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THE INFLUENCE OF THE AUDIT COMMITTEE AND AUDIT QUALITY ON PREVENTION OF EARNING MANAGEMENT

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Abstract. *The purpose of this study is to examine the effect of audit quality and audit committee on earnings management. Earnings management is a manager's action to report earnings that can maximize personal or company interests using accounting method policies. Audit quality in this study is measured by the Public Accounting Firm (KAP) into the big four and non-big four, while the audit committee is measured by the number of meetings held by the audit committee. The data used in this study is secondary data derived from the financial statements of property and real estate companies listed on the Indonesia Stock Exchange in 2016-2018. By using purposive sampling, this study got 31 samples of companies. The data processing technique will be performed using the computational calculation of the SPSS 23 program. The results of the study conclude that audit quality proxied by the size of public accounting firm (the big four and non-big four) has no effect on earnings management and the audit committee proxied by the number of meetings conducted by the audit committee has a significant positive effect on earnings management.*

Keywords: Audit committee, Audit quality, Prevention, Earning management

1. **Introduction.** The financial statement is a report containing information related to a company's finances that describes the condition of the firm. The information provided in the financial statements plays an important role in determining the company's performance. The financial statements must be presented with quality to support decision-making by shareholders [1]. Therefore, this gives rise to actions taken by management to adjust the financial statements, so that the report shows the company's performance results are better [2]. The audit committee is responsible for supervising the preparation of financial reports. It can minimize profit management opportunities [3]. Earnings management is caused by agency problems that occur due to information gaps and differences in interests between shareholders as principals and company management as agents [4]. In this case, the audit committee within the company is considered a corporate governance mechanism that can reduce the occurrence of earnings management actions. The audit committee plays a role in overseeing various actions of management and providing independent professional opinions to the board of commissioners on financial reports or anything that may influence decision making. The greater the number of audit committees in the company, the smaller the management's actions in carrying out earnings management practices [5]. Audit quality also plays an important role, and the purpose of the financial statement audit is to assure the integrity of the financial statements presented by management [2].

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Chairman of Bapepam Herwidayatmo stated that the management of PT Ades Alfindo Putrasetia Tbk (ADES) had manipulated information to the public. The information manipulation is related to differences in the calculation of production figures and sales figures in the company's financial statements. The new ADES management reported discrepancies in financial statements from 2001 to 2003. In 2001, there was a difference in the calculation between the volume of production and the volume reported by the company to the trademark owner on net sales estimated at a maximum of Rp 13 billion. In 2002, it was Rp 45 billion, 2003 was Rp 55 billion and Rp 2 billion for the middle of 2004. This estimate can explain that the maximum difference is 10%, 30%, 32%, and 3% lower than the reported sales. ADES shares were suspended since August 5, 2004, this is due to allegations of differences in the sales report above and it can only be traded in the Negotiation Market [6]. Other cases, CNBC Indonesia stated that Bukopin had modified credit card data in Bukopin more than five years ago. The number of modified credit cards is quite large, namely more than 100,000 cards. The modification caused Bukopin's credit position and commission-based income to increase inappropriately. Bank Bukopin must revise its 2016 net profit down to Rp 183.56 billion from the previous Rp 1.08 trillion. The largest decrease was in the portion of fees and commissions, which was income from credit cards. This income decreased from Rp 1.06 trillion to Rp 317.88 billion. Apart from credit card issues, revisions were also made to the financing of a subsidiary of Bank Syariah Bukopin (BSB) related to the addition of the allowance for impairment losses on certain debtors. It caused the company's expenses to increase by IDR 148.6 billion [7].

Academic and practical contributions in this research provide empirical evidence that audit quality and audit committee affect the earnings management of a company and help the company avoid the occurrence of earnings management through the role of the audit committee in the company, especially in the property and real estate sector. Based on the background, this study will discuss about the effect of audit committee and audit quality on the prevention of earnings management (study case on Property and Real Estate Companies listed on the Indonesia Stock Exchange in 2016-2018).

2. Literature Review.

2.1. Audit quality. Audit quality greatly determines the credibility of financial statements. In this case, external auditors can be a control mechanism for management. So, management can present financial information reliably and prevent fraudulent accounting practices [8]. The size of the accounting firm is representative of audit quality (auditor independence) because no one client is important for one large KAP (big four KAP) and has a greater reputation for loss if they misreported [9]. National audit can improve investment and innovation efficiency and has a role in restraining management corruption and earnings management behavior. The national audit has played a similar role in internal control [10].

2.2. Audit committee. The definition of an audit is several members of the company's board of directors who are responsible for helping auditors to remain independent and management [11]. The duties of the audit committee include reviewing accounting policies implemented by the company, assessing internal control, reviewing external reporting systems and compliance with regulations [12].

