

Editor  
06/04/20  
12:34 PM

Dear Author(s),

We have received the review reports for your paper "The Effect of Audit Committee on Audit Opinion Through Earning Management as Mediation Variable".

We require now that you implement in your submission the following recommendations made by the reviewers:

Reviewer A Comments:

=====

Suggestions which would improve the quality of the paper but are not essential for publication:

The English language needs to be improved significantly as there are so many grammatical errors and expressions

Changes which must be made before publication:

My only concern is that "there is lack of theoretical and empirical background" suggesting that earnings management can be used as the mediating variable in the study. I could not find any papers in reputable journals that assert on this mediating role.

Reviewer's annotated version file:

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Suggestions which would improve the quality of the paper but are not essential for publication:

The author(s) shall rewrite many aspects of the manuscript in particular the reason behind the use of earnings management as the mediating variable.

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major revisions are needed

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Reviewer B Comments:

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Changes which must be made before publication:

1. This manuscript needs proofread for qualified language. There are many grammatically and wording errors
2. There is no information detail in methodology about the population and sample. It should be added, who became the sample and what is the reason for choosing it.
3. The discussion of this article novelty does not clearly include yet.

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Your prompt attention is much appreciated.

Prof. D.K. Malhotra  
Afro-Asian J. of Finance and Accounting (AAJFA)  
[submissions@inderscience.com](mailto:submissions@inderscience.com)

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Author Juniarti --

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- Updated the metadata (mainly abstract and keywords) according the recommendations received from the Editor, making sure that the title, abstract and keywords are totally free of English Spelling and Grammar errors.
- Uploaded the "Author's final version."
- Uploaded a zipped file with the Copyright Agreement forms signed by each author.

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Author Juniarti --

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# The Effect of Audit Committee on Audit Opinion Through Earning Management as Mediation Variable

**Abstract :** This study aims to examine whether earnings management can mediate the influence of the audit committee on audit opinion. This research is quantitative by using company data in the sectors of infrastructure, utilities, and transportation contained in the IDX in 2011-2017. The sectors of infrastructure, utilities, and transportation have the highest qualified audit opinion in the study period compared to other sectors. The independent variable is the audit committee, the dependent variable is the audit opinion, and the intervening variable is earnings management. This study adds control variables, namely firm size and leverage. The data of this study were processed using SPSS 20. This study was tested in two stages. The first test is the audit committee with scoring and the second test is each of the audit committee attributes. The results of the study show that earnings management cannot mediate the influence of the audit committee on audit opinion. The role of the audit committee cannot prevent the existence of earnings management, but can monitoring auditor through the issuance of opinion.

**Keywords :** Audit Committee, Earning Management, Audit Opinion

## 1.

### INTRODUCTION

Financial report scandals in several companies have triggered a crisis of trust and have a detrimental effect on stakeholders (Zgarni, Hlioui, & Zehri, 2016). In addition, audit quality has become a concern and among these scandals, the Enron case is a concern because of the collapse of Arthur Andersen (Chen, Lin, & Zhou, 2005). According to Nogler (2008), After Enron's bankruptcy, followed by another bankruptcy on large companies, namely WorldCom, Global Crossing, and Ual Crop where the company has received an unqualified opinion from Arthur Andersen. The case in Indonesia in 2018, the Otoritas Jasa Keuangan (OJK) gave Deloitte's sanctions to Public Accountants and Auditors for failing to conduct financial statement audits (OJK, 2018). PT Sunprima Nusantara's previous financial statements received unqualified opinions. However, as a result of the OJK's examination, the company has presented financial statements that are not in accordance with the actual financial conditions which have caused losses to many parties. The case raises concerns about how the Public Accounting Office practices in developing countries in accordance with the code of ethics.

The presence of external auditors can oversee the fairness in the financial statements through audit opinions that will be issued. However, there are conflicts between management and external auditors because of differences of opinion relating to accounting estimates, interpretations of accounting standards, and disclosure problems (Salleh & Stewart, 2012). The auditor is appointed by the company and can be dismissed if the opinion is different and consequently the financial statements are often negotiated between the auditor and the company manager (Mohd Saleh, Mohd Iskandar, & Mohid Rahmat, 2007). This causes the published audit opinion to be biased.

Audit committees are appointed to act independently in resolving conflicts between managers and auditors (Klein, 2002; Salleh & Stewart, 2012). In addition, the audit committee monitors the independence and objectivity of external auditors through the audit process (Wu, Hsu, & Haslam, 2014). The results of previous audit committee studies have a positive effect on audit opinions (Bronson, Carcello, Hollingsworth, & Neal, 2009; Carcello & Neal, 2000, 2003; Hoitash & Hoitash, 2009; Pomeroy & Thornton, 2008). According to Hoitash & Hoitash (2009) states that the role of an effective audit committee makes auditors

more independent in conducting audits so that opinions issued are in accordance with the conditions of the company. In addition, Hoitash & Hoitash (2009) explained that the dismissal of auditors can occur because the auditor publishes qualified opinions which are not in accordance with the wishes of management. This causes the company to look for other auditors with audit opinions that are profitable for the company.

Earning management is a deliberate intervention in the process of financial reporting to external parties for personal gain (Healy & Palepu, 1990; Messod D. Beneish, 2001; Skinner & Dechow, 2000). Managers can use judgment on financial reporting and transaction structure so that later the information presented can be misleading for stakeholders and influence financial reporting quality (Bratten, Causholli, & Sulcraj, 2019; Healy & Wahlen, 1999). Earning management opportunities can be narrowed by the existence of an audit committee. This is evidenced by the results of previous studies stating that audit committees can reduce earnings management (Bradbury, Mak, & S.M.Tan, 2006; Inaam & Khamoussi, 2016; Mohd Saleh et al., 2007; Zgarni et al., 2016). But there are studies that state that audit committees have no effect on earnings management (Rahman & Mohamed Ali, 2006).

When a company manages profits, it will affect the audit opinion issued (Suryanto & Grima, 2018). According to Johl, Jubb, & Houghton (2007) states that when managers manage earnings, the auditor will issue a qualified opinion. Francis & Krishnan (1999) conducted a research on accrual level on audit opinion. From the results of his research stating that the company's accrual level is high, the auditor will issue a qualified opinion. Accrual levels are related to high abnormal (discretionary) accruals (S. Johl et al., 2007).

Giving an audit opinion is the responsibility of the external auditor to see the fairness in the financial statements. The audit committee is responsible for overseeing the financial reporting process so that opinion results are issued in accordance with the conditions of the company. Although many studies directly examine, research that involves earning management as a mediating variable has not been done much. The author wants to develop research by adding earnings management mediation variables so that the results of new research become more comprehensive and become a reference in opening a new paradigm of the factors that influence audit opinion. Therefore, researchers are interested in conducting more in-depth research on the Effect of the Audit Committee on Earning Audit Opinion through Earning Management as a Mediation variable in Non-Financial Sector Companies Registered on the Stock Exchange for the 2011-2017 Period.

## **LITERATURE REVIEW**

### **2.1. Agency Theory**

In agency theory, the motivation of a rational agent is to act on behalf of the principal, but the interests of the agent are contrary to the interests of the principal (Scott, 2015). The agent's responsibility is to maximize the benefit of the principal, but the agent has other interests to maximize his welfare. This is called conflict of interest (Jensen & Meckling, 1976). Manager's opportunistic behavior can be minimized through the audit committee. The audit committee can reduce this agency problem so that it can improve the quality of financial reporting and maintain information that will be conveyed to stakeholders (Islam, Islam, Bhattacharjee, & Islam, 2014). This agency problem is a lack of companies, such as lack of internal control effectiveness, lack of independent auditors, and others.

### **2.2 Effectiveness of The Audit Committee**

Beasley, Carcello, Hermanson, & Lapides (2000) stated that audit committees oversee the financial reporting process and ensure financial reporting correctly and fairly. The effectiveness of the audit committee is closely related to supervisory activities. This monitoring area includes three things, namely monitoring the financial reporting process, monitoring internal controls and risks, and monitoring the activities of external auditors (Beasley, Carcello, Hermanson, & Neal, 2009; Kusnadi, Leong, Suwardy, & Wang, 2016). Monitoring the financial reporting process includes monitoring accounting policies, compliance with regulations, and investigating problematic accounting practices (Beasley et al., 2009).

### **2.3 Earning Management**

Earning management is one indicator of financial reporting quality. Low earnings management represents higher financial reporting quality. Previous research using earnings management as one of the indicators of financial reporting quality is Cendrar, Chang, & Zheng (2012); S. K. Johl, Kaur Johl, Subramaniam, & Cooper (2013); Krishnan, Wen, & Zhao (2011); Toms (2017). Quality financial reporting can help interested parties in decision making. Based on IFRS (2018), information is said to be useful or quality, if the information is relevant and provides a representation of what is faithful representation.

According to Bellovary, Giacomin, & Akers, (2005), profits managed by management do not reflect actual company performance.

## 2.4 Audit Opinion

Audit reporting as a communication tool used by auditors to inform outside parties about the results of their audits (Habib, 2013). According to Moalla (2017), external audit is an external governance mechanism in reducing information asymmetry and conflicts of interest between managers and shareholders. This can increase investor confidence and ensure that the information presented by the manager is not in its own interest. External auditors are parties contracted by companies, but must work independently from managers so that the formulation of their opinions is more objective (Moalla, 2017). According to Arens, Elder, & Beasley (2015), there are 4 types of audit opinions in audit reports based on the findings of auditors: Unqualified Opinion (unqualified), Qualified Opinion (reasonable with exceptions), Adverse Opinion, Opinion Disclaimer (refusing to give opinion )

Agency theory explains the contractual relationship between agents and principals where the principal wants to maximize the performance of the company through publishing opinions. As an agent, the auditor is an independent party appointed by the company to audit the financial statements. Auditors find it difficult to issue qualified opinions because they are vulnerable to management pressure (Ballesta & Meca, 2005). According to Carcello & Neal (2000) stated that auditor difficulties in issuing qualified opinions can be minimized when the role of the audit committee is more effective in overseeing the auditor when the financial statements have been audited. The role of the audit committee becomes effective when the size of the audit committee is large, the more independent the audit committee, there is the expertise of the audit committee, and the high audit committee meetings (Abbott, 2000; DeFond & Francis, 2005; Hichem & Samaha, 2016; Mohd Saleh et al., 2007). The large number of audit committees will increase the monitoring of audit committees in conducting supervision (DeFond & Francis, 2005). Then Abbott (2000) explains that independent audit committees and holding meetings will improve audit quality for auditors. Audit quality is defined as the possibility of detecting and reporting material misstatements (DeAngelo, 1981). Besides the audit committee that has expertise and independence, can understand the tenure of the audit process, it can protect the auditor when qualified opinions are issued (Carcello & Neal, 2003).

