

ACCOUNTING CONSERVATISM AND THE ROLE OF AUDIT COMMITTEE

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ABSTRACT: *Financial reporting depends on the accounting policies set by the manager, therefore the manager can prioritize personal interests to gain profits by reporting excessive company revenue. Hence the audit committee can encourage the implementation of conservative accounting policies to deter excessive revenue reporting. This study uses financial data of companies listed on the Indonesian Stock Exchange in 2012-2016. This study uses Partial Least squares structural equation modeling. The results of this study found audit committees independent did not have an influence on the implementation of accounting conservatism but the number of meetings and expertise had a significant influence on the implementation of accounting conservatism.*

Keywords: audit committee, accounting conservatism

1. INTRODUCTION

In agency theory, the relationship between principal and agent is known as a nexus of contract [7]. Principals are shareholders or investors and agents are management that manages the company and in practice, the relationship between principal and agent is difficult to create and there will be a conflict of interest [10]. The occurrence of a conflict of interest caused by management as the managing party of the company knows more about information relating to operations and overall company performance rather than shareholders, this difference in information is called information asymmetry.

Conflict of interest that occurs between management and shareholders will lead to mutual distrust because management will act in the personal interest of getting a high bonus for its performance [27]. To get a bonus, management will practice fraud by displaying excessive profits in the financial statements thus the company's performance looks good and attracts the attention of shareholders or investors. However, excessive profits are implemented based on accounting policy in preparing a financial statement. Therefore, to prevent the implementation of accounting policies that have an impact on excessive profits, companies can practice conservative accounting policies.

Accounting conservatism is an accounting policy that results in a decrease in net asset value [21] and accounting conservatism practices will recognize the costs and liabilities immediately rather than income [26]. Therefore, by applying accounting conservatism, this will minimize the opportunity for managers to apply excess profits to their personal interest, by applying conservative accounting policies, the managers will be less likely to engage in income manipulative activities [12].

The manager has the authority to determine the application of conservatism in financial reporting in the company because the manager has control over financial reporting. To encourage and supervise managers in practicing accounting conservatism in the preparation of financial reports, therefore the application of corporate governance is needed [16]. One form of corporate governance implementation in the company is the supervision of the audit committee; with the existence of an audit committee, it will encourage management to implement conservative accounting in the preparation financial statements [1, 24].

After the financial crisis in 1997 the Indonesian government required companies to have audit committees and in 2012 the Indonesian securities market required the company to have an audit committee consisting of 3 (three) members from independent commissioners and external parties [22].

One member of the audit committee is required to have expertise in finance and accounting, this obligation shows that a committee member must be able to understand the process of preparing financial statements and know the impact of accounting policies applied in preparing financial statements on company performance. Audit committee members must have expertise in reporting financial statements, business processes in the company and capital market laws so that they can encourage managers to implement conservative accounting in financial reporting[8]. In addition, the audit committee should understand and have expertise in management's accounting and audit process [19], moreover audit committee has to understand internal controls [24] and responsible for selecting and appoint an external auditor [28].

In Indonesia, the stock exchange has a regulation that regulates the audit committee has the obligation to conduct an audit committee meeting four times a year. With a meeting held every three months or four meetings in a year, it is expected that the audit committee can oversee the accounting policies applied by management in preparing financial statements, therefore, management will prepare financial statements in accordance with generally accepted accounting standards. With the supervision of the audit committee, the manager will be more careful in recognizing income so that the financial statements will not recognize excessive income that can deceive investors. Independent audit committee members who often held meetings would encourage the adoption of conservative accounting practices [23].

Indonesia is now starting to adopt International Financial Reporting Standards (IFRS) which emphasize the relevance of the value of accounting information for the future by applying fair value principles. The application of the fair value principle is applied to the valuation of company assets, such as land valuation. Therefore, in preparing financial statements based on the fair value principle, the company is required to re-assess the company's assets in accordance with the reporting date. However, to face uncertain future economic conditions, the application of fair value principles must still be carried out carefully (prudence), this is certainly

in line with the principle of conservatism which aims to anticipate the recognition of excessive profits hence information provided by the company can describe past conditions, and predict future economic conditions.

Hence the importance of prudential principles is applied in the preparation of financial statements, the role of the audit committee is needed to oversee and ensure the manager chooses conservative accounting policies.

2. THEORETICAL FRAMEWORK AND PREVIOUS EMPIRICAL EVIDENCE

Agency theory explained that the agency relationship arises when shareholders employ managers to provide services and delegate decision-making authority to managers[7]. Therefore manager and principal will have different depths of information, this difference is caused by the manager's authority to manage policies in the preparation of financial statements [5], and hence managers have the opportunity to take personal interests. To control economic action by managers, corporate governance is applied to separate functions between management control and decision making. [6]. One of the mechanisms for corporate governance is the existence of an audit committee in the company. The attributes that must be present in the audit committee are having adequate knowledge of finance and financial reporting, being independent in decision making and always holding meetings to supervise the preparation of financial reports and promoting conservative accounting practices. [15]. However, past research has found that the independence attribute on the audit committee does not correlate with the adoption of conservative accounting policies [23], and accounting conservatism in Australia is not affected by the independence of audit committees [11] however, the frequency of meetings held by the audit committee in the company, has a relationship to accounting conservatism [2] and the independent members of the audit committee who meet regularly will promote conservative accounting practices [23]. While conservatism is negatively related to audit committee expertise[3].

