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Research Article

The Watchdogs of Financial Reporting: Audit Committee Quality, Auditor Size, and Earnings Management

Nazila Alfiyasahra[1], Auliffi Ermania Challen[2*]
[1,2] Faculty of Economics and Business, YARSI University, Jakarta

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Abstract

This study investigates the impact of audit committee quality and the size of public accounting firms on earnings management. The audit committee's characteristics are assessed through proxies, including the size of the audit committee, the frequency of its meetings, the independence of its members, and their relevant expertise. The research utilizes secondary data from companies classified within the basic and chemical manufacturing industries that are listed on the Indonesia Stock Exchange (IDX). A purposive sampling method yielded a sample of 16 firms spanning the period from 2015 to 2017. The analytical approach employed was multiple regression. The findings suggest that an independent audit committee has a positive influence on earnings management. Conversely, factors such as the size of the audit committee, the number of meetings held, the expertise of committee members, and the size of the public accounting firm do not significantly affect earnings management. The managerial implications of this study recommend that companies should prioritize the independence of their audit committees, recognizing it as an effective oversight mechanism for mitigating earnings management practices.

Keywords: Audit Committee Size, Number of Audit Committee Meetings, Independent Audit Committee, Audit Committee Expertise, Size of Public Accounting Firm, Earnings Management

JEL Classification: M41, M42, G34

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Corresponding Author: Auliffi Ermania Challen (auliffi.ermian@yarsi.ac.id)

1. Introduction

The increasingly complex global business world has increased demands for transparency and accountability in corporate financial reporting (Chen et al., 2007). Financial reports should be a reliable source of information for stakeholders; however, manipulation through earnings management remains a common practice, thereby diminishing the credibility of financial reports (Mughni & Cahyonowati, 2015). Accounting scandals in various companies, such as the one that befell PT Garuda Indonesia in 2018, demonstrate that revenue recognition practices that do not comply with accounting standards can create public distrust and harm investors (DetikFinance, 2019). This phenomenon highlights the importance of research into corporate governance mechanisms that can effectively curb earnings management practices.

Earnings management is defined as managerial intervention in the financial statement preparation process to obtain specific benefits, either by increasing or decreasing reported earnings (Scott, 2012). This practice can be conducted legally in accordance with accounting standards or illegally through transaction manipulation (Purnomo & Pratiwi, 2009). Although sometimes considered a form of accounting flexibility, earnings management practices fundamentally degrade the quality of financial reports and mislead users in decision-making (Yateno, 2016). Therefore, the role of governance mechanisms, such as audit committees and external auditors, is crucial in minimizing the risk of financial information distortion (Dewi & Khoiruddin, 2016).

The existence of an audit committee is one of the main pillars of good corporate governance, serving to oversee the integrity of financial reports and the effectiveness of internal control systems (Khurnanto & Syaffrudin, 2015). Previous research has demonstrated that audit committee characteristics, including independence, size, expertise, and meeting frequency, can impact the level of earnings management employed by a company (Sihombing & Laksito, 2017). However, research findings remain inconsistent. For example, Kusumaningtyas and Farida (2015) found that audit committee competence significantly influences earnings management, while Mughni and Cahyonowati (2015) found that audit committee size has no effect. This creates a research gap regarding the effectiveness of the audit committee's role in curbing earnings management practices across various corporate contexts.

In addition to internal factors, the quality of external audits also plays a crucial role. The size of a Public Accounting Firm (PAF) is often used as a proxy for audit quality, assuming that Big Four firms have better resources, reputation, and independence than non-Big Four firms (DeAngelo, 1981; Christiani & Nugrahanti, 2014). Both international and domestic research have yielded varying findings. Some studies have found that companies audited by large public accounting firms tend to have lower levels of earnings management (Zgarni et al., 2016). However, other studies have reported conflicting results, suggesting that firm size is not always a significant factor in earnings management (Marsha & Ghozali, 2017). These differing results reinforce the research gap that requires further study, particularly in the context of emerging markets like Indonesia.

This research gap is also evident in the limited number of studies that simultaneously examine the effect of audit committee quality and PAF size on earnings management, using recent data from Indonesia. In fact, a combination of internal (audit committee) and external (public accounting firm) mechanisms is believed to provide stronger oversight and reduce earnings management practices (Rahmadani & Haryanto, 2018). Therefore, this research is important to provide the latest empirical evidence that can enrich the literature on corporate governance and financial reporting quality.

Based on the description above, this study focuses on analyzing the influence of audit committee quality and public accounting firm size on earnings management in manufacturing companies listed on the Indonesia Stock Exchange. The research questions are formulated as follows: (1) Does audit committee quality affect earnings management? Moreover, (2) Does public accounting firm size affect earnings management?

The purpose of this study is to empirically test the influence of audit committee quality and public accounting firm size on earnings management. This research is expected to provide theoretical benefits by contributing to the development of the corporate governance and auditing literature, particularly in the area of oversight mechanisms for financial reporting quality. Furthermore, this research provides practical benefits for companies, regulators, and investors in understanding the role of audit committees and external auditors as control mechanisms for earnings management.

The novelty of this research lies in its attempt to combine two oversight mechanisms: internal, through audit committee quality, and external, through the size of the public accounting firm, in the context of contemporary Indonesian manufacturing companies. This research is expected to strengthen the understanding that integrating internal and external oversight can suppress earnings management practices and provide relevant empirical evidence to support more transparent and accountable business decision-making (Soliman & Ragab, 2014; Idris et al., 2018).

2. Literature Review and Hypothesis

Literature Review

Earnings Management

Earnings management is the practice of managers manipulating reported earnings for specific purposes, either to increase or decrease profits to meet specific targets (Scott, 2012). This practice can be conducted legally by exploiting the flexibility of accounting standards or illegally through transaction manipulation (Purnomo & Pratiwi, 2009). Earnings management impacts the quality of financial reports by misleading users in decision-making (Yateno, 2016). Therefore, effective governance mechanisms are needed to curb earnings management practices (Chen et al., 2007).

Audit Committee Quality

The audit committee is a corporate governance mechanism that oversees the integrity of financial reports and the effectiveness of internal control systems (Khurnanto & Syaffrudin, 2015). Audit committee characteristics such as size, meeting frequency, independence, and expertise are often used to measure its quality (OJK, 2015). Previous research has shown varying results. Sihombing and Laksito (2017) found that audit committee expertise can reduce earnings management practices, while Mughni and Cahyonowati (2015) stated that audit committee size has no significant effect. Other research found that audit committee independence is negatively related to earnings management (Soliman & Ragab, 2014). These differing results indicate an inconsistency that requires further investigation.

Public Accounting Firm Size

The size of a public accounting firm (KAP) is often used as an indicator of external audit quality. Larger firms (the Big Four) are considered to have greater resources, experience, and reputation, thus tending to produce better-quality audits than non-Big Four firms (DeAngelo, 1981; Christiani & Nugrahanti, 2014). Several studies have found that companies audited by large KAPs have lower levels of earnings management (Zgarni et al., 2016; Rahmadani & Haryanto, 2018). However, other research indicates that accounting firm size has no significant effect on earnings management (Marsha & Ghozali, 2017). This discrepancy in research findings highlights an interesting research gap that merits further investigation in the Indonesian context.

Hypothesis

The Effect of Audit Committee Size on Earnings Management

An audit committee with a larger number of members is expected to increase the effectiveness of financial reporting oversight (Puspa, 2015). Research by McMullen (1996) suggests that the size of audit committees is associated with the reliability of financial reports. However, Mughni and Cahyonowati (2015) found that audit committee size had no significant effect on earnings management, while Nugraha (2016) found a positive effect. Therefore, this study re-examines the effect of audit committee size on earnings management.

H1: Audit committee size influences earnings management.

