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Board Characteristics, Audit Committee and Audit Quality: The Case of Indonesia

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Abstract:

The purpose of this research is to examine the relationship between board size, number of non-executive directors, the financial expertise of the non-executive directors representing the audit committee and the audit quality.

Data from non-financial firms listed in the Indonesian Stock Exchange have been used. To achieve the research objectives, we have used the logit regression. The data of 121 listed firms in a five-year period from 2012 to 2016 is collected from the printed audit accounts available on companies' websites. The emergence of corporate governance phenomena has brought upon many structural changes in firms' governance structure such as the audit committee role and the audit quality.

The second decade which starts with the warmth of subprime crisis has seen a significant development in the code of corporate governance. The role of the audit committee is now significant and being recognized as the solution of prevention of internal fraud.

The findings of the study have shown that in non-financial firms listed in the Indonesian Stock Exchange audit committee and board characteristics have significant effect on audit quality. This study will be helpful for students, auditors, policymakers and researchers to understand the impact of corporate governance in audit quality.

Keywords: *Board characteristics, audit committee, non-financial firms.*

1. Introduction

The turbulent impacts of the worldwide financial related emergency has highlighted the basic significance of tenable excellent financial reporting. The business environment in Nigeria for example, has been graded negatively by foreign investors few weeks after this emergency. Akinjobi and Omowumi (2010) decreed explanations behind this statement incorporating the failure of financial reports to address the issues of this group of clients. The commonness of fraud over the earnings management and other financial activities in the nation, has decreased the level of certainty rested in these financial statements and in the capacity of these remarks to perform their essential capacities. Considering the expense of fakes to the business and the guilty party, it is critical to create strategies to avert or distinguish business fraud and investigating the dangerous elements connected with the business.

The respectability of the financial related reporting system is being scrutinized, the trustworthiness of the auditor is in uncertainty and an organization control structure is at risk to be blamed in perspective of the absence of auditor flexibility and oversight from the board. DeFond and Francis (2005) and DeFond and Zhang, (2014) claimed that the result of the corporate shock has restored the importance of self-ruling audits and their linkage to the checking part of corporate governance. Fulfilling quality financial reporting depends upon the part that the outside audit plays in supporting the way of financial reporting as referred to organizations.

Numerous and inevitable changes in the governance and evaluating systems keep on emphasizing the key part of the audit committee in viable stewardship. Audit committee serves the premiums of stakeholders and investors through their autonomous oversight of the yearly corporate reporting process, incorporating the organization's correlation with the outside auditor.

This desire is predictable with the commendations of Levitt's Blue-Ribbon Panel. Auditing reacts inside of the setting of an accounting firm. The discernible result of the audit is an audit report that is issued for the sake of the accounting firm, alongside with the investors and clients inspected financial performance. Audits are of higher quality at the info level when the general individuals actualizing audit tests are able and autonomous, and when the testing systems utilized are equipped for delivering solid and applicable confirmation (Hapsoro and Suryanto, 2017; Suryanto and Thalassinos, 2017).

Audit quality is a reliable evidence amongst the most basic issues in audit practice today. Audit quality has been characterized as the joint likelihood that a current material blunder is identified and reported by an auditor (DeAngelo, 1981). This directly affects the financial reporting, audit quality can assist by characterized as the capacity of an auditor to give an autonomous audit free from misquoting,

mistakes and misrepresentation (Baldacchino *et al.*, 2017). The accounting firms are to convey information on the financial ground, execution corporate governance practices of a firm and high caliber that is convenient for financial specialists and creditors to settle on investors choices. The audit committee and accounting firms assume a huge part in finding out the legitimacy, worthiness and unwavering quality of high caliber. Both audit committee and quality can minimize agency cost.

This study assesses, how organizations give an ideal setting to consider the impact of auditor choice on their loan fees. It shows, connecting with a Big Four auditor, which has a brand name reputation for supplying a higher-quality audit could upgrade the believability of financial proclamations, empowers young firms to decrease their acquiring costs.

