**Real Earnings Management and Audit Committee Characteristics**

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**ABSTRACT**

Whether audit committee (AC) could discharge its responsibility effectively in monitoring financial reporting process has been an important issue in accounting literature. This paper examines whether AC characteristics are important factors in constraining earnings manipulation. In particular, we examine the effect of AC competence, independence, meeting and size on real earnings management. The sample is public firms listed on Bursa Malaysia over the period 2014-2017. Our results show that AC competence is important characteristic that could curb real earnings management. As the level of competence increases, the level of real earnings management decreases. We also find that AC meeting is positively associated with real earnings management. The result suggest that AC meets more often when there are issues in financial reporting. However, AC independence and size have no relationship with real earnings management. This study provides insights on the role of AC with policy implication on regulator.

**Keywords:** Real earnings management, audit committee, Malaysia

**INTRODUCTION**

Many studies have tried to establish evidence as to the relationship between board characteristics and financial reporting quality. Earnings management is among the measures used in the studies as a proxy for financial reporting quality. Earnings management can be defined as the use of judgment by the management in the process of preparing financial report with the intention to mislead users of financial information with regard to firm actual economic performance (Healy & Wahlen, 1999).

Malaysia issued its Code on Corporate Governance in 2000. The objective is to provide public listed firms with the principles and best practices of good governance. In addition, it provides guidelines for optimal corporate governance structures and internal processes. The compliance with the Code is mandatory for all public listed firms to enable the shareholders and the public to assess and determine the standards of corporate governance. In 2007, a revision of the Code was issued as an effort to strengthen corporate governance practices by improving the quality of board of directors. It is to ensure that the board of directors discharge their roles and responsibilities effectively. Subsequently, the Code was again revised in 2012 to uphold financial reporting integrity through strengthening board structure and composition. The Code was again revised in 2017 to ensure it remains relevant.

It specifies the importance of the establishment of audit committee (AC), the expertise and the independence of AC members.

AC, a sub-committee of the board of director, is entrusted with the responsibility to safeguard the integrity of financial reporting. It is necessary for the AC to be transparent, focus and independent in order to oversee the financial reporting process. This can only be achieved when the AC possess high quality characteristics. In accounting literature, AC characteristics have been the important subject of many studies. Abbott et al. (2003), Carcello et al. (2002) and Lary and Taylor (2012) examine the association of AC characteristics with audit related matters. Abbott et al. (2004), Aier et al. (2005), Farber (2005) and Beasley (1996) examine the effect of AC characteristics on the integrity of financial statements.

In this paper, we extend the literature to examine the effect of AC characteristics on the quality of financial reporting of Malaysian firms. In particular, we examine the effect of AC competence, independence, meeting and size on real earnings management. Our sample is public firms listed on Bursa Malaysia. The data is 1,178 firm-year observations over the period 2012-2015.

The remainder of this paper is organized as follows. The next section describes the literature review and hypothesis development. Section 3 is the research method. Section 4 presents the results and the final section is the conclusion.

**LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT**

**Real Earnings Management**

Earnings management is the practice of using judgement and structuring transactions in order to alter financial reports to misrepresent the underlying economic performance (Healy & Wahlen, 1999). Literature indicates two methods of engaging earnings management. One is known as accrual-based earnings management. Accrual is defined as the difference between earnings and cash flow from operating activities. It can be classified into discretionary and non-discretionary. Discretionary accruals are non-obligatory expenses that managers can choose to adjust cash flows. Non-discretionary accruals are accounting adjustment to affect cash flows as mandated by accounting regulation.

Second is known as real earnings management. This involves real activities manipulation that is the departure of normal operational practices. This is to mislead some stakeholders into believing that certain goals are achieved through normal operational activities. These real activities manipulation can reduce firm value as increasing earnings in current period would have a negative effect on cash flows in future periods. Real activities manipulation could be achieved through the manipulation of sales, production cost and discretionary expenses. Sales of the current period is manipulated through the use of favorable credit terms and discounts to increase reported earnings. Similarly, reported earnings can be increased in the current period by increasing production as such cost per unit decreases. For discretionary expenses, corporate managers may utilize expense at discretion such as selling, administrative and general expense; advertising expense; research and development expense for the purpose to increase short-term reported earnings (Roychowdhury, 2006). Several studies indicate that firms engage in various real activities to manage earnings. Dechow and Sloan (1991) and Bushee (1998) reveal that managers reduce spending on R&D to increase short term earnings. Graham et al. (2005) find that firms reduce discretionary expenditures to meet earnings target.

**AC Characteristics**

The Malaysian Code on Corporate Governance (MCCG) provides principles to support the company to achieve its goals and to prevent unwanted conflict. These principles when properly embraced would help the company produce long term value. One of the principles is concerned with AC effectiveness. In the literature, it is argued that AC effectiveness is dependent on its characteristics namely AC competence, AC independence, AC meeting and AC size.

AC is the key role in a company’s governance structure. Hence, AC members must be financially literate and have skills necessary to understand financial reporting process. Without financial expertise, AC will not be able to effectively monitor financial reporting process (Abbot et al., 2004; Aier et al., 2005; Carcello & Neal, 2002). According to McMullen and Raghunanthan (1996), AC members with financial expertise are able to curb financial problems. This is possible as they would demand high quality audit (Abott et al., 2003). Furthermore, it is shown that corporate governance is strengthened when AC members have financial expertise (Defond, Hann & Hu, 2005). Abdul-Manaf et al. (2018) reveals that financial reporting quality is greater when AC members are more financially literate. Bedard et al. (2004) document a negative relationship between earnings management and AC competence. With necessary knowledge and skills, we expect AC members are able to curb the practices of real activities manipulation. Therefore, we hypothesize that:

H1: AC competence is negatively related to real earnings management.

AC independence refers to the extent AC consists of independent directors. Independent directors are those who are not current and former employees, are not relatives of management, and do not receive compensation from the firms (BRC, 1999). The MCCG (2017) recommends that AC should comprise only independent directors. This would enable AC to oversee and monitor financial reporting process more effectively. This is consistent with the requirements in many countries such as the USA, the UK and European Union that demand firms to have independent directors as the majority of AC members (Zaman et al., 2011). Studies indicate that AC independence is associated with good governance. Restatement of financial statements (Abbott et al., 2004; Farber, 2005) and fraud (Beasley, 1996) are less likely in firms with high presentation of independent directors in AC. High audit quality is also observed in firms with larger number of independent directors (Ghafran & O’Sullivan, 2013). With respect to the practice of discretionary accrual to manage earnings, Salleh and Che Haat (2014) reveal that AC independence is able to curb earnings management. Through greater monitoring, we expect real earnings management is less in firms with greater AC independence. Therefore, we hypothesize that:

H2: AC independence is negatively related to real earnings management.

Frequent AC meeting has been argued as an effective practice of good governance. This is to ensure that AC members are provided with more time to monitor financial reporting process more effectively. AC with more frequent meetings is often regarded as more effective (Zaman et al., 2011). Studies have provided results that support the argument. Xie et al. (2003) show that AC meeting frequency is associated with reduced level of discretionary accrual. Garcia et al. (2012) find that the opportunity to detect mistakes in financial reporting is greater when AC meets more often. Inaam et al. (2012) report that AC is able to limit sale manipulation when meetings are held more often. Based on the abovementioned arguments, we hypothesize that:

H3: AC meeting is negatively related to real earnings management.

It has been argued that AC is more effective as its size increases. More AC members are more likely to bring diversity of views and skills. AC with large number of members would have sufficient skills and this means they are more capable to resolve issues in financial reporting (Li et al, 2012). Xie et al. (2003) show that earnings management is lower in firms with larger AC size. Similarly, Ghosh et al. (2010) document that firms with large AC size are less likely to engage in earnings management. With respect to real earnings management, we expect AC size is also an important factor for AC effectiveness. Therefore, we hypothesize that:

H4: AC size is negatively related to real earnings management.

**RESEARCH METHOD**

Our sample consists of 1,178 firm-year observations of non-financial firms listed on Bursa Malaysia over the period 2014-2017. This study uses the annual reports and financial database in gathering the necessary information. The data on company annual reports is retrieved from the Bursa Malaysia website ([www.bursamalaysia.com](http://www.bursamalaysia.com)). The financial data is retrieved from the Thomson Advance Database. We employ the following regression model:

REMit = α1 + β1ACCOMPETENCEit + β2ACINDEPENDENCEit + β3ACMEETINGit + β4ACSIZEit + ɛit.

