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The Effects of Audit Committee Tenure and Duality Role on Earnings Management in Indonesia: The Moderating Effect of External Audit Quality

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ABSTRACT- The issue of earnings management has become a concern, especially in respect to corporate governance as an internal and external monitoring mechanism to ensure the financial reporting quality. Indonesia companies have high earnings management and have new regulation on audit committee characteristic especially, audit committee tenure and audit committee duality.The objective of the study has been to examine the relationship between the audit committee tenure and audit committee duality role and earnings management and moderating effect of external audit quality between relationship duality and tenure audit committee and earnings management based on the agency theory. The relationship between the audit committee tenure and audit committee duality role and earnings management and the moderating effect of external audit quality on the between relationship duality and tenureaudit committee and earnings quality of is examined. Data from 216 non-financial firms listed in Indonesia Stock Exchange for the years 2013 to 2016 is used. Real earnings management models were used to measure earnings management. Significant association was found between audit committee tenure and earnings management. In addition, significant the moderating effect of external audit quality relationship between audit committee duality and earnings management. However, no significant relationship was found between audit committee duality and earnings management. The appropriateness of policy audit committee tenure may be considered by policy makers.

Keywords: **audit committee characteristics, earnings management.**

I. INTRODUCTION

In 2002 the US Congress passed the Sarbanes-Oxley Act and in recent years researchers have focused on presenting the accounting profile restatement in minimizing earnings management within the company. Critical attention has focused on the role of the internal mechanism of corporate governance in this regard, the board and audit committee in overseeing executive activities, especially in carrying out creative accounting.
With the Sarbanes-Oxley Act in Indonesia as well as the Financial Services Authority (OJK), the regulation is implemented in listed companies on the Indonesia Stock Exchange. OJK regulates the structure of corporate governance in general and specifically the board of commissioners, assisted by the audit committee in protecting the interests of shareholders and stakeholders, one of which is in limiting earnings management. Previous research has examined the role of boards in overseeing earnings management after implemented the Sarbanes-Oxley Act (Klein 2002a).

The type of accruals in earnings management is still a major concern, such as the misrepresentation of receivables or inventories and aggressive recognition of earnings, etc. In manipulating corporate earnings not only by accrual but also delaying or taking production or making income adjustments to the desired target, this type is referred to as real earnings management. Real earning management leads to manipulation by misallocation of company activities so that the role of monitoring the audit committee as an assist of the board in overseeing the financial reporting process can control real earnings management practice (Sun et al., 2014).

Graham et al (2005) found the post-Sarbanes-Oxley era manager tends to do earnings management with real earnings management. Some previous researches on the wide occurrence of earnings management through real with a sample of 9,567 companies in the period 1996 to 2002. Some studies on the characteristics of the audit committee such as the tenure audit committee and the audit committee duality role affect earnings management (Surbakti&Shaari, 2018; Vafeas, 2003; Hoitash&Hoitash, 2009). Using a model real earnings management by Cohen and Zarowin (2010) and Cohen et al. (2008) This study examines the relationship between the tenure audit committee and the audit committee and real earnings management and duality role and external audit quality as moderating variables. In addition to the internal mechanisms' variables of corporate governance and financial performance including the control variables used in this model.The introduction of a combined association between earnings management and audit committee characteristics (tenure, and role of duality) and external audits of appropriate quality and possible contributions for agency theory.

II. REVIEW OF LITERATURE

Agency Theory

Agency problems relate to potential conflicts of interest between shareholders and managers in a company because of the separation between the owner as the principal and management as the agent. Fama and Jensen (1983) state that commissioners are an effective for monitoring management and reducing agency costs.The agency theory is the basis of corporate governance through internal and external mechanisms (Roberts et al., 2005; Weir et al., 2002). Directors with longer tenures possess greater business expertise, accumulated knowledge, experiences, and more effective monitoring abilities, and are more effective in constraining earnings management (Ghosh et al., 2010; Peasnellet al., 2001). Overlapping members of directors are less effective in performing their duties due to time constraints (Hoitash&Hoitash, 2009;Surbakti&Shaari, 2018). Thus, the presence of the duality role of AC members may cause the ineffectiveness of the AC in performing its function in monitoring EM practices. With the perspectives of the agency theory, the characteristic of the audit committee(tenure and duality role) can increase the monitoring of the managers to protect the interests of the shareholders, which will reduce agency cost and decrease earnings management (McKnight & Weir, 2009; Surbakti&Shaari, 2018).

Corporate governance

Cadbury (1992) notes that the corporate governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources.Based on Indonesian Corporate Law 2007, Corporate Law 1995 noted Indonesia used the two-tier system, where having two boards namely: the board of directors and the board of commissioners.The above measurements are widely used to ensure the effectiveness of the audit committee with the characteristics regarded as a mechanism to control the direct management in the financial reporting process, detect earnings management(Baxter & Cotter, 2009).Accordingly, Ghosh et al. (2010) noted that with a longer tenure of committee is moreexperiences,greater business expertiseand accumulated knowledge, in monitoring financial reporting process.Laux and Laux (2009), (Agussalim et al., 2020)suggested that CEOs with overlapping tasks were less effective in their financial reporting controls. Thus, the presence of the duality role of the AC leads to the ineffectiveness of the audit committee in carrying out its function in monitoring the management.

HYPOTHESIS DEVELOPMENT

Audit Committee Tenure and Earnings Management

Audit committee tenure is the average number of years AC members have served in the AC of a firm (Dhaliwal et al., 2010). Ghosh et al. (2010) and Yang and Krishnan (2005) mentioned the longer the tenure of the AC members, then the AC would have more greater business expertise in monitoring the financial reporting process. Whilst, the effect of a longer board service allows directors to gain stronger specific knowledge to handle the complex committee processes, resulting in improved performance in protecting shareholders' interests (Pfeffer, 1983; Kosnik, 1990). This result is also like the result of, Beasley (1996) who found that longer tenures of outside directors can help in monitoring fraud and make more less instances of fraud in companies.In line with the agency theory perspective, this study has made the same argument that, the longer the audit committee tenure is, the more effective control there is over earnings management practices. Some previous, Yang and Krishnan (2005) and Ghosh et al. (2010) studies found more longer tenure of audit committee more effective control earnings management practice. Based on discussion above, this study hypothesized as follows:

H1:There is negative relationship between audit committee members tenures and earnings management.

Audit Committee Duality Role and Earnings Management

The audit committee duality role is a situation where an audit committee member has a duality role in the corporate governance structure within the company.Gul and Leung (2004) found that companies that have members with dual roles (CEO/Chairman) revealed less information. An overlapping board structure can affect the effectiveness of the board oversight (Chang et al., 2012) because the directors of the boards prevalently focus more on monitoring functions than strategies or the protection of the shareholders' interests (Adams, 2003).When a person has two top positions at once in one company, that person could be very powerful and cannot be controlled (Ramdani&Witteloostuijn, 2010), and someone who has unlimited power will tend to perform actions that prioritise personal interests rather than the interests of the company (Jensen, 1986).With the duality role, it is considered that the role of the AC is less effective in overseeing the process of financial statements and leads to the unavailability of checks and balances in performing their tasks (Stiles & Taylor, 1993).A person who holds the top two positions will tend to prioritise his or her personal interests rather than the company's interests (Jensen &Meckling, 1976). Some previous studies on the relationship between dual roles (CEO/Chairman) and EM found that, the separation of the dual role (Chairman/CEO) can reduce earnings management activities (Sun & Liu 2012; Hashim & Devi 2008).In the same line, Laux and Laux (2009) and Chang et al. (2012) also found that overlapping board structures have an association with EM. Based on discussion above, this study hypothesized as follows:

H2: There is positive relationship between audit committee members tenures and earnings management.

