

# Audit Committe and Earning Management The Moderating Effect of Financial Distress and Earning litigation

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## **Audit Committee and Earnings Management: The Moderating Effect of Financial Distress and Earnings Litigation**

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### **Abstract**

The purpose of this study was to examine the effect of an audit committee on earnings management moderated by financial distress and earnings litigation. To examine this phenomenon, a sample consisting of manufacturing companies listed in the Indonesia Stock Exchange in period 2005-2011 was employed. Examination was done using path analysis test through multiple-group analysis testing.

The testing results led to the conclusion that audit committees have an influence on earnings management if either the financial distress or the earnings litigation variable exists. In so doing, generally it can be concluded that the effectiveness of the audit committees in overseeing earnings management will be more apparent if the companies are under pressure.

**Keywords:** audit committee, earnings management, moderation, financial distress, earnings litigation

### **1. Introduction**

Within the last few years, the effectiveness of a corporate audit committee in overseeing the financial reporting process is often questionable. This is consistent with the occurrence of several financial cases to companies such as Enron, Xerox, Lippo Bank, and PT Ades. The core of all the above financial problems is the existence of the earnings management phenomenon (Goncharov 2005).

Unfortunately, the effectiveness of audit committees in overseeing earnings management behavior is often debated. It is due to several research findings that are conflicting one another regarding the relationship between an audit committee and earnings management. The research by Ebrahim (2007) proves the existence of a negative relationship while the research by Peasnell et al. (2005) does not find any relationships.

Those conflicting research findings may occur since they do not consider motivation when examining the relationship among variables (Ruddock et al. 2006). The effectiveness of overseeing performed by audit committees will be more apparent if the sample of companies used consists of companies with a strong motivation to perform earnings management. This view is directly stated in the *Spring 2008 Audit Committee Roundtable Report* which explains that "...audit committees need to be sensitive to the increased risk of earnings management arising from pressures on management to meet earnings targets and to satisfy debt covenants". Hence, audit committees should be more sensitive to earnings management due to evasion to the violations of debt covenants and due to pressure to meet earnings targets or litigation to meet the earnings targets.

It is therefore important to take into consideration the moderating effect of financial distress and earning litigation when examining the effectiveness of audit committee. The bonus plan hypothesis states if the amount of the bonus managers are going to receive is based on the earnings generated, they are expected to choose accounting methods that can increase earnings and thus the earned bonus will increase as well. The debt covenant hypothesis explains that companies must comply with the terms of a debt covenant such as maintaining financial ratios such as the debt to equity ratio, the minimum working capital ratio, as well as other restrictions that are generally associated with a company's accounting data. If these terms are violated, the concerned company will be sanctioned with restrictions on dividend payment or on increased debt interest (Scott 1997).

In this paper we propose that the financial distress and earning litigation will impact the relationship between audit committee and earning management. To test these predictions, we examine of 147 manufacturing companies listed in Indonesia Stock Exchange in the period 2005 – 2011.

Our result indicates that financial distress and earning litigation have significant effect in the relationship between audit committee and earning management. Under distress condition and earning litigation, the role of audit committee more apparent.

The remainder of the paper is organized as follows. Section I survey the literature on audit committee, earning management, financial distress and earning litigation. Section II describe our sample and methodology, while section III discusses variables used in our test. Section IV provide results on our analysis. Section V concludes and discusses the limitation of our study and offer implication for future research.

## 2. Literature Review and Hypothesis Development

### 2.1 The Relationship Audit Committee and Earning Management

Audit committees have the characteristics or properties that influence their role in overseeing a company, those are independence, expertise, the size and activities. The independence of an audit committee is often considered as the main characteristics necessary to influence the effectiveness in overseeing the reporting process. Independent audit committees hold a good position as a active supervisor in the reporting process so as to have sufficient capability to prevent manipulation of earnings performed by the management (Klein 2002b). In some previous studies, it is suggested that independent audit committees have a significant relationship with earnings quality (Davidson et al. 2005). Bedard et al. (2004) find a significantly negative relationship with aggressive behaviour of the earnings management.

In addition to independence, the level of expertise of an audit committee is generally also regarded as an important characteristic in performing their duties. In order to have the overseeing become effective, an audit committee must have sufficient expertise in the fields of accounting and

auditing in order to assess the problems properly (DeFond et al. 2005). Several previous studies have found a relationship between the level of expertise and the quality of earnings (Bedard et al. 2004).