### **H1: Audit committee has a positive influence on audit opinion**

Based on agency theory, it requires a supervisory mechanism in the relationship between agents and principals. This oversight mechanism is to monitor agent behavior so that it can minimize opportunistic behavior and non-compliance from the agent. According to Martinez & Fuentes (2011) states that the role of the audit committee can oversee the preparation of financial statements and prevent discrepancies between auditors and management. This can reduce management errors and non-compliance in preparing financial statements. Previous research examined the characteristics of the audit committee for earnings management. According to DeFond & Francis, (2005) states that the size of a large audit committee can provide effective monitoring of the audit committee so that it can encourage management to improve the quality of financial reporting. In addition, audit committees that are independent and active in meetings can reduce accounting irregularities (Dechow, Sloan, & Sweeney, 1996; Nor, Shafie, & Hussin, 2010). Then DeZoort & Salterio (2001) states that the expertise of the audit committee in the field of accounting and finance can understand well the auditor's assessment and can support the auditor in the conflict between management and the auditor. Then Klein (2002) study states that an independent audit committee can reduce earning management because it provides clear responsibilities in overseeing the accounting, financial reporting, and audit processes so as to reduce earnings management.

### **H2: The audit committee has a negative influence on earnings management.**

Earning management occurs when managers use judgment in financial reporting that affects the accounting numbers to be reported (Healy & Wahlen, 1999). This will affect the audit opinion that will be issued. Audit opinion communicates whether financial statements are free of material misstatement and are in accordance with accounting standards. According to Johl et al (2007) states that the higher the earning management, the auditor will issue opinions other than unqualified. This means that earnings management can be detected through an audit opinion. This is supported by research by Butler, Leone, & Willenborg (2004) which states that companies that conduct earnings management will receive a qualified opinion.

### H3: Earning Management has a negative influence on Audit Opinion

According to Kassem (2018) stated that management's motivation in committing fraud was to get bonuses related to the company's performance or other financial targets. According to Suryanto & Grima (2018) When a company fails to achieve profit, management will take advantage of the flexibility of accounting standards to modify profits to be reported. This profit modification will affect the audit process and audit opinion. Suryanto & Grima (2018) explained that audit opinions are very important in enhancing the company's reputation and increasing investor interest in investing. Modification of earnings can be prevented through the role of the audit committee so that the opinions issued describe the condition of the company. The role of the audit committee becomes less effective, if it has a small number of members and lack of skills and knowledge (Rahmat, Iskandar, & Saleh, 2009). According to (Bilal, Chen, & Komal, (2018) stated that audit committees that have expertise can monitor management activities. An independent audit committee can minimize conflicts between auditors and management (Kusnadi et al., 2016). In addition, the high frequency of audit committee meetings will make the governance mechanism more transparent. This is because the audit committee will discuss financial reporting issues to find solutions and take corrective actions (Hichem & Samaha, 2016).

### H4: Earning Management mediates the influence of the audit committee on Audit Opinion

## 3. METHOD

This research will be tested using SPSS 20 because SPSS facilitates logistic regression and multiple linear regression. The object of this research will be to use public companies listed on the Indonesia Stock Exchange in 2011-2017 in the non-financial sector and have met the sampling criteria. The criteria used are: (1) The business entity that presents the financial statements for the year ended December 31 and has been audited. (2) The business entity presents a complete annual report during the study period and has financial data supporting the existing research variables. (3) The business entity sector that presents audit reports with the highest qualified opinion in the research period. Then the research model is explained in figure 1:

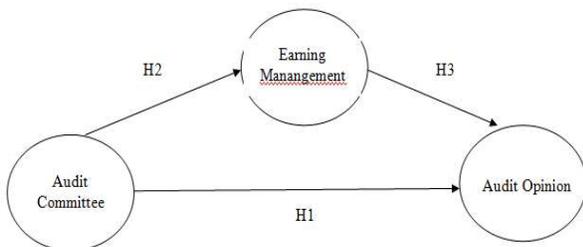


Figure 1. Research Model

Two independent variables will be measured on the audit committee, the first using scoring using 4 indicators based on Baxter, (2010). The calculation is that the audit committee size (SIZEAC) will be worth 1 if the audit committee consists of more than 3 people, while worth 0 if the number of audit committee members is 3 or less than 3. Then the independent audit committee (ACIND) will be worth 1 if the proportion exceeds 50%, while worth 0 if the proposal is 50% or less than 50% (Baxter, 2010). The audit committee that has expertise (ACEXPERT) will be worth 1 if the proportion exceeds 50%, while it is worth 0 if the proportion is 50% or less than 50%. In the audit committee meeting (ACMEET) more than three times will be 1, while worth 0 if the meeting is less than 3 times in 1 year. The value of the audit committee is calculated by summing the scores obtained from the 4 indicators of the characteristics of the audit committee (KA). The higher the score on the effectiveness of the audit committee, the more effective the role of the audit committee in conducting supervision. The second calculation on the audit committee will test each of the audit committee attributes. This second calculation is an additional test to see each of the attributes of a significant audit committee. The size of the audit committee (SIZEAC) uses the number of audit committee members, the proportion of independent commissioners in the audit committee (ACIND), the proportion of audit committee expertise in accounting and finance (ACEXPERT), and number of meeting audit committee for one year (ACMEET).

The dependent variable is audit opinion (OA) using a variable dummy. If the company gets an unqualified audit opinion it will be worth 1. But if the company gets a qualified audit opinion, it will be worth

0 (Johl et al., 2007). Controlling mediating variables, namely earnings management (EM) using Discretionary accruals. The calculation uses modified Jones by (Dechow, Sloan, & Sweeney, 1995). Then the abnormal accrual calculation results will be absolute to see how much the company manages its earnings. How to calculate it as follows:

$$\frac{TA_{i,t}}{A_{i,t-1}} = \beta_1 \left( \frac{1}{A_{i,t-1}} \right) + \beta_2 \left( \frac{\Delta REV_{i,t}}{A_{i,t-1}} \right) + \beta_3 \left( \frac{PPE_{i,t}}{A_{i,t-1}} \right) + \varepsilon_{i,t} \quad (1)$$

$$AA = \frac{TA_{i,t}}{A_{i,t-1}} - \left[ \hat{\beta}_1 \left( \frac{1}{A_{i,t-1}} \right) + \hat{\beta}_2 \left( \frac{\Delta REV_{i,t} - \Delta REC_{i,t}}{A_{i,t-1}} \right) + \hat{\beta}_3 \left( \frac{PPE_{i,t}}{A_{i,t-1}} \right) \right] \quad (2)$$

Where  $TA_{i,t}$  is the total accruals at company  $i$  for year  $t$ , which is defined as net income minus operating cash flows;  $AA$  is abnormal accruals;  $\Delta REV_{i,t}$  is the change in revenue for company  $i$  for year  $t$ ;  $\Delta REC_{i,t}$  is a change in receivable for company  $i$  for year  $t$ ;  $A_{i,t-1}$  is the total assets of the company at the beginning of the year  $t$ ;  $PPE_{i,t}$  is a fixed asset at company  $i$  for year  $t$ ;  $\beta_1$ ,  $\beta_2$ , and  $\beta_3$  are estimates of regression of the coefficients  $\beta_1$ ,  $\beta_2$ , and  $\beta_3$ ; and  $\varepsilon_{i,t}$  is an error or residual regression

The control variable in this study uses firm size (FSIZE) measured using Natural Logarithm of Total Assets and leverage (LEV) using debt ratios divided by assets

Based on the explanation above, the research regression model is as follows:

$$OA_{i,t} = \alpha_0 + \alpha_1 KA_{i,t-1} + \alpha_2 FSIZE_{i,t-1} + \alpha_3 LEV_{i,t-1} + \varepsilon_{i,t} \quad (3.1)$$

$$EM_{i,t-1} = \beta_0 + \beta_1 KA_{i,t-1} + \beta_2 FSIZE_{i,t-1} + \beta_3 LEV_{i,t-1} + \varepsilon_{i,t} \quad (3.2)$$

$$OA_{i,t} = \gamma_0 + \gamma_1 EM_{i,t-1} + \gamma_2 FSIZE_{i,t-1} + \gamma_3 LEV_{i,t-1} \quad (3.3)$$

$$OA_{i,t} = \theta_0 + \theta_1 KA_{i,t-1} + \theta_2 EM_{i,t-1} + \theta_3 FSIZE_{i,t-1} + \theta_4 LEV_{i,t-1} + \varepsilon_{i,t} \quad (3.4)$$

#### 4. RESULT

Table 1. Statistic Deskriptive

	N	Min	Max	Mean	S.Dev
KA	247	0	4	1,88	0,703
SIZEAC	247	1	7	3,24	,707
%ACIND	247	20%	100%	36,8498%	13,46841%
%ACEXPERT	247	20%	100%	75,2448%	23,97785%
ACMEET	247	1	57	8,17	9,173
EM	247	0,0000	1,8811	0,086311	0,1615361
FSIZE	247	9,9586	14,2977	12,548438	0,8432104
LEV	247	0,0038	7,1700	0,485561	0,6668880

Descriptive statistical results in Table 1 can be seen that the KA variable has an average of 1.88. This shows that the average company that has an audit committee has not been effective in conducting supervision. The SIZEAC variable has an average number of audit committee members of 3.24. This shows that the average number of audit committee members has met the requirements in the formation of an audit committee. Then the ACIND variable has an average of this variable at 36.8498%. This means that overall the independent audit committee has fulfilled the requirements in establishing an audit committee. In the ACEXPERT variable it has an average of 75.2448%. This shows the overall average expertise of the audit committee has met the requirements in the formation of an audit committee. In addition, the ACEMEET variable has an average of 8.17. This shows that the overall audit committee has fulfilled the requirements in holding regular meetings within 1 year.

EM variable is earnings management. The average value in this variable is equal to 0.086311. This means that overall the company has good financial reporting quality or little managing its profits. The FSIZE variable is a control variable that measures the size of a company. Overall, the average size of the company is 12,548438. Then, the LEV variable has a company average of 0.485561, which means that the average company is 48.561% of its assets funded by debt.

This research uses 247 companies in the infrastructure, utilities and transportation sectors which have unqualified opinions of 210 companies or 85% of the total companies in the infrastructure, utilities and transportation sectors, the remaining 15% are companies that have qualified opinions. This means that the company has presented financial statements fairly and in accordance with applicable accounting standards.