2.3. Earning management. Earnings management is a manager's action to report earnings that can maximize personal or company interests by using accounting method policies [13]. The higher the debt/equity ratio of a company, which is equivalent to the closer the company is to constraints in debt covenants and the greater the probability of covenant violation, the more likely it is for managers to use accounting methods that increase income [14]. In general, the purpose of management in carrying out earnings management practices is to maximize management's welfare, manipulate earnings that are reported to shareholders.

3. **Hypothesis.** Based on the results of research conducted by Lidiawati it states that the audit committee has a negative effect on earnings management. This means that the existence of an audit committee can reduce earnings management activities [5]. Then the results of research conducted by Sanjaya concluded that public accounting firms affiliated with the big four have a negative effect on real activity manipulation (real earnings management). The quality of auditors proxied by public accounting firms affiliated with the big four can prevent and detect real earnings management [15]. Based on research conducted by Lufita and Suryani it states that audit quality proxied by KAP size does not have a significant effect on earnings management in a positive direction. In manufacturing sector companies are listed on the Indonesia Stock Exchange in 2014-2016. This shows that the size of KAP does not guarantee that it can minimize earnings management practices. Meanwhile, the audit committee, which is measured by the frequency of audit committee meetings, has a significant effect on earnings management in a positive direction in manufacturing sector companies listed on the Indonesia Stock Exchange in 2014-2016 [16].

3.1. **Audit quality and earning management.** To control earnings management practices, it is necessary to conduct an audit of financial statements, which aims to assure the integrity of the financial reports presented by management. Certainty regarding the relevance and reliability of the company's financial statements is needed to assist external parties in making business decisions [2]. In this case, the role of auditors is very important, both internal and external auditors, to control management in presenting accurate financial report information. The audit quality used in this study is the KAP size proxy. Audit quality is defined as all the possibilities whereby the auditor when auditing the client's financial statements can find violations that occur in the client's accounting system and report them in the audited financial statements, where in carrying out their duties the auditor is guided by auditing standards and the relevant public accountant code of ethics [17]. This proxy represents the size of the big four and non-big four accounting firms. The quality of audits performed by public accountants can be seen from the size of the KAP that conducts audits [9]. Big accounting firms (big four accounting firms) are perceived to be doing higher quality audits than small accounting firms (non-big four accounting firms) because large accounting firms have more resources and more clients, so they are not dependent on just one or a few clients and a reputation that has been considered good by the community causes them to conduct audits more carefully. Based on this description, the hypothesis is as follows.

H1: Audit quality has a significant negative effect on earnings management.

3.2. **Audit committee and earning management.** The existence of an audit committee is useful in ensuring transparency, the openness of financial reports, fairness for stakeholders, and disclosure of information carried out by management. The audit committee is tasked with monitoring to improve effectiveness in creating transparency and quality financial reporting, compliance with applicable laws and regulations, and adequate internal supervision [18]. The audit committee is a committee under the board of commissioners consisting of at least one independent commissioner and independent professionals from outside the company, whose responsibilities include helping auditors remain independent from management [19]. The role of the audit committee in overseeing risk-taking became more important after the financial crisis (2008). Based on a survey conducted by KPMG 2009, most of the audit committee members agreed that they had improved direct involvement with management during a financial crisis where they are to improve enterprise risk management by strengthening their supervisory role [20]. The audit committee in this study was measured using a proxy for the frequency of audit committee meetings. The presence of an audit committee, in this case, can be important because it can help the board of commissioners in supervising management related to the preparation of the company's financial statements. Based on this description, the hypothesis is as follows.

H2: Audit committee has a significant negative effect on earnings management.

4. Methodology.

4.1. Population and samples. The population used is all property and real estate companies listed on the Indonesia Stock Exchange from 2016 to 2018 that have published their financial reports. The total population is 77 companies. The sample obtained was 31 companies based on the consideration criteria used in order to obtain 93 annual report data for 2016-2018. The method used by researchers used purposive sampling technique, with the following criteria:

1) Property and real estate company listed on the IDX;
2) Property and real estate companies that publish audited annual financial reports for the period 31 December 2016-2018;
3) Property and real estate companies that did not experience losses from 2016-2018;
4) The published financial reports have complete information (there is information related to the audit committee and the KAP that audited) for the period 2016-2018.

4.2. Type of data and sample collection method. This research method uses a quantitative approach, which is expressed in the form of numbers or values that can be measured in size. Sources of data in this study used secondary data. The methods used in collecting sample data in this study include literature study where researchers get literature sources from both books (e-books) and journals to obtain relevant theories or information related to the topics discussed and documentation technique where researchers collect financial and annual reports of property and real estate companies listed on the Indonesian stock exchange for the period 2016-2018 which are published on the Indonesia Stock Exchange, through their official website (www.idx.co.id).

