Association of Audit Committee Accounting and Finance Expertise with Earnings Quality

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Abstract. This study aimed to investigate the relationship between audit committee accounting and finance expertise and earnings quality, with a focus on examining the impact of complexity and industry on this relationship. The study utilized multiple linear regression and control variables, such as the amount of audit committee meetings, to analyze data from 149 listed companies in IDX from 2018 to 2020. The results showed that audit committee accounting and financial expertise were positively associated with earnings quality. However, the hypothesis that earnings quality in complex companies and audit committees with accounting-financial expertise is higher than in less complex companies and audit committees with accounting-financial expertise was not supported. These findings suggest that companies should prioritize the appointment of audit committees with accounting and finance expertise to improve earnings quality. However, the complexity of the industry does not significantly impact this relationship.

Keywords: Audit committee · accounting · finance · expertise · earnings quality

1 Introduction

The separation of functions between management and owners has the consequence of a conflict between the two because of different interests. Management has its own interests and does not always act in the best interests of the owners. Conflict of interest between management and owners create information asymmetry issues stemming from management's ability to access and use information for its own benefit [1]. Situations in which management does not always act in the best interests of owners encourage owners to establish a control mechanism. Agency theory argues that the monitoring system is one important solution to reduce the conflict of interest to increase the reliability and subsequently the quality of financial reporting [1]. From the agency theory point of view, the audit committee is an important monitoring mechanism in the corporate governance structure [2].

The audit committee is one of the committee under the board of commissioners whose main function is to review the company's financial reporting process. Thus, in carrying out its functions, the audit committee simultaneously monitors management practices and helps owners overcome the problem of information asymmetry in order to reduce agency costs [2, 3].

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Indonesian regulations require companies listed on the Indonesia Stock Exchange to form an audit committee. The audit committee is one of the committees under the Board of Commissioners whose function is to monitor and review financial reports prepared by management. To function effectively, the audit committee is equipped with various requirement, one of which is competence. Financial Services Authority Regulation Number 55/POJK.04/2015 concerning the Establishment and Guidelines for the Work Implementation of the Audit Committee requires at least one member of the audit committee to have accounting and financial expertise. These requirements are relevant to the main task of the audit committee. Previous research found that audit committee with acounting and financial expertise are associated with forward-looking disclosure [4], earnings quality [5], international audit function [6], audit fees [7, 8], tax aggressiveness [9], and timeliness of audit reports [10].

Agency theory underlies the importance of the existence of various audit committee expertise so that the financial reporting review function can be carried out effectively [2, 11]. An effective audit committee is expected to mitigate agency conflict issues and minimize business risks. Previous research has confirmed that an effective audit committee as an internal governance mechanism reduces audit risk and the effort associated with the preparation of auditor reports, thereby encouraging companies not to be late in publishing audited financial statements [7, 12].

The purpose of this study is to investigate the attributes of audit committee expertise that are important in improving the quality of financial reporting. The expertise of the audit committee referred to in this study is accounting and finance expertise. The design in this study was designed to explore various dimensions of audit committee expertise in relation to improving the quality of financial reporting. That is, by investigating the association of audit committee with accounting and financial expertise and earnings quality and by examining the association of audit committee with accounting and financial expertise with earnings quality in industries with high and low accounting complexity.

2 Literature Review

2.1 Institutional Condition in Indonesia

Indonesia adheres to a two-tier board system, namely a corporate governance system with separate functions and roles of the Board of Commissioners and the Board of Directors. The Board of Commissioners carries out the function of supervising and monitoring the decisions of the board of directors, while the board of directors has the role of implementing and managing the company. In carrying out its function, the Board of Commissioners forms one or several committees, such as the audit committee, compensation/remuneration committee, nomination committee, and other committees according to the company's needs. The audit commitee assists the Board of Commissioners in fulfilling its supervisory responsibilities, especially the review of the annual report and audited financial statements, the review of the financial reporting process and internal control system, as well as supervision of the audit process. In its capacity, the

audit committees responsible for opening and maintaining and maintaining communication between the audit committee and the Board of Commissioners, directors, Internal auditor, and managers.