This study also fulfilled the feasibility test requirements for logistic regression models (Overall model fit, Nagelkerkel R Square, and Hosmer and Lemeshow) and classical assumption tests (normality, heteroscedasticity, multicollinearity, and autocorrelation). The results of hypothesis testing will be explained through the model image (Figure 2) of the study to explain the hypothesis received in this study

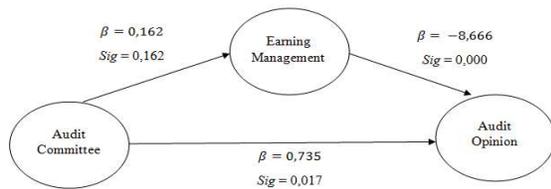


Figure 2. The Result of Research Model

In Figure 2, it shows that the audit committee has a positive influence on audit opinion so that hypothesis 1 (H1) is accepted. But when tested by each of the audit committee attributes, only audit committee meetings have a positive influence on opinion. The audit committee on earnings management does not have a significant effect on earnings management so hypothesis 2 (H2) is rejected. When the attributes of the audit committee are tested, it turns out that the number of audit committees, independent audit committees, expertise, and meetings do not have a significant effect on audit opinions. In hypothesis 3 (H3) is accepted, namely earnings management has a negative influence on audit opinion. Furthermore, in hypothesis 4 (H4) will include earnings management as a mediating variable to see how the audit committee influences the audit opinion which can be seen in the table 2 below:

Table 2. Hypothesis Testing Results (H4)

	$\beta$	Sig.
$KA_{i,t-1}$	0,835	0,018
$EM_{i,t-1}$	-8,469	0,001
$FSIZE_{i,t-1}$	-0,026	0,938
$LEV_{i,t-1}$	-1,513	0,001

This result can be seen that the audit committee has a coefficient value of 0.835, a significance of more than 0.018. This means that overall the audit committee has a positive influence on audit opinion. Then the earning management of the audit opinion has a coefficient value of -8,649 with a significance of 0.001. This means that the higher the company conducts earnings management, the opinions issued by qualified opinion. Furthermore, the significance of this mediation test will be proven by the sobel test. The results of the sobel test calculation have a z-value of -1.5475 or smaller 1.96 which indicates that earning management cannot significantly mediate the influence of the audit committee on audit opinion. Then when the audit committee attributes are tested each, they have the same results. This means that overall earnings management cannot mediate the influence of the audit committee on audit opinion.

## 5. DISCUSSION

Overall the audit committee has a positive influence on opinion so that hypothesis 1 (H1) is accepted. Then the results of testing on the audit committee are tested respectively, only the audit committee meeting has a positive influence on the audit opinion. Auditors' independence and objectivity can be overseen by audit committees (Carcello & Neal, 2000; Wu et al., 2014). Independent audit committees and holding meetings can increase the auditor's ability to detect and report material misstatements (Abbott, 2000; DeAngelo, 1981). This is contrary to Choi, Jeon, & Park (2004) which explains that although the audit committee is independent and has expertise but does not hold meetings, the role of the audit committee has not been effective. The audit committee meeting shows the activities of the audit committee in conducting oversight. This oversight will make the auditor more independent when conducting the audit process so that the opinions issued reflect the true condition of the company (Hoitash & Hoitash, 2009). Therefore, a transparent governance mechanism occurs when an audit committee can oversee management actions when the auditor conducts an audit process. The size of the audit committee has no significant effect on the audit opinion. This means that the size of the audit committee has no influence on the issuance of opinion. According to Haji (2015) states that the number of large audit committees is difficult to make decisions because it has a variety of opinions. Other opinions

such as DeFond & Francis (2005) state that the size of the audit committee is small, so monitoring the audit committee becomes less effective. The size of the audit committee is not a significant factor in conducting supervision (Alkdai & Hanefah, 2012). Bédard, Chtourou, & Courteau (2004) propose that the size of the audit committee is not so large, but large enough to ensure effective monitoring. The issuance of opinion by the auditor can be monitored by the audit committee if the number of audit committees is large enough to carry out monitoring.

The results of the hypothesis study (H2) show that the audit committee does not have a significant effect on earnings management. Then when each audit committee component is tested, it does not have a significant effect on earnings management. The number of audit committees is small, so the role of the audit committee becomes less effective in carrying out supervision. But if the number of audit committees is large, it tends to be easy to follow the opinions of other members so that the audit committee becomes less independent. Therefore, the number of audit committees needs to be adjusted to the needs of the company (Kipkoech, Kenyatta, & Rono, 2016). Then the independent audit committee, audit committee expertise, and audit committee meetings do not have a significant effect on earnings management so that overall hypothesis 2 (H2) is rejected. This is supported by several studies which state that independent audit committees, audit committee expertise, and audit committee meetings do not have a significant influence on earnings management (Bédard et al., 2004; Peasnell, Pope, & Young, 2000; Rahman & Mohamed Ali, 2006). According to Rahman & Mohamed Ali (2006) explained that the role of the audit committee cannot prevent earnings management so that the formation of an audit committee within the company has not yet achieved its objectives. The establishment of an audit committee is only based on compliance with regulations that require that the company must have an audit committee.

Earning management has a negative influence on audit opinion so hypothesis 3 (H3) is accepted. According to Bellovary et al (2005) stated that the profit managed, does not reflect the condition of the company so it does not describe the real condition of the company. This managed profit will affect the audit process and audit opinion (Suryanto & Grima, 2018). This research is supported by Butler et al (2004) and Johl et al (2007) which state that the higher the earning management, the auditor issues opinions other than unqualified. This means earnings management can be detected through an audit opinion. The published audit opinion is more objective or in accordance with the condition of the company if the auditor works independently without being intervened by the manager (Moalla, 2017).

Then in hypothesis 4 (H4) overall earnings management cannot mediate the influence of the audit committee on audit opinion. However, when the audit committee component is tested each turns out that earning management insignificantly mediates the effect of audit committee meetings on audit opinion. Reasons for earnings management cannot mediate because the existence of an audit committee cannot detect the presence of earnings management. The role of the audit committee needs to be improved in overseeing the financial reporting process so that it can improve the quality of financial reporting. On the influence of the audit committee on audit opinion, it can be seen that the audit committee meeting has a major contribution in overseeing the opinions issued by the auditor. The audit committee meeting shows the activities of the audit committee in fulfilling its responsibilities in conducting oversight (Abbott, 2000). Monitoring mechanisms are more effective when audit committees hold meetings and meetings more often (Rahmat et al., 2009). Then the earnings management can be detected through an audit opinion. This means that the auditor has worked effectively in detecting material errors and misstatements in the financial statements. The auditor needs to be independent so that the formulation of opinions is more objective and unbiased (Moalla, 2017). Auditors' independence and objectivity need to be monitored by the audit committee (Wu et al., 2014). All fraud and illegal actions discovered by the auditor, can be reported to the audit committee regardless of materiality (Arens et al., 2015).

## **6. CONCLUSION**

This study aims to analyze the influence of the audit committee on audit opinion by earning management of mediating variables. This test have several stages. The first tests the audit committee as a whole on audit opinion through earnings management as a mediating variable. The second tests in detail each audit committee (audit committee size, independent audit committee, audit committee expertise, and audit committee meeting) on audit opinion through earnings management as a mediating variable. The conclusion obtained in this study is that overall the audit committee has a positive influence on audit opinion. Then on each component of the audit committee, it only audit committee meetings have a significant positive effect on audit opinion. But the size of the audit committee, the independent audit committee, and the expertise of the

audit committee have no influence on the audit opinion. In the overall hypothesis 2 the audit committee does not have a significant effect on earnings management. However, the components of the audit committee tested each also did not have a significant effect on earnings management. Furthermore, hypothesis 3, namely earnings management has a significant negative effect on audit opinion. In hypothesis 4, it is rejected, which shows that overall earnings management cannot mediate the influence of the audit committee on audit opinion.

Managerial implications based on the results of this study are that companies need to pay attention to and empower audit committee meetings effectively. The meeting shows the activities of the audit committee in fulfilling its responsibilities. The number of large audit committees, independence, and expertise is indeed needed, but if there is no meeting, there is no activity of the audit committee and not enough in conducting supervision. Then, the existence of an audit committee can oversee between auditors and management so that problems and conflicts between auditors can be overcome by the existence of an audit committee. The auditor's role can capture the existence of earnings management through the issuance of opinion because the financial statements presented have not yet described the actual performance conditions.

Limitations and constraints faced are this research using the Infrastructure, Utilities, and Transportation sectors for the period 2011-2017. This is because the number of opinions in the sector can only be used in this study compared to other sectors that have a small number of qualified opinions. Therefore, further research can use the business entity sector in other countries that have the same conditions or conditions as Indonesia. Then earnings management is only one indicator in measuring financial reporting quality. Although there are other indicators that can measure the quality of financial reporting, the data are not available in full. Future research is expected to be able to use other indicators so that the results of the study are more comprehensive.

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## Editorial Review Author Response AAJFA\_263127

1 message

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To: "Prof. D.K. Malhotra" <davinder.malhotra@jefferson.edu>, Juniarti -- <yunie@petra.ac.id>

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I have made the requested changes and uploaded a revised Author Version, as well as noting those changes in the "Editor/Author" Comments.

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We hope that this has been as requested.  
Thank you.

Best regards,

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\*Dr. Juniarti, M.Si., Ak., CA\*  
Department of Accountancy  
Petra Christian University  
Jl.Siwalankerto 121-131  
Surabaya 60236  
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Dear Fany Lim, Devie Devie, Juniarti --,

Ref: Submission "The Effect of Audit Committee on Audit Opinion Through Earning Management as Mediation Variable"

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## The effect of audit committee on audit opinion through earnings management as mediation variable

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**Abstract:** This study aims to examine the mediating effect of earnings management in the influence of the audit committee on audit opinion. The research samples are listed companies in the IDX in the sectors of infrastructure, utilities, and transportation for 2011–2017. This selection of industrial sectors due to these sectors obtains many qualified audit opinions in the study period compared to other sectors. This study adds control variables, namely firm size and leverage. We measure audit committee using two approaches, the first is the total score of each component of audit committees including size, independence, expertise, and meeting and the second is the partial score of each attribute of the audit committee. The results show that the audit committee influences the audit opinion and there is a negative significant influence of earning management and audit opinion, but, this study fails to prove the mediating effect of earning management in the relationship of the audit committee and audit opinion.

**Keywords:** audit committee; earning management; audit opinion.

**Reference** to this paper should be made as follows: Juniarti, Fany and Devie (xxxx) 'The effect of audit committee on audit opinion through earnings management as mediation variable', *Afro-Asian J. Finance and Accounting*, Vol. X, No. Y, pp.xxx–xxx.

