

**FINANCIAL CONDITION MODERATED THE EFFECTIVENESS OF AUDIT COMMITTEE TO REDUCE EARNINGS MANAGEMENT**

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*Abstract*

*Some cases of financial fraud invite inquiries about the effectiveness of corporate governance mechanism in financial distress companies. This study empirically examines whether the financial distress moderate the impact of corporate governance mechanism to earnings management. The sample of this study is manufacturing companies listed at Indonesia Stock Exchange for period 2010 -2012. Discretionary accruals are used as a proxy for earnings management, while financially distressed and non-distressed firms are identified based on Altman Z-score test. Corporate governance mechanism is measured by four characteristics of the audit committee, i.e. size (total number of audit committee members), independence (audit committee composition), activity (frequency of audit committee meeting), and expertise (the number of audit committee have finance or accounting background).*

This study finds that (1) financial distress does not moderate the impact of total members of audit committee to earnings management; (2) financial distress does not moderate the impact of *frequency of audit committee meeting* to earnings management; (3) financial distress does not moderate the impact of *audit committee composition* to earnings management; (4) financial distress moderates the impact of *audit committee finance/accounting knowledge* to earnings management. These results suggest that the effectiveness corporate governance is low, and finance/accounting literacy of audit committee should be alert.

**Keywords:** *corporate governance, earnings management, financial distress*

**I. RESEARCH BAKGROUND**

Business competition today requires company to improve its performance in order to survive, even win the competition. According to Veronica (2012), inability of the company to survive in the global competition may cause the company runs into diminution of business volume that may ultimately have an impact on business bankruptcy. One of the causes of business bankruptcy is sustaining financial distress problem in a company. According to Platt and Platt (2002) in Atmini (2005), financial distress is a decline stage of financial condition in a company, which occurred prior to the bankruptcy or liquidation. This condition is usually characterized by delivery delays, declining product quality and delay bill payments from the bank.

In practice, a financial distress company tends to do variety ways to hide their real performance to the external parties, such as investors, creditors, and public. One of them is perform earnings management. According to Jaggi and Lee (2002) in Jaggi and Sun (2005), it has been well documented in the literature that managers of financially distressed firms

would have a strong motivation to engage in earnings manipulation for sending positive signals or reducing the impact of negative signals emanating from financial distress.

Around the year 2000s, the business world was surprised by the bankruptcy of several major companies in the United States such as Enron Corporation (2001), WorldCom (2002), and Xerox Corporation (2001). According to Purnomo and Pratiwi (2009), Enron's earnings manipulation was done by the executive and their auditor, so Enron can increase their profit approaching 1 billion USD, which actually never existed. Similarly, Xerox manipulates its earnings by window dressing their revenue in the amount of USD 6 billion. The similar case in Indonesia is financial fraud of PT. Kimia Farma. PT. Kimia Farma overstated profit in their 2001 financial report (Tempo, 2002). All of these frauds can happen because of ineffectiveness of companies' corporate governance mechanism.

According to Ruzaidah and Takiah (2004), audit committee is one of the key elements in the corporate governance structure that helps control and monitor management. The audit committee contributes to development of company strategic plan and is expected to provide input and recommendations to the board with regard to any financial or operational matters. Charan (1998) and Craven and Wallace (2001) in Rahmat and Takiah (2008), prove that an effective audit committee would focus on improving the company performance and competitiveness, particularly in a changing business environment which is beyond the control of the company. Thus it can be said that corporate governance has a significant effect on the company financial condition. However, Chagaanti et al. (1985) in Wardhani (2006) who examine the structure of corporate governance, i.e. the composition of the board of directors, did not find evidence to support that the bankruptcy associates to the composition of the board of directors.

Lo et al. (2008) prove that good corporate governance can reduce earnings management practice in a company. Similar result was also obtained by Uadiale (2012) who does research on Nigeria listed companies. Uadiale (2012) found that the mechanisms of corporate governance as measured by board independence and audit committee negatively affect earnings management practices.