All public companies in Indonesia are required to form an audit committee. The existence of an audit committee for public companies in Indonesia began in 2001 in Indonesia, namely the Surat Edaran Bapepam/the Circular Letter of Bapepam (Capital Market Supervisory Agency) No: SE–03/PM/2000 which contains an appeal to the need for an audit committee to be owned by each issuer. In its development, the Board of Directors of the Jakarta Stock Exchange required a listed company to form an audit committee (Letter of the JSX Board of Directors Number Kep–315/BEJ/06/2000 Securities Listing Regulation Number I-A: Regarding General Provisions for Listing Equity Securities on the Exchange). The Board of Directors' letter also stipulates the number, composition, and duties of the audit committee. The minimum number of audit committees is three members, one of whom is an Independent Commissioner who also serves as the chairman of the audit committee. The other members are independent external parties, at least one of whom is competent in accounting and/or finance. The audit committee's responsibilities are reviewing the company's financial information, the adequacy of audits conducted by public accountants, the effectiveness of the company's internal control, and the level of compliance with relevant laws and regulations, as well as examining allegation of errors in the decisions of the board of directors' meetings or irregularities in the implementation of the results of the board of directors' meeting decisions.

In the next course, the obligation to form an audit committee is stated in Keputusan Ketua Bapepam/the Decree of the Chairman of Bapepam No. Kep–41/PM/2003, Bapepam–LK Regulations No. IX.I.5. Regarding the Establishment and Work Implementation Guidelines of the Audit Committee dated 22 December 2003 and amended by Keputusan Ketua Bapepam/the Decree of the Chairman of Bapepam No. Kep–29/PM/2004, Regulation No. IX.I.5. Regarding to the Establishment and Work Implementation Guidelines of the Audit Committee dated 7 December 2012. The transfer of the authority to regulate and supervise financial services activities in the Capital Markets sector from the Capital Market and Financial Report Supervisory Agency (Bapepam-LK) to the Financial Services Authority (OJK/FSA), the regulations for the Establishment and the Audit Committee Work Implementation Guidelines issued prior to the formation of OJK/FSA were also amended into OJK/FSA Regulations. Therefore, OJK/FSA issued OJK Regulation Number 55/POJK.04/2015 regarding the Establishment and Guidelines for the Work Implementation of the Audit Committee which was stipulated on 23 December 2015.

The Indonesian regulator's efforts to strengthen the role of the audit committee are manifested in Surat Keputusan Ketua Bapepam/the Decree of the Chairman of Bapepam Number Kep–643/BL/2012 which expands the duties and responsibilities of the audit committee. Previously, the duties and responsibilities of the audit committee were limited to internal matters, such as reviewing financial information produced by public companies, reviewing compliance with laws and regulations, and reviewing the performance of internal auditors. However, starting with the 2012 regulation, the role of the audit committee has expanded to become a mediator between management and the

external auditor in the event of a difference of opinion between management and the external auditor. In addition, strengthening the role of the audit committee lies in its task of recommending the appointment of an external auditor to the board of commissioners. Financial Services Authority Regulation Number 13/POJK.03/2017 regarding the Use of Public Accountants and Public Accounting Firms in Financial Services Activities emphasizes the role of the audit committee in the appointment of external auditors that the proposed appointment of public accountants and KAP submitted by the board of commissioners must consider the recommendations of the audit committee (Article 13 Paragraph 4). The role of the audit committee is also enhanced by evaluating the work of public accountants and public accounting firms scan audit. The audit committee also evaluates the potential risk of using the services of a KAP that has been using its services for a long time to recommend auditor replacement.

2.2 Previous Research and Hypothesis Development

Agency theory provides a basis for the importance of the audit committee as part of a company's board of commissioners [1]. The separation between owner and manager (management) creates an agency conflict, especially if the two have different interests. It is in the interest of the owner to align the interests of management to act in the best interests of the owner. The audit committee as an independent party in the company is expected to reduce agency costs arising from the differences in the interests of owners and management. The audit committee is assigned to review the financial reports prepared by management.

The audit committee functions well if it meets certain criteria. Characteristics of audit committee is defined as composition, authority, resources, and activities. These four attributes are important determinants of the effectiveness of the audit committee [13]. Several studies have proven the relationship between audit committee characteristics and financial reporting quality [7]. Other study specifically examines one of the attributes of the audit committee, for example financial expertise, one of the elements of the audit committee that has been widely studied [14].

Several studies have found evidence that audit committee effectiveness increases with financial expertise [15, 16]. Other evidence shows that audit committee financial expertise is positively associated with earnings quality via restrictions on aggressive earnings management [17–19]. Audit committee accounting, finance, and insurance expertise that is associated with more accurate loss reserve estimation is confirmed positive [20]. Research conducted outside the United States shows the same conclusion. The financial expertise of audit committee in Australia and found that audit committee members with financial expertise and experience improve earnings quality with earlier loss recognition than audit committee members without such expertise [12]. These results were also found in New Zealand [16], China [21], Germany [22, 23], and Malaysia [24].

