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Relationship Between the Audit Committee and Earning Management in Listed Companies in Vietnam*

Diem Nhat Phuong NGO¹, Anh Thi Hong LE²

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Abstract

This study aims to examine the impact of audit committee characteristics on income management of companies listed on the Stock Exchange of Vietnam. Research data was collected from all 745 listed companies on Vietnam's stock market over four years, from 2015 to 2018. After excluding companies that did not qualify, there were 216 companies with 864 observations. With the help of dedicated software Stata 15, the impact of audit committee characteristics (through independent variables and control variables such as Audit Committee Independence, Auditing Committee size, Auditing Committee Expertise, Auditing Committee Meeting Frequency, Company Size, Financial Leverage, and Operating Cash Flow) to earning management through a multivariate regression model was determined. Research results from Vietnamese listed companies during this period show that the size and expertise of the audit committee are inversely related to the discretionary accruals representing earning management. At the same time, the research results also identify a positive relationship between firm size and earning management, and the inverse relationship between financial leverage, net cash flow from operating operations and earning management. However, the multivariate regression results do not find clear evidence of a relationship between audit committee independence and the audit committee meeting frequency to earning management.

Keywords: Audit Committee, Earnings Management, Listed Companies, Vietnam

JEL Classification Code: L25, M40, M42

1. Introduction

Public confidence – especially investors – about the quality of financial statements has been shaken after a series of scandals around the world about the integrity of

financial reports such as Enron, Worldcom, Xerox, and others. This raises the question of the role of corporate governance – including the audit committee – in monitoring the quality of financial statement. The audit committee is an important part of the corporate governance mechanism, demonstrating the effectiveness of corporate governance and assisting management in fulfilling its responsibilities in running its operations company (Bédard & Gendron, 2010; Li, Mangena & Pike, 2012). The audit committee is a specialized department and is responsible for ensuring the accuracy and reliability of the financial statements produced by management. Audit committee effectiveness is of growing concern due to its role in monitoring the quality of financial statements. However, when the financial statements do not meet the quality standards, the audit committee accepts the blame and criticism for their failure to complete the financial reporting supervision for reasons of independence (Pergola, 2005). To maximize the company's interests or maximize the value of their benefits, managers often use profit management through the use of accounting policies or influencing economic activities. As noted from Healy and Wahlen (1999): "Income management occurs when

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¹First Author. Faculty of Accounting and Auditing, University of Finance - Marketing, Ho Chi Minh City, Vietnam.

Email: ngophuongdiem@gmail.com ; ngodiem@ufm.edu.vn

²Corresponding Author. Faculty of Law, The National Economics University, Hanoi, Vietnam [Postal Address: 207 Giai Phong Road, Dong Tam Ward, Hai Ba Trung District, Hanoi, 116000, Vietnam] Email: honganhneu@gmail.com

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managers use subjective judgment in financial reporting and in constructing the structure of transactions to change financial statements to cause misunderstanding to related parties on the basic economic performance of the company or the effect of contract results depending on the reported accounting number". Restoring the reliability of financial statements by restricting income management and accounting fraud is also a primary objective of the (Cohen, Dey, & Lys, 2007). The goal of restoring investor confidence has been addressed in various laws, such as the Sarbanes - Oxley Act 2002 in the United States (Cohen, Dey, & Lys, 2007) and the Corporate Governance Code of many countries such as Law on Enterprises of Vietnam (National Assembly, 2014; National Assembly, 2020).

To date around the world, a growing number of studies acknowledging the importance of the audit committee in improving the quality of financial statements and limiting earnings management (Xie, Davidson, & DaDalt, 2003; Abbott, Parker, & Peters, 2004). However, in Vietnam, research on this issue is quite limited. Therefore, in this study, we want to examine whether the audit committee does a good job of monitoring financial statements and limiting earnings management behaviour through accumulated variables.

