

## **An Investigation of Audit Committee Characteristics on Audit Quality towards the Changes on Real Earnings Management: Evidence from Jordan**

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### **Background of the Study**

The regulators' trust in financial statements was affected because of the WorldCom accounting scandals and owing to the accounting scandals that occurred in the US companies such as (Waste Management, Sunbeam, Cendant, Enron, and WorldCom), the main cause of these fraudulent accounting scandals was generally attributed to the earnings management (e.g. Cullinan, 2004). The media was reasonably wondering about the purposes that made the auditors conceal these unusual accounting transactions. Also, the financial reports are considered significant characteristics of the communication in the capital market; to which the auditor is considered as an effective third party role who helps to reduce information asymmetry and the conflict of interests that arise between investors and the management of the company (Kitiwong, 2014).

Subsequently, the downfall of several high-profile corporations due to the financial misdemeanors of their managers, more attention has been devoted to real earning management and its relationship with the audit quality in the world (Abdulmalik & Che-Ahmad, 2016; Osemeke & Adegbite, 2016). Especially, in developing countries such as Jordan which has been affected by the financial crises in the financial market of the recent decade. Thereafter, the investors have repeatedly questioned the role of both the audit committee and the external auditors because the audited financial reports have been confirmed to be illusive in several recent financial scandals (Alves, 2013).

Moreover, (Habbash, 2010) contended that earnings management revealed the exact business' financial performance and covered the facts from stakeholders. Rusmin, (2010) added that practicing the earnings management reduced the trustworthiness of the investors about the financial reporting quality by preventing the effective flow of the capital in the financial markets.

From heretofore, an increasing number of studies embarked upon addressing earnings management. Corporate stakeholder's attention had applied significantly a great

amount of attention to earnings management. The main aim of the present study is to investigate the effect of the audit committee and audit quality on earnings management in a developing country like Jordan. Thus, there is a need to employ the advanced technique to examine the influence of the audit quality on an audit committee in relation to the earnings management. The reason is that; it has been ascertained that the complementary functions of the characteristics of an audit committee related to the audit quality are complex. It goes beyond a direct relationship and permits further research to be carried out to explore the effect of the audit committee and audit quality on earnings management (Goodwin-Stewart & Kent, 2006).

In addition, this study adds value to the agency theory by providing initial insight into how the complementary effects of the characteristics of an audit committee and audit quality can reduce the agency conflicts and limit the earnings management. The literature on the relationship between an audit committee, audit quality, and real earnings management was, therefore, reviewed. Based on this assumption formulated in the previous studies, a framework was purposed to exhibit how an audit quality can mediate the association between the characteristics of an audit committee and real earnings management. This was an issue that received limited attention to the prior literature. The proposed framework in the present study is expected to be tested using mediation analysis advanced in the prior studies in the social psychology literature (Baron & Kenny, 1986; Hayes & Rockwood, 2017; Holmbeck, 1997; Wu & Zumbo, 2008).

## **Literature Review**

### **Agency Theory**

Agency theory originated from the study of Berle and Means (1932) and was advanced by Jensen and Meckling (1976). Agency theory has been broadly employed in the managerial studies and appeared to be the dominant paradigm in several aspects of the corporate governance research (Dedman, 2004; Davis, Schoorman, & Donaldson, 1997). Agency theory has been used in the prior literature to create a link between the audit committee and real earnings management and likewise between the audit quality and real earnings management (DeFond & Zhang, 2014; Menon & Williams, 1994).

Agency theory proposes that the primary duty of the audit committee is to confirm that managers are acting in the best interests of shareholders. DeFond and Zhang (2014) affirmed that higher audit quality provides better assurance to reduce real earnings management as well as manipulation of financial statements. It has been maintained that external auditors play a significant role in corporate governance, which serves as a complementary mechanism for enhancing the legal protection of shareholders (Kausel & Slaughter, 2011). This may, in turn, reduce agency conflict between management and stakeholders because shareholders depend heavily on external auditors' monitoring efforts.

The present study proposes that the characteristics of an effective audit committee demand better audit assurance from the external auditors to provide the real earnings management as the characteristics of an audit committee and audit quality are two complementary monitoring mechanisms (Al-dhamari, Almagdoub, & Al-gamrh, 2018; Goodwin-Stewart & Kent, 2006).

### **Audit Committee Characteristics**

The audit committee is one of the board's committees that are constituted to help boards and to carry out the specific duties. The role of the audit committee, in particular, is

directly related to overseeing the financial reporting and auditing activities (Dobija, 2015). Therefore, given this role of the audit committee, it is expected to contribute to improving the quality of audit services.

