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The Characteristics of Audit Committee, Audit Quality and Profit Management in Non-Financial Sector Companies

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ABSTRACT

One of the main things that often attracts the attention of users of financial statements in assessing the company's performance is to look at the company's profits for that period. This encourages managers to show the best performance for their interests, so it is not uncommon for managers to practice earnings management. With the auditing of financial statements carried out by the audit committee and external auditors, it is hoped that they can detect and prevent those manipulation. The purpose of this study is to provide empirical evidence regarding the effect of audit committee characteristics and audit quality on earnings management. The data used in this study are non-financial sector companies listed on the Indonesia Stock Exchange for the 2018-2020 period which were selected using the purposive sampling method. The hypotheses were tested using multiple linear regression models. The results showed that audit committee size, audit committee expertise, the size of the Public Accounting Firm (KAP) and firm size had a significant effect on earnings management.

Keywords: *Earnings Management, Characteristics of the Audit Committee, Audit Quality.*

INTRODUCTION

The financial report aims to report the results of management's performance in managing business entity and carrying out their responsibilities to the company's stakeholders. One of the main things that often become the attention of report users in assessing company's performance is the profits earned by the company in certain period. According to Statement of Financial Accounting Concept (SFAC) No. 1, earnings information has an important role in measuring and estimating management performance. Within the tendency to pay attention to company profits, encouraging management to fight for their interests by implementing a good performance, it is not uncommon thing for management to implementing the earnings management. This earnings management practice is supported by the imbalance of information between management and shareholders, which the internal parties of company have more access than the external parties. This condition above known as the information asymmetry.

The case of earnings management that happened to PT Garuda Indonesia Tbk (GIAA) could be taken as an example. To overcome this, it is expected that good quality of audit can help to reduce earning manipulation. It is also able to provide financial reports that relevant and credible for its users. According to Tandiotong (2016), the quality of audit can be seen from the actions of an auditor who discover any violations and report it. Moreover, there are parties referred as the audit committee and external auditors. These parties have a task to carry out important supervisory functions, it can be by reducing earnings management practices and providing protection for company's shareholders. The audit committee and external auditors have a role in carrying out an effective control to reduce the desire of management to the practice of earnings management (Savitri, 2016). The existence of audit committee and examination of the external auditor is an obligation that should be fulfilled by public company that include in Indonesia Stock Exchange in order to carry out financial report.

This study aims to determine the effect of the audit committee characteristic and audit quality on earnings management. This study uses the latest data from the company financial data that listed on 2018-2020 Indonesia Stock Exchange. The results of this study are expected to be able to indicate the effectiveness of regulations on the characteristics of audit committee and the condition of business sector audit quality in Indonesia because it uses by almost every industrial sector except financial sector.

RESEARCH HYPOTHESIS

Based on the background that has been previously described, researcher formulates several research hypotheses to examine the effect of the audit committee characteristic and audit quality on earnings management as following below:

The Relationship between the Number of Audit Committees and Earnings Management

Menon & Williams (1994) stated that an audit committee with less than three members may cause the audit committee could not performing a proper supervisory role.

H₁: The characteristics of audit committee as proxied by the number of audit committee members which affect the earnings management

The Relationship between Audit Committee Financial Expertise and Earnings Management

Carcello et al. (2006) in his research found that the existence of a member on audit committee who has financial expertise can affect earnings management practices to be lower.

H₂: The characteristics of the audit committee as proxied by financial expertise have an effect on earnings management.

The Relationship between Audit Committee Meeting Frequency and Earnings Management

The frequency of audit committee activities indicates the level of diligence and supervision carried out by committee members. Because the audit committee must be proactive and able to ask probing questions about financial reporting (Kamolsakulchai, 2015), more frequent committee meetings tend to demand higher quality of report. Therefore, the proactive attitude of audit committee indicated that earnings management is lower for companies with more frequent meetings.

H₃: The characteristics of audit committee as proxied by the audit committee meetings frequency have an effect on earnings management.

The Relationship between the standard of auditor and Earnings Management

Audit quality can be determined from the standard of how Public Accounting conduct the auditory process. For the Big Public Accounting Firm (big-4 accounting firm) perceived to have a higher quality of audit than small accounting firm (nonbig-4 accounting firm). One of the reasons is because Big accounting firm have more resources and experience due to the number of clients, it has many and varied clients.

H₄: Audit quality which is proxied by auditor standard has an effect on earnings management.

