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Effect of Audit Committee Characteristics on Relationship between Financial Distress and Income Maximization Actions

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Abstract

The study aims to obtain empirical evidence regarding the influence of audit committee characteristics on the relationship between financial distress and income maximization actions. The population in the current study are companies listed on the Indonesia Stock Exchange from 2015 to 2018. The sampling technique used non-probability sampling with a purposive sampling method to get 37 observation periods as research samples. The data analysis technique uses moderated regression analysis. The test results prove that high financial expertise can weaken the influence of financial distress on income maximization actions. This study also finds empirical evidence that the frequency of meetings is not a moderating effect of financial distress on income maximization. The third hypothesis testing shows that the independence of the audit committee can moderate the relationship between financial distress on income maximization.

Keywords

financial distress;
financial expertise;
income maximization;
independence;
meetings frequency;

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1 Introduction

PSAK 25 concerning accounting policies, changes on accounting estimates, and errors explain accounting policies are certain principles, principles, conventions, regulations, and practices. They have applied entities in the preparation and presentation of financial statements. Matters relating to certain regulations and practices in the presentation of financial statements, especially, profit figures are related to company costs and revenues. Determination of accounting policies focus on earnings can trigger earnings management in the company. The objective is to be achieved from earnings management actions is to show the company managed by management still looks in good condition even though the company is in a difficult condition.

The phenomenon of earnings management occurs in the company PT. Timah, the first semester in 2015. PT Timah financial reports were fictitious. Due to the first semester in 2015, their operating profit had lost IDR. 59 billion (Soda, 2016; Dahiya & Chaudhary, 2016). Case of loss suffered by PT. Timah actually begins with an increase in debt recorded, an increase in debt of almost 100% compared to 2013.

Earnings management actions, unlike this phenomenon, are triggered by the financial distress condition of the company itself. Financial distress is a stage of decline in financial conditions experienced by a company. It has occurred before bankruptcy or liquidation (Widhiadnyana & Ratnadi, 2018). The condition begins on the difficulties faced by the company to pay off its obligations to third parties or the level of product sales. It began to decline while routine costs unlike salaries for permanent employees must be charged.

The inconsistency of previous research is not only limited to the difference in proxies used. It is evident research conducted by Kumar & Madhu (2017), using the same proxy as four previous studies namely Vega & Lailatul (2014), Bisogno & de Luca (2015), Alamanda & Wahyu (2017), as well as Ariesanti (2015). Their studies used the same proxy for earnings management, the Modified Jones Model. Kumar & Madhu (2017), stated there is a lower significance of earnings management during the financial crisis than before and after the financial crisis. The four studies have found companies experience financial distress will take steps to manage earnings with a pattern of increasing earnings. Therefore, the company is able to maintain the continuity of its business in the coming period.

The audit committee has a very important and strategic role in maintaining the credibility of the financial report preparation process. It is as well as maintaining the creation of an adequate corporate supervision system and the implementation of good corporate governance (Rachmawati & Triatmoko, 2007). *Financial Services Authority Regulation (POJK)* No. 55/POJK04/2015 concerning the establishment and guidelines for the work implementation of the audit committee states the audit committee must have at least one person with an educational background and expertise in accounting and finance. Badolato *et al.,* (2014), found audit committees with financial expertise were more effective in reducing earnings management. POJK No. 55/POJK04/2015 also stated the audit committee meets regularly at least 1 (one) time in 3 (three) months. Pangestika & Luna (2014), found the frequency of audit committee meetings had a negative effect on the level of corporate earnings management. Other audit committee characteristics contained on the POJK are independence. Jaggi & Sun (2010), found an effective independent audit committee succeeded in reducing earnings management actions by management, especially companies in distress conditions.

Literature Review and Hypothesis

An agency relationship is defined as a contract stating one or more shareholders ask another person (agent) to perform certain services in the interests of shareholders by delegating authority to the agent (Jensen & Meckling, 1976; Bire *et al.,* 2019). Explained agency conflicts and information asymmetries between managers and shareholders offer opportunities for earnings manipulation. The results of this study are supported by Ujiyantho & Bambang (2007), who obtained the results the higher the information gap. It is owned by the agent and shareholders. It will encourage earnings management actions from the agent.

Income maximization actions taken on management to show the profits generated by the company has increased. Vega & Lailatul (2014), showed the companies experienced financial distress during the period 2008 to 2011 conducted earnings management with income maximization patterns. Errors in decision making can be reduced by the existence of a *good corporate governance (GCG)* mechanism. The issue of good corporate governance is motivated by agency theory. It was stated that agency problems arise when the management of a company was separate from its ownership (Kusanti, 2015).

Badolato *et al.,* (2014), found the audit committees with financial expertise were more effective on reducing earnings management. It shows the more audit committees have expertise in finance, the earnings management actions indicated by an increase or decrease in nominal profits can be reduced.

H1: The higher financial distress, the lower-income maximization action, especially, on companies with a high level of audit committee financial expertise.

An effective audit committee can minimize the condition of information asymmetry among shareholders, management, and prevent management from using the information asymmetry conditions for personal gain (Rachmawati & Triatmoko, 2007). The statement was supported by Pangestika & Luna (2014), showed the effectiveness of the audit committee as indicated by the frequency of meetings of the audit committee was able to influence earnings management actions taken by the company. The audit committee increasingly conducts meetings will increasingly understand the problems that occur in the company through brainstorming at these meetings. Therefore, the adverse actions for external parties unlike earnings management can be reduced. POJK No. 55/POJK04/2015 stated the audit committee meets regularly at least 1 (one) time in 3 (three) months.

H2: The higher financial distress, the lower-income maximization action will be, especially, on companies that have high-frequency audit committee meetings.

The one effort is to the shareholders reducing the existence of information asymmetry. It is to form an independent audit committee. POJK No. 55/POJK04/2015 also confirmed the audit committee consists of at least three people, chaired an independent commissioner and members from outside the company. The audit committee here really needs independence on overseeing the financial reporting process (Pamudji & Aprillya, 2010). Audit committee members who are external auditors have an independent tendency on carrying out their duties. Therefore, it is expected to provide an opinion. There is a comprehensive, efficient, and effective control framework clearly documented and consistently applied to prevent material misstatements on financial statements (Paino *et al.,* 2015).

H3: The higher financial distress, the lower-income maximization action will be, especially, on companies that have a high level of audit committee independence.

2 Materials and Methods

The population on the present study is the companies listed on the Indonesia Stock Exchange. The sampling technique used is purposive sampling and data analysis techniques used including the classic assumption test and the *moderated regression analysis (MRA)* test with the following multiple regression equation:

$$Y = \alpha + \beta_1X_1 + \beta_2X_2 + \beta_3X_3 + \beta_4X_4 + \beta_5X_1X_2 + \beta_6X_1X_3 + \beta_7X_1X_4 + \varepsilon \quad (1)$$

Description:

Y = Income maximization

X1 = Financial distress
X2 = Expertise on financial audit committee
X3 = Frequency of audit committee meetings
X4 = Independence of the audit committee
α = Constant
β = Regression coefficient
ε = Error

3 Results and Discussions

Based on the results of data processing with SPSS, the results are presented in the following Table 1.

Table 1
Regression Test Results

Variable	Unstandardized Coefficients		Standardized Coefficients	t	Sig
	B	Std. Error	Beta		
(Constant)	0,089	0,070		1,283	0,210
X_1	-0,065	0,063	-1,229	-1,033	0,310
X_2	-0,005	0,019	-0,056	-0,257	0,009
X_3	-0,008	0,008	-0,191	-0,977	0,337
X_4	0,025	0,027	0,194	0,942	0,024
X_1X_2	-0,046	0,033	-1,021	-1,403	0,041
X_1X_3	0,018	0,013	1,241	1,417	0,167
X_1X_4	-0,017	0,019	-0,963	-0,925	0,032
F count			0,639		0,001
Adjusted R^2			0,440		

Source: Processed Data, 2019

Based on Table 1, the regression equation can be arranged as follows:

$$Y = 0,089 - 0,065X_1 - 0,005X_2 - 0,008X_3 + 0,025X_4 - 0,046X_1X_2 + 0,018X_1X_3 - 0,017X_1X_4 + \varepsilon \ldots\ldots\ldots(2)$$

Financial expertise is able to moderate the effect of financial distress on income maximization. Therefore, it can be concluded H1 is accepted. The frequency of meetings is not a moderating effect of financial distress on income maximization. Thus, the conclusions can be drawn H2 is rejected. Independence is able to moderate the influence of financial distress on income maximization. Then, it can be concluded H3 is accepted.

