THE INFLUENCE OF AUDIT COMMITTEES’ CHARACTERISTICS ON EARNINGS QUALITY: EVIDENCE FROM INDONESIA

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Abstract: The objective of this research is to get empirical evidence audit committees’ characteristics: financial expertise, number of meetings, audit committees’ sizes that moderate the effects of unexpected earnings to cumulative abnormal return. This research also includes independent variables that theoretically influence the relation of unexpected earnings to cumulative abnormal return such as CEO stock ownerships, earnings persistence, market beta, percentage of reporting loss and discretionary accruals. The sample of this research is companies listed in Indonesia Stock Exchange (IDX) during year 2007 to 2009. This research uses 147 data with 49 companies selected per year. The analysis tools used in this research is multiple linear regression. The result shows that financial expertise, number of meetings, audit committees’ sizes and others variables altogether do not moderate the effects of unexpected earnings to cumulative abnormal return or earnings quality reported in financial report. It shows that investors in Indonesia do not consider the characteristics of audit committees in their investment decision making process and the characteristic of audit committees itself does not influence the quality of reported earnings.

Keywords: Audit committee’s characteristics, Audit committees’ expertise, Unexpected Earnings, Cumulative Abnormal Return.

Abstrak: Tujuan penelitian adalah untuk mendapatkan bukti empiris karakteristik komite audit yang ahli keuangan, jumlah pertemuan, ukuran komite audit yang memoderasi pengaruh unexpected earnings terhadap cumulative abnormal return. Penelitian ini juga memasukkan variabel independen yang mempengaruhi hubungan unexpected earnings dan cumulative abnormal return seperti kepemilikan saham CEO, earnings persistence, market beta, percentage of reporting loss dan discretionary accruals. Sampel penelitian adalah perusahaan yang terdaftar di Bursa Efek Indonesia selama 2007 sampai 2009. Penelitian ini menggunakan 147 data dengan 49 perusahaan yang dipilih per tahun. Alat analisis yang digunakan dalam penelitian ini adalah regresi linier berganda. Hasil penelitian menunjukkan bahwa komite audit yang ahli keuangan, jumlah pertemuan, ukuran komite audit dan variabel lain tidak memoderasi pengaruh unexpected earnings terhadap cumulative abnormal return atau kualitas laba yang dilaporkan dalam laporan keuangan. Hal ini menunjukkan bahwa investor di Indonesia tidak mempertimbangkan karakteristik komite audit dalam proses...
INTRODUCTION

Generally, company organizations structure consists of multilevel structure of authority. Whereas, among the board of directors, audit committees help the directors to review the financial reports of the companies and control the performance of the managers. This complies with the Securities and Exchange Commission rule which stated that Audit committees play a critical role in the financial reporting system by overseeing and monitoring management’s and the independent auditors’ participation in the financial reporting process (SEC, 1999). In Indonesia, the recommendation to have audit committees among companies is issued by BAPEPAM in 2000. It was legally stated as regulation in 2003 where it required all public companies to have audit committees before the end of December 31st, 2004 (BAPEPAM, 2003). Thus, the boards of directors assign part of the responsibility to the audit committee. The audit committee must be ‘first among equals’ in the financial reporting process, since the audit committee is an extension of the full board and hence the ultimate monitor of the process (SEC, 1999 in Bryan et al. 2004). The integrity of financial reporting process becomes part of audit committee’s responsibility as independent committee in the company’s organization structure.

As described in the section 404, the commission shall prescribe rules requiring each annual report to contain an internal control report which shall state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting Sarbanes Oxley Act, 2002. Based on the rule, the audit committees have the responsibility to review internal control. All these multilevel authorities are used to ensure that the financial report provides the valid data to the users.

This research observes the relationship between audit committee characteristics and the earnings quality of the company. Although most of the companies have audit committees in their organization structure, it cannot be fully assured that financial report will not have any misstatement of their financial reports. Some of the accounting scandals that caused companies liquidated and collapsed drive us to try to figure out the commitment, responsibility and audit committee’s financial literacy to enhance the integrity and quality of financial report.

