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Audit Committee Characteristics and Factors Related to Earnings Management

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The pervasiveness of corporate governance cannot be separated with the existence of audit committee. It is expected that audit committee would be able to mitigate the agency costs caused by the asymmetric of information, thus aligning the interests of management and shareholders. However, there is no such a guarantee that the likelihood of management to act according to their interest would be completely eliminated. Hence, there is still a tendency for the management to expropriate the resources of the corporation and use the private information they possessed to manipulate earnings. This article indentifies several characteristics of audit committee in determining their effectiveness to perform monitoring role and what factors of the characteristics are related to earnings management practices. The extant literatures show that several characteristics effectively reduce the earnings management practices, while the others do not have significant evidence in alleviating these practices.

Key words: Audit committee; Earnings management; Agency theory

INTRODUCTION

Agency theory explains that there is asymmetric information between shareholders as the principal and manager as the agent. Managers tend to act based on their self-interests since they have better knowledge about the corporation than shareholders do (Jensen & Meckling 1976). This phenomenon leads to the existence of board of directors as part of monitoring costs, in order to align the interest of the shareholders and the manager's. The board of directors has the responsibility to oversee and control the activities of the management. Besides, it is the mediator between the internal parties of the corporation with its external stakeholders. To be more effective in performing its role, the board of directors is generally segregated into several sub-committees that have different function. One of the sub-committee is the audit committee whose general responsibility is to, "... review the integrity of the company's financial reporting and oversee the independence of the external auditors" (ASX 2003). Indeed, the existence of audit committee as required in best practices of good corporate governance is expected to provide unbiased monitoring device to the corporation that can reduce the asymmetric of information between manager and shareholders (Fama & Jensen 1983; Pincus et al. 1989). However, it will not be able to totally eliminate managers' incentives to expropriate corporation's resources. Thus, it still opens the opportunity for the corporation to engage in earnings manipulation. This article identifies what characteristics of the audit committee that are expected to be important in determining its effectiveness to perform monitoring role, and what factors that have been proven to be related to earnings management practices.

Audit Committee Characteristics Regulation requires listed corporations to have an audit committee. In Australia, since 2003 every corporation that is part of the S&P/ASX All Ordinaries Index should mandatorily have an audit committee in the first year of their listing (ASX 2003). While in the United States, audit committee has become one of the recommended practices by the stock exchanges since December 1999. In fact, McMullen (1996, p. 100) states that corporation which has an audit

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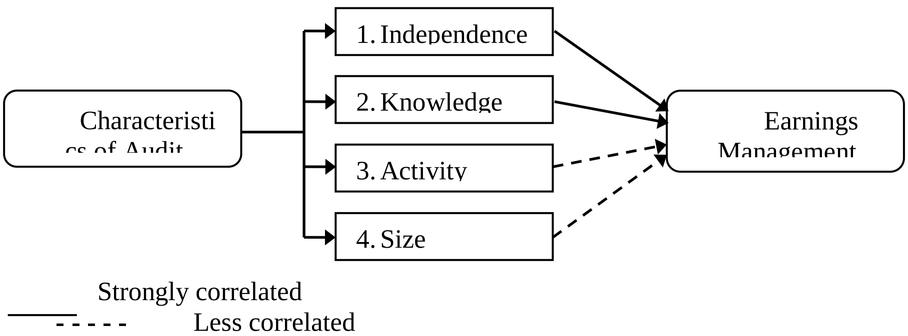
committee is likely to have more accountable financial reporting. Therefore, these days the existence of audit committee has become more prevalent since the regulations require that every board of directors in every listed corporation should have this sub-committee.

Drawing from the literature and the regulation, in order to ensure the effectiveness of its role an audit committee should fulfil several characteristics: first, it should be independent to be able to firmly carry their monitoring role; second, the member of the committee should possess relevant knowledge, particularly in accounting and financial management; third, the committee should have regular meetings; and fourth, the size of a committee should consist of at least three members. Hence, failed to implement these requirements will potentially undermine the responsibility of the committee to oversee the accounting process and to ensure the credibility of financial reporting. As a consequence, this will open the opportunity for management to involve in earnings management practices.

It is perceived that audit committee characteristics, i.e. independent and knowledge, would be strongly correlated with the managers' propensity to involve in earning management practices. On the other hand, it is suspected that other characteristics such as activity and size have less correlation with earnings management. The perceived correlation between audit committee characteristics and earnings management is depicted in figure 1. Next section provides detailed discussion about the independence, knowledge, activity and size of the audit committee which are beneficial in determining its effective monitoring role. Subsequently, every part will also discuss the relationship between the characteristics and earnings management.