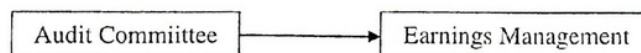
In addition to the expertise level of an audit committee, there are other factors affecting the effectiveness of the committee's duties, namely the size of the audit committee. The size of an audit committee has a positive effect on the quality of earnings. The larger the size of an audit committee, the more effectively they oversee a company since a large committee can incorporate various members with different skills (Choi et al. 2004).

Another factor that can increase the effectiveness of an audit committee's duties in improving the quality of earnings is the level of activities of the audit committee. Menon and Williams (1994) state that the mere establishment of an audit committee unit cannot by itself improve the overseeing process. It must also be supported with participation. Choi et al. (2004) states that an active audit committee will be more capable of detecting earnings management than a passive audit committee. Based on the explanation, the researcher proposes a hypothesis:

H1: Audit committees have a negative effect on earnings management

The phenomena of those hypotheses, if depicted in a research model, will take a form as follows:

Figure 1: The Relationship between Audit Committees and Earnings Management



## 2.2 Financial Distress Moderates the Relationship between Audit Committees and Earnings Management

The explanation above has described the relationship between audit committees and earnings management. An audit committee serving a supervisory function of the company is responsible for overseeing every single actions performed by the company, including the actions of earnings management. This earnings management behavior will be more apparent when the company is experiencing financial distress (Sweeney, 1994). It was also stated in the *Spring 2008 Audit Committee Roundtable Report* that it is necessary for audit committees to be sensitive to increased risks of earnings management arising due to strong pressure to the management to comply with the terms of debt covenants.

Financial distress is a condition that can lead a company to payment default, not suitable with the agreed contract. This payment default will cause the company to face conditions in which it is unable to repay its debt which has fallen due to the creditor or a condition known as not *solvable* (insolvency).

Management behavior due to financial distress in accounting can be understood in the positive accounting theory. Watts and Zimmerman (1986) use the positive accounting theory to explain and predict management behavior related to the selection of accounting procedures done by managers in their attempt to achieve certain goals. Watts and Zimmerman propose three types of hypotheses, namely the hypotheses related to the bonus program, debt covenant hypothesis, and the size of a company. The positive accounting theory predicts that managers have a tendency to raise earnings to conceal their poor performance.

In relation to a financial distress situation of a company, the closest hypothesis to understand the behavior of the management is the debt covenant hypothesis. Watts and Zimmerman (1986) state that in the debt covenant hypothesis, companies close to debt covenant violations will try to do any accounting choices that can improve earnings. The higher the ratio of debt/ equity of a company, the close the company to the terms of a debt covenants and the greater the probability of debt covenant violations, the more likely the managers use accounting methods that increase profitability (Belkaoui 2000). Sweeney (1994) states that managers manipulate earnings reporting to avoid violations of debt covenants and use selected accounting methods to achieve this goal. Companies close to debt covenant

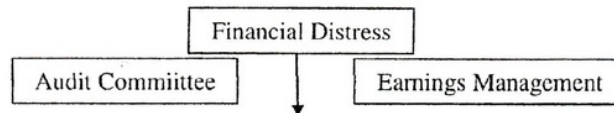
In the literature, it has been explained that managers of companies that are in financial distress will usually have a strong motivation to manipulate earnings. Jaggi and Lee (2002) say that managers use discretionary accruals when they violate debt covenants due to financial distress. Jaggi and Sun (2006) state that companies experiencing financial distress have higher discretionary accruals than companies that are not experiencing financial distress.

Reynolds and Francis (2000) reveal a positive relationship between financial distress and accrual earnings management. DeFond and Park (1997) note that income smoothing (as a proxy of earnings management) will be increased (decreased) when the performance of a company is poor (good). Based on the above explanation, the following hypothesis is proposed:

H2: Financial distress has a moderating effect on the negative relationship between audit committees and accrual earnings management

The phenomena of this second hypothesis, if depicted in a research model, will take a form as follows:

**Figure 2:** Financial Distress Moderates The Relationship between Audit Committees and Earnings Management



### 2.3 Litigation Moderates the Relationship between Audit Committees and Earnings Management

Information is an essential element for investors and business actors as intrinsically it presents descriptions, records or overview either related to past, current or future conditions for the sake of a company's survival and its market effect. Complete, accurate and timely information is crucial for investors of a capital market as an analytical tool to make investment decisions. If the information contains a positive value, it is expected that the market will react during the announcement and welcome it.

Considering that the market reacts to the information given, then this situation brings concerns for the company if the information submitted contains bad news, which will then receive negative responses from the market. These negative responses of the market are nothing but the threat of litigation in the form of decreases in stock prices or even delisting.

The threat of delisting or decreases in stock prices are one form of litigation risks with which companies are confronted. Companies experiencing high growth are generally under the threat of litigation from its shareholders in order that these companies do not show decreasing performance. Litigation risks are defined as risks inherent in a company that allows the threat of litigation by the parties concerned with the disadvantaged company. Parties concerned with a certain company include creditors, investors, and regulators. Johnson et al. (2000) and Qiang (2003) state that risks of litigation are triggered by the inherent potential of a certain company relating to its failure to meet the interests of its investors and creditors. Breeden (1995) asserts that fear of litigation appears to be understood as a company facing litigation will encounter significant decreases in values. Bhagat et al. (1998) show that litigated companies have their value decreased by nearly one percent. Literature suggests that litigated companies delisted from the stock market will suffer high losses, including significant declines in stock prices, falling stock liquidity and increasing volatility of stock returns (Macey, O'Hara, and Pompilio 2004).

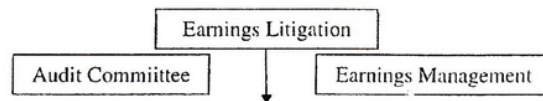
Companies exposed to the threat of litigation in the form of delisting due to violating the minimum requirements of capital markets have a strong motivation to push up their stock price. Previous research suggests that opportunistic measures such as accrual and real earnings management has been successful in increasing the stock price (Bens et al., 2002).

Research that directly examines the impact of aggressive accounting on the incidence of litigation has been performed among others by Johnson, Nelson and Pritchard (2002). They note that variables of aggressive accounting such as restatements, abnormal accruals, and sales growth have something to do with the risks of class action. DuCharme et al. (2003) find that the abnormal accounting accruals are positively associated with litigation. Research by Jaggi and Sun (2006) reveals that litigated companies have higher discretionary accruals. Kasznik (1999) discovers that companies manipulate discretionary accruals to meet their forecast targets because of fear of litigation risks. Based on the above explanation, the researcher proposes the following hypothesis:

H3: Litigation has a moderating effect on the negative relationship between audit committees and earnings management

The phenomena of this third hypothesis, if depicted in a research model, will take a form as follows:

**Figure 3:** Earnings Litigation Moderates The Relationship between Audit Committees and Earnings Management



### 3. Data and Methodology

The research population consisted of companies listed in the Indonesia Stock Exchange for the period of 2005-2011. While the research sample consisted of manufacturing companies listed in the Indonesia Stock Exchange. Based on the data obtained from the Indonesian Capital Market Directory (ICMD), there were 1029 firm years of manufacturing companies listed in the Indonesia Stock Exchange during the period of 2005-2011. Sample selection was done using the method of purposive sampling. To select a sample of companies with financial distress, the researcher employed the criteria with an ICR (interest coverage ratio) of less than 1. And to select a sample of companies encountering litigation, the researcher employed the criteria with changes in a value of return on assets (ROA) between 0 to 0.0008. Based on the above criteria, we obtained data as follows:

**Table 1:** The Sample Selection

This table presents a description of the sample selection stage. First, we take the data of manufacturing firm years during the 2005 – 2011 period. Then, we determine the company is not experiencing financial distress and litigation earnings. Next, we look for the sample of firms experiencing financial distress with criteria  $ICR < 1$ . Last, we define the sample of firms that experience earnings litigation based on criteria  $\Delta ROA$  between 0 to 0.00008.

No	Description	Total
1	Firm years of manufacturing companies listed in the Indonesia Stock Exchange for the period of 2005-2011 which data were available	1029
2	Firm years of manufacturing companies that did not experience financial distress and litigation during the period of 2005-2011	(853)
3	Sample of firm years	176
4	Sample of firm years of financial distress	127
5	Sample of firm years of litigation	49

From the total number of manufacturing companies in the Indonesia Stock Exchange for the period of 2005-2011, there were 176 firm years of companies experiencing the criteria of financial distress and companies experiencing litigation. From this sample of 176 companies, the number of companies experiencing financial distress reached 127 companies while the number of companies experiencing litigation reached 49 companies.

The dependent variable of this research was the accrual earnings management (MLA). The calculation of the accrual earnings management was performed by calculating the discretionary accruals. The calculation of discretionary accruals as a proxy for earnings management employed Jones' Model (1991) as modified by Dechow et al. (1995). This model was used because it is considered the best model in detecting earnings management (Siallagan and Machfoedz, 2006).

The Aggregate accruals-based model employed was the Modified Jones Models. Dechow *et al.* (1995) discover that the modified version of the model developed by Jones (1991) is the most powerful tool for detecting earnings management. The model uses Discretionary Accruals (DACC) as a proxy for earnings management.