The professional ethics of auditor is made to ensure the performance quality of the auditor and accountant. In the first point of general accepted auditing standard (GAAS), it is stated that the auditor must have adequate technical training and proficiency to perform the audit. It means that the standard required auditor to have formal education in auditing and accounting, adequate practical experience for the work being performed and continuing professional education (Arens et al. 2011, 54). The professionalism of the audit committees has strong reflection to the quality of its performance and to the quality of the earnings which they are responsible of.

Therefore, the quality of the earnings that presented in the financial statement becomes the major concern that motivates this research to evaluate the quality and relates it with the audit committee characteristics. The variances of the results from some previous researches also motivate this research. Bryan et al. (2004) found that financial literate, number of meeting and commitment of audit committees enhance earnings quality by improving the informativeness of reported earnings.
While, the research done by Lin et al. (2006) resulted that the audit characteristics such as independence, financial expertise, activity and the stock ownership are not supported to the higher earnings quality. Their study did not give any evidence of the positive relation between those characteristics to the earnings quality. The other research found that there is no difference between the quality of the company with or without the audit committee (Crowford, 1987; Kalbers, 1992; Beasley, 1996 in Suaryana, 2005). The result contrasts with other research which gives evidence that characteristics' audit committees enhance the quality of the reporting. In the other words, there is controversy if the existence of the audit committees and its characteristics could affect quality of companies' financial reports.

Researcher replicates Bryan et al. 2004 to evaluate the relation of earnings quality and the audit committees' characteristics. The differences of this research with previous research are variables and the period of the research. This research excludes variables related to the forecast activities and the internal relationships of the audit committees to the employees which the data is not widely provided in Indonesia. The purpose of the research is to get the empirical evidence of the research problems that audit committees' financial expertise, audit committees' meeting, audit committees' commitment, CEO ownership, market beta, earnings persistence, percentage reporting loss, discretionary accrual moderates the effect of unexpected earnings to cumulative abnormal return.

**Financial Expertise Audit Committees on Earnings Quality**

Menon and Williams (1994) in Bryan et al. (2005) argued that by forming audit committee in the company does not mean that the board relies on the committee, but the board will more rely on an audit committee with a financial expertise. Bryan et al. (2004) found that financial literate audit committees enhance earnings quality by improving the informativeness of reported earnings. McMullen and Raghunandan (1996), Agrawal and Chadha (2005) in Dhaliwal et al. (2006) explained that audit committee accounting expertise is negatively associated with SEC enforcements and restatements. Felo et al. found that audit committees with financial literacy and higher level of expertise on the audit quality increase the quality of reported earnings (Felo et al. 2003).

Dhaliwal et al. (2006) stated that accounting audit committee expertise is positively associated with accruals quality that related to higher quality of financial reporting. They found a significant positive interaction effect between audit committee accounting expertise and strong audit committee governance where positive association between audit committee accounting expertise and accruals quality stated for firms with strong governance in audit committees by evaluating it with the audit committees' characteristics include audit committee size, independency, and number of meetings.

Previous study provided the evidence that the audit committee with accounting-literate expert is more likely to generate high quality of reported earnings than that without accounting expertise by checking the relation between audit committee financial expertise and earnings quality (Qin, 2007). Defond et al. (2005) in the Bryan et al. (2004) relate the financial literacy of the audit committee to market returns found that the market reacts positively surrounding the announcement of a financial expert to the audit committee.

**The Audit Committees Board Size on Earnings Quality**

Archambeault and DeZoort (2001) in Dhaliwal et al. (2006) found that audit committee independence and board size are negatively related to the probability of firms dismissing auditors subsequent to the disclosure of a reportable event. Bryan et al. (2005) found that audit committee time commitment or member size greater the earnings informativesness related to the earnings quality.
While Vafeas (2000) in Bryan et al. (2004) investigated whether the earnings returns have relation varies with board independence and board size. The result showed the earnings returns relation is stronger for firms with smaller board. Rosdini found that there is no significant influence of the existence of the audit committees to earnings quality (Rosdini, 2011). Investors do not pay attention to the existence and characteristics of audit committees.