The Relationship between Industrial Auditor Specialization and Earnings Management

Auditors who have experience and knowledge in certain industry areas tend to be better on detecting errors of data client compared to auditors with no experience. Their ability to provide higher quality of audits come from their experience on serving other clients in the same industry also by learning and sharing industry-wide best practices (Yasser & Soliman, 2018).

H5: The audit quality proxied by auditor's specialization industry has an effect on earnings management

The Relationship between Tenure Audit and Earnings Management

Long audit tenure tends to cause a closer relationship between auditor and his client, it makes the independence of auditor become weak in detecting fraud and reporting irregularities (Sun et al., 2014). Therefore, it has an impact on decreasing the quality of information in audit report and it is detrimental to the report users.

H6: Audit quality which is proxied by audit period has an effect on earnings management.

RESEARCH METHODOLOGY

This study uses annual report data from every publicly trading companies which listed on Indonesia Stock Exchange (IDX) for 2018 to 2020 in non-financial industrial sectors. The Determination of research sample using purposive sampling method with the final result as many as 872 companies. The following below are the criteria for selecting research sample.

Table 1. *Selection of Samples as Research Objects*

Information	The number of companies on 2018-2020			
	2018	2019	2020	Total
Companies listed on IDX	600	632	713	1945
Companies of Financial Sector	(91)	(90)	(94)	(275)
Companies that have incomplete data for research	(189)	(222)	(299)	(707)
Companies that available as sample	320	320	320	960
Samples removed as outliers	(40)	(24)	(24)	(88)
Final sample	280	296	296	872

The research variables used in this study consisted of the dependent, independent and control variables. The dependent variable in this study is earnings management with discretionary accrual measurements. The independent variables

consist on the number of audit committee members, audit committee financial expertise, audit committee meeting frequency, Standard accounting firm, industry specialization auditors and audit tenure. And the control variables that used are the standard of firm and leverage. The following below is an explanation measurement of each variable:

Table 2. Variable Definition and Measurement

Variable	Symbo l	Measurement
<i>Discretionary Accrual</i>	DA	$DACC_{it} = TACC_{it} - NDACC_{it}$
Number of Audit Committee Members	ACSIZE	\sum Audit Committee Member
Audit Committee Financial Expertise	ACEXP	\sum Member of the Audit Committee Financial Expert
Frequency of Audit Committee Meetings	ACMEET	\sum Annual Committee meeting
The Standard Public Accounting Firm	BIG	Dummy variables; 1 when the company audited by "Big 4" and 0 for the opposite.
Industry Specialization Auditor	SPEC	Dummy variable; 1 when the market share $\geq 20\%$ and 0 for the opposite.
<i>Audit Tenure</i>	AUTEN	\sum cooperation years between auditor and the auditee company
Company Size	SIZE	total assets logarithm
<i>Leverage</i>	LEV	The Proportion of total debt to total assets

This research uses multiple linear method analysis to test the research hypothesis. The following below is a research regression model:

$$DA = \alpha_0 + \alpha_1 ACSIZE + \alpha_2 ACEXP + \alpha_3 ACMEET + \alpha_4 BIG + \alpha_5 SPEC + \alpha_6 AUDTEN + \alpha_7 SIZE + \alpha_8 LEV + \varepsilon$$

RESULT

Descriptive Statistic

Table 3. Statistic Descriptive Result

	Minimum	Maximum	Mean	Std. Deviation
DA	-1.79660	1.01374	0.0003445	0.07005666
ACSIZE	1	5	3.05	0.378
ACEXP	0	4	1.95	0.789
ACMEET	0	59	6.41	5.759
AUDTEN	1	3	1.77	0.775
SIZE	21.9068318315	33.4945329662	28.5204229598	1.7782476415
LEV	0.0063616261	3461.9776484997	5.1147797071	115.8554030843

The DA variable has minimum value of -1.79660, this minimum value is owned by Bakrie Telecom Tbk (BTCL) in 2018. While the maximum value of DATA in the table above is 1.0 137, where the maximum value of DA is the DA value of PT Blue Bird Tbk (BIRD) in 2019. Besides, it is also known that the average value is 0.0003445 and the standard deviation value is 0.07005666. From 872 samples of non-financial sector companies on 2018 to 2020, there are 402 companies that perform earnings management downwards (negative value) and the remaining 470 companies perform earnings management upwards (positive value). Besides, it can be seen in the table, the minimum number of audit committee meetings (ACMEET) held in a period is 0. It was found in 4 research samples out of 872 total samples. Whereas, based on the regulation of POJK Number 55/POJK.04/2015, it requires that the number of meetings that was held by the audit committee at least once in three months or in the other words it is known that there are still companies that did not implementing the applicable regulations.

