International Journal of Economics, Commerce and Management
United Kingdom ISSN 2348 0386 Vol. VII, Issue 3, March 2019
http://ijecm.co.uk/

THE EFFECT OF AUDIT COMMITTEES ON THE EARNINGS QUALITY IN PUBLIC COMPANIES LISTED IN JORDAN

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Abstract

This paper seeks to examine the effect of the characteristics of the Audit Committee (Size, Experience) on the earnings quality in the presence of corporate governance in the public companies listed on the Amman Stock Exchange (ASE). This paper provides evidence that earnings quality positively impacted by the quality of Audit Committees (AC). This study has two main objectives; the first is to conduct a review of the Jordanian laws and regulations related to audit committees in order to explore the extent of their application in public companies listed in (ASE). The second is to study the effects of audit committees on the quality of earnings in the future continuity and quality offered by these committees of financial information in these companies.

Keywords: Audit Committee, Size, Experience, Quality of Earnings, Amman Stock Exchange

INTRODUCTION

The world has seen financial collapses and management scandals in leading companies in many countries, such as the United States of America, East Asia, and Russia, which have affected the economies of these countries, this led to financial and administrative corruption and mismanagement (Puat Nelson & Devi, 2013).

In 1990 and after the bankruptcy of Petra Bank, which was one of the reasons for the weakness and failure of internal control in these locations, Jordan has suffered from a lack of confidence of investors making the parties responsible for the issuance of a number of laws and regulation, including the Securities Law No. (7) For the year (2017) and which obligates all public shareholding companies in Jordan to form audit committees (Siam, Laili, Khairi, & Jebreel, 2014). According to (Bouaziz & Triki, 2012) the audit committees now one of the most important tools that depend on them in the management decision-making, (Ng, 2013) attention in recent years has increased the role of audit committees as a mechanism for institutional governance.

Due to the prevailing conditions in the business world, many administrations of the public shareholding companies resort to financial statements in order to improve the financial statements in terms of earnings or financial position to achieve self-objectives, these administrations use creative accounting (manipulation of earnings and financial statements) (Abdullatif, Ghanayem, Ahmad-Amin, Al-shelleh, & Sharaiha, 2015) (Al Daoud, Ismail, & Lode, 2015). It was, therefore, necessary to form audit committees in these companies to prevent such cases in the presence of corporate governance (Abdullatif et al., 2015), (Al Daoud et al., 2015), (Alzoubi, 2016), (Ammer & Ahmad-Zaluki, 2017b), (Alqatamin, 2018), (Amin, Lukviarman, Suhardjanto, & Setiany, 2018).

LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

Audit committees have seen growth in recent years as a result of corporate governance and the importance of audit committees to improve the quality of financial reporting (Al-Rassas & Kamardin, 2015), (Inaam & