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AUDIT COMMITTEE CHARACTERISTIC AND EARNINGS MANAGEMENT: EVIDENCE BASED ON INDONESIAN FIRMS

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Abstract

There are some cases of Indonesian listed companies practicing earnings management to reduce tax payments while at the same time shows increasing income, despite the requirement to have an audit committee, audit committees in Indonesia should be led by an independent director and must have the financial capability to oversee the performance of management. In addition, the audit committee has the obligation to conduct audit committee meetings at least once in three months. Hence this study examines the audit committee (AC) characteristic (i.e. independence, expertise, and number of meeting) with the earnings management practice. This study uses Indonesian listed companies' financial data from 2012 – 2016. Panel data analysis using the generalized method of moment estimation is being conducted to control for the individual effect and unobserved heterogeneity as well as to mitigate the endogenous problem. The results of this study suggest that AC expertise, AC meeting and AC independence has influence in reducing earnings management practice.

Keywords: Audit committee, expertise, number of meetings, earnings management.

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1. Introduction

Revenue is the most important component in financial statements and it is the main concern of creditors, shareholders and board of directors so that managers practice earnings management by manipulating accounting policies to change company performance (Guan, Lin, & Fang, 2014). The company's failure to prepare transparent financial statements has an impact on income reports that are not in accordance with the company's performance. Therefore, investors will make wrong decisions and the company has the potential perform tax evasion. Hence the regulator in Indonesia requires companies listed on the Indonesian stock exchange (IDX) to have an audit committee (AC).

According to the regulations of Financial Services Authority (Otoritas Jasa Keuangan) (2015) AC members must understand the company's business and financial reports, minimum must have one member with an educational and experience background in accounting and finance, review the financial information to be issued by the company, conducts a review of compliance with laws and regulations relating to company activities, reviews the implementation of audits by internal auditors.

With the presence of the AC, the preparation of the financial statements can be more transparent so that it can provide information that is in line with the company's performance, but according to Jong et al (2014) the chief financial officer believes that by practicing earnings management, it can improve company valuation by investor because companies can generate performance that meets investor expectations. Therefore, this study aims to investigate whether the AC can prevent the practice of earnings management in companies listed on IDX from 2012 - 2016.

The audit committee in this study used three characteristics, namely the existence of AC independent, AC expertise and AC meetings. Following Gras-gil, Manzano and Fernández (2016) to measure earnings management (EM) we apply discretionary (DA) accruals with absolute values.

1.1. Background and literature review

There are many studies regarding earnings management and characteristics of audit committees conducted from various countries and the results of these studies have various conclusions, Lin and Hwang (2010) conducted a meta-analysis using 48 studies from 1997 - 2007 revealed that the AC independence expertise, and its size has a negative relationship to EM, as well as the board of directors and its expertise have a negative relationship with earnings management, however, it is different from the AC share ownership has a positive effect on EM.

In Portugal, Maria and Alves (2011) conducted a study in 2002-2007 found no evidence of AC existence could influence EM. However, in 2013 Alves (2013) uses a sample of 33 non-financially listed Portuguese firms-years from 2003 to 2009 obtaining DA is positively influenced by the AC and external auditor.

Kang, Kilgore and Wright (2011) has conducted research in Australia found several characteristics of the AC had a significant relationship to the level of DA. The Jones model is applied to measure EM and the characteristics of a significant AC are the proportion of independent directors in the AC, the expertise of the AC members, and the number of AC meetings.

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Other research conducted in Malaysia is Saleh and Iskandar (2007) using data 548 firms annual reports 2001 from the Bursa Malaysia found that the presence of an independent AC completely reduced EM practices and companies that had AC members who had expertise and often held AC meetings, practiced earnings management less. these results are consistent with Kasipillai and Mahenthiran (2013) found an independent AC could prevent the activities of EM with a pattern decreasing income in the Malaysian PLC. In line with Nelson and Devi, (2013) using financial data in 2008 in Malaysia obtaining the level of EM practices can be significantly reduced by the presence of accounting experts and non-accounting experts. these results are different with Mohammad, Wasiuzzaman and Salleh (2016) using a sample firms in Malaysia, the data set consists of a total of 1,206 firm-year observations revealed that AC were positively related to EM.

