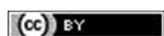


Political Connection, Auditor Selection, Audit Fee & Audit Report Lag : A Review in Indonesia

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Abstract - This study aims to explore the political connection regarding three auditing issues which are auditor selection, audit fee and audit report lag. We collect and analyze articles related to the topics published from 1997 to 2018. Based on the literature review, I found that connected firms in Indonesia tend to choose non big 4 auditor and pay greater audit than their non-connected peers. I also found that connected firms in Indonesia have a longer audit report which commonly due to tunneling through related party transactions, therefore the auditor assessed that there is a higher risk related to those firms so that more efforts are needed in the audit process. For further research, I suggest to explore the relationship between companies that have political connections with audit quality and audit fees using the effectiveness of the BoC and AC as moderating variables.

Keywords - *Political Connection, Audit, Auditor Selection, Audit Fee, Audit Report Lag.*

I. INTRODUCTION

Previous researchers (Shleifer & Vishny, 1994; Fisman, 2001; Acemoglu & Jhonson, 2005; Khwaja & Mian, 2005; Faccio, 2006; Gul, 2006; Fan et al, 2007; Bukanwanicha & Wiwattanakantang, 2009; Berkman, Cole & Fu, 2010) found that political connections emerged in countries with weak legal protection. Goldman, Rocholl & So (2009) later found that political connections were also found in developed countries such as the United States (Wong & Hooy, 2018).

From the perspective of politicians, the Government needs the support of business people to achieve their political goals or to achieve socio-economic goals (Shleifer and Vishny, 1998). Politicians need resources to support campaigns or fundraising during the election period (Miettinen and Poutvaara, 2014), to stabilize the regime and keep them in power (Choi and Thum, 2009), and share the Government's burden, such as reducing unemployment (Wu, Wu & Rui, 2012) in Habib et al., (2018).

From the company perspective, there are many benefits that can be obtained from the existence of political connections, such as privileged access to creditors (Faccio,

2006; Johnson & Milton, 2003; Khwaja and Mian, 2005; Leuz and Oberholzer-Gee, 2006), low debt costs (Boubakri et al., 2012; Houston et al., 2014), the high probability of getting a bail out (Faccio, Masulis & McConnell, 2006); get a favorable Government contract (Goldman, Rocholl & So, 2009); regulations that emphasize the company (Goldman et al., 2009); not too strict supervision (Faccio, 2006) and import rates (Goldman et al., 2009) in (Habib et al., 2018).

Regardless of the benefits to the company, political connections are seen as harming minority shareholders because they can lead to high agency costs (Khan et al., 2016), rent-seeking activities (Frye & Shleifer, 1997), tunneling (Qian et al., 2011) and earnings management (Chaney et al., 2011). The negative impact of these political connections made companies with political connections in public attention and public supervision more stringent when compared to companies that did not have political connections (Chaney et al., 2011).

Effort to reduce the risk of expropriation of minority shareholders is through audits by independent parties (Newman, Patterson & Smith, 2005). Gul et al., (2003) and Khan et al (2016) found that audits can reduce agency costs and even audit moderate relations between political

connections and agency costs. On the other hand Khan, Mihret & Muttakin (2016) states that auditor selection can help management companies that have political connections in providing signals about the reliability of management in providing information.

Research that studies about auditing in companies that have political connections to date provides different results. Referring to this condition, I conduct this study to explore the connection among auditor selection, fee audit and audit report lag in companies that have political connections, especially in Indonesia.

II. RESEARCH METHOD

This research is a literature review by examining articles related to the topic published from 1997 to 2018. The discussion of various literature will be presented in several sections as explained later.