The Effect of the Number of Audit Committee Meetings on Earnings Management

A higher frequency of audit committee meetings reflects greater oversight intensity (FCGI, 2002). Kusumaningtyas and Farida (2015) found that audit committee meetings had a significant adverse effect on earnings management. Similar results were also found by Ayemere and Elijah (2015). However, Mishra (2016) stated that the number of meetings had no effect. This creates a research gap that warrants further investigation.

H2: The number of audit committee meetings influences earnings management.

The Effect of Audit Committee Independence on Earnings Management

An independent audit committee has greater objectivity in its oversight, thereby reducing the potential for earnings manipulation (Kawak & Nuritomo, 2017). Research by Soliman and Ragab (2014) found that independence has a significant adverse effect on earnings management. Similarly, research by Eriabie and Odia (2016) and Usman (2016) supports the notion that independence suppresses earnings management. However, Juhmani (2017) found that independence is not always a significant factor.

H3: Audit committee independence influences earnings management.

The Effect of Audit Committee Expertise on Earnings Management

Audit committee members with an accounting/finance background can understand earnings manipulation techniques and detect them more quickly (Sihombing & Laksito, 2017). Kusumaningtyas and Farida (2015) found that audit committee competence has a significant adverse effect on earnings management. Research by Ayemere and Elijah (2015) also showed a similar finding. However, Siagian and Siregar (2018) found that audit committee expertise does not always have an impact.

H4: Audit committee expertise influences earnings management.

The Effect of Public Accounting Firm Size on Earnings Management

Firm size is seen as an indicator of external audit quality. Big Four accounting firms tend to have better audit quality due to their high reputation and independence (DeAngelo, 1981). Research by Christiani and Nugrahanti (2014) and Zgarni et al. (2016) has shown that the size of an accounting firm has a significant negative effect on earnings management. However, Marsha and Ghozali (2017) found no effect.

H5: Public Accounting Firm Size influences earnings management.

Framework

The framework of this study comprises the dependent variable, earnings management, and the independent variables, audit committee quality and audit committee size. Audit committee quality is proxied by audit committee size, number of committee meetings, audit committee independence, and audit committee expertise. This study uses earnings management as the dependent variable. It examines the following independent variables: audit committee size, the number of audit committee meetings, audit committee independence, audit committee expertise, and the size of the public accounting firm. The framework can be described as follows:

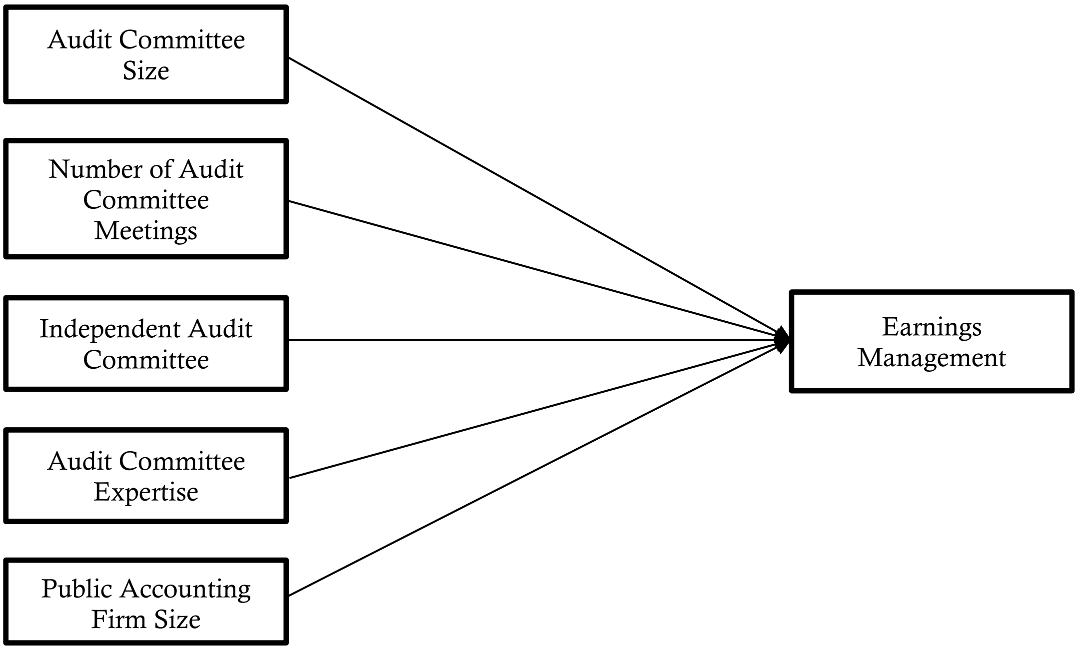

Figure 1. Framework

3. Data and Method

Research Type

Research design is a plan for collecting, measuring, and analyzing data in accordance with the study's research questions and objectives. This type of research uses a quantitative approach. The research used is an empirical study. Empirical studies are based on secondary data that is analyzed and processed to produce conclusions that represent the data studied. This study aims to test whether the independent variables—audit committee size, number of audit committee meetings, audit committee independence, audit committee expertise, and the size of the Public Accounting Firm—cause or influence earnings management as the dependent variable. The secondary data used is data from companies listed on the Indonesia Stock Exchange from 2015 to 2017.

Population and Sample

A population is a group of people, events, or things of interest about which the researcher wishes to form an opinion based on sample statistics. The population used in this study is manufacturing companies listed on the Indonesia Stock Exchange from 2015 to 2017. A sample is a portion of the population. A sample consists of several members selected from the population. In other words, some, but not all, elements of the population are included in the sample. The sampling method used in this study is purposive sampling.

Data Collection Techniques

The data collection technique used in this study was documentation, which involved collecting, recording, and reviewing secondary data from the annual reports of manufacturing companies in the basic and chemical industries for 2015-2017, which were fully published on the Indonesia Stock Exchange.

Data Analysis Methods

The data analysis method used in this study was quantitative analysis. Quantitative analysis is a method of analyzing a problem using quantitative methods. Quantitative analysis in this study involves qualifying the data to generate information. The analytical tool used in this study was multiple regression analysis, assisted by IBM SPSS 25. This analysis utilized descriptive statistics, classical assumption tests, hypothesis testing, and statistical tests.

4. Results

Normality Test

The normality test was conducted using graphical analysis, including histogram and standard plot methods. More details about the results of this study's normality test can be seen in Figure 2 below:

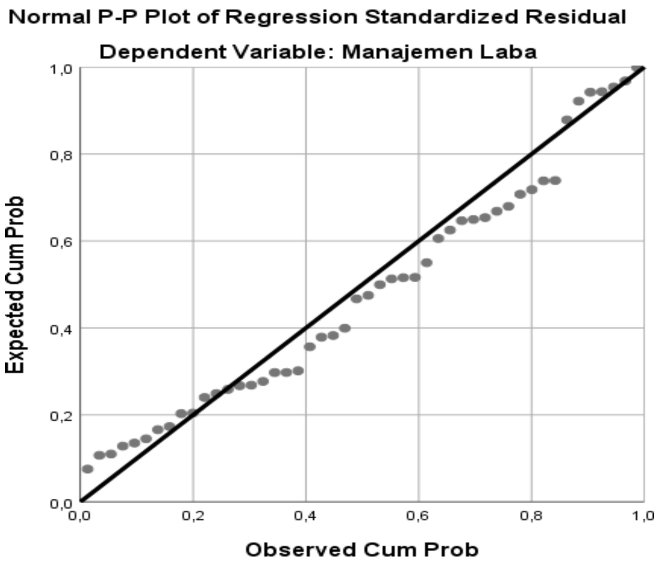

Figure 2. Normality Test

Based on observations in Figure 2, it can be concluded that the residual values of the observational data are typically distributed, as the graph tends to follow a typical curve pattern. Meanwhile, in Figure 2, the distribution of the observational data tends to spread around the diagonal line, thus meeting the assumption of normality.

