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 BACKGROUND

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...