2. Literature Review

The effective performance of the audit committee is an important topic of increasing public concern due to growing concerns about the quality of financial statements. The conflict of interests of managers with the pressure to maximize company value and their interests have a strong impact on profit management (Jensen, 2005; Leuz, Nanda, & Wysocki, 2003). Meanwhile, outside members who have the position of director are considered valuable because they worry about reputation damage, and litigation risks may lose board opportunities in the future and therefore they will perform well as a financial statement supervisor (Fama & Jensen, 1993). Because of the audit committee is responsible for overseeing the independent audit, overseeing the performance of the board of directors, overseeing the performance of the manager, the audit committee will be motivated to improve operational efficiency and investors will have greater confidence in the value of a company's financial statements. There have been quite a few studies that acknowledge the role of the audit committees in ensuring the reliability of financial reporting and pay attention to the function of improving the quality and accuracy of financial information through manager supervision (Fama & Jensen, 1983; Abbott, Park, & Parker, 2000). Auditing committees are seen as a monitoring mechanism to reduce information asymmetry between management and stakeholders (Klein, 2002; Davidson, Goodwin-Stewart, & Kent, 2005);

Dhaliwal, Naiker, & Navissi, 2010); Li, Mangena, & Pike, 2012).

Studying the impact of audit committee activities and independence on corporate fraud, Abbott, Park, and Parker (2000) noted that the presence of an audit committee that meets the operational thresholds, and minimum independence would have been related to the likelihood of both fraud and non-fraud. Klein (2002), when considering whether the relationship between the audit committee and board characteristics with corporate earnings management, realized there is a negative non-linear relationship between commission independence audit committee and income manipulation. Besides, this study also realizes a positive relationship between earning management and CEO participation in the board's salary and bonus committee, and an inverse relationship with the number of shares held by the CEO and the participation of major external shareholders in the audit committee of the board.

Referring to the impact of some audit committee characteristics on improving the audit committee's effectiveness and the company's ability to adjust finances, Abbott, Parker, and Peters (2004) found that there was a significant negative relationship between financial adjustments with (1) the independence and operations of the audit committee, and (2) the audit committee composed of at least one member with financial and managerial expertise. Davidson, Goodwin-Stewart, and Kent (2005), studying the role of a firm's internal governance structure in terms of earning management, have identified a significant negative relationship between earnings management and the presence of a board comprised of a majority of non-executive directors. Other characteristics such as the voluntary establishment of an internal audit function and choice of auditors are not significantly related to reduced discretionary accruals.

Studying the relationship between audit committee characteristics and income restatement, Lin, Li, and Yang (2006) found a negative relationship between audit committee size and occurrence the earnings restatement, while the audit committee's independence, financial expertise, operations and stock ownership did not have a significant effect on the quality of the earnings report. The operation of the audit committee will be effective when the controller fully perform its functions (Persons, 2009; Dhaliwal, Naiker, & Navissi, 2010; Li, Mangena, & Pike, 2012). An audit committee of the right size and a combination of skills and experience will function well in detecting and preventing earnings management. Xie, Davidson, and DaDalt (2003) studied the relationship between audit committee characteristics and the anomalous accruals representing earnings management and that research shows that earnings management through accruals is less likely to this occurs in companies with an audit committee with a majority of independent members.

Meanwhile, other studies have shown that companies with a large number of meetings are less penalized for fraud or accounting mistakes (Abbott, Park, & Parker) or as empirical evidence from research, Klein (2002) showed that the size of the audit committee and the financial and accounting expertise of the members of the audit committee were likely to limit earnings management.

Vafeas (2005), studying the relationship between the audit committee and board of directors with the quality of financial statements, found that factors like equity ownership of committed members, other services the committee's ties are closely related to earning management, while the term of office and the number of seats on the board seem to play only some role in explaining the quality of income. This study also found that the audit committee and the company board of directors are structured and operated properly to help improve the quality of financial reporting.