Table 4. *Dummy Variable Descriptive Statistics Results*

Variable	Value	Frequency	Persentase
BIG	0	611	70.1
	1	261	29.9
	Total	872	100.0
SPEC	0	650	74.5
	1	222	25.5
	Total	872	100.0

Based on the results of the descriptive statistics in the table above, it is known that from 872 research samples, around 70.1% or 611 companies did not use the services of big-four Accounting Firm. Meanwhile, around 29.9% or 261 companies use the services of big-four Accounting Firm. In terms of specialist auditors, 74.5% or 650 companies use the services of non-industrialized Accounting Firm. Moreover, around 25.5% or 222 companies use Accounting Firm services in the industrial specialization category.

Classic Assumption Test

Table 5. Normality Test Result

One-Sample Kolmogorov-Smirnov Test		
		Unstandardized Residual
N		872
Normal Parameters ^{a,b}	Mean	0.0000200
	Std. Deviation	0.06911440
Most Extreme Differences	Absolute	0.042
	Positive	0.021
	Negative	-0.042
Test Statistic		0.042
Asymp. Sig. (2-tailed)		.001 ^c

The results from the table above indicate that the research data is not normally distributed with the asymp value. Sig. (2-tailed) ranges from 0.001 below the normal requirement which is equal to or higher than 0.05. Previously, several steps were carried out, such as the deletion of data which considered to have extreme value using the *boxplot* method. However, the final value of significance probability still does not look normal. According to Gujarati (Kouaib & Jarboui, 2014), normality problems that arise in the research with the samples that more than 100, it did not have critical impact on data processing. Therefore, the test of this research model did not have a critical normality problem, because the research sample is more than 100 which is 872 samples.

Table 6. Summary of Multicollinearity and Heteroscedasticity Test

Collinearity Statistics			
	Tolerance	VIF	Sig.
Characteristics of the Audit Committee			
ACSIZE	0.815	1.227	0.019
ACEXP	0.968	1.033	0.090
ACMEET	0.807	1.239	0.605
Audit Quality			
BIG	0.573	1.744	0.032
SPEC	0.569	1.757	0.366
AUDTEN	0.996	1.004	0.105
Control Variables			
SIZE	0.708	1.413	0.238
LEV	0.971	1.029	0.213

It can be seen in table 6, the results of multicollinearity test from the table above indicated the tolerance value for each variable more than 0.10, and VIF value is less than 10. It shows that the research regression model is exempt from the problem of multicollinearity. Meanwhile, related to the heteroscedasticity test, it is known that there is one variable that has a significance below 0.05, namely ACMEET. Therefore, it can be said that ACMEET variable indicated heteroscedasticity. However, according to Gujarati (2003), heteroscedasticity that occurs in large samples of more than 100 will not damage the consistency of the data. Therefore, the problem considered as insignificant.

Multiple Linear Regression

Table 7. Coefficient of Determination Test Results

R	R Square	Adjusted R Square	Std. Error of the Estimate
.207 ^a	0.043	0.034	0.06885015

From the table above, it is known that the value of Adjusted R Square is 0.034 or 3.4%. It indicates that the ability of eight independent variables of the study can only explain the DA (dependent) variable of 3.4% or in the other words, it limits the ability of the independent variables. While the remaining 96.6% is influenced by other factors which is not examined in this study.

Table 8. simultaneous test results (F-test)

	Sum of Squares	df	Mean Square	F	Sig.
Regression	0.184	8	0.023	4.849	.000 ^b
Residual	4.091	863	0.005		
Total	4.275	871			

It can be seen from table 8, that the sig value is 0.000 which is smaller than 0.05. It indicates that the research regression model can be used to predict the dependent variable, which called as DA. In the other words, the eight independent variables of the research have an influence on DA (Dependent Variable).

