The Effect of Female Directors and Financial Expertise of Audit Committees on Earnings Quality: A Conceptual Framework

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Abstract

A quality financial reporting which produces quality information on profit is essential in making investment decisions. The profit revealed is considered qualified if the earnings information is accurate and unbiased. However, the adoption of the accrual basis may prompt management to conduct earnings management activities hence, in the use of accrual basis, the profits contain elements of cash and accrual (non-cash). Accrual items occur based on management policy (discretionary accruals) or management non-policy (nondiscretionary accruals). Previous study found that the increase in profit accompanied by high accruals indicate low-quality earnings and is associated with low-returns in the future. To prevent the excessive earnings management activities, the implementation of corporate governance is required within the company. Some of the determinants that may be expected to minimize earnings management activities are the involvement of female directors and effective board committees in the company. Thus, the present study evaluates the existing literature in order to link between board governance and earnings quality. Based on the summary, this study develops a conceptual framework to examine the influence of board governance characteristics and earnings quality among pubic listed companies in Indonesia. This study provides more insights into the literature of governance and quality of earnings particularly on the involvement of women in board and the committees of audit.

Keywords: Earnings quality, Female directors, Financial expertise of audit committees.

1.0 Introduction

Corporate governance system which has evolved over the centuries takes place as a response from a systemic crisis that occurs in companies.. The South Sea Bubble of the 1700s was the first governance failure, which ended with a revolution in law and business practice in England. Similarly, the fall of the US stock market in 1929, ended with the enactment of many securities laws in the US. In addition, many other similar crises took place, such as the secondary banking crisis of the 1970s in Britain; US savings and loans which brought disaster in the 1980s; 1998 financial crisis in Russia; the 1997-1998 financial crisis in Asia (especially in Indonesia, South Korea and Thailand); and the 2008 global financial crisis. In this regards, corporate governance mechanism effectively controls the operational activities of the company and identifies all parties who have different interest, so as to ensure or convince the capital owners that managers take the best action for the benefit of the company by providing sound return on investment (Sheifer and Vishny, 1997).

Many researchers have examined the relationship between earnings quality and ownership (Ferramosca & Allegrini, 2018; Liu et al., 2017; Sousa & Galdi, 2016); risk committee (Ames et al., 2018; Florio and Leoni, 2017); board of directors (Lara et al., 2017; Gull et al., 2017); and audit committee (Bilal et al., 2018; Zalata et al., 2018). This study concerns women on board and it considers the issue of gender in the director structure as well as expertise of audit committee. Research has found that female directors tend to have high caution in business decision makings (Huang and Kisgen, 2013 and Levi et al., 2013). At the same time, the number of female directors or leaders in public listed companies of Indonesia is still very small compared to men and there are also no rules governing the involvement of women in the board of directors. Based on IFC (2013) data, half of the total workforce in Indonesia is female, but members of directors are still below 10%. With regards to audit committee, they must execute the supervisory duties, advising the board in implementing an internal accounting control system, and preparing financial reports (Zalata et al., 2018; Arun et al., 2015). In order to improve the effectiveness of audit committee, Indonesia regulates that an audit committee consists of member that acquires his/her expertise in financial sector implying that, the members must possess knowledge in economic and business (Indonesian Corporate Governance Code, 2012).

This paper presents the conceptual model about the relationship between boards, audit committees, and earnings quality. In this study, the first section discusses the background of research and the importance of earnings quality research in Indonesia. In the following section, two of corporate governance mechanisms comprising female directors and, financial expertise of audit committee, and their relation to earnings quality are explained, followed by the development of the conceptual framework. Finally, the potential contributions of the study are presented.

2.0 Background of Study

The 1997-1998 financial crisis had a devastating effect on social, economic and politics of Indonesia. The rupiah dropped to its lowest point, by almost 80% which dramatically increased poverty. According to some experts, the recession in Indonesia was triggered by many factors, including the weakening of Indonesia's economic growth which was caused by the increase in the value of the American currency, an increase of private foreign debt, and the many cases of corruption that occurred in Indonesia (Qonita, 2017), compounded by the implementation of policies that are not carried out continuously (Tarmidi, 1999). Furman and Stiglitz (1998) noted that the depth of the collapse in Indonesia, is among the largest peacetime contractions since 1960, excluding the experience of the transition economies. Out of more than 600 listed companies in Indonesia, only 30 companies improve their performance when the crisis hit in 2008 and 2014 (Susanti, 2017). The companies that survive in the crisis manage their financial matter very well and avoid any activities that could damage the company’s decision making process (earnings management) while the quality of earnings information is important to avoid any mistakes in decision making. As emphasized by Sarun (2016), corporate earnings information is the main indicator of its financial performance, and low information asymmetry indicates that the company has high earnings quality, and it serves as a signal of the true value of the firm to the capital market.

Earnings quality serves as a strong basis for the valuation of a company and it helps investors to make right decisions, hence if investors do not have access to good earnings quality information from the company, they tend to compensate for risk by imposing high capital costs (Leuz & Verrechia, 2004); mislead users that result in wrong decision making (Myes and Omer, 2003); and affect the overall value of the company. (Easley and O'Hara, 2004). Although the major crisis of 2008 and 2014 are over, earnings management activities remain a problem in Indonesia and it has adversely affected the quality of financial reporting. For instance, the case of PT Inovisi Infracom in 2017 with the discovery of indication of material misstatement in the 2014 financial statements, and the case of PT Coca Cola Indonesia which allegedly outsmarted taxes since 2002 until 2006.

3.0 Development of Conceptual Framework and Research Hypotheses

3.1 Female Directors and Earnings Quality

One of the governance issues that has been developed in recent years is the issue of gender diversity which specifies that females and males have different capabilities because of differing socialization processes (Srinindhi et al., 2011). Men with masculine traits have characteristics of self-reliance, full consideration, rationale, and competitive, while women with feminine traits have the characteristics of nurturing, caring, sensitive, and relying on intuition (Unger, 1979). Kusumastuti et al. (2007) state that women have a high attitude of cautionn and they tend to avoid risk, and are more conscientious than men. Most importantly, women are more ethical in their professional lives and less likely than men to act in immoral ways for financial gain (Betz etal., 1989; Kaplan, Pany, Samuel, &Zhang, 2009).

Companies that have a high level of gender diversity tend to have a broad view in making decisions and some recent research indicates that companies that have more women as members of the board of directors have a better performance. A study of the Credit Suisse Research Institute (2013) which compares the stock performance of companies with a total value of over 10 billion shares in the last six years, found that companies with women as a member of the Board has a 26% higher performance than the board of directors that only consists of men. The diversity of a company needs to be able to optimize and enhance innovation in companies since women give greater attention to the management of the company. At the same time, female directors have the potential to make decisions that are more precise and low risk, and they are more enthusiastic in participating or leading meetings.

Krishnan and Parsons (2008) found that companies with more women in senior management reported high quality earnings. The findings of Srinidhi et al. (2011), echoed by Gavious et al. (2012), also showed the beneficial impact of female directors on earnings quality. Similar findings by Arun et al. (2015) showed that companies in the UK with a majority of female directors and independent women on their board adopted controlled earnings management practices. A recent study by Gull et al. (2017) found that the presence of female directors prevented managers from managing earnings. Lara et al. (2017), also found that the increasing percentage of women among independent directors was significantly related to lower earnings management practices. Given the above findings, our hypothesis is formulated as follows:

H_{1a}: Composition of female directors effects earnings quality
H_{1b}: Female board leadership effects earnings quality
H_{1c}: Composition of female independent directors effects earnings quality
H_{1d}: Educational expertise of woman directors effects earnings quality
H_{1e}: Tenure of woman directors effects earnings quality

3.2 Audit Committees Financial Expertise and Earnings Quality

In implementing an internal system of accounting controls and preparing financial reports, an audit committee is needed to oversee and advise management (Arun, Almahrog, and Aribi, 2015; Sun, Liu, and Lan, 2011). This committee acts as the supervisors of the company's financial reporting process, and internal accounting controls (Klein, 2002). As stated by the Sarbanes-Oxley Act (SOX) the criterion of a financial expert is that he has studied and has experience as a public accountant (for example, CPA, CFA), or he has become a major financial officer, financial supervisor, or principal accounting officer of a company or has experience through the performance of similar functions (for example, CEO, CFO) and have core competencies related to: (1) understanding of GAAP and financial statements, (2) experience in (a) preparation or audit of financial statements that are generally comparable and (b) application of principles relating to accounting for estimation, accruals and reserves, (3) experience with internal accounting controls, and (4) understanding of the functioning of the audit committee (SEC, 2002).