Audit Committee Tenure, Audit Committee Duality, external audit quality and Earnings Management

Ashbaugh and Warfield (2003) explained that, the external auditors usually perform the function of the oversight mechanisms in corporate governance. The audit committee and the external auditors have a role to ensure the integrity of the financial reporting (Cohen et al., 2004). The external audit protects the interests of the shareholders, especially in the reporting of financial information (Weir et al, 2002; Roberts et al., 2005). Also, external audit quality can reduce opportunistic management (Watts & Zimmerman, 1983), (Sulaeman et al., 2019).

Based on the agency theory perspective, this study followed the same argument that the moderating effect of external audit quality on the relationship between internal monitoring corporate governance mechanisms (AC tenure, and AC duality role) and EQ.In view of the above submissions and references from the extant literature, the following hypotheses were, therefore, developed:

H3: External audit quality strengthens the relationship between the presence of AC tenure and EM.
H4: External audit quality strengthens the relationship between the presence of AC duality role and EM.

III. RESEARCH METHODOLOGY

Population and Samples

The population used in this research was nonfinancial companies listed in Indonesia Stock Exchange. The sample of the study is comprised of 216 companies' period 2013 to 2016 from public sources, the Indonesian Stock Exchange website (www.idx.co.id).

Model Research

EM $((RM1)_{it}, (RM2)_{it,}) = \beta_0 + \beta 1ACTENUREit + \beta 2ACDUALITYit + \beta_3 BOCIND_{it} + \beta_4 BOCSIZE_{it} + \beta_5 ACIND_{it} + \beta_6 ACSIZE_{it} + \beta_7 ACMEET_{it} + \beta_8 ACEXPERT_{it} + \beta_9 ACATTEND_{it} + \beta_{10} LOSS_{it} + \beta_{11} LEV_{it} + \beta_{12} ROA_{it} + \beta_{13} FAMOWN_{it} + \beta_{14} FSIZE_{it} + e_{it}$………………….. (1)

EM $((RM1)it, (RM2)it) = \beta 1ACTENUREit + \beta 2ACDUALITYit + \beta 3BOCINDit + \beta 4BOCSIZEit + \beta 5ACINDit + \beta 6ACSIZEit + \beta 7ACMEETit + \beta 8ACEXPERTit + \beta 9ACATTENDit + \beta 10EXAUDITQit + \beta 18ACTENURE*EXAUDITQit + \beta 19ACDUALITY*EXAUDITQit + \beta 20LOSSit + \beta 21LEVit + \beta 22ROAit + \beta 23FAMOWNit + \beta 24 FSIZEit + eit$ ………….. (2)

Table 1. *Variables measurement*

Acronym	Variable	Operational Definition and Measurement
Dependent Variable		
EM	Earnings management	Aggregate real earnings management indicated that there was an EM practice, using RM1 by Cohen and Zarowin (2010) model and RM2 byCohen et al. (2008).

Independent Variables		
ACTENURE	Audit Committee Tenure	Average tenure of the members of the audit committee per year.
ACDUALITY	Audit Committee Duality Role	Proportion of the AC members having a dual role in the corporate governance structure within the company
Moderating Variable		
EXAUDIT	External Audit Quality	Dummy variable equals to 1 if a firm had been audited by a Big 4 audit firm (e.g., Deloitte Touche Tohmatsu, Price Waterhouse Coopers, Ernst & Young or KPMG) and zero otherwise
Control Variables		
BOCIND	Board of Commissioners Independence	Proportion of the independent directors on the board of commissioners
BOCSIZE	Board of Commissioners Size	Total number of the board members
ACIND	Audit Committee Independence	Proportion of the Independent directors on the audit committee
ACSIZE	Audit Committee Size	Number of audit committee members
ACMEET	Audit Committee Meeting	Frequency of AC meetings in a fiscal year
ACEXPERT	Audit Committee Expertise	the proportion of audit committee members who had accounting or financial backgrounds knowledge
ACATTEND	Audit Committee Meeting Attendance	Proportion of the average meeting attendance of the members of the AC
LOSS	Loss	Dummy variable that equals 1 if the firm reported losses in prior year, and 0 otherwise
LEV	Leverage	Ratio of total liabilities to total assets
ROA	Return on Assets	Proportion of earnings before interest and tax (EBIT) to total assets
FAMOWN	Family Ownership	Proportion of family ownership
FSIZE	Firm size	The natural logarithm of total assets

IV. RESULT

Descriptive Statistics

Table 2. *Descriptive Statistics of the Data*

Variable	n	Mean	Std. Dev.	Min	Max
RM1	864	-.0364	.5581	-.9256	1.3983
RM2	864	-.0593	.5877	-1.074	1.4807
ACTENURE	864	4.2588	2.7233	1.000	18.0000
ACDUALITY	864	.3702	.09664	.3300	.6700
BOCIND	864	.4142	.1052	.2222	1.0000
BOCSIZE	864	4.259	1.7870	2.0000	12.0000
ACIND	864	.9911	.04611	.7500	1.0000
ACSIZE	864	3.0393	.3277	2.0000	4.0000
ACEXPERT	864	.67390	.2642	0.0000	1.0000
ACMEET	864	6.4294	4.541	3.0000	24.0000
ACATTEND	864	.9729	.0621	.7500	1.0000

LEV	864	.5108	.27998	.07074	1.469
ROA	864	.0505	.0982	-.1724	.3216
FAMOWN	864	.2636	.1663	0.0000	.9500
FSIZE	864	14.6063	1.7395	8.5332	19.3833

Table 2 shows in terms of the aggregate real earnings management, the results were interpreted on the basis of the mean values. Models of RM1 and RM2 had negative coefficients, indicating income-decreasing earnings management.Tenure of audit committee members average 4.2 years. Average value of 37% and maximum 67% for audit committee role duality other word have more one member have overlapping in corporate governance structure in many firms.

Table 3. *Descriptive Statistics of the Dichotomous Data*

Variable	Observations	Frequency		Percentage	
		1	0	1	0
EXAUDITQ	864	377	487	43.64%	56.36%
LOSS	864	217	647	25.12%	74.88%

Table 3 shows that 864 observation firms-years (43.64%) are audited by Big4 audit firms while 377 firms (56.36%) are audited by non-Big4 and from 864 observation firm-years 74.18% of the companies have income profit while 25.12% have net income loss.

Firstly, winsorized distribution was conducted to eliminate possible outliers in all continuous variables at the top and bottom so as to uphold the features of the original data. Also, Driscoll and Kraay standard error was conducted with a view to estimate the regression models in solving autocorrelation heteroskedasticity, and cross-sectional independence problem. In addition, to test the normality assumption of the study data, skewness and kurtosis were used. According to Hair et al (2006), skewness should stay within a threshold of ±3 and kurtosis should not be more than ±10. After conducting the test, the results show that the data is normally distributed.

Table 4.*Multiple Regression Results*

Variables	**Predicted Sign**	**RM1**		**RM2**	
		Drisc/Kraay		**Drisc/Kraay**	
		Coef.	**t-stat.**	Coef.	t-stat.
_cons	+/-	.9235943	1.98	.4515876	0.44
ACTENURE	-	-.0317364	-3.83**	-.0314808	-4.85**
ACDUALITY	+	.0357825	2.35*	-.0399744	-0.43
BOCIND	-	-.1610288	-2.16	-.2352246	-1.07
BOCSIZE	-	-.0090459	-1.48	-.0370248	-2.65*
ACIND	-	-.6887386	-3.30**	-.8977933	-2.82*
ACSIZE	-	-.0021545	-0.11	.0245443	0.81
ACMEET	-	.0005047	0.12	-.0013526	-0.36
ACEXPERT	-	.0524168	1.14	.0676806	0.95
ACATTEND	-	-.0867522	-0.42	-.0683389	-0.35
LOSS	+	.0541591	1.30	.0280538	0.45
LEV	+	.1028924	1.78	.1599109	5.83**
ROA	+	.3788145	4.44**	-.0047454	-0.02
FAMOWN	+	.1331977	2.67*	.1116342	2.06

