# THE EFFECT OF AUDIT COMMITTEES AND CORPORATE GOVERNANCE ON EARNINGS MANAGEMENT: EVIDENCE FROM INDONESIA MANUFACTURING INDUSTRY

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**ABSTRACT**

*The purpose of the research is to get empirical evidence about the effect of audit committees' characteristics, board of directors, independent commissioner, managerial ownership, firm size and losses on earnings management. Characteristic of the audit committee include tenure, gender, education, work experience in accounting and meetings. The research uses sample of 62 manufacturing firms which listed in Indonesia Stock Exchange during 2009 until 2012. The sample selection is based on purposive sampling method. The research uses multiple regression analysis to hypothesis testing. The result of the research shows that gender and education of audit committee, audit committees' meetings, board of directors, independent commissioners, managerial ownership, firm size and losses have influence to earnings management. While tenure and financial working experience of audit committee have not influence to earnings management. Characteristics of audit committees effect on earnings management. The audit committee to act as a watchdog management to earnings management.*

Key words**:** Earnings management, audit committee, board of directors, independent commissioners, managerial ownership.

## Introduction

Earnings management is a difficult phenomenon to be avoided because it is the impact of the financial statements. The financial statements are used as a means to account for what is done by the manager over resource owners. Earnings information becomes the most important part because such information is generally regarded as a representation of performance management in a given period. Therefore, the management seeks to 'beautify' their financial statements. Earnings management is likely to cause the quality of the financial statements will be lower because of earnings management goal is to mislead the users of financial statements

The task of the audit committee is to assist the commissioners in overseeing the financial reporting process by the management. The audit committee has reviewed the accounting methods used by the company in making financial reports, in addition to the audit committee also noted the company's internal controls and adherence to existing regulations. This study further outlines the audit committee that led to earnings management. This research is the development of Qi and Tian (2012). The development is done by adding variables, audit committee meeting, firm size, firm losses, board of directors, independent commissioner and managerial ownership. This study aims to find empirical evidence that audit committees' characteristics, board of directors, independent commissioner, managerial ownership, firm size and losses affect earnings management.

## Agency Theory

Jensen and Meckling (1976) define the agency theory as the relationship between principal and agent. Principals are shareholders in a company, while the agent is the management. The relationship between the principal and the agent based on existing contracts. Agency theory assumes that each party acting on their own interests. Principals see the good performance of the agent if the agent is able to maximize earnings and allocated to dividend distribution. The higher earnings and share price, the better the performance of the agent so that the agent gets a high incentive. If there is no supervision of the principal, the agent can manipulate the company's condition. This may occur because of the information asymmetry between principal and agent. Information asymmetry may provide opportunities for agents to perform earnings management. The audit committee is one form of supervision to minimize earnings management.

## Tenure of Audit Committee and Earnings Management

Tenure of audit committee affects the performance and the way in decision making. A senior audit committee must have experience working in the field of financial auditing and more junior than the audit committee (Qi and Tian, 2012). In addition, senior audit committee has more capacity to meet the challenges of work compared with audit committees junior. The longer the tenure of the audit committee of more and more experience. This affects the competence and effectiveness in working specifically suppress earnings management (Wardhani and Joseph, 2010). Tenure of audit committee has a negative effect with earnings management. This indicates that audit committee considering the security of their careers and trying to minimize earnings management (Qi and Tian, 2012). Senior audit committee assessed work more effective in reducing earnings management practices than the junior audit committee. Tenure of audit committee negatively affect earnings management practices (Wardhani and Joseph, 2010). The hypothesis is:
$H_1$ The longer tenure of audit committee, the lower earnings management.

**Audit Committee of Women and Earnings Management**

The last few years a lot of research that discuss the effect of gender differences in a manufacturing company. Some studies focus that the company's performance affected audit committee of women. This indicates gender differences in the ability to make decisions, conservative stance on financial performance and corporate value (Peni and Vahamaa, 2010). The audit committee has the attitude of conservative women than men of the audit committee and the audit committee of women was also considered to have a higher ethical audit committee than men (Qi and Tian, 2012). The audit committee of women has a negative effect on earnings management compared to the audit committee of men (Qi and Tian, 2012). Women have a firm stance and high ethical than men. The different results indicate that there is no difference between the earnings management of women and men (Peni and Vahamaa, 2010 and Sun et al., 2011). The hypothesis is:
$H_2$ The audit committee of women minimize earnings management

**Education of Audit Committee and Earnings Management**

Audit committee members who have higher education can find some strategies in dealing with the dilemma of earnings management (Qi and Tian, 2012). Higher education is able to make better decisions because of their cognitive abilities to process and analyze the information as disclosed. The higher education audit committee members are expected to be more competent in their duties (Wardhani and Joseph, 2010). The different results indicate that high education audit committee can not confirm itself into an effective watchdog in view of earnings management. Education audit committee members have no effect on earnings management (Qi and Tian, 2012 and Wardhani and Joseph, 2010). The hypothesis is:
$H_3$ The higher education of audit committee the lower of earnings management.