Based on those previous studies, this study intends to examine whether financial distress that occurs in the company will moderate the effect of corporate governance to the earnings management. Research objects that are examined in this study is manufacturing companies listed on the Indonesia Stock Exchange in the period 2010 - 2012

## **II. LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT**

According to the rule of Indonesia securities exchange commission (Bapepam, or now OJK) No. Kep-643/BL/2012, every listed company should have an audit committee. The duties and responsibilities of audit committee include (1) assess financial information that will publish to public, such as financial statement, financial forecast, (2) provide independent opinion if there is disagreement between management and accountant, (3) assess the company management risk, (4) analyze complain related to accounting and financial reporting process, (5) analyze and provide suggestion to board of directors regarding the potential conflict of interest. Therefore, audit committee as a one of internal corporate governance mechanism has a primary role regarding to the quality of financial reporting. The quality of financial reporting that is related to the effectiveness of audit committee is measured by earnings management (Klein, 2002).

Consistent to the debt covenant hypothesis (Watts and Zimmerman, 1986), financial distress company is predicted increase probability to manage its earnings. Duh et al. (2009) find evidence that earnings management practices are more pronounced in firms facing earnings decline. However, they also find evidence the effectiveness of corporate governance mechanism mitigate the earning management practices to avoid earnings decline.

Therefore, in this study if the audit committee has commitment to do its duties and responsibilities, it will decrease earnings management, whenever company financial condition. However, if the audit committee compromised to the company financial condition, it will reduce the effectiveness of audit committee in detecting earnings management, even support to earnings management in order to hide the company performance when company is in the financial distress condition. Therefore it is empirical question whether the financial distress condition will increase or decrease the effectiveness of audit committee in term of reducing earnings management practices.

### **2.1. Size of Audit Committee**

The more members of audit committee, it is expected to increase the effectiveness of its company control on financial reporting quality. Without considering company financial condition, Margareta (2012) finds that the existence of audit committee had no effect on earnings management practices on the banking industry are listed in the Indonesia Stock Exchange in the period 2008-2010. On the other hand, Lin and Hwang (2010) in Kang et al.(2011) find a negative relation between the number of audit committee and earnings management. Due to limited previous studies, this study predicts as follows.

H1: Financial distress moderate the impact of total members of audit committee to earnings management

### **2.2. Meeting Frequency of Audit Committee**

According to According to the rule of Indonesia securities exchange commission (Bapepam, or now OJK) No. Kep-643/BL/2012, audit committee meetings should be held at least once in three months. Xie et al. (2003) in Kang et al. (2011) frequency of audit committee meeting also can reduce the earnings management. Meetings held by the audit committee is an opportunity for management and external auditors to discuss problems they find, so audit committee meeting be expected can reduce earnings *management*. On the other hand, Baxter and Cotter (2009) and Davidson et al. (2005) who use Australian data find no evidence of a significant relation between the number of audit committee meetings and earnings management. Due to limited previous studies that consider effectiveness of audit committee in financial distress companies, this study predicts as follows.

H2: Financial distress moderate the impact of frequency of audit committee meeting to earnings management

### **2.3. Composition of Audit Committee**

According to the rule of Indonesia securities exchange commission (Bapepam, or now OJK) No. Kep-643/BL/2012, at least three members of audit committee are independent board commissioner and non-executive. Alkdai and Hanefah (2012) find that the composition of audit committee can reduce earnings management practice. This result is consistent to Ching et al (2002); they find the composition of non - executive audit committee and external director effective in monitoring financial reporting. According to Rahmat and Iskandar (2008), audit committees with a higher composition of non-executive directors are considered more independent than those with more executive directors. It makes non – executive audit committee can provide a more independent opinion for top management. Thus, non - executive audit committee plays a positive role in good corporate governance because they are more independent, so they can monitor the company from earnings management practices effectively.

However, Farida et al. (2010) find the composition of independent members on board and audit committee has no impact to earnings management that occurred in the Indonesian banking company. Again, due to limited previous studies that consider effectiveness of audit committee in financial distress companies, this study predicts as follows.

H3: Financial distress moderate the impact of *audit committee composition* to earnings management

#### 2.4. Financial or Accounting Literacy of Audit Committee

Audit committee has the primary role relating to financial reporting process, thus knowledge in accounting and finance is important. It should increase the effectiveness of audit committee to reduce earnings management practice in a company. According to Audible (2012) audit committee with knowledge in accounting and finance is capable of increasing the public's confidence in the credibility and objectivity of published financial statements. Her research found that audit committee members who have a certain level of financial competence will reduce the likelihood of earnings management.

This result is consistent to Hambrick and Mason (1984), where in that research finds that knowledge in accounting and finance provides a good basis for audit committee members to examine and analyse financial information. The educational background becomes an important characteristic to ensure audit committees perform their roles effectively. Therefore, audit committee members who have financial knowledge would be more professional and more adaptable to change and innovation. Therefore, audit committees with finance or accounting literate members are expected to adopt a high standard of accountability and level of achievement and to strive for excellent corporate image and performance, so earnings management practice in a company can be reduced. In term of earnings management, Bedard et al. (2004) and Lin and Hwang (2010) find a negative association between audit committee accounting expertise and upward earnings management. However, the effectiveness of financial or accounting literacy of audit committee to detect earnings management constrained by company financial condition has not examined intensively, thus following hypothesis is developed:

H4: Financial distress moderate the impact of finance or accounting knowledge of audit committee to earnings management

### III. RESEARCH METHOD

#### 3.1. Sample

Sample of this study is manufacturing companies that were listed on the Indonesia Stock Exchange (IDX) during 2010 – 2012. Only companies that have complete data, reporting currency in Rupiah, and firm with the period ended on December are selected as sample. All data are collected from the financial statements and annual reports of the companies of the year 2010- 2012. The final sample is 252 firm years, as illustrated on Table 1.

**Table 1 Sample Selection**

Descriptions	2010	2011	2012	Total
Manufacturing firms listed at Indonesia Stock Exchange	132	136	136	404
Less: Reporting currency other than Rupiahs	10	11	25	46
Less: Unavailable data	10	10	9	29
Less: Fiscal period ended other than December 31	0	1	1	2
Sample	112	114	101	327
Less: Outlier				75
Final sample				252

### 3.2. Research Model

The impact of corporate governance to earnings management moderated by company financial condition was investigated using multivariate linear regression. The main regression model is defined in the following equation:

$$EM = a + b FD + c ACSIZE + d ACCOMP + e ACMEET + f ACLITERACY + g FD*AC SIZE + h FD*AC COMP + i FD* ACMEET + j FD* ACLITERACY + k* LEVERAGE + l*PB RATIO + e \quad (1)$$

Where,

EM earnings management,

FD financial distress condition,

ACSIZE audit committee size,

ACCOMP audit committee composition

ACMEET audit committee meetings

ACLITERACY audit committee literacy in finance or accounting

LEVERAGE leverage

PB RATIO price book ratio

### 3.3. Variables

#### 3.3.1. Earnings Management

In this study, earnings management is dependent variable. Earnings management is measured by *Performance – Adjusted Current Discretionary Accruals (PACDA)* based on the research of Jaggi and Sun (2005). There are some steps to calculate PACDA:

1. Finding the value of the coefficient on the following regression model:

$$CA = \alpha_0 + \alpha_1 \left( \frac{1}{lagasset} \right) + \alpha_2 (\Delta Rev) \quad (2)$$

Where,

CA = Current accruals, reflected by net income before extraordinary items plus depreciation and amortization minus operating cash flows scaled by the total asset at the beginning of fiscal year t.

Lag asset = Total assets at the beginning of the fiscal year t.

$\Delta Rev$  = Net sales in year t less net sales in year t-1 scaled by the total asset at the beginning of fiscal year t.

2. Insert the estimated coefficient of regression model (2) to calculate the expected current accruals (ECA), using the following equation:

$$ECA = \hat{\alpha}_0 + \hat{\alpha}_1 \left( \frac{1}{lagasset} \right) + \hat{\alpha}_2 (\Delta Rev - \Delta AR) \quad (3)$$

Where,

$\Delta AR$  = Account receivable in year t less account receivable in year t-1, scaled by the total asset at the beginning of fiscal year t..

3. Calculate *discretionary current accruals (DCA)*, using the following equation:

$$DCA = CA - ECA \quad (4)$$

4. Calculate PACDA using the following equation:

$$PACDA = DCA - \text{median DCA of the matching portfolio} \quad (5)$$

Notes:

Median DCA is calculated by divided all of the samples into 10 groups based on the value of ROA in year t-1. After that we calculate the median DCA from each group.

### 3.3.2. Financial Distress

In this study, financial distress is a moderating variable. Financially distressed firms are identified using Altman Z-Score (Altman 1968).

$$Z\text{-score} = 0.012*(\text{Working Capital}/\text{Total Assets}) + 0.014*(\text{Retained Earnings}/\text{Total Assets}) + 0.033*(\text{Earnings before Interest and Tax}/\text{Total Assets}) + 0.006*(\text{Market Value Equity}/\text{Book Value of Total Debt}) + 0.999*(\text{Sales}/\text{Total Assets}) \quad (6)$$

Company is scored one (1) if Altman Z-Score is smaller than 1.81, and otherwise scored zero (0).

### 3.3.3. Corporate Governance(CG)

In this study, CG is an independent variable. The proxy of company corporate governance mechanism is four characteristics of audit committee, they are (1) audit committee size (AC SIZE), (2) meeting frequency of audit committee (AC MEET), (3) audit committee composition (AC COMP) and (4) financial/accounting literacy of audit (ACLITERACY). Audit committee size is measured by total number of audit committee members. Meeting frequency is measured by frequency of audit committee meeting in the fiscal year t. Audit committee composition (AC COMP) is measured by the ratio of non-executive audit committee to total members of audit committee. Financial/accounting literacy is measured by the number of audit committee that have accounting or finance educational background and professional experience.

### 3.3.4. Control Variables

This study controls other factors that influence firm earning management practices. Two control variables are *leverage* and Price to book ratio (PBRATIO). Leverage is proxy for company risk, and price to book ratio is proxy for growth. We compute leverage by dividing book value of total debt at year t to total assets in year t-1. Price to book ratio is measured by firm's closing price in year t scaled by firm's par value in year t

## IV. RESULT

### 4.1. Descriptive

Table 2 and 3 shows descriptive statistics for all variables used in regression models. Table 2 shows the descriptive statistics for distress companies, while Table 3 shows the descriptive statistics for non-distress companies.

**TABLE 2**  
**Descriptive Statistics for Distress Companies**

	N	Minimum	Maximum	Mean	Std. Deviation
AC SIZE	219	0	4	3,06	,465
AC MEET	219	0	41	6,03	5,057
AC COMP	219	,0000	3,0000	,112253	,2597258
ACLITERACY	219	0	3	1,88	,901
PACDA	219	-,6202	,6654	,023579	,2432662
Leverage	219	-6,3945	2,9838	,491826	,6749196
PB RATIO	219	,0174	359,0000	16,738613	37,3058113

**TABLE 3**  
**Descriptive Statistics for Non- Distress Companies**

	N	Minimum	Maximum	Mean	Std. Deviation
AC SIZE	33	3	4	3,18	,392
AC MEET	33	2	14	4,94	2,609
AC COMP	33	,0000	2,0000	,257576	,5049080
AC LITERACY	33	0	4	1,94	1,029
PACDA	33	-,7584	,9257	-,020483	,3523055
LEVERAGE	33	-4,2204	7,3524	,550021	1,4863208
PB RATIO	33	,3000	2085,0000	215,132760	548,7608069

In addition, we check the univariate mean difference t-test between the two group of companies, i.e. distress and non-distress companies. We find that there is no significantly different mean in term of audit committee size, meeting, composition, and literacy. However, the mean difference test for variable PACDA indicates that distress companies more likely to use earnings management to increase income. This may be done for sending positive signals or reducing the impact of negative signals emanating from financial distress. On the other side, non-distress companies more likely use earnings management to decrease income to avoid taxes or to avoid public monitoring. While, mean difference for variable PBRATIO in indicate that non- distress company's stock price is more expensive than distress company's stock price.

#### 4.2. Classical Test Assumptions

To obtain the efficient and accurate regression results, the data must be free from violations of classical assumptions. There are four requirements that must be fulfilled, i.e. normality test, heteroscedasticity test, autocorrelation test, and multicollinearity test.

