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THE ROLE OF AUDITOR CHARACTERISTICS: EARNINGS MANAGEMENT AND AUDIT COMMITTEE EFFECTIVENESS

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Abstract. This study aims to analyze the moderating effect of auditor characteristics on the relationship between audit committee effectiveness and earnings management. Mechanisms of good corporate governance can limit and control the opportunistic actions of management. A highly effective audit committee will reduce the prevalence of earnings management. In addition to the audit committee as an internal party that oversees the credibility of financial statements, it is also necessary to supervise external parties, through the use of external auditors. With expectations of reducing earnings manipulation, this study examines the effects of the combination of an effective audit committee and an independent auditor. The research sample selection uses a purposive judgmental non-probability sampling technique. The sample obtained is 754 firm years, consisting of three years of company observations in the Indonesian capital market between 2016 and 2018, except those in the financial sector. Earnings management is measured by accrual value using a modified Jones model. The independent variable of the study is the effectiveness of the audit committee (EFAC) which will be assessed using the DeZoort index. The results of the empirical testing support the research hypothesis; the more effective the audit committee is and the longer the external audit period is, the more prevalent earnings management will be. In addition, the more effective the audit committee is, coupled with the use of one of the big four auditors, the less prevalent earnings management will be, which means the auditor's reputation also strengthens the relationship between the effectiveness of the audit committee and earnings management. Further, the moderating effect of auditor specialization on the influence of the audit committee on earnings manipulation did not provide significant results.

Keywords: earnings management; specialist auditor; audit committee; audit quality; governance

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1. Introduction

There are two main causes of corporate governance issues (Zgarni, Hlioui & Zehri, 2016). First, strong stakeholder pressure, rapid technological change and ever-changing environmental and social culture promotes good governance and demand transparency of financial reporting. Second, financial reporting issues in a number of companies trigger a decline in confidence in the accuracy of the information provided and adversely affect the behavior of stakeholders. Recently, in Indonesia, an accounting firm called Satrio Bing Eny & Partners (KAP SBE), which is an affiliate of Deloitte in Indonesia, experienced difficulty with the auditing process. Both public accountants from SBE's public accountant office, Malinna and Merliyana Syamsul, received administrative sanctions from the OJK. Based on a decision from the Center for Financial Professional Development (P2PK), both of them are unable to provide audit services to financial service entities for a period of one year. Sanctions given to SBE public accounting firms include the prohibition on the addition of new clients in the financial services sector (CNBC Indonesia, 2018).

In agency theory, information asymmetry triggers earnings management practices. Information asymmetry is a condition of information disparity between management and shareholders. The management, as the managers of the company, have access to more information, particularly in relation to the company's financial affairs, than the shareholders (Christiani & Nugrahanti, 2014). The data contained in financial statements can be manipulated by choosing certain accounting policies or arranging transactions to appear different from the actual conditions; this is also referred to as earnings management, the ultimate goal of which can mislead readers of financial statements about the company's performance (Healy & Wahlen, 1999). Good governance can control and regulate a company to create added value for each stakeholder. According to Inaam and Khamoussi (2016), the function of the governance mechanism in financial reporting is to ensure consistency between maintaining the credibility and reliability of a company's financial statements with financial accounting standards. Specifically, this study analyzes audit committees as part of corporate governance. Halim (2015) shows that the audit committee can reinforce the relationship between independent auditors and management. High quality audits conducted by external auditors and audit committees encourage a high quality of earnings (Becker et. al., 1998). The higher the effectiveness of the audit committee, the less prevalent earnings management will be (Abbott, Park, & Parker, 2000).

This paper enriches the existing literature, both theoretically and empirically, concerning the impact of audit committee characteristics on earnings management. Theoretically, it will expand on the agency theory and governance in improving the quality of financial reporting. Empirically, the results of research on interactions between audit committees and external auditors on the quality of reporting have been carried out in countries with advanced capital markets. Conversely, studies in countries with developing capital markets are still rare.

This paper consists of several sections. The previous section explained the background, objectives, and research contributions. The second section provides theories and logical thinking about developing research hypotheses. The research methods and models are contained in part three followed by the empirical results in part four. A discussion and critical evaluation with a consideration of previous findings is presented in the fifth section and the last section concludes the paper.