Moreover, Rickard (1993) describes the Audit Committee that is consisted of a group of senior staff, chaired by the chief executive officer or his deputy. The committee's responsibility is to safeguard the independence of the internal audit function and ensure continual improvement in management performance and accountability by seeking actions on internal audit and external audit reports."

Furthermore, another definition sees the Audit Committee in terms of its functions and expected responsibilities; "The Audit Committee is a committee which is composed of independent, non-executive directors charged with oversight functions of ensuring responsible Corporate Governance, a reliable financial reporting process, an effective internal control structure, a credible audit function, and informed whistleblower complaint process and an appropriate code of business ethics with the purpose to create long-term shareholder value by protecting the interests of other stakeholders" (Rezaee, 2009).

### **Real Earnings Management**

Past studies also revealed that earnings management had various strategies from which they could manage it such as real earnings management by Dechow et al. (2012) and Kothari et al. (2012).

Moreover, Gunny (2010) defined earnings management as it has some negative impacts of economic value on long term firm's value because of having the direct effect of cash flow. In addition to this, real earnings management activities have a direct impact on cash flows which is a fact and it is considered more difficult as compared to accrual-based earnings management. Also, the researchers provided evidence that the real earnings management garbed the market as it was associated with the level of information asymmetry (Abad, Cutillas-Gomariz, Sánchez-ballesta, & Yague, 2018).

Recently, previous studies provided evidence that financial illusive companies engaged in real earnings management practices before the fraud event occurred (Nasir, Ali, Razzaque, & Ahmed, 2018; Perols & Lougee, 2011). This evidence provides more gap to further investigate to engage in real earnings management. Therefore, this research focuses on the Characteristics of the audit committee and audit quality on real earnings management.

### **Audit Quality**

External audit function plays a significant role in the corporate governance system as it bridges a gap between those who prepare financial information (management) and those who use it (shareholders). It is considered as a key monitoring device because it enhances the quality of financial statements, safeguards the shareholders' interests, and helps the investors for their investment decisions and by giving them confidence about the company's status (Habbash, 2010; Brown et al., 2011).

The main role of external auditors is to put a curb to the opportunistic behavior and manipulation in financial statements by the managers to provide credible auditing services for contracting and outside shareholders (Sulaiman, 2011).

In addition to this, Basiruddin and Rohaida (2011) further defined audit quality as the auditor's competency which could identify the errors and error objectivity in the reporting which could be factual or in appearance (p. 54). Furthermore, they discussed that both auditor quality and audit quality was used in the prior literature alternatively. Regardless of

differences in the definitions of audit quality, there is no doubt about its importance in minimizing agency costs and increasing investors' confidence by enhancing the credibility of financial information.

### **Audit Committee Characteristics and Real Earning Management**

Managers are using earnings management to maximize the company's interest (shareholders interest) or to maximize their own interest, this causes an agency problem. However, both have different interests and this leads to conflicts (Jensen, 2005). Fama and Jensen (1983) have argued that outside directors with directorships are perceived to be valuable because they are concerned about their reputation damage, litigation risks and possible loss of future board opportunities and therefore will be motivated to perform their monitoring role effectively. Dhaliwal et al., (2010) have argued that the audit committee is responsible for the external auditing of the firm financial statements. Due to the existence of remuneration and audit committee characteristics monitor of board performance, it is expected that the board will be motivated to improve performance, and investors will gain more confidence in the value of the firm's financial statement.

Researchers have identified the role of the audit committee as being critical in ensuring the credibility of the financial statement (Abbott et al., 2000). Therefore, the audit committee is viewed as a monitoring mechanism intended to reduce information asymmetries between management and stakeholders, since its key functions are to improve the quality and accuracy of financial information through constantly monitoring the management's opportunistic behaviors (Li et al., 2012). Also, many of the previous studies investigated to check the qualities of audit committees being one of the tools of corporate governance and their effects e.g., controlling earnings management. The present research used the secondary data obtained from the prior studies to show the impact of audit committees on real earning management.

Thoopsamut and Jaikengkit (2009) have examined the relationship between the characteristics of the audit committee, audit size, and earnings management of the companies listed on the Stock Exchange of Thailand. A negative relationship was found between the average tenure of the audit committees and earnings management. However, the number of meetings of the audit committees and audit firm size were not significantly related to earnings management. These results indicate that the average tenure of audit committees affects the quality of financial reports.

Furthermore, Baxter, et al (2009) examined whether the existence of an audit committee was associated with the earnings quality. They found that the formation of an audit committee reduced the earnings management. Another related study conducted by Hamdan, et al., (2012) examined characteristics of the audit committee and found no significantly related to accounting conservatism excluding the financial experience of the audit committee, which, however, found to have a positive relationship.

### **Audit Committee Characteristics and Audit Quality**

It should be an equal number of the audit committee subject to a minimum of three members whose role should be to examine the auditor's report and make recommendations thereon to the annual general meeting. As a result of the audit committee responsible for overseeing internal control and financial reporting, good governance dictates that the members of an audit committee should possess a certain level of competencies (Chtourou, Bedard, & Courteau, 2001). In a similar vein, Arens et al. (2012) have also examined the major

goal in the constitution of an audit committee that is to increase the auditing quality and retaining the independence of the auditor for questioning the board of directors. Moreover, Mitchell et al. (2008) showed that the relation between an Audit Committee and the quality of the audit could potentially enhance the quality of the published financial statements.

Therefore, owing to the increased audit coverage required by the characteristics such audit committee to improve the audit quality. Since, the audit committee chooses the external auditor; therefore, there is a possibility that both monitoring devices may operate jointly to limit the earnings manipulation (Alves, 2013). This provides greater assurance by decreasing legal liability, and encouraging investors' interest (Carcello et al., 2002). Thus, it is expected that the characteristics of an audit committee may demand a higher audit quality, which will ultimately limit earning management.

Moreover, Hamdan and Mushtaha (2011) conducted a study with the aim to analyze the relationship between the possibility of the company receiving an audit clean report from external auditors and the characteristics of the audit committees of the industrial Jordanian companies listed in ASE. The findings of their study showed a negative impact on the stock ownership of the members of audit committees on the external auditor's report. They also showed a positive impact on the size of the members of an audit committee on the external auditor's the report. At the same time, the number of meetings or the independence of members of the audit committee were revealed having no impact on the opinion of the external auditor.

### **Audit Quality and Real Earning Management**

Audit quality represents a greater assurance of high financial report quality and limits the earning management too. For instance, DeAngelo (1981) defined AQ as the "market-assessed joint probability that a given auditor detects a breach in the client's accounting system as well as report the breach" (p. 186).

Better audit quality is linked to an independent assurance of the reliability of financial reports, which enhances investors' protection and confidence. Thus, audit quality improves financial report quality by enhancing the credibility of the financial reports by reducing the manipulation such as earning management (DeFond & Zhang, 2014; Gaynor, Kelton, Mercer, & Yohn, 2016).

DeFond and Zhang (2014) contends that audit quality is a necessary construct of financial report quality and limits the management and also argues that financial report quality is a function of an audit quality. This study recommends that audit quality and financial report quality limit the aggressive earning management and have mutually observable outcomes (DeFond & Zhang, 2014; Gaynor et al., 2016).

Consequently, DeFond and Zhang (2014) categorized audit quality into Big N auditors, audit fees. Input-based measurements consist of an audit firm size proxy, such as Big N membership and audit fees. Therefore, they suggested audit fees and Big 4 auditors as substitutes for the audit quality because Big 4 auditors appeared in all of the above three classifications. Audit firm size, measured by Big 4 membership, is a robust proxy for audit quality because larger auditors are expected to be strongly motivated and more able to deliver high-quality auditing (DeAngelo, 1981). And therefore limit earning management has greater construct validity (DeFond & Zhang, 2014). The audit fee is a good replacement because it considers audit efforts that are obviously relevant to an audit quality (DeFond & Zhang, 2014; Gaynor et al., 2016).

### Research Framework

The framework shown in Figure 1 below explains association among the independent variables, mediator variable, and dependent variable. This study will examine the impact of the audit committee characteristics (audit committee size, audit committee meeting, audit committee independence, and audit committee expertise) on audit quality (audit size, audit fees) toward real earnings management (audit size, audit fees) toward real earnings management.