3.1 The influence of financial expertise possessed by the audit committee on the relationship between financial distress and income maximization

The results show the financial expertise is able to moderate the negative influence of financial distress on income maximization. These results indicate H1 stated the higher financial distress, the lower-income maximization actions, especially, on companies with a high level of audit committee financial expertise received. It indicates a large number of members of the audit committee who have expertise in finance will minimize the possibility of income maximization when the company is experiencing financial distress.

This finding is consistent with Badolato *et al.,* (2014), who found the audit committees on financial expertise were more effective in reducing earnings management. In accordance with agency theory, it shows there is a conflict of interest between the shareholders and management, a *good corporate governance (GCG)* mechanism is needed to reduce the conflict through the actual disclosure of profits. Disclosure of actual profits from management can be triggered by the existence of an audit committee. It has expertise in the financial sector, including the presentation of financial statements. Thus, as to reduce the fraudulent disclosure of information occurs or provide guidance to management in the preparation of reasonable financial statements. The more audit committees have expertise on the financial sector, the earnings management actions indicated by an increase or decrease in nominal profits can be reduced (Pangestika & Luna, 2014).

3.2 The effect of the audit committee meetings frequency on the relationship between financial distress and income maximization

The results show the meeting frequency is not a moderating effect of financial distress on income maximization. These results indicate H2 stated the higher financial distress, the lower-income maximization action, especially, on companies with high-frequency audit committee meetings are rejected.

This result is not in accordance with Pangestika & Luna (2014), showed the frequency of audit committee meetings can reduce earnings management actions taken by management. The results of this study indicate that the frequency of audit committee meetings is not able to provide prevention of earnings management actions when the company is in financial distress. This is due to the audit committee meetings within the company are only mandatory against existing regulations (Pamudji & Aprillya, 2010). The high frequency of meetings only serves as compliance with existing regulatory provisions. They do not guarantee a reduction in income maximization actions when a company experiences financial distress if it is not matched with expertise in good financial sector. The existence of companies have not followed the FSA regulations to meet once in three months or four times a year can be one of the causes of the inability variable frequency of audit committee meetings to reduce fraud actions committed by management (Prabowo, 2014).

3.3 The effect of audit committee independence on the relationship between financial distress and income maximization

The results show the independence is able to moderate the negative influence of financial distress on income maximization. These results indicate H3 stated the higher financial distress, the lower-income maximization action, especially, on companies with a high level of audit committee independence is accepted. This indicates a large number of independent audit committee members will reduce the possibility of income maximization when the company is experiencing financial distress.

An audit committee formed from independent members will encourage management to report according to company conditions. Therefore, income maximization can be minimized. The results of this study are consistent with Pangestika & Luna (2014), obtained the results that an independent audit committee had a negative effect on earnings management conducted by the company. This shows the reason why POJK explained that there were at least three independent parties on the audit committee membership. Pamudji & Aprillya (2010), also obtained results the performance of the audit committee is effective. If its members have independence on expressing attitudes and opinions.

4 Conclusion

Based on the formulation of the problem, objectives, theoretical basis, hypotheses, analysis results, and the discussion has been above presented, it can be concluded the following matters:

a) Financial expertise negatively moderates (weakens) the influence of financial distress on the income maximization actions of mining companies listed on the Indonesia Stock Exchange in 2015-2018. The higher financial distress, the lower actions of income maximization, especially, on companies with a high level of audit committee financial expertise.
b) The frequency of audit committee meetings is not a moderating effect of financial distress on income maximization of mining companies listed on the Indonesia Stock Exchange in 2015-2018. The high frequency of audit committee meetings does not guarantee a reduction in income maximization actions when the company is experiencing financial distress.

c) Independence negatively moderates (weakens) the effect of financial distress on the income maximization actions of mining companies listed on the Indonesia Stock Exchange in 2015-2018. The higher financial distress, the lower-income maximization action, especially, on companies with a high level of audit committee independence.

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