Figure 1. The Correlation between Audit Committee Characteristics and Earnings Management



Independence. The independence of audit committee members is essential so that they will unbiasedly exercise their judgment. This independence will contribute to a better performance in mitigating contracting costs (Deli & Gillan 2000). ASX (2003) denotes that being independent means the members are not the executive directors of the corporation. They also should not be the representation of the majority shareholders and should not possess any material relationship with the corporation. Additionally, they are required to support the function of external auditors and at the same time promote the accountability of internal management audit function, without conflicting the relationship between these two parties (Shailer 2004, p. 41). Generally, Kang et al. (2007, p. 197) summarize that the board which comprises of majority independent members will be positively improved their responsibility to monitor and guaranteed a better performance of the corporations.

An audit committee which is only comprised of solely independent members is more effective in performing its duty, even though there is inconclusive evidence that majority independent members will also be sufficient. Several studies find that it is important for the committee to have members who are completely independent so that it is able to exercise the monitoring role efficiently (Bedard et al. 2004; McMullen & Raghunandan 1996; Saleh et al. 2007). These studies are supporting the recommendation of solely independent audit committee by the regulation (ASX 2003; BRC 1999, SOX 2002). Indeed, corporations that are in a financial distressed situation would perform better when they have solely independent audit committee (Bronson et al. 2009, p. 266). Moreover, the study of Abott et al. (2000, p. 61) shows that a corporation whose audit committee is only assembled of independent members as required by Blue Ribbon Committee (BRC), will unlikely be penalized by the Security and Exchange Commission (SEC). On the other hand, other studies show that the effectiveness of audit committee monitoring role would be enhanced when majority of the members are independent (Klein 2002, p. 389; Rahman & Ali 2006, p. 787). In fact, the study of Lee and Shailer (2008, p. 130) shows that the confidence of individual and institutional investors is increased whenever audit committee consists of majority compares to solely of independent directors. However, these studies are not conclusive, since they do not clearly mention the reason of why majority independent members will make an audit committee be better than having solely independent members. Therefore, since the regulation require an audit committee to have solely independent members, it will be more preferable for every listed company to comply with the requirement.

Audit committee independence is significantly related to earnings management practices. The study of Saleh et al. (2007, p. 156) proves that the tendency to manage the earnings are decreased when Malaysian corporations have completely independent audit committee members. Their study is recent study which is also using Malaysian corporations by Saleh et al. (2007). This latter study is conducted with more sample size and found that there is a significant association between those two variables. beneficial to improve the corporate governance practice in Malaysia, since Malaysian Code on Corporate Governance only requires that audit committee be consisted of majority non-executive directors. Furthermore, Bedard et al (2004) test the significance for the corporation that has majority independent members compare to audit committee whose members are solely independent. Their results show that the corporations whose audit committee consists of solely independent members demonstrate a considerable decline of the probability to aggressively manipulate their earnings (Bedard et al. 2004, p. 29). In addition, Klein (2002, p. 398) also summarizes that independent characteristic of audit committee has an association with earnings management. However, she finds that there is no significant relationship between audit committee that has completely independent members and the abnormal accruals which indicates management discretion to manipulate earnings. In general, Peasnell et al. (2005, p. 1339-1340) state that corporations with large number of independent directors have less tendency to upwardly manage their earnings but they could not find similar indication for income-decreasing earnings management. Further, Beasly's (1996, pp. 454-457) study shows that the corporations which are mostly engaged in financial reporting fraud are those that have less independent board and no audit committee. On the contrary, Rahman and Ali (2006) in their study do not find sufficient evidence that there is a negative association between the composition of independent audit committee members and discretionary accruals among Malaysian corporations (Rahman & Ali 2006, p. 798). However, this study is only comprised of 97 corporations and conducted in a fairly short period of 2002 to 2003. These results should be analysed carefully, since there is an inconsistency with more Therefore, it can be concluded that the independence of audit committee members is a significant factor in preventing the earnings management practices. This is because the committee will be able to unbiasedly monitor the financial reporting process in the company, besides to exercise their judgement without intervention from the management.

The effective monitoring role of independent audit committee particularly in preventing earnings management practices will not be adequate if it is not supported by a proper compensation mechanism. It is asserted that the members of an audit committee should not be remunerated by stock options since this type of compensation will deteriorate their independence and induce bias in their monitoring role (Bedard et al. 2004, p. 29). In fact, if they are able to exercise their options close to the vesting date, there is a tendency for the audit committee to tolerate earnings management practices in order to increase the stock price. Thus, in order to maintain the independence of the committee, the compensation mechanism should not give incentives for the members to tolerate the company in managing its earnings.