Normality test is done by one sample Kolmogorof Smirnov test. Then, this test also uses box plot method in order to identify outlier data. After removing all outlier data, asymp. significant. (2-tailed) is greater than 0.05. These results indicate that the regression model has passed the normality test.

Heteroscedasticity test is done by *Glejser* test. The significance value must be higher than 0.05 in order to indicate that there is no heteroscedastisity problem. There is no heteroscedasticity problem in this data.

Autocorrelation test is done by Durbin-Watson test. The value of Durbin-Watson must be larger than du but smaller than 4 – du ( $du < DW < 4-du$ ) as indication free from autocorrelation problem. The data does not indicate autocorrelation problem.

Multicollinearity test is done by checking the value of Variance Inflation Factor (VIF) and the amount of Tolerance. The VIF must be no more than 10, and the Tolerance must be more than 0.1. The data does not show any multicollineraity problem, except for moderating variables as predicted.

#### 4.3. Hypothesis Testing

The result of regression linear testing in Table 4 shows that there is no significant impact of total members of audit committee to earnings management. It can be seen from the significant value of AC SIZE variable i.e. 0.718. After including financial distress component, the result shows that financial distress does not moderate the impact of total

members of audit committee to earnings management. It can be seen from the significance value of FD\*ACSIZE variable i.e. 0.907. Thus H1 is rejected.

There is no significant impact of frequency of audit committee meeting to earnings management. It can be seen from the significant value of AC MEET variable i.e. 0.419. After including financial distress component, the result shows that financial distress does not moderate the impact of frequency of audit committee meeting to earnings management. It can be seen from the significance value of FD\*AC MEET variable i.e. 0.410. Thus H2 is rejected.

The impact of audit committee composition to earnings management is not significant. It can be seen from the significant value of AC COMP variable i.e. 0.192. After including financial distress component, the result shows that financial distress does not moderate the impact of audit committee composition to earnings management. It can be seen from the significance value of FD\*AC COMP variable i.e. 0.478. Thus H3 is rejected

The finding shows that there is a significant impact of audit committee finance/accounting literacy to earnings management. It can be seen from the significant value of ACLITERACY variable i.e. 0.000 which is less than 0.05. After including financial distress component, the result shows that financial distress moderate the impact of audit committee finance/accounting literacy to earnings management. Thus H4 is accepted.

**TABLE 4**  
**Regression Result (t-test)**

Variable	Coefficient	Sig.
Constanta	-0.67	0.905
DISTRESS	0.391	0.499
AC SIZE	-0.070	0.718
AC MEET	-0.016	0.419
AC COMP	-0.196	0.192
<b>ACLITERACY</b>	<b>0.196</b>	<b>0.000</b>
<b>Leverage</b>	<b>0.003</b>	<b>0.000</b>
PB RATIO	-8.930E-5	0.282
FD*ACSIZE	-0.023	0.907
FD*ACCOMP	0.116	0.478
FD*ACMEET	0.017	0.410
<b>FD*ACLITERACY</b>	<b>-0.202</b>	<b>0.001</b>
F test	3.700	0.000
Adjusted R <sup>2</sup>	0.106	

## V. DISCUSSIONS

The study shows that only finance/accounting literacy attribute of audit committee influences firm earnings management practice. Audit committee size, meeting frequency and composition are not significant attributes in order to detect earnings management practice in company. It may suggest that the effectiveness of audit committee in Indonesia listed companies is still low, although it is mandatory for them to have an audit committee and there is rigid requirement for audit committee members and activities.

In term of finance/accounting literacy of audit committee, this study finds interesting result, which this attribute influences differently when the company financial consideration is considered. In the financial distress company, more members of audit committee who have finance or accounting background will reduce firm earnings management practices. However, if the company financial condition does not take account, it will increase firm earnings management practice. This finding suggests that they utilized their expertise in finance or accounting in optimum. They will support the earnings management when the company is in



the good condition; it may the earnings management is for efficient reason (Scott, 2012). However, when the company is in financial distress, they become watchdog to ban the earnings management.