The calculation measures of accrual earnings management using the modified Jones model are:

1. Calculating the total accrual value using the following formula:  

$$TA_{it} = NI_{it} - CFO_{it}$$
2. Calculating the parameter values  $\alpha_1$ ,  $\alpha_2$ , and  $\alpha_3$  using the following formula:  

$$TA_{it}/A_{it-1} = \alpha_1(1/A_{it-1}) + \alpha_2(\Delta REV_{it}/A_{it-1}) + \alpha_3(PPE_{it}/A_{it-1}) + \epsilon_{it}$$
3. Calculating the NDA (*non-discretionary accruals*) value using the following formula:  

$$NDA_{it} = \alpha_1(1/A_{it-1}) + \alpha_2(\Delta REV_{it}/A_{it-1} - \Delta REC_{it}/A_{it-1}) + \alpha_3(PPE_{it}/A_{it-1})$$

the parameter values  $\alpha_1$ ,  $\alpha_2$ , and  $\alpha_3$  are generated from the calculation in the step no. 2.
4. Calculating the value of discretionary accruals that is an indicator for accrual earnings management using the following formula:  

$$DA_{it} = TA_{it} - NDA_{it}$$

Where

- 4
- $TA_{it}$  = total accruals of the company *i* in year *t*
  - $NI_{it}$  = net income of the company *i* in year *t*
  - $CFO_{it}$  = cash flow operation of the company in year *t*
  - $NDA_{it}$  = nondiscretionary accruals of the company *i* in year *t*
  - $DA_{it}$  = discretionary accruals of the company *i* in year *t*
  - $A_{it-1}$  = total assets of the company *i* in years *t-1*
  - $\Delta REV_{it}$  = income of the company *i* in year *t* minus its income in year *t-1*
  - $\Delta REC_{it}$  = accounts receivable of the company *i* in year *t* minus the accounts receivable of the company *i* in year *t-1*
  - $PPE_{it}$  = fixed assets of the company *i* in year *t*

The independent variable of this research was audit committees. Following the previous studies, this study also employed the score of each characteristic to calculate the effectiveness of audit committees (KA), namely:

$$KA = \text{Size} + \text{Indep} + \text{Akt} + \text{Meeting}$$

Where:

- Size = total members of an audit committee
- Indep = total number of independent audit committees
- Akt = members with an education background in accounting
- Meeting = total number of meetings held by the audit committees

Moderating variables are variables that affect (in the sense of either strengthening or weakening) the relationship between the independent variable and the dependent variable. This research employed two moderating variables, namely financial distress (FD) and litigation (LIT).

This research defined whether a company experiences financial distress or not by referring to the research by Classens et al (1999) i.e. a company with an interest coverage ratio (ICR) less than 1 (one). It is

done by considering that companies experiencing financial distress will be definitely characterized by difficulty in interest payments. To calculate the interest coverage ratio, the following formula is used:

$$ICR = \text{Operating Profit} / \text{Interest Expense}$$

Companies with an ICR score less than 1 are companies with financial distress.

The next measure was to divide the data of the sample that consisted of companies experiencing financial distress into two groups based on their respective mean or median value as the denominator limit. The values of financial distress that was higher than the mean or median were coded 0, while those smaller than the mean or median were coded 1.

Litigation in this study was measured using the calculation model used by Altamuro & Beatty (2010). The calculation performed by Altamuro & Beatty (2010) is actually the calculation of benchmark-beating over earnings. This calculation measures investors' demands to the management to produce higher earnings than the previous year.

The litigation variable was calculated by calculating the change ( $\Delta$ ) in the ROA of the companies during years  $t$  and  $t-1$ . A company was said to perform benchmark beating if the value of the ROA change is between 0 to 0.0008 (Altamuro & Beatty, 2010). Companies with a change ( $\Delta$ ) in the ROA in the interval between 0 to 0.0008 were indicated to report a smaller profit growth than the previous year. The companies simply met earnings targets as they did in the previous year.

In the next stage, the researcher divided the data on the litigation sample into two groups based on the mean or the median. The data on the litigation values that were smaller than the mean or the median were coded 1 while the litigation values that were higher than the mean or median were coded 0.

In this study, the control variables taken into account consisted of assets and audit quality. The asset variable was a control variable that measured the size of a company. According to Cornet et al. (2008) the size of a company can affect earnings management. The variable of the size of a company was measured by calculating the logarithm of the company's assets (LNASET).

Meanwhile, the control variable of audit quality (KAP) was a variable alleged to affect earnings management. According to Chen et al. (2005) the quality of an auditor provides a significantly negative effect on earnings management. Companies with qualified auditors were alleged to perform a little profit management. Companies with qualified auditors were alleged to perform a little profit management. This variable of audit quality was measured by calculating the accounting firm that audited a company. If a company was audited by KAP Big 4, then a value by 1 was given, and otherwise if it was not.