This study argues that audit committee with financial expertise have better knowledge and experience in understanding accounting policies and practices so that they can carry out monitoring more effectively. Furthermore, audit committee with financial expertise are better able to limit management activities to manipulate earnings. In line with this expectation, this study proposes the following hypotheses:

Table 1. Research Data

Information	2018	2019	2020
Population	600	632	632
Finance & Banking	142	142	142
Incomplete Data & Outliers	339	448	442
Processed Data	59	42	48

Source: Data processed, 2022

H1: Audit committee accounting and financial expertise is positively associated with earnings quality.
H2: Earnings quality in complex firms and audit committee with accounting-financial expertise is higher than earnings quality in less complex firms and audit committee with accounting- financial expertise.

3 Methodology

The population in this study is all companies listed on the Indonesia Stock Exchange in 2018–2020, except the financial and banking industries. In 2018, as many as 600 (142 financial and banking institutions); in 2019 as many as 632 (142 financial and banking institutions); in 2020 as many as 632 (142 financial and bangking institutions) (Table 1).

3.1 Operational Variable

This research hypothesis was tested using multiple regression analysis for the period 2015–2020. The dependent variable in this study is earnings quality while the independent variable is the audit committee with accounting and financial expertise and industry complexity. While the control variables in this study are the number of audit committees, the number of independent audit committee members, the number of audit committee meetings, ROA, and sales growth. Audit committee data is collected manually from the statements contained in the company's annual report. Financial data to calculate earnings quality is obtained from the company's financial statements. Most of the data on the control variables were obtained from the company's financial statements.

Earnings quality in this study was measured using the performance-adjusted modified Jones model introduced by Kothari [25], as used Weber [5]. This measure is an extension of the modified Jones model developed by Dechow et al. [26]. The performance-adjusted modified Jones model controls for the effect of firm performance on the measured discretionary accruals. Kothari et al. Claim that controlling for the effect of firm performance strengthens the specification of statistics test and makes it more powerful [25]. All variables in the regression model used to predict abnormal accruals are divided by total assets of the previous period to reduce heteroscedasticity. Therefore, the residuals from the cross-sectional regression model are used as estimation of 'discretionary accruals as follows:

$$\frac{TA_{it}}{A_{i\,t-1}} = \propto 0\left(\frac{1}{A_{i\,t-1}}\right) + \propto 1\left(\frac{\Delta REV_{it} - \Delta REC_{it}}{A_{i\,t-1}}\right) + \propto 2\left(\frac{PPE_{it}}{A_{i\,t-1}}\right) + \propto 3\left(\frac{ROA_{it}}{A_{i\,t-1}}\right) + \varepsilon_{it} \quad (1)$$

In this case *TAit* is the total accruals for company *i* in year *t*. Total accruals in year *t* are obtained from the difference between earnings before extraordinary items and discontinued operations and net cash flows from operating activities. *Ait-1* is total assets in year *t-1*; *ΔREVit* is the change in year t income from year *t-1*; *ΔRECit* is the change in year t income from *t-1*; *PPEit* is the gross value of property plant and equipment of company *i* in year *t*; *ROAit* is the total assets divided by the net profit of company *i* in year *t*. This study uses the absolute value of discretionary accruals (*AbsDA*) as the dependent variable in the main regression model. The lower the absolute value of discretionary accruals adjusted for company performance (measured by ROA), the higher the earnings quality.

Measurement of audit committee accounting and financial expertise is following the study of Velte [23]. The audit committee is classified as having accounting and financial expertise if it has experience as a president director (CEO), Director of Finance (CFO), Director of Operations (COO), holds a Certified Public Accountant (CPA) degree, has an accounting or management education background, has worked in an accounting firm public as an auditor, or have work experience in the accounting/management field. If it meets the above qualifications, it is coded 1, if it does not meet the above qualifications, it is coded 0.

The criteria for grouping companies into complex and non-complex industries follow the previous study [27], as used by other researchers [28] and [29]. The classification of companies according to the Jakarta Stock Industrial Classification (JASICA) is compared to the list of industrial groups to determine whether the company is included in the category of complex or less complex industry [27]. If it is in the complex category, it is coded 1 and if not, it is coded 0.

The control variables in this study were divided into two groups, namely variable governance and variable company-specific characteristics. The control variables included in the research model were based on the previous literature reviews. Variables of governance included in this study are (1) *RAK* is the number of audit committee meetings or meetings reported in the annual report for one year, (2) *AKA* is the number of audit committee including the chairman of the audit committee, (3) *KAI* is the proportion of independent members of audit committee, and (4) *ROA*, (5) *PERTPENJ* is sales growth.