**Work Experience in Accounting and Earnings Management**

Decision-making technique a member of the audit committee can show his experience. A member of the audit committee who has a lot of experience in the accounting field has certainly used to dealing with the problem of accounting and good at making decisions (Qi and Tian, 2012). Audit committee members who have had work experience in accounting in particular audit can improve the competence of the audit committee in reducing earnings management (Wardhani and Joseph, 2010). Different results showed that work experience in finance has a positive effect on earnings management (Qi and Tian, 2012). This indicates that the audit committee who are not experienced working in finance will be a lot to learn and maximize the ability to suppress earnings management. The same result states that the audit committee members work experience in accounting, especially audit has a positive influence on earnings management (Wardhani and Joseph, 2010). The hypothesis is:
$H_4$ The higher work experience in accounting, the lower earnings management.

**Frequency of Audit Committee Meetings and Earnings Management**

The frequency of audit committee meetings can be considered to minimize earnings management. The more frequent audit committee meetings, the easier it is for an audit committee to oversee the activities of the management company. The frequency of audit committee meetings has a negative effect on earnings management (Qi and Tian, 2012). This suggests that the more frequent audit committee meetings, the easier it is for an audit committee to oversee the management of the company as well as the possibility of detecting earnings management. The higher the frequency of audit committee meetings held, the lower the earnings management (Gulzar and Wang, 2011). The hypothesis is:
$H_5$ The more the frequency of audit committee meetings, the lower earnings management.

**Board of Directors and Earnings Management**

The number of board of directors will be less effective in doing so is believed to minimize the monitoring of earnings management. The different results indicate that the board does not have an influence on earnings management (Wirawan, 2010). This indicates that the number of board of directors is little do not effect on the company's control. It is same with Farida et al. (2010), Sun et al. (2011) and Widyaningdyah (2001) which showed that the number of board of directors does not affect the occurrence of earnings management. The hypothesis is:
$H_6$ Effective board of directors has a negative effect on earnings management.

**Independent Commissioner and Earnings Management**

The existence of an independent commissioner in the company serves as a counterweight in the decision-making process in order to provide protection to minority shareholders and other parties related to the company (Guna and Herawaty, 2010). If the company has a lot of independent commissioners, the likelihood of earnings management will be smaller. This is because they do not side with management and capable of detecting earnings management. It is the same with Gulzar and Wang (2011) and Jao and Pagalung (2011) which showed that the independent commissioner negative affect earnings management. The hypothesis is:
$H_7$ Independent commissioner has a negative effect on earnings management.

**Managerial Ownership and Earnings Management**

Greater share ownership has greater incentives to monitor the performance of management companies. When managerial ownership is low, increasing the likelihood of earnings management. The different results indicate that managerial ownership has

no effect on earnings management (Handayani and Rachadi, 2009). This indicates that high managerial ownership does not affect earnings management. This is consistent with Guna and Herawaty (2010) and Jao and Pagalung (2011) that managerial ownership has no effect on earnings management. The hypothesis is:
$H_8$ Managerial ownership has a negative effect on earnings management.

**Firm Size and Earnings Management**

Medium and large firm have a strong pressure from the shareholders to the company's performance accord with expectations compared to small firms. This prompted the management to meet these expectations (Barton and Simko, 2002). The larger the firm the greater the invested capital so that the company gets more attention from shareholders. Firm size has a negative effect on earnings management. This indicates that large firms are relatively small in earnings management than do small firms. Firm size has negative effect on earnings management (Peni and Vahamaa, 2010; Guna and Herawaty, 2010; Gulzar and Wang, 2011; Jao and Pagalung, 2011). The different results indicate that firm size has a positive effect on earnings management (Wardhani and Joseph, 2010). The larger the company the more motivation do earnings management. One of them is to satisfy the desire of investors to show good financial performance. The hypothesis is:
$H_9$ The larger the firm the less earnings management.

**Company Losses and Earnings Management**

The company losses became a factor for the onset of earnings management behavior management will strive to improve its financial statements. Companies that have a worse financial statement are less likely to make earnings management (Peni and Vahamaa, 2010). The company losses has a positive effect on earnings management. This indicates that the poor performance of a company can lead to earnings management (Sun et al., 2011; Peni and Vahamaa, 2010). The hypothesis is:
$H_{10}$ The company losses have a positive effect on earnings management.

