The Impact of Internal Monitoring Mechanism and External Audit on Earnings Quality Evidence from Indonesia

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Abstract: The objective of this study is to examine the combined effect of external audit and internal monitoring mechanism corporate governance on earnings quality. The paper uses panel data with fixed-effects model to examine the effect of external audit, internal monitoring mechanisms and the interaction between these two monitoring mechanisms on earnings quality. A sample of 216 listed Indonesian firms (non-financial) covering the period: 2013 to 2016 was used for the study. The findings of the study reveal that both board size and audit committee independence have positive relationships with earnings quality which is in contrary to the result of most previous studies. In essence, the result of this study indicates that both internal monitoring mechanisms (audit committee independence, board size and Audit committee meeting) and external audit have a joint effect to reduce earnings management. Thus, this show that the internal monitoring mechanism and external audit would jointly reduce earnings management and thereby improves earnings quality. Furthermore, the results of this study provide a beneficial information to investors in Indonesia to evaluate the influence external audit and internal monitoring mechanisms on earnings quality.

Keywords: Earnings Quality, Internal Monitoring Mechanisms, External audit

I. Introduction

Information on earnings in a financial statement is a very important measure of the performance of a company (Dichev, Graham, Harvey, & Rajgopal, 2013). Accordingly, creditors, investors and shareholders use the information on earnings in assessing how well the management of a company has performed (Schipper & Vincent, 2003). Hence, changes made to the application of accounting standards based on the International Financial Reporting Standard (IFRS), audit and good corporate governance are all efforts geared towards increasing the level of financial reporting openness and transparency as well as the improvements in earnings quality (Ewer & Wagenhofer, 2013).

According to Baker and Al-Thuneibat, (2011), the responsibility for furnishing the stakeholders with rightful information that regards to the activities of a firm lies with the management through financial reporting. However, managers do take advantage of the integral flexibility and elasticity of accounting standards and misrepresent information. As such, to guarantee the financial reporting process of a firm, an independent examination of financial statements is required to be presented by the management (Chan et al., 1993). Previous studies have shown that high quality of external audit and internal monitoring mechanisms are significantly related with higher earnings quality (Balsam et al., 2003). As such, it is a well-known fact that internal monitoring mechanisms and external audit perform a crucial role in ensuring the truthfulness of financial reporting process (Francis et al.; Cohen et al., 2004, & Vafeas, 2005).

According to agency theory, the interest of both managers and shareholders should align with monitoring mechanisms so as to mitigate the conflict of interests and any other opportunistic behavior resulting therefrom. Jensen and Meckling (1976) characterized auditing function as a vital connection mechanism through which firm can identify manager’s interest and external equity holders. Similarly, Arens et al. (2010) and Messier et al. (2007) are the view that audit function is meant to reduce the constant conflicts of interest and that exist between managers and shareholders and the information asymmetry. Chan et al. (1993) suggests that auditing process should function as a monitoring device with the aim of reducing managers’ inducements and vulnerability in manipulating reported earnings in the financial statements. For instance, the findings of Becker et al. (1998) on the relationship between external audit quality and earnings management revealed that less earnings management activity is being used by the clients of the Big Six auditors than those clients of the other auditors. In addition, it is evidenced from the study of Benkel et al. (2006) that audit committee is directly connected with earnings management.

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Due to the collapse of some firms that resulted from manipulation of accounting figures by managers, there is an increasing demand and concern among stakeholders on the quality of accounting figures in the financial statements and their relationship with the quality of the auditing process. As a result, regulators and investors often criticize both internal monitoring mechanisms and external auditors for poor performance due to the fact that it has been proved beyond doubt that, in most reported accounting scandals, considerable number of audited financial statements are found to be untruthful and misleading. As such, the question of knowing whether internal monitoring mechanisms or external audit improves earnings quality is an issue that remains in debate among researchers. Given these concerns, in order to ascertain integrity of financial reporting of firms, it is paramount to investigate the association of internal monitoring mechanisms and external audit quality with regards to earnings quality.

Therefore, this study aims to examine the effect of internal audit mechanisms and external audit on earnings quality. This is because, it is expected that whenever the audit committee (internal monitoring) chooses external auditor and the later reports to the former, it is likely that both the two mechanisms can jointly operate and convive to moderate earnings quality. As such, examining the joint association between the dependent variable (earnings quality) and the two-independent variable (monitoring mechanisms) is paramount to be studied in Indonesian firm especially after the implementation of regulation corporate governance practice (BAPEPAM-LK, 2012) which is related with audit committee tenure and audit committee meeting attendance in financial statement disclosure.