3.2 Research Model

This study uses panel data regression analysis to test hypotheses 1 to 2. Hypothesis 1 suggests that audit committee accounting and financial expertise is positively associated with earnings quality. Meanwhile, hypothesis 2 suggests that earnings quality in complex companies and audit committees with accounting-financial expertise is higher than earnings quality in less complex companies and audit committees with accounting-financial expertise. The regression model to test H1 and H2 is as follows:

Table 2. Hypothesis Result (H1)

Unstandardized Coefficients				Standardized Coefficients			Collinearity Statistics	
Model		B	Std. Error	Beta	t	Sig.	Tolerance	VIF
1	(Constant)	160.080	83.976		1.906	.059		
	X1K	20.761	19.768	.080	1.050	.295	.948	1.055
	X2	−3.805	50.270	−.011	−.076	.940	.271	3.684
	X3	−98.709	58.211	−.240	−1.696	.092	.278	3.601
	X4	3.603	3.049	.093	1.182	.239	.892	1.121
	X5	.055	.121	.034	.454	.650	.982	1.018
	X6	−5.589	1.127	−.372	−4.961	<.001	.987	1.013

Source: Data processed, 2022

(H1) $AbsAD_{it} = \beta_0 + \beta_1 KK_{it} + \beta_2 AKA_{it} + \beta_3 KAI_{it} + \beta_4 RKA_{it} + \beta_5 ROA_{it} + \beta_6 PERTPENJ_{it} + \varepsilon_{it}$

(H2) $AbsAD_{it} = \beta_0 + \beta_1 KI_{it} + \beta_2 AKA_{it} + \beta_3 KAI_{it} + \beta_4 RKA_{it} + \beta_5 ROA_{it} + \beta_6 PERTPENJ_{it} + \varepsilon_{it}$

In this case, *AbsADit* shows the absolute value of discretionary accruals adjusted for performance of company *i* year *t*. *KKit* is the accounting and finance expertise of the audit committee of the company *i* year *t*. *RKAit* is measured as the number of audit committee meetings in a year of company *i* year *t*. AKA*it* is the number of members of the audit committee of company *i* year *t*. *KAIit* is the number of independent members of the audit committee of company *i* year *t*. *ROAit* is net income before special dividends divided by average total assets. *PERTPENJit* is sales growth which is calculated as the difference between sales of company *i* in year *t* and year *t–1* divided by sales in year *t–1*. KI is an industrial complexity.

In this case, *KKit* is a dummy variable with number 1 if the audit committee has accounting and financial expertise in complex companies and number 0 for others. This regression model is designed to examine differences in earnings quality in high-complex companies with accounting-financial expertise audit committees and lower-complex companies with financial- accounting expertise audit committees. The prediction $\beta 1$ is positive and significant. The regression coefficient $\beta 1$ is positive, which means that earnings quality is higher in companies with high complexity with accounting-financial expertise audit committee than in companies with lower complexity with audit committees with accounting-financial expertise.

4 Result and Discussion

Here are the results of multiple linear tests to test the first hypothesis (Table 2).

Table 3. Hypothesis Result (H2)

		Unstandardized Coefficients		Standardized Coefficients			Collinearity Statistics	
Model		B	Std. Error	Beta	t	Sig.	Tolerance	VIF
1	(Constant)	158.922	85.260		1.864	.064		
	X2	6.603	50.918	.019	.130	.897	.265	3.772
	X3	−104.664	57.787	−.254	−1.811	.072	.282	3.542
	X4	4.077	3.022	.105	1.349	.179	.910	1.099
	X5	.048	.121	.030	.394	.694	.978	1.022
	X6	−5.513	1.123	−.367	−4.908	< .001	.995	1.005
	X1I	−16.556	18.297	−.072	−.905	.367	.866	1.155

Source: Data processed, 2022

The results of testing the first hypothesis, namely testing the association of audit committee accounting and financial expertise with earnings management, the results are supported. The test results show a positive association between the audit committee's accounting and financial expertise and earnings management of 0.080, although it has no significant effect. The percentage of the number of audit committees that have expertise in accounting and finance is 0.78, and the average number of audit committees studied is three. Audit committee members are required to have expertise in finance. An audit committee was formed to oversee the financial reporting process and to limit the reporting of opportunistic managers (Badolato 2014). The SarbanesOxley Act of 2002 (SOX) emphasizes the importance of the role of audit committee expertise in improving the quality of financial reporting [17]. Financial Services Authority Regulation Number 55/POJK.04/2005 regarding the establishment and guidelines for the implementation of audit committee work states that companies must have at least 1 (one) member of the audit committee with educational background and expertise in accounting and finance.