**Research Methods**

The sample used in the study is listed manufacturing companies in Indonesia Stock Exchange. The sample selection in this study using purposive sampling method. The data used in hypothesis testing as many as 185 data drawn from public manufacturing company from 2009 to 2012. Earnings management is behavioral or management actions taken to improve (reduce) earnings reported on a unit and responsible managers, without resulting in an increase (decrease) in long- term economic profitability of the unit (Widyaningdyah, 2001). Earnings management is measured using discretionary accruals. Value of discretionary accruals is the residual value of the results of the following regression

$$TAC_t = a_1 + a_2\Delta SAL_t + a_3PPE_t + e \qquad (1)$$

Where TACt total accruals on period t (operating income-operating cash flow), $\Delta SAL_t$ change of revenue, $PPE_t$ gross property plant and equipment in year t. All calculation scaled by total asset in year t-1.The measurement of variables are summarized in Table 1.

Table 1: Measurement of Variable

| Variable | Measurement |
|---|---|
| ADA | Absolute discretionary accruals, calculated using Jones model as presented in equation (1) |
| PERIOD | Tenure of the chairman of the audit committee |
| *GENDER* | Dummy variable, which value of 1 there are female members in audit committee and 0 otherwise |
| EDUC | Dummy variable, which value of 1 the chairman of the audit committee with post graduate and 0 otherwise. |
| FIN_EXP | Accounting working experience, the proportion of members that have accounting working experience in audit committee |
| MEET | Frequency of audit committee meetings can be measured by how many audit committee meetings held within 1 year |
| BOD | Dummy variable, which value of 1 the number of board of directors in a company ≤ 7 and 0 otherwise |
| IND_ KOM | Independent commissioners, the proportion of commissioners who come from outside the company in commissioners |
| MAN_OWN | Dummy variable, which value of 1 there is a company that owns the management and 0 otherwise. |
| SIZE | Firm size, the logarithm of a firm's total assets |
| LOSS | Dummy variables, which value of 1 a firm report net loss in year t and 0 otherwise |

Tenure of the chairman of the audit committee is the length of a chairman of the audit committee to work in a company that believed the longer the term of office of the chairman of the audit committee, the more competent itself as the audit committee (Wardhani and Joseph, 2010). The audit committee of women was measured using a dummy variable, value of 1 there are female members of audit committee and 0 otherwise. The higher education chairman of the audit committee, the more its academic knowledge (Wardhani and Joseph, 2010). The variable is a dummy variable, value of 1 the chairman of the audit committee with post graduate and 0 otherwise. Work experience in accounting to know if the members of the audit committee has particular experience in accounting audit (Wardhani and Joseph, 2010). Work experience in the field of accounting measured using the proportion of audit committee members who have experience working in the field of accounting and had worked at the registered public accountant. The frequency of audit committee meetings are conducted regular meetings with the audit committee to oversee the management performance (Gulzar and Wang, 2011). The frequency of audit committee meetings can be measured by how many audit committee meetings held within 1 year.

The board of directors is the size of a board of directors in a company (Qi and Tian, 2012). The board of directors can be measured using a dummy variable, value of 1 if the number of board of directors in a company ≤ 7 and 0 otherwise. Independent commissioner is the commissioner who did not come from a party affiliated with management (Guna and Herawaty, 2010). Independent commissioners can be measured by calculating the percentage of the commissioners who come from outside the company to all its commissioners (Jao and Pagalung, 2011). Managerial ownership is shares owned by management on number of shares outstanding (Jao and Pagalung, 2011). The variable is measured using a dummy variable, value of 1 there is a company that owns the Management and 0 otherwise. Firm size is the size of a company. Large companies tend to be noticed by the public, so they are more careful in doing financial reporting (Jao and Pagalung, 2011). Firm size was measured by using the logarithm of a firm's total assets. Losses company is a condition of the company suffered a loss in a given period (Qi and Tian, 2012). The variable is a dummy variable, value of 1 the company suffered a loss in year t and 0 otherwise.

**Results And Discussions**

Test results of descriptive statistics and hypothesis testing can be seen in the following table 2 and 3:

Table 2: Descriptive Statistics

| Variable | Minimum | Maximum | Mean | Std. Deviation |
|---|---|---|---|---|
| ADA | 0.00056 | 0.94000 | 0.178325 | 0.1925617 |
| PERIOD | 1 | 17 | 5.95 | 3.531 |
| *GENDER* | 0 | 1 | 0.31 | 0.465 |
| EDUC | 0 | 1 | 0.74 | 0.442 |
| FIN_EXP | 0.12780 | 1.00000 | 0.783506 | 0.2390795 |
| MEET | 1 | 44 | 6,23 | 5,660 |
| BOD | 0 | 1 | 0,86 | 0,348 |
| IND_ KOM | 0.04310 | 1.00000 | 0.390283 | 0.1159786 |
| MAN_OWN | 0 | 1 | 0,34 | 0,475 |
| SIZE | 9.37520 | 14.26070 | 11.992914 | 0.7275040 |
| LOSS | 0 | 1 | 0,12 | 0,331 |