II. Literature Review

Some researchers believed that real activities manipulation deviate from normal operational practices which always results whenever managers modify the structure of operations, transactions or the investment of a firm in order to boost earnings in current period (Dechow & Skinner, 2000; Roychowdhury, 2006). The accrual earnings management measurement model is still considered not sufficient to disclose the full condition of earnings management practices due to the fact that the model disregards the association between cash flow and accrual transactions (Dechow et al., 1995; Subramanyam, 1996). A strong evidence was found from a survey that was carried out by Graham, Harvey and Rajgopal (2005) that top management prefer to engage in real earnings management more than the accrual management with a view to achieve profit targets. Thus, this study uses real earnings management with a development from Roychowdhury (2006) developed by Cohen (2008).

In financial reporting, the main objective of corporate governance structure is ensuring that reports comply with standard financial accounting reporting system so that the credibility of financial statements could be ascertained (Bushman and Smith, 2003). Also, auditing is found to be a monitoring mechanism that lessens information asymmetry between managers and the market as well as ensuring that credibility of firm’s financial statements is ascertained (Becker et al., 1998), hence monitoring and reduction of agency costs can be effectively achieved through this valuable mechanism (Watts and Zimmerman, 1983; Jensen and Meckling, 1976). The primary function of the internal monitoring mechanisms is to monitor the possibility of manipulating earnings by the manager and to administer the financial reporting process. On the other hand, the role of external auditor is to express an independent opinion on the truth and fairness as well as ensuring that an entity’s financial statements is free from material misstatements. Additionally, it is the function of internal monitoring mechanisms and external auditors to establish the validity and reliability of firm’s reported earnings. Thus, monitoring of firm’s financial reporting, assessment of internal monitoring mechanisms and ensuring that external auditors with high reputation are deemed to deliver effective monitoring of earnings management so as to improve earnings quality.

2.1 Internal monitoring mechanisms and earnings quality

In the corporate governance monitoring mechanism, the BOC is at top (KNKG, 2006). Hermawan (2011) Board of commissioner submits that effectiveness is the extent to which a BOC can perform the main tasks associated with their responsibilities. Fama and Jensen (1983) argues that in any organization, the board of directors serves to protect the interests of shareholders from other regulatory agencies. In the present proposed study, the relationship between internal monitoring mechanisms (boards of commissioners and audit committee) on earnings quality at the infancy stage of empirical examination in Indonesia. Though the ability of the features of the audit committee (size, meeting, independence and expertise) have been theoretically posited and a few studies done, further examining this relationship in the Indonesian context would be worthwhile (Rusmin, 2011; Susanto & Pradifta, 2016; Siregar & Utama, 2008).

In 2012, in the quest to strengthen the activities of audit committee, the regulator in Indonesia (BAPEPAM-LK) added charter on audit committee in annual report of firms which provided further information about audit committee meeting attendance and audit committee tenure. Disclosure of meetings attendance as it cores components is aim at highlighting the need for audit committee members to be present in all audit committee meetings. By this, monitoring is improved, there will be reduce earnings management and
by extension, possible increase in earnings quality (Musa, Kamardin & Abdul Malak, 2017; Ormin, Tuta & Shadrach, 2015). Unfortunately, there is a huge paucity of empirical underpinnings in this regard that needs urgent attention. Tenure of members of audit committee is another critical point to note. On the revised guidelines on the audit committee work issued by BAPEPAM-LK in 2012, committees are required to disclose the specific tenure of audit committee members in the new code of corporate governance. However, the BAPEPAM-LK (2012) limits the tenure of audit committee members to a maximum 10 years which previously has not been regulated in Act No 40 of 2007 on Limited Company. With term limits, it is expected that audit committee would be more independent in performing their duties. Accordingly, Vafeas (2003) argues that an audit committee with a long tenure is likely to create compromise since friendly relations have already been built. Thus, the longer the tenure of the audit committee, the more exposed the committee is to compromise which will eventually lead to lower earnings quality.

In this study, a test of internal monitoring mechanisms: characteristics of the board of commissioner (independence and size) and audit committee characteristics (independence, size, meeting, tenure, duality role, expertise and meeting attendance) on the earnings quality after implementation of the audit committee guidelines (BAPEPAM-LK, 2012) would be carried out through the following hypotheses:

\[ H_1 - H_{10} \]: There is relationship between internal monitoring mechanisms (board independence and board size, audit committee size, audit committee independence, audit committee expertise, audit committee meeting, audit committee meeting attendance, audit committee tenure and audit committee duality role) and earnings quality.

2.2 Interaction between internal monitoring mechanisms and external audit with earnings quality.

In some past studies, internal monitoring mechanisms and external auditors were independent monitoring instruments with regards to earnings management (Sun et al., 2011; Baxter and Cotter, 2009). Nonetheless, it is a well-known fact that both the two mechanisms are part of the whole corporate governance structure of a firm. As such it is doubtful to operate them independent from each other within the corporate governance structure.

Based on Committee of corporate governance in Indonesia (KNKG), audit committee is a committee that assists the board in controlling the company both internally and select external audit to be able to supervise the financial reporting process to protect the interests of shareholders. For example, the studies of Ashbaugh and Warfield (2003) explained that, the external auditors usually perform the function of oversight mechanisms in corporate governance. Audit committee and external auditors have a role to make sure that the integrity of financial reporting is assured (Cohen et al., 2017; Johl et al., 2007).

Moreover, external audit plays an important role in guaranteeing stakeholders to make capital decisions based on the credibility of the published financial statements. This is because, the internal monitoring mechanisms and external auditor have the right to issue high quality reports. In addition, the internal monitoring mechanisms and external auditor are required to produce a high-quality audit work so that the reputation, reliable audit could be assured and with a view to evade legal liability that may arise therefrom. Therefore, in this respect, both the monitoring mechanisms can jointly operate to alleviate earnings quality. Hence the following hypotheses were developed:

\[ H_{10} - H_{10} \]: The presence of internal monitoring mechanisms (board independence and board size, audit committee size, audit committee independence, audit committee expertise, audit committee meeting, audit committee meeting attendance, audit committee tenure and audit committee duality role) and external audit within the firm has a joint effect on earnings quality.

III. Methodology

The sample of the study is comprised of 216 non-financial listed companies in bursa Indonesia for the period between 2013 and 2016. Earnings quality is measured with real earnings management using a developed model Roychowdhury by Cohen (2008). The following model represent cash flow from operations (CFO):

\[
\frac{CFO_t}{Assets_{t-1}} = \alpha_0 + \alpha_1 \left( \frac{1}{Assets_{t-1}} \right) + \beta_1 \left( \frac{Sales_t}{Assets_{t-1}} \right) + \beta_2 \left( \frac{\Delta Sales_t}{Assets_{t-1}} \right) + \varepsilon_t \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots (1)
\]

Where:

- \( CFO_t \) = cash flow from operations retrieved from the statement of cash flows of firm in year \( t \)
- \( Assets_{t-1} \) = total assets at the end of year \( t - 1 \)
- \( Sales_t \) = net sales for firm in year \( t \)
- \( \Delta Sales_t \) = changes in net sales for firm \( i \) between year \( t \) and year \( t - 1 \)
- \( \varepsilon_t \) = the error terms.
The following model is individual proxy (abnormally high production costs):

\[
\frac{PROD_{t}}{\text{Assets}_{t-1}} = \alpha_0 + \alpha_1 \left( \frac{1}{\text{Assets}_{t-1}} \right) + \beta_1 \left( \frac{\text{Sales}_{t}}{\text{Assets}_{t-1}} \right) + \beta_2 \left( \frac{\Delta \text{Sales}_{t}}{\text{Assets}_{t-1}} \right) + \beta_3 \left( \frac{\Delta \text{Sales}_{t-1}}{\text{Assets}_{t-1}} \right) + \epsilon_t \]

(2)

Where:

- \( PROD_t \) = production costs of firm are in year \( t \), which is equal to the sum of the cost of sales plus changes in inventory.
- The third proxy is abnormal discretionary expenses (ADISX): \( \frac{DISX_{t}}{\text{Assets}_{t-1}} = \alpha_0 + \alpha_1 \left( \frac{1}{\text{Assets}_{t-1}} \right) + \beta \left( \frac{\text{Sales}_{t}}{\text{Assets}_{t-1}} \right) + \epsilon_t \)

(3)

Where: \( DISX_{it} \) = discretionary expenditures which include general, selling and administrative expenses, advertising and R&D, for firm in year \( t \).

Second step measure earnings quality with aggregate real management, this research also uses aggregate real earning management by Cohen et al (2008). Thus, the aggregate, earnings management (RM) is measured by the following equation:

\[
RM = \text{abnormal cash flow from operations} + \text{abnormal production costs} - \text{abnormal discretionary expenses} \]

(4)

In this study an attempt is made to examine the relationship between internal monitoring mechanisms (board characteristics - independence and size, and audit committee characteristics - size, independence, frequency of meetings, attendant meeting, financial expertise, tenure, and duality role). In addition, following previous studies, we include firm size, return on assets, leverage, loss, industry and family ownership as control variables (Ismail et al., 2009; Lin et al., 2006; Peasnell, Pope & Young, 2005; Siregar & Utama, 2008).

\[
EQ = \beta_0 + \beta_1 \text{BOCIND} + \beta_2 \text{BOCSIZE} + \beta_3 \text{ACIND} + \beta_4 \text{ACSIZE} + \beta_5 \text{ACMEET} + \beta_6 \text{ACEXPERT} + \beta_7 \text{ACTENURE} + \beta_8 \text{ACDUALITY} + \beta_9 \text{LEV} + \beta_10 \text{FSIZE} + \beta_11 \text{ROA} + \beta_12 \text{LOSS} + \beta_13 \text{FAMOWN} + \epsilon
\]

Table 1: Summary of Measurement of Study Variables

<table>
<thead>
<tr>
<th>Variables</th>
<th>Measurement</th>
</tr>
</thead>
<tbody>
<tr>
<td>EQ</td>
<td>Using value aggregate real earnings management development Roychowdhury model by Cohen (2008)</td>
</tr>
<tr>
<td>BOCIND</td>
<td>Percentage of independence members from total number of board of commissioners (Siregar &amp; Utama.,2008),</td>
</tr>
<tr>
<td>BOCSIZE</td>
<td>Total number of the board members (Rusmin, 2011)</td>
</tr>
<tr>
<td>ACIND</td>
<td>Percentage of independent members from total number of audit committee (Muhardi, 2010)</td>
</tr>
<tr>
<td>ACSIZE</td>
<td>Number of audit committee members (Rusmin, 2011)</td>
</tr>
<tr>
<td>ACMEET</td>
<td>Number of meetings of audit committee per year (Rusmin, 2011)</td>
</tr>
<tr>
<td>ACEXPERT</td>
<td>percentage of audit committee members who have accounting background or financial (Badolato et al, 2013)</td>
</tr>
<tr>
<td>ACTENURE</td>
<td>Percentage of meeting attendance of audit committee members for one year (Musa et al., 2017)</td>
</tr>
<tr>
<td>ACDUALITY</td>
<td>Average tenure of a member of the audit committee per year (Dhalwal et al., 2010)</td>
</tr>
<tr>
<td>LEV</td>
<td>Percentage of total liabilities represented by total assets (Abdul Rahman &amp; Ali., 2006)</td>
</tr>
<tr>
<td>FSIZE</td>
<td>The natural logarithm of total assets (Abdul Rahman &amp; Ali., 2006)</td>
</tr>
<tr>
<td>ROA</td>
<td>Percentage of earnings before interest and tax (EBIT) represented by total assets (Ismail et al., 2009)</td>
</tr>
<tr>
<td>LOSS</td>
<td>Dummy variable equal one if firm has loss and zero otherwise (Lin et al., 2006).</td>
</tr>
<tr>
<td>FAMOWN</td>
<td>Percentage proportion of family ownership in ownership structure in firm. (Siregar &amp; Utama, 2008).</td>
</tr>
</tbody>
</table>

IV. Analysis of Results

Table 1: Descriptive Statistics

<table>
<thead>
<tr>
<th>Variable</th>
<th>Obs</th>
<th>Mean</th>
<th>Std. Dev.</th>
<th>Min</th>
<th>Max</th>
</tr>
</thead>
<tbody>
<tr>
<td>RM</td>
<td>864</td>
<td>-.0592655</td>
<td>.5877244</td>
<td>-1.074564</td>
<td>1.480735</td>
</tr>
<tr>
<td>BOCIND</td>
<td>864</td>
<td>.4141852</td>
<td>.1052099</td>
<td>.2222222</td>
<td>1</td>
</tr>
<tr>
<td>BOCSIZE</td>
<td>864</td>
<td>4.259259</td>
<td>1.787016</td>
<td>2</td>
<td>12</td>
</tr>
<tr>
<td>ACIND</td>
<td>864</td>
<td>.9911265</td>
<td>.0461087</td>
<td>.75</td>
<td>1</td>
</tr>
</tbody>
</table>
Table 1 shows the average size of board of commissioners of Indonesia companies listed is average firm have four members and board independent members 41.41%. The audit committee members are independent mean 99.11%. Average frequency meeting audit committee six times with attendance meeting average 97.29% members and minimum 75% attendance members in one year. Tenure of audit committee members average 4.2 years Average value of 37% and maximum 67% for audit committee role duality other word have more one members have overlapping in corporate governance structure in many firms.