Table 9. Partial Test Result (t-Test)

Unstandardized Coefficients			Standardized Coefficients	t	Sig.
B	Std. Error	Beta			
Characteristics of the Audit Committee					
ACSIZE	-0.016	0.007	-0.087	-2.367	0.018
ACEXP	-0.008	0.003	-0.084	-2.489	0.013

ACMEET	0.000	0.000	0.032	0.851	0.395
Audit Quality					
BIG	-0.027	0.007	-0.179	-4.080	0.000
SPEC	0.001	0.007	0.007	0.148	0.883
AUDTEN	-0.001	0.003	-0.006	-0.170	0.865
Control Variables					
SIZE	0.005	0.002	0.115	2.903	0.004
LEV	0.000	0.000	0.016	0.476	0.634

Discussion

Hypothesis 1

Based on the test results in table 9, it is known that the larger the standard of audit committee, the lower DA value. Thus, H_1 is accepted. The results of this study support research from Lin, Li, and Yang (2006); Juhmani (2017). Within a large number of audit committee members, it tends to increase the strength and effectiveness of the audit committee's role in a company (Kalbers & Fogarty, 1998). The number of audit committee members with sufficient standard is better at monitoring the financial reporting process than smaller committee (DeZoort et al., 2002).

Hypothesis 2

Based on the test results, it can be seen that ACEXP has significant effect on Dependent Variable. Therefore, it indicates that the more members of audit committee who are experts in finance, the lower DA value will be obtained. This result support the research of Carcello *et al.* (2006). The audit committee's financial expertise increases the possibility that detected material misstatements will be communicated to the audit committee and will be corrected on time (DeZoort et al., 2002).

Hypothesis 3

The results of the table indicated that the frequency of audit committee meetings has positive but not significant effect on Dependent variable. Therefore Hypothesis 3 is rejected. It is related to the research result by Masak and Noviyanti (2019); Pembayun and Januarti (2012); Trihartati (2010) which also stated that the frequency of audit committee meetings has no significant effect on earnings management. It is because the meetings are not always attended by all the members of audit committee in full and interested parties. Thus, it will be difficult for the audit committee to obtain more information about the state of company (Pamudji & Trihartati, 2010).

Hypothesis 4

The fourth hypothesis is accepted within the statement that Public Accounting Firm size has significant negative effect on the value of Dependent Variable. The

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results of this study also supported by the research from Dinuka (2014) who found that Accounting Firm has an influence on earnings management practices. Rahdal (2017) stated that in large Public Accounting Firm and their affiliates, the economic dependence factor on clients is smaller, therefore the independence of large Accounting Firm auditors is more guaranteed.

Hypothesis 5

Based on the test results in table 9, it can be seen that the value of sig. SPEC >5%. Therefore, Hypothesis 5 is rejected, SPEC has no significant influence on earning management. The results of this study are in line with the research of Kono and Yuyetta (2013). The aspect that underlie this result is Indonesian law enforcement which considered as weak; thus, it makes the auditor's ability to detect earnings management is low (Fitriany, 2012). Fitriany argues that a factor that can affect the ability of industry specialization auditors is a good legal environment.

Hypothesis 6

Similar to the fifth hypothesis, the sixth hypothesis is also rejected within a sig value of >5%. It indicates that the period of cooperation between auditor and auditee company has no significant effect on earnings management. The similar research was done by Nicolin (2003); Kono and Yuyetta (2013). The limitation of cooperation time can cause the auditor to not be able to recognize the characteristics and the company's business environment. It allows the auditor to detect the earnings management failures. Kono and Yuyetta (2013) stated that the auditor needs sufficient time to study and recognize the characteristics of management in presenting financial statements.

Control Variables

SIZE seems to have significant positive effect on earnings management. These results are consistent with the research conducted by Ali (2015). Barton and Simko (2002) states that a big company tend to manage earnings because they get various pressures from investors and financial analysis. Therefore, in big companies cannot showing their actual profit.

However, on the other hand, the results indicated that leverage has no significant effect on earnings management. This is related to the research result by Christiani and Nugrahanti (2014) which stated that companies should not choose to engage in earnings management just to avoid violating debt covenants. Earnings management is not the right decision to avoid the risk of inability to fulfill the obligations.

CONCLUSION

The results of this study provide the evidence that agency theory still relevant. By the existence of audit committee and external auditors, they play a role

in reducing the occurrence of agency costs and information asymmetry. Moreover, the financial reports produced by go public companies, especially in Indonesia are more transparent. It can be proven by the influence on the number of audit committees and the expertise of audit committees that have an important role in overseeing company's financial report and reducing manipulation practices by management. The role of external auditors, especially Big-four accounting firm along with competent auditors, therefore, they can detect the existence of earnings management.

This research cannot be separated from the limitations of variables used in this study; it cannot explain earnings management as a whole. Moreover, the research period is relative short, which is 3 years by the research objects used not from every industry, therefore it cannot describe the condition of Indonesian Industry as a whole. It is expected that the following research can enhance variables, the length of research period and use all industrial sectors in Indonesia.

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