Multicollinearity Test

According to Ghozali (2018), the multicollinearity test aims to determine whether there is a correlation between independent variables in a regression model. A good regression model should not correlate with independent variables. To detect the presence of multicollinearity in a regression model, the Variance Inflation Factor (VIF) and Tolerance values can be assessed. If the Variance Inflation Factor (VIF) is less than 10 and the Tolerance is greater than 0.1, the regression model is free from multicollinearity. If the VIF is greater than 10 and the Tolerance is less than 0.1, the regression model is experiencing multicollinearity. The results of the multicollinearity test in this study are presented in Table 1.

Table 1. Multicollinearity Test Results

Model		Collinearity Statistics	
		Tolerance	VIF
1	(Constant)		
	Audit Committee Size	,462	2,165
	Number of Audit Committee Meetings	,669	1,495
	Independent Audit Committee	,716	1,397
	Audit Committee Expertise	,467	2,140
	Size of Public Accounting Firm	,650	1,539

Source: Processed Data (2018)

Table 1 above shows that all independent variables have a tolerance value less than 1 (one), indicating no correlation between the independent variables. The Variance Inflation Factor (VIF) results also show the same result, namely, all independent variables have a Variance Inflation Factor (VIF) value of less than 10 (ten), with values for audit committee size of 2.165, number of audit committee meetings of 1.495, audit committee independence of 1.397, audit committee expertise of 2.140, and size of Public Accounting Firm of 1.539. Therefore, it can be concluded that the regression model in this study is free from multicollinearity problems.

Autocorrelation Test

According to Ghozali (2018), the autocorrelation test aims to examine whether there is a correlation in the linear regression model between the confounding factor in period t and the confounding error in period t-1 (i.e., the previous period). If a correlation occurs, it is considered an autocorrelation problem. In this study, the autocorrelation test results were analyzed using the Durbin-Watson (DW) test. This value was then compared with the d_l value in Table 2 of the Durbin-Watson test at a 5% significance level. Data were considered autocorrelation-free if the Durbin-Watson value was greater than the du value. The results of the autocorrelation test are presented in Table 2.

Table 2. Autocorrelation Test Results

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	,376[a]	,141	,039	,0575281	2,525

Source: Processed Data (2018)

Based on Table 2 above, the autocorrelation test results show a D-W value of 2.525. We will compare this value with the value in Table 2 using a 5% significance level. For this study, using n = 48 (as shown in the DW Table) and k = 5 (where k represents the number of independent variables), the dl value is 1.3167 and the du value is 1.7725. Therefore, the 4-dl can be calculated as 2.6833 and the 4-du value as 2.2275. Since the DW value (2.525) is in the intermediate range (4-du 2.2275 < d 2.525 < 4-dl 2.6833), it can be concluded that there is no autocorrelation.

Heteroscedasticity Test

According to Ghozali (2018), the heteroscedasticity test aims to determine whether the regression model exhibits unequal variances in the residuals (errors) from one observation to the next. If no clear pattern is visible, and the points are spread above and below zero on the Y-axis, heteroscedasticity is not present. In this study, heteroscedasticity was observed; further details are presented in Figure 3.

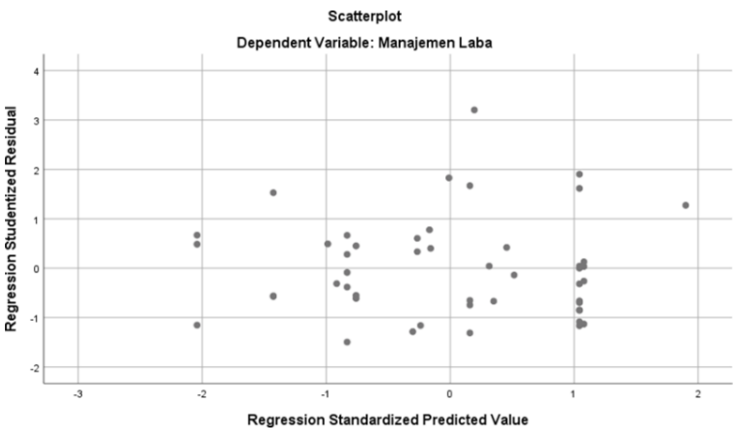

Figure 3. Heteroscedasticity Test

Figure 3 shows the heteroscedasticity test the scatterplot graph above shows that the sample data is randomly distributed and does not form a specific pattern. The data are both above and below the zero mark on the Y-axis. This concludes that there is no heteroscedasticity problem in this regression model.

Coefficient of Determination (R2) Test

The determination test is used to determine the percentage of the independent variable's contribution to the dependent variable. The coefficient of determination essentially measures the model's ability to explain variation in the dependent variable. The coefficient of determination can be obtained by squaring the correlation coefficient, also known as R-squared (R^2). The results of the determination test are presented in Table 3.

Table 3. Results of the Coefficient of Determination Test

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	,376[a]	,141	,039	,0575281	2,525

Source: Processed Data (2018)

Table 3 above shows the coefficient of determination (R2) test result of 0.141. This means that 14.1% of the earnings management variable can be explained by variations in the five variables: audit committee size, number of audit committee meetings, audit committee independence, audit committee expertise, and the size of the public accounting firm. The remaining 96.1% is attributed to factors not included in the regression model.

t-Statistic Test

Hypothesis testing is conducted to test the regression equation model for each independent variable partially. An individual or partial test analysis (t-test) is necessary to determine whether the independent variables have a significant partial effect on the dependent variable. Decision-making in this test is based on a significance level of 5% or 0.05. Table 4 shows the results of the individual parameter significance test (t-statistic test):

Table 4. Results of the t-Statistic Test

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	1,000	,086		11,579	,000
	Audit Committee Size	-,017	,023	-,161	-,766	,448
	Number of Audit Committee Meetings	,001	,001	,119	,681	,500
	Independent Audit Committee	,132	,061	,369	2,183	,035
	Audit Committee Expertise	-,057	,049	-,246	-1,176	,246
	Size of Public Accounting Firm	-,041	,021	-,356	-2,005	,051

Source: Processed Data (2018)

Based on the t-test results shown in Table 4, the Audit Committee Size variable has a significant value of 0.448, which is greater than 0.05. Therefore, the size of the audit committee does not affect earnings management. The Number of Audit Committee Meetings also shows a significant value of 0.500, which is greater than 0.05. This means that the number of audit committee meetings does not affect earnings management. Furthermore, the Independent Audit Committee variable has a significant value of 0.035, which is less than 0.05. This implies that the independence of the audit committee has a substantial impact on earnings management. The Audit Committee Expertise variable yields a significant value of 0.246, which exceeds 0.05. This means that the expertise of the audit committee does not affect earnings management. Finally, the Size of Public Accounting Firm variable shows a significant value of 0.051, which is slightly greater than 0.05. This means that the size of the Public Accounting Firm does not significantly affect earnings management.

5. Discussion

Audit Committee Size on Earnings Management

The discussion reveals that the size of the audit committee has the potential to influence earnings management. Audit committees with a larger number of members should be able to perform a more effective oversight function due to the diverse perspectives and expertise of their members.

This aligns with research by McMullen (1996), which emphasizes that having more members can improve the quality of oversight of financial reporting. However, several other studies, such as those by Mughni and Cahyonowati (2015), show that audit committee size does not always have a significant impact. These differing findings indicate that not only the number of members is important, but also the quality and effectiveness of the roles played by each audit committee member.

Number of Audit Committee Meetings on Earnings Management

The number of audit committee meetings reflects the intensity of oversight of financial reporting practices. Audit committees that meet frequently have a greater opportunity to identify potential fraud and provide appropriate recommendations to management. Research by Kusumaningtyas and Farida (2015) and Ayemere and Elijah (2015) supports the correlation between higher meeting frequency and decreased earnings management practices. However, Mishra (2016) found different results, indicating that the number of meetings was not always a significant factor. This indicates that the quality of discussions and follow-up on meeting outcomes is more important than the number of meetings alone.