**Biographical notes:**

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## 1 Introduction

Financial report scandals in several companies have triggered a crisis of trust and have a detrimental effect on stakeholders (Zgarni et al., 2016). Audit quality has been highlighted in these scandals. One of the notable scandals is the Enron case because it has to lead the collapse of Arthur Andersen (Chen et al., 2005). According to Nogler (2008), some large companies, such as WorldCom, Global Crossing, and Ual Crop followed the Enron case, even, these companies have received an unqualified opinion, previously. Indonesia also experienced similar scandals. In 2018, the Otoritas Jasa Keuangan (OJK, 2018) gave sanctions to Deloitte's Public Accountants for failing to conduct financial statement audits. Its client, PT Sunprima Nusantara received unqualified opinions, however, as the result of the OJK's examination, the financial of the company is not presented as the actual financial conditions. The case raises concerns about how the Public Accounting Office practices in developing countries following the code of ethics.

The presence of external auditors aims to oversee fairness in the financial statements. However, there are conflicts between management and external auditors because of differences of opinion related to accounting estimates, interpretations of accounting standards, and disclosure problems (Salleh and Stewart, 2012). The auditor is appointed by the company and can be dismissed if the opinion does not match the manager's expectations. This often lead manager and auditor enter into negotiation of some conditions of its financial statements (Mohd Saleh et al., 2007). As a consequence, the published audit opinion is biased and misleads interested parties.

Audit committees are appointed to act independently in resolving conflicts between managers and auditors (Klein, 2002; Salleh and Stewart, 2012). They monitor the independence and objectivity of external auditors through the audit process (Wu et al., 2014). Prior studies suggested that there is a positive effect of the audit committee and audit opinion (Bronson et al., 2009; Carcello and Neal, 2000, 2003; Hoitash and Hoitash, 2009; Pomeroy and Thornton, 2008). According to Hoitash and Hoitash (2009), the role of an effective audit committee makes auditors more independent in conducting audits so that the opinions issued are under the conditions of the company. Hoitash and Hoitash (2009) explained that the dismissal of auditors can occur because the auditor publishes qualified opinions that are not under the expectation of management. This causes the company to look for other auditors to obtain audit opinions as the manager's expected.

Earning management is a deliberate intervention in the process of financial reporting to external parties for personal gain (Healy and Palepu, 1990; Beneish, 2001; Skinner and Dechow, 2000). Managers can use judgment on financial reporting and transaction

structure so that the information presented can be misleading for stakeholders and influence financial reporting quality (Bratten et al., 2019; Healy and Wahlen, 1999). Earning management opportunities can be narrowed by the existence of an audit committee. Some previous studies support that audit committees can reduce earnings management (Bradbury et al., 2006; Inaam and Khamoussi, 2016; Mohd Saleh et al., 2007; Zgarni et al., 2016). However, other studies found the opposite, that audit committees do not affect earnings management (Rahman and Mohamed Ali, 2006).

When a company manages profits, it will affect the audit opinion issued (Suryanto and Grima, 2018). It is also in line with the finding of Johl et al. (2007) when managers manage earnings, the auditor will issue a qualified opinion. Francis and Krishnan (1999) researched accrual level on audit opinion. The result showed that when the company's accrual level is high, the auditor will issue a qualified opinion. Accrual levels are related to high abnormal (discretionary) accruals (Johl et al., 2007).

Issuing audit opinion is the responsibility of the external auditor. On the other hand, the audit committee is responsible for overseeing the financial reporting process and the audit process, so that the company obtains an audit opinion following the conditions of the company. Many prior studies directly examine the relationship between the audit committee and earning management or earnings management and audit opinion. This study will develop a comprehensive model, by proposing earnings management as the mediating variable in the relationship of the audit committee and audit opinion. We argue that the role of the audit committee in obtaining proper audit opinion should be indirect. It is due to the role of committee audit is first to oversee the management so that managers will be limited to manage earnings as they want, but as the real condition of the companies. Many prior studies supported that the audit committee limits earning management opportunities (Bradbury et al., 2006; Inaam and Khamoussi, 2016; Mohd Saleh et al., 2007; Zgarni et al., 2016). Then, the audit committee will drive a proper audit opinion through limiting of earnings management opportunity. The study of the partial relationship among variables will mislead the role of the audit committee. The existence of an audit committee is required by good corporate governance mechanism, to help the Board of Commissioner to monitor managers. Therefore, the comprehensive evaluation of the performance of the audit committee should be conducted comprehensively. This study also will provide evidence of the effectiveness of audit committees, whether they carry out its role as required.

## **2 Literature review**

### *2.1 Agency theory*

In agency theory, the motivation of a rational agent is to act on behalf of the principal, but the interests of the agent are contrary to the interests of the principal (Scott, 2015). The agent has the responsibility to maximise the benefit of the principal, but the agent has other interests to maximise his welfare. This is called a conflict of interest (Jensen and Meckling, 1976). Manager's opportunistic behaviour can be minimised through the audit committee. The audit committee can reduce this agency problem so that it can improve the quality of financial reporting and maintain information that will be conveyed to stakeholders (Islam et al., 2014). This agency problem is a lack of companies, such as lack of internal control effectiveness, lack of independent auditors, and others.

## 2.2 *Effectiveness of the audit committee*

Audit committees oversee the financial reporting process and ensure financial reporting is presented correctly and fairly (Beasley et al., 2000). The effectiveness of the audit committee is closely related to supervisory activities. This monitoring area includes monitoring of the financial reporting process, monitoring internal controls and risks, and monitoring the activities of external auditors (Beasley et al., 2009; Kusnadi et al., 2016). Monitoring the financial reporting process includes monitoring accounting policies, compliance with regulations, and investigating problematic accounting practices (Beasley et al., 2009).

## 2.3 *Earning management*

Earning management is one of the indicators of financial reporting quality. Low earnings management represents a higher financial reporting quality. Much previous research using earnings management as an indicator of financial reporting quality, among others are Chandar et al. (2012), Johl et al. (2013), Krishnan et al. (2011) and Al Shaer (2017). Qualified financial reporting leads to better decision-making of interested parties. Based on IFRS (2018), information is useful, if it is relevant and provides a representation of what is a faithful representation. Thus, the profits managed by management do not reflect actual company performance (Bellovary et al., 2005).

## 2.4 *Audit opinion*

An audit is one of the governance mechanisms which aim to reduce information asymmetry and conflicts of interest between managers and shareholders (Moalla, 2017). The audit opinion is the result of audit processes. There are four types of audit opinions, which are unqualified, qualified, or reasonable with exceptions, adverse, and disclaimer or refuse to give an opinion (Arens et al., 2015). An audit can increase investor confidence and ensure that the information presented by the manager is not in its interest. External auditors are parties contracted by companies, but they must work independently from managers so that they can produce an objective opinion. Often, this situation makes auditors face difficulties, especially when issuing qualified opinions because they are vulnerable to management pressure (Ballesta and Meca, 2005). Qualified opinion is an opinion that is not desired by the manager because it shows the poor quality of the financial statements. This can be minimised when the role of the audit committee is more effective. An effective audit committee can keep audit quality (Carcello and Neal, 2000).

Prior studies identified the following characteristics of the effective audit committee:

- 1 has a large size
- 2 has enough independent committee
- 3 has an expertise and experience in his tasks
- 4 has high committee meetings (Abbott, 2000; DeFond and Francis, 2005; Hichem and Samaha, 2016; Mohd Saleh et al., 2007).

An effective audit committee will monitor and supervise tightly during the audit processes to ensure the audit (DeFond and Francis, 2005; Abbott, 2000). The auditor will be protected from manager pressure and can publish opinions according to the facts.

H1 Audit committee has a positive influence on the audit opinion.

Agency theory requires a supervisory mechanism in the relationship between agents and principals. This mechanism is to monitor agent behaviour so that it can minimise opportunistic behaviour and non-compliance from the agent. The role of the audit committee is to oversee the preparation of financial statements and to prevent discrepancies between auditors and management (Martinez and Fuentes, 2011). This can reduce management errors and non-compliance in preparing financial statements. Previous research examined the characteristics of the audit committee for earnings management. According to DeFond and Francis (2005), the size of a large audit committee can provide effective monitoring so that it encourages management to improve the quality of financial reporting. Independent audit committees and audit committees that frequently meeting can reduce accounting irregularities (Dechow et al., 1996; Nor et al., 2010). DeZoort and Salterio (2001) also found that the expertise of the audit committees in the field of accounting and finance enables them to understand well the auditor's assessment and will mediate the conflict between management and the auditor. An independent audit committee limits earning management because it provides clear responsibilities in overseeing the accounting, financial reporting, and audit processes to reduce earnings management. Then Klein (2002) study states that:

H2 The audit committee has a negative influence on earnings management.

Earning management occurs when managers use judgment in financial reporting that affects the accounting numbers to be reported (Healy and Wahlen, 1999). The higher the earning management, the more likely the auditors' issue opinions other than unqualified (Johl et al., 2007). Audit opinion communicates whether financial statements are free of material misstatement and are following accounting standards. The qualified auditors can detect the existence of earning management practices, then they will communicate it through their opinion. The previous study supported that companies that conducted earnings management, received a qualified opinion (Butler et al., 2004)

H3 Earning management has a negative influence on audit opinion.

One of the motivations of management in committing fraud is to get bonuses related to the company's performance or other financial targets (Kassem, 2018). When a company fails to achieve profit, management will take advantage of the flexibility of accounting standards to modify profits to be reported (Suryanto and Grima, 2018). This profit modification will affect the audit process and audit opinion. Suryanto and Grima (2018) explained that audit opinions are very important in enhancing the company's reputation and increasing investor interest in investing. Modification of earnings can be prevented through the role of the audit committee so that the opinions issued describe the condition of the company. The role of the audit committee becomes less effective if it has a small number of members and lack of skills and knowledge (Rahmat et al., 2009). The audit committees that have expertise can monitor management activities (Bilal et al., 2018). An independent audit committee can minimise conflicts between auditors and management (Kusnadi et al., 2016). Besides that, the activity of monitoring through the high frequency

of audit committee meetings will make the governance mechanism more effective. This is because the audit committee will discuss financial reporting issues to find solutions and take corrective actions (Hichem and Samaha, 2016).

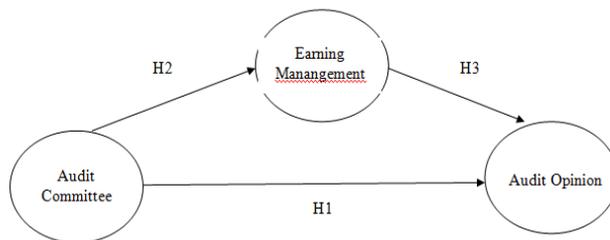
H4 Earning management mediates the influence of the audit committee on audit opinion.