4.3. Data analysis methods. The data processing technique will be performed using the computational calculation of the SPSS program (Statistical Program for Social Science). This method uses tests such as descriptive statistical analysis, linear regression analysis and hypothesis testing. In this study, the analysis is used to determine the influence of audit quality and audit committee on earning management.

4.4. Operationalization of variables. The operationalization of the variables in this study are as follows.

1) Dependent variable
   a. Earnings management
      Earnings management is an effort made by company managers to influence the information in financial reports which aims to deceive stakeholders who want to know the performance and condition of the company [18]. It also refers to the use of accounting practices that result in desired financial statements regarding the financial position and healthy organizational financial performance [21]. Earnings management in this study is measured using discretionary accruals with the Modified Jones Model. There are 4 steps that need to be done, including
      1. Total Accrual

$$\mathrm{TA}_{it} = \mathrm{NI}_{it} - \mathrm{CFO}_{it}$$

      2. Total Accrual Value (TA) estimated by the ordinary least square regression equation

$$\frac{\text{TA}_{it}}{A_{it}-1} = \beta_1\left(\frac{1}{A_{it}-1}\right) + \beta_2\frac{\Delta\text{REV}_{it}}{A_{it}-1} + \beta_3\frac{\text{PPE}_{it}}{A_{it}-1}$$

3. Non-Discretionary Accruals (NDA)

$$\text{NDA}_{it} = \beta_1\left(\frac{1}{A_{it}-1}\right) + \beta_2\left(\frac{\Delta\text{REV}_{it}}{A_{it}-1} - \frac{\Delta\text{REC}_{it}}{A_{it}-1}\right) + \beta_3\frac{\text{PPE}_{it}}{A_{it}-1}$$

4. Discretionary Accrual (DA)

$$\text{DA}_{it} = \frac{\text{TA}_{it}}{A_{it}-1} - \text{NDA}_{it}$$

Note:
DA_{it} = Discretionary accruals for company i in period t
NDA_{it} = Nondiscretionary accruals of company i in period t
TA_{it} = Total accruals of company i in period t
NI_{it} = Net income of company i in period t
CFO_{it} = Cash flow from operating activities of company i in period t
$A_{it} - 1$ = Total assets for company i in period $t-1$
ΔREV_{it} = Operating income of company i in period t minus the operating income of company i in period $t-1$
ΔREC_{it} = Net receivables of company i in period t fewer net receivables of bank i in period $t-1$
PPE_{it} = Balance of gross (fixed assets) bank i at the end of period t

2) Independent variable
a. Audit quality
Audit quality is all the possibilities where an auditor when auditing the client's financial statements can find discrepancies that occur in the client's accounting system [22]. The auditors from the big four KAP are considered to have more ability and expertise in conducting audits compared to the non-big four KAPs so that the information produced is of higher quality. Big four auditors have high experience and reputation in limiting the amount of earnings management among the public [23]. In this study, to calculate the quality of the audit, a dummy variable is used, namely giving the number 1 if the company audited by KAP is affiliated with the big four KAP and giving the number 0 if the company audited by KAP is non-big four.
b. Audit committee
The audit committee is formed and appointed by the board of commissioners with the aim of overseeing the performance of management in relation to financial reporting. The main function of an audit committee is to influence the quality and integrity of the financial statements produced [24]. The effectiveness of the audit committee's activities can be measured by the number of meetings the audit committee has held. This variable is measured numeral, which is seen from the nominal number of meetings held by the audit committee in the current year.

5. Result and Discussion.

5.1. **Descriptive statistics.** Based on data from Table 1, the amount of data used (N) from this study is 93 data, and this number is based on the results of selecting a sample of 31 companies that were put together for 3 years. The earning management variable has a minimum value of 0.00000, a maximum value of 0.00362, an average value (mean) of 0.0001478, and a standard deviation of 0.00046457. The positive mean (mean) earning management value indicates that the average property and real estate company listed on the IDX (Indonesia Stock Exchange) and its significance is less than 0.05, indicating that the company is not normally distributed and almost not all do management profit.

Table 1. Descriptive statistics

	N	Minimum	Maximum	Mean	Std. deviation
Audit quality	93	.00	1.00	.25	.434
Audit committee	93	2.00	15.00	5.99	3.269
Earning management	93	.00000	.00362	.0001478	.00046457
Valid N (listwise)	93				

The audit committee variable as measured by the number of audit committee meetings conducted during the year has a minimum value of 2.00, a maximum value of 15.00, an average value (mean) of 5.99, and a standard deviation of 3.269. The results of SPSS data processing show that the standard deviation value is smaller than the average value (mean). This shows that the distribution of data for the audit committee variables is evenly distributed and there is no high difference between one another.