The descriptive-statistical analysis provides the description of the data seen from the minimum and maximum values, the mean and the standard deviation resulted from the research variables. The results of the descriptive-statistical analysis generate the following data:

**Table 2:** Descriptive-Statistics of Variables

This table reports mean, minimum, maximum, and standard deviation for our variables of interest. Definitions for all variables are provided in Appendix A.

	Mean	Min	Max	Standard Deviation
KA	10,2443	6,00	20,00	2.05704
LNASET	13,3541	9,63	18,54	1.55322
KAP	0,2557	0,00	1,00	0.43749
MLA	0,1991	0,00	1,78	0.31589

Based on the results of the descriptive-statistical analysis, it is revealed that the number of observations made on the research sample was 176. For the variable of audit committees (KA) as an independent variable of the research sample, it generated a mean value by 10.2443 and standard deviation by 2.05704. With a minimum value by 6 and a maximum value by 20, it means that the median was 13. If the score of the median is compared with the mean of KA, it means the mean of the sample of the audit committees is low as it is smaller than the median ( $10.2443 < 13$ ). The control

variable of assets (LNASET) generated a mean by 13.3541 and standard deviation by 1.55322. The minimum score of this asset variable was 9.63 while the asset variable maximum score was 18.54. It means that the median was 14.085. With the mean of the asset by 13.3541, it means that the number of assets that belongs to the sample of the companies is evenly distributed because the score is almost equal to the median. The control variable of audit quality (KAP) generated a mean by 0.2557 and standard deviation by 0.43749. With a minimum value by 0.00 and a maximum value by 1.00. It means that the median reached 0.50. With a mean of the control variable of audit quality (KAP) by 0.2557, smaller than the median, it means that the majority of the sample companies were not audited by KAP BIG 4.

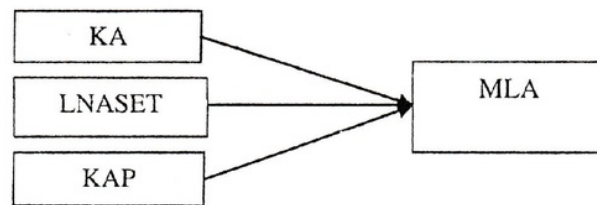
In relation to the dependent variable of the accrual earnings management (MLA), it generated a mean value by 0.1991, standard deviation by 0.31589, a minimum value by 0.00 and a maximum value by 1.78. With a minimum value by 0.00 and a maximum value by 1.78, it means the median was 0.89. If this median is compared with the mean, it implies that the mean of the sample is smaller than the median. It suggests that a majority of the sample rarely perform the accrual earnings management.

#### 4. Data Analysis

The method of analysis used to examine the first hypothesis was the path analysis. This path analysis was used for testing in this research because it allows for the complex data examination through a structural equation. This path analysis approach allows for the simultaneous examination of research variables.

The empirical path diagram employed is illustrated in the following figure:

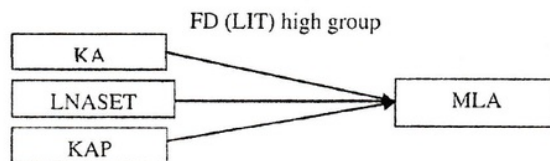
**Figure 4:** The Path Diagram for the Empirical Research Model: the Relationship between Audit Committees and Earnings Management

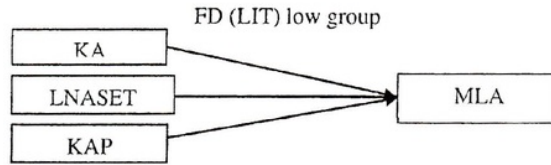


##### 4.1 The Examination of the Moderation Model

Moderation testing used to examine hypotheses (H2 and H3) was the multiple-group path analysis (Ghozali 2011). This analysis is useful for examining the moderating effect of a category-characterized variable. By using the multi-group analytical method, it means that moderating variables were going to be classified into two types: high financial distress and low financial distress. Likewise, the litigation variable was also classified into two categories: high litigation and low litigation. Thus, the empirical model employed to examine the moderating effect of FD and LIT is given as follows:

**Figure 5:** The Path Diagram for the Empirical Research Model: the Relationship between Audit Committees and Accrual Earnings Management Moderated by FD (LIT)