III. LITERATURE REVIEW AND DISCUSSION

III.1. Audit Needs in Indonesia

The Limited Liability Company Law No. 40 of 2007 requires certain types of companies to be audited by Public Accountants' Offices, such as listed companies, companies, companies with activities to collect and manage public funds, companies that issue bonds to the public, companies that have assets or sales more than Rp.50 billion (fifty billion rupiah) and certain companies are required to be audited by the applicable provisions. Capital Market Law No.8 of 1995 requires registered companies to issue annual reports within 90 calendar days after the end of the year and certain reports required by Bapepam-LK. Even listed companies are also required to submit semester financial reports to Bapepam-LK in 30 days for unaudited, 60 days for review and 90 days for those audited. Bank Indonesia Regulation Np.3/22/PBI/2001 requires banks to prepare and report semester and annual financial reports in 60 days and 4 months respectively and both of them have been audited.

The financial statements must be audited in accordance with the applicable audit standards in Indonesia, which is almost the same as the audit standards generally accepted in the United States (Basioudis & Fifi, 2004). In giving opinions on the fairness of the client's financial statements, the auditor refers to the GAAP as well as applicable domestic regulations and regulations. For matters that are not included in 2 (two) standards, the auditor refers to the International Accounting Standards (Main & Main, 2014). Regulation No. 423/KMK.06/2002 requires public accountants and accounting firm to comply with the ethical

and technical standards issued by IAI. Even to avoid conflicts of interest, public accountants are not justified in occupying executive positions in government, government-owned companies and certain other entities (Muhammadi, 2016).

Auditing also plays an important role in encouraging and protecting investor rights through the detection of expropriation by parties within the company (Newman, Patterson & Smith, 2005) while providing benefits to management through signals regarding the reliability of management in providing information. The decision to appoint a particular auditor is a crucial element that is influenced by various factors in the company while the auditor's decision (accounting firm) to accept the engagement of a client who has a political connection is part of the results of the accounting firm risk assessment.

Audit risk is the risk of giving an opinion that is not in accordance with the conditions of the company's financial statements (Tuanakotta, 2013). One type of audit risk is the inherent risk inherent in the company. One form of inherent risk is the risk associated with fraud committed by management (Tuanakotta, 2013).

III.2. Political connection

a. Definition

Political connections can be defined as social relations which include conspiracy to obtain authority or power. The purpose of political connections can be explained by resource dependence theory which states that one of the ways companies can reduce the uncertainty of the external environment is to build political connections (Pfeffer and Salancik, 1978; Hillman and Dalziel, 2003) that will give companies more definite resources such as relations with the Government, guidance and experience. Faccio (2010) and Mitchell & Joseph (2010) in stating that political connections are valuable assets because companies can minimize external risks, especially in developing countries (Wong & Hong, 2018).

One part of politics is political parties (Wulandari & Raharja, 2013). Mietzner (2007) found that the majority of Indonesian political parties depend on state subsidies and donations from the business world because only a small proportion of party expenditures can be financed by members' contributions and internal party donations (Muhammadi, 2016).

The enactment of Law Number 2 of 2011 Article 34 and 35 which regulates financial resources and the maximum contribution limit for political parties illustrates that one of

the sources of political party finance is a contribution from a company and/or business entity. Ethics reciprocity is still thick in Indonesia give the view that donations given by companies to political parties are not free. Profit-oriented companies expect reciprocity or benefits derived from these donations. From the relationship between companies and political parties, the term "politically connected" company appears (Wulandari & Raharja, 2013).

The definition and measurement of political connections in the majority of research refers to the results of research conducted by Faccio (2006), namely one of the largest shareholders (at least 10% of voting rights) or one of the company's top officials (CEO, Commissioner, Directors, Secretary), Ministers or close relations with top politicians or political parties. The definition of close relationships includes: a) company whose extraction or shareholders are known (via the media) has a friendship relationship with the head of state, local government, minister or member of parliament. b) friendship with former head of region, head of state and or Minister c) Friendship with outside state politicians (foreign politicians) d). Other relationships found in previous studies (Gomez & Jomo, 1997; Jhonson and Milton 2003).

b. Conditions of Political Connections in Indonesia

Muhammadi (2016) stated that Indonesia has interesting conditions in research related to political connections because political connections play a dominant role in determining the value of the company. Fisman (2001) found that firm value is strongly influenced by political connections. By using event study on rumors of President Suharto's health from 1995 to 1997, she found that returns shares of companies that have a close relationship with President Suharto are significantly lower than companies that do not have connections.