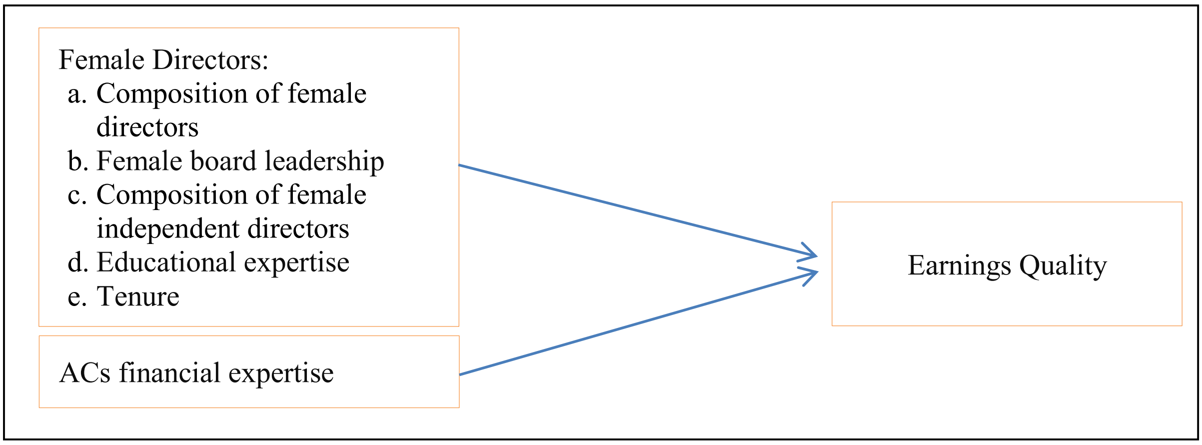
Badolato et al., (2014) and Qi and Tian (2012) found that earnings management activity is detected lower, when the company has an audit committee with good financial expertise. In addition, restatement of financial statements is lower with at least one member of the audit committee with financial experience (Abbott, Parker, and Peters, 2004; Agrawal and Chadha, 2005) as well as lower levels of accrual-based earnings management with at least one financial expert on the audit committee (Bedard et al., 2004; Hossain, Mitra, Rezaee & Sarath, 2011). Corroborating the statements of the previous researchers, Dhaliwal et al. (2010) explained that in addition to have the ability in the field of financial monitoring, members of the audit committee with a background in financial knowledge, also had to have independence, sufficient work tenure, the availability of directors from outside parties, and also the composition of scattered share ownership, to improve earnings quality.

In line with that, Srinidhi et al. (2011) found that woman on board were more likely to challenge the traditional practices and policies of CEOs, and Zalata (2018) asserts that although all members of the audit committee are assumed to have the same level of financial expertise, audit committees with a background in financial science are more likely to have a more tangible effect in minimizing earnings management. In a different form, Inaam and Khamoussi (2016) found a negative relationship between the financial expertise audit committee and earnings management. Also recent study by Bilal, Chen and Komal (2018) find that firm with financial experts on its audit committee enjoys a higher level of earnings quality. Consistence with prior studies, the hypothesis is:

H_2: The financial expertise of audit committee has a significant effect on earnings quality

4.0 Construct of Conceptual Framework

Figure 1: Proposed Research Framework



The framework of this study is based on the studies of Gull et al. (2017); Lara et al. (2017); Zalata (2018); and Bilal, Chen, and Komal (2018). However, these studies concentrate on the relationship in two corporate governance structure namely female directors and audit committees, as well as earnings quality. In this study, female directors attributes are explored further particularly the composition of female directors, female board leadership, composition of female independent directors, educational expertise, and tenure. The conceptual framework is shown below:

5.0 Research Contributions and Conclusion

This study extends corporate governance and earnings quality research. Prior studies have focused on commissioner structures, numbers of board of director, the composition of committee of audit, and ownership structures (e.g. institutional ownership and managerial ownership). However, there is still limited study on the gender of board of director and financial expertise in audit committee. In relation to female directors, recent research has found that the presence of women in the board of directors will improve the company's performance. Arun et al. (2015) found that firms with a higher composition of women, and having independent female directors tended to be more conservative in adopting accounting policies,implying that female managers tend to suppress earnings management activities. With regards to female directors, there is still limited number of women who are on the board of directors in Indonesia. While for the audit committee, previous studies generally investigate the composition of audit committee namely the number of members. However, it is still rare to examine the educational background and gender of audit committee members. Indonesian Code for Corporate Governance (2001) explains that one of the responsibilities of the audit committee is improving the quality of financial disclosure and reporting. Therefore, it is important to have audit committee members with formal education qualifications in business and finance. While equivalent to the presence of women in the board of directors, the presence of women in the audit committee is considered capable of improving the quality of corporate earnings.

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