Audit Committee Independence Regarding Earnings Management

Independence is a key element determining the effectiveness of an audit committee. Independent committee members have greater objectivity in carrying out their oversight function and are therefore less susceptible to management interests. Soliman and Ragab (2014) and Eriabie and Odia (2016) found that independence significantly reduced earnings management practices. However, research by Juhmani (2017) showed that independence is not always effective. This indicates that formal independence within the organizational structure does not always guarantee substantive independence in practice. Organizational culture and management transparency also play a significant role in strengthening the audit committee's independent oversight function.

Audit Committee Expertise Regarding Earnings Management

The expertise of audit committee members in accounting and finance is a crucial factor in effective oversight. With adequate knowledge, committee members can understand earnings manipulation techniques and detect indications of irregularities more quickly. Research by Sihombing and Laksito (2017) and Kusumaningtyas and Farida (2015) supports the belief that audit committee competence reduces earnings management practices. Conversely, research by Siagian and Siregar (2018) found no significant effect. This suggests that while technical competence is important, oversight effectiveness also depends on the integration of expertise with overall corporate governance mechanisms.

Public Accounting Firm Size on Earnings Management

The size of a public accounting firm is often considered a proxy for the quality of external audits. Larger accounting firms, particularly those classified as the Big Four, possess greater resources, reputation, and experience, and are therefore expected to provide stricter oversight of clients' financial statements. Research by Christiani and Nugrahanti (2014) and Zgarni et al. (2016) supports the finding that companies audited by larger accounting firms tend to have lower levels of earnings management. However, research by Marsha and Ghozali (2017) found that the size of an accounting firm does not always have a significant effect. This shows that although the size of the KAP is important, audit quality is also influenced by other factors such as the auditor's industry specialization, audit tenure, and the intensity of supervision provided.

6. Conclusion

Based on the analysis and discussion results, this study concludes that neither the size of the audit committee nor the number of audit committee meetings affects earnings management. Therefore, neither the number of members nor the frequency of meetings is effective in curbing earnings management practices. Conversely, audit committee independence is effective in curbing earnings management practices because independent members demonstrate objectivity and a critical approach to oversight. Meanwhile, the audit committee's expertise in accounting and finance, as well as the size of the Public Accounting Firm, also had no significant impact, indicating that technical competence and the reputation of the external auditor alone are insufficient to deter management from manipulating earnings.

Managerial Implications: The results of this study provide implications for companies and regulators to place greater emphasis on strengthening audit committee independence rather than simply increasing the number of members, the frequency of meetings, or the expertise of the audit committee members for formal purposes. Companies should select audit committee members who are genuinely independent and possess high integrity for more effective oversight. Furthermore, the presence of a large external auditor, such as the Big Four, does not automatically guarantee a reduction in earnings management practices. Therefore, company management needs to improve internal transparency and good governance to ensure higher-quality financial reporting.

Recommendation

Regulators are advised to strengthen governance regulations by emphasizing the independence of audit committee members rather than focusing solely on size or meeting frequency. Companies should prioritize selecting audit committee members with proven integrity and independence to enhance the effectiveness of their monitoring. External auditors, regardless of firm size, need to improve industry specialization and audit procedures to detect earnings manipulation more effectively. For investors, careful evaluation of corporate governance quality should be a key consideration in decision-making. Future researchers are encouraged to explore additional governance mechanisms and non-financial factors that may influence earnings management.

Limitations and avenues for future research

This study has several limitations, including the focus on a specific sector and a limited observation period, which may limit the generalizability of the findings. The variables used, such as audit committee quality and auditor size, may not fully capture all governance mechanisms influencing earnings management. Additionally, the study relies on secondary data and a quantitative design, which may overlook valuable qualitative insights. Future research could expand its scope to different industries and more extended periods, integrate additional governance and non-financial variables, and employ mixed-methods approaches to provide a more comprehensive understanding of earnings management practices.

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