REM is the level of real earnings management. Our measure for real earnings management is based on the method proposed by Roychowdhury (2006). Real earnings management is measured by abnormal cash flow from operation (CFO), which is the difference between actual CFO and estimated CFO. Following is the formula used to compute estimated CFO:

**Estimated CFO** = CFOt/At-1 = α0 + α1(1/At-1) + β1 (St/ At-1) + β2 **(∆S/** At-1**)+** Ɛt

Where:

|  |  |
| --- | --- |
| CFO | = cash flow from operation |
| At-1 | = total assets for the previous year |
| St | = sales for a current year  |
| ∆S  | = changes in sales which calculated as sales in current year minus sales in a previous year |

ACCOMPETENCE is AC competence. It is the percentage of AC members who have accounting or finance background or experience. ACINDEPENDENCE is AC independence which is measured by the number of AC members who are independent directors. ACMEETING is AC meeting which is measured the number of meeting held during the year, and ACSIZE is AC size. We measure AC size as the number of AC members.

**RESULTS**

Table 1 presents the descriptive statistics. Real earnings management has a minimum value of 0.001 and a maximum value of 4.742 with mean of 0.698. The mean of AC competence is 0.377 which indicates that many AC members are not financial expertise. AC independence has a mean value of 2.979. The mean values for AC meeting and AC size are 5.046 and 3.228, respectively.

Table 2 presents the regression results for real earnings management on AC competence, AC independence, AC meeting and AC size. The adjusted R2 is 0.01. It shows that AC competence has a significant and negative relationship with earnings management at 5 percent level. The coefficient is -0.249.The result suggests that AC members who are financially literate are able to detect and reduce the activities of real earnings management. Therefore, the results confirm hypothesis 1 that states AC competence is negatively related to real earnings management. Furthermore, the results show that the coefficient on AC independence is -0.007. However, the relationship between AC independence and real earnings management is not statistically significant. It appears that AC independence is not an important factor to address real earnings management. Hence, hypothesis 2 that states AC independence is negatively related to real earnings management is rejected.

**Table 1: Descriptive Statistics**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Variables | Mean | Median | Min | Max |
| REM  | 0.698 | 0.552 | 0.001 | 4.742 |
| ACCOMPETENCE | 0.377 | 0.333 | 0.000 | 1.000 |
| ACINDEPENDENCE | 2.979 | 3.000 | 0.000 | 6.000 |
| ACMEETING | 5.046 | 5.000 | 1.000 | 11.000 |
| ACSIZE | 3.228 | 3.000 | 2.000 | 6.000 |

**Table 2: Regression results for Earnings Management on AC Competence, AC Independence, AC Meeting**

**and AC Size**

|  |  |  |  |
| --- | --- | --- | --- |
|  | Coefficient |  | P-value |
| Intercept | 14.64 | \*\*\* | 0.000 |
| ACCOMPETENCE | -0.250 | \*\* | 0.013 |
| ACINDEPENDENCE | -0.007 |  | 0.769 |
| ACMEETING  | 0.046 | \*\*\* | 0.000 |
| ACSIZE | 0.004 |  | 0.927 |
| Adjusted R2  |  0.01 |  |  |
| n | 1,178 |  |   |

Our results also show that AC meeting is significantly and positively related to real earnings management. Hypothesis 3 that states AC meeting is negatively related to real earnings management is rejected. This result can be interpreted as that real earnings management is regarded as an issue that requires the attention of AC. Therefore, AC meets more often when there are more issues on real earnings management that need to be addressed. Finally, we find that AC size has no significant relationship with real earnings management. It shows that AC size is not an important characteristic to curb the activities of real earnings management. Hence, hypothesis 4 that states AC size is negatively related to real earnings management is rejected. Overall, our results reveal that AC competence alone is the important factor to address issue on real earnings management.

**CONCLUSION**

Whether AC is able to effectively monitor financial reporting process is an important issue in corporate governance. This paper addresses the issue by examining the effect of AC competence, AC independence, AC meeting and AC size on real earnings management. Our sample is 1,178 firm-year observations of non-financial firms listed on Bursa Malaysia over the period 2012-2015. We find that only AC competence is an important AC characteristic that could hinder real earnings management. As the level of competence increases, the level of real earnings management decreases. Our results also show that high real earnings management is observed in firms with high AC meeting. This can be interpreted as that AC members meet more often as they need to address more financial issues. With regard to AC independence and size, there is no significant relationship with real earnings management. This result suggests that AC competence alone is the important characteristic to constrain real earnings management.

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