Table 3: Result of Hypothesis Testing

| Variable | B | T | VIF |
|---|---|---|---|
| Constant | 0.867*** | 3.501 | |
| PERIOD | -0.004 | -1.131 | 1.200 |
| *GENDER* | -0.069** | -2.462 | 1.200 |
| EDUC | 0.057** | 2.007 | 1.117 |
| FIN_EXP | 0.008 | 0.154 | 1.139 |
| MEET | 0.006*** | 2.860 | 1.132 |
| BOD | -0.168*** | -4.316 | 1.277 |
| IND_ KOM | 0.398*** | 3.774 | 1.043 |
| MAN_OWN | -0.065** | -2.444 | 1.106 |
| SIZE | -0.061*** | -3.304 | 1.255 |
| LOSS | 0.082** | 2.222 | 1.043 |

** 5%, *** 1%, Adjusted $R^2$ 0.288, F 8.450***

Results of hypothesis testing showed that tenure has a coefficient value of -0.004 (-1.131) and not significant, $H_1$ is not accepted, which means that the term of office does not have an influence on earnings management. This is consistent with Wardhani and Joseph (2010). This suggests that the longer the chairman of the audit committee may not be able to suppress shake earnings management. The longer a person serves no possibility of attachment to the company and leads no longer independent. This leads to the task as an audit committee is not able to suppress the occurrence of earnings management.

The audit committee has a woman coefficient -0.069 (-2.462) and significance, $H_2$ can be accepted, which means the audit committee of women to have an influence on earnings management. This consistent with Peni and Vahama (2010) and Qi and Tian (2012). This indicates that the audit committee of women can reduce the earnings management than men. Education audit committee has a coefficient value of 0.057 (2.007) and significance, $H_3$ is not accepted, which means education has a significant influence on earnings management. The higher the education level of the audit committee is less likely to be able to suppress the occurrence of earnings management. This is due to the higher education less effective in performing supervisory task. Work experience in the field of accounting has a coefficient value of 0.008 (0.154) and no significance, $H_4$ is not accepted, which means work experience in the accounting field has no effect on earnings management. This is consistent with Susanto and Pradipta (2016). The more experienced audit committee in accounting may not be able to suppress earnings management. The frequency of audit committee meetings have coefficient 0.006 (2.860) and significance, $H_5$ is not accepted, which means that the frequency of audit committee meetings have a positive effect on earnings management. This is consistent with Susanto and Pradipta (2016).

The board of directors has a coefficient value of -0.168 (-4.316) and significance, $H_6$ can be accepted, which means the board of directors has a negative effect on earnings management. This is consistent with Pradipta (2011). This shows that the more effective the lower the number the board of directors they do earnings management. Independent commissioner has coefficient 0.398 (3.774) and significance $H_7$ is not accepted, which means that an independent commissioner to have a positive effect on earnings management. Managerial ownership has a coefficient value of -0.065 (-2.444) and significance, $H_8$ can be accepted, which means that managerial ownership has a negative effect on earnings management. This is consistent with Jao and Pagalung (2011) and Wirawan (2010). This suggests that the increase in managerial ownership will reduce earnings management.

Firm size has a coefficient value of -0.061 (-3.304) and significance, $H_9$ can be accepted, which means that the negative effect of firm size on earnings management. This is consistent with Qi and Tian (2012), Jao and Pagalung (2011), Sun et al. (2011), Wardhani and Joseph (2010) and Kusumawardhani (2012). This shows that the larger the size of a company, the lower earnings management. Large companies tend to rarely perform earnings management because they already have a lot of capital that can be met from inside. Losses company has coefficient 0.082 (2.222) and significance, $H_{10}$ can be accepted, which means the loss of the company has a positive effect on earnings management. This is consistent with Peni and Vahamaa (2010) and Qi and Tian (2012). This shows that the companies that have poor performance alleged earnings management.

**Conclusion, Limitation And Recommendation**

The audit committee of women, education of the audit committee, the audit committee meeting frequency, firm size, firm losses, board of directors, independent commissioner and managerial ownership have an influence on earnings management. The tenure and work experience of audit committee do not have an influence on the earnings management. This study has several limitations of the first, used the study period is relatively short, ie from year 2010 to 2012 so that earnings management is observed less describe actual conditions. For further research to extend the period of study, a minimum of 5 years so that the data obtained can better describe the actual condition of earnings management. Second, the sample of companies used in this study is only limited to the manufacturing companies listed in Indonesia Stock Exchange, so the lack of research results can be generalized. To further expand the study sample into non-financial companies listed on the Indonesia Stock Exchange. Audit committees' characteristics and corporate governance of each country is different because the culture of each country is different. The different of audit committees' characteristics and corporate governance can be used as development of future research for other country.

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