

IMPACT OF THE AUDIT COMMITTEE AND AUDIT QUALITY ON BANKING EARNINGS QUALITY

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ABSTRACT

The purpose of the research is to prove empirically how the characteristics of the Audit Committee, namely the characteristics of independence, size / number, and financial expertise (accounting), can improve the quality of earnings generated by banks listed on the Indonesia Stock Exchange. The research method used is quantitative description using annual report data. The research sample is Banking companies in the period 2019-2022. The results of this study prove that the independence and number of audit committees can improve the quality of banking profits, while the expertise and accounting expertise of the audit committee cannot improve or reduce the quality of Indonesian banking earnings

Keywords: *Earnings quality, Audit Committee Characteristic*

1. INTRODUCTION

These financial statements should provide reliable, timely and relevant information to help users make important decisions, especially investment decisions (Kibiya et al., 2016). This suggests that information should be current and clear, with additional evidence included as supporting footnotes to aid in explanation. The financial information presented should not contain significant errors or biases, including those that could mislead users of the financial information (Gina et al., 2014). Therefore, the information needs to present business activities and other events appropriately, reproduce the basic substance of events, and carefully present estimates and uncertainties by using appropriate disclosures (Gina et al., 2014). The relevance and reliability of accounting earnings determine the accuracy of this information. Corporate misconduct and delinquency still occur in Malaysia. Large businesses such as Transmile Group Bhd., Malaysian Airlines Systems, LFE Company Berhad, Promto Bhd. and MEMS Technology Bhd. are all linked to a large number of financial improprieties in Malaysia (Hasnan et al., 2013). (Mohamed Sadique et al., 2010) talked about a survey conducted by Pricewaterhouse Coopers, which controlled 48% of companies in Malaysia and found that 62% of the companies were involved in fraud.

Current earnings help predict future earnings and the ability to pay dividends in the future, and management discretionary behaviour and economic fundamentals affect the volatility of firm-specific returns (Dempster & Oliver, 2019). Therefore, we can say that users consider earnings quality as one of the reliable and most important indicators for making financial forecasts about returns and for pointing out data asymmetries.

After facing the COVID-19 pandemic, the current banking conditions began to experience an increase in profits. During the pandemic, banking profits have decreased due to investors' perception that the government has not taken serious action against COVID-19. After the Covid-19 pandemic occurred, investors tended to withdraw their funds from the capital market,

which resulted in a decrease in profits (Mayasari et al., 2020). Banks face two problems as a result of the Covid-19 pandemic, the first is the closure or restriction of banking service offices, which causes branch offices (KC) to take over services previously provided by sub-branch offices (KCP). The second is an increase in operational costs due to the need to provide project support tools such as masks, disinfectants, multivitamins, and hand sanitizers in sufficient quantities to maintain environmental health (Mayasari et al., 2020).

To support the increase in banking profits, an Audit Committee that has characteristics can improve earnings quality. As in the research of (Baxter & Cotter, 2009) proves that the characteristics of Audit Committee independence are significantly related to earnings quality measures (Kharashgah et al., 2019). The next Audit Committee characteristic is financial expertise (accounting) which is proven to have a positive relationship with earnings quality (Rafique Yasser & Al Mamun, 2016); (Bilal et al., 2018). The characteristics of the number of Audit Committees owned by the Company can affect earnings quality. According to (Bala, 2015) the results of his research have proven that the number of Audit Committees of more than three (according to the law) owned by Nigerian consumer goods companies can improve earnings quality. The reason is because larger Audit Committee members will more effectively monitor management activities, and they are also better at maintaining the financial reporting process (Bala, 2015). Based on some of the research results described in the previous alinea on various company sectors, except banking, the results of the research are different or inconsistent. This prompted the author to conduct a re-study by taking banking sector companies.

Based on the description of the research problem above, the research questions posed are as follows: (1) Do the characteristics of audit committee independence have a positive impact on earnings quality?; (2) Do the characteristics of the financial expertise (accounting) of the Audit Committee have a positive impact on earnings quality?; (3) Does the size characteristic of the Audit Committee have a positive impact on earnings quality?

This study provides benefits to provide insight into the importance of the role of the characteristics of the Audit Committee in carrying out its duties in Indonesian banking. The characteristics include independence, financial and accounting expertise, and the number of audit committees.

Earnings Quality

Earnings quality is defined by (Al-Momani, 2018) as earnings stability, i.e. the extent to which earnings performance is maintained in subsequent periods. Earnings quality is shown when earnings reflect the company's performance and provide an indication of the company's future performance (Al-Othman, 2019), thus emphasizing earnings quality is the company's current ability to generate real profits. a picture of the company's performance and survival in the future. According to users of financial statements, creditors view earnings as a measure of credit decisions, while shareholders view earnings as a measure of management efficiency.

Audit Committee

Audit committees have long been seen as essential to an organization's ability to support executive management oversight by performing oversight duties pertaining to internal audit, finance, and accounting. One of the main reasons for using an Audit Committee is to further improve earnings and FRQ (Calomiris & Carlson, 2016). According to (Abbadi et al., 2016); (Calomiris & Carlson, 2016), there is a negative relationship between misleading information and gaining the trust of executives. Meanwhile, (Har Sani Mohamad et al., 2012) found a strong

relationship between the Audit Committee and earnings quality. Therefore, it requires the characteristics that exist within the Audit Committee to support the duties and functions of the Audit Committee, including Independence, Financial and Accounting Expertise, and Audit Committee Size.

Agency Theory

Financial statements can be a means of monitoring the contract between agents and principals, and can reduce uncertainty. One of the pieces of information contained in financial statements is profit. Earnings are an important element in the agency contract. Earnings are related to bonus planning, debt covenants, and political costs (Scott, 2012). If earnings quality is low, the agency contract is ineffective and inefficient, resulting in high agency costs. Information asymmetry also causes agency problems, namely conflicts of interest between principals and agents, conflicts between majority and minority shareholders. Efforts to reduce agency problems will lead to agency costs, namely monitoring costs, bonding costs, and residual losses (Jensen & Meckling, 1976). Agency problems can be reduced by implementing corporate governance mechanisms, one of them is by supervising the company's operational work carried out internally and externally. Internal supervision is carried out by the Board of Commissioners and the Audit Committee. The purpose is to control the opportunistic behaviour of agents (management) in the preparation of financial statements.

Supporting internal supervision by the Audit Committee, several characteristics that the Audit Committee has to maximize the effectiveness of the Audit Committee's work, including independence, financial expertise (accounting), and the number of Audit Committees.

The Agency hypothesis states that the presence of an independent audit committee can raise the caliber of corporate earnings because of the committee's greater independence, which is comparable to the board of directors' improved oversight of shareholders' power. The agency theory states that the audit committee director's independence is crucial to effectively overseeing management conduct. It has been emphasized that the independent Audit Committee has no financial perks or personal ties to the management. Additionally, it is more likely that members of the Independent Audit Committee will act impartially and independently without interference from management, as noted by (Kharashgah et al., 2019). Furthermore, additional research findings suggest that the growing number of independent directors on the Audit Committee may be the cause of the reduction in the quality of financial statements (Wan Mohammad & Wasiuzzaman, 2019). Thus, the following is the theory proposed:

H1: Audit Committee independence has a positive effect on banking earnings quality

If the members of the audit committee are not only independent but also possess specialized knowledge in areas like finance and accounting, their work on value will be able to oversee the company's operational activities more successfully. According to research findings, the quality of earnings can be impacted by the Audit Committee's accounting and financial knowledge, professional certifications, and higher education (Hamdan et al., 2013). Research from (Inaam & Khamoussi, 2016a) (Kharashgah et al., 2019) indicates that when the Audit Committee is composed of individuals with experience in finance and accounting, there is a reduction in profit management and an increase in earnings quality.

Financial statement interpretation and comprehension are improved by audit committees with experience in finance and accounting. Furthermore, they possess the ability to pose pertinent queries and press management and external auditors to enhance the caliber of financial

reporting (Kharashgah et al., 2019). Consequently, corporation reporting will be transparent. Consequently, agency problems in agency theory are restricted to information flow problems. The aforementioned justifications indicate that the members of the Audit Committee need to possess the necessary training and expertise, particularly in the areas of accounting and audit. With this knowledge, the Audit Committee's performance can be enhanced and the quality of profits from the financial statements can rise, leading to the following hypothesis:

H2: Financial expertise (Accounting) Audit Committee has a positive effect on banking earnings quality

The estimate of the review committee in terms of the number of individuals serving is considered as a sign of the assets accessible for the adequacy of the inspector committee. Where a expansive number of review committees can discover and unravel issues that happen in budgetary detailing. This is often since degree features a propensity to supply the essential synergies and differing qualities of skill and experiences to guarantee successful and productive checking carried out by the Review Committee. The least number of individuals of the review committee proposed by the Code of Corporate Administration of Jordan is three. The same comes about were illustrated by inquire about (Hamdan, 2020); (Inaam & Khamoussi, 2016); (Hamdan et al., 2013) which demonstrated that the huge measure of the Review Committee can diminish the control of benefits so that the benefits created in quality monetary explanations can be trusted. Subsequently, this inquires about proposes a speculation:

H3: Audit Committee size has a positive effect on banking earnings quality

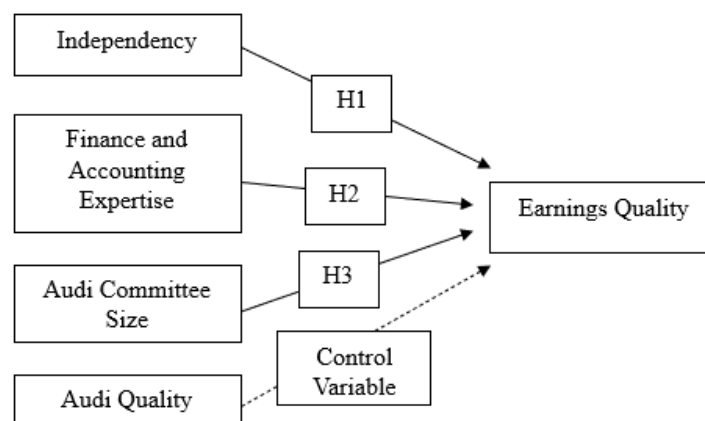


Figure 1. Conceptual Framework

2. RESEARCH METHOD

Companies in the financial industry listed on the Indonesia Stock Exchange (IDX) for the 2019–2022 timeframe comprised the study's population. Purposive sampling was employed in order to obtain a sample that met the predefined requirements, which included: a. Listed on the IDX continuously in the 2019-2022 period; b. Did not experience losses in the 2019-2022 period; c. The financial statements use the rupiah currency (symbol: IDR); d. Did not conduct a merger in the 2019-2022 period; e. Not conducting an IPO within the 2019-2022 period; f. Not experiencing delisting from the IDX in the 2019-2022 period. Based on the criteria stated above, the sample of companies that entered the criteria was 29 companies with 116 observations.

The research model uses panel data regression analysis with the panel data regression equation as follows: $KL_t = a + bIND_t + cKKA_t + dUKA_t + eKAP_t + e \dots\dots\dots(1)$

Notes:

KL = Earnings quality

IND = Independence

KKA = Financial and accounting expertise

UKA = Audit Committee Size

KAP = Audit Quality

e = error

Table 1. Operationalization of variables

Variable	Measurement
1. Dependent Variable	
Earnings Quality (Penman & Zhang, 2002)	<i>Operating Cash Flow / Net Income</i>
2. Independent Variable	
Independency (Khaled Ahmad Kharashgah, Noor Afza Binti Amran, & Rokiah Binti Ishak, 2019)	Measured by dividing the number of independent members of the Audit Committee by the total number of Audit Committee members.
Finance and Accounting Expertise (Khaled Ahmad Kharashgah, Noor Afza Binti Amran, & Rokiah Binti Ishak, 2019)	Measured by dividing the number of Audit Committee members who have financial and accounting expertise by the number of Audit Committee members.
Audi Committee Size Bilal, Songsheng Chen, dan Komal, Bushra Komal (2018)	Measuring by adding up the Audit Committee
3. Control Variable	
Audit Quality	Measured by dummy variable, where 1 for Big 4 KAP and 0 for non-Big 4 KAP.

Research using panel data regression techniques which according to (Hsiao, 2003) has several advantages, namely: a) Panel data can solve the problem of a larger spectrum and unbiased, which cannot be solved using cross-sectional or time series data alone; b) It generates more degrees of freedom and reduces the level of collinearity between explanatory variables, resulting in increased estimation efficiency. So, with these virtues, the classical assumption test on the panel data model does not have to be done (Gujarati & Porter, 2015); (Ekananda, 2016). Pooled OLS, within-group fixed effects, random effects, and fixed effects least square dummy variable (LSDV) models are the four models utilized in panel data regression. (Gujarati & Porter, 2015). The selection of the model to be used is selected by the model specification test. There are two specification tests, namely fixed effects or random effects.

Furthermore, after the research model has been determined, followed by a significance test, namely the F test and the t test. The F test and t test are carried out using the probability of t count, when the prob < 10% sig level. concluded Ho is rejected and Ha is accepted. After the significance test, it is continued to determine the extent to which the research model is able to explain the variation of the dependent variable, called the coefficient of determination (R^2). The value of R^2 is usually in the range 0-1, so it is said that the closer to 1, the better the research model, and vice versa.

3. RESULTS AND DISCUSSIONS

Panel Data Model Analysis Technique

Chow Test. The aim is to understand which fixed effect or common effect model is best applied in this study.

H0: Common Effect

Ha: Fixed Effect

If the chi-square probability shows a result $< 5\%$, then H0 is not accepted. So it can be concluded that the study uses a fixed effect model.

Table 2. Redundant Fixed Effect-Likelihood Ratio Model Test Results
 Source: output Eviews 12

Effect Test	Prob.
Cross-section F	0.0324
Cross-section Chi-square	0.0031

From the table above, it is concluded that the right model is fixed effect, because the probability value is $< 5\%$. Then the Hausman test is carried out with the criteria:

H0: Random Effect

Ha: Fixed Effect

If the chi-square probability shows a result $< 5\%$, then H0 is not accepted. So it can be concluded that the research uses a fixed effect model.