Other variables are measured using a dummy variable, namely the independent variable in the form of audit quality, so that it is analyzed using a frequency table.

Based on data from Table 2, the audit quality variable has a total frequency for companies whose annual reports are not audited by big four KAP, namely 70 companies with a percentage of 75.3%, while 23 companies whose annual reports are audited by big four KAP 24.7%.

Table 2. Audit quality

		Frequency	Percentage	Valid percentage	Cumulative percentage
Valid	.00	70	75.3%	75.3%	75.3%
	1.00	23	24.7%	24.7%	100.0%
	Total	93	100.0%	100.0%	

5.2. **Partial hypothesis test (T-test).**

5.2.1. *Audit quality and earnings management.* Based on the results of the t-test output, the significance value of the audit quality variable is 0.070 which indicates that the significance value is greater than 0.05. This shows that the audit quality variable does not have a significant effect on earnings management variables. This means that the audit quality hypothesis which has a negative effect on earnings management is rejected. In this case, property and real estate companies in Indonesia are mostly audited by non-big four KAP. Partial hypothesis test (T-test) on manufacturing sector companies can be seen from Table 3. Of course, this shows that these companies do not pay attention to the KAP that will audit the company. KAP size in this study does not affect earnings management. This is because the practice of earnings management occurs. After all, the company has the desire that the company's financial performance looks good in the eyes of potential investors but ignores the existence of big four auditors [25]. In addition, the existence of big four auditors is not intended to reduce earnings management, but rather to increase the credibility of financial reports by reducing disturbances in them so that this can produce more reliable financial reports [26]. Investors see the results of financial reports that reflect the condition of the company to make investment decisions. Companies that have a good performance will attract investors to invest so that they are not influenced by the size of the KAP. The results of this study support the results of research conducted by Lufita and Suryani which states that audit quality proxied by the size of KAP does not have a significant positive effect on earnings management in manufacturing sector companies listed in Indonesia Stock Exchange in 2014-2016 [16]. However, the results of this study are not in line with the results of research conducted by Sanjaya who

Table 3. Partial hypothesis test (T-test)

Coefficients[a]

Model		Unstandardized coefficients		Standardized coefficients	t	Sig.
		B	Std. error	Beta		
1	(Constant)	−0.000238	.000		−1.794	.076
	Audit quality	−0.000257	.000	−.180	−1.831	.070
	Audit committee	0.000060	.000	.314	3.204	.002

[a] Dependent variable: Earning management

stated that public accounting firms affiliated with the big four have a negative effect on real activity manipulation (real earnings management) [15,30].

5.2.2. *Audit committee and earnings management.* Based on the results of the t-test output, the significance value of the audit committee variable is 0.002, which indicates that the significance value is smaller than the significance level of 0.05, so H2 is rejected. The conclusion from the output results shows that the audit committee variable has a significant effect on the earnings management variable. If you see the level of significance < 0.05, the audit committee has a positive effect on earnings management. This means that the hypothesis which states that the audit committee has a negative effect on earnings management is rejected. From these results, the number of audit committee meetings frequency does not necessarily reduce earnings management activities. This is because the audit committee meetings are only mandatory with regards to the regulations that advise the audit committee to hold regular meetings, which means that at least a company's audit committee must meet 4 times. In addition, in every meeting conducted by the audit committee, the audit committee does not necessarily carry out its duties and responsibilities optimally so that its functions and roles are ineffective. So regardless of the frequency of committee meetings, it does not affect reducing earnings management actions carried out by management [27,29]. The results of this study support the results of research conducted by Lufita and Suryani which states that the audit committee as measured by the frequency of audit committee meetings has a significant effect on earnings management in a positive direction in the manufacturing sector companies listed on the Indonesia Stock Exchange in 2014-2016 [16]. However, the results of this study are not in line with the results of research conducted by Lidiawati which states that the audit committee has a negative effect on earnings management [5,28].

6. **Conclusions.** Based on the data that has been collected and tests that have been carried out on the problem using multiple regression analysis models, it can be concluded that the audit quality proxied by the size of KAP (big four KAP and non-big four KAP) does not affect earnings management. This shows that KAP size does not guarantee to minimize earnings management practices. So, there is no difference between big four KAP and non-big four KAP in preventing earnings management practices. Then the audit committee which is proxied by the number of meetings held by the audit committee has a significant positive effect on earnings management. This shows that the audit committee that meets at least 4 times is not necessarily able to minimize earnings management practices. So, no matter how much the frequency of meetings held by the audit committee in a company does not necessarily affect reducing earnings management carried out by company managers. The suggestions that can be given are for further researchers, and it is hoped that they can use other industries for research samples and be supported using different variables from this study such as adding firm value variables, to obtain different results.

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