Datar *et al.* (1991) contend that substantial, prestigious public accounting firms worried about securing their interest in reputation capital having more motivator than different auditors to supply reliable and transparency audit quality. Balvers *et al.* (1988) found that high-reputation auditors allow capitalist to diminish the degree of extent of ex- ante uncertainty in new value issues. Copley and Douthett (2002) observed the extensive literature on the connection between the expense of capital in firms' underlying open offerings and audit quality. Lenders may incline toward that young firms, which are simply framing their reputations for obligation overhauling, have higher-quality audits.

2. Literature Review

Audit quality broadly refers to the services performed by the auditors engaged by the client firms. Firms demanded higher quality audit because of the standard and the experience they have acquired. Hiring audit quality would attract more investors and picture the performance of the organization. Hence, stakeholders and investors will have confidence and trust in the company that engaged in higher audit quality because of reputation and experiences that accounting firms with audit quality provided (Fama, 1980; Fama and Jensen, 1983).

Therefore, there is no decided measurement in measuring the audit quality. Previous studies have used different proxies in measuring the audit quality. Some of the studies used audit fees as a proxy as in Yassin and Nelson (2012). They used accrual quality as a proxy for audit quality. The other proxy used in measuring the audit quality as being discretionary accruals, the ex-ante cost of equity capital and analyst forecast accuracy and employ propensity-score used as proxies as in Lawrence *et al.*, 2011. Hence, one of the proxies for audit quality used in this study is the Big Four versus non Big Four reputation as used by Eshleman and Guo (2014) and McGowan *et al.*, (2014)

The reputation of the auditor is one of the ways to measure the audit quality and high reputation auditors are considered to the target players in the audit market which broadly refers to the Big Four Firms. DeAngelo (1981) provides the best normal descriptions of the level of audit quality. The description of audit quality was characterized as the *''market assessed chance that a given auditor can (a) discover a breach within the client's register and (b) report the breach."* The designation is gotten by the business sector because the capacity of an audit to discover accounting errors thus, inapplicable audit sentiment. Watts and Zimmerman (1986) relate to breach of auditor reports into two probabilities: the discovered breach (independence) by auditor reports and the auditor discovered the breach (competence).

Therefore, detecting and revealing/correcting an error in the financial statement is a function of independence and competence of the Big Accounting Firms. DeAngelo (1981) also described that wherever the essential part alludes to auditor's capacity and the elements the auditors apply to the audit, in terms of experience, unqualified reports, transparency and standard litigation would determine whether the auditor is independent. Schandl (1978) claims the auditor's independence as a required situation to the competence of Big Accounting Firms.

Citron and Taffler (1992) reveal that audit quality has valued when both technically independence and competence are attributed to the audit process. Wolnizer (1987) expressed, the motto *"independent in fact and independent in appearance"* served as objectivity and attitude of impartiality i.e. the *" mental"* process of the auditor and the *"competence"* as the perception of investors, shareholders, clients, regulatory board and financial market on Big Accounting Firms. Flint (1988) observed in fact and in appearance to independence as trust and capacity of judgment between the clients and higher audit quality.

The competence and independence of Big Accounting Firms should be considered as reliable information, qualification, sufficient knowledge, and experience to deliver higher audit quality (Flint, 1988). Lee and Stone (1995) documented the probable of Big Accounting Firms' competence to be followed by higher quality in independence. The more probable the local accounting firm is incompetent, the more is probably the low quality is dependent. Hence, auditor competence dominates the evaluation of audit quality.