After the data had been grouped into two categories, bootstrapping was then performed to generate the path coefficient and the standard of errors of each category. This examination was performed using the *smartPLS* program. The different estimated value of each path coefficients was then compared and tested in terms of its significance using t-test (Chin 2000). Chin (2000) proposes the following formula to calculate the value of t-count if the value of the standard of errors of both categories are not the same:

$$t = \frac{pathsamp1 - pathsamp2}{\sqrt{se^2_{sursamp1} + se^2_{sursamp2}}}$$

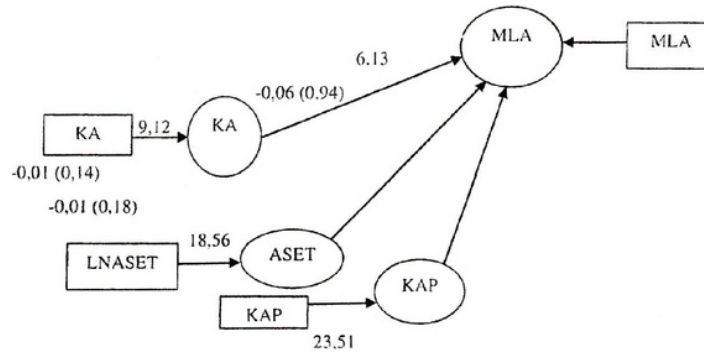
If the resulted t-count is higher than t-table, then the hypothesis indicating the existence of a moderating effect is accepted.

**5. Results**

**5.1 Examination Related to the Effect of Audit Committees over Earnings Management**

The proposed hypothesis to examine the effect of audit committees over earnings management was that audit committees have a negative effect on earnings management (H1). The hypothesis-testing for hypothesis H1 was done using path analysis. The figure and table containing the results of the path analysis are given as follows.

**Figure 6:** Path Analysis for the First Hypothesis Testing



**Table 3:** Path Coefficients

This table reports the path coefficients and t statistics of the results of path analysis test. Path analysis processed with the *smartPLS* program

	Original Sample (O)	T Statistics ( O /STERRI)
LNASET → MLA	-0,012934	0,146703
KA → MLA	-0,060898	0,948866
KAP → MLA	-0,016523	0,189808

Based on Table 4.3 and the obtained sample, the results of the first hypothesis testing is rejected although the coefficient is negative as expected (-0.060898), but because the t-count is smaller than t-Table at 5% ( $0.948866 < 1.96$ ), then it cannot accept the proposed hypothesis.

This finding is similar to the findings of the research by Peasnell et al. (2005). Peasnell et al. (2005) found no evidence of earnings manipulation with the existence of audit committees in British companies. Likewise, Beasley (1996) states that audit committees do not have a significant effect on the level of fraud in financial reporting. Similarly, Zahn and Tower (2004) also found no relationship between earnings management and the level of expertise of an audit committee. Choi et al. (2004), Bedard et al. (2004) and Davidson et al. (2005) found no significant relationship between audit committees and earnings management.

Similarly, several studies conducted in Indonesia also found no relationship between audit committees and earnings management. The findings of this research which fail to prove the existence of the influence of audit committees over accrual earnings management are consistent with the results of the research conducted by Siregar and Utama (2005). The research conducted by Siregar and Utama (2005) proved that audit committees provide a negative effect over accrual earnings management. However, the effect is not significant. Research conducted by Khomsiyah et al. (2005), Murtanto and Maulana (2005), as well as Rokhim (2009) provide evidence that the existence of audit committees do not affect the earnings quality of Indonesian companies. Those studies suggested that the characteristics of audit committees do not have a significant influence on the effectiveness of the role of an audit committee.

The weak evidence of the influence of audit committees on earnings management is indeed unable to show the real role of an audit committee. However, the influence of an audit committee on earnings management is expected to be apparent after moderation testing with multiple-groups. Because it is by including the moderating variables into the examination, the conditions that lead to the emergence of the dependent variable, i.e. earnings management, are expected to become more obvious. Luddock, Taylor, and Taylor (2006) state not including motivation in the earnings management examination makes the relationship generated in the research less capable of showing the existence of a moderating test in explaining the resulted relationship.

## 2 Examination on the Moderation of Financial Distress

After directly examining the effect of audit committees on earnings management, the next step to take was to examine the moderation effect of the financial distress variable over the relationship between audit committees and (real) accrual earnings management. The testing was done using path analysis with the multiple-group method. By using this multiple-group method, it means that the data of the companies would be divided into two groups, namely the group with high financial distress and the group with low financial distress. Based on the research, the data in the form of firm year experiencing financial distress reached 127 samples. The sample data were then divided into two based on the median of the financial distress scores. The results of the sample distribution indicated that the sample experiencing low financial distress reached 63 samples while the sample experiencing high financial distress reached 64. The table below presents the results of path analysis in relation to the effect of audit committees on accrual earnings management for the sample of low and high financial distress.

