

ANALYSIS OF THE CHARACTERISTICS AUDIT COMMITTEE ON EARNINGS QUALITY

Kiryanto

Economic of Faculty, Sultan Agung Islamic University, Kaligawe Street Km. 4 PO. Box. 1235 Semarang, Central Java, Indonesia (50112)

E-mail: kiryanto_fe@yahoo.co.id

ABSTRACT

The objective of this research is designed to develop conceptual framework of association between of audit committee characteristics including size, independence, expertise and activity with earnings quality that approximated by earnings management, conservative accounting and earnings response coefficient. The results find significant evidence of a positive association between audit committee characteristics of size and independence and earning response coefficient and earnings management. The second of results indicate that audit committee characteristics of expertise and activity not positive affect earning response coefficient and earnings management and accounting conservatism. The third find significant evidence of a negatively association between earnings management and earnings response coefficient. The last results show that earnings management and accounting conservatism were not mediate of association between audit committee characteristics and earnings response coefficient.

Keywords: earnings quality, earnings management, accounting conservatism, audit committee, earnings response coefficient

INTRODUCTION

The main issue of this study is the role of audit committees in maintaining the quality of earnings. The audit committee has a role to help the commissioners oversee the management in the process of preparing financial statements. Therefore, the subject matter of this research is how relationship the model of the characteristics of the audit committee with earnings quality

This study examined relationship the characteristics of the audit committee with earnings quality. This research is important for several reasons. First, the financial scandals of the 1980s to the present. This issue is interesting because of the emergence of the contradiction between the existence of an audit committee in maintaining the quality of earnings and the financial scandals that still happens. Role of the audit committee is a representasi the board of commissioners to receive a key responsibility of to the problems relating to the credibility of the financial statements, the external auditor, and everything related to corporate governance (Pike, 2005). The Blue Ribbon Committee (BRC, 1999) states that the audit committee plays a key role in monitoring the process of preparing financial statements. Therefore, the audit committee is a very important element in the process of corporate governance so that the audit committee is expected to monitor and improve the quality of the process of preparation of financial statements in the company. Some previous empirical research suggests audit committees have a positive role in maintaining the quality of financial information, especially the quality of earnings. Research Ho and Wong (2001) showed that the existence of audit committees influence positively the extensive disclosures. Pike (2005) and Peasnell et al (2001) found that firms that have audit committees reduce the occurrence of fraudulent financial statements.

Second, some previous studies also still apparent contradiction of the results of a study with other studies. The results of the study of Abbott et al., 2000; DeZoort and Salterio, 2001; Felo et al., 2003; Song and Windram, 2004) showed that the independence and expertise is a characteristic that is very important in enhancing the effectiveness of the audit committee. Instead Archambeault and DeZoort (2001) found that the negative relationship between the number of audit committee with the possibility of a replace public accountant firm. Abbott et al. (2004) and Bedard et al. (2004) found that the number of audit committee is not related to earnings management. Xie et al. (2003) found that the activity of the audit committee meetings negatively associated with accruals deskresi while Bedard et al (2004) found no association between the amount of activity with discretionary accruals meeting

THEORITICAL BACKGROUND AND HYPOTHESIS DEVELOPMENT

Relation of Audit Committee Characteristics with the Earnings Response Coefficient

The role of the audit committee is strongly influenced by the characteristics of the audit committee. The better the characteristics of the audit committee of the audit committee's role in assisting the board of commissioners will increase. The results of the study of Anderson et al. (2003) found that independent, activity and the audit committee amount of influence on the content of the information. Similarly, Bryan et al. (2004) found that independent and expertise the audit committee of influence the response coeffisien earnings.

Instead Dechow et al (1996) showed that the financial reporting process error (earnings manipulation) occur if no audit committee independence. Similarly, Carcello and Neal (2007) found a negative relationship between the composition of the audit committee with the possibility of receiving the auditor's going-concern report. Similarly, Klein (2000) suggests that the independence of the audit committee has no effect on earnings management. Research Chtourou, et al (2001) showed that the

frequency of audit committee meetings effect with a large of earnings management. The findings were also supported by research Xie et. al. (2003) found that the frequency of meetings held by the audit committee affect the current discretionary accruals.