### 3 Methodology

The sample of this research is public companies listed in the Indonesia Stock Exchange from 2011–2017, excluded the non-financial sector. Companies have a book year ending December 31, with the highest qualified opinion in the research period.

The research model is explained in Figure 1.

**Figure 1** Research model



We measure the audit committee, using two approaches. The first one is the total score of each component of audit committees including size, independence, expertise, and meeting (Baxter, 2010). If the audit committee's size consists of more than three people, it will be scored 1, otherwise, 0. If the audit committee has independent audit members equal to or more than 50%, it will be scored 1, otherwise, 0. If the audit committee has members with expertise in accounting or finance or both, it will be scored 1, otherwise, 0. The last is the meeting frequency, if the audit committee meeting is more than three times a year, will be scored 1, otherwise, 0. The score of the audit committee (KA) is obtained by summing the score of each component. The higher the total score means the more effective the role of the audit committee. The second approach is using the partial score of each attribute of the audit committee, size (SIZEAC) calculated by a number of audit committee members, independent audit committee (ACIND) is the proportion of independent commissioners in the audit committee (ACIND), audit committee expertise is the proportion of audit committee expertise in accounting and finance (ACEXPERT), audit committee meeting (ACMEET) is the number of meeting audit committee for one year.

The dependent variable is audit opinion (OA) measured using a dummy variable. If the company receives an unqualified audit opinion, it will be scored 1, otherwise, 0 (Johl et al., 2007). Earnings management (EM) is measured using the modified Jones model (Dechow et al., 1995). The steps to measure earnings management using John modified is as follow:

$$\frac{TA_{i,t}}{A_{i,t-1}} = \beta_1 \left( \frac{1}{A_{i,t-1}} \right) + \beta_2 \left( \frac{\Delta REV_{i,t}}{A_{i,t-1}} \right) + \beta_3 \left( \frac{PPE_{i,t}}{A_{i,t-1}} \right) + \varepsilon_{i,t} \quad (1)$$

$$AA = \frac{TA_{i,t}}{A_{i,t-1}} - \left[ \hat{\beta}_1 \left( \frac{1}{A_{i,t-1}} \right) + \hat{\beta}_2 \left( \frac{\Delta REV_{i,t} - \Delta REC_{i,t}}{A_{i,t-1}} \right) + \hat{\beta}_3 \left( \frac{PPE_{i,t}}{A_{i,t-1}} \right) \right] \quad (2)$$

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where  $TA_{i,t}$  is the total accruals at the company  $i$  for year  $t$ , which is defined as net income minus operating cash flows;  $AA$  is abnormal accruals;  $\Delta REV_{i,t}$  is the change in revenue for the company  $i$  for year  $t$ ,  $\Delta REC_{i,t}$  is a change in receivable for the company  $i$  for year  $t$ ;  $A_{i,t-1}$  is the total assets of the company at the beginning of the year  $t$ ;  $PPE_{i,t}$  is a fixed asset at the company  $i$  for year  $t$ ;  $\beta_1$ ,  $\beta_2$ , and  $\beta_3$  are estimates of regression of the coefficients  $\beta_1$ ,  $\beta_2$ , and  $\beta_3$ ; and  $\varepsilon_{i,t}$  is a residual.

The control variables in this study are firm size ( $FSIZE$ ) measured by natural logarithm of total assets and leverage ( $LEV$ ) measured by debt divided by assets.

The research model in this study is as follows:

$$OA_{i,t} = \alpha_0 + \alpha_1 KA_{i,t-1} + \alpha_2 FSIZE_{i,t-1} + \alpha_3 LEV_{i,t-1} + \varepsilon_{i,t} \quad (3.1)$$

$$EM_{i,t-1} = \beta_0 + \beta_1 KA_{i,t-1} + \beta_2 FSIZE_{i,t-1} + \beta_3 LEV_{i,t-1} + \varepsilon_{i,t} \quad (3.2)$$

$$OA_{i,t} = \gamma_0 + \gamma_1 EM_{i,t-1} + \gamma_2 FSIZE_{i,t-1} + \gamma_3 LEV_{i,t-1} \quad (3.3)$$

$$OA_{i,t} = \theta_0 + \theta_1 KA_{i,t-1} + \theta_2 EM_{i,t-1} + \theta_3 FSIZE_{i,t-1} + \theta_4 LEV_{i,t-1} + \varepsilon_{i,t} \quad (3.4)$$

#### 4 Result

The profile of the research variables is presented in Table 1.

**Table 1** Statistic descriptive

	N	Min	Max	Mean	S.Dev
KA	247	0	4	1,88	0,703
SIZEAC	247	1	7	3,24	,707
%ACIND	247	20%	100%	36,8498%	13,46841%
%ACEPERT	247	20%	100%	75,2448%	23,97785%
ACMEET	247	1	57	8,17	9,173
EM	247	0,0000	1,8811	0,086311	0,1615361
FSIZE	247	9,9586	14,2977	12,548438	0,8432104
LEV	247	0,0038	7,1700	0,485561	0,6668880

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KA has an average of 1.88. This means that on average, the effectiveness of the audit committee is quite low. Using the second approach measurement of the audit committee, the score of each attribute is as follows, on average companies have 3.24 mean of SIZEAC, this shows that the average number of audit committee members meet the requirements; then the ACIND variable has an average of 36.8498%. This means that overall, companies can fulfil the minimum requirement of the independent audit committee. The third attribute is ACEPERT variable it has an average of 75.2448%

means that the expertise of the audit committee meets the requirements. Besides, the ACEMEET variable has an average of 8.17. This shows that the overall audit committee have fulfilled the requirements in holding regular meetings within 1 year.

EM variable has an average value in this variable is equal to 0.086311. This means that overall the company has good financial reporting quality or little managing its profits. The FSIZE variable is a control variable that measures the size of a company. Overall, the average size of the company is 12,548438. Then, the LEV variable has a company average of 0.485561, which means that the average company is 48.561% of its assets funded by debt.

Two hundred forty-seven companies qualify the sample criteria, as 85% of the companies have unqualified opinions and the remaining 15% are companies that have qualified opinions. This means that the company has presented financial statements fairly and following applicable accounting standards. This study also fulfilled the feasibility test requirements for logistic regression models (overall model fit, Nagelkerkel R square, and Hosmer and Lemeshow) and classical assumption tests (normality, heteroscedasticity, multicollinearity, and autocorrelation). The results of hypothesis testing will be explained through the model image (Figure 2) of the study to explain the hypothesis received in this study.

**Figure 2** The result of research model

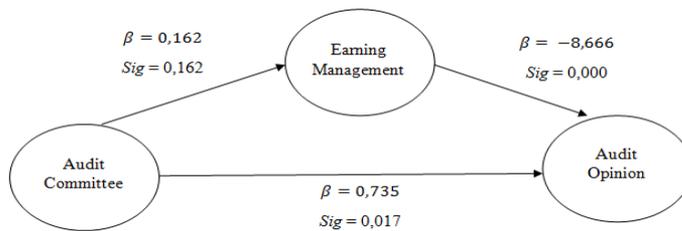


Figure 2 shows that the audit committee has a positive influence on audit opinion so that Hypothesis 1 (H1) is accepted. But when tested by each of the audit committee attributes, only audit committee meetings have a positive influence on opinion. The audit committee on earnings management does not have a significant effect on earnings management so Hypothesis 2 (H2) is rejected. When the attributes of the audit committee are tested, it turns out that the number of audit committees, independent audit committees, expertise, and meetings do not have a significant effect on audit opinions. In Hypothesis 3 (H3) is accepted, namely earnings management has a negative influence on audit opinion. Furthermore, Hypothesis 4 (H4) will include earnings management as a mediating variable to see how the audit committee influences the audit opinion which can be seen in Table 2.

This result can be seen that the audit committee has a coefficient value of 0.835, at significance level 0.018. This means that overall the audit committee has a positive influence on audit opinion. Then the earning management of the audit opinion has a coefficient value of  $-8.649$  with a significance of 0.001. Therefore, if a company manages its earnings according to the management interest, it will lead to having an opinion other than unqualified. Furthermore, the significance of this mediation test will

be proven by the Sobel test. The results of the Sobel test calculation have a z-value of -1.5475 or smaller 1.96 which indicates that earning management cannot significantly mediate the relationship of the audit committee and audit opinion. Then when the audit committee attributes are tested each, they have the same results. This means that overall earnings management cannot mediate the influence of the audit committee on audit opinion.

**Table 2** Hypothesis testing results (H4)

	$\beta$	Sig.
$KA_{i,t-1}$	0,835	0,018
$EM_{i,t-1}$	-8,469	0,001
$FSIZE_{i,t-1}$	-0,026	0,938
$LEV_{i,t-1}$	-1,513	0,001

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## 5 Discussion

This study finds that the audit committee has a positive influence on opinion. From the partial approach of the audit committee, we find that only the audit committee meeting has a positive influence on the audit opinion. This finding is supported by Choi et al. (2004) which explain that although the audit committee is independent and has expertise but does not hold meetings, the role of the audit committee has not been effective. The audit committee meeting shows the activities of the audit committee in conducting oversight. Previous studies found that auditors' independence and objectivity can be monitored by audit committees (Carcello and Neal, 2000; Wu et al., 2014). Independent audit committees and holding meetings can increase the auditor's ability to detect and report material misstatements (Abbott, 2000; DeAngelo, 1981). This oversight will make the auditor more independent when conducting the audit process so that the opinions issued reflect the true condition of the company (Hoitash and Hoitash, 2009). The size of the audit committee has no significant effect on the audit opinion. This means that the size of the audit committee does not influence the issuance of the opinion. According to Haji (2015) the number of large audit committees is difficult to make decisions because it has a variety of opinions. Other opinions such as DeFond and Francis (2005) stated that the size of the audit committee is small, therefore, the monitoring of the audit committee becomes less effective. The size of the audit committee is not a significant factor in conducting supervision (Alkdai and Hanefah, 2012). Bédard et al. (2004) proposed that the size of the audit committee is not so large, but large enough to ensure effective monitoring. The issuance of an opinion by the auditor can be monitored by the audit committee if the number of audit committees is large enough to carry out monitoring.

Our second finding is the audit committee does not have a significant effect on earnings management. The number of audit committees is small so that the role of the audit committee becomes less effective in carrying out supervision. But if the number of audit committees is large, it tends to be easy to follow the opinions of other members so that the audit committee becomes less independent. Therefore, the number of audit committees needs to be adjusted to the needs of the company (Kipkoech et al., 2016). Several prior studies found that independent audit committees, audit committee expertise, and audit committee meetings do not have a significant influence on earnings

management (Bédard et al., 2004; Peasnell et al., 2000; Rahman and Mohamed Ali, 2006). According to Rahman and Mohamed Ali (2006), the role of the audit committee cannot prevent earnings management. It seems that the formation of an audit committee within the company has not yet achieved its objectives.

This study also proves that earning management has a negative influence on audit opinion. According to Bellovary et al. (2005), the profit managed does not reflect the condition of the company, it does not represent the real condition of the company. The managed profit will affect the audit process and audit opinion (Suryanto and Grima, 2018). This finding is also supported by Butler et al. (2004) and Johl et al. (2007) which stated that the higher the earning management, the auditor issues opinions other than unqualified. This means that earnings management can be detected through an audit process and resulting opinions other than unqualified. The published audit opinions reveal the condition of the company, where the auditor works independently without being intervened by the manager (Moalla, 2017).

Further, we find that earnings management cannot mediate the influence of the audit committee on audit opinion. The existence of an audit committee cannot detect the presence of earnings management. The role of the audit committee needs to be improved in overseeing the financial reporting process so that it can improve the quality of financial reporting. On the influence of the audit committee on audit opinion, it can be seen that the audit committee meeting has a major contribution in overseeing the opinions issued by the auditor. The audit committee meeting shows the activities of the audit committee in fulfilling its responsibilities in conducting oversight (Abbott, 2000). Monitoring mechanisms are more effective when audit committees hold meetings more often (Rahmat et al., 2009). Then the earnings management can be detected through an audit opinion. This means that the auditor has worked effectively in detecting material errors and misstatements in the financial statements. The auditor needs to be independent so that the formulation of opinions is more objective and unbiased (Moalla, 2017). Auditors' independence and objectivity need to be monitored by the audit committee (Wu et al., 2014). All fraud and illegal actions discovered by the auditor can be reported to the audit committee regardless of materiality (Arens et al., 2015).

## 6 Conclusions

This study aims to search the mediating effect of earning management on the influence of the audit committee on audit opinion. The research models are tested in two stages. The first test is using the audit committee a whole on audit opinion through earnings management as a mediating variable. The second is tested the partial attributes of the audit committee such as the audit committee's size, independent audit committee, audit committee expertise, and audit committee meeting. This study finds that the audit committee has a positive influence on audit opinion. The meeting activities of the audit committee are an important attribute that effectively influences the audit opinion. However, the existence of the audit committee does not have a significant effect on earnings management. Furthermore, this study shows that earnings management has a significant negative effect on audit opinion. This study cannot prove the mediating effect of earnings management in the influence of the audit committee toward audit opinion.

Managerial implications based on the results of this study are that companies need to pay attention to and empower audit committee meetings effectively. The meeting shows

the activities of the audit committee in fulfilling its responsibilities. The number of large audit committees, independence, and expertise is indeed needed, but if there is no meeting, there is no activity of the audit committee and not enough in conducting supervision. Then, the existence of an audit committee can oversee between auditors and management so that problems and conflicts between auditors can be overcome by the existence of an audit committee. The auditor's role can capture the existence of earning management through the issuance of opinion because the financial statements presented have not yet described the actual performance conditions.

This study has some limitations including a sample that are restricted only certain sectors so that the result cannot generalised in other sectors. The reason to restrict the industrial sectors is based on the number of qualified opinions received in the sectors. Further research can be applied in the similar sample characteristic but in different study period in order to get the robust results. This study also uses a single proxy to measure financial reporting quality that is earning management. Future study is expected to use other indicators so that the results of the study are more comprehensive.

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**Juniarti .** <yunie@petra.ac.id>  
To: Vie Campos <inderscience@allsetbposervices.com>  
Cc: Richard Sharp <sharp\_richard@btconnect.com>

Wed, Oct 14, 2020 at 9:25 AM

No, I didn't receive it.

[Quoted text hidden]

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**Richard Sharp** <sharp\_richard@btconnect.com>  
To: Vie Campos <inderscience@allsetbposervices.com>, yunie@petra.ac.id

Wed, Oct 14, 2020 at 4:45 PM

Thanks Vie.

Dick

[Quoted text hidden]

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**inderscience@allsetbposervices.com** <inderscience@allsetbposervices.com>  
To: "Juniarti ." <yunie@petra.ac.id>

Thu, Oct 15, 2020 at 10:05 PM

Dear Author,

I have sent the proof again. Please let if you were able to received it.

Warm regards,

Vie

[Quoted text hidden]

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**Juniarti .** <yunie@petra.ac.id>  
To: Vie Campos <inderscience@allsetbposervices.com>

Thu, Oct 15, 2020 at 10:18 PM

Dear Vie,

Ok, I have received it, and I will send it back after addressing all the correction/comment

Thank you.

Best regards,

[Quoted text hidden]

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**Juniarti .** <yunie@petra.ac.id>  
To: Vie Campos <inderscience@allsetbposervices.com>

Mon, May 17, 2021 at 11:56 AM

Hello... Could you help me, when our paper will be published? Because all the process was finished last year?

I see that my paper is still on the list of forthcoming papers.

I hope that my paper can be published soon, since I am worried that the issue of my paper will become obsolete if it is published too late.

Thanks

[Quoted text hidden]

\*Dr. Juniarti, M.Si., Ak., CA, CPA (Aust)\*

[Quoted text hidden]

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**Vie Campos** <inderscience@allsetbposervices.com>  
To: "Juniarti ." <yunie@petra.ac.id>

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## **The effect of audit committee on audit opinion through earnings management as mediation variable**

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**Abstract:** This study aims to examine the mediating effect of earnings management in the influence of the audit committee on audit opinion. The research samples are listed companies in the IDX in the sectors of infrastructure, utilities, and transportation for 2011–2017. This selection of industrial sectors due to these sectors obtains many qualified audit opinions in the study period compared to other sectors. This study adds control variables, namely firm size and leverage. We measure audit committee using two approaches, the first is the total score of each component of audit committees including size, independence, expertise, and meeting and the second is the partial score of each attribute of the audit committee. The results show that the audit committee influences the audit opinion and there is a negative significant influence of earning management and audit opinion, but, this study fails to prove the mediating effect of earning management in the relationship of the audit committee and audit opinion.

**Keywords:** audit committee; earning management; audit opinion.

**Reference** to this paper should be made as follows: Juniarti, Fany and Devie (xxxx) ‘The effect of audit committee on audit opinion through earnings management as mediation variable’, *Afro-Asian J. Finance and Accounting*, Vol. X, No. Y, pp.xxx–xxx.

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Fany graduated from Master of Management Petra Christian University. She obtained her Bachelor of Accounting from University of Surabaya, Faculty Business and Economics.

Devie is an Associate Professor at Accounting Department, Petra Christian University. He is also a former Dean in Faculty of Economics of Petra (2000–2008). He is doing his professional work as a lecturer and also a business consultant. His research interest includes managerial accounting, financial management, and accounting behaviour.

## 1 Introduction

Financial report scandals in several companies have triggered a crisis of trust and have a detrimental effect on stakeholders (Zgarni et al., 2016). Audit quality has been highlighted in these scandals. One of the notable scandals is the Enron case because it has to lead the collapse of Arthur Andersen (Chen et al., 2005). According to Nogler (2008), some large companies, such as WorldCom, Global Crossing, and Ual Crop followed the Enron case, even, these companies have received an unqualified opinion, previously. Indonesia also experienced similar scandals. In 2018, the Otoritas Jasa Keuangan (OJK, 2018) gave sanctions to Deloitte's Public Accountants for failing to conduct financial statement audits. Its client, PT Sunprima Nusantara received unqualified opinions, however, as the result of the OJK's examination, the financial of the company is not presented as the actual financial conditions. The case raises concerns about how the Public Accounting Office practices in developing countries following the code of ethics.

The presence of external auditors aims to oversee fairness in the financial statements. However, there are conflicts between management and external auditors because of differences of opinion related to accounting estimates, interpretations of accounting standards, and disclosure problems (Salleh and Stewart, 2012). The auditor is appointed by the company and can be dismissed if the opinion does not match the manager's expectations. This often lead manager and auditor enter into negotiation of some conditions of its financial statements (Mohd Saleh et al., 2007). As a consequence, the published audit opinion is biased and misleads interested parties.

Audit committees are appointed to act independently in resolving conflicts between managers and auditors (Klein, 2002; Salleh and Stewart, 2012). They monitor the independence and objectivity of external auditors through the audit process (Wu et al., 2014). Prior studies suggested that there is a positive effect of the audit committee and audit opinion (Bronson et al., 2009; Carcello and Neal, 2000, 2003; Hoitash and Hoitash, 2009; Pomeroy and Thornton, 2008). According to Hoitash and Hoitash (2009), the role of an effective audit committee makes auditors more independent in conducting audits so that the opinions issued are under the conditions of the company. Hoitash and Hoitash (2009) explained that the dismissal of auditors can occur because the auditor publishes qualified opinions that are not under the expectation of management. This causes the company to look for other auditors to obtain audit opinions as the manager's expected.

Earning management is a deliberate intervention in the process of financial reporting to external parties for personal gain (Healy and Palepu, 1990; Beneish, 2001; Skinner and Dechow, 2000). Managers can use judgment on financial reporting and transaction structure so that the information presented can be misleading for stakeholders and influence financial reporting quality (Bratten et al., 2019; Healy and Wahlen, 1999). Earning management opportunities can be narrowed by the existence of an audit committee. Some previous studies support that audit committees can reduce earnings management (Bradbury et al., 2006; Inaam and Khamoussi, 2016; Mohd Saleh et al., 2007; Zgarni et al., 2016). However, other studies found the opposite, that audit committees do not affect earnings management (Rahman and Mohamed Ali, 2006).

When a company manages profits, it will affect the audit opinion issued (Suryanto and Grima, 2018). It is also in line with the finding of Johl et al. (2007) when managers manage earnings, the auditor will issue a qualified opinion. Francis and Krishnan (1999) researched accrual level on audit opinion. The result showed that when the company's

accrual level is high, the auditor will issue a qualified opinion. Accrual levels are related to high abnormal (discretionary) accruals (Johl et al., 2007).

Issuing audit opinion is the responsibility of the external auditor. On the other hand, the audit committee is responsible for overseeing the financial reporting process and the audit process, so that the company obtains an audit opinion following the conditions of the company. Many prior studies directly examine the relationship between the audit committee and earnings management or earnings management and audit opinion. This study will develop a comprehensive model, by proposing earnings management as the mediating variable in the relationship of the audit committee and audit opinion. We argue that the role of the audit committee in obtaining proper audit opinion should be indirect. It is due to the role of committee audit is first to oversee the management so that managers will be limited to manage earnings as they want, but as the real condition of the companies. Many prior studies supported that the audit committee limits earnings management opportunities (Bradbury et al., 2006; Inaam and Khamoussi, 2016; Mohd Saleh et al., 2007; Zgarni et al., 2016). Then, the audit committee will drive a proper audit opinion through limiting of earnings management opportunity. The study of the partial relationship among variables will mislead the role of the audit committee. The existence of an audit committee is required by good corporate governance mechanism, to help the Board of Commissioner to monitor managers. Therefore, the comprehensive evaluation of the performance of the audit committee should be conducted comprehensively. This study also will provide evidence of the effectiveness of audit committees, whether they carry out its role as required.

## **2 Literature review**

### *2.1 Agency theory*

In agency theory, the motivation of a rational agent is to act on behalf of the principal, but the interests of the agent are contrary to the interests of the principal (Scott, 2015). The agent has the responsibility to maximise the benefit of the principal, but the agent has other interests to maximise his welfare. This is called a conflict of interest (Jensen and Meckling, 1976). Manager's opportunistic behaviour can be minimised through the audit committee. The audit committee can reduce this agency problem so that it can improve the quality of financial reporting and maintain information that will be conveyed to stakeholders (Islam et al., 2014). This agency problem is a lack of companies, such as lack of internal control effectiveness, lack of independent auditors, and others.

### *2.2 Effectiveness of the audit committee*

Audit committees oversee the financial reporting process and ensure financial reporting is presented correctly and fairly (Beasley et al., 2000). The effectiveness of the audit committee is closely related to supervisory activities. This monitoring area includes monitoring of the financial reporting process, monitoring internal controls and risks, and monitoring the activities of external auditors (Beasley et al., 2009; Kusnadi et al., 2016). Monitoring the financial reporting process includes monitoring accounting policies, compliance with regulations, and investigating problematic accounting practices (Beasley et al., 2009).

### 2.3 *Earning management*

Earning management is one of the indicators of financial reporting quality. Low earnings management represents a higher financial reporting quality. Much previous research using earnings management as an indicator of financial reporting quality, among others are Chandar et al. (2012), Johl et al. (2013), Krishnan et al. (2011) and Al Shaer (2017). Qualified financial reporting leads to better decision-making of interested parties. Based on IFRS (2018), information is useful, if it is relevant and provides a representation of what is a faithful representation. Thus, the profits managed by management do not reflect actual company performance (Bellovary et al., 2005).

### 2.4 *Audit opinion*

An audit is one of the governance mechanisms which aim to reduce information asymmetry and conflicts of interest between managers and shareholders (Moalla, 2017). The audit opinion is the result of audit processes. There are four types of audit opinions, which are unqualified, qualified, or reasonable with exceptions, adverse, and disclaimer or refuse to give an opinion (Arens et al., 2015). An audit can increase investor confidence and ensure that the information presented by the manager is not in its interest. External auditors are parties contracted by companies, but they must work independently from managers so that they can produce an objective opinion. Often, this situation makes auditors face difficulties, especially when issuing qualified opinions because they are vulnerable to management pressure (Ballesta and Meca, 2005). Qualified opinion is an opinion that is not desired by the manager because it shows the poor quality of the financial statements. This can be minimised when the role of the audit committee is more effective. An effective audit committee can keep audit quality (Carcello and Neal, 2000).

Prior studies identified the following characteristics of the effective audit committee:

- 1 has a large size
- 2 has enough independent committee
- 3 has an expertise and experience in his tasks
- 4 has high committee meetings (Abbott, 2000; DeFond and Francis, 2005; Hichem and Samaha, 2016; Mohd Saleh et al., 2007).

An effective audit committee will monitor and supervise tightly during the audit processes to ensure the audit (DeFond and Francis, 2005; Abbott, 2000). The auditor will be protected from manager pressure and can publish opinions according to the facts.

H1 Audit committee has a positive influence on the audit opinion.

Agency theory requires a supervisory mechanism in the relationship between agents and principals. This mechanism is to monitor agent behaviour so that it can minimise opportunistic behaviour and non-compliance from the agent. The role of the audit committee is to oversee the preparation of financial statements and to prevent discrepancies between auditors and management (Martinez and Fuentes, 2011). This can reduce management errors and non-compliance in preparing financial statements. Previous research examined the characteristics of the audit committee for earnings management. According to DeFond and Francis (2005), the size of a large audit

committee can provide effective monitoring so that it encourages management to improve the quality of financial reporting. Independent audit committees and audit committees that frequently meeting can reduce accounting irregularities (Dechow et al., 1996; Nor et al., 2010). DeZoort and Salterio (2001) also found that the expertise of the audit committees in the field of accounting and finance enables them to understand well the auditor's assessment and will mediate the conflict between management and the auditor. An independent audit committee limits earning management because it provides clear responsibilities in overseeing the accounting, financial reporting, and audit processes to reduce earnings management. Then Klein (2002) study states that:

H2 The audit committee has a negative influence on earnings management.

Earning management occurs when managers use judgment in financial reporting that affects the accounting numbers to be reported (Healy and Wahlen, 1999). The higher the earning management, the more likely the auditors' issue opinions other than unqualified (Johl et al., 2007). Audit opinion communicates whether financial statements are free of material misstatement and are following accounting standards. The qualified auditors can detect the existence of earning management practices, then they will communicate it through their opinion. The previous study supported that companies that conducted earnings management, received a qualified opinion (Butler et al., 2004)

H3 Earning management has a negative influence on audit opinion.

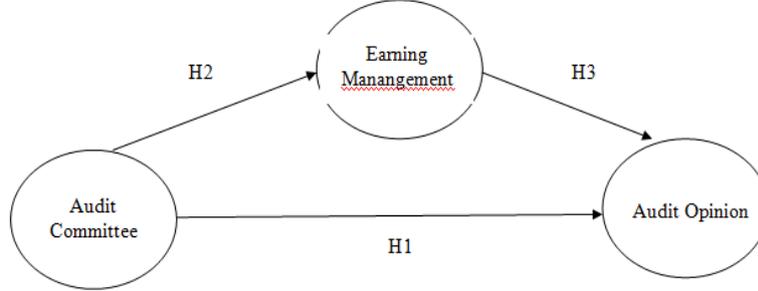
One of the motivations of management in committing fraud is to get bonuses related to the company's performance or other financial targets (Kassem, 2018). When a company fails to achieve profit, management will take advantage of the flexibility of accounting standards to modify profits to be reported (Suryanto and Grima, 2018). This profit modification will affect the audit process and audit opinion. Suryanto and Grima (2018) explained that audit opinions are very important in enhancing the company's reputation and increasing investor interest in investing. Modification of earnings can be prevented through the role of the audit committee so that the opinions issued describe the condition of the company. The role of the audit committee becomes less effective if it has a small number of members and lack of skills and knowledge (Rahmat et al., 2009). The audit committees that have expertise can monitor management activities (Bilal et al., 2018). An independent audit committee can minimise conflicts between auditors and management (Kusnadi et al., 2016). Besides that, the activity of monitoring through the high frequency of audit committee meetings will make the governance mechanism more effective. This is because the audit committee will discuss financial reporting issues to find solutions and take corrective actions (Hichem and Samaha, 2016).

H4 Earning management mediates the influence of the audit committee on audit opinion.

### **3 Methodology**

The sample of this research is public companies listed in the Indonesia Stock Exchange from 2011–2017, excluded the non-financial sector. Companies have a book year ending December 31, with the highest qualified opinion in the research period.

The research model is explained in Figure 1.

**Figure 1** Research model

We measure the audit committee, using two approaches. The first one is the total score of each component of audit committees including size, independence, expertise, and meeting (Baxter, 2010). If the audit committee's size consists of more than three people, it will be scored 1, otherwise, 0. If the audit committee has independent audit members equal to or more than 50%, it will be scored 1, otherwise, 0. If the audit committee has members with expertise in accounting or finance or both, it will be scored 1, otherwise, 0. The last is the meeting frequency, if the audit committee meeting is more than three times a year, will be scored 1, otherwise, 0. The score of the audit committee (KA) is obtained by summing the score of each component. The higher the total score means the more effective the role of the audit committee. The second approach is using the partial score of each attribute of the audit committee, size (SIZEAC) calculated by a number of audit committee members, independent audit committee (ACIND) is the proportion of independent commissioners in the audit committee (ACIND), audit committee expertise is the proportion of audit committee expertise in accounting and finance (ACEXPERT), audit committee meeting (ACMEET) is the number of meeting audit committee for one year.

The dependent variable is audit opinion (OA) measured using a dummy variable. If the company receives an unqualified audit opinion, it will be scored 1, otherwise, 0 (Johl et al., 2007). Earnings management (EM) is measured using the modified Jones model (Dechow et al., 1995). The steps to measure earnings management using John modified is as follow:

$$\frac{TA_{i,t}}{A_{i,t-1}} = \beta_1 \left( \frac{1}{A_{i,t-1}} \right) + \beta_2 \left( \frac{\Delta REV_{i,t}}{A_{i,t-1}} \right) + \beta_3 \left( \frac{PPE_{i,t}}{A_{i,t-1}} \right) + \varepsilon_{i,t} \quad (1)$$

$$AA = \frac{TA_{i,t}}{A_{i,t-1}} - \left[ \hat{\beta}_1 \left( \frac{1}{A_{i,t-1}} \right) + \hat{\beta}_2 \left( \frac{\Delta REV_{i,t} - \Delta REC_{i,t}}{A_{i,t-1}} \right) + \hat{\beta}_3 \left( \frac{PPE_{i,t}}{A_{i,t-1}} \right) \right] \quad (2)$$

where  $TA_{i,t}$  is the total accruals at the company  $i$  for year  $t$ , which is defined as net income minus operating cash flows;  $AA$  is abnormal accruals;  $\Delta REV_{i,t}$  is the change in revenue for the company  $i$  for year  $t$ ,  $\Delta REC_{i,t}$  is a change in receivable for the company  $i$  for year  $t$ ;  $A_{i,t-1}$  is the total assets of the company at the beginning of the year  $t$ ;  $PPE_{i,t}$  is a fixed asset at the company  $i$  for year  $t$ ;  $\beta_1$ ,  $\beta_2$ , and  $\beta_3$  are estimates of regression of the coefficients  $\beta_1$ ,  $\beta_2$ , and  $\beta_3$ ; and  $\varepsilon_{i,t}$  is a residual.

The control variables in this study are firm size (FSIZE) measured by natural logarithm of total assets and leverage (LEV) measured by debt divided by assets.