Firms with greater natural instability (greater information asymmetry between the firm and outcasts) have a motivation to talk about their characteristic quality by enlisting an extra solid, top-notch auditor. This contention has primarily been made inside the connection of initial public offerings (IPOs) and hence the evidence shows that there is diminished proof of spatial property (i.e. less underpricing) once opens to the world about large brand auditor (Beatty, 1989; Azam *et al.*, 2016). Big Four Firms are sued nearly less as a rule when overwhelming for

business size, and massive Big Four Firms authorized less as a rule by the Securities and Exchange Commission (Palmrose, 1988).

Auditors spend significant time in fluctuated businesses to acknowledge an item separation and supply higher quality audit (Simunic and Stein, 1987; Suryanto, 2014; Suryanto and Thalassinos, 2017). Higher nature of audit by industry specialized moreover credited to the certainty that they put vigorously in innovations, physical offices and structure management system that change them to watch anomalies and distortions, a great deal of basic responsibility (Simunic and Stein, 1987; Hadi *et al.,* 2016). Their capacity to supply higher quality audits originates from their ability in serving numerous customers inside the same learning, industry and sharing best practices over the business (Thalassinos and Liapis, 2014; Denisova *et al.,* 2017).

Big Four Firms contain several semi-autonomous, city-based takes after workplaces. DeAngelo (1981) contention on audit quality and auditor size might be connected to the work environment level. As far as financial significance, for instance, a client that is little with respect to a Big Four Firm might be vital to no less than one of its workplaces. Consequently, previous studies have started to research audit quality at the working environment level (Reynolds and Francis, 2000). For example, Francis and Yu (2009) demonstrated that the larger workplaces of the Big Four Firms region unit of upper quality, which can be ascribed to greater workplaces, has a lot of measure in-house experience.

Big Four Firms expertise area unit combines lot of independence and supply in higher quality audits. Dopuch and Simunic (1980) posit that accounting firms with higher quality management have been recognized as larger firms in lightweight of the actual fact that they need additional distinguished reputation to confirm. Moreover, it can be contended that Big Four Firms offer unmatched audit quality as their sheer size will bolster additional vigorous reports, standardized review procedures and additional decisions for correct second supporter audits.

Table 1: *BIG 4 Audit Firms in 2017*

Audit Firm	Revenue	Employees	Fiscal year
Deloitte	$38.8 bn	263,900	2017
PwC	$37.7 bn	236,235	2017
EY	$31.4 bn	247,570	2017
KPMG	$25.9 bn	188,982	2016

Source: *Companies Official Website and Printed Accounts.*

Although, there are no boot contentions with relevancy why large Big Four and Non-Big Four Firms may offer equal audit quality? First, massive Big Four and Non-Big Four firms are controlled by the identical body and knowledgeable

benchmarks, and in this manner, each kind of audit companies should stick to a useful wise level. This thought is bolstered by Government Accountability Office (GAO) of USA report issued in 2008 demonstrating that non-Big Four auditors are trying to induce cheap obligation protection scope (GAO 2008). Agency theory perceives evaluating together of the first perceptive instruments to manage hostile circumstances and cut office prices.

Soltani (2014) claims that auditors utilize a couple of technics to understand misquotes in clients accounting structure and report the errors. Audit quality is the questionable problems for the late decades and the most past confirmation recommends that absence of audit quality is among the foremost imperative purpose behind financial and company outrage. Previous studies prove that audit quality, as an external company administration perceptive will improve the organization's performance (Gul and Leung, 2004; Bokhari and Khan, 2013). Auditors' obligations amplify well past the essential identification of *"highly contrasting"* GAAP infringement by giving confirmation of financial reportage quality.

This obligation emerges from professional examining gauges that oblige auditors to contemplate *"the quality, not solely the agreeableness"* of the client's financial reporting Statement of Accounting Standard (SAS 90). It is more mirrored within the audit assessment, which provides certification that the *"financial statements area unit properly exhibited as per GAAP,"* since cheap presentation needs a dependable illustration of the company's basic financial aspects as set by the Financial Accounting Standard Board (FASB, 1980). The auditor's wide charge to contemplate financial reporting quality is in addition with court selections that hold examiners subject to deluding cash connected proclamations once these statements entirely have been adjusted to accumulation.

The role of the audit committee in corporate governance is the subject of increasing public and regulatory interest. The audit committee is a sub-group of the full board. The audit committee gives the correspondence between the full board, insider auditor, outsider auditor, the executive officers, and fund executives. Jensen and Meckling (1976) displayed a method of reasoning for the presence of the board audit committee that managers take the chance to act against shareholders' benefits when the agency cost increase. Contractual connections in the middle of shareholders and managers decrease agency costs. In any case, these agreements must be along with the lines observed.

The development of an audit committee emerges from the need to screen these agreements. Audit committee serves as trustees in a governance system, decreases information asymmetry in the middle of internal and external levels and in this manner, mitigates agency issues. Beasley *et al.* (2009) trusted that a successful audit committee has qualified individuals with authority and assets to ensure shareholders by safeguarding dependence on financial reporting, inward controls and hazard management.

The independence of audit committees from the management plays an important role in organizations because they have good reputations to transform transparency, support the board of directors, prevent inadequate activity and oversight function of financial reporting. The language of independence has been termed as the degree to which an audit committee comprises of non-executive's directors. The Code of Corporate Governance in Indonesia (2016) posits that an independent director is a non-executive director who is not a considerable shareholder of the organization, is one whose shareholding, straightforwardly or in a roundabout way, does not surpass 0.1% of the organization's capital.

The independent non-executive directors on corporate groups identify with better checking of management choices and exercises by a corporate group. There is an indirect confirmation supporting the thought that an autonomous non-executive audit committee can deflect financial reporting aggressiveness and misrepresentation. Audit advisory groups have no less than two means accessible to practice oversight of financial reporting, the external auditor, and the inside auditor capacity.

Blue Ribbon Committee (Millstein, 1999) observed to reinforce the part of audit groups, as regulators of the financial reporting process for the New York Stock Exchange (NYSE) and the National Association of Securities Dealers Automated Quotations System (NASDAQ) also called (NASD) firms. BRC (1999) is about the change of necessity of NYSE and NASD to give space for recorded organizations to have audit boards of trustees without executive's directors. Numerous other independent counseling bodies have planned rules with a recommendation to change both the audit committee and audit process. For instance, it was prescribed by the Treadway Commission (Grundfest and Berueffy, 1989) that: *"the audit board individuals from all public sectors ought to stay out from exclusively autonomous executives".*

The committee of the audit should be free to perform their task appropriately (Zaman and Collier, 2005). Independence is pretty much as essential to the audit committee as it is imperative to the auditor (Carcello *et al.,* 2011). This will permit them to manage the organization's issues in a targeted way with no type of bias. An autonomous audit committe is required to upgrade the open trust in the corporate system with respect to their openness, competence in reporting and a consolation of adequate protections against false reporting and innovative accounting (Rezaee *et al.,* 2003).

It is likewise foreseen that the audit group ought to cradle the relationship among governance organs inside the firm and organs outside the firm (Rezaee, 2009). The freedom audit group advisory is vitally critical in upgrading the relationship between the outside auditor and management over the span of their obligations as well as in instances of quarrels between them (Arena *et al.,* 2010). Keeping in mind the end goal to release their oversight capacities viably, is imperative that the committee is independent, non-executives of management.

Expertise and experience of audit committee individuals is an essential part of audit advisory group viability in managing the evaluated financial articulations. Corporate governance procurements internationally require that the audit committee be made from persons that have later and pertinent financial experience inferring that they ought to have the capacity to, at any rate, read and comprehend the financial proclamations which incorporate the cash flow statement, notes to the accounts, income statement and the balance sheet. Furthermore, a large portion of these procurements additionally requires that no less than one individual among the individuals ought to have recent significant financial capabilities.