industry		(omitted)		0 (omitted)	
FSIZE	-	-.008101	-0.37	.0424491	1.03
F-value	6.58			35.28	
Sig	0.0733			0.0067	
R-squared	0.0636			0.0448	
n	864			864	

Where: *, **, *** are p-value < .10, .05, .01, respectively

The results in Table 4 RM1and RM2 models were negative and significant, where the t-statistics values were (t = -3.83, p< 0.05; and t = -4.85, p< 0.05, respectively).This suggests that the longer the AC tenure, the lower the earnings management. Thus, hypothesis H1 was supported. Table 1 showed a significant and positive association between ACDUALITY and RM1, where the t-statistics values were (t = 2.35, p< 0.10).Thus, H2 was accepted.RM2had t-statistics values of (t = -0.43, p > 0.10) and this result did not support H2.In Table 4 the show control variable with BOCSIZE, ACIND, leverage, ROA FAMOWN is significant relationship with EM.

Table 5. *Multiple Regression Results with the Moderator*

Variables	Predicted Sign	RM1		RM2	
		Drisc/Kraay		Drisc/Kraay	
		Coef.	t-stat.	Coef.	t-stat.
_cons	+/-	.9033522	1.90	.4753199	0.45
ACTENURE	-	-.0317319	-3.54**	-.0314724	-4.98***
ACDUALITY	+	.1595499	1.46	-.2464154	-2.53*
EXAUDITQBIG4		.0961291	1.35	-.1235422	-5.48***
ACTENURE*EXAUDITQ	-	-.0011825	-0.49	.0008528	0.20
ACDUALITY*EXAUDITQ	+	-.2267254	-1.30	.3731757	9.38***
BOCIND	-	-.1792149	-1.90	-.1992018	-0.94
BOCSIZE	-	-.0060574	-0.73	-.0417277	-3.25**
ACIND	-	-.6993837	-3.24**	-.9068839	-3.09**
ACSIZE	-	-.0041084	-0.20	.0263333	0.87
ACMEET	-	.0011926	0.27	-.0024947	-0.63
ACEXPERT	+	.0554355	1.07	.0617845	0.93
ACATTEND	+	-.0911471	-0.46	-.0888301	-0.42
LOSS		.0532608	1.33	.03065	0.48
LEV	-/+	.1047709	1.68	.1644651	7.27***
ROA	-/+	.3563714	4.56**	.0351579	0.14
FAMOWN	-/+	.1396804	2.46*	.1002849	1.93
industry	-/+	(omitted)	(omitted)	(omitted)	(omitted)
FSIZE	-/+	-.0095485	-0.42	.0481318	1.19
F-value		45.5		308.72	
Sig		0.0046		0.000	
R-squared		0.05		0.1778	
N		864		864	

Where: *, **, *** are p-value < .10, .05, .01, respectively.

Table 5 showed that EM (RM1 and RM2) models were no significant relationship with ACTENURE*EXAUDITQ, where the t-statistics values were (t = -0.49, p> 0.10; and t = -0.20, p> 0.10, respectively).Thus, H3 was rejected. The result table 5 showed was negative and significant between the ACDUALITY*EXAUDITQ and RM2 where the t-statistics values were (t = 9.38, p< 0.01). Thus, hypothesis H4 was supported. RM1 model no significant relationship with ACTENURE*EXAUDITQ.