3. METHODOLOGY

This study used accounting conservatism equation from Khan and Watts,

$$X_i = \beta_1 + \beta_2 D_i + R_i \left(\mu_1 + \mu_2 Size_i + \frac{\mu_3 M}{B_i} + \mu_4 Lev_i \right) + D_i R_i \left(\lambda_1 + \lambda_2 Size_i + \frac{\lambda_3 M}{B_i} + \lambda_4 Lev_i \right) + e_i \quad (1)$$

$$G\ Score = \beta_3 = \mu_1 + \mu_2 Size_i + \mu_3 M/B_i + \mu_4 Lev_i \quad (2)$$

$$C\ Score = \beta_4 = \lambda_1 + \lambda_2 Size_i + \lambda_3 M/B_i + \lambda_4 Lev_i \quad (3)$$

The good news timeliness (represents the sensitiveness of accounting earnings to positive returns), the measure is β_3 . The measure of incremental timeliness for bad news (indicates the incremental response of earnings to negative returns) over good news is β_4 .

Where :

- X_i : Earnings
- B_i, β_2 : Constant
- D_i : Dummy variable equal to 1 when $R < 0$ and equal to 0 otherwise
- R_i : Stock Return
- $\mu_1 - \mu_4$ and $\lambda_1 - \lambda_4$: Empirical estimators
- $Size_i$: Ln Total asset
- M/B_i : Market to book ratio
- Lev_i : Leverage
- e_i : residual

This study define accounting conservatism proxy as the annual of the total timeliness (G-Score + C-Score)[13]. Characteristics of the audit committee in this study consist of audit committee independent is measured by the proportion of independent directors on the audit committee, the proportion of directors with financial expertise on the audit committee. Expertise is defined if audit committee has fulfilled conditions as follow : (a) experience as a public accountant, chief financial officer, controller, principal or chief accounting officer or (b) experience as a CEO or president of the firm. A last characteristic is a number of the annual audit committee meeting held in one year. Based on regulations in Indonesia the minimum frequency of meetings in one year is four times, therefore if it meets the regulation it is scored 1 and otherwise is zero. Control variable implemented to ensure the relationship between variables is not biased. In this study, the control variables is leverage: measured by percentage debt to equity [14, 17] and market to book ratio: measured by book liabilities plus market value of equity divided by book value of assets [23, 28, 20].

Figure 1 presents an empirical model for the partial least square (PLS) regression analysis. Partial Least Squares Structural Equation Modeling (PLS-SEM) is a very useful tool for the development of accounting and management theory because it can overcome the problems of small sample size, missing data, and multicollinearity [9], further it can be used for structural modeling of secondary data such as transactional data or data from financial reports [18].

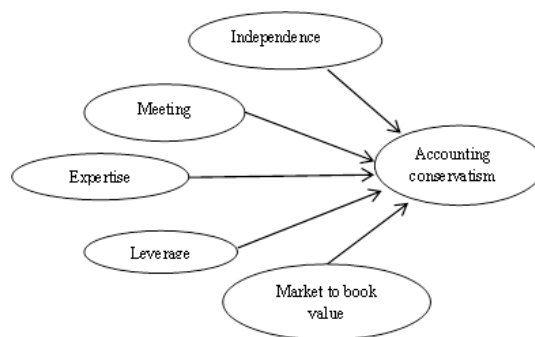


Fig (1) Relationship studied

The econometric model takes the form:

$$Cons_{it} = \alpha + \beta_1 ACInd_{it} + \beta_2 ACExp_{it} + \beta_3 ACMet_{it} + \beta_4 Lev_{it} + \beta_5 MtB_{it}$$

Where cons is accounting conservatism, ACInd is audit committee independent, ACExp is audit committee expertise, ACMet is Audit committee meeting, Lev is leverage and MtB is market to book ratio. The sample in this study consists of 67 companies listed in Indonesian Stock Exchange, Accounting data were collected from 2012 – 2016 so the total data observation in this study amounted to 335 data and the sample exclude financial industry due to differences in financial reporting standards applied.

4. RESULTS AND DISCUSSION

Table 1 presents the Assessment of goodness of fit, the two criteria for Goodness of Fit (GOF) applied in this study are if the standardized root mean value is less than 0.08, it is considered good fit and the Normed Fit Index must be above 0.9, then the fit is acceptable [25]. Table 1 explains the estimation results for the SRMR model are 0.000 and NFI 1. Therefore the model in this study is fit.

