The Influence of Audit Committee to Earnings Management

I Putu Sugiartha Sanjaya
Email: iputusugiartha@gmail.com
University of Atma Jaya Yogyakarta

ABSTRACT
The role of the audit committee continues to be of importance to regulators. The New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) co-sponsored a Blue Ribbon Committee (BRC) to make recommendations for improving the effectiveness of the audit committee. In Indonesia, the Jakarta Stock Exchange (JSX) issued a regulation in 2001. The regulation emphasize all companies (which treaded publicly) must have audit committee. On the basis of the regulation, existing audit committee is expected to be able to restrict earnings management. According to Millstein (1999), it is totally consistent that good corporate governance practice points to the audit committee as the focal point for improvement in financial statements. This study investigates whether audit committee formation can reduce earnings management. Data is collected from JSX in 2001 and 2002 for manufacturing companies. Using independent sample t-test, the result suggests that audit committee can reduce earnings management.

Key words: Audit Committee, Earnings Management, Good Corporate Governance.

ABSTRAK
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INTRODUCTION

One of the important issues in good corporate governance is whether audit committee can restrict earnings management. This issue has been widely discussed in the characteristic context functions of board of directors and audit committee. Klein (2002) finds that there is a negative relation between board of directors and independence of audit committee and abnormal accruals. Similarly, Peasnell et al. (2000) suggest that boards (outside board members and audit committee) contribute towards the integrity of financial statement, as predicted by agency theory. Chtourou et al. (2001) provides evidence that effective boards and audit committee constrain earnings management activities. Xie et al. (2001) finds that board and audit committee activity and their members’ financial sophistication may be important factors in constraining the propensity of managers to engage in earnings management.

According to Baridwan (2002), audit committee has an important role in good corporate governance. According to Millstein (1999) practice of good corporate governance points to the audit committee as the focal point for improvement quality of financial reporting. Bapepam (2001) also emphasizes that audit committee helps the board of commissioner to control operation of the firm.

On December 1999, NYSE and NASDAQ modified regulation about audit committee. The regulation requires audit committee should consist of independent directors, have at least three financially literate directors with knowledge in accounting and/or finance at least one member of audit committee. The regulation is based on advocates of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees. The committee recommends strengthening the role of audit committee in overseeing the process of the financial reporting. There are ten recommendations categorized to five groups as the independence of the audit committee members, financial literacy, audit committee structure, the independent issues of outside auditors, and quality of accounting principles.

al. (2001), Klein (2002a), Fleming (2002), Landes (2002). The researchers find that audit committee should be independent, with accounting and finance knowledge, regularly meet with management, internal and external auditor to increase its effectiveness.

In Indonesia, JSX issued a regulation requiring all companies must have audit committee (BEJ, 2001). Based on the regulation, existent of audit committee is expected to be able to prevent earnings management activities. According to Healy and Wahlen (1999), earnings management is motivated by several factors such as capital market, contract, and regulation. Perry and Williams (1994), Teoh et al. (1998a), Teoh et al. (1998b), Rangan (1998), and Erickson and Wang (1998) find that earnings management is motivated by capital market. Healy (1985), Holthausen et al. (1995), Gaver et al. (1995), and Guidry et al. (1998) find that earnings management is done to contract and compensation motivation. Jones (1991), Cahan (1992), Na’im and Hartono (1996), Key (1997), and Navissi (1999) find that earnings management is done to antitrust and for regulation. In Indonesia, Saiful (2000), Sutanto (2000), Sulistyanto (2002), and Santioso (2002) find that there is earnings management done by firms especially in JSX. Based on empirical results, the objective of this study is to investigate whether audit committee can reduce earnings management.

LITERATURE REVIEW AND HYPOTHESIS FORMULATION

Financial Statement

SFAC No. 1 emphasizes that the general purpose of financial statement is to give information in decision making. SFAC No. 2 deals with qualitative characteristics of accounting information. The qualitative is relevance (predictive value, feedback value, and timeliness) and reliability (verifiability and representational faithfulness) (see Wolk et al. 2000).

Agency Theory

Jensen and Meckling (1976) define relationship between principle and agent in the company. The principle delegates some authority for agent to make decision in using company resources. If each party maximize their utilities, there is a reason that agent will not always act to principle interest. Therefore, there is an agency conflict between principle and agent.

Audit Committee

On July 20, 2001, public companies are required to form audit committee to implement good corporate governance. The members of the audit committee are at least three persons from outside firm (independence). One among three persons is an independent board of
commissioner that also as the chairman of audit committee. At least one of the members has knowledge in accounting and/or finance.

**Independence of Audit Committee**

Kalbers and Fogarty (1993) find the legitimate factors and independence of audit committee members in terms of organizational power, formal, written authority coupled with observable support from top management play the most important roles in audit committee power as it relates to effectiveness. McMullen and Raghunandan (1996) find that companies with financial reporting problems; only 67% had audit committees composed of outside directors. In contrast, the companies without financial statement problems, 86% had audit committees of solely outside directors.

Abbott and Parker (2000) find that firms with audit committee that do not include employees and meet at least twice per year are more likely to use auditor specialists. Carcello and Neal (2000) have shown that more percentage of affiliated directors on audit committee, the lower the probability the auditor will issue going-concern report. Beasley and Salterio (2001) suggest that Canadian firms voluntarily include more outside directors on audit committee than the mandated minimum have larger boards with more outsiders serving on those boards and are more likely to segregate the board chairperson position from the CEO/president positions. DeZoort and Salterio (2001) find that the more independent director in audit committee member, the greater their support independent auditor advocating a substance over form approaches. Conversely, the more a senior member of management in audit committee more support management.

Klein (2002a) has shown that audit committee independence is associated with economic factors. He also finds those audit committee independence increases with board size and board independence and decrease with the firm’s growth opportunities and for firms that report consecutive losses.

**Experience and Knowledge in Accounting and Finance**

According to Kalbers (1992), training of audit committee on auditing, accounting, and internal control issues can play an important role in helping audit committees meet their responsibilities. Kalbers and Fogarty (1993) find only one direct link between expert power and effectiveness. Expert power is highly associated with financial reporting effectiveness.

McMullen and Raghunandan (1996) show the companies with financial reporting problems; only 6% has an audit committee with at least one CPA. In contrast, the companies without problems, 25% has audit committees with at least one CPA. According to Fleming (2002), audit committee responsibilities must include the tasks ensuring practices of financial reporting are true.
**Meeting with Management and Internal Auditor**

According to Kalbers (1992), audit committees must communicate their intention to carry out their responsibilities to management and auditors. McMullen and Raghunandan (1996) find that audit committees of problem companies were less likely to have frequent meetings. Only twenty three percent of audit committees of problem companies have regularly scheduled meetings three or more times a year. Forty percent of audit committees of companies without financial reporting problems met at least three times annually.

According to Fleming (2002), audit committee members should spend considerable periods of time at the company when performing audit committee duties. Meeting should not be limited to just three or four times a year depend on the size and risks associated with a company. Audit committee members should be expected to spend 100 to 300 hours a year company performing audit committee oversight.

**Definition of Earnings Management**

According to Healy and Wahlen (1999), earnings management occurs when manager uses a judgment on financial report and structuring transactions. The purpose of earnings management is to mislead stakeholder on performance of the firm or to influence contractual. Scott (2000) explained that earnings management is the choice of accounting policies by manager to achieve some specific objective.

**Motivation for Earnings Management**

According to Scott (2000), earnings management is done to achieve bonus purposes, other contractual, political, taxation, changes of CEO, initial public offerings, and to communicate information to investors.

**Earnings Management for Bonus Purposes**

Bonus plan hypothesis is ceteris paribus; managers of firms with bonus plans are more likely to choose accounting procedures that shift reported earnings from future periods to the current period (Watts and Zimmerman, 1986). Healy (1985) find that changes in accounting procedures by managers is related to adoption or modification of their bonus. Guidry et al. (1999) find that business-unit managers manipulate earnings to maximize their short-term bonus plan. Gaver et al. (1995) find that when earnings before discretionary accruals fall below the lower bound, managers select income-increasing discretionary accruals. Holthausen et al. (1995) document that managers manipulate earnings downwards when their bonuses are at the maximum bound.
The Other Contractual Motivations

The objective of earnings management to credit contract is explained by debt/equity hypothesis in positive accounting theory. Debt/equity hypothesis is ceteris paribus; the larger a firm’s debt/equity ratio, the more likely the firm’s manager is to select accounting procedures that shift reported earnings from future periods to current period (Watts and Zimmerman, 1986). Sweeney (1994) finds that firms managers approaching default respond with income-increasing accounting changes and that the default costs imposed by lenders and the accounting flexibility available to managers are important determines by managers accounting responses. DeFond and Jiambalvo (1994) find that in the year prior to covenant violation, abnormal accruals are positive significantly.

Political Motivations

Jones (1991) finds that managers decrease earnings through earnings management during import relief investigations. Cahan (1992) supports the political-cost hypothesis. The result of his study is consistent with the view that managers adjust earnings in response to monopoly-related antitrust investigations. Na’im and Hartono (1996) support the political cost hypothesis for manufacturing firms. Key (1997) also supported political cost hypothesis. Navissi (1999) provides evidence of income decreasing discretionary accruals by manufacturing firms for the years during which they could apply for price increases.

Taxation Motivations

In U.S.A., firms using LIFO method for inventories having tax as a purpose have to use the method in financial reporting. The firms can use LIFO method to decrease earnings. Management also can use FIFO method to increase earnings. Dopuch and Pincus (1988) find that there is relationship between economizing tax and choosing accounting method to valuing inventories. In Indonesia, Santioso (2002) finds that discretionary accrual is greater when there is a change in regulation.

Changes of CEO

DeFond and Park (1997) find that job safety is an incentive for management to conduct income smoothing either current or future job position.

Capital Market Hypothesis

Perry and Williams (1994) provide evidence of discretionary accruals manipulation in the predicted direction in the year preceding the public announcement of management’s intention to bid for control of the company. Burgstahler and Dichev (1997) find that firms manage reported earnings to avoid earnings decreases and losses. Teoh et al. (1998a) find that
issuers who adjust discretionary current accruals to report higher net income prior to the offering have lower abnormal stock returns and net income in the long run. Teoh et al. (1998b) find that issuers report greater net income in prospectus than before IPO. Rangan (1998) finds that the stock market temporarily overvalues issuing firms and is subsequently disappointed by predictable declines in earnings caused by earnings management. Erickson and Wang (1999) find that acquiring firms manage earnings upward in the periods before merger agreement. Kiswara (1999) finds that there is earnings management caused by industrial classification. Saiful (2002) finds earnings management occurs during the year around the initial public offerings (IPO). Sulistyanto (2002) finds that the firms do earnings management opportunistic when they do the IPO.

**Audit Committee and Earnings Management**

Peasnell et al. (2000) show that the likelihood of managers making income increasing accruals to avoid reporting both losses and earnings reduction is negatively related to proportion of outsiders on the board. Chtourou et al. (2001) find that earnings management is significantly associated with some practices of the governance practice by audit committees and boards of directors. Xie et al. (2001) support the Blue Ribbon Panel recommendation indicating that a lower level of earnings management is associated with greater independent outside representation on the board. Xie et al. also found that the presence of corporate executives and investment bankers on audit committee associate with a reducing practice of earnings management. Klein (2002b) finds a negative association between abnormal accruals and the percent of outside directors on the audit committee.

Based on discussion from normative theory (SFAC No. 1 and 2), agency theory, and the empirical results, this study presents alternative hypotheses as follows.

**H1:** Discretionary accruals between before and after formed audit committee are different.

**H2:** Discretionary accruals between and after formed audit committee that is eligible to JSX standard are different.

**H3:** Discretionary accruals between and after formed audit committee that is ineligible to JSX standard are different.

**RESEARCH METHOD**

**Population and Sample Selection**

This study uses the population of all firms listed in JSX that announce financial statement during 1999-2002. The sample selection uses purposive
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sampling method. There are some criteria of the sample. First, firms announce audited financial statement during 1999-2002 with a December 31 accounting period. Second, the firms report the formation of audit committee to JSX, and then JSX report the firms that their audit committee is eligible and ineligible to JSX standard. Based on the criteria above 136 samples is collected from manufacturing companies during 1999-2002 in Table 1.

<table>
<thead>
<tr>
<th>Sample to measure total accrual, discretionary accrual, non discretionary accrual to manufacturing industry</th>
<th>2001</th>
<th>2002</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>From 136 firms, they formed audit committee</td>
<td>49</td>
<td>44</td>
<td>93</td>
</tr>
<tr>
<td>Audit committee is eligible to JSX standard</td>
<td>44</td>
<td>41</td>
<td>85</td>
</tr>
<tr>
<td>Audit committee is ineligible to JSX standard</td>
<td>5</td>
<td>3</td>
<td>8</td>
</tr>
</tbody>
</table>

Data Collection
The data is obtained from the Jakarta Stock Exchange (www.jsx.co.id), Pojok Galeri Fakultas Ekonomi Universitas Atma Jaya Yogyakarta, and Indonesian Capital Market Directory.

Model Formulation
This study uses Jones’ model (1991). The model is as follows.

\[ TA_i = \alpha_1 \left( \frac{1}{A_{i-1}} \right) + \alpha_2 \left( \frac{\Delta \text{Rev}_i}{A_{i-1}} \right) + \alpha_3 \left( \frac{\text{PPE}_i}{A_{i-1}} \right) + \varepsilon_i \]  

(1)

Where \( TA_i \) is total discretionary accruals firm \( i \) period \( t \) (difference between net income before extraordinary, discontinued operation, and changing of accounting policy and cash flow from operation). \( A_{i-1} \) is total active firm \( i \) period \( t-1 \). \( \Delta \text{Rev}_i \) is changing revenue firm \( i \) period \( t \) (difference between current revenue and previous revenue). \( \text{PPE}_i \) is fixed assets firm \( i \) period \( t-1 \). \( \varepsilon_i \) is error term firm \( i \) period \( t \).

\[ NDA_i = \alpha_1 \left( \frac{1}{A_{i-1}} \right) + \alpha_2 \left( \frac{\Delta \text{Rev}_i}{A_{i-1}} \right) + \alpha_3 \left( \frac{\text{PPE}_i}{A_{i-1}} \right) \]  

(2)

\[ DA_i = TA_i - NDA_i \]  

(3)

From formula above, NDA is non-disccretionary accrual. DA is discretionary accruals.

Testing Hypothesis
To test hypothesis \( H_1, H_2, \) and \( H_3 \), this study uses paired sample test and Wilcoxon signed ranks test.
DATA ANALYSIS

Test Difference of Discretionary Accruals

The result of examining hypothesis one, two, and three is presented in Table 2.

<table>
<thead>
<tr>
<th>Company forming the audit committee in 2001 Column_A</th>
<th>Company forming the audit committee in 2002 Column_B</th>
<th>Company forming the audit committee in 2001 according to the standard Column_C</th>
<th>Company forming the audit committee in 2002 according to the standard Column_D</th>
<th>Company forming the audit committee in 2001 not according to the standard Column_E</th>
<th>Company forming the audit committee in 2002 not according to the standard Column_F</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean discretionary accruals t-1</td>
<td>Mean discretionary accruals t</td>
<td>Mean discretionary accruals t</td>
<td>Mean discretionary accruals t</td>
<td>Mean discretionary accruals t</td>
<td>Mean discretionary accruals t</td>
</tr>
<tr>
<td>0.1345</td>
<td>0.1431</td>
<td>0.1339</td>
<td>0.1441</td>
<td>0.1243</td>
<td>0.1025</td>
</tr>
<tr>
<td>0.1243</td>
<td>0.1025</td>
<td>0.1214</td>
<td>0.1044</td>
<td>0.1025</td>
<td>0.1025</td>
</tr>
<tr>
<td>1.018E-02</td>
<td>4.059E-02</td>
<td>1.248E-02</td>
<td>3.971E-02</td>
<td>1.75 (negative)</td>
<td>3 (negative)</td>
</tr>
<tr>
<td>3.83 (positive)</td>
<td>3.83 (positive)</td>
<td>1.50 (positive)</td>
<td>3.83 (positive)</td>
<td>1.50 (positive)</td>
<td>3.83 (positive)</td>
</tr>
<tr>
<td>t-test</td>
<td>z-test</td>
<td>Asymp. Sig. (2-tailed)</td>
<td>Asymp. Sig. (2-tailed)</td>
<td>Asymp. Sig. (2-tailed)</td>
<td>Asymp. Sig. (2-tailed)</td>
</tr>
<tr>
<td>0.391</td>
<td>2.231</td>
<td>0.432</td>
<td>2.063</td>
<td>-1.084</td>
<td>0</td>
</tr>
<tr>
<td>-1.084</td>
<td>0</td>
<td>0.279</td>
<td>1</td>
<td>0.279</td>
<td>1</td>
</tr>
</tbody>
</table>

Mean differentiation in Table 2-column_A indicates that the firms forming audit committee has smaller discretionary accruals after forming an audit committee. After measuring mean from two groups, this study does a test to show whether the different of the mean is statistically significant. The result in Table 2-column_B reports the difference of the mean is not significant statistically. It may be caused by companies that forms audit
committee at the end of 2001. Therefore, audit committee has shorter working period.

This study will conduct a mean test for firms forming audit committee in 2002, but have not yet formed the audit committee in 2001. There are 44 companies that forms audit committee in 2002. The result in Table 2-column_B shows that mean of discretionary accruals is different. This study will test compare means using paired samples test. The result in Table 2-column_B shows the difference of the mean discretionary accruals for the audit committee formed in 2002 is significant statistically at alpha 5%.

The different results between audit committee formed in 2001 and 2002 possibly due to working period of audit committee in 2001 is shorter than 2002. Lot of company formed the audit committee during November and December 2001. Audit committee formed in 2002, working period is longer because many of companies form audit committee in the early until in the middle of 2002. Based on the result, alternative hypothesis (H1) is partially supported and consistent with previous research as Peasnell et al. (2000), Chtourou et al. (2001), Xie Te al. (2001), and Klein (2002b).

There are 44 companies which have an audit committee that was eligible to JSX standard for companies forming audit committee in 2001. The result of the paired samples statistic test is shown in Table 2-column_C, indicates mean difference after forming audit committee of the amount of discretionary accruals become smaller. This study conducts a two mean discretionary accruals test to know whether this difference is statistically significant. The result in Table 2-column_C shows that is not significant statistically.

This study compare mean of discretionary accruals of 41 companies, which was eligible to JSX standard in 2002. The result in Table 2-column_D shows a difference in mean between before and after the formation of the audit committee. This study will test the difference of two means (2001-2002) by paired samples test. The result in Table 2-column_D indicates difference of mean between before and after the audit committee formation in 2002 that is significant statistically at alpha 5%. It shows performance of audit committee formed in 2002 is better than in 2001. The result partially supports the hypothesis H2.

This study uses JSX announcement clarifying firm’s audit committee is ineligible to the JSX standard on February 18, 2002, August 8, 2002, and January 29, 2003. For the companies forming audit committee in 2001, there are five firms which audit committee is ineligible to JSX standard. For the examination of hypothesis H3, this study uses non-parametric Wilcoxon signed ranks test to examine difference of mean between before and after formation audit committee. Table 2-column_E presents discretionary accruals between before and after the formation of the audit committee for 2001 is 1.75 (negative ranks) and 3.83 (positive ranks). Afterwards, this
study will test the difference of the two discretionary accruals above by Wilcoxon signed ranks test. Z table at alpha 5% is equal to -1,645. Z test is equal to -1,084. The result in Table 2-column_E indicates that discretionary accruals between before and after the formation of the audit committee is not different statistically.

In 2002, there are three companies which audit committee is ineligible to JSX standard. Table 2-column_F presents discretionary accruals between before and after formation of audit committee is 3 (negative ranks) and 1.50 (positive ranks). Next, this study will test the different of two discretionary accruals above by Wilcoxon signed ranks test. The result presents that Z table at alpha 5% is equal to -1,645. Z test is equal to 0. The result in Table 2-column_F indicates those discretionary accruals between before and after the formation of the audit committee is not statistically different. Therefore, hypothesis three (H3) is not supported.

This result may be caused by membership of audit committee, which does not meet standard requirements. For example, two members of audit committee representing commissioner of company are internal party of the company. The members of the audit committee are less than three people. There are non-independent commissaries as a committee chief of the audit committee.

CONCLUSIONS AND FUTURE RESEARCH

Findings from this research conclude that decline of accrual discretionary in year 2001 is not statistically significant, while the decline of accrual discretionary is statistically significant when audit committee was formed in the year 2002. Based on the result, this study concludes that there is an important role of the audit committee to oversee the board of directors in running its duty and oversee the compilation of the financial statement so this report submits more reliable information in companies.

These results also show that there is a role in audit committee to reduce earnings management which is shown by a decline in accrual discretionary when there is audit committee. The same result also shown for eligible audit committee to JSX standard. Audit committee formed in the year 2001 has worse performance than audit committee formed in the year 2002. For ineligible audit committee, it has bad performance both formed in 2001 and 2002.

This research has some limitation. Motivation of earnings management is randomly done. Second, a period formation of audit committee is limited to year 2001 and 2002. Future research can improve this research weakness. Adding the period of time can do future research. Also, future research can compare the performance of the audit committee between more regulated industry and less regulated industry.
REFERENCES