Table 4: Moderation FD Test

This table presents the test of moderation FD variables. In panel A is displayed path coefficients and standard errors in the company which have low FD condition, whereas in panel B shows the company in high FD condition. In panel C is shown the calculation of FD moderation t-test.

### Panel A. FD Low

	Original Sample (O)	Standard Error (STERR)
.SET -> MLA	0,094284	0,163394
.A -> MLA	0,208711	0,145318
.AP -> MLA	-0,102015	0,085833

Panel B. FD High

	Original Sample (O)	Standard Error (STERR)
ASET -> MLA	0.042628	0.119161
KA -> MLA	-0.148365	0.122395
KAP -> MLA	0.153601	0.157566

Panel C. T test of FD moderation:

$t = \frac{\text{pathsampel1} - \text{pathsampel2}}{\sqrt{\text{se}^2\text{sampel1} + \text{se}^2\text{sampel2}}}$ $t = \frac{-0.148365 - 0.208711}{\sqrt{(0.122395)^2 + (0.145318)^2}}$ $t = -1.8794$
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Since the value of t-count is smaller than the value of t-Table at 10% (-1.8794 < -1.64), the second hypothesis that FD moderates the negative relationship between KA and MLA is accepted.

The second hypothesis aims to examine the moderating effect of financial distress on the relationship between audit committees and accrual earnings management. The findings obtained by the researcher indicate the results that the researcher has expected that the conditions of a company will strengthen the negative relationship between audit committees and accrual earnings management. Under the distress condition, the role of the audit committee becomes more apparent. It is because the condition of a company experiencing financial distress will encourage the company to perform earnings management. Previous research has found empirical evidence that the conditions of a company will encourage earnings management. Corporate managers of a company experiencing financial distress usually have a strong motivation to manipulate earnings (Sweeney 1994; DeFond and Jambalvo 1994; DeAngelo et al. 1994; Burgstahler and Dichev 1997; Jaggi and Lee 2002). Sweeney (1994) found that managers manipulate earnings reporting to avoid violating debt covenants and use the selection of accounting methods to achieve that goal. DeFond and Jambalvo (1994), DeAngelo et al., (1994) as well as Jaggi and Lee (2002) assert that managers use discretionary accruals when they violate debt covenants due to financial distress. Jaggi and Sun (2006) state that companies experiencing financial distress have higher discretionary accruals than companies that are not under financial distress. Research by Achmad et.al (2007) also found that the practices of accrual earnings management in Indonesia are driven by the motivation of the debt covenant hypothesis, which suggests that the condition of financial distress will affect the magnitude of accrual earnings management.

Thus, it proves the moderating influence of financial distress over the relationship between audit committees and earnings management. In short, it supports the debt covenant hypothesis in the positive accounting theory.

The findings obtained by the researcher prove that the conditions of a company will reveal the role of an audit committee in reducing earnings management. These findings are consistent with the statement given by Ruddock, Taylor, and Taylor (2006) that not include motivation in testing earnings management will make the significant relationship generated in the research less capable of showing the existence of power test in explaining the resulted relationship. Thus, it is expected that inconsistency in the research findings regarding the relationship between the audit committees and earnings management can be overcome by considering the distress condition of a company.

### 5.3 Examination on the Moderation of Litigation

The proposed hypothesis to examine the moderating effect of litigation is that litigation has a moderating effect on the negative relationship between audit committees and accrual earnings management (hypothesis 3). Similar to the examination on the moderation of financial distress that employed a multiple-group method, to examine the moderating effect of litigation, the sample was also divided into two groups: the sample with high litigation and the sample with litigation low

Using the criteria, a sample consisting of 49 companies experiencing litigation was obtained. This sample of companies was then divided into two based on the mean of the litigation scores.

Companies with a litigation score above the mean were classified as companies with high litigation while Companies with a litigation score below the mean were classified as companies with low litigation.

**Table 5:** Moderation LIT Test

This table presents the test of moderation LIT variables. In panel A is displayed path coefficients and standard errors in the company which have low LIT condition, whereas in panel B shows the company in high LIT condition. In panel C is shown the calculation of LIT moderation t-test.