The focal issue to this procurement is the requirement for the individual as non-executive of the audit council to have between them the required experience and aptitude to have the capacity to release their oversight works adequately. As per Song and Windram (2004) a high level of financial proficiency is important for an audit brain trust to adequately supervise an organization's reporting and financial control. The part of an audit brain trust in supervising responsibility of the organization because the activity of the committee would cover and monitor the management and financial reporting. This requires the audit panel to have accounting information concept to procure an inside and outside comprehension of financial reporting and enhance consistency with administrative necessities.

Moreover, DeFond *et al.* (2005) recommend that positive business sector response is focused on the organizations that are moderately solid in corporate governance. Educated audit brain trusts are better prepared to comprehend auditor's judgments and observe the substance of contradictions in the middle of administration and the outer inspector (DeZoort and Salterio 2001). The attestation that compelling audit advisory brain trust must contain individuals who have abundant financial experience is predictable with a prior study on audit group skills. Based on the theoretical point of view this study is depended on agency theory.

As indicated by agency theory, organization relationship is an agreement under which *"one or more persons (main) who is the economic assets proprietor draw in someone else (agent) who is accused of utilizing and controlling these assets to perform some administration for their sake, which includes appointing some basic leadership power to the agents"* (Jensen and Meckling, 1976).

Nonetheless, this theory expects that management (as agents) cannot be trusted to make the best move for the general shareholders and public (as main) because the agents will represent their own advantages. To accomplish the arrangement of the agent's interest, limit agency cost and principal advantage, different inside and outside corporate governance components, have been recommended (Haniff and Huduib, 2006).

3. Data and Methodology

The collection of secondary data of 121 firms listed in the Indonesian Stock Exchange was collected through the channel of annual reports for the years 2012-2016. The annual reports were used to collect the data concerning the audit committee and Big Four/Non-Big Four Firms. The independent and dependent variables are measured classified and quantified into a numerical scheme. Therefore, the association between the audit committee and the audit quality is examined and assessed in a very applied statistical mean from the data collected. The study is predicated on a panel data methodology.

Al-Ghamdi (2001) claimed that regression method is broadly utilized for breaking down the relationship between dependent variable and one or more independent variables. Logistic regression, like Least Squares Regression, is a measurement method that is utilized to investigate the relationship between a dependent variable and at least one independent variable. The regression techniques can be connected when the dependent variable is categorical. As a result, the remainder of this study discussion will focus on independent variables in this regression analysis.

The study carried out some diagnostic test to confirm the validity of the regression result. Based on linear regression model the variance of each error term needs to be constant (homoscedasticity) likewise there should be the absence of correlation between the error terms (autocorrelation). Based on the Wooldridge test for autocorrelation the prob > F test is significant (0.000) suggesting the presence of autocorrelation. Similarly, the white test for homoscedasticity reveals a prob > chi2 that is significant at 0.0214 rejecting the null hypotheses of homoscedasticity and showing the presence of heteroscedasticity, which indicates that the error terms are not constant.

On this note, the logit regression model was used considering the robust standard error as suggested by Hoechle (2007). Hoechle states that the robust standard error accounts for both the heteroscedasticity and autocorrelation issue. The results obtained from Logit regression are presented in Table 2 bellow.

To measure the impact of corporate governance on audit quality we have used the model as shown in equation 1:

$$AUDITQ_{it} = \alpha_0 + \alpha_1 NEDAC_{it} + \alpha_2 FENEDAC_{it} + \alpha_3 ACM_{it} + \alpha_4 BS_{it} + \alpha_5 SIZE_{it} + \alpha_6 LEV_{it} + \alpha_7 PROF_{it} + \varepsilon_{it} \quad (1)$$

where, i refers to each company for each year t; AUDITQ is a dummy variable which takes value 1 if it is engaged with Big Four auditing Firms and 0 otherwise; NEDAC is the ratio of non executive director member of the audit committee to a

total member of audit committee; FENEDAC is a dummy variable which takes value 1 if non-executive director of audit committee is accounting qualified and 0 otherwise; ACM the frequency of audit committee meetings; BS is the business sector of the company; SIZE is the size of the company; LEV is the leverage of the company; PROF is the profession of the committee member;