Table 1 Descriptive statistics

	Saturated Model	Estimated Model
SRMR	0.000	0.000
NFI	1.000	1.000

Table 2 presents the coefficient of determination, to determine the magnitude of the influence of exogenous variables on endogenous variables, it can be seen that the coefficient of determination is such as 0.02, it is weak, 0.13 is moderate and 0.26 is substantial [4]. In this study, the determination score of 0.273 is shown in table 2 Therefore the effect of audit committee independence, audit committee expertise, audit committee meeting to accounting conservatism is substantial

Table 2 Coefficient of determination (R²)

	R Square	R Adjusted Square
accounting conservatism	0.273	0.262

Table 3 Path Coefficient and Hypothesis Testing present the results of this study to test Hypothesis 1: Audit committee independence has a positive effect on accounting conservatism. However, this study found that the independent audit committee had no effect on accounting conservatism with a confidence level of 95% (P value 0.350) but has a positive direction as shown in Table 3. Based on these findings, the independent audit committee does not encourage conservative accounting, so these results do not support

hypothesis 1. However the result in this study in line with [23, 11] which stated that accounting conservatism has a positive relationship with the independent audit committee, however, no association was found between audit committee independence and conservatism. The results Hypothesis 2: Accounting conservatism is influenced by meeting frequency. In this study, it was found that accounting conservatism was influenced by the frequency of meetings in a year held by the audit committee with a confidence level of 95% (P value 0.002). The more often the audit committee holds meetings, the more it can promote the application of accounting conservatism. Hence the results are in line with [2, 23] who also found accounting conservatism was influenced by the number of meetings. The last is hypothesis 3 audit committee expertise has a significant and negatively influence on accounting conservatism. This study found that accounting conservatism was influenced by the expertise of the Audit Committee in a negative direction with a confidence level of 95% (P value 0.001). These results support hypothesis 3 which indicates the adoption of accounting conservatism in firms is not promoted by audit committee expertise. Therefore the results of this study support the findings by [3] which also found audit committee expertise have negatively direction to accounting conservatism. Audit committee members who have expertise in finance are indicated to be able to reduce the adoption of conservative accounting policies because there is still a lack of availability of professionals who have expertise in finance who can fill the position of audit committee members. Therefore the available professionals will hold concurrent positions in other institutions that have an impact on the ability to oversee the application of accounting policies in each company.

Table 3 Path Coefficient Hypothesis Testing

	Std Beta	Sample Mean (M)	Standard Deviation (STDEV)	T Statistics (O/STDEV)	P Values
Audit committee independent → accounting conservatism	0.047	0.045	0.050	0.934	0.350
Audit committee meeting → accounting conservatism	0.136	0.138	0.045	3.051	0.002
audit comitee expertise → accounting conservatism	-0.132	-0.132	0.041	3.244	0.001
Leverage → accounting conservatism	-0.364	-0.359	0.150	2.430	0.015
MTB -> accounting conservatism	0.520	0.527	0.073	7.115	0.000

5. CONCLUSIONS

The characteristics of audit committee employ in this study consist of independent, expertise and the number of meetings held by the audit committee, Based on Table 3, an audit committee independent does not support the adoption of accounting conservatism with p-value 0.350, this finding indicates to apply accounting conservatism in the company is not sufficient by only the presence of an independent audit committee members.

Thus audit committee needs members who have expertise in accounting and finance, members who have expertise will oversee the policies applied in the preparation of financial reports in more detail so as to encourage the application of accounting conservatism. However, the results of this study show a negative direction of -0.132 with P value 0.001. This indicates that members who have expertise do not support the application of accounting conservatism.

Based on those findings, the audit committee cannot support the application of accounting conservatism if its members only meet the requirements of independence and have expertise in finance and accounting.

Independent members may not have expertise in the field of finance, so it will be difficult to understand the applied accounting policies and their impact on the performance reported in the financial statements, while members who have a background in financial expertise may not be able to oversee the application of accounting policies applied in the company because busy in the same position at other institutions.

Therefore be required an indicator that can encourage the audit committee to be able to optimally support the application of accounting conservatism in the company. It requires audit committee conducts meetings at least four times a year, hence it can supervise the policies applied to the preparation of financial statements in the company. This study supported audit committee meeting can encourage implementation accounting conservatism, table 3 shown audit committee meetings have a positive direction with p-value 0.002.

It can be concluded the most important characteristic in encouraging the adoption of accounting conservatism is the number of meetings held because in the meeting the audit committee members can examine, discuss and supervise the policies that have been taken by the manager in applying conservative accounting policies. Therefore, it can be suggested to regulators to consider increasing the minimum number of meetings that must be held by an audit committee in a year so that it can encourage managers to apply accounting conservatism in preparing financial statements. Suggestions for further researchers, because this study applies a balanced panel so that it requires a complete financial report every year from each company so that it has an impact on the small sample size. Therefore it is recommended to try to use the unbalanced panel so that more samples are obtained or the next researcher employs a sample focus on each subsector on the stock exchange.

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