CHAPTER I
INTRODUCTION

A. Background

A Financial statement is the records of company's financial information that contains information about company's performance to communicate financial information to parties outside the corporation. One measure of company performance that is often used as a basis for decision making is the profit generated by the company. The profit measurement is an accrual basis (Subramanyam et al. 1996 in Christiani et al. 2014). The company's management performance is reflected in earnings that are contained in the financial statement. Therefore, earnings information is important information which can be used as a basis for decision making. However, earnings information is often the target of management opportunistic of the company actions to maximize its interests by managing the earnings information and taking benefit from it. In order to anticipate that practice, Alzoubi (2016) said that monitoring mechanisms are needed to align the interest of company's management as well as to mitigate the conflict of interest and any opportunistic behavior generating from it. The behavior of regulating corporate profits in accordance with the wishes of management is known as earnings management.

Earnings management happened because the management of the company wants to make smooth the earnings over time by using accounting strategies by showing the company is in a good performance. There is certain interests of management to do those earnings smoothing such as getting bonuses, promotion, and the others. On the other hand, the stakeholders have no enough detailed information about that since they do not run the company directly. This can lead to a phenomenon called information asymmetry that occurs due to the company’s management has more or better information than corporate stakeholders. Earnings management through information asymmetry can harm the shareholders by having limitation information in terms of the real performance of the company. The shareholders probably do not know the real condition or performance of the company that has been invested by the shareholders and keep investing money because of the fake information. On the other hand, company’s management has more information regarding the real condition of the company and hides that information from the stakeholder. Even though the real information regarding the financial statement of the company is also the right that belong to the shareholder as the party who invest the money in invested company. Moreover, that practice can raise distrust from the corporate stakeholders. It is a must for the company’s management to render the trust to every related party as contained in Qur’an Surah An-Nisa verse 58 as follows:

۞ إِنَّ ٱللَّهَ يَأۡمُرُكُمۡ أَن تُؤَدُّواْ ٱلۡأَمَٰنَٰتِ إِلَىٰٓ أَهۡلِهَا وَإِذَا حَكَمۡتُم بَيۡنَ ٱلنَّاسِ أَن
تَحۡكُمُواْ بِٱلۡعَدۡلِۚ إِنَّ ٱللَّهَ نِعِمَّا يَعِظُكُم بِهِۦٓۗ إِنَّ ٱللَّهَ كَانَ سَمِيعَۢا بَصِيرٗا ﴿٥٨﴾

Meaning: “Indeed, Allah commands you to render trusts to whom they are due and when you judge between people to judge with justice. Excellent is that which Allah instructs you. Indeed, Allah is ever Hearing and Seeing.” (QS. An-Nisa verse 58).

The verse above explains about rendering trust to everyone who has the right to receive it. In terms of this research, the company side or the manager itself should inform the detailed and clear information about the condition of the company to the principal or shareholders through a financial statement without hiding any important information. Those actions needed to take since the shareholders have the right to know information about the company's performance in order to prevent information asymmetry between the principal or shareholder and the agent or manager of the company. Therefore, it is needed to render the trust to prevent asymmetry information that can lead to fraud or scandal like earnings management.

Accounting scandals related to earnings management had ever happened to PT Kimia Farma from Indonesia. Dedhy et al. (2011) explained that after an inspection by Bapepam, the net profit presented in PT Kimia Farma's financial statements for the year ended 31 December 2001 was overstated by Rp32.7 billion, of which 2.3% came from sales and 24.7% from PT Kimia Farma's net profit. Kimia Farma. The reasons for these errors were due to (1) overstated sales in the raw material industry unit of Rp. 2.7 billion; (2) errors in the form of overstated stock of goods amounting to Rp 23.9 billion in the logistics unit center I; and (3) overstated Rp. 8.1 billion in merchandise inventory and Rp. 10.7 billion overstated sales, both of which occurred in the Pharmaceutical Wholesaler unit (Capital Market Supervisory Agency press release dated 27 December 2002). Another case also happened to Transmile Group Berhad from Malaysia in 2007. Abdullah et al. (2012) explained that the problem occurred when the company failed to adhere to the deadline in submitting the audited annual accounts for the financial year ended 31 December 2006 to Bursa Malaysia for public release, where it must be submitted within a period of not more than four months before public release which was on 30 April 2007 for the deadline. The problem was even worse when its external auditor, Deloitte & Touche, via a letter to the Board of Directors (BOD) on 4 May 2007, refused to approve the annual account due to lack of certain supporting documents. In response to that situation, on 7 May 2007, the BOD appointed Moores Rowland Risk Management to conduct a special audit on issues raised by Deloitte & Touche. It was later discovered, amongst others, that the revenues and profits had been overstated not only in year of 2006 unaudited annual accounts but also in the 2004 and 2005 audited annual accounts.

