

EARNINGS MANAGEMENT: EVALUATION OF AUDIT COMMITTEE ACTIVITY IN INDONESIA

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Abstract

The paper is intended to provide evidence of the effect audit committee meeting, attendance meeting, size, and appointment on earnings management. The population of the paper are public non financial companies from 2016 to 2018. The paper uses 85 samples selected through purposive sampling method, hence amounting to 255 firm year. The result indicates that audit committee size statistically influenced earnings management. Audit committee meeting, attendance meeting, and appointment have no influence toward earnings management. Audit committee size positively influenced earnings management by inefficiency while they doing their task to monitor management when it is too large.

Keywords: *Audit committee meeting, attendance meeting, appointment, earnings management, size.*

JEL Classification: *G3, M4*

1. INTRODUCTION

Financial statement has been primary indicator for investor or owner to evaluate the performance of the company. They will measure how many return they will get and whether the company can maximize their wealth. Nowadays, almost all companies in the world have separate management and owner that lead to the appearance of Agency Theory. Meanwhile, management use this chance to manipulate or manage their earnings when they have not reached principal's goals at the end of period. By doing that, management also can get incentives or bonus if they reach the goals. On the other hand, management may make their earnings as low as possible or even loss with a big amount that is known as *Big Bath*. So, in the next period the management can show better performance and avoid replacement with another professional.

Based on that explanation, financial statements has not reflect the real condition of the company that will affect the wrong decision taken by the users. To minimize or avoid this action, corporate governance through the existence of audit committee is one of the solution. A corporate governance system is the combination of mechanisms which ensure that the management runs the firm for the benefit of one or several stakeholders (Susanto

2013). Audit committee will review the company's process of assessing the risk of fraudulent reporting and also the program that established by management to monitor compliance with the code of corporate conduct. The Securities and Exchange Commission (SEC) required all public companies to establish audit committees, first supported the concept of the Audit Committee around 1940 in response to requests from non-executive directors of several issuers who requested an Audit Committee consisting of non-executive directors on duty to nominate and select external auditors and determine parameters in the engagement with the external auditor. In Indonesia, the existence of Audit Committee started since 2001 through a legal letter from OJK (Otoritas Jasa Keuangan) No: 55/PJOK.04/2015 which contain the need of the Audit Committee to be held by each company. The existence of an audit committee in accordance with its function to oversee management. The audit committee is expected to minimize opportunistic earnings management. The results of the research on the effect of the audit committee on earnings management have an effect (Qamhan et al. 2018) and have no effect (Firnanti 2017).

In regards to those reasons above, some research problem are formulated about whether audit committee meeting, attendance meeting, size, and appointment affect the earnings management. Hence, the objective of the paper is to gain better knowledge and insights about whether audit committee meeting, attendance meeting, size, and appointment affect the earnings management. This research is comprised of introduction, research method, analysis and discussions, and closing.

2. LITERATURE REVIEW

2.1. Audit Committe Meeting

The existence of audit committee is important in overseeing and monitoring the financial reporting process, so the output will be usefull for the users to take right decision. An effective audit committee will reduce financial reporting fraud, meanwhile the effectiveness is seen from the audit committee activity. Menon and Williams (1994) explained one of the approaches to measure the effectiveness of audit committee is by looking from number of their meetings. Previous reseacrh done by González and García-Meca (2013) and Soliman and Ragab (2014) which found that audit committee meeting has negative influence on earnings management. However, Lin et al. (2006), Hamdan et al. (2012) and Prastiti and Meiranto (2013) found different result that audit committee meeting

has no influence on earnings management. In the other hand, positive influence on earnings management found by Susanto and Pradipta (2016).

H₁: Audit committee meeting has influence on earnings management.

2.2. Attendance Audit Committee Meeting

Number of meeting that held by audit committee is not enough to analyze the effectiveness of audit committee in mitigating earnings management. But also with the member who attend the meeting to analyze the diligence of audit committee member to monitor the management and the effectiveness of the meetings (Qamhan et al. 2018). Previous research done by Qamhan et al. (2018) found that attendance audit committee meeting has negative impact on earnings management.

H₂: Attendance audit committee meeting has influence on earnings management.