The Number of Meetings of Audit Committees on Earnings Quality

The researches that include the meeting of audit committees are performed by several researchers. The result said that four or more meetings are related positively to the audit committee size which consist at least three members, the financial expert (Abbott et al. 2002). Abbott et al. 2004 in Bryan et al. 2005 also concluded that the firms whose audit committees meet less than the minimum are more likely to restate the earnings. Thus, it will decrease the earnings quality reported by the company.

Bryan et al. (2005) found that audit committee meeting frequency greater the earnings informativeness related to the earnings quality. Anderson et al. (2003) found that earnings informativeness increased with board independence and number of audit committees meeting. The earnings quality has a close relation with the earnings informativeness, by meaning that earnings informativeness shows how strong the earnings represent the information to the users where as the earnings quality shows the quality of the earnings reported to the users.

While, the research done by Lin et al. (2006) resulted that the audit characteristics such as independence, financial expertise, activity and the stock ownership are not supported to the higher earnings quality. Their study did not give any evidence of the positive relation between those characteristics to the earnings quality.

Other Variables on Earnings Quality

There are some factors which that may influence the audit committee’s oversight of the financial reporting process which consist of: the CEO’s influence over the board, the CEO holdings in the firm (Bryan et al. 2004). CEOs may manipulate earnings to increase their short-term stock returns when they have big influence in the company (Aboody, Kasznik, 2000 and Yermack, 1997 in Klein, 2006).

Other additional control variables are included in the research agree with the previous research done by Bryan et al. (2004). Market beta, earnings persistence, negative loss, discretionary accruals, CEO ownerships resulted in Bryan et al. (2004) have influence in the relation between unexpected earnings and cumulative abnormal returns.

Regarding to the previous theory, the hypothesis could be developed as follows.

H1 Audit committees’ financial expertise characteristic moderates the effect of unexpected earnings to cumulative abnormal return.

H2 Audit committees’ meeting moderates the effect of unexpected earnings to cumulative abnormal return.

H3 Audit committees’ size moderates the effect of unexpected earnings to cumulative abnormal return.

H4 CEO ownership moderates the effect of unexpected earnings to cumulative abnormal return.

H5 Market beta moderates the effect of unexpected earnings to cumulative abnormal return.

H6 Earning persistence moderates the effect of unexpected earnings to cumulative abnormal return.

H7 Percentage reporting losses moderates the effect of unexpected earnings to cumulative abnormal return.

H8 Discretionary accrual moderates the effect of unexpected earnings to cumulative abnormal return.
RESEARCH METHODS

This research uses companies listed in Indonesia Stock Exchange as the research population. Researcher uses purposive sampling technique in case to select the samples based on some criteria. The descriptions and procedure of purposive sampling are described as below.

Table 1 Purposive Sampling

<table>
<thead>
<tr>
<th>Descriptions</th>
<th>Companies</th>
<th>Data</th>
</tr>
</thead>
<tbody>
<tr>
<td>All companies consistently listed in IDX from 2007 to 2009 exclude banking,</td>
<td>261</td>
<td>783</td>
</tr>
<tr>
<td>securities, insurance and government companies</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Companies which do not use IDR in financial reporting</td>
<td>(12)</td>
<td>(36)</td>
</tr>
<tr>
<td>Annual reports do not available in IDX</td>
<td>(121)</td>
<td>(363)</td>
</tr>
<tr>
<td>Incomplete data:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less in Audit committees profiles, number of meetings and members</td>
<td>(65)</td>
<td>(195)</td>
</tr>
<tr>
<td>Less in availability of earnings data from 2002 to 2009</td>
<td>(10)</td>
<td>(30)</td>
</tr>
<tr>
<td>Less in date of issuance of financial report</td>
<td>(1)</td>
<td>(3)</td>
</tr>
<tr>
<td>Less in error data</td>
<td>(3)</td>
<td>(9)</td>
</tr>
<tr>
<td>Total companies and data</td>
<td>49</td>
<td>147</td>
</tr>
</tbody>
</table>