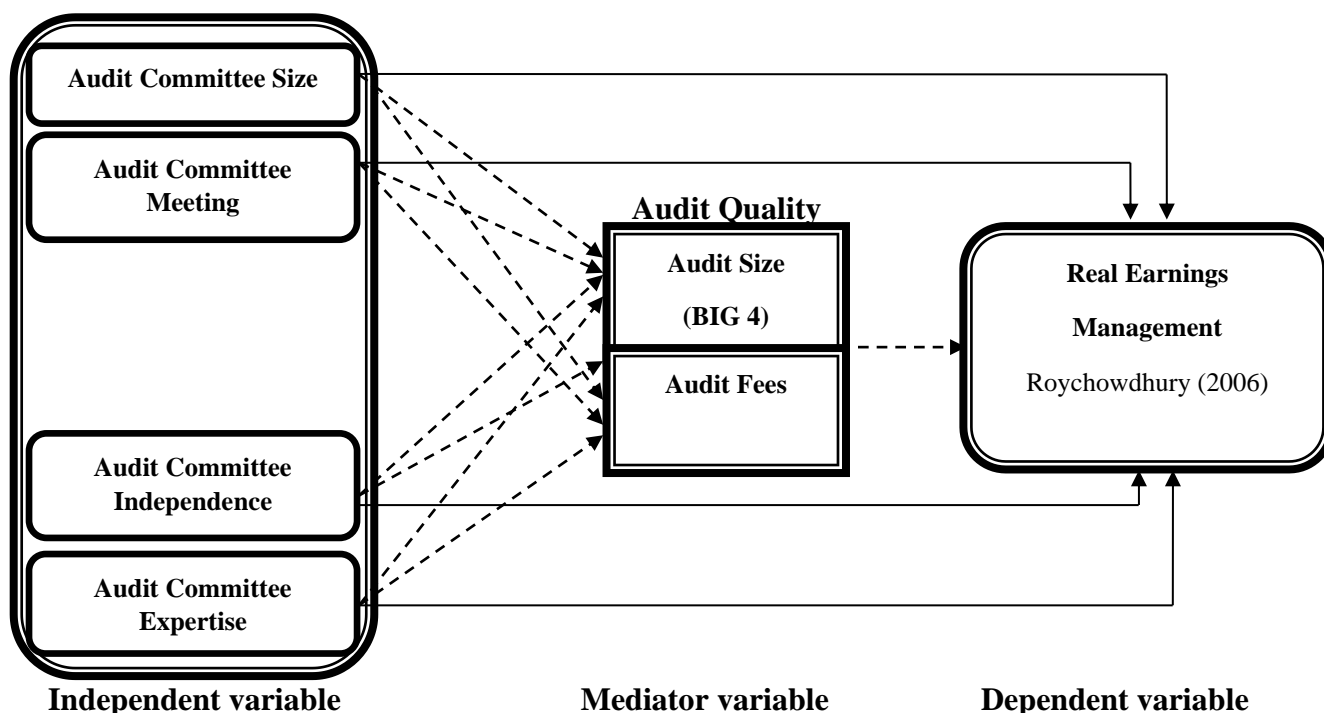


Figure 1: Research Framework

In light of the previously reviewed literature about the complementary functions of the characteristics of an audit committee with respect to audit quality, it is, therefore, referred to an anticipation that audit quality may stand as an intermediate variable (mediator) that can be influenced by the audit committee, which in turn reduces the real earnings management. This is because a mediator variable serves as a middle variable that signifies the productive device through which the predictor variable is able to account for the outcome variable (Baron & Kenny, 1986; Hayes & Scharkow, 2013).

A simple mediation model is assumed when the predictor variable is premised to affect the mediator and, in turn, the mediator affects the outcome variable (Wu & Zumbo, 2008). This implies that a change in audit committee will bring about a change in audit quality, and a change in audit quality will bring a reduction of real earnings management. This is clearly shown in the proposed framework of the present study. It is based on the sequence of relationships that represents the conditions of mediation. According to Baron and Kenny (1986). As shown in Figure 1.

Thus, the conceptual framework depicts the mediation effect of an audit quality proxy by audit fees and big 4 auditors which proposes that the characteristics of an audit committee are likely to improve audit quality proxy, which reduces the real earnings management and is aligned to agency theory, that assumes that audit efforts are required to lessen agency conflicts arising from the interests of the owners and management (Menon & Williams, 1994;



Watts& Zimmerman, 1983). Consequently, it is expected that more powerful boards will hire better auditors who, in turn, will possibly be more active monitors of managerial actions and ensure proper financial reports and disclosure (Carcello et al., 2002).

## Conclusion

The present research paper reviewed the previous literature on the characteristics of an audit committee, audit quality, and real earnings management. This paper also reviewed the current and pioneering literature on audit committee characteristics and real earnings management as well as audit quality and Real Earnings Management. Some gaps are identified in the previous literature and this study also provided a conceptual framework on how to fill these gaps. Reviewed literature showed that the studies on the characteristics of the audit committee and real earnings management had presented mixed results. The study also found that there is little evidence regarding the influence of expertise on the characteristics of an audit committee. Consequently, this permits further research by the new research scholars.

Finally, some suggestions offered for the future research; Future research should concentrate on some of the characteristics of an audit committee that have been given less attention by the previous studies because there is little evidence. Future research should concentrate on some of the characteristics of an audit committee that have been given less attention by previous studies, such as audit committee Tenure, audit committee gender and audit committee public accounting expertise. There is a need for future studies to pragmatically examine our framework that aims to conceptually and theoretically explain the expected mediating effect of audit quality on the link between the characteristics of the audit committee and real earnings management.

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