2. Literature Review

Agency theory and corporate governance are used in this study as a theoretical framework to investigate the preferences of managers in companies. The role of the audit committee and the characteristics of the auditor can be explained using this theory. It recognizes this as the most critical oversight mechanism that can reduce agency costs, manage conflicts of interest, and reduce earnings management. Audit committees and external auditors, as corporate governance actors, provide supervision that is expected to reduce the potential for earnings

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management. Agency theory predicts that supervision ensures the quality of financial reporting (Zgarni et. al., 2016).

The big four public accounting firms are often assumed to have better audit quality, because they have an international reputation, have large clients, and use sophisticated technology in their activities. The interaction between the audit committee and the external auditor is related to the honesty and objectivity of the auditor, thereby reducing earnings management. The audit committee and external auditor aim to publish high-quality reports so they can carry out high-quality audits to maintain their reputation and avoid legal liability. Hence, it can be said that the audit committee and the use of external auditors can reduce agency problems and thereby reduce the prevalence of earnings management practices.

H1: The more effective the audit committee and the use of reputable external auditors, the less prevalent earnings management will be.

Mutmainnah and Wardhani (2013) suggest that auditors specializing in industrial practices tend to be more solution-oriented and responsive in carrying out audit procedures. Extensive experience and working hours I the relevant field will help the audit committee to conduct and advance the quality of supervision and control of financial statements. Zgarni et. al. (2016) show that companies that have an effective audit committee and industry specialization auditors can reduce earnings management. This is because there is a complementary relationship between the effectiveness of audit committees and industry specialization auditors in limiting earnings management practices.

H2: The more effective the audit committee, coupled with the use of specialized external auditors, the less prevalent earnings management will be.

The moderation effect of the audit committee and independent auditors can increase with the length of the audit period. This is because more effective audit committees tend to retain their auditors as long as the auditor can provide high-quality financial reporting (Meixner & Welker, 1988). According to Fitriany, Utama, Martani and Rosietta (2016), the longer an auditor remains engaged by a company, the more competent the auditor will be, because the auditor will obtain greater knowledge about the company's specific risks and its internal control systems.

H3: The more effective the audit committee and the longer the audit tenure, the less prevalent earnings management will be.

3. Research Methodology

The research sample selection uses a purposive judgmental non-probability sampling technique. The sample obtained was 754 years of the company, consisting of three years of observation between 2016 and 2018. The data used came from the audited financial statements and annual reports. Data can be obtained from the Indonesian capital market website or company website. The total sample has complete data and consists of all industries, except the financial sector, which has specific regulations.

3.1 Measurement of Variables

The dependent variable of this study is earnings management which is proxied by discretionary accrual (DAC), measured using the Modified Jones Model on a cross-sectional basis according to Dechow et. al. (1995). The discretionary accrual calculation using the Modified Jones Model is as follows:

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a. Total accruals (TA) calculated using a formula:

$$\frac{TA_{i,t}}{A_{i,t-1}} = \beta_1\left(\frac{1}{A_{i,t-1}}\right) + \beta_2\left(\frac{\Delta REV_{i,t}}{A_{i,t-1}}\right) + \beta_3\left(\frac{PPE_{i,t}}{A_{i,t-1}}\right) + \varepsilon_{i,t} \qquad (1)$$

b. Non-discretionary accruals calculated using a formula:

$$NDA_{i,t} = \beta_1\left(\frac{1}{A_{i,t-1}}\right) + \beta_2\left(\frac{\Delta REV_{i,t} - \Delta REC_{i,t}}{A_{i,t-1}}\right) + \beta_3\left(\frac{PPE_{i,t}}{A_{i,t-1}}\right) \qquad (2)$$

c. Discretionary accruals calculated using a formula:

$$DAC_{i,t} = \frac{TA_{i,t}}{A_{i,t-1}} - NDA_{i,t} \qquad (3)$$

The independent variables in this study are the effectiveness of the audit committee and audit quality. The measurement of the effectiveness of the audit committee refers to the research of DeZoort, Hermanson, Archambeault and Reed (2002), while the measurement of audit quality refers to the research of Zgarni et. al. (2016).