Suaryana (2005) defined unexpected earning as the difference of the expected annual earnings with the actual reported earnings in financial statement. The formula to calculate unexpected earnings is described as follow (Suaryana, 2004).

\[ UE_{it} = \frac{E_{it} - E_{i,t-1}}{E_{it-1}} \]

Where,

\( UE_{it} \) = Unexpected earnings of company i in t period
\( E_{it} \) = Earnings reported in financial statement by company i in t period
\( E_{it-1} \) = Earnings reported in financial statement by company i on t-1 period

Cumulative abnormal return is the dependent variable of this research as it affected by independent variable. Cumulative Abnormal Return is calculated from the holding period returns cumulated from the day after the prior years' earnings announcement date for year t-1 during the day or the current earnings announcement date for year t, less market holding period returns for the same period (Bryan et al. 2005). Researcher uses the date of issuance stated in financial report as the base to calculate abnormal return with 15 window days. The stated date in the financial report is used as the -7 day in the research to consider about the time lag of the issuance date and the date where the report received by the users. The calculation is described as the below (Mulyani, 2007).

\[ Ab(R) = R_{it} - R_{i} \]

Where,

\( Ab(R) \) = Abnormal return of i security in t period
\( R_{it} \) = Actual return of i company share in t period
\( R_{i} \) = Expected return of i security in t period

\[ R_{it} = \frac{P_{t} - P_{t-1}}{P_{t-1}} \]

Where,

\( R_{it} \) = Actual return of i company share in t period
\( P_{t} \) = Share price in t day
\( P_{t-1} \) = Share price in t-1 day

The formula to calculate expected return is described as below (Prihantoro, 2002).

\[ R_{i} = R_{mt} \]

\[ R_{mt} = \frac{IHSG_{t} - IHSG_{t-1}}{IHSG_{t-1}} \]

Where,

\( R_{mt} \) = Expected market return in t period
\( IHSG_{t} \) = IHSG value in t period
\( IHSG_{t-1} \) = IHSG value in t-1 period
Financial expertise is an indicator variable which sets to one if all audit committee members are identified as financially expertise. If not all audit committee members are identified as financially expertise or have economic background, it sets to zero. Indicator variable set to one if the audit committee meets at least four times within the fiscal year. Otherwise, if the audit committee meeting is less than four times, it sets to zero. Indicator variable set to one if all audit committee members serve on no more than three boards. If all audit committee members serve more than three boards than it sets to zero.

CEO stock ownership means that percentage of a firm's common stock owned by the CEO. This variable identified as dummy variable where it set to 1 if CEO has ownerships in the company and otherwise is 0. Market beta is assumed same as market risk. This market risk is potentially effect the relation of unexpected earnings and cumulative abnormal return. Researcher uses monthly company returns and monthly market returns in the research period to calculate the market beta. The formula to calculate market beta (Mulyani, 2007) is described as below.

\[
R_{it} = \alpha_i + \beta_i R_{mt} + \epsilon
\]

Where as,
- \( R_{it} \) = return of company i in t period
- \( R_{mt} \) = market return in t period
- \( \epsilon \) = error

Earning persistence is the coefficient of the earnings that could inform investors. It measured from the slope of the regression result from current year earnings with previous year earnings (Mulyani, 2007). Researcher uses 5 years company earnings data in the regression.

\[
X_{it} = \alpha + \beta X_{it-1} \epsilon + \epsilon
\]

Where as,
- \( X_{it} \) = company earnings in t period
- \( X_{it-1} \) = company earnings in previous period
- \( \epsilon \) = error

Percentage reporting losses is analyzed from the earnings reported in company's financial report. It is used to measure the percentage of firms reporting a net loss for current year, where it set to 1 if the company report loss in current year, and set to 0 if company does not report loss in current year (income).