The recent corporate accounting scandals have made the role of auditing in ensuring the quality of earnings that are reported by the company has come under considerable scrutiny (Balsam et al., 2003 in Soliman et al., 2014). At the same time, earnings management has been significant attention by stakeholders and has become a substantial concern in the literature. The concern is related to the impact that can harm any parties, such as corporate stakeholders. Many works of literature have been explained that earnings management masks the truth of financial results and business positions and hides the facts that must be known by stakeholders (Loomis, 1999 in Soliman et al., 2014). Moreover, what actually happens is that the financial statements provided are irrelevant. So that financial performance becomes biased. However, the information presented in the financial statements is very important because it reflects the company's performance and can be used for decision making.

The information in the financial statement which is needed for the economic decision-making of the company is not credible due to the earnings management practice. Earnings management practice has generated a doubt to every party that is related to the users of financial statement such as stakeholders who need to know the real condition of company which is reflected by the financial information. If the financial information is not really suitable for the real condition of the company, the right decision could not be made. This is also exacerbated by the presence of information asymmetry, which makes the stakeholder could not know clearly whether the information is reliable or not. That problem can be solved by audit area such as audit quality and audit committee effectiveness. Audit quality helps mitigate information asymmetry and conflict of interests between management and investors. On the other hand, audit committee effectiveness has a supervisory role in ensuring the quality of financial reporting and corporate accountability.

Auditors are considered to be effective third parties which help reduce information asymmetry and conflicts of interest between management and investors. Auditors have a duty to check the validity of financial statements of the company to detect any oddities from earnings management. Therefore, the auditor is responsible for disclosing transparency in financial reporting processes that in turn generate high-quality financial statements (Soliman et al., 2014). A good audit quality from the process of audit service is needed to restore the trust of financial statement users. Luhgiatno (2008) stated that high audit quality means the auditor can find any misleading financial information in the financial statement, then the company can make an evaluation to prevent any fraud that can occur in the future.

Audit committee effectiveness has an important role in monitoring to ensure the quality of financial statement that will be reported and also ensure corporate accountability (Carcello et al., 2003 in Soliman et al., 2014). In addition, the audit committee within the company will play a role in overseeing the management of the company so that it is better to review financial information such as financial reports so that it can help management take action to prevent various risks. In assessing the effectiveness of the audit committee's performance, there are several characteristics of the audit committee that can be used as performance parameters. As a mediator between the external auditor and the company's board, an audit committee facilitates the monitoring process prevents the information asymmetry between the external auditor and the company's board (Klein, 2002 in Soliman et al., 2014).

This study aims to investigate whether audit committee effectiveness and audit quality are able to influence the practice of earnings management in two different countries, which implement several different aspects in financial accounting standard from each country. Aryati et al., (2015) found that IFRS Convergence can reduce the income smoothing in Indonesia, Malaysia, and Singapore. The different IFRS convergence in each country indicated that there are differences in the implementation or adaptation of financial accounting standards. Further, the different IFRS convergence can reduce the income smoothing, which is one of the earnings management practices. Therefore, this study aims to take Indonesia and Malaysia as the empirical study. Besides that, the empirical study will be on manufacturing companies because manufacturing companies are the largest issuers.