Yang and Krishnan (2005), when examining the relationship between audit committee characteristics and quarterly earning management measures, point three problems: (1) lower quarterly earnings management for firms whose audit committee directors have greater expertise in governance, (2) the degree of stock ownership of the audit committee directors is positively related to the management of quarterly earnings, and (3) the average tenure of the audit committee directors involved. negative to quarterly earning management.

Persons (2009), considering the relationship between specific characteristics of an audit committee with the possibility of voluntary ethical disclosure, found that the level of voluntary ethical disclosure was very low compared to required disclosure. His research results also reveal that companies that previously disclosed voluntary ethics were more likely to have a larger and more independent audit committee, meet more frequently, and are less likely to engage in more fraudulent financial reporting.

Lin and Hwang (2010), when studying the factors affecting earning management, found negative relationships between the following factors and earning management: (1) the independence of the council of directors and its expertise, (2) independence of the audit committee and auditors, (3) the size of the auditor, (4) the qualifications of the auditor, and (5) number of meetings. In contrast, the audit committee's share ownership is positively related to earning management. The study also indicates that the following relationships have negligible effects on earnings management: (1) board stock ownership, (2) audit committee existence and, (3) the separation of the position of chairman of the board of directors from the position of chief executive officer.

Waweru and Riro (2013), when investigating the effects of corporate governance and firm-specific characteristics on earnings management of listed firms in emerging

economies, prove that structure ownership structure and board composition are corporate governance factors that mainly affect earning management, especially companies using high financial leverage.

Research by Alves (2013) on the effect of external audit and audit committees on earning management has noted a positive relationship between audit committee existence and external audit and discretionary accruals. This study also specifies that the existence of an audit committee and external auditors both reduce the management of income by their existence as a monitoring device to reduce regulatory incentives to manipulate the reported earnings.

Soliman and Ragab (2014), when looking at the relationship between audit committee effectiveness, audit quality and earning management, saw that independence of audit committee, experiences of audit committee members, audit committee meetings, and audit quality are significantly negatively associated with earning management, while audit committee size is not significantly related to earning management.

Siagian and Siregar (2018), when examining the impact of the audit committee's financial expertise (as measured by audit committee experience in accounting, oversight and finance) and the commission's status the audit committee (about management) for earning management, has found that the auditing firm's financial expertise, the audit committee's status, and expertise have no significant effect on earning management, while the audit committee's financial expertise has a positive effect on accruals to reduce earnings.

When investigating the impact of audit characteristics on company performance, Rahman, Meah, and Chaudhory (2019) conclude that audit characteristics such as external audit quality and audit committee size had a significant positive effect on performance, while the frequency of audit committee meetings has a negative relationship to company performance.

Research by Al-Absy, Ismail, Chandren, and Al-Dubai (2020) shows that the audit committee in which the chairman of the board is a normal member will have a significant effect on larger discretionary accruals. From there, they recommend policy-makers, stakeholders and researchers on the audit committee chair's influence to limit the management of earnings and, therefore, need to add policies to improve AC independence.

Study of Januarti, Darsono, and Chariri (2020) on the relationship between the performance of an audit committee and the number of audit fees has found that the size and frequency of the independent audit committee's meetings have a positive effect on audit fees; in the audit committee's expertise gas was hardly affected. This finding suggests that an increase in the number of independent audit committee members and the frequency of audit committee meetings

will result in higher quality financial statements despite higher audit fees.

Studying the relationship between management performance and the quality of financial statements, Omer, Aljaaidi, and Yusof (2020) recognize a negative relationship between companies with effective management performance and the revision of financial statements.

3. Research Hypotheses and Methods

3.1. Hypotheses

There are many controversial views about the number of members in the supervisory board, there is an argument that the supervisory board has less than three members, the audit committee does not perform well their supervisory role (Menon & Williams, 1994). Meanwhile, the number of supposedly perfect members ranged from three to four (Abbott, Parker, & Peters, 2004). It is also argued that if the size of the audit committee is too small, the audit committee does not have enough members to perform the functions so the effectiveness of supervision will be reduced (Vafeas, 2005).