Knowledge. Possessing the appropriate knowledge of accounting and finance is desirable for audit committee members, especially if they are part of accounting professional body. The appropriate knowledge would enhance the responsibility of the audit committee members to effectively monitor and safeguard the financial reporting integrity. The regulations signify that at least one of the members of audit committee should be a financial expert (ASX 2003; BRC 1999; SOX 2002). Besides, it would be preferable if the financial expert members are affiliated with accounting professional body or having experience as public accountant, auditor or financial officer (McMullen & Raghunandan 1996, p. 80). This will ensure that these members have enough understanding regarding accounting standards and financial management practices to be able to carry out their duties.

Several studies show that the audit committee which has members with particular knowledge is more effective in performing its monitoring role. McDaniel et al. (2002, p. 163) support that financial expertise of the audit committee members will help them to ensure the quality of financial reporting of the corporation. In fact, Bedard et al. (2004, pp. 27-29) assert that not only financial knowledge, but also governance knowledge and specific knowledge about the operations of the corporation will accentuate the effectiveness of audit committee role. Moreover, McMullen and Raghunandan (1996, pp. 79-81) conduct a survey of 51 corporations with financial problems and 77 corporations without financial problems. They found that only 6% of the financial-problem corporations have CPA in their audit committee. Quite the opposite, 25% of the non-financial problem corporations have financial expert who is a CPA in their audit committee. In addition, McDaniel et al. (2002, p. 142) state, the existence of financial experts in the audit committee will improve the financial reporting quality. This is because they have the appropriate knowledge that will make them dedicate most of their mind and time to examine and monitor the financial reporting activities. Furthermore, the existence of financial expertise among the members of audit committee brings positive reaction to the stock price of the corporation (Davidson et al. 2004, p. 287-289). This suggests that market is highly appreciated the corporations whose directors are competence in overseeing the financial reporting activities. Therefore, an audit committee which has financial and accounting expert members should be more effective in performing their monitoring role and increase the value of the company.

There is some evidence that employing members with specific knowledge about financial reporting helps the committee to be more effective in preventing the likelihood for the corporation to engage in earnings management practices. Specifically, having the combination of active meeting and employing financial expertise in the audit committee lessen the likelihood of earnings manipulation in the corporation (Saleh et al. 2007, p. 156). Indeed, the corporation which has less number of financial expert members in the committee tend to experience financial difficulties (Rahmat et al. 2009, p. 633). However, Bedard et al. (2004, p. 17) argue that the effectiveness of audit committee expertise will be reduced whenever the members possess more directorships outside the corporation. In fact, Lee and Shailer (2008, p. 128-129) contend that these additional duties create trade-off between their competence and time commitment to the corporation. This gives the implications that on the one hand the members of audit committee would be able to gain better experience and knowledge by having other directorships. While on the other hand, they would be less devoted to perform better monitoring role especially to prevent earnings management practices. Hence, having financial and accounting experts in the audit committee will expectedly contribute to the effective control over the financial reporting process in a company, so that any tendency for the managers to manipulate earnings would be inhibited.

Activity. The audit committee which is more active in conducting meetings will be more effective in its monitoring role. ASX (2003) states, in order for the audit committee to perform their role effectively, it should conduct frequent meeting. In fact, BRC prescribes that the committee should meet at least four times a year and even more regular if needed (BRC 1999). Several studies describe that by conducting more frequent meetings the audit committee would be able to be more effective in overseeing the corporation's financial reporting activities (Menon & Williams 1994, p. 137; McMullen & Raghunandan 1996, p. 81). This means that any potential problem particularly regarding the financial reporting in the company would be recognized earlier.

Some studies indicate that the activity of audit committee is related to the occurrence of earnings management practices. Audit committee which conducts regular meetings according to the prescribed threshold is found to lessen the corporations' tendency in misstating their earnings (Abbott et al. 2000, p. 61). In fact, as the frequency of the meeting increase, there is likelihood that corporations' discretionary accruals will decrease (Xie et al. 2003, p. 310). This indicates that the meetings provide the means for the committee to be better performed their monitoring role. However, Bedard et al. (2004, p. 30) find that meeting frequency of the committee has no significant association with the possibility of the corporations to conduct earnings management aggressively. Similarly, Lin et al. (2006, pp. 929-930) discover that when testing the relationship between audit committee activity and earnings restatement the result shows that there is no significantly negative relationship between those two variables. Consistent with these studies, Saleh et al. (2007, p. 149) also find that the average frequency of four meetings per year does not lead to more effective monitoring of earnings management among Malaysian corporations. Nevertheless, they contend that the regularity of meeting could possibly indicate that the audit committee encounters more issues regarding the corporations' financial reporting (Saleh et al. 2007, p. 159). Hence, to some extent the activity of audit committee is not a strong factor in determining the likelihood of a company to manage earnings. There should be more than just conducting frequent meetings for an audit committee to be able to perform better, because the quality of the meetings is more important. The committee should spend more time in analysing the company's financial reports and addressing critical issues that have a tendency to facilitate earnings management practices.