The task of the audit committee was review the financial statements are issued and reviewing the effectiveness of the company 's internal control system (Bapepam, 2001). Therefore, members of the audit committee must have a financial and accounting background so that they are able to carry out their duties properly. This results of the study Felo, Krishnamurthy, and Solleri, (2003) found that the number and level of competence of the audit committee in finance or accounting effect on the quality of the company 's financial statements. The finding was been also supported research Bedard et al., (2004) found that audit committee expertise is negatively related to the level of discretionary accruals. Xie et al (2003) found that the frequency of audit committee meetings negatively associated with the level of discretionary accruals.

Instead research Bedard et al., 2004 found that there was no relationship between the frequency of audit committee meetings with the level of discretionary accruals made by manajemen. Xie et al (2003) which showed that the number of audit committee is not related to the level of discretionary current accruals. Likewise Based on the results of several studies are still varied, so this hypothesis research as follows :

hypothesis 1: Characteristics of the audit committee has a positive effect on the quality

Relation of Characteristics Audit Committee with Earnings Management

In general, the literature defines earnings management as exploitation of manager with using accounting standard policies for external financial reporting that deviate from the interests of stakeholders on the economic condition of the company for personal benefit manager (Healy, 1998; Schipper, 1989). Research Schipper (1989) found that earnings management is done specific for personal gain. In this context, the motivation of earnings management are some of the activities carried out by the manager and majority shareholder to affect reported earnings to enhance the compensation or management welfare and major shareholders.

Research Chtourou, Bedard and Courteau, (2001) showed that the effectiveness of the board of directors and audit committee can to limit the earnings management . While Klein (2002) examined the relationship characteristics of the audit committee , the board of directors with earnings management. Research results show that there is not linear relationship between the independence of the audit committee with earnings manipulation and in particular does not occur a significant relationship between the independence of the audit committee with the earnings management.

The results of the study Feltham and Pae (2000) suggests that if management does not to act earnings management, this it will cause fluctuated earnings so that earnings response coefficients will be high. So a larger audit committee to participate in the corporate governance process and more likely to exercise control and comprehensive financial reporting. Abbott et al (2004) found that the effectiveness of the audit committee was relationship to the number of audit committee. In order for the audit committee can do its job professionally then they should be independent. Empirical evidence from Klein, (2002) and Xie et al., (2003) found that audit committee independence affects the discretionary accruals. Empirical studies of Bedard et al (2004) was showed that of audit committee expertise effected on earnings management. Xie et al (2003) found no effect of audit committee expertise on earnings management. More and more activities are carried out by the audit committee, they can expected to monitor the process of the preparation of the financial statements properly so the quality the better the financial statements. Xie et al (2003) found that the activity of the audit committee meetings is negatively related to earnings management . Based on several studies related to the characteristics of the audit committee with earnings quality is still not consistent then it is likely there are other variables that mediate between the two variables. Therefore hypothesis 2 : Audit committee characteristics negatively affect earnings management.

Relation of Earnings management with the Earnings Response Coefficient

According to agency theory, the separation of ownership and control of the company led to the opportunistic behavior of management because management interests in the financial statements (Jansen & Meckling, 1976). The behavior opportunistic of management leads to the use of accounting policies that benefit management that the financial statements are reported lower. Feltham and Pae (2000) found that earnings management affect the information content of earnings. Therefore, hypothesis 3: Earnings management negatively affect earnings quality proxied by the earnings response coefficient company

Relation of Characteristics of Audit Committee with Accounting Conservative

Historically, conservatism policy was formed as part of the process of drafting standards and is the fundamental concept underlying the measurement in accounting . Conservative policy is used to decrease compensate management in financial reporting is too optimistic. Devine (1963) stated that the policy of conservatism is characterized by a delay recognition of transactions that are profitable and accelerate recognition for transactions that are not profitable . Empirically Beaver and Dukes (1973) find evidence that investors respond differently to conservative accounting profit with the aggregate accounting earnings in accordance with the efficient market hypothesis.