H1: *The audit committee size is inversely related to earning management.*

The audit committee's primary role is to oversee the to ensure and improve the quality of financial statement. Therefore, the audit committee with members with experience in accounting and finance will improve efficiency and ability to detect and prevent earnings management. Studies have found a significant negative correlation between the supervisory board with at least one member with expertise in finance and accounting and earnings management (Xie, Davidson, & DaDalt, 2003; Bédard, Chtourou, and Courteau, 2004; Soliman and Ragab, 2014; Juhmani, 2017).

H2: *The audit committee expertise is negatively associated with earning management.*

Klein (2002) emphasizes the importance of the independence of the audit committee to the oversight of financial statements and requires all audit committee members to be independence and independence member affect the effectiveness in monitoring financial reporting. Abbott, Park, and Parker (2000) suggested that financial statements are less prone to errors if the audit committee has many independent members. The studies by Bédard, Chtourou, and Courteau (2004), Abbott, Parker, and Peters (2004), and Yang and Krishnan (2005) also evidence that the completely independent audit committee protects shareholders' interests well and performs well its supervisory

role because of the objectivity of members of the supervisory board. The research results show that there are many different views on the relationship between the independence of the audit committee and the abnormal accrual rate. Klein (2002), Xie, Davidson, and DaDalt (2003), Davidson, Goodwin-Stewart, and Kent (2005), Lin and Hwang (2010), Soliman and Ragab (2014) acknowledge a negative relationship between the independent members of the audit committee and the executive board. Meanwhile, Bédard, Chtourou, and Courteau (2004) argued that positive earnings management has a negative relationship with the audit committee with completely independent members. Several other studies have found a negligible relationship between the independence of audit committee and headphone management (Lin, Li, and Yang, 2006; Siregar & Utama, 2008; Wareru and Rio, 2013; Juhmani, 2017).

H3: *The audit committee independence is negatively associated with earning management.*

An important objective of the audit committee is that members have sufficient time to undertake the responsibility of monitoring the financial reporting process (Lin and Hwang, 2010). Karamanou and Vafeas (2005), Li, Mangena, and Pike (2012), Xie, Davidson, and DaDalt (2003) also argue that members of the audit committee who meet more often can effectively perform their supervisory roles. Abbott, Parker, and Peters (2004) show that the audit committee meeting at least four times per year is negatively associated with earnings management. However, some studies find no evidence to show a significant relationship between the frequency of meetings of the audit committee and the degree of earnings management (Bédard, Chtourou, and Courteau, 2004; Davidson, Goodwin-Stewart, and Kent, 2005, Lin, Li, and Yang, 2006; Juhmani, 2017).

H4: *The frequency of audit committee meetings is negatively associated with earning management.*

3.2. Research Materials and Methods

The sample includes all listed companies in Vietnam from 2015 (the year when the corporate governance regulations applied to listed companies and also the year the 2014 Enterprise Law officially has taken effect) up to 2018 is 745 companies. After excluding companies that do not meet the conditions of the sample (data reported in relation to the audit committee and corporate governance are not full data or operating in the financial and real estate sectors), only 216 companies have sufficient information on audit committee characteristics with a total of 864 observations.

Table 1: Variables Definitions and Measurements

Variables	Definitions and Measurements
Dependent variable	
EM	Earnings Management, measured by discretionary accruals as a proxy
Independent variables	
ACIND	Audit Committee Independence, the number of independent directors on the audit committee;
ACSIZ	Audit Committee Size, number of members on the audit committee;
ACEXP	Audit Committee Financial Experts, the number of audit committee members having expertise in accounting or financial management
ACMEET	Audit Committee Meetings, number of audit committee meeting held during the fiscal year.
Control Variables	
SIZ	Company Size, the companies' natural log of total assets;
LEV	Financial Leverage, measured as the ratio of the companies' total liabilities to the companies' total assets.
OCF	Operating Cash Flow, measured as the ratio of the companies' operating cash flow to the companies total assets