Table 2: Descriptive Statistics of Dichotomous Variables

<table>
<thead>
<tr>
<th>Variable</th>
<th>Observations</th>
<th>Frequency</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>EXAUDITQBIG4</td>
<td>864</td>
<td>377</td>
<td>43.64%</td>
</tr>
<tr>
<td>LOSS</td>
<td>864</td>
<td>217</td>
<td>25.12%</td>
</tr>
</tbody>
</table>

Table 2 shows that 864 observation firms-years (43.64%) are audited by Big4 audit firms while 377 firms (56.36%) are audited by non-Big4 and from 864 observation firm-years 74.18% of the companies have income profit while 25.12% have net income loss.

Firstly, winsorized distribution was conducted to eliminate possible outliers in all continuous variables at the top and bottom so as to uphold the features of the original data. Also, Driscoll and Kraay standard error was conducted with a view to estimate the regression models in solving heteroskedasticity, autocorrelation and cross-sectional independence problem. In addition, to test the normality assumption of the study data, skewness and kurtosis were used. According to Hair et al (2006), skewness should stay within a threshold of ±3. On the other hand, Kline (1998) recommends that kurtosis should not be more than ±10. After conducting the test, the results show that the data is normally distributed. Furthermore, Pearson correlation was carried out to test for multicollinearity and fortunately enough, there is absence of multicollinearity as no correlation coefficient that is more than 0.80 (Hair et al., 2006). Moreover, in this study, fixed effects regression was used and adjusted as suggested by Hoechle (2007) to control for autocorrelation, heteroscedasticity and cross-sectional dependence.

Table 3: Multiple Regression Results

<table>
<thead>
<tr>
<th>EQ =  + β1BOCIND + β2BOCSIZE + β3 ACIND + β4 ACSIZE + β5 ACMEET + β6 ACEXPERT + β7 ACATTEND + β8 ACTENURE + β9 ACDUALITY + β10 EXAUDITQ + β11 BOCIND<em>EXAUDITQ + β12 BOCSIZE</em>EXAUDITQ + β13 ACIND<em>EXAUDITQ + β14 ACSIZE</em>EXAUDITQ + β15 ACMEET<em>EXAUDITQ + β16 ACEXPERT</em>EXAUDITQ + β17 ACATTEND<em>EXAUDITQ + β18 ACTENURE</em>EXAUDITQ + β19 ACDUALITY*EXAUDITQ + β20 LOSS + β21 LEV + β22 ROA + β23 FAMOWN + β24 FSIZE + ℰ</th>
<th>Predicted</th>
<th>Direct</th>
<th>With moderator</th>
</tr>
</thead>
<tbody>
<tr>
<td>Variables</td>
<td>Sign</td>
<td>Drisc/Kraay Coef.</td>
<td>t-stat.</td>
</tr>
<tr>
<td>_cons</td>
<td>?</td>
<td>4515876</td>
<td>0.44</td>
</tr>
<tr>
<td>BOCIND</td>
<td>-</td>
<td>-0.2352246</td>
<td>-1.07</td>
</tr>
<tr>
<td>BOCSIZE</td>
<td>-</td>
<td>-0.0370248*</td>
<td>-2.65</td>
</tr>
<tr>
<td>ACIND</td>
<td>-</td>
<td>-0.8977933*</td>
<td>-2.82</td>
</tr>
<tr>
<td>ACSIZE</td>
<td>-</td>
<td>0.0245443</td>
<td>0.81</td>
</tr>
<tr>
<td>ACMEET</td>
<td>-</td>
<td>-0.0015326</td>
<td>-0.36</td>
</tr>
<tr>
<td>ACEXPERT</td>
<td>-</td>
<td>0.0676806</td>
<td>0.95</td>
</tr>
<tr>
<td>ACATTEND</td>
<td>-</td>
<td>-0.0683389</td>
<td>-0.35</td>
</tr>
</tbody>
</table>
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Table 3 presents a significant and negative association between board size and real earnings management (RM), where the t-statistic value level of real earnings management (t = -2.65, p > 0.10). In other words, H2 is accepted. The result supports H2, which indicates that higher board members leads to a decrease in the level of real earnings management, eventually, to higher earnings quality. This finding provides support for the argument of the agency theory, which posits that a large number of directors bring more experience and diversity, which significantly enhances board effectiveness (Fama & Jensen, 1983). With regard Table 3 presents the relationship audit committee independence and real earnings management is found to be negative and significant at the 10% level (t = -2.82, p < 0.10). The result supports H3, which indicates that a higher percentage of members’ independence on the audit committee leads to a decrease in the level of real earnings management, eventually, to higher earnings quality. The above finding offers support for the argument of the agency theory, which posits that a large percentage of audit committee independent members bring more effective monitoring management to reduce earnings management and improve earnings quality result similar to previous studies by; Siagian & Tresnaningsih (2011) and Baxter & Cotter, 2009. For audit committee tenure (ACTENURE), the coefficient is negative for RM significant at RM (-4.85, p < 0.05). This suggests that decreasing the ACTENURE leads to more RM and a decrease in earnings quality. Thus, hypothesis H8 is rejected. This result is in contrast with the result of Dhaliwal et al. (2010) and Vafeas (2005), which found that ACTENURE is positively significant with earnings management and negatively with earnings quality. A
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possible explanation for this result is that, decrease in the audit committee tenure is attributed to the firms following the recommendations of the BAPEPAM-LK (2012). This study has not found significant relationship between internal monitoring mechanisms (such as: board independence, audit committee meeting, audit committee independence, audit committee expertise, audit committee meeting attendance and audit committee duality role) and earnings quality.

However, Table 3 show indicates that the coefficients of the interaction of BOCSIZE with EXAUDITQ (ACIND * EXAUDITQ) and RM are significantly negative. While RM at both 5% level has the coefficient RM 3 (t = -3.19, p< 0.05). This indicates that Board size and external audit quality has the joint effect reduce earnings management and improve earnings quality (with decrease real earnings management). Thus, H11 is supported. This means that high quality of external audit and more member of board joint plays a significant role in reducing earnings management practice which enhance the earnings quality of the firm. The coefficients of the interaction of AC independence (ACIND) with external audit quality (EXAUDITQ) (ACIND * EXAUDITQ) and earnings quality is negatively significant at the 1% level with RM (t = -6.65, p< 0.01). This indicates that ACIND and EXAUDITQ has the joint effect decrease earnings management and improve earnings quality. Thus, H12 is supported. The explanation of this result is that the increase in ACIND with high quality of external audit leads to reduced earnings management (high earnings quality). The direct relationship shows a negatively significant influence of audit committee tenure on earnings quality and insignificant with RM. However, in Table 3, the coefficient of ACTENURE * EXAUDITQ is positively significant at the 5% level with RM (t = 3.7, p< 0.05). This shows that EXAUDITQ perform a moderating effect between internal mechanisms and real earnings management. Thus, H18 is supported. The explanation of this result is that the high quality of external audit and less audit committee members overlapping in structure corporate governance jointly monitoring earning management activities and enhancing earnings quality. Moreover, these results are consistent with other authors who claimed that to enhance the quality of financial reporting in firms, a less overlapping board structure is required (Laux & Laux, 2009; Chang et al., 2012).

In Table 3 the show control variable with leverage is significantly positive the t-value is (t = 5.83, p <0.01). This is similar to the studies of Davidson et al. (2005) and Klein (2002), showed that leverage has a significant and positive relation with EM activities. While, other variable controls such as: loss, ROA FAMOWN and firms are not significant relationship with earnings quality.

VI. Conclusion and Recommendation

In conclusion, this research paper has examined the influence of internal monitoring mechanisms and external auditor on earnings quality. It was also established from the findings that audit committee and are two mechanisms that are likely to jointly connive to mitigate earnings quality. The paper also examines the joint association between the two motoring mechanisms and the earnings quality. It was found that internal monitoring mechanisms (board size, audit committee independence and audit committee tenure) have significant relationships with earnings quality. Also, the finding revealed a significant relationship between both internal monitor mechanisms and external audit with real earnings management. In other words, the results of this study provide that internal monitoring mechanism and external audit can provide effective monitoring of earnings management so as to improve earnings quality in Indonesian listed firm. Notwithstanding, internal monitoring mechanism alone might not be enough to scrutinize the reliability of a firm’s accounting and auditing system and process respectively. Having such confirmation will in turn protect the interest of shareholders. Therefore, it is highly recommended that Indonesia regulator (OJK) should give much emphasis and focus more on issues that relates to the ensuring of continuous regulatory effectiveness of internal monitoring structure in Indonesian listed firms.

References


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