While Pincus (1993) found no evidence to reject the null hypothesis of no difference between the effect of the selection of the underlying accounting measurement of accounting profit measurement. Therefore, the level of conservatism affect investors' perceptions of the cash flow in the future.

Conservatism is potential useful in corporate governance in several ways, among others: conservatism limits the over estimate of management (Watts, 2003). Conservatism also prevent managers to perform investasi on projects with a net present value

(NPV) is negative (Ball, 2001; Ball and Shivakumar, 2005). While Ball, (2001) and Watts (2003) states that conservatism prevents managers eliminate projects that the NPV is negative so that it raises the signal to the board of directors to conduct an investigation on the manager.

Research Ohlson (1999) shows that size or the finance background of the audit committee accounting positive effect on the stock market reaction. Weil et al . (2005) find that the stock market reaction is very good against companies that have an audit committee financial background. Based on several studies Ohlson (1999) , DeFond et al. (2005), and Weil et al. (2005) showed that members of the audit committee have accounting or financial expertise affect accounting conservatism. Ball (2001) suggest that accounting conservatism is a fundamental characteristic of the financial statements. Watts (2003a and 2003b) asserts that conservatism can increase effectiveness in overseeing managers. Similarly, the Treadway Commission (1987) states that the expertise of the members of the audit committee will improve the accounting conservatism. Accounting conservatism not only affect the reported values of the balance sheet but also the quality of reported earnings from the income statement. Research Penman and Zhang (2002) show that accounting conservatism affects the quality of earnings. Bedard et al (2004) showed that the number of audit committees influence the low level of aggregation of accounting. Bedard et al. (2004) showed that the independence of audit committees influence the low level of aggregation of accounting. Empirical studies of Bedard et al (2004) too showed that audit committee expertise affect negative on accounting aggregation. Abbott et al (2004) found that audit committee activity affects the possibility of changes in the financial statements. Based on the description above, the hypothesis 5: Audit committee characteristics affect accounting conservatism

Relation of Accounting Conservatism with Earnings Response Coefficient

Conservatism is the principle that most influence the judgment in accounting (Watts, 2003a). Therefore conservatism until now still has an important role in accounting practices. Some experts claim that conservatism produces a higher quality earnings because of this principle prevents the action of earnings management and helps users of financial statements by presenting earnings and assets not overstate. Feltham and Ohlson (2005), Watts (1993) proved that the earnings and assets are calculated with conservative accounting can improve the quality of earnings that can be used to assess the company .

Signalling theory explains that the signaling is done by managers to reduce information asymmetry . Managers provide information through financial statements show that the company applying accounting conservatism policies to produce a higher quality earnings. Therefore , the research hypothesis 6 as follows : Accounting conservatism positive effect on the earnings response coefficient.

METHODOLOGY

The population of this study is manufacturing companies listed on the Jakarta Stock Exchange (JSX) from 2004 to 2006 and purposive sampling was used to obtain representative samples in accordance with the specified criteria.

Exogenous variables:

Size (SIZEKOM) is measured by the number of audit committee. The independence (FREEKOM) as measured by the number of audit committee members are independent. Expertise (EXPERTKOM) as measured by the number of committees that finance or accounting background. Activity (ACTIVEKOM) as measured by the number of audit committee meetings held.