Using quantitative research method, based on table database, with the help of Stata 15 software, our research conducted build regression model with one dependent variable (Earning Management - EM) and four independent variables (Audit Committee Independence - ACIND, Audit Committee Size - ACSIZ, Audit Committee Financial Experts - ACEXP, Audit Committee Meetings - ACMEET) and three control variables (Company Size - SIZ, Financial Leverage - LEV, Operating Cash Flow - OCF). The model looks like this:

$$EM = \beta_0 + \beta_1 ACIND + \beta_2 ACSIZ + \beta_3 ACMEET + \beta_4 ACEXP + \beta_5 SIZ + \beta_6 LEV + \beta_7 OCF + \epsilon$$

Where:

$\beta_0, \beta_1, \beta_2, \beta_3, \beta_4, \beta_5, \beta_6, \beta_7$, are coefficients
 ϵ is error

4. Results and Discussion

The descriptive statistical results presented in Table 2 show that the median earning management (EM) is -0,00026. The number of independent audit committee members (ACIND) is 2.604167 with a minimum value of one and a maximum of five. The minimum number of audit committee members is two, the maximum is five members, with mean (ACSIZ) of 3.159722. The average number of audit committee meetings in a minimum fiscal year is one and a maximum of nine, and the average (ACMEET) is 3.216435. The minimum standard for audit committee members is 0 and a maximum of three, the average is 0.945476

Table 3 shows the Pearson correlation coefficient between the dependent and independent variables. The results point out that the variables in the regression model have no intact correlation (correlation coefficient <0.8) and not multicollinear phenomenon (vif <10).

Besides, based on the regression model to argue, the study tested the variance change and the phenomenon of autocorrelation. Research using both White tests and Woolridge test, Prob> chi2 = 0.8024 results and Prob> F = 0.5711 is greater than the 5% significance level, meaning the model has constant and non-existent variance at the phenomenon of autocorrelation.

Finally, after implementing F tests, LM tests, the POLS model is the best estimation model with the results shown in Table 4.

The regression results in Table 4 show that independent variables and control variables explain 65% variation of EM variable, meaning that the change of the earnings management level is explained by 65% of changes of independent variables and variables control. Simultaneously with the coefficient Prob> F = 0.000, it means the model is reliable enough to estimate and argue the results. The results in Table 4 indicate a significant negative association at the 1% level between earnings management measured through discretionary accruals and ACSIZ. This finding supports Hypothesis 1, showing that audit committee with many members has a significant negative relationship with the earning management of listed companies in Vietnam.

Table 2: Descriptive Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
EM	864	-0.00026	0.124567	-0.5922756	0.621249
ACSIZ	864	3.159722	0.54247	2	5
ACIND	864	2.604167	0.730581	1	5
ACEXP	862	0.945476	0.836478	0	3
ACMEET	864	3.216435	1.231362	1	9
SIZ	864	11.8991	0.616884	10.26529	13.52149
LEV	864	0.464309	0.214509	0.0472276	0.966925
OCF	864	0.092547	0.136652	-0.3902872	1.189263

Table 3: Pearson Correlations and VIF Values

	EM	ACSIZ	ACIND	ACEXP	ACMEET	SIZ	LEV	OCF	VIF
EM	1								
ACSIZ	-0.0843	1							1.27
ACIND	-0.0177	0.204	1						1.09
ACEXP	-0.0546	0.1241	0.1621	1					1.13
ACMEET	-0.0688	-0.1605	-0.0962	-0.1565	1				1.13
SIZ	0.0554	0.3756	0.0146	0.2271	0.046	1			1.29
LEV	-0.0573	0.1437	-0.0687	0.0016	-0.144	0.1975	1		1.13
OCF	-0.7645	0.0426	0.0145	0.0137	0.169	0.0154	-0.2068	1	1.08
MEAN VIF									1.16