Table 2: *Logit Regression*

Dependent Variable AUDITQ	Coefficient	Robust Std. Error	Z	VIF
NEDAC	-0.786	0.245	-2.75*	1.09
FENEDAC	0.324	0.146	0.87**	1.07
ACM	0.222	0.447	0.31	1.12
logBS	-1.875	0.648	-2.71**	1.26
logSIZE	1.123	0.321	4.28***	1.39
PROF	0.234	0.342	2.12	1.21
LEV	-0.029	0.008	2.45*	1.09
Cons	-0.769	-0.786	-0.534	
Number of Obs	605	*Prob>Chi2*	0.000	
Pseudo R2	0.4321	Mean Vf	1.30	

*Notes: *, **, *** denote statistical significance the 0.10, 0.05 and 0.01% level respectively.*

Table 3 presents the results on the bivariate statistical correlation among all the relevant variables. The correlation analysis shows that audit quality is positively correlated with audit committee independence and financial expertise whereas negatively correlated with audit committee meetings.

Table 3: *Correlation Analysis*

	AUDITQ	NEDAC	FENEDAC	ACM	SIZE	PROF	LEV
AUDITQ	1						
NEDAC	0.4079*	1					
FENEDAC	0.3764**	0.4354*	1				
ACM	-0.2327	-0.2127	0..2906	1			
SIZE	-0.1037**	0.2056**	-0.2148*	-0.4328*	1		
PROF	-0.2433**	0.4313*	-0.1711*	-0.2492*	0.1982	1	
LEV	0.4391***	0.2452**	-0.5741*	-0.2101*	0.2101	-0.1205	1

4. Results and Discussion

Assuming that the first research hypothesis of this study is the positive relationship between non-executive directors of the audit committee (NEDAC) with audit quality (AUDITQ) the results shown that this hypothesis is rejected as presented in Table 2.

On the opposite the coefficient for NEDAC is negative, -0.786, and statistically significant at 10% level of significance (Z statistic -2.75). However, this relation remains significantly negative when the non-executive directors are measured as the number of non-executive directors on the committee as a proportion. Audit committee independence has a negative relation to audit quality. The findings of the study are consistent with the other findings by Chan *et al.,* (2013). They found that audit committee independence has a negative relation with audit quality on the interaction of audit committee independence and audit industry specialization. It is also supporting the view that the audit committee independence director is significant in guaranteeing the respectability of the financial reporting process.

Another hypothesis to be tested is the positive relationship between the financial expertise of non-executive director's audit committee (FENEDAC) and audit quality (AUDITQ). The study shows that the relationship is positive, coefficient 0,324 statistically significant at 5% level. The financial expertise of non-executive director is measured as the actual number of audit committee members who have the financial expertise or as a dichotomy. The result is not consistent with the study of Lin, Li and Yang (2006) that do not provide any significant relationship between accounting or financial expertise and audit quality.

5. Conclusion

The issue of corporate scandals has a negative effect in accounting manipulations, regulators, practitioners, researchers and organizations anywhere in the world. Therefore, there is a need to review the code of corporate that governed the corporations of many countries. As such the new regulations and practices in developed countries, Indonesia was not lacked behind. This study addresses the problem that arises on the poor and fraudulent financial reporting in Indonesia that revealed the role and the responsibilities of board audit committee has to play in the organization and to provide openness information or results either directly or indirectly as they are charged with overseeing financial reporting. Audit committees assume imperative parts in financial parts of corporate governance as they guarantee audit quality while in the meantime securing the enthusiasm of investors. The audit committee and accounting firms play a significant role in ascertaining the validity, acceptability, and reliability of high quality audits.

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