The research model in this study is as follows:

$$OA_{i,t} = \alpha_0 + \alpha_1 KA_{i,t-1} + \alpha_2 FSIZE_{i,t-1} + \alpha_3 LEV_{i,t-1} + \varepsilon_{i,t} \quad (3.1)$$

$$EM_{i,t-1} = \beta_0 + \beta_1 KA_{i,t-1} + \beta_2 FSIZE_{i,t-1} + \beta_3 LEV_{i,t-1} + \varepsilon_{i,t} \quad (3.2)$$

$$OA_{i,t} = \gamma_0 + \gamma_1 EM_{i,t-1} + \gamma_2 FSIZE_{i,t-1} + \gamma_3 LEV_{i,t-1} \quad (3.3)$$

$$OA_{i,t} = \theta_0 + \theta_1 KA_{i,t-1} + \theta_2 EM_{i,t-1} + \theta_3 FSIZE_{i,t-1} + \theta_4 LEV_{i,t-1} + \varepsilon_{i,t} \quad (3.4)$$

#### 4 Result

The profile of the research variables is presented in Table 1.

**Table 1** Statistic descriptive

	<i>N</i>	<i>Min</i>	<i>Max</i>	<i>Mean</i>	<i>S. dev</i>
KA	247	0	4	1.88	0.703
SIZEAC	247	1	7	3.24	0.707
%ACIND	247	20%	100%	36,85%	13,47%
%ACEXPERT	247	20%	100%	75.24%	23.98%
ACMEET	247	1	57	8.17	9.17
EM	247	0.000	1.881	0.086	0.162
FSIZE	247	9.96	14.30	12.55	0.84
LEV	247	0.004	7.170	0.486	0.667

KA has an average of 1.88. This means that on average, the effectiveness of the audit committee is quite low. Using the second approach measurement of the audit committee, the score of each attribute is as follows, on average companies have 3.24 mean of SIZEAC, this shows that the average number of audit committee members meet the requirements; then the ACIND variable has an average of 36.8498%. This means that overall, companies can fulfil the minimum requirement of the independent audit committee. The third attribute is ACEXPRT variable it has an average of 75.2448% means that the expertise of the audit committee meets the requirements. Besides, the ACEMEET variable has an average of 8.17. This shows that the overall audit committee have fulfilled the requirements in holding regular meetings within 1 year.

EM variable has an average value in this variable is equal to 0.086311. This means that overall the company has good financial reporting quality or little managing its profits. The FSIZE variable is a control variable that measures the size of a company. Overall, the average size of the company is 12,548438. Then, the LEV variable has a company average of 0.485561, which means that the average company is 48.561% of its assets funded by debt.

Two hundred forty-seven companies qualify the sample criteria, as 85% of the companies have unqualified opinions and the remaining 15% are companies that have qualified opinions. This means that the company has presented financial statements fairly and following applicable accounting standards. This study also fulfilled the feasibility test requirements for logistic regression models (overall model fit, Nagelkerkel R square, and

Hosmer and Lemeshow) and classical assumption tests (normality, heteroscedasticity, multicollinearity, and autocorrelation). The results of hypothesis testing will be explained through the model image (Figure 2) of the study to explain the hypothesis received in this study.

**Figure 2** The result of research model

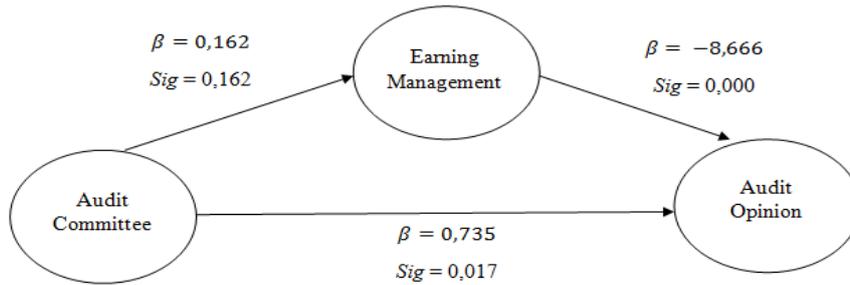


Figure 2 shows that the audit committee has a positive influence on audit opinion so that Hypothesis 1 (H1) is accepted. But when tested by each of the audit committee attributes, only audit committee meetings have a positive influence on opinion. The audit committee on earnings management does not have a significant effect on earnings management so Hypothesis 2 (H2) is rejected. When the attributes of the audit committee are tested, it turns out that the number of audit committees, independent audit committees, expertise, and meetings do not have a significant effect on audit opinions. In Hypothesis 3 (H3) is accepted, namely earnings management has a negative influence on audit opinion. Furthermore, Hypothesis 4 (H4) will include earnings management as a mediating variable to see how the audit committee influences the audit opinion which can be seen in Table 2.

This result can be seen that the audit committee has a coefficient value of 0.835, at significance level 0.018. This means that overall the audit committee has a positive influence on audit opinion. Then the earning management of the audit opinion has a coefficient value of  $-8.649$  with a significance of 0.001. Therefore, if a company manages its earnings according to the management interest, it will lead to having an opinion other than unqualified. Furthermore, the significance of this mediation test will be proven by the Sobel test. The results of the Sobel test calculation have a z-value of  $-1.5475$  or smaller 1.96 which indicates that earning management cannot significantly mediate the relationship of the audit committee and audit opinion. Then when the audit committee attributes are tested each, they have the same results. This means that overall earnings management cannot mediate the influence of the audit committee on audit opinion.

**Table 2** Hypothesis testing results (H4)

	$\beta$	Sig
$KA_{i,t-1}$	0.835	0.018
$EM_{i,t-1}$	-8.469	0.001
$F\text{SIZE}_{i,t-1}$	-0.026	0.938
$LEV_{i,t-1}$	-1.513	0.001

## **5 Discussion**

This study finds that the audit committee has a positive influence on opinion. From the partial approach of the audit committee, we find that only the audit committee meeting has a positive influence on the audit opinion. This finding is supported by Choi et al. (2004) which explain that although the audit committee is independent and has expertise but does not hold meetings, the role of the audit committee has not been effective. The audit committee meeting shows the activities of the audit committee in conducting oversight. Previous studies found that auditors' independence and objectivity can be monitored by audit committees (Carcello and Neal, 2000; Wu et al., 2014). Independent audit committees and holding meetings can increase the auditor's ability to detect and report material misstatements (Abbott, 2000; DeAngelo, 1981). This oversight will make the auditor more independent when conducting the audit process so that the opinions issued reflect the true condition of the company (Hoitash and Hoitash, 2009). The size of the audit committee has no significant effect on the audit opinion. This means that the size of the audit committee does not influence the issuance of the opinion. According to Haji (2015) the number of large audit committees is difficult to make decisions because it has a variety of opinions. Other opinions such as DeFond and Francis (2005) stated that the size of the audit committee is small, therefore, the monitoring of the audit committee becomes less effective. The size of the audit committee is not a significant factor in conducting supervision (Alkdai and Hanefah, 2012). Bédard et al. (2004) proposed that the size of the audit committee is not so large, but large enough to ensure effective monitoring. The issuance of an opinion by the auditor can be monitored by the audit committee if the number of audit committees is large enough to carry out monitoring.

Our second finding is the audit committee does not have a significant effect on earnings management. The number of audit committees is small so that the role of the audit committee becomes less effective in carrying out supervision. But if the number of audit committees is large, it tends to be easy to follow the opinions of other members so that the audit committee becomes less independent. Therefore, the number of audit committees needs to be adjusted to the needs of the company (Kipkoech et al., 2016). Several prior studies found that independent audit committees, audit committee expertise, and audit committee meetings do not have a significant influence on earnings management (Bédard et al., 2004; Peasnell et al., 2000; Rahman and Mohamed Ali, 2006). According to Rahman and Mohamed Ali (2006), the role of the audit committee cannot prevent earnings management. It seems that the formation of an audit committee within the company has not yet achieved its objectives.

This study also proves that earning management has a negative influence on audit opinion. According to Bellovary et al. (2005), the profit managed does not reflect the condition of the company, it does not represent the real condition of the company. The managed profit will affect the audit process and audit opinion (Suryanto and Grima, 2018). This finding is also supported by Butler et al. (2004) and Johl et al. (2007) which stated that the higher the earning management, the auditor issues opinions other than unqualified. This means that earnings management can be detected through an audit process and resulting opinions other than unqualified. The published audit opinions reveal the condition of the company, where the auditor works independently without being intervened by the manager (Moalla, 2017).

Further, we find that earnings management cannot mediate the influence of the audit committee on audit opinion. The existence of an audit committee cannot detect the

presence of earnings management. The role of the audit committee needs to be improved in overseeing the financial reporting process so that it can improve the quality of financial reporting. On the influence of the audit committee on audit opinion, it can be seen that the audit committee meeting has a major contribution in overseeing the opinions issued by the auditor. The audit committee meeting shows the activities of the audit committee in fulfilling its responsibilities in conducting oversight (Abbott, 2000). Monitoring mechanisms are more effective when audit committees hold meetings more often (Rahmat et al., 2009). Then the earnings management can be detected through an audit opinion. This means that the auditor has worked effectively in detecting material errors and misstatements in the financial statements. The auditor needs to be independent so that the formulation of opinions is more objective and unbiased (Moalla, 2017). Auditors' independence and objectivity need to be monitored by the audit committee (Wu et al., 2014). All fraud and illegal actions discovered by the auditor can be reported to the audit committee regardless of materiality (Arens et al., 2015).

## **6 Conclusions**

This study aims to search the mediating effect of earning management on the influence of the audit committee on audit opinion. The research models are tested in two stages. The first test is using the audit committee a whole on audit opinion through earnings management as a mediating variable. The second is tested the partial attributes of the audit committee such as the audit committee's size, independent audit committee, audit committee expertise, and audit committee meeting. This study finds that the audit committee has a positive influence on audit opinion. The meeting activities of the audit committee are an important attribute that effectively influences the audit opinion. However, the existence of the audit committee does not have a significant effect on earnings management. Furthermore, this study shows that earnings management has a significant negative effect on audit opinion. This study cannot prove the mediating effect of earnings management in the influence of the audit committee toward audit opinion.

Managerial implications based on the results of this study are that companies need to pay attention to and empower audit committee meetings effectively. The meeting shows the activities of the audit committee in fulfilling its responsibilities. The number of large audit committees, independence, and expertise is indeed needed, but if there is no meeting, there is no activity of the audit committee and not enough in conducting supervision. Then, the existence of an audit committee can oversee between auditors and management so that problems and conflicts between auditors can be overcome by the existence of an audit committee. The auditor's role can capture the existence of earning management through the issuance of opinion because the financial statements presented have not yet described the actual performance conditions.

This study has some limitations including a sample that are restricted only certain sectors so that the result cannot generalised in other sectors. The reason to restrict the industrial sectors is based on the number of qualified opinions received in the sectors. Further research can be applied in the similar sample characteristic but in different study period in order to get the robust results. This study also uses a single proxy to measure financial reporting quality that is earning management. Future study is expected to use other indicators so that the results of the study are more comprehensive.

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