3.2 Audit Committee Effectiveness (ACEff)

Audit committee effectiveness is measured by the total score of the audit committee effectiveness index by reference to DeZoort et. al. (2002) with a maximum score of 14. The four dimensions that determine the effectiveness of the audit committee are (table 1):

Table 1. Audit Committee Effectiveness Index

Dimension	Code	Proxy	Skoring
Composition	ACIND	Audit Committee Independence All members of the audit committee must come from outside the company or independent parties	1;0
	ACEXP	Audit committee Expertise At least one member has a background in accounting or finance	1;0
Authority	ACCHART	Audit Committee Charter Proxy statement regarding the audit committee agreement (work program)	1;0
	ACDUTY	Audit Committee Responsibility If the company writes in detail about the duties and responsibilities of the audit committee on financial information, it is given a score of 2. If the company writes a brief statement about the review conducted by the audit committee on the company's financial information, it is given a score of 1. If there is no	2;1;0

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		disclosure, then given a score of 0.	
Resources	ACSIZE	Audit Committee Size The audit committee has a minimum of 3 members	1;0
Diligence	ACMEET	Audit Committee Meeting The audit committee meeting at least 4 times a year	1;0
	ACVOLDIS	Audit Committee Voluntary Disclosure The audit committee voluntarily discloses more financial information than other regulations or companies	1;0

The measurement of audit characteristics is by reference to Zgarni et. al. (2016) using three proxies. First, the auditor's reputation (REPUT) is given a score of 1 if the company is audited by one of the Big Four Public Accounting Firm and 0 if it is audited by a Non-Big Four Public Accounting Firm. Second, specialization of the auditor industry (SPEC), if the company being audited with a market share of more than 10%, then it is worth 1 and if less than 10% will be worth 0. The total sales of clients audited by KAP in the industry are divided by total sales in the industry. Third, the audit period (TENURE) is the number of consecutive years the client maintains the KAP. The number of tenure years is counted backward, starting from year t (research year) and traced to the year the client moves to another auditor.

3.3 Regression Model

$$DAC_{it} = \alpha + \beta_1 ACEff_{it} + \beta_2 REPUT + \beta_3 ACEff_{it} \times REPUT_{it} + \beta_4 FSIZE_{it} + \beta_5 LEV_{it} + \beta_6 MTB_{it} + \beta_7 ROA_{it} + \varepsilon_{it}$$

$$DAC_{it} = \alpha + \beta_1 ACEff_{it} + \beta_2 SPEC_{it} + \beta_3 ACEff_{it} \times SPEC_{it} + \beta_4 FSIZE_{it} + \beta_5 LEV_{it} + \beta_6 MTB_{it} + \beta_7 ROA_{it} + \varepsilon_{it}$$

$$DAC_{it} = \alpha + \beta_1 ACEff_{it} + \beta_2 TENURE_{it} + \beta_3 ACEff_{it} \times TENURE_{it} + \beta_4 FSIZE_{it} + \beta_5 LEV_{it} + \beta_6 MTB_{it} + \beta_7 ROA_{it} + \varepsilon_{it}$$

DAC, Discretionary accruals at the company i for years t. ACEffit. The effectiveness of the audit committee is measured using the Dezoort index. REPUT, auditor's reputation (1 if audited by a Big Four public accountant and 0 if not). SPEC, Specialization of auditor industry. TENURE, length of the audit engagement. ACEff x REPUT, Interaction between the effectiveness of the audit committee and the auditor's reputation. ACEff x SPEC, Interaction between the effectiveness of the audit committee and the auditor's specialization. ACEff x TENURE, Interaction between the effectiveness of the audit committee and the audit period. SIZE, company size (Ln of total assets). LEV, Leverage (total debt divided by total assets). MTB, market to book ratio (share market value divided by book value of equity). ROA, return on assets (net profit divided by total assets).