Research on the influence of AC on the level of EM is also carried out by Badolato, Donelson and Ege (2014) in America using sample from BoardEx, found that the presence of relative status and financial expertise prevents EM. In 2018 Mansour, Tauringana and Tingbani (2018) found the proportion of financial expertise at the AC and gender reduced EM pratice in addition they examined whether gender financial experts were important. In the study found EM practices can be significantly reduced by the AC which has a proportion of female members but EM practices are not influenced by the proportion of men on the audit committee.

EM is also practiced in Middle East and North Africa so an audit committee role is needed to prevent such practices, Alzoubi, (2016) found the presence of independent AC members could prevent EM practices and AC meetings showed that the frequency of meetings over a year could limit the practice of EM as well as the size of AC that significantly reduced EM activities. Different results are obtained by Al-Thuneibat, Al-Angari, and Al-Saad (2016) revealed that EM practices were not significantly affected by the AC, internal audit and the board of directors. However, AC independent and internal audits have a negative direction on EM practices

Other research conducted in Australian stock exchange by Safari (2017) shows that a high level of compliance with board and AC principles influences lower EM practices.

2. Problem Statement

Kazemian and Mohd, (2015) stated that agency theory is the basis for EM practice because there is a separation of ownership and control so that the manager will use financial statements that are in line with manager needs. Hence companies with good corporate governance practices are more likely to constrain earning's management (Shan, 2014, Hutchinson, Percy, & Erkurtoglu, 2008; Anuar, Adibah, Ismail, & Ervina, 2012; Saleh & Iskandar, 2007; Usman & Kamardin, 2015; Alzoubi 2016; Zgarni, & Haliou, 2016). Companies listed on the Indonesian stock exchange are required to have a AC because AC can prevent companies from practicing earnings management, however, there are still several cases related to EM practices that commit fraud in reporting financial statements such as the case KPC incorporated is suspected by the directorate general of taxation, has underpayment of IDR 1.5 trillion and found indications of criminal offense's taxes to manipulate the sales to minimize taxes (www.ortax.org) and Katarina incorporated alleged to have committed a number of asset bubbles by entering fictitious projects worth USD 29.6 billion in the company report (Source: Detik.com). CCI incorporated

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manipulates the financial statements, causing a shortage of tax payments worth IDR. 49.24 billion. By reporting greater costs so taxable income is reduced (source: www.kompas.com)

With the different research results related to the AC role in preventing EM, it is necessary to know how the role of the AC in Indonesia is in preventing EM practices.

3. Research Questions

1.How does audit committee (AC) independent affect earnings management (EM)?

2.How does audit committee (AC) expertise affect earnings management (EM)?

3.How does audit committee (AC) meeting affect earnings management (EM)?

4. Purpose of the Study

This study contributes to academic literature and regulators, the study will find out the effect of the percentage of independent AC members, AC expertise and the number of meetings held by the AC can prevent the practice of EM. With the recognition of the role of the AC, it can provide evaluation and improvement of policies by the capital market regulator in Indonesia.

5. Research Methods

This study uses the annual financial data of companies listed on IDX period 2012 – 2016, selection of the samples for this study using certain criteria, the company publishes full financial statements from 2012 to 2016. In this study, the sample did not include banking firms and other financial areas due to differences in policies and regulations in financial reporting. After the company's data is adjusted to the above criteria then obtained 67 companies as sampled, the data used in this study includes 335 companies financial data for five years. Characteristics of the audit committee consist of independence, the number of meetings each year and financial expertise. Measurement following variables is following Sultana (2015).

a) The proportion of independent directors on the AC is used to measure the independent AC.
b) if the AC member has financial expertise such as one of the following conditions: (a) has a background as a public accountant, auditor, chief financial officer, controller and / or (b) serves as CEO. Then the AC members are considered to have expertise. Variables are measured based on the proportion of AC members who have financial expertise.
c) The number of meeting variables held by the AC is given a value of one if the frequency of the AC meeting during the period t the AC holds four or more meetings, otherwise scored zero.