For control variables, only leverage has positive significant relation to earnings management. It support debt covenant hypothesis (Watts and Zimmerman, 1986) that closer company to debt violation, as measured by higher leverage, it will increase probability of company to increase their earnings by accruals management.

## **VI. CONCLUSIONS**

Best practice in audit committees is an important determinant of good corporate governance. An effective audit committee has a significant bearing on the financial performance and future direction of the company. Being one of the key players in good corporate governance, an effective audit committee would bring companies to a higher level of performance.

This study examine whether the financial distress moderate the impact of good corporate governance to earnings management. Moderation of financial distress can strengthen the implementation of CG or weaken the implementation of CG. It is said to strengthen the implementation of CG, in financial distress condition, the audit committee of the company would provide an effective monitoring of earnings management. So that the company can get out from distress condition.

But on the other side, moderation of financial distress will weaken the implementation of GCG if in financial distress condition the company does not pay attention again the implementation of CG. The company will do the earnings management for sending positive signals or reducing the impact of negative signals emanating from distress condition.

Findings of this paper show that financial distress moderate the impact of audit committee accounting knowledge to earnings management. It can be happen because audit committee with knowledge in accounting and finance is capable to increase public's confidence about credibility and objectivity of published financial statements. According to Hambrick and Mason (1984), knowledge in accounting and finance provides a good basis for audit committee members to examine and analyse financial information. The educational background becomes an important characteristic to ensure audit committees perform their roles effectively. So that, audit committee members who have financial knowledge would be more professional and more adaptable to change and innovation. Therefore, audit committees with finance or accounting literacy members are expected to adopt high standards of accountability and level of achievement and to strive for excellent corporate image and performance. This is the reason why accounting knowledge of audit committee can reduce the earnings management in distress company.

This study indicates that financial distress does not moderate the impact of three other audit committee characteristics (size, meeting frequency, and composition) to earnings management. This may happen because the appointment of audit committee may perhaps only be done by a company for regulatory compliance respect to size, composition of audit committee, and meeting frequency.

This paper finds that, on average, both financially distressed and non-distressed companies meet the minimum requirements on audit committee as prescribed by rule of Indonesia securities exchange commission (Bapepam, or now OJK) No. Kep-643/BL/2012 with respect to size and composition of audit committee. However, these requirements are not enough to increase the effectiveness of audit committee in doing their job.

This paper has several limitations. First, the result of this study should be interpreted for manufacturing firms listed from 2010-2012. Second, this research only used Altman Z-Score model to identify financially distressed and non-distressed company.

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# SOCIAL RESPONSIBILITY AS COMPETITIVE ADVANTAGE IN GREEN BUSINESS

Proceeding 11th International Annual Symposium on Management  
Batu - East Java, Indonesia, 15th-16th March 2014



11<sup>th</sup> **INSYMA**  
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## **Proceeding**

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#### Published by:

Department of Management, faculty of Business & Economics  
Universitas Surabaya

Jl. Raya Kalirungkut

Surabaya, Indonesia 60293

Phone : +62-31-2981139

Fax : +62-31-2981239

ISBN: 978-979-99365-8-5

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## FOREWORD

INSYMA has become a tradition of its own for the management department of Universitas Surabaya. For more than a decade this event has become a forum for academics and practitioners to share knowledge. Every year management department always brings the latest theme that becomes an important issue for the development of science.

This year, INSYMA raise the theme "***SOCIAL RESPONSIBILITIES AS A COMPETITIVE ADVANTAGE IN GREEN BUSINESS***". This theme interesting, considering that at this time all the business need to be more accountable to the public and the environment. Corporate social responsibility is not only an obligation, otherwise it would be a distinct competitive advantage for the company.

Hundreds of scientific papers are sent to a conference committee, and the results of a rigorous selection of more than 100 elected. This paper is derived from a variety of authors, both within and outside the country, academics and practitioners. All the articles are then presented at the symposium and documented in these proceedings.

We hope that these proceedings can contribute to the development of science and business practices. Hopefully you can enjoy and gain valuable lessons from this article collection. We look forward to your participation in next INSYMA.

Batu, East Java, Indonesia  
15th-16th March 2014

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