Table 3. Hausman test results Model
 Source: output Eviews 12

Test Summary	Chi-Sq.Statistic	Prob.
Cross-section random	0.852395	0.0931

From the table above, it is concluded that the right research model is random effect compared to fixed effect, because the random cross-section value has Prob $> 5\%$. Estimation results based on panel data regression:

Table 4. Model Estimation Result (Random Effect Model)
 Source: output Eviews 12

Variable	Coefficient	t-stat.	Prob.
C	65.16170	1.051848	0.0295
IND	68.90929	-1.144373	0.0255
KKA	-6.527138	0.238325	0.8122
UKA	3.003678	0.401788	0.0688
KAP	13.29406	0.301126	0.0764
R ²	0.380812	DW stat.	2.276150
Adjusted R ²	0.142089		
F-stats.	1.595203		
Prob. F-stats.	0.047179		

The research trial with the application of panel data analysis aims to gain an understanding of the effect of independence, financial and accounting expertise, audit committee size and banking audit quality on the quality of earnings generated. The research model used is a random effect model with panel data regression.

$$KL = 65.1617 - 68.9092*IND + 6.5271*KKA + 3.0036*UKA + 13.2940*KAP$$

Based on the regression equation, the constant coefficient value is 65.1617. The independent variables in the model that have an impact on firm value are defined as:

Table 5. Hypothesis Result
 Source: output evIEWS12

Hypothesis	Hypothesis Explanation	Prob. Value	Conclusion
H1	Audit Committee Independence has a positive effect on banking earnings quality	0.0255	Accepted
H2	Audit Committee financial and accounting expertise does not have a positive effect on the quality of banking earnings	0.8122	Rejected
H3	Audit Committee size has a positive effect on banking earnings quality	0.0688	Accepted

H1: Audit Committee Independence has a positive effect on banking earnings quality

The result of proving hypothesis 1 is that the independence of the Indonesian banking audit committee is proven to improve the quality of banking profits. This is because the high proportion of independent audit committees can increase the monitoring role of the audit committee on the quality of corporate earnings (Alkebsee et al., 2022).

H2: Audit Committee financial and accounting expertise does not have a positive effect on banking earnings quality

This research has provided evidence of accepting hypothesis 2, namely audit committees that have expertise in finance and accounting do not improve the quality of banking profits. These results support the research of (Bala, 2015) that the characteristics of financial and accounting expertise possessed by the Audit Committee in Nigerian food and beverage companies cannot improve earnings quality. These results are reinforced by the reality that occurs in the Indonesian banking industry, that audit committee members who have financial and accounting expertise are no more than two people out of five Audit Committees. In addition, the reason why the Audit Committee's financial and accounting expertise does not improve earnings quality is because the experience of being an Audit Committee in several companies that can be proven to improve earnings quality is 350 FTSE companies in the UK as a research sample (Ghafran & Yasmin, 2018).

H3: The size of the Audit Committee has a positive impact on banking earnings quality

The results of Hypothesis 3 are consistent with the research conducted by (Bala, 2015), which established that the presence of more than three Audit Committees (as required by law) within Nigerian consumer goods corporations can enhance the quality of earnings. Additionally, it bolsters the findings of a study by (Amin et al., 2018), which found that large audit committees are seen to be more successful at monitoring since they typically have a diverse range of members who can keep a closer eye on financial reporting methods.

Gives a conclusion that review quality proxied by a sham variable for a esteem of 1 for banks whose monetary explanations are reviewed by KAP The Enormous 4 and a esteem of for banks whose monetary articulations are reviewed by KAP Non-Big 4. The result of the research is that KAP The Big 4 can improve the quality of banking profits, the reason is that the public still considers that companies audited by KAP The Big 4 provide reliable audit results so as not to mislead their readers (Hasan et al., 2020).

4. CONCLUSIONS AND SUGGESTIONS

The result of the study is that the independence of the Indonesian banking audit committee is proven to improve the quality of banking profits. This is because the high proportion of independent audit committees can increase the monitoring role of the audit committee on the company's earnings quality. The Audit Committee that has expertise in finance and accounting cannot improve the quality of banking profits due to the experience of being an Audit Committee in several companies that can be proven to improve the quality of profits of 350 FTSE companies in the UK as a research sample. The characteristics of the number of Audit Committees can improve earnings quality because large Audit Committees are believed to be more effective in monitoring because they tend to include members with diverse expertise to monitor financial reporting practices more intensely.

Due to the limitations of the research, which only included three audit committee criteria, additional characteristics including gender, nationality, and job experience are added in subsequent studies which can improve earnings quality.

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