Discretionary accrual measured to one if the total accrual for firms 1 is ranked in the lower half of the sample distribution, otherwise zero. It could be find by following method (Klien, 2000).

\[
\frac{\text{TAC}_{jt}}{\text{TAC}_{jt-1}} = \alpha_1 \left( \frac{1}{\text{A}_{jt-1}} \right) + \alpha_2 \left( \frac{\Delta \text{REV}_{jt}}{\text{A}_{jt-1}} \right) + \alpha_3 \left( \frac{\text{PPE}_{jt}}{\text{A}_{jt-1}} \right) + \epsilon
\]

Discretionary or unexpected accrual defined as:

\[
\text{DAC}_{jt} = \frac{\text{TAC}_{jt}}{\text{TAC}_{jt-1}} - \left[ \alpha_1 \left( \frac{1}{\text{A}_{jt-1}} \right) + \alpha_2 \left( \frac{\Delta \text{REV}_{jt}}{\text{A}_{jt-1}} \right) + \alpha_3 \left( \frac{\text{PPE}_{jt}}{\text{A}_{jt-1}} \right) + \epsilon \right]
\]

\[
\text{TAC}_j = \text{Total accruals i.e. working capital minus depreciation and changes in the short term debt for firm j and year t,}
\]

\[
\text{A}_{jt} = \text{Total assets from firm j and year t-1,}
\]

\[
\Delta \text{REV}_{jt} = \text{Changes in revenue for firm j and year t-1 to year t,}
\]

\[
\text{PPE}_j = \text{Property, plant and equipment for firm j, and year t,}
\]

\[
\alpha_{1,2,3} = \text{Specific parameters for firm j,}
\]

\[
\epsilon = \text{Errors for firm j, and year t.}
\]
RESEARCH RESULT

Descriptive Statistic Variables

Table 2 Result of Descriptive Analysis

<table>
<thead>
<tr>
<th>Variable</th>
<th>Minimum</th>
<th>Maximum</th>
<th>Mean</th>
<th>Std. Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABNORMAL</td>
<td>-0.7280</td>
<td>0.9270</td>
<td>0.011561</td>
<td>0.1690702</td>
</tr>
<tr>
<td>CEO</td>
<td>0</td>
<td>1</td>
<td>0.16</td>
<td>0.371</td>
</tr>
<tr>
<td>MEETING</td>
<td>0</td>
<td>1</td>
<td>0.94</td>
<td>0.241</td>
</tr>
<tr>
<td>MEMBER</td>
<td>0</td>
<td>1</td>
<td>0.86</td>
<td>0.344</td>
</tr>
<tr>
<td>EXPERTIS</td>
<td>0</td>
<td>1</td>
<td>0.56</td>
<td>0.498</td>
</tr>
<tr>
<td>PERC_LOS</td>
<td>0</td>
<td>1</td>
<td>0.16</td>
<td>0.371</td>
</tr>
<tr>
<td>MARKET_B</td>
<td>-2.0560</td>
<td>18.3370</td>
<td>1.016333</td>
<td>3.0265197</td>
</tr>
<tr>
<td>DAD</td>
<td>0</td>
<td>1</td>
<td>0.33</td>
<td>0.473</td>
</tr>
<tr>
<td>EARNG_PS</td>
<td>-7.8890</td>
<td>36.6260</td>
<td>0.546238</td>
<td>3.8190172</td>
</tr>
<tr>
<td>UNEXPECT</td>
<td>-74.7156</td>
<td>28.8755</td>
<td>-0.133307</td>
<td>7.7594486</td>
</tr>
</tbody>
</table>

The result shows that audit committee’s financial expertise has significant value 0.246. Because sig. value is bigger than alpha (0.246>0.050), it means that financial expertise does not moderate the effect of unexpected earnings to cumulative abnormal return. The result shows that audit committee’s meeting has significant value 0.978. Because sig. value is bigger than alpha (0.978>0.050), it means that audit committee’s meeting does not moderate the effect of unexpected earnings to cumulative abnormal return. The result shows that audit committee’s commitment has significant value 0.853. Because sig. value is bigger than alpha (0.853>0.050), it means that audit committees’ commitment does not moderate unexpected earnings to cumulative abnormal return. The result shows that CEO ownerships has significant value 0.276. Because sig. value is bigger than alpha (0.276>0.050), it means that CEO ownerships does not moderate unexpected earnings to cumulative abnormal return. The result shows that market beta has significant value 0.335. Because sig. value is bigger than alpha (0.335>0.050), it means that market beta does not moderate unexpected earnings to cumulative abnormal return.