2.3. Audit Committee Size

Audit committee play an important role in the company to oversee and monitor the financial reporting process, then audit committee must be effective in doing their task. One of the indicator to asses how effective the audit committee is by their size which Sarbanex-Oxley Act 2002 recommend that audit committee should have at least three members. Lin et al. (2006) found that there is negative influence between audit committee size and earnings management. However, Asitalia and Trisnawati (2017) and Firnanti (2017) found no influence of audit committee size on earnings management. In the other hand, Rahman and Ali (2006) and Asward and Lina (2015) showed that earnings management is positively related to the audit committee size.

H₃: Audit committee size has influence on earnings management.

2.4. Appointment Audit Committee

The number of audit committee is the most disputed characteristic of audit committee. The appointment new member of audit committee will affect on the stability, performance and role of the committee in overseeing and monitoring the financial reporting process. Previous research done by Qamhan et al. (2018) found that appointment audit committee has positive impact on earnings management.

H₄: Appointment audit committee has influence on earnings management.

2.5. Audit Quality

The presence of external auditor is to ensure that the financial statements has been presented fairly and free from material misstatement by gathering an appropriate and sufficient evidence and conduct the audit procedure. The high quality auditor are more likely to detect questionable accounting practices and material error than low quality auditor. They are better to question or negotiate with clients who attempt to adopt aggressive accounting procedures than low quality auditor. Previous research done by Craswell et al. (1995) found that the audit quality has negative impact on earnings management. Meanwhile, Alexander and Hengky (2017), Arifin and Destriana (2018) and Florencia and Susanty (2019) showed that there is no influence of audit quality on earnings management.

2.6. Managerial Ownership

Jensen and Meckling (1976) found evidence that managerial ownership succeeded for reducing agency problems from managers by aligning the interests of managers with shareholders. This research found that manager interests with external shareholder can be held together if the share ownership by the manager is enlarged so the managers won't manipulate on their behalf. Farida et al. (2010) found that the managerial ownership has negative influence on earnings management. In contrast with Asward and Lina (2015) found that the relation between earnings management and managerial ownership is positive. However, Napitupulu (2012), Nugraheni et al. (2015), Arifin and Destriana (2018) and Susanto (2013) found that there is no influence between managerial ownership and earnings management.

2.7. Firm Size

Different views exist regarding to the influence of firm size on earnings management. One of them refers to the internal control. The large firms have more effective internal control than the small firms, then large the firm size less the earnings management. Previous research done by Jao and Pagalung (2011), González and García-Meca (2013), Susanto (2016), and Susanto, Pradipta, & Cecilia (2019) found that firm size has negative influence on earnings management. However, Arifin and Destriana (2018) and Florencia and Susanty (2019) showed that firm size has no influence on earnings

management. In the other hand, Ajay and Madhumathi (2015) found that firm size has positive impact on earnings management.

2.8. Leverage

Positive accounting theory highlights some basic incentives for earnings management, one of which is debt agreements. As such, this is related to corporate leverage which shows the possible relationship between debt covenants and earnings management (Lazzem and Jilani 2018). Previous research done by Beatty and Weber (2003), Napitupulu (2012), Abbadi (2016), and Susanto, Pirzada, & Adrienne (2019) found that leverage has positive impact on earnings management. Meanwhile, Asitalia and Trisnawati (2017) and Guna and Herawaty (2010) found that leverage has negative impact on earnings management. In the other hand, research done by Ardison et al. (2012) found that leverage has no impact on earnings management.

2.9. Profitability

Kapoor and Goel (2017) and Susanto (2013) showed return on asset has no influence on earnings management. Meanwhile, research by Amertha (2013), Alexander and Hengky (2017), Yunietha and Palupi (2017), and Susanto, Pradipta, & Cecilia (2019) showed that profitability has positively influence earnings management.

2.10. Operating Cash Flow

Operating cash flow is one indicator for companies to predict their performance (Fairfield et al. 2003). To hide the company's bad performance, management practices earnings management in financial statements and manages operating cash flow to show good performance. The aim is to cover low operating cash flow and thus to show that the company's performance is good for attracting more investors and creditors. Zeller and Stanko (2000), Yoon and Miller (2002), Yuliana and Trisnawati (2015) found that operating cash flow has a negative impact on earnings management.