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4. Results

4.1 Descriptive Statistics

The descriptive statistics for the 754 company years in the sample are presented in Table 2. The average absolute DAC is 4.11% of total assets, with a standard deviation of 0.17. TENURE has a value minimum and maximum of 1 and 20. Frequency statistical results show that Big Four auditors represent 27.6% of the sample companies, while companies audited by non-Big 4 audit firms represent less than 72.4% of the sample. In addition, the overall industry specialization (SEPC) average was 28.4%.

Table 2. Descriptive Statistics

	Min	Max	Mean	SD
DAC_{it}	-1,0113	1,5768	-0,0411	0,1771
ACEff	1	14	9,28	2,5040
TENURE	1	20	6,66	5,2340
ACEff x REPUT	0,00	14,00	3,0557	5,0600
ACEff x SPEC	0,00	14,00	3,0822	5,0409
ACEff x TENURE	1	252	65.0013	58,7541
FSIZE	9,9753	14,7541	12,4030	0,7145
LEV	0,00006	22.6105	0,5391	1,0019
MTB	-7,1200	26,2000	1,9554	2,6224
ROA	-1,0099	2,1920	0,0285	0,1376
n = 754				

4.2 Results of the Regressions

The results of the coefficient of determination are presented in Table 3. Models 1, 2, and 3 in this study show an adjusted R2 value of 0.384, 0.383, and 0.395. Table 3 also shows that the independent variable has a significant simultaneous effect on DACit because the significance value is below 0.05 or 5%. For model 1, 2 and 3, the F test results were 68.150, 67.833, and 71.183 with a significance value of 0.000. The coefficient of the interaction variable between audit effectiveness and the auditor's reputation (ACEff × REPUT) is negative and significant. These results support H1, which is that a higher audit committee effectiveness, and the presence of Big Four auditors will reduce earnings management. The effectiveness score of the audit committee and auditor specialist (ACEff × SPEC) is not significant meaning H2 is not supported. The coefficient of the interaction variable between audit effectiveness and the auditor's tenure (ACEff × TENURE) is negative and significant meaning H3 is supported.

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Table 3. Regression Results (Audit Committee and Earning Management)

	(1)		(2)		(3)	
	t	Sig.	t	Sig.	t	Sig.
Constant	-2,153**	0,016	-2.301**	0,011	-2.846***	0,003
ACEff	-0,562	0,287	-0.560	0,287	1.986**	0,023
REPUT	1,539*	0,062				
SPEC			1.144	0,126		
TENURE					3.946***	0,000
ACEff x REPUT	-1,337*	0,090				
ACEff x SPEC			-0.988	0,162		
ACEff x TENURE					-3.656***	0,00
FSIZE	1,638*	0,051	1.789**	0,037	1.422*	0,078
LEV	-1,072	0,142	-1.069	0,142	-1.156	0,124
MTB	-3,849***	0,000	-3.941***	0.00	-4.083***	0.00
ROA	21,056***	0,000	21,155***	0,00	21,274***	0,00
F	68,150***		67,833***		71,183***	
n	745					
Adj. R2	0,384		0,383		0,395	

* Significant level 0.1; ** Significant level 0.05; *** Significant level 0.01

5. Discussion

The relationship between ACEff x REPUT and DAC in the tables above shows that there is a significant and negative effect. This indicates that hypothesis 1 is accepted, which means that the more effective the audit committee is, coupled with the use of a big four auditor, the less prevalent earnings management will be. This is consistent with the study of Alves (2013) which shows that the interaction between the effectiveness of the audit committee and the use of a big four auditor has a significant negative effect on earnings management. Rahmadani and Haryanto (2018) also found that the use of the big four external auditors had a significant negative effect on earnings management. Big four auditors have better incentives to detect and disclose reporting errors made by management. Big four auditors are more at risk when an audit failure occurs, so that the big four auditor can more effectively monitor the auditee. The audit committee has a close relationship with external auditors. The audit committee and external auditor have obligation to publish high quality financial statements. The oversight mechanism by the audit committee or external auditor cannot be carried out independently and separately because supervision they provide is a unity in the corporate governance structure.