**Panel A LIT Low**

	Original Sample (O)	Standard Error (STERR)
ASET -> MLA	-0,236929	0,234900
KA -> MLA	0,561654	0,190932
KAP -> MLA	-0,161787	0,174381

**Panel B LIT High**

	Original Sample (O)	Standard Error (STERR)
ASET -> MLA	-0,172587	0,285490
KA -> MLA	-0,169508	0,284226
KAP -> MLA	0,048009	0,233626

**Panel C. T test of LIT moderation:**

$$t = \frac{\beta_{\text{pathsample1}} - \beta_{\text{pathsample2}}}{\sqrt{se^2_{\text{sample1}} + se^2_{\text{sample2}}}}$$

$$t = \frac{0,561654 - (-0,169508)}{\sqrt{(0,190932)^2 + (0,284226)^2}}$$

$$t = 2,133388$$

Since the value of t-count is smaller than the value of t-Table at 5% ( $2,133388 > 1,96$ ), the third hypothesis that Litigation moderates the negative relationship between KA and MLA is accepted.

The third objective of the research aimed to examine the moderating effect of earnings litigation on the relationship between audit committees and earnings management. This objective is based on previous empirical studies conducted by Dechow et al. (2000). Skinner and Sloan (2002) indicate strong motivation for companies to improve their earnings reporting due to the threat of punishment from the investors if they cannot meet their earnings target. Jaggi and Sun (2006) assert that companies with litigation conduct high discretionary accruals.

The findings of the research that the researcher obtain suggest that the moderating influence of litigation over the relationship between audit committees and accrual earnings management was proven to exist. The research findings support the presumption of Cao and Narayanamoorthy (2005) which state that motivation of an audit committee to more strictly oversee earnings management, in addition to financial distress, is also resulted from litigation against the company. In the Spring 2008 Audit Committee Roundtable Report, it is stated that "...audit committees need to be sensitive to the increased risk of earnings management arising from pressures on management to meet earnings targets and to satisfy debt covenants". In so doing, audit committees should be more sensitive to earnings management due to the attempts not to violate debt covenants and due to pressure to meet earnings targets or litigation to satisfy earnings targets.

Breeden (1995) states that the fear of litigation might occur since companies facing litigation will encounter significant decreases in values. Bhagat, Bizjak, and Coles (1998) show that litigated companies encounter decreases in values of nearly one percent. This aspect of litigation is important to note because companies with high risks such as growing companies will usually tend to manipulate earnings. This is done because the companies strives to meet market expectations (Dechow et al. 2000). As a consequence, strong motivation to increase the earnings reporting can be found among these growing companies due to the threat of punishment from the investors if the companies do not

meet earnings targets (Skinner dan Sloan, 2002). Jaggi and Sun (2006) state that companies with litigation conduct high discretionary accruals.

## 6. Discussion and Conclusions

The main objective of this research was to examine the moderating effect of financial distress and earning litigation towards the relationship between audit committees and accruals and real earnings management. The researcher presumes the inconclusive previous research findings as resulted from not considering factors that strengthen the relationship between audit committees and earnings management. In the researcher's opinion, the factors of financial distress and earnings litigation will strengthen the relationship between audit committees and earnings management.

The analysis results of this research provide the following general conclusion that the effectiveness of an audit committee in overseeing earnings management will be apparent if companies are experiencing financial distress and earnings litigation. The above general conclusions are obtained from the first conclusion that audit committees have no effect on earnings management. Second, financial distress has a moderating effect on the relationship between audit committees and earnings management. Third, litigation has a moderating effect on the relationship between audit committees and accrual earnings management.

Theoretically, it implies that the findings of this research strengthen the phenomena of the debt covenant hypothesis and the bonus plan hypothesis that occur in the Indonesia Stock Exchange. The practical implication of these findings is the necessity for increased overseeing performed by an audit committee to companies experiencing financial problems and smooth increases in earnings.

Some of the limitations found in this research consisted of problems with variation in magnitude of the effectiveness of audit committees and the magnitude of earnings litigation. This research was conducted by adding up the number of the size, a background in accounting and independent members of audit committees. Of the three parameters, it is found that most of the sample companies have relatively the same size which consists of 3 people and have one member of the audit committee with a background in accountin. Similarly, the number of independent members of the audit committee of a majority of sample companies was only 1 member. Therefore, it will be difficult for the research to examine the effect of these three parameters over the dependent variable.

Based on the above limitations of the research, the researcher suggests that further research can be conducted by not only considering the characteristics, such as the numbers or the background in accounting, or the independent audit committees. It is necessary to develop criteria for the effectiveness of the audit committees that directly measure their performance.

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PAGE 1

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PAGE 2

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PAGE 3

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PAGE 4

---

PAGE 5

---

PAGE 6

---

PAGE 7

---

PAGE 8

---

PAGE 9

---

PAGE 10

---

PAGE 11

---

PAGE 12

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PAGE 13

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# Audit Committee and Earning Management The Moderating Effect of Financial Distress and Earning litigation

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