Several previous studies found that expertise in finance was able to limit earnings management actions by management [15]. This finding is supported by other studies which found that audit committees with expertise in accounting/finance were able to reduce the tendency of fraud [3] and earning restatement [30]. Meanwhile, Farber found that companies that commit fraud [31] or overstate their earnings tend to have a smaller number of audit committes [32].

One of the reasons for the lack of influence of accounting expertise and financial expertise on earnings management is the placement of audit committee team members with accounting and financial expertise only to comply with existing regulations [33]. This finding is not in line with the previous study of Nelson and Devi (2013) stating that the presence of accounting expertise on the audit committee team will reduce the company's earning management [24].

While the results of linear regression testing to test hypothesis 2 are as follows (Table 3).

The results of testing the second hypothesis, namely earnings quality in complex companies and audit committees with accounting and financial expertise is higher than earnings quality in less complex companies and audit committees with accounting and financial expertise. The test results show a negative association between industrial complexity and earnings management of −0.072, although it has no significant effect. The percentage of companies that have industry complexity is 0.32. The association in this test shows negative, meaning that complex companies tend not to carry out earnings management. So, the hypothesis in this study is not supported. Based on the processed data, this is probably because the percentage of complex companies that are processed is only 0.32 of the sample.

According to several studies, the more companies have many subsidiaries, the more difficult the accounting complexity of the company will be. Companies that have more subsidiaries tend to conduct earnings management more aggressively through transactions with parties that have special relationships with them [34]. When the parent company has a dominant relationship with an affiliated company, the parent company can regulate or structure transactions between its company and its affiliates so that the company can achieve its profit reporting targets. Thus, it can be concluded that companies with many subsidiaries will increase organizational complexity and then increase information asymmetry between managers and investors. Information asymmetry like this can open opportunities for earnings management because investors may not have sufficient incentives, resources, and access to monitor managers' actions [35]. According to the agency conflict hypothesis, the ability of managers to distort information and manipulate earnings depends on the level of complexity of the company [36]. Diversified companies provide more favorable conditions for earnings management. This is because the problem with diversified companies is that they have many subsidiaries, making it difficult for shareholders to monitor the performance of managers. Geographically diversified companies have subsidiaries located overseas. This can increase information asymmetry as well as agency problems or conflicts. Managers in overseas subsidiaries can practice earnings management without being noticed by the company owners because of the lack of supervision. Geographical diversification has a positive effect on earnings management [36], while other study shows that geographical diversification has a negative effect on earnings management [37].

The earnings volatility hypothesis states that company diversification can result in lower earnings variability because the profit generated from various company units are less than focused companies [36]. Industry diversified companies operate in different business segments. This causes managers in subsidiaries to find it difficult to manipulate earnings through accruals because accruals generated from different business units tend to be written off. Therefore, industry diversified companies can reduce earnings management. Thus, industry diversification has a negative effect on earnings management [36].

5 Conclusion

The audit committee is one of the committees under the board of commissioners whose main function is to review the company's financial reporting process. Thus, in carrying

out its functions, the audit committee simultaneously monitors management practices and helps owners overcome the problem of information asymmetry, thereby reducing agency costs.

The first hypothesis is to test the association of audit committee accounting and financial expertise with earnings management. The results are supported. The test results show a positive association between the audit committee's accounting and financial expertise and earnings management of 0.080, although it has no significant effect. The percentage of the number of audit committees that have expertise in accounting and finance is 0.78, and the average number of audit committees studied is 3.

The second hypothesis is that earnings quality in complex companies and audit committees with accounting and financial expertise is higher than earnings quality in less complex companies and audit committees with accounting and financial expertise. The test results show a negative association between industrial complexity and earnings management of −0.072, although it has no significant effect. The percentage of companies that have industry complexity is 0.32. The association in this test shows negative, meaning that the company is complex tend not to do earnings management. So, the hypothesis in this study is not supported.

This research examines accounting and finance expertise together, not separately. Meanwhile there is a difference between expertise in finance and expertise in accounting. Accounting expertise focuses on the financial reporting process to produce financial statements that describe the company's financial condition, while financial expertise usually focuses more on how to manage finances in the company's operational activities. This condition indicates the need for separation between audit committees with accounting expertise and those with financial expertise to illustrate that accounting expertise has a more specific effect on earnings management than financial expertise.

This study uses industry complexity variables in the test. The grouping of industries in this study is based on the grouping conducted by JASICA. There are several industries whose grouping is different for each year, so there needs to be another model for measuring industry complexity.

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