Endogenous variables:

Earnings management (ML) as measured by the modified Jones models. Conservative accounting accrual rate (AK) was measured with a model accrual that calculated the working capital. Earnings response coefficients (KL) measured by the market response to earnings

Data analysis tool used in this study Path Analysis (Path Analysis) with Linear Structural Relations program (LISREL). or path analysis. There are 3 (three) in the path analysis model formulations are essentially the following equation:

$$KL = \gamma_1(SIZEKOM) + \gamma_2(FREEKOM) + \gamma_3(EXPERTKOM) + \gamma_4(AKTIVEKOM) + \gamma_2 (AK) + \gamma_3(ML) + e_1 \dots\dots\dots(2)$$

$$AK = \beta_1(SIZEKOM) + \beta_2(FREEKOM) + \beta_3(EXPERTKOM) + \beta_4(AKTIVEKOM) + e_2 \dots\dots\dots(3)$$

$$ML = \alpha_1(SIZEKOM) + \alpha_2(FREEKOM) + \alpha_3(EXPERTKOM) + \alpha_4(AKTIVEKOM) + e_3 \dots\dots\dots(4)$$

RESULTS AND DISCUSSION

Influence of Characteristics of Audit Committee on Earnings Response Coefficient

The results of this study indicate that the number of audit committee members significant positive effect on earnings quality proxied by the earnings response coefficient at the 5% significance level where value 5.81 greater than value 1.96 table. The results of this study support previous research (Archambealut and DeZoort, 2001; Felo et al, 2003) that the number of audit committee members affect the quality of earnings. However, this study does not support the research that has been conducted by Anderson et.al (2003) who found that firms a smaller that audit committee members have higher information content and vice versa.

Table 1 shows the empirical evidence that the independent of audit committee members affect the earnings response coefficient with a significance level of 5%. This result supports the signaling theory and research Vafeas (2005) which showed that the percentage of audit committee independent affects the quality of the company's financial statements. However, expertise and the activity of the audit committee does not significantly affect the earnings response coefficient. The results are consistent with research Carcello et al (2006); DeFond et al. (2005), Lee et al. (2005), and Anderson et al. (2003) who found that there was no relationship between audit committee expertise with earnings quality as measured by earnings management.

Table 1
Summary of Hypothesis Testing Results

	Adj. R ²	t _{hitung}	Kesimpulan
Persamaan 2	0.10	1,49	reject
AK		-1,76 ^{*)}	no reject 10 %
ML		5, 81 ^{**)}	no reject 5 %
SIZEKOM		4,81 ^{**)}	no reject 5 %
FREEKOM		1,40	reject
EXPERTKOM	0.66	1,47	reject
Persamaan konservatisme			
SIZEKOM		0,36	reject
FREEKOM		1,38	reject
EXPERTKOM		0,69	reject
AKTIVKOM	0,26	reject	
Persamaan manajemen laba	0,012		
SIZEKOM			
FREEKOM			
EXPERTKOM		-2,06 ^{**)}	no reject 5%
AKTIVKOM		-1,77 ^{*)}	no reject 10 %
		- 0,66	reject
		- 0,21	reject

** Significant at 0.05 level. * Significant at 0.1 level.

Influence of Characteristics of Audit Committee on Earnings Management

The empirical results show that the number of audit committee members effected a significant negative on earnings management. These results support the research DeZoort (2001) who found that companies that have a number of audit committee members smaller more possible replace auditors than is number of members audit committee greater. However, in contrast to the results of research Xie et al (2003) also found that the number of audit committee members did not significantly affect discretionary accruals. While the results of others suggest that audit committee independence negative significant effect on earnings management at a significance level of 10 % so that these results support Klein (2002a); Dhaliwal , Naiker , and Navissi (2006), Abbott et al (2000). These results are in contrast to studies of Kim and Yoon (2008), Xie et al . (2003), Felo et al. (2003), Anderson et al. (2003) who found that the independence of the audit committee no affect the quality of financial reporting. Conversely, expertise and activity of audit committee does not significantly affect earnings management. The results of this study support the study of Abbott et al (2001) and Kim and Yoon (2008) who provide empirical evidence that expertensi and audit committee activity does not significantly affect earnings management.

Effect of Earnings Management on Earnings Response Coefficient

The results of this empirical study shows that the of earnings management negative effect on earnings quality. These results are consistent with the signaling theory which says that the private market will respond to the information presented by management through disclosure of financial statements published by the company (Chaney and Philipich 2002; Krishnamurthy, Zhou, and Zhou 2002; Krishnan 2004; Callen and Morel 2003). Results of other studies indicate that the effect of audit committee characteristics on the quality of earnings is not mediated by earnings management . This happens due to the influence of the quality of the audit committee with the of size , independent, expertensi, and activity does not significantly affect of earnings management

Influence of Characteristics of Audit Committee on Accounting Conservatism

The results of this study indicate that the characteristics of the members of the audit committee as a whole has no effect at accounting conservatism. In order to strengthen the results of this study, then tested against all the characteristics of the different members of the audit committee and the different test results indicate that there is no difference of accounting conservatism for all of the company's audit committee characteristics.

Influence the Accounting Conservatism on earnings response coefficient

The results of this study indicate that accounting conservatism has no effect of the earnings response coefficient. These results do not support previous research (Mayangsari and Wilopo (2002), however support the research of Penman and Zhang (2000).

Mediation Effect of Accounting Conservatism on relationship the Audit Committee Characteristics with earnings response coefficient.

The results of empirical research shows that the influence of audit committee characteristics on earnings response coefficient are not mediated by consevatisme accounting . This was probably due to the influence of the characteristics of the audit committee did not significantly influence accounting conservative.

CONLUSSION AND IMPLICATION

The first empirical findings of this study is that the characteristics of the audit committee is a predictor of earnings quality proxied by the earnings response coefficient are very small though . This is due to not all the determinants of audit committee characteristics significantly affect the earnings response coefficient. The number and independence of the audit committee are significantly positive effect on the earnings response coefficient. This indicates that the number and independence of the audit committee were formed companies responded positively by capital markets. Whereas of two characteristics of audit committee expertise and activities are not a significant positive effect the earnings response coefficient then this indicates that expertise and activities the audit committee that were formed the company not responded positively by capital markets. These findings support the signaling theory, that information is presented in a transparent manner in information financial statement of will be responded by the market well. Conversely, if the information is not presented in the financial statement disclosure is transparent then the information can not be responded well by the market.

The second finding of this study is that most of the characteristics of the audit committee significant negative influence on earnings management and partly no significant negative effect. Characteristics the number of audit committee and independence significantly negative influence on earnings response coefficient. This finding is consistent with agency theory which states that the conflict of interest between owners (principal) and management (agent) can be aligned with one of corpoarate governance mechanisms (Jensen, 2003).

The third finding is that earnings management was negatively effect on earnings response coefficient. This shows that the indication of earnings management in the enterprise market responded negatively (Teoh , Welch , and Wong , 1998). The existence of the market response will affect the investor decision to sell or buy shares so that they can affect stock prices is reflected in increase earnings response coefficient. Therefore, these findings also support the theory of signaling (Chaney and Philipich 2002; Krishnamurthy, Zhou, and Zhou 2002; Krishnan 2003; Callen and Morel 2003).

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The latest findings from this study is that accounting conservatism also positive affect on earnings response coefficient, although not significantly. These findings indicate that stock market participants responded positively to information conservatism of accounting reflected in earnings response coefficients (Teoh, Welch, and Wong, 1998). The theoretical implication of this research is to Bapepam support the signaling theory; corporate governance and agency theory. While the policy implications of this research is the need for a policy of transparency in revealing the characteristics of the audit committee and the need to use the principle of conservatism in the preparation of the financial statements.

LIMITATIONS AND FUTURE RESEARCH

The findings from this study has several limitations, therefore, some suggestions for further research are presented below. First, this study only obtain a sample of 151 companies then further research can expand the sample through the expansion of the object of observation as well as extending the period of observation (longitudinal study). Samples that more and more research can improve generalization of research results better. Second, further penellitian can be done using another measurement for variable expertise and activity. This research may result in a very low coefficient of determination then to study further the development of more comprehensive research model.

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