2.11. Sales Growth

Firms with low growth of sales may have intention to manage their earnings in order to make their financial statement looks good and attract more investor. Then,

previous research done by González and García-Meca (2013) and Yunietha and Palupi (2017) found that sales growth has positive impact on earnings management. Conversely, Abbadi et al. (2016) found that sales growth has negative impact on earnings management. In the other hand, Savitri (2014) found that sales growth has no impact on earnings management.

3. METHODS

The object of the paper will be taken from all public non financial companies from the year of 2016 to 2018 (three years). The samples used are 85 listed non financial companies, hence amounting to a total of 255 data to be used.

Table 1. Sample Selection Procedure

Criteria	Firms	Data
Public non financial firms from the year 2015 to 2018	426	1278
Public non financial firms which do not consistently 31 December	(18)	(54)
Public non financial firms which do not consistently use IDR currency	(77)	(231)
Public non financial firm which do not generates net income	(131)	(393)
Public non financial firm which do not have managerial ownership	(83)	(249)
Public non financial firm which do not disclose attendance audit committee members	(30)	(90)
Number of sample firms	87	261
Data Outlier	(2)	(6)
Total	85	255

Source: Processed data

The measurement of earnings management adapted by previous research (Nugraheni et al. 2015). Total accruals are different between net income before extraordinary items and operating cash flow. Discretionary accruals (DAC) are the residual value from the equation below:

$$\frac{TAC_{it}}{A_{it-1}} = \beta_0 \frac{1}{A_{it-1}} + \beta_1 \frac{\Delta REV_{it} - \Delta REC_{it}}{A_{it-1}} + \beta_2 \frac{PPE_{it}}{A_{it-1}} + \epsilon_{it} \quad (1)$$

TAC_{it} total accruals in year t, A_{it-1} previous year total assets, ΔREV_{it} revenue in year t less revenue in previous year, ΔREC_{it} net receivables in year t less net receivables in previous year, PPE_{it} gross property, plant, and equipment in year t. Meetings (ACMET) is measured by the number of meetings held by the audit committee (Qamhan et al. 2018). Attendance meeting (ACATT) is measured by the proportion of members attendance at meetings (Qamhan et al. 2018). Size (ACSIZ) is measured by the total number of members (Qamhan et al. 2018). Appointment (APACC) is measured by a dummy variable that takes the value of either 1 for the occurrence of appointment of members or 0 otherwise. Audit Quality (BIG4) is measured dummy variable, which takes a value of 1 if company is audited by Big 4 audit firms, or 0 otherwise (Qamhan et al. 2018).

Managerial ownership (MAOWN) is the proportion of the company's shares owned by the management (Nugraheni et al. (2015). Firm size (FSIZE) is measured by natural logarithm of total assets (Qamhan et al. 2018). Leverage (LEVER) is the ratio of book value of all long term debt to total asset (Qamhan et al. 2018). Profitability (ROA) show how the company able to generates income. Based on Qamhan et al. (2018), it is calculated by the ratio of net income to total assets. Operating cash flow (OCF) show how the company using cash for their operating activities. Based on Qamhan et al. (2018), it is calculated by the ratio of cash flow from operating activities to beginning total assets. Sales growth (SALGR) is measured by calculated the difference of sales in certain year divided by sales in previous year (Qamhan et al. 2018).

4. RESEARCH RESULT

The descriptive statistics results of this research is summarized as in the following Table 2:

Table 2. Descriptive Statistics

Var.	Min.	Max.	Mean	Std. Dev.
DAC	-0.23617	0.34104	-0.0010653	0.07439785
ACMET	2	59	8.73	8.403
ACATT (%)	50	100	93.25	9.239
ACSIZ	2	6	3.17	0.524
APACC	0	1	0.30	0.460
BIG4	0	1	0.44	0.497
MAOWN	0.000000	0.846872	0.06092029	0.135565492
FSIZE	25.640461	33.473728	29.38664063	1.590806960
LEVER	0.000111	0.551634	0.15242575	0.116587125
ROA	0.000026	0.466601	0.06662284	0.068385209
OCF	-0.273543	0.650860	0.07767369	0.112706126
SALGR	-.513054	1.106197	0.11746377	0.218065540

Source: Output SPSS

The t-test results of this research is summarized as the following Table 3:

Table 3. t-Test Result

Variable	B	Significance
ACMET	0.000	0.314
ACATT	-1.158E-5	0.949
ACSIZ	0.012	0.002
APACC	0.001	0.750
BIG4	-0.002	0.704
MAOWN	0.036	0.004
FSIZE	-0.004	0.005
LEVER	0.040	0.008
ROA	1.083	0.000

Variable	B	Significance
OCF	-0.896	0.000
SALGR	0.017	0.027

Source: Output SPSS

Audit committee meeting has no significant influence on earnings management. The Blue Ribbon Committee BRC neglected the number of meetings of that committee because they did not find any absolute impact between number of meetings on the improvement of financial reports quality (Hamdan et al. 2012). This also happen because the number of meetings that held by audit committee just to fulfill the requirement that ruled out by regulator (Prastiti and Meiranto 2013).