The prior researches, which already study about the relationship between audit committee effectiveness and audit quality on earnings management, showed the inconsistency in the research. Soliman et al., (2014) said that empirical evidence related to the influence of audit quality and audit committee effectiveness on earnings management are inconsistent. According to prior research of Soliman et al., (2014) and Zgarni et al., (2016), which had a limitation on a small sample which is only from one country and recommended to taking companies from a wider range. In order to prevent the limitation and continue the recommendation from prior research, this research takes the sample from manufacturing companies listed in Indonesia and Malaysia to wider the range. Zgarni et al., (2016) also recommended adding an audit fee in future research in order to solve the limitation in the research. The prior research from Soliman et al., (2014) breaks down the variables of audit quality and audit committee into several dimensions as the variable. Audit committee effectiveness consists of audit committee size and audit committee meeting, while audit quality consists of audit fee and firm size. In order to develop prior researches, this research will put Audit committee effectiveness consists of audit committee size and audit committee meeting as the dimensions, and then audit quality consists of firm size and audit fee.

The main focus of this study is to examine the influence of audit quality and audit committee effectiveness on earnings management in Indonesia and Malaysia. Developing prior studies, this study will compare the effect of the independent variable in two different countries: Indonesia and Malaysia, with the title “The Influence of Audit Quality and Audit Committee Effectiveness on Earnings Management” (An Empirical Study on Manufacturing Firm listed in the Indonesia Stock Exchange and Malaysia Stock Exchange year 2016 until 2018).

B. Research Scope

This study focuses on the influence of audit aspects with two dimensions, such as audit committee effectiveness and audit quality. Further, each dimension will have several dimensions as the independent variables that are expected to have an influence on earning management. In the audit committee, there are several dimensions such as audit committee size and audit committee meeting. In audit quality, there are also several dimensions such as audit fee and firm size. This study is also comparing the earnings management in Indonesia and Malaysia.

C. Research Question

The researcher formulated research question based on the explanation above, as follows:

1. Does audit fee have a significant negative influence on earnings management in Indonesia?
2. Does audit fee have a significant negative influence on earnings management in Malaysia?
3. Does firm size have a significant negative influence on earnings management in Indonesia?
4. Does firm size have a significant negative influence on earnings management in Malaysia?
5. Does audit committee size have a significant negative influence on earnings management in Indonesia?
6. Does audit committee size have a significant negative influence on earnings management in Malaysia?
7. Does audit committee meeting have a significant negative influence on earnings management in Indonesia?
8. Does audit committee meeting have a significant negative influence on earnings management in Malaysia?
9. Is there any difference in earnings management between Indonesia and Malaysia?

D. Research Objective

The objective of this study needs to be achieved by the researcher, as follows:

1. To examine whether the audit fee has a significant negative influence on earnings management in Indonesia.

2. To examine whether the audit fee has a significant negative influence on earnings management in Malaysia.
3. To examine whether the firm size has a significant negative influence on earnings management in Indonesia.
4. To examine whether the firm size has a significant negative influence on earnings management in Malaysia.
5. To examine whether the audit committee size has a significant negative influence on earnings management in Indonesia.
6. To examine whether the audit committee size has a significant negative influence on earnings management in Malaysia.
7. To examine whether the audit committee meeting has a significant negative influence on earnings management in Indonesia.
8. To examine whether the audit committee meeting has a significant negative influence on earnings management in Malaysia.
9. To examine and compare the earnings management between Indonesia and Malaysia.

E. Research Benefit

The researcher hopes this study can bring benefit for knowledge and related parties. The expected benefit of this study as follows:

1. Theoretical Benefit

a. This study provides developing research about determinant factors that affect auditor turnover intention related to social exchange theory.

b. This study provides information that is expected to contribute as a reference for future research.

2. **Practical Benefit**

   a. This study expected for every related parties to prevent asymmetry information in financial report.

   b. This study provides developing research about determinant factors that affect earning management in the audit aspect related to agency theory. It also provides information that is expected to contribute as a reference for future research.