Leuz and Oberholzer-Gee (2006) found that the performance volatility of companies that have political connections increases with the closeness of the relationships they have. The ownership structure of companies in Indonesia is highly concentrated (Brown, 2006; Claessens, Djankov, & Lang, 2000), with an average of 16.6% of market capitalization in the hands of one family. Then 57.7% were in the hands of the top 10 family companies in Indonesia centered on companies that had connections with Suharto and the military (Brown, 2006; Claessens et al., 2000). The high concentration of ownership then raises type II agency problems such as the risk of appropriating minority shareholders by majority shareholders. special relationship transactions are very common in Indonesia,

around 90% of listed companies in Indonesia carry out various types of special transactions (Utama & Utama, 2013).

Indonesia has long been regarded as a country with weak corporate governance implementation (Juliarto, Tower, Zahn, & Rusmin, 2013), and this provides an opportunity for companies that have political connections to abuse special relationship transactions to channel company funds from minority shareholders. Besides Indonesia's weak corporate governance, it is also weak in law enforcement and regulation (Wulandari & Rahman, 2004).

III.3. Empirical Research Result Related

Political connections can benefit companies in various ways. But from another perspective, seeing that political connections can have a negative impact on the company when the costs incurred for the connection outweigh the benefits (Morck, Stangeland dan Yeung, 2000). Qian, Hongbo Pan and Yeung (2011) found that the value expropriated by outside investors in China exceeds the value obtained from political connections. Dominant shareholders in companies that have political connections have a greater opportunity to divert the company's resources to get less strict supervision from regulators. For Example, Berkman, Cole and Fu (2010) found that stock returns in China imply that minority shareholders see that regulators will fail in protecting their interests when they are dealing with majority shareholders who have political connections. The same thing was found in US research by Correia (2010) and Yu & Yu (2011) where companies that have political connections that overstate fraud get more 'good' tolerance than companies that make similar mistakes but do not have political connection (Guedhami, Pittman & Saffar, 2014).

Many political connection studies imply that the monitoring capability provided by Big 4 accounting firm is better than Non Big 4 accounting firm. However, the question arises, whether the quality of monitoring of Big 4 accounting firm outperforms Non Big 4 accounting firm in countries where investor protection is low? There is evidence that severe penalties are given to auditors for inadequate audit quality, more commonly found in the US than other countries (Khurana & Raman, 2004; El Ghouli, Guedhami and Pittman, 2012). Although reputation incentives and litigation incentives encourage quality audits in the US (Baber, Kumar & Verghese, 1995; Mansi, Maxwell & Miller, 2004), Big 4 accounting firms are more likely to be motivated by reputation motives (Guedhami, Pittman & Saffar, 2014).

In other words, reputation incentives alone are not sufficient to encourage audit quality in other countries that have low enforcement of auditors. In accordance with the arguments of DeAngelo (1981) and Rogerson (1983), the above implies that auditors with good reputation tend to carry out tighter monitoring functions. For example, research in Germany (Weber, Willenborg and Zhang, 2008) and in Japan (Skinner and Srinivasan, 2012) found that reputation incentives encourage auditors to maintain audit quality while keeping accounting firm from lawsuits. Moreover, the Big 4 accounting firm which also operates globally also provides quality insurance services to avoid damage to reputation (Humphrey, Loft and Woods, 2009).

Companies that have political connections will tend not to appoint Big 4 accounting firms because they can increase company transparency and without that companies can still get access to low interest loans from Government Banks (Claessens, Feijen & Laeven, 2008). Leuz and Obelholzer-Gee (2006) found that Indonesian companies that have political connections avoid the source of arm's length transactions because they tend to cover up transactions with the politicians they approached. This is consistent with the findings of Piotroski, Wong and Zhang (2008) that companies that have political connections have incentives to hide activities related to connections from minority shareholders (Guedhami, Pittman & Saffar, 2014). The above illustrates that companies that have political connections tend to reduce transparency in financial statements that are presented to cover the activities and costs incurred related to political connections.