Table 4: Estimating regression using POLS, FEM, REM

EM	POLS		FEM		REM	
	Coef.	Prob	Coef.	Prob	Coef.	Prob
ACSIZ	-0.01393	0.008***	-0.01423	0.007***	-0.01438	0.008***
ACIND	-0.00303	0.398	-0.00289	0.419	-0.00301	0.432
ACEXP	-0.007781	0.014**	-0.007801	0.014**	-0.007197	0.033**
ACMEET	0.002627	0.228	0.002585	0.233	0.002698	0.23
SIZ	0.025312	0.000***	0.02534	0.000***	0.026822	0.000***
LEV	-0.13947	0.000***	-0.13879	0.000***	-0.14022	0.000***
OCF	-0.74635	0.000***	-0.7452	0.000***	-0.75993	0.000***
_cons	-0.1315	0.01**	-0.13153	0.01**	-0.14618	0.008***
R-Squared	R-squared = 0.6528		within: 0.6531		within: 0.7100	
	Adj R-squared: 0.65		between: 0.7894		between: 0.4889	
			overall: 0.6529		overall: 0.6528	
	F(7, 854): 229.42		F(7, 851): 228.9		wakt chi2(7): 1705.97	
	Prob>F: 0.000		Prob>F: 0.000		Prob>chi2: 0.000	
F test that all u _i =0: F(3, 851) = 1.48 Prob > F = 0.2189						
LM Test: Var(u) = 0, Chibar2(01) = 0; Prob>F: 1.0000						

With: **, *** at 5% significance level; and 1%

The results in Table 4 also show that there is a significant negative association at the 5% level between earnings management and ACEXP. This finding does support Hypothesis 2 given that higher level of ACEXP is associated with a significant decrease in earnings management among Vietnam listed companies.

Audit committee independence and meetings can play an important role in monitoring the quality of financial statements and can reduce earnings management. However, the multivariate regression results found no evidence to show a significant relationship between them and earnings management. This means that ACIND and ACMEET have no impact on earnings management.

The regression results also show an inverse relationship between the control variables (financial leverage, operating cash flow) and earning management at 1% level. This shows that the degree of financial leverage used and operating cash flow tends to decrease earning management. However, the results of the regression model show a significant positive relationship between earnings management and firm size at 1% level. In large firms, the degree of earning management is higher in small firms, similar to some studies such like Xie, Davidson, and DaDalt (2003), Alves (2013), Soliman and Ragab (2014).

5. Conclusions

Recent accounting scandals have emphasized the role of the audit committee's effectiveness in detecting material misstatements, thus limiting earnings management. This study provides evidence of the relationship between audit committee characteristics and earnings management in listed companies in Vietnam. Specifically, the study examines the impact of the audit committee on earnings management such as: the audit committee size, the audit committee independence, the audit committee meetings and the audit committee expertise. To achieve the objective of this study, the study collected and analyzed data on the annual reports of listed companies in the period from 2015 to 2018. The multivariate regression results admitted that there was a significant negative relationship between discretionary accruals represent earnings management and audit committee size. Besides, the results also show sufficient evidence to support a significant negative relationship between earnings management and audit committee expertise. These findings show that the size and expertise of the audit committee reduce discretionary accruals or limit earnings management behavior. In addition to, the results of the regression model also admit that company size has a positive correlation with earnings management and a negative correlation between the debt ratio, net cash flow from operating activities and earnings management at 1% significance level.

This study offers several contributions. First, it provides new evidence of the relations between audit committee characteristics and earnings management. Second, it proposes a theoretical background on the relationship between the audit committee and earnings management. Although this study may contribute to a background understanding of the relationship between audit committee characteristics and earnings management in Vietnam, it may not be generalizable to other countries because of differences in economic environments, business, legal environment. Therefore, studying this issue in different countries with different results is required.

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