Size. The effectiveness of audit committee's monitoring role is relatively determined by the size of the committee. ASX and BRC both explicitly advise that audit committee should at least consist of three members (ASX 2003; BRC 1999). This size is potentially associated with the members' expertise. Saleh et al. (2007, p. 150) state that audit committee should possibly benefit from having more members.

Since, it is more likely that more knowledge and expertise that are available inside the committee which provide adequate resources to perform its duty.

Several studies show that the size of an audit committee is contributing to its possessing more ability to exercise the monitoring role. Pearce and Zahra (1992, cited in Saleh et al. 2007, p. 150) affirm that whenever the audit committee composed of relatively large number of members, there would be possibility that they have more knowledge that is useful in performing their role. More general, Dalton et al. (1999, pp. 676-677) assert that the relation between size of the board and their monitoring role exhibit a positive correlation. Thus, larger size of board will improve the monitoring mechanism and increase the performance of the corporation. This association should also be applied to the characteristic of audit committee. However it is argued that the audit committee which is too large or too small would adversely affect their effectiveness (Rahmat et al. 2009, p. 627). Excessively large size committee would create the incentives for each member to rely on to other members, hence lessen their participation in the committee, even though they might have more diverse skills and knowledge. While the audit committee which is too small in size would potentially render less monitoring support to the corporations, since it might have less essential knowledge and skills to perform the duties. In addition, Pincus et al. (1989, p. 261) contend that the relationship between the size of audit committee and performance of the corporation is insignificant. Indeed, they find that audit committee size is not the main factor in determining the efficient composition of the committee. Therefore, a reasonable size of the audit committee should also be supported by the proper skills and knowledge for the committee to enhance their role.

There is only limited evidence which show that there is a relationship between the size of an audit committee and earnings management practices. Specifically, Lin et al. (2006, pp. 929-930) find that concerning the effectiveness of their role, there is a negative association between the size of audit committee and earnings restatement which is the more observable form of earnings management. This means that the larger the size of the audit committee, the less likely of a corporation to engage in earnings management. However, when examined the performance difference of audit committee characteristics on financial and non-financial difficulties corporations, Rahmat et al. (2009, p. 631) find that the size of audit committee does not have impact on financial performance of the corporations. Hence, there is not enough evidence to conclude that the size of the audit committee is a factor that is related to earnings management.

CONCLUSION

In conclusion, the existence of audit committee inside the corporation will help to align the interests of management and shareholders. Several characteristics of audit committee such as; independence, knowledge, activity and size, show that it is capable to perform better and effective monitoring role, especially in safeguarding the quality of financial reporting. In fact, it will be better performed when comprises of majority or solely of independent member, has enough financial expert members, performs frequent meetings and consists of reasonable number of members. Moreover, Abbott et al. (2000, p. 57) state that audit committee members should possess two motivations that will lead to more effective monitoring mechanism. Firstly, they should be able to maintain their reputational capital by performing qualified service to the committee. Secondly, they should be aware of the imposed director’s liability which will prevent them from being involved in unlawful activities.

Several characteristics of audit committee are strongly correlated with earnings management practices. First, some studies show that the independence of audit committee reduces the likelihood of earnings management practices. This is because they would be able to perform well without influence from the management. Second, having financial expertise in accounting and financial management also allow the members to be able to monitor and safeguard the quality of financial reporting of the corporation. However, other characteristics such as frequency of meeting and size of the committee do not show strong correlation with the possibility of reducing the tendency to engage in earnings management practices. Based on the literature, the assumption regarding the correlation between audit committee characteristics as summarized on figure 1 has been proved.

Finally, regardless how well the characteristics of audit committee, every corporation should not only be able to comply with the regulation but also ensure they are well-govern. This will relatively guarantee that they would be able to act according to the best interest of the corporation and to be more aligned with the shareholders' interests. Since the audit committee and its characteristics are specified in the regulation, it is important for every listed company to comply with the requirements. This helps to demonstrate their willingness to be more transparent and accountable to the investors. To a large extent, whenever every listed company is able to comply with the best practices in corporate governance, it is expected that the capital market will be more thrived and will attract more investors to participate.

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