Then what is the condition of auditing for companies that have political connections according to previous research? the question will be answered by the following section.

III.3.1. Auditor Choice

Previous research has concluded several determinant factors in the selection of auditors by companies, namely: Ethnicity (Ahmad, Houghton & Yusof, 2006), Culture of secrecy (Hope, Kang, Thomas & Yoo, 2008), Status of ownership-state or foreign property (Guedhami, Pittman & Saffar, 2009; He, Rui, Zheng & Zhu, 2014; Wang et al, 2008), Family relations (Khan, Muttakin & Shiddiqui, 2015), Ethics of the board of commissioners (Houqe, Zijl, Dunstan & Karim, 2010), Political connection with moderation of ownership structure and level of state institutions (Guedhami et al, 2014) and management incentives (Cheng, Hsu & Kung, 2015) in Muhammadi (2016).

Previous research on the selection of auditors in companies that have political connections found inconsistent results. Some found that politically connected companies tended to use Big 4 accounting firm services (Bliss & Gul, 2012; Guedhami et al., 2014) compared to other companies that did not have political connections and some found the opposite (Cheng et al., 2015; Habib et al, 2017).

Guedhami et al., (2014) found that the tendency to use Big 4 accounting firm services strengthened when companies also had concentrated ownership structures and if companies were in countries with weak institutional structures. Khan et al., (2016) found that companies with political connections in Bangladesh tended to use quality accounting firm services to reduce agency costs. However, in his paper there was no additional explanation that it could be that companies with high agency costs tend to make political connections to protect companies from investors, supervision and regulation (Habib, et al., 2018).

Cheng, Hsu & Kung (2015) found that local-owned enterprises (BUMN) and closed companies that have political connections tended not to use the services of 'big' accounting firm. Habib, Muhammadi and Jiang (2017) found that companies with political connections in Indonesia tended to use Non-Big 4 accounting firm to cover tunneling actions through loans to related party transactions. The finding argument above is the demand side or appointment from the client company. Next, we examine the supply side, from the auditor's side, which is reflected in the audit fee side.

III.3.2. Audit fee

By considering audit risk, the auditor will determine how much effort is needed in conducting audit procedures which will then determine the amount of the audit fee that will be charged to the client. Simunic (1980) developed a model that states that audit fees are derived from audit efforts and risk assessments of the client's business (risk premium) where the higher the company's risk is seen by the auditor, the higher the audit fee will be charged by the auditor due to the many audit procedures which is conducted. So that it can be understood that the determination of the audit fee is not only from the auditor's side as the provider of audit services but also from the client's side as the service user in determining the audit fee amount they are willing to pay (Hay et al., 2006). This is in accordance with the supply-side theory and demand-side theory (Ariningrum & Diyanty, 2017).

Supply-side theory holds that the determination of the audit fee is based on the auditor's decision as the provider of audit services needed by the client. Thus, auditors have a role in determining audit fees related to variables according to the auditor's assessment attached to the client. Examples of variables assessed by auditors on their clients are the inherent risk of the client and the complexity of the client's business. Simply put, if the auditor sees that the client company has a high risk and a very complex business, the auditor will ask for a higher audit fee because the auditor will carry out more audit procedures (Hay et al., 2006).

Demand side theory, explains that clients play a role in determining the amount of audit fees they are willing to pay. For example, a company that has an effective corporate governance implementation will usually ask for better audit quality, so even though from the perspective of the auditor this company has a lower risk than other companies, the audit fee amount will be higher because the auditor needs to perform audit procedures more to meet quality audit requests. What's more, companies also want to pay a higher audit fee to get better audit quality. Thus, even though audit fees charged by auditors are lower because of low risk assessment, companies that implement good corporate governance can pay higher audit fees because of the demand side side of quality audits (Hay et al., 2006).