To measure EM apply discretionary accrual used is the Modified Jones Model (1995), the modified Jones model is the most powerful to detect EM among the alternative models to measure unexpected accruals (Chen, Jian, Chen, & Lin 2007; Suzan, Jomana, & Serdaneh, 2012). And it is as follows:

$$DA_{it} = TA_{it} - NDA_{it}$$ **Equation 1**

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Corresponding Author: Dudi Pratomo
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Where: DAit is discretionary accruals are accruals whose value is determined by policy discretion, TAit is total accruals firm i in period t and NDAit is non-discretionary accruals for firm i in period t. Following previous studies Grasgil, Manzano, and Fernández (2016) we employ the absolute value of discretionary accruals as our measure of EM because our hypothesis does not depend on the accrual direction, but the magnitude of the accrual adjustment, the test statistic is based on an absolute value.

Control variable implemented to ensure that the relationship between variables is not biased. In this study, the control variables are most commonly used in previous studies.

a) firm size: measured by the natural logarithm of total assets (LnAssets) (Maria & Alves, 2011; Mulyadi & Anwar, 2015).
b) Leverage: measured by percentage debt to equity (Maria & Alves, 2011; Mulyadi & Anwar, 2015).
c) Return On Asset (ROA): measured by net income divided by the total asset (Zgarni & Zehri, 2016; Sun, & Lan, 2014).
d) Market to Book Ratio: measured by book liabilities plus market value of equity divided by book value of assets (Sultana, 2015; Zgarni & Zehri, 2016 ; Ramalingegowda & Yu, 2012).

This research is a study that combines time-series data and cross sections so this research will use panel data technique. Saunders, Lewis, and Thornhill (2016) stated regression analysis is a statistical method that is used to model the function of the relationship between the dependent variable (bound) with one or more independent variables (free) . Equation analyses of panel data model used for this study are:

Regression earnings management and audit committee characteristic

$$DA_{it} = \alpha + \beta_1 ACInd_{it} + \beta_2 ACExp_{it} + \beta_3 ACMet_{it} + \beta_4 Size_{it} + \beta_5 Lev_{it} + \beta_6 Roa_{it} + \beta_7 MtB_{it}$$

Equation 2

Where:

DA	= Earnings Management *i* at time *t*
α	= Intercept term
β_1, β_2 ,β_3 ,β_4	= Coefficients of regression
$ACInd_{it}$	= Audit Committee Independence of firm *i* at time *t*
$ACExp_{it}$	= Audit Committee Expertise of firm *i* at time *t*
$ACMet_{it}$	= Audit Committee Meeting of firm *i* at time *t*
$Size_{it}$	= Size of firm *i* at time *t*
Lev_{it}	= Leverage of firm *i* at time *t*
Roa_{it}	= Roa of firm *i* at time *t*
MtB_{it}	= MtB of firm *i* at time *t*
e_{it}	= error term

Previous studies Kwon, Lee, and Ki (2014) show that corporate governance is endogenously determined. The companies can hire big auditors and provide high payment for audit,. It can make biased conclusions in an unknown direction. Thus, an investigation of endogenous problems may be required for corporate governance variables.

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To correct the bias caused by endogenous variables, this study used the generalized moment estimation method (GMM) following Arora and Sharma, (2016) stated that GMM, which effectively overcomes the problem of endogeneity and simultaneity bias and furthermore Lozano, Martínez, and Pindado (2015) stated that there are two advantages to implementing the GMM estimator system, which can control the effects of unobserved heterogeneity and second to mitigate the endogeneity problem.

6. Findings

In this study conducted multicollinearity test for independent variables used for the regression equation relationship between AC characteristic and EM. Based on Table 1 the independent variables used in this study do not have multicollinearity problems because the VIF value is not more than 10 and tolerance value (1/VIF) above than 0.10 (Hassan & Ahmed, 2012).

Table 01. Variance Inflation Factor - Independent Variable for Earnings Management

Variable	Abbreviation	VIF	1/VIF
Market to Book Ratio	Mtb	1.63	0.612365
Leverage	Lev	1.49	0.672801
Return on Asset	Roa	1.15	0.866528
Firm Size	Size	1.20	0.836708
Audit Committee Expertise	Acexp	1.11	0.898838
Audit Committee Meeting	Acmet	1.07	0.934787
Audit Committee independent	Acind	1.03	0.971133
Mean VIF		1.23	

6.1. Empirical results

Table 02. Dynamic panel-data estimation (two-step system GMM) Earnings Management and Audit Committee Characteristic