The result shows that earnings persistence has significant value 0.374. Because sig. value is bigger than alpha (0.374>0.050), it means that earnings persistence does not moderate unexpected earnings to cumulative abnormal return. The result shows that percentage reporting loss has significant value 0.884. Because sig. value is bigger than alpha (0.884>0.050), it means that percentage reporting loss does not moderate unexpected earnings to cumulative abnormal return. The result shows that discretionary accrual has significant value 0.240. Because sig. value is bigger than alpha (0.249>0.050), it means that discretionary accruals does not moderate unexpected earnings to cumulative abnormal return.

CONCLUSIONS, LIMITATIONS AND RECOMMENDATIONS

Audit committees’ financial literate characteristic does not moderate the effect of unexpected earnings to cumulative abnormal
return. This research inconsistent with the research did by Bryan et al. (2004) which stated that financial literate of audit committee exhibit higher earnings quality. This research agree with the research did by Lin et al. (2006) which resulted that the audit characteristics financial expertise is not supported to the higher earnings quality. Their study did not give any evidence of the positive relation between those financial expertise characteristic to the earnings quality.

Audit committees’ meeting does not moderate the effect of unexpected earnings to cumulative abnormal return. This research inconsistent with Bryan et al. (2005) which found that audit committee meeting frequency greater the earnings informativeness related to the earnings quality. This research agree with the research done by Lin et al. (2006) which resulted that the audit committee activity is not supported to the higher earnings quality. Their study did not give any evidence of the positive relation between audit committee activities to the earnings quality.

Audit committees’ size does not moderate the effect of unexpected earnings to cumulative abnormal return as moderating variable. This research inconsistent with Bryan et al. (2005) which found that audit committee time commitment or member size greater the earnings informativeness related to the earnings quality. This agrees with Rosdini who found that there is no significant influence of the existence of the audit committees to earnings quality (Rosdini, 2011). In other words, investors do not pay attention to the existence and characteristics of audit committees. The number of audit committees’ member also does not be considered by investors in their making decision process as the number of the member already regulated by BAPEPAM.

CEO ownership does not moderate the effect of unexpected earnings to cumulative abnormal return. This result inconsistent with the research did by Bryan et al. (2004) which stated that CEO ownership moderates the effect of unexpected earnings to cumulative abnormal return. Market beta does not moderate the effect of unexpected earnings to cumulative abnormal return. This result inconsistent with the research did by Bryan et al. (2004) which stated that market beta moderates the effect of unexpected earnings to cumulative abnormal return.

Earning persistence does not moderate the effect of unexpected earnings to cumulative abnormal return. This result inconsistent with the research did by Bryan et al. (2004) which stated that earnings persistence moderates the effect of unexpected earnings to cumulative abnormal return. Percentage reporting loss does not moderate the effect of to cumulative abnormal return. This result inconsistent with the research did by Bryan et al. (2004) which stated that percentage reporting loss moderates the effect of unexpected earnings to cumulative abnormal return. Discretionary accrual does not moderate the effect of to cumulative abnormal return. This result inconsistent with the research did by Bryan et al. (2004) which stated that discretionary accrual moderates the effect of unexpected earnings to cumulative abnormal return.

This research have some limitations such as the research is using the period of research that relatively short, which is only three years. Recommendations that can be suggest by researcher to be done for the next research or observation related to the earnings quality is increasing the number of data variety. By increasing the number of the data, the number of the firms and years of observation.
REFERENCES:


