPT_SALES_Rs* and *RPT_LOANS_Rs* are significantly different from each other.

In Table 3, we conduct individual tests to examine the effect of different types of RPTs on audit fees. Overall, the results support our main findings. Specifically, the coefficients on *RPT_SALES_Rs*, *RPT_PURCH_Rs*, *RPT_LOANS_Rs,* *RPT_GUARGIV_Rs,* *RPT_FAINVSALES_Rs*, and *RPT_FAINVPURCH_Rs* are positive and significant at $p < 0.05$.

The Impact of the Companies Act of 2013

The enactment of *The 2013 Act* marked a significant turning point for Indian companies, particularly regarding the regulatory framework pertaining to RPTs. *The 2013 Act* mandated listed Indian companies to disclose comprehensive details of RPTs along with justifications, while also imposing restrictions on certain potentially opportunistic transactions. It further required audit committee approval for all RPTs, followed by subsequent approval of the board of directors (unless the transactions were considered "ordinary" and conducted at arm's length). Additionally, *The 2013 Act* mandated that companies seek shareholder approval if RPTs were not conducted at arm's length.

There are two divergent perspectives regarding the impact of regulatory requirements like *The 2013 Act* on audit fees. First, this regulatory oversight limits opportunistic behavior due to improvements in reporting requirements and internal controls, and reduces information asymmetries because of closer monitoring by regulators. Boo and Sharma (2008) document

that stricter regulations act as a "partial substitute" for external auditing. Therefore, the extent of effort required from auditors should be lower. Thus, implementation of *The 2013 Act* may lead to lower audit risk and, therefore, lower audit fees.

Conversely, Fang et al. (2018) provide evidence that heightened regulatory oversight increases the likelihood of issuance of RPT-related modified audit opinions. Furthermore, like *SOX* in the US, *The 2013 Act* increased the liability for Indian auditors (by imposing monetary penalties, imprisonment up to one year, and class action lawsuits against the auditors in cases of audit-related violation). Prior research shows that audit fees in the US increased after the implementation of *SOX* (Griffin and Lont 2007; Ghosh and Pawlewicz 2009). Accordingly, *The 2013 Act* may lead to higher audit fees due to an increase in audit effort and liability because of the risks associated with RPTs.

Since *The 2013 Act* was implemented in 2014, we divide our sample period into two distinct periods: 2010 through 2013 (pre-CA2013) and 2014 through 2019 (post-CA2013). T-test results presented in Table 4 indicate that the average fees charged by the auditors during the post-CA2013 period were significantly higher than in the pre-CA2013 period. However, we do not observe a significant difference in the average value (based on the square root of the ratio of RPTs to total assets) of most RPTs between the pre-CA2013 and post-CA2013 periods. The exceptions are for *RPT_BORROWINGS_Rs*, *RPT_GUARTKN_Rs*, and *RPT_FAINVPURCH_Rs*.

We observe an increase in the number of initial-year audits in the later period, driven by *The 2013 Act*'s mandatory rotation requirements. *The 2013 Act* provided a five-year transition period for the mandatory auditor rotation requirement. We observe this in our data in 2017 when initial year audits (*INITIAL*) rose to 64.9 percent, compared to a range of 5-10% in other years. To test the sensitivity of our findings, we exclude the year 2017 from our sample and rerun the regression analyses; our results remain qualitatively similar to those reported in

the paper and our inferences continue to hold in such analysis. Finally, except for audit fees, although some of the other variables exhibit statistically significant differences between the two periods, the magnitude of the differences observed between the pre-CA2013 and post-CA2013 periods are relatively small. Audit fees are significantly higher in the post-CA2013 period.

Table 5 presents the results from regression analyses separately examining the effect of RPTs on audit fees during the pre-CA2013 and post-CA2013 periods. The striking result is that RPS are strongly associated with the audit fees in the post-CA2013 period (coefficient = 0.21, t-statistic = 3.97) but not in the pre-CA2013 period. In terms of economic significance, a movement in the value of RPS from the first quartile (0.02) to the third quartile (0.24) in the post-CA2013 period is associated with a 4.73 percent increase in audit fees.[18] Because RPS tend to be more complex and challenging to identify as 'opportunistic' compared to related party loans (Jiang et al. 2010), increased external pressure from the regulators and investors in the post-CA2013 period may have contributed to higher audit fees for RPS. However, in both the pre-CA2013 and post-CA2013 periods, there is a positive association between related party loans and audit fees.

Additional Analyses

The effect of RPTs on audit fees before and after *The 2013 Act* can vary due to firm-specific factors. Hence, we further partition the data into subsamples based on client size, auditor type, and business group affiliation.

Client Size. Larger firms tend to have larger and more complex RPTs, which would require more audit effort. Additionally, Hwang, Chiou, and Wang (2013) show that larger firms have stronger incentives to manage earnings using RPTs than smaller firms. Conversely, larger firms are under greater scrutiny from the press and regulators. Therefore, it is an empirical

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[18] $(e^{0.21 \times [0.24 - 0.02]} - 1) \times 100\% = 4.73\%$

question whether the relation between RPTs and audit fees differs based on firm size. We partition our sample into large firms (with total assets greater than the median value) and small firms (with total assets smaller than or equal to the median value) to examine whether the relation between RPTs and audit fees differs for large and small clients before and after *The 2013 Act*. Consistent with findings presented in Table 5, in untabulated results we find a strong positive association between RPS and audit fees for both the small and large client subsamples in the post-CA2013 period, but not in the pre-CA2013 period.

Auditor Type. We next partition the sample based on auditor type (i.e., Big 4 or not) and examine whether the relation between RPTs and audit fees varies for Big 4 versus non-Big 4 audit clients before and after *The 2013 Act*. As with the client size-based partitions, there is a significant and positive association between RPS and audit fees for both Big 4 and non-Big 4 clients in the post-CA2013 period, but not in the pre-CA2013 period.

Business Group Affiliation. Bertrand et al. (2002) document that controlling shareholders of business group-affiliated firms are more likely to engage in tunneling. Hence, the association between RPTs and audit fees may differ for standalone versus business group-affiliated firms. We classify our sample into standalone (non-BG) and business group-affiliated (BG) subsamples and examine whether the impact of RPTs on audit fees differs for BG versus non-BG firms before and after *The 2013 Act*. As with the other partitions, we find a significant association between RPS and audit fees in both types of firms in the post-CA2013 period, but not in the pre-CA2013 period.

Auditor Resignations

Higher audit fees are one of the ways in which auditors can react to RPTs. Other possible auditor actions include resignations, increasing the likelihood of issuing going-concern modified audit opinions (GCOs), or increasing adverse internal control opinions. As part of additional analysis, we examine if auditors are more likely to resign from engagements

in the presence of different types of RPTs. We do not examine changes in GCOs and internal control opinions because these data are not available in the Indian corporate databases. Narayanaswamy et al. (2012, 595) examine 323 of the *BSE500* firms (i.e., companies included in the Bombay Stock Exchange Index) using hand-collected data and note: "none of the firms had any internal control weakness disclosure. Furthermore, in our extensive experience with annual reports of Indian public companies, we have not come across any mention of weaknesses in internal control systems." Although we have seen adverse internal control opinions and GCOs in more recent years, modified audit opinions continue to be quite rare in India.

Discussions with audit partners indicate that auditor resignations would be less likely to occur late in the fiscal year, but would be much more likely to occur after the prior year's audit has been completed. Therefore, any resignations occurring because of risks associated with RPTs would be driven by the prior year's RPTs. Accordingly, we use the following logistic regression model to estimate the association between (lagged) RPTs and auditor resignations:[19]

$$RESIGN_{it} = \beta_0 + \beta_1 RPT\_SALES\_Rs_{it-1} + \beta_2 RPT\_PURCH\_Rs_{it-1}$$

$$+ \beta_3 RPT\_LOANS\_Rs_{it-1} + \beta_4 RPT\_BORROWINGS\_Rs_{it-1}$$

$$+ \beta_5 RPT\_GUARGIV\_Rs_{it-1} + \beta_6 RPT\_GUARTKN\_Rs_{it-1}$$

$$+ \beta_7 RPT\_FAINVSALES\_Rs_{it-1} + \beta_8 RPT\_FAINVPURCH\_Rs_{it-1}$$

$$+ \beta_9 SIZE_{it-1} + \beta_{10} LEV_{it-1} + \beta_{11} LOSS_{it-1} + \beta_{12} SALESGROWTH_{it-1}$$

$$+ \beta_{13} ROA_{it-1} + \beta_{14} BIG4_{it-1} + \beta_{15} ABN\_LNAF_{it-1} + \beta_{16} TENURE_{it-1}$$

$$+ Industry\ Fixed\ Effects\ + Year\ Fixed\ Effects + error \qquad (2)$$

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[19] The use of lagged independent variables for models with auditor resignation as the dependent variable is common practice in audit research; see, for example, Krishnan, Sun, Wang, and Yang (2013) and Bryan and Mason (2020).

The dependent variable, *RESIGN*, is a binary variable indicating whether an auditor resigns or retains the client in the following year. It takes the value of 1 if the auditor resigns in the subsequent year, 0 otherwise. Following prior studies on auditor resignation, we include client size (*SIZE*), leverage (*LEV*), profitability (*LOSS* and *ROA*), sales growth (*SALESGROWTH*), auditor type (*BIG4*), abnormal audit fees (*ABN_LNAF*), and tenure (*TENURE*) as control variables (Krishnan et al. 2013; Bryan and Mason 2020). *LOSS* is a dummy variable that takes the value of 1 if net income is less than zero, and 0 otherwise. Additionally, we define sales growth (*SALESGROWTH*) as the increase in sales from the previous year, and define tenure (*TENURE*) as the natural logarithm of the number of years to date the auditor has audited the firm. The remaining variables in Equation (2) are defined similarly to those in Equation (1). Consistent with Krishnan et al. (2013), abnormal fees are the residuals from estimating Equation (1).

Table 6 presents the results from estimating two logistic regressions, one for the pre-CA2013 period and one for the post-CA2013 period. The results show that the coefficient on *Lag_RPT_SALES_Rs* is positive and significant in the latter period, but not in the former period. Hence, auditors are more likely to resign from client engagements in the presence of high values of RPS in the post-CA2013 period. This finding is consistent with our earlier results that audit fees are associated with RPS in the post-CA2013 period, but not in the pre-CA2013 period.

Audit Effort

Higher audit fees could arise due to increased audit effort, heightened audit risk, or both. Some prior studies use measures such as audit hours or audit report lag to differentiate between audit effort and audit risk (Jiang and Son 2015; Niemi 2002). In fact, many studies using data from the US and some other countries use audit report lag to proxy for audit effort

(Knechel and Payne 2001). However, data regarding audit effort, such as audit hours or audit report lag, are not available in the Indian corporate databases.

One of the authors, who currently serves on the audit committee of a large Indian bank, had discussions with four audit partners to gain additional insights about the effects of RPTs on the auditing process.[20] Table 7 describes the findings from these discussions with audit partners. The partners are from two Big 4 audit firms and two non-Big 4 firms; each of the non-Big 4 firms has more than 10 Indian public company audit clients.[21]

All four partners indicated that their firm's audit procedures formally require that auditors actively test for the presence of RPTs in every audit of public companies. We asked about the extent to which audit procedures increase in the presence of different types of RPTs using a scale of 1 to 10, where 1 indicates very little or no increase in audit procedures, and 10 indicates a very substantial increase in audit procedures. The table shows that there were only minor variations across different types of RPTs, except for in the case of the second non-Big 4 firm. In contrast, our empirical results show that audit fees increase significantly in the presence of RPS but not for most other types of RPTs.

We also asked the audit partners about the effects of *The 2013 Act* on audit procedures related to RPTs. Specifically, we asked: "On a scale of 1 to 10, how did *The Companies Act of 2013* impact the audit effort for related party transactions? (Please use a scale of 1 to 10, where 1 indicates very little or no increase in audit effort, and 10 indicates a very substantial increase in audit effort)." The responses were 8 and 7 for the two Big 4 firms, and 10 and 8 for the two non-Big 4 firms. These responses corroborate the results from our archival analyses: *The 2013 Act* led to increases in audit effort and, hence, audit fees in the presence of RPTs.

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[20] These discussions are part of a broader project dealing with Corporate Governance in India for which the last author obtained an "exempt" category certification from his University's Institutional Review Board.

[21] The conversations were on the telephone and the audit partners were known to the author. The questions were pilot-tested with another auditor prior to these discussions.

VI. SUMMARY AND CONCLUSIONS

Related party transactions (RPTs) pose significant challenges to auditors because of the complexity involved in identifying related parties and reliance on managerial disclosure of RPTs. Due to these challenges and the potential of RPTs to be used for opportunistic purposes (i.e., earnings manipulation and the transfer of wealth between related parties), the presence of RPTs significantly increases audit risk. This study examines the impact of various types of RPTs on audit fees in Indian firms. This evidence is particularly interesting given the increasing importance of India in the global economy and the prevalence of RPTs in emerging economies in general.

Using data from 1,174 Indian firms, comprising 7,232 observations, from 2010 through 2019, we find consistent evidence that RPS are associated with higher audit fees after the implementation of *The 2013 Act*, suggesting that the new law increased how much effort auditors put into auditing some types of RPTs. Evidence suggests that *The 2013 Act* increased the cost of auditing RPTs in terms of potential penalties and lawsuits. Therefore, the regulations may have been necessary to incentivize auditors to audit RPTs more rigorously. Our conclusion, which is consistent with views in Narayanaswamy et al. (2012), is that the market for audit services is not very efficient in India because the market mechanism alone does not effectively motivate auditors to protect the public. That is, the "public good" side of the audit is not priced in the absence of a legislative and/or regulatory mandate. Therefore, Indian policymakers responded by increasing the audit committee's responsibility for approving and monitoring RPTs. To the extent audit committees in turn required more work from auditors (given their dependence on external auditors to provide greater assurance on RPTs) this led to auditors spending more effort on audits of RPTs.[22]

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[22] We thank an anonymous reviewer suggesting these linkages.

The alternative view is that the new law added costs in the form of more effort around RPTs with no corresponding benefits. The failure of Satyam and the government's response suggest a perceived problem related to RPTs needed to be addressed. Because the government effectively transferred responsibility related to the approval and monitoring of RPTs to audit committees (and, thus, to the auditor), it follows that the auditor would increase audit work related to RPTs, leading to higher audit fees. The higher auditor resignation rate in the post-2013 period suggests that auditors perceived greater risk.

In additional analyses, we find that for various sub-groups (when the full sample is partitioned based on company size, auditor type, and business group affiliation) the association between RPS and audit fees continues to remain significant in the post-CA2013 period. Overall, the results are consistent with prior research that shows that RPS are used for propping up earnings (Jian and Wong 2010) and for transferring wealth (Jiang et al. 2010) in emerging economies. Therefore, RPTs can serve as "red flags" for auditors (Kohlbeck and Mayhew 2017). The results also reinforce the notion that researchers examining issues related to RPTs should distinguish between the different types of RPTs.

Our findings on the association between RPTs and audit fees differ from results reported for the US and other countries such as China. As such, they reinforce Narayanaswamy et al. (2012, 2021)'s point about the unique aspects of Indian corporate governance and the need for caution when generalizing findings across countries.

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Table 1. Descriptive Statistics.

(N = 7,232)

Panel A: Continuous variables

Variable	Mean	St. Dev.	Q1	Q2	Q3
LNAF	14.24	1.25	13.43	14.29	15.07
RPT_SALES_Rs	0.17	0.20	0.02	0.10	0.24
RPT_PURCH_Rs	0.13	0.16	0.00	0.07	0.19
RPT_LOANS_Rs	0.08	0.13	0.00	0.00	0.12
RPT_BORROWINGS_Rs	0.04	0.09	0.00	0.00	0.01
RPT_GUARGIV_Rs	0.06	0.16	0.00	0.00	0.00
RPT_GUARTKN_Rs	0.03	0.12	0.00	0.00	0.00
RPT_FAINVSALES_Rs	0.02	0.05	0.00	0.00	0.00
RPT_FAINVPURCH_Rs	0.05	0.08	0.00	0.00	0.07
SIZE	9.34	1.43	8.33	9.23	10.29
WORKING_CAPITAL	0.36	0.19	0.22	0.34	0.49
LEV	0.31	0.26	0.12	0.28	0.44
QUICK	0.83	0.79	0.37	0.63	0.98
ROA	0.04	0.09	0.002	0.03	0.08
CSO	0.55	0.15	0.46	0.56	0.67
IO	0.12	0.13	0.01	0.07	0.19

Panel B: Dichotomous variables

Variable	Mean
BIG4	0.28
INITIAL	0.14
JOINT_AUDIT	0.07
BG	0.57
RPT_SALES	0.79
RPT_PURCH	0.75
RPT_LOANS	0.49
RPT_BORROWINGS	0.26
RPT_GUARGIV	0.21
RPT_GUARTKN	0.06
RPT_FAINVSALES	0.20
RPT_FAINVPURCH	0.44

Panel C: Yearly average (square root of ratio of RPTs to total assets)

Variable	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Number of firms	607	624	678	690	707	768	788	804	880	686
RPT_SALES_Rs	0.17	0.17	0.17	0.17	0.17	0.17	0.17	0.17	0.16	0.17
RPT_PURCH_Rs	0.14	0.14	0.13	0.12	0.13	0.12	0.12	0.13	0.13	0.13
RPT_LOANS_Rs	0.06	0.08	0.10	0.08	0.08	0.08	0.08	0.08	0.08	0.08
RPT_BORROWINGS_Rs	0.02	0.03	0.04	0.04	0.04	0.04	0.04	0.05	0.05	0.05
RPT_GUARGIV_Rs	0.05	0.06	0.06	0.06	0.06	0.07	0.07	0.07	0.07	0.06
RPT_GUARTKN_Rs	0.01	0.01	0.02	0.03	0.03	0.03	0.03	0.03	0.03	0.03
RPT_FAINVSALES_Rs	0.02	0.02	0.02	0.02	0.01	0.02	0.01	0.01	0.01	0.02
RPT_FAINVPURCH_Rs	0.05	0.06	0.05	0.05	0.05	0.05	0.04	0.04	0.04	0.05

Note. This table presents the descriptive statistics of continuous variables in Panel A, dichotomous variables in Panel B, and the yearly average of RPTs (square root of the ratio of RPTs to total assets) in Panel C. The variables are defined in Appendix 1. N = Number of observations; St. Dev. = Standard deviation; Q1 = 25th Percentile; Q2 = Median; Q3 = 75th Percentile.

Table 2. Audit Fees and Related Party Transactions.

Panel A: Regression Analysis

DV: *LNAF*

	(1)	
Variable	**Coeff.**	**t-stat.**
RPT_SALES_Rs	0.16	3.61***
RPT_PURCH_Rs	0.04	0.63
RPT_LOANS_Rs	0.32	4.24***
RPT_BORROWINGS_Rs	-0.03	-0.25
RPT_GUARGIV_Rs	0.04	0.68
RPT_GUARTKN_Rs	0.06	0.88
RPT_FAINVSALES_Rs	0.29	1.60
RPT_FAINVPURCH_Rs	0.22	2.13**
SIZE	0.53	62.88***
WORKING_CAPITAL	0.15	2.79***
LEV	-0.27	-5.54***
QUICK	-0.09	-7.29***
ROA	0.17	1.44
BIG4	0.68	38.16***
INITIAL	-0.05	-1.72*
JOINT_AUDIT	0.20	6.69***
CSO	0.18	2.75***
BG	0.08	4.39***
IO	0.93	10.51***
Constant	8.55	93.25***
Industry Fixed Effects	Yes	
Year Fixed Effects	Yes	
Std. Error Clustered	Yes	
Observations	7,232	
Adjusted R2	0.72	
F Statistic	328.90***	

Panel B. F-tests for coefficient differences in model (1).

RPT_SALES_Rs. – RPT_PURCH_Rs. = 0	0.12
RPT_SALES_Rs. – RPT_LOANS_Rs. = 0	<0.01
RPT_SALES_Rs. – RPT_BORROWINGS_Rs. = 0	0.06
RPT_SALES_Rs. – RPT_GUARGIV_Rs. = 0	0.10
RPT_SALES_Rs. – RPT_GUARTKN_Rs. = 0	0.20
RPT_SALES_Rs. – RPT_FAINVSALES_Rs. = 0	0.49
RPT_SALES_Rs. – RPT_ FAINVPURCH_Rs. = 0	0.58
RPT_LOANS_Rs. – RPT_PURCH_Rs. = 0	<0.01
RPT_LOANS_Rs. – RPT_BORROWINGS_Rs. = 0	0.07
RPT_LOANS_Rs. – RPT_GUARGIV_Rs. = 0	<0.01
RPT_LOANS_Rs. – RPT_GUARTKN_Rs. = 0	<0.01
RPT_LOANS_Rs. – RPT_FAINVSALES_Rs. = 0	0.85
RPT_LOANS_Rs. – RPT_ FAINVPURCH_Rs. = 0	0.44

Note. Panel A presents the results from regression analyses where *LNAF* is the dependent variable. Standard errors are clustered by firm. ***, **, and * indicate statistical significance at the 1%, 5%, and 10% levels (two-tailed), respectively. The variables are defined in Appendix 1. DV = dependent variable; *LNAF* = natural logarithm of audit fees. Panel B presents the F-tests for coefficient differences in model (1).

Table 3. RPTs and Audit Fees.

DV: *LNAF*

Variable	(1)		(2)		(3)		(4)		(5)		(6)		(7)		(8)	
	Coeff.	t-stat.	Coeff.	t-stat.	Coeff.	t-stat.	Coeff.	t-stat.	Coeff.	t-stat.	Coeff.	t-stat.	Coeff.	t-stat.	Coeff.	t-stat.
RPT_SALES_Rs	0.20	4.65***														
RPT_PURCH_Rs			0.14	2.47**												
RPT_LOANS_Rs					0.36	4.98***										
RPT_BORROWINGS_Rs							0.02	0.15								
RPT_GUARGIV_Rs									0.14	2.46**						
RPT_GUARTKN_Rs											0.08	1.22				
RPT_FAINVSALES_Rs													0.48	2.80***		
RPT_FAINVPURCH_Rs															0.33	3.17**
Control Variables	Included		Included		Included		Included		Included		Included		Included		Included	
Industry Fixed Effects	Yes		Yes		Yes		Yes		Yes		Yes		Yes		Yes	
Year Fixed Effects	Yes		Yes		Yes		Yes		Yes		Yes		Yes		Yes	
Std. Error Clustered	Yes		Yes		Yes		Yes		Yes		Yes		Yes		Yes	
Observations	7,232		7,232		7,232		7,232		7,232		7,232		7,232		7,232	
Adjusted R2	0.72		0.72		0.72		0.72		0.72		0.71		0.72		0.72	
F Statistic	358.60***		357.40***		359.20***		357.00***		357.50***		357.10***		357.50***		357.70***	

Note. This table presents the results from regression analyses where *LNAF* is the dependent variable. Standard errors are clustered by firm. ***, **, and * indicate statistical significance at the 1%, 5%, and 10% levels (two-tailed), respectively. The variables are defined in Appendix 1. DV = dependent variable; *LNAF* = natural logarithm of audit fees.

Table 4. Univariate Test – Pre Vs. Post Companies Act 2013.

Variable	Mean		*p*-value
	Pre-CA2013 (N = 2,599)	**Post-CA2013 (N = 4,633)**	
LNAF	2.78	3.60	<0.01
RPT_SALES_Rs	0.17	0.17	0.87
RPT_PURCH_Rs	0.13	0.13	0.12
RPT_LOANS_Rs	0.08	0.08	0.88
RPT_BORROWINGS_Rs	0.03	0.04	<0.01
RPT_GUARGIV_Rs	0.06	0.07	0.02
RPT_GUARTKN_Rs	0.02	0.03	<0.01
RPT_FAINVSALES_Rs	0.02	0.01	0.03
RPT_FAINVPURCH_Rs	0.05	0.04	<0.01
SIZE	9.29	9.37	0.01
WORKING_CAPITAL	0.36	0.36	0.98
LEV	0.33	0.30	<0.01
QUICK	0.82	0.84	0.29
ROA	0.04	0.03	<0.01
BIG4	0.27	0.29	0.04
INITIAL	0.06	0.18	<0.01
JOINT_AUDIT	0.08	0.06	<0.01
CSO	0.54	0.55	<0.01
BG	0.61	0.55	<0.01
IO	0.12	0.12	0.94

Note. This table presents the results from univariate analyses (*t*-test) between the Pre-CA2013 and Post-CA2013 subsamples. Because most Indian public companies follow the April-March reporting period, we denote the period from April 1, 2013, to March 31, 2014, as 'year 2013'. Years up to 2013 are referred to as Pre-CA2013, and years following 2013 are denoted as Post-CA2013. The variables are defined in Appendix 1. N = Number of observations.

Table 5. Audit Fees Analyses: Pre Vs. Post Companies Act 2013.

DV: *LNAF*

	Pre-CA2013 (1)		Post-CA2013 (2)	
	Coeff.	**t-stat.**	**Coeff.**	**t-stat.**
RPT_SALES_Rs	0.08	0.97	0.21	3.97***
RPT_PURCH_Rs	0.05	0.47	0.01	0.16
RPT_LOANS_Rs	0.34	2.97***	0.32	3.20***
RPT_BORROWINGS_Rs	-0.08	-0.43	0.01	0.07
RPT_GUARGIV_Rs	0.18	1.77*	-0.03	-0.36
RPT_GUARTKN_Rs	-0.12	-0.99	0.13	1.55
RPT_FAINVSALES_Rs	0.32	1.14	0.23	1.01
RPT_FAINVPURCH_Rs	0.04	0.22	0.33	2.61***
Control Variables	Included		Included	
Industry Fixed Effects	Yes		Yes	
Year Fixed Effects	Yes		Yes	
Std. Error Clustered	Yes		Yes	
Observations	2,599		4,633	
Adjusted R^2	0.70		0.73	
F Statistic	127.50***		237.20***	

Note. This table presents the results from regression analyses where *LNAF* is the dependent variable. Our sample is classified into Pre-CA2013 (model 1) and Post-2013 subsamples (model 2). Because most Indian public companies follow the April-March reporting period, we denote the period from April 1, 2013, to March 31, 2014, as 'year 2013'. Years up to 2013 are referred to as Pre-CA2013, and years following 2013 are denoted as Post-CA2013. Standard errors are clustered by firm. ***, **, and * indicate statistical significance at the 1%, 5%, and 10% levels (two-tailed), respectively. The variables are defined in Appendix 1. DV = dependent variable; *LNAF* = natural logarithm of audit fees.

Table 6. Auditor Resignations: Pre Vs. Post Companies Act 2013

DV: *RESIGN*

	Pre-CA2013 (1)		Post-CA2013 (2)	
	Coeff.	Chi-sq.	Coeff.	Chi-sq.
Lag_RPT_SALES_Rs	0.98	0.56	1.01	4.05**
Lag_RPT_PURCH_Rs	0.02	0.00	-0.96	1.23
Lag_RPT_LOANS_Rs	3.15	2.36	-0.49	0.28
Lag_RPT_BORROWINGS_Rs	-1.74	0.12	1.03	1.09
Lag_RPT_GUARGIV_Rs	-3.98	0.87	-0.75	0.78
Lag_RPT_GUARTKN_Rs	3.73	4.31**	1.07	3.34*
Lag_RPT_FAINVSALES_Rs	-2.90	0.15	-1.92	0.31
Lag_RPT_FAINVPURCH_Rs	1.95	0.26	-5.98	5.30**
Lag_SIZE	-0.05	0.03	-0.02	0.03
Lag_LEV	-1.11	0.27	0.93	3.65*
Lag_LOSS	-0.18	0.03	0.06	0.04
Lag_SALESGROWTH	-0.71	0.34	-0.79	4.24**
Lag_ROA	-3.91	0.41	-0.92	0.29
Lag_BIG4	-0.27	0.09	-0.22	0.56
Lag_ABN_LNAF	-0.86	4.70**	0.05	0.11
Lag_TENURE	-0.93	1.50	-0.43	6.45**
Constant	-38.32	0.00	-3.07	8.90***
Industry Fixed Effects	Yes		Yes	
Year Fixed Effects	Yes		Yes	
Observations	1,629		4,030	
Wald Chi-sq.	42.40***		65.00***	
Pseudo R^2	0.28		0.11	

Note. This table presents the results from regression analyses where *RESIGN* is the dependent variable. Our sample is classified into Pre-CA2013 (model 1) and Post-2013 subsamples (model 2). Because most Indian public companies follow the April-March reporting period, we denote the period from April 1, 2013, to March 31, 2014, as 'year 2013.' Years up to 2013 are referred to as Pre-CA2013, and years following 2013 are denoted as Post-CA2013. Standard errors are clustered by firm. ***, **, and * indicate statistical significance at the 1%, 5%, and 10% levels (two-tailed), respectively. The variables are defined in Appendix 1. DV = dependent variable; *RESIGN* = 1 if the auditor resigns in the subsequent year, 0 otherwise.

Table 7. Responses from Discussions with Audit Partners

Item	Question	Response from			
		B1	**B2**	**NB1**	**NB2**
1	Do your firm's audit procedures formally require that auditors actively test for the presence of RPTs in every audit of public companies	Yes	Yes	Yes	Yes
2	Do your audit procedures for public companies vary depending on whether or not RPTs exceed some materiality threshold?	Yes	Yes	No	Yes
3	What proportion of public companies audited by your audit firm have RPTs, irrespective of materiality (your best estimate)?				
	- Less than 10%				
	- 10%-24%				
	- 25-49%				
	- 50% and more	x	x	x	x
4	What proportion of public companies audited by your audit firm have RPTs exceeding the materiality threshold (your best estimate)?				
	- Less than 10%				x
	- 10%-24%		x		
	- 25-49%	x		x	
	- 50% and more				
5	Assume that in each of the following instances, the RPTs for each type of transaction exceed the materiality limit. In such instances, to what extent do your audit procedures increase in the presence of each of the following types of RPTs (please use a scale of 1 to 10, where 1 indicates very little or no increase in audit procedures, and 10 indicates a very substantial increase in audit procedures):				
	- Sales to Related Parties:	10	7	10	5
	- Purchases from Related parties	10	7	10	5
	- Investments from/in related parties	10	6	10	10
	- Guarantees from/to related parties	10	6	10	10
6	On a scale of 1 to 10, how did *The Companies Act of 2013* impact the audit effort for related party transactions? (Please use a scale of 1 to 10, where 1 indicates very little or no increase in audit effort, and 10 indicates a very substantial increase in audit effort):	8	7	10	8

7	How does your interaction with the audit committee (and/or the board) change in the presence of RPTs:				
	- *More meetings during the year and longer meetings*			x	
	- *Longer meetings (without more meetings)*	x			
	- *Little/no change in interaction with the audit committee/board*		x		x

Note: This table presents the results from discussions with four audit partners (one from each firm). B1 and B2 refer to two of the Big 4 firms, and NB1 and NB2 refer to two non-Big 4 firms.

Appendix 1. Variable Definition.

Variable	Description
LNAF	Natural logarithm of audit fees paid to the auditors
RPT_SALES	1 if the RPS of goods and services are more than zero, 0 otherwise.
RPT_PURCH	1 if the related party purchases of goods and services are more than zero, 0 otherwise.
RPT_LOANS	1 if the related party loans are more than zero, 0 otherwise.
RPT_BORROWINGS	1 if the related party borrowings are more than zero, 0 otherwise
RPT_GUARGIV	1 if the related party guarantees given are more than zero, 0 otherwise.
RPT_GUARTKN	1 if the related party guarantees taken are more than zero, 0 otherwise.
RPT_FAINVSALES	1 if the RPS of assets and investments are more than zero, 0 otherwise.
RPT_FAINVPURCH	1 if the related party purchases of assets and investments are more than zero, 0 otherwise
RPT_SALES_Rs	Square-root of the ratio of RPS of goods and services to total assets
RPT_PURCH_Rs	Square-root of the ratio of related party purchases of goods and services to total assets
RPT_LOANS_Rs	Square-root of the ratio of related party loans to total assets
RPT_BORROWINGS_Rs	Square-root of the ratio of related party borrowings to total assets
RPT_GUARGIV_Rs	Square-root of the ratio of related party guarantees given to total assets
RPT_GUARTKN_Rs	Square-root of the ratio of related party guarantees taken to total assets
RPT_FAINVSALES_Rs	Square-root of the ratio of RPS of assets and investments to total assets
RPT_FAINVPURCH_Rs	Square-root of the ratio of related party purchases of assets and investments to total assets
SIZE	Natural logarithm of total assets (measured in millions of Indian rupees)
WORKING_CAPITAL	Total working capital divided by total assets
LEV	Total debt divided by total assets
QUICK	Current assets minus inventories divided by current liabilities at the end of the current year
ROA	Net income divided by total assets of the previous year
BIG4	1 if the firm is audited by one of the big four firms, 0 otherwise
INITIAL	1 if it is a first-year audit (initial year), 0 otherwise
JOINT_AUDIT	1 if more than one statutory auditor audits the firm, 0 otherwise
CSO	The proportion of controlling shareholders' ownership
BG	1 if the firm is affiliated with a business group, 0 otherwise
IO	The proportion of institutional ownership
RESIGN	1 if the auditor resigns in the subsequent year, 0 otherwise
LOSS	1 if the net income is less than zero, 0 otherwise
SALESGROWTH	Increase in sales from the previous year
ABN_LNAF	Residual value estimated from Equation (1).
TENURE	Natural logarithm of the number of years the auditor audited the firm