Attendance audit committee meeting has no significant influence on earnings management. This is consistent with Prastiti and Meiranto (2013) that the meetings only is mandatory to fulfill the requirement, thereby audit committee can not perform their task efficiently.

Audit committee size has significant influence on earnings management. The coefficient of audit committee size is 0.012 and can be explained as if the audit committee size is higher, the earnings management will be higher. This is consistent with Asward and Lina (2015) that suggest larger size of audit committee will cause inefficiency while they doing their task because factor of communication.

Appointment audit committee has no significant impact on earnings management. This is based on a notion that appointment of audit committee by company might be just to fulfill the requirement or to comply with the regulation, but not to create good corporate governance to mitigate earnings management (Asward and Lina 2015).

Audit quality has no significant impact on earnings management. In line with the Alexander and Hengky (2017), whether the company is audited by big four audit firm or not, earnings management may still occur because the company has a desire to make the financial performance looks good for potential investor.

Managerial ownership has significant impact on earnings management. The coefficient of managerial ownership is 0.036 and can be explained as if managerial ownership is higher, the earnings management will be higher. This is consistent with

Asward and Lina (2015) that manager has self interest that is return from their ownership. Those, manager has probability to manipulate company's earnings to maximize their wealth by level of ownership which give them strong position to do control of the company. In case, manager have more information regarding the company, so external shareholder will experience difficulty in controlling manager actions.

Firm size has significant impact on earnings management. The coefficient of firm size is -0.004 and can be explained as if firm size is higher, the earnings management will be lower. This is consistent with Susanto (2016) and Susanto, Pradipta, & Cecilia (2019) that large companies tend to rarely perform earnings management because they already have a lot of capital that can be met from inside. This result also consistent with González and García-Meca (2013) that suggest larger companies are expected to have more sophisticated control systems, skilled advisers and are subject to increased monitoring by investors and analysts.

Leverage has significant impact on earnings management. The coefficient of leverage is 0.040 and can be explained as if leverage is higher, the earnings management will be higher. This is consistent with Abbadı (2016) and Susanto, Pirzada, & Adrienne (2019) suggests that leveraged firms tend to manipulate earnings and distort their financial statements to maintain a margin of safety to the creditors and to avoid debt covenant violation.

Profitability has significant impact on earnings management. The coefficient of profitability is 1.083 and can be explained as if profitability is higher, the earnings management will be higher. Amertha (2013) showed that earnings management done to make the performance of the companies look better which results in managers getting a bigger bonus. Another reason from Yunietha and Palupi (2017) and Susanto, Pradipta, & Cecilia (2019) that the higher the profitability, the higher tax will be charged to the company. Then, company will tend to do earnings management to reduce tax charges.

Operating cash flow has significant impact on earnings management. The coefficient of operating cash flow is -0.896 and can be explained as if operating cash flow is lower, the earnings management will be higher. Yuliana and Trisnawati (2015) showed that the smaller cash inflow to the entity, the bigger management intention to do the earnings management so that financial statement or firm performance looks good in the eyes of investor.

Sales growth has significant impact on earnings management. The coefficient of sales growth is 0.017 and can be explained as if sales growth is higher, the earnings management will be higher. Yunietha and Palupi (2017) found that if the company has high growth of sales, it can be utilized by management to get bigger bonus by doing earnings management.

5. CONCLUSION

Conclusion of the research that audit committee size, managerial ownership, firm size, leverage, profitability, operating cash flow and sales growth influenced earnings management, meanwhile audit committee meeting, attendance meeting, appointment and audit quality do not influenced earnings management. Limitation of the research is population is relatively small, which only uses non financial companies for 3 years. Recommendation for future researcher, which is expand the research period to make it more accurate.

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