Da	*Expected sign*	*Coef.*	*P>z*
Audit committee Independent	(-)	-1.50e+09	0.019*
Audit Committee Expertise	(-)	-1.70e+09	0.000*
Audit Committee Meeting	(-)	-3.20e+08	0.003*
Control Variable			
Size		5.63e+08	0.000*
Leverage		-5.20e+07	0.001*
Return on Asset		-5.56e+09	0.000*
Market to Book Value		1.74e+07	0.164
Constant		-8.18e+09	0.000*

*Level of significant 0.05
Arellano-Bond test for AR(1) in first differences: z = -2.32 Pr > z = 0.020
Arellano-Bond test for AR(2) in first differences: z = 1.04 Pr > z = 0.300
Hansen test of overid. restrictions: chi2(33) = 41.17 Prob > chi2 = 0.155

Table 2 above shown correlation use arrelano bond test show that there no correlation in second differences disturbances AR(2) P-value above than 0.05 and Hansen test indicate that the model are valid (P-value above 0.05).

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Based on table 2, it is shown that AC independent has a significant influence which means that AC independent can prevent the occurrence of EM practices with coefficient -1.50e+09 these results are in line with Saleh and Iskandar (2007) Lin, and Hwang, (2010) Kang, Kilgore, and Wright (2011) Kasipillai, and Mahenthiran (2013), Alzoubi (2016). Furthermore, it is known that the AC expertise has significant influence which means that the AC expertise can prevent the occurrence of EM practices with coefficient -1.70e+09, these results are in line with Saleh and Iskandar (2007), Lin, and Hwang, (2010) Kang, Kilgore, and Wright (2011), Nelson and Devi (2013) Mansour, Tauringana, and Tingbani (2018). As well as AC meeting have a significant influence which means that AC meetings can prevent the occurrence of EM practices with coefficient -3.20e+08, these results are consistent with our hypothesis and in line with Saleh and Iskandar (2007), Kang, Kilgore, and Wright (2011), Badolato, Donelson, and Ege (2014), Alzoubi, (2016).

6.2. Robustness checks

In order to determine the robustness of our results, we will compare the role of an audit committee independent to earnings management if only supported by one audit committee characteristic, such as expertise or meeting. Based on table 3 model 1 audit committee independent does not have an influence on earnings management with coefficient-2.77e + 08 if the audit committee members only have expertise. However different results are found in table 3 model 2 where audit committee independent has an influence on earnings management with coefficient -4.39e + 09 if supported by the number of meetings held.

Table 03. Explanatory Model Dynamic panel-data estimation (two-step system GMM) Earnings Management and Audit Committee Characteristic

Model 1			**Model 2**		
Da	***Coef.***	***P>z***	***Da***	***Coef.***	***P>z***
Audit committee Independent	-2.77e+08	0.745	Audit committee Independent	-4.39e+09	0.010*
Audit Committee Expertise	-1.60e+09	0.000*	Audit Committee Meeting	-4.71e+08	0.000*
Control Variable			**Control Variable**		
Size	4.91e+08	0.000*	Size	5.95e+08	0.000*
Leverage	-4.30e+07	0.035*	Leverage	-3.08e+07	0.215
Return on Asset	-6.22e+09	0.000*	Return on Asset	-4.15e+09	0.000*
Market to Book Value	3746501	0.825	Market to Book Value	3.24e+07	0.084
Constant	-8.17e+09	0.000*	Constant	-7.53e+09	0.000*

*Level of significant 0.05
Arellano-Bond test for AR(1)
in first differences: z = -2.45 Pr > z = 0.014
Arellano-Bond test for AR(2)
in first differences: z = 1.30 Pr > z = 0.193
Hansen test of overid. restrictions:
chi2(24) = 32.58 Prob > chi2 = 0.113
(Robust)

*Level of significant 0.05
Arellano-Bond test for AR(1)
in first differences: z = -2.26 Pr > z = 0.024
Arellano-Bond test for AR(2)
in first differences: z = 0.63 Pr > z = 0.528
Hansen test of overid. restrictions:
chi2(25) = 36.66 Prob > chi2 = 0.062
(Robust)

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7. Conclusion

Audit committees in Indonesia have played a role in preventing earnings management practices, furthermore the biggest role in preventing EM is the role of AC meetings which means that the number of meetings held at least four times a year can oversee the activities and processes of preparing the appropriate financial statements with company performance. As well as AC expertise and AC independent can prevent the implementation of EM

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