Research on the influence of political connections on audit fees found that companies with political connections tended to pay higher audit fees. During the crisis, companies that have political connections show a higher risk of material misstatement due to deteriorating performance due to a lack of support from the Government. However, the audit fees decreased with the improvement in the backing of support from the Government, thereby reducing the tendency to manipulate financial statements (Habib, et al., 2018).

Ariningrum & Diyanty (2017) found that companies that have political connections pay a greater audit fee compared to similar companies that do not have political connections. This is due to the auditor assessing that the risks possessed by the company with a political connection are greater so that the auditor needs more efforts to provide adequate assurance of the opinions given. Then on the other hand, companies that have an effective board of commissioners and audit committees will tend to demand quality audits. For these demands the auditor will provide more effort during the audit process so that the auditor will also charge a higher audit fee.

Wahab et al., (2011) found that companies with good governance tended to pay lower audit fees and they also wanted good quality audits and this was not found in companies that had political connections. In another study, Wahab et al. (2011) found that accounting firm would charge a higher audit fee to companies that have political connections with institutional ownership structures and at the same time they also want quality audits to detect if there is rent-seeking activity (rent-seeking activities). Tee et al., (2017) found that institutional ownership would want a quality audit that resulted in a high audit fee and a positive relationship between institutional ownership and audit fees getting stronger if the company had a political connection (Habib, et al., 2018).

III.3.3. Report Lag Audit (ARL)

ARL is defined as the period between the end of the company's fiscal year and the date of the audit report (Bamber et al., 1993). Because audit reports contain audit opinions regarding the credibility of financial statements, investors prefer ARL which is shorter because they can more quickly find out audit opinions so they can make faster investment decisions (Habib & Muhammadi, 2016). There are contradictory arguments regarding the relationship between political connections and ARL. The first argument comes from signaling theory, companies with political connections will try to have ARL faster. Companies with political connections have incentives and opportunities to engage in rent seeking behavior, which makes the company in a tighter public scrutiny than companies that have no political connections. One form of supervision is through external audits. With ARL that is short or a timely audit report, the company can signal confidence to stakeholders (outside parties) regarding the quality of the company's financial reporting that seems better so that the auditor does not need additional time to conduct an audit. (Chaney et al., 2011).

The second argument states that politically connected companies have ARL that is longer than companies that do not have political connections. Chaney et al. (2011) find lower financial reporting quality in companies that have political connections compared to companies that do not have political connection. A number of financial report manipulations can be carried out by companies with political connections to cover rent-seeking activities that are usually carried out through tunneling resources from minority shareholders (Chaney et al., 2011).

Harymawan and Nowland (2016) found that the quality of earnings of politically connected companies declined

during a period of stable political conditions, then if the company did tunneling and the auditors were suspicious of this then ARL gave a longer signal that the auditor evaluated the risks associated with related party transactions on financial statements. Then Habib & Muhammadi (2016) argue that to detect and report on these activities auditors need more effort so that the ARL time is extended.

Habib and Muhammadi (2016) conducted research on listed companies in Indonesia during the period of 2007 to 2013 and found that a shorter ARL in companies that had political connections; the existence of special relationship transactions (operational and loan) thus increasing the length of ARL time.

IV. CONCLUSIONS

Companies that have political connections in Indonesia tend to choose Non Big 4 accounting firm to cover tunneling actions through loans to related party transactions. Companies that have political connections in Indonesia also will be charged a higher audit fee than similar companies that have no political connection by the auditor. This is due to the auditor assessment that there is a higher risk for companies that have political connections so that more efforts are needed in the audit process.

Monitoring the management and choosing accounting firm for the firm is the responsibility of Board of Commissioners (BoC) with the assistance from the Audit Committee (AC). Therefore the effectiveness of BoC and AC in conducting their responsibilities should affect the choice of auditor, the audit fee and audit report lag, at least in a moderating manner. However through the literature review by the author, there is no research that examines how the relationship between companies that have political connections with audit quality and audit fees using the effectiveness of the BoC and AC as moderating variables. Author suggest for further researcher to investigate this issue.

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