CAN AUDIT COMMITTEE REDUCE REAL EARNINGS MANAGEMENT?

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Abstract: The objective of research was to give empirial evidence the influence of audit committee and directors on real earnings management (REM). The samples of this research consist of 336 data from 84 public manufacturing companies from 2013 until 2016 and selected by purposive sampling method. The result showed that the audit committee expertise and independence directors have significantly and positive influence on REM. The board of directors have significantly and negative influence on REM. The influence of audit committee tenure, size, meeting on REM is not significantly. The results of this research shows that outsider of the firm like audit committee and independence directors can’t detect REM. The chance for management doing REM. While, board of directors as insider of the firm can detect and reduce REM.

Keywords: Audit committee, directors, independence directors, real earnings management

INTRODUCTION

Earnings management (EM) is defined as the company cheating by increasing profits so that investors are interested on the company. However, many investors are deceived by very high profits. This happens because of the weak control in the company and causes the company not to be managed efficiently, in the long run it affects the performance and growth of the company (Susanto, Pradipta, & Djashan 2017).

The public companies to have audit committee (AC) and directors to cover the existence of EM in Indonesia. Corporate governance is relationship between company owner, shareholders, directors, commissioners in order to achieve company goals. It is important for companies to have AC and directors in company so that they can suppress the existence of EM in company (Susanto, Pradipta, & Cecilia 2019; Zarkasyi 2008).
Since REM distorts financial reporting, the important task of directors and AC is to provide certainty regarding the integrity of financial reporting. Audit committee can improve the credibility and quality of company's financial statements (Sun et al. 2014). Although AC plays a key role in overseeing financial statements, but with an unclear reporting process, audit committee can effectively inhibit REM. The research question is whether expertise, tenure, committee size, meeting, directors, independence directors affect REM.

**Expertise and REM**

AC who has financial and accounting expertise can facilitate company in seeing more effective financial reporting processes. Be’dard et al. (2004) and Lin et al. (2006) state that financial expertise have negative effect on EM. While, Susanto (2013), Sun et al. (2014), Pamudji and Triharti (2010), Susanto and Pradipta (2016) found different results which stated that expertise had no effect on EM. This shows that the establishment of AC with competencies in accounting and finance is mandatory in the regulations.

AC who has field of accounting and finance had a positive effect on EM (Krishnan & Visvanathan 2008). The research found that AC consisting of at least one financial expertise would reduce EM. AC that are experts in accounting and finance can pressure management to do REM. The hypothesis is:

H₁ Audit committee expertise affects on REM.

**Tenure and REM**

AC on behalf of commissioners representing the owner has the duty and function to oversee the financial reporting process so that no manager's behavior will harm the owner. Longer term of AC, better understand the characteristics of management in managing the company (Prasetyo 2014). AC with a long term of office may have experience and expertise in auditing on financial statements. The tenure does not influence REM. AC is not effective in finding EM (Sun et al. 2014).

The average tenure had a positive influence on accrual quality (Dhaliwal et al. 2010). The length of the tenure has a positive influence on REM. Meanwhile, Bedard et al. (2004) found a negative relationship between aggressive EM and term of AC. The hypothesis is:

H₂ Audit committee tenure affects on REM.

**Size and REM**

The large number of AC is more likely to have a variety of skills to manage the practice of financial statements to be more practical (Baxter & Cotter 2009). However, the large number of AC can be possible to deal with problems that can reduce the effectiveness of corporate arrangements (Sun et al. 2014).

The size proved to have no effect on EM (Al-Matari et al. 2012, Alkdai & Hanefah 2012). This happens because the company's goal is to form audit committee just to fulfill mandatory OJK regulations (Agustia 2013). This is consistent with Sun et al. (2014), Susanto and Pradipta (2016) who assume that the size does not affect REM. Meanwhile, the size has a positive influence on REM (Kusumaningtyas 2014). The hypothesis is:

H₃ Audit committee size affects on REM.

**Meeting and REM**

The meetings between members of AC is expected to reduce the level of EM. AC that always hold meetings will continue to monitor and supervise the reporting process because with more and more meetings, it will not provide an opportunity for management to manipulate financial reporting because the AC will continue to be auditing (Prasetyo 2014).

AC activities does not affect EM (Pamudji & Triharti 2010, Nasution & Setiawan 2007). While, the frequency of meetings negatively affecting EM (Qi & Tian 2012). The high frequency of meetings can reduce EM (Guizar & Wang 2011). The more frequency of
meetings, the easier it is for AC to detect EM (Susanto & Pradipta 2016). The hypothesis is: 

H4 Audit committee meeting affects on REM.

Directors and REM

The directors size is criticized with a variety of criticisms, where there is a relationship with optimizing company performance. Supporters from the theory agency showed that optimizing the number of directors can easily carry out internal communication and decision making (Jensen 1993, Yermack 1996). The large number of directors, with a specific knowledge, can benefit intercompany transactions (Pearce & Zahra 1992). The directors size had a positive effect on REM (Talbi et al. 2015).

Directors is an important governance mechanism, because directors can ensure that managers follow the board's interests (Susanto, Pirzada, & Adrianne 2019). A large number of board is less effective than a small number of boards. This is because the large number of directors will increase agency problems (Beiner et al. 2004). The hypothesis is:

H5 Board of directors affects on REM.

Independence and REM

The structure of directors is a key in the effectiveness of company. The presence of an independent directors can reduce conflicts in the company and management responsibilities (Susanto et al. 2019; Shleifer & Vishny 1997). Some research questions the effectiveness of directors who are dominated from outside the company. Indeed, directors from outside the company have little information about the company's internal. The unique characteristics of REM techniques are needed to know broadly in terms of the company's operations. Talbi et al. (2015) states that the independence of directors has a positive effect on REM. The hypothesis is: 

H6 Independence directors affects on REM.

METHODS

The study sample used manufacturing companies public from 2013 to 2016. Based on the sampling criteria, the number of manufacturing companies sampled was 84 companies. The sampling procedure can be seen in table 1. The collecting data uses secondary data. Data can be taken on the website, which can be accessed at http://www.idx.co.id.

Table 1 Sampling

| No | Criteria | Firm | Data |
|----|----------|------|------|
| 1. | Public Manufacturing companies during the period 2013-2016 | 132 | 528 |
| 2. | Financial statements as of December 31 | (10) | (40) |
| 3. | Rupiah | (27) | (108) |
| 4. | Firms that do not have information about audit committee meeting | (11) | (44) |
| | The total of companies and data | 84 | 336 |

REM can be done in 3 (three) ways, namely:

1) Sales Manipulation, the calculation (Sun et al., 2014):

\[
\frac{CFO_t}{TA_{t-1}} = a_0 + \frac{1}{TA_{t-1}} + a_1 \frac{Sales_t}{TA_{t-1}} + a_2 \frac{\Delta Sales_t}{TA_{t-1}} + \varepsilon (1)
\]

Abnormal CFO was the residual value of the equation (1). The higher abnormal CFO, the lower REM.

2) Discretionary Expenditures, the calculation (Sun et al., 2014):
\[
\text{DIS}_t = \frac{1}{T_{A,t-1}} \text{Sales}_t + \epsilon 
\]  \hspace{1cm} (2)

Abnormal discretionary expenses was the residual value of the equation (2). The higher abnormal discretionary expenses, the lower REM.

3) Over Production, the calculation (Sun et al., 2014):

\[
\text{PROD}_t = \frac{1}{T_{A,t-1}} + \text{Sales}_t + \frac{\Delta \text{SALES}_t}{T_{A,t-1}} + \epsilon 
\]  \hspace{1cm} (3)

Abnormal production cost was the residual value of the equation (3). The higher abnormal production cost, the higher REM. The measurement of variables are summarized in the following table.

**Table 2 Variable Measurement**

| Variable  | Measurement |
|-----------|-------------|
| REM       | Sum of standardized of abnormal CFO, abnormal discretionary expenses, and abnormal production cost. |
| Expert    | The proportion of members that have accounting and finance working experience in AC. |
| Tenure    | The proportion of members who served two consecutive periods in AC. |
| Size      | The size of AC. |
| Meeting   | Frequency of AC meetings. |
| Director  | The number of directors. |
| Independent | The proportion of directors who come from outside. |

The study using multiple regression analysis, which will be, described the regression equation as follows:

\[
\text{REMT}= b_0 + b_1 \text{Exp} + b_2 \text{Ten} + b_3 \text{Size} + b_4 \text{Meet} + b_5 \text{Dir} + b_6 \text{Ind} + e 
\]  \hspace{1cm} (4)

**RESULTS**

The descriptive of variable and result can be seen in Table 3 and 4:

**Table 3 Descriptive**

| Var. | Min. | Max. | Mean | Std. Dev. |
|------|------|------|------|-----------|
| REM  | -1,664547 | 2,585458 | 2,273E-16 | 0,462712 |
| Exp  | 0 | 1 | 0,782738 | 0,243417 |
| Ten  | 0 | 1 | 0,387500 | 0,409885 |
| Size | 1 | 5 | 3,083333 | 0,493742 |
| Meet | 1 | 49 | 7,032738 | 6,202224 |
| Dir  | 2 | 16 | 5,044643 | 2,464270 |
| Ind  | 0 | 0.60 | 0,119022 | 0,145534 |
Accounting and finance expertise (Exp) has positive effect on REM. The accounting and finance experts cannot detect is REM. AC is an external party their company does not have all the information about the company's real activities. This encourages management to do REM.

The tenure (Ten) does not affect REM. AC is not effective in finding REM, but requires real activities in companies such as independent directors who have company data (Sun et al. 2014).

The size does not affect REM. This happens because the company's goal is to form an audit committee just to fulfill mandatory OJK regulations (Agustia 2013).

The meeting (Meet) does not affect REM. The meetings cannot detect REM. The meetings are conducted to fulfill corporate governance and are not effective in supervising management in conducting REM.

The director (Dir) has a negative influence on REM. The board of directors can suppress REM. They have all the information related to the company's real activities. The independence director (Ind) has a positive effect on REM. The independence of directors has little information on the company's real activities. They cannot supervise management optimally. This makes management can do REM.

CONCLUSION

The conclusion of the research showed that expertise, board of directors, and independence directors influence REM. The tenure, size and meeting do not influence REM. The difficulty of outside parties in detecting REM can make management more free to do REM. The accounting information contained in the published financial statements cannot be used to detect REM. The need for more disclosure of the company's real activities in published financial statements and knowledge of audit committee and independent directors in detecting REM.

The future research uses trading company as samples. The future research uses AC gender that can affect REM. The further research using manufacturing companies from Southeast Asian countries that have similar characteristics but different cultural backgrounds, especially related to the behavior of AC and independent directors in detecting the occurrence of REM.
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