The results in the tables above show that ACEff x SPEC has no significant relationship to DACit. This indicates that hypothesis 2 is rejected, which means that the effectiveness of the audit committee and the use of specialist auditors do not have a significant effect on earnings management. These results contradict previous studies, such as Zgarni et. al. (2016), which concludes that the complementary relationship between the effectiveness of the audit committee and auditor specialists will lower the prevalence of earnings management. The inability of auditor specialization to reduce the level of earnings management in the Indonesian stock market is perhaps because specialization is still in the initial stages in Indonesia. Further, only a small number of companies are audited by specialized auditors. The results of this study are in line with Dian and Yuyetta (2013), which states that auditors who are specialized in specific industries have no significant effect on earnings management. This

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might be due to weak law enforcement in Indonesia, which makes auditors less able to develop the ability to detect earnings management practices. Auditors who are specific to certain industries and those not specific to certain industries have not been able to detect earnings management because the object of manipulation is not a financial report, but a process of reducing discretionary costs. This research is also in line with Fung, Gul and Krishnan (2012), which states that auditors who have experience and expertise are not necessarily independent and objective because they tend to retain their clients. Hence, it can be concluded that the ACEff and SPEC variables respectively do not have a significant effect on earnings management, and if the ACEff variable is modulated with SPEC, this also does not have a significant effect on earnings management.

Table 3 shows that ACEff x TENURE has a significant effect on DACit. This indicates that hypothesis 3 is accepted, which means the more effective the audit committee is, and the longer the external audit period, the less prevalent earnings management will be. This result is in line with Inaam and Khamoussi (2016), who state that an effective audit committee and a long audit period can reduce earnings management. Meixner and Welker (1988) suggest that interactions between audit committees and external auditors can increase with increasing audit periods (tenure) because more effective audit committees tend to retain auditors as long as the auditor can provide high-quality financial reporting. Further, Fitriany et. al. (2016) suggest that the longer the audit period, the more competent an auditor will be because they are able to achieve a deeper understanding of the company's internal controls, accounting information systems, and company-specific risks. This is also supported by Gul, Jaggi and Krishnan (2007), who state that auditors who do not have a deep understanding of clients will tend to depend on estimates and information provided by client companies. Audit quality and tenure have a non-linear or quadratic relationship, so that when it reaches its' optimal point, the independence of the auditor will decrease which will affect the auditor's relationship with the client, and will ultimately result in decreased audit quality. In the early years of audit assignments, there are many audit errors meaning that a longer audit period will result in better audit quality.

6. Conclusion

In conclusion, this study examines the effect of auditor characteristics on the relationship between audit committee effectiveness and earnings management practices in Indonesian companies. Acknowledging that Indonesia has an environment with different characteristics and regulations for company operations compared to other countries, this justifies an investigation of the problem in the Indonesian context. This study contributes to agency theory, enriching our understanding of how to effectively reduce agency costs by forming audit committees in Asian countries such as Indonesia. Countries with inadequate legal protection such as Indonesia will need more effective audit committees than countries with good legal protection.

The empirical results support the agency theory and corporate governance theory. The relationship between the audit committee and the quality of the external audit, which is an important mechanism of corporate governance, can reduce the manipulation of financial statements. The increased effectiveness of the audit committee and the high quality of auditors, which is characterized by the Big Four auditor, will be able to mitigate the possibility of earnings management. The effectiveness of the audit committee and the length of the audit work period can also reduce earnings management. However, specialist auditors and audit committee effectiveness cannot reduce earnings manipulation.

This study has some limitations. First, this research cannot be generalized to the entire world, particularly for developed countries. The results of the study may illustrate the condition of states with diffuse or no pyramid ownership, low investor protection, family ownership is common, and weak dependence on public debt. In addition, managers in developed countries often use more complex techniques, which are less likely to be captured with the accrual model in this study, thus making information for investors more opaque.

Secondly, earnings manipulation will be able to eliminate or reduce the ability of the cross-sectional expectation accrual model to detect earnings management actions. Third, estimates and choices of accounting policies are usually decided to signal private information. The use of one model to measure earnings management is subject to criticism.

Future research may wish to include aspects or other measures of earnings quality, such as actual earnings management or income smoothing. Further, it is also recommended that other measures of good corporate governance be used in future research. Other considerations include politically connected variables in the selection of company CEOs and state governments, as well as the role of audit committees in organizations with political connections in Indonesia.

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