V. DISCUSSION

The results the relationships between ACTENURE and EM (RM1 and RM2) significant the effect of longer board service allows directors to gain stronger specific knowledge to handle complex committee processes, resulting in improved performance in protecting shareholder interests (Kosnik, 1990; Pfeffer, 1983). Directors with longer tenures possess greater business expertise, accumulated knowledge, experiences, and more effective monitoring abilities, and are more effective in constraining earnings management (Ghoshet al., 2010; Peasnell et al., 2001). Board members having served as audit committee members over longer periods are more experienced about the firms financial reporting practices. Therefore, audit committee members with longer tenures are in a better position to perform their oversight responsibilities of the reporting process, which suggests that longer tenures constrain earnings management.Consistent with these views, Ghosh et al. (2010) found that the audit committee directors with longer tenures were more effective in mitigating EM. Peasnell et al. (2001) also found that the average tenure of non-executive directors on the board was negatively associated with the level of earnings management. This result is also similar to the result of Beasley (1996) who found the tenure of outside directors to have had a negative and significant association with the instances of fraud.

The explanation for this result is that the AC duality role significantly decreases the level of real earnings management (RM1). Directors with overlapping memberships reduce the effectiveness of the corporate governance (Liao & Hsu, 2013). This result is consistent with the result of Laux and Laux (2009) and Liao and Hsu (2013) who also found that, firms which had less overlapping or duality membership roles for their directors had earnings management that was low.

This Study found external audit quality cannot strengthens the relationship between the presence of AC tenure and EQ.This supports the findings of Alves (2013) who argued that external audits with big 4 audit firms had not been effective in identifying and preventing unscrupulous accounting practices.This study documented external audit quality strengthens the relationship between the presence of AC Duality and EQ. Moreover, these results are consistent with other authors who claimed that to enhance the quality of financial reporting in firms, a less overlapping board structure is required (Laux & Laux, 2009; Liao & Hsu, 2013). This effective monitoring mechanism can be derived from the good relationship between the AC and the external audit (Alves, 2013), (Sulaeman et al., 2019).

Control variable related internal monitoring corporate governance(BOCSIZE and ACIND) have significant negative relationship with EM. This result also same with (i.e. Sharma &Kuang, 2014; Baxter & Cotter, 2009). Leverage, ROA, FAMOWNalso variables control found significant relationship with EM, this result also support previous study (i.eIsmail et al., 2010; Jaggi et al., 2009; Siregar& Utama, 2008;(Agussalim et al., 2020), Davidson et al., 2005).

VI. CONCLUSION

The study investigated the AC tenure and AC duality role, and the external audit on EM.The study findings significant relationship between the AC tenure and AC duality rolewith EM in Indonesian listed companies.In addition, the main contribution to knowledge of the research is the findings that the external audit quality moderate the relationships between the AC duality and EM, which suggests that firms with external audit quality can strengthen relationship between ACduality earnings management. However, not all the elements of the measured effectiveness, as the study has found no evidence that ACTENURE*EXAUDITQ were significantly related to EM.In relation to the new dimension of ACTENURE, the findings indicated a practical contribution of the longer tenure of AC members decreasing the level of EM in Indonesian listed companies. Thus, the findings of this study provide evidence for policymakers to focus on a longer ACTENURE, which will enhance other characteristics to monitor the management and improve the internal corporate governance mechanisms, and, consequently, lead to decrease in the level of earnings management. Another practical implication for the OJK regulations is that overlapping AC members in the structure of internal monitoring (ACDUALITY) might present another potential threat to audit committee members who are busier. With less ACDUALITY, the AC can affectively monitor the financial reporting process. Like any other research paper, this study is also limited in scope to cover only Indonesia listed companies for a specific period of four years (2013 to 2016). It is recommended that future studies should endeavor to examine specific audit committee tenure effectiveness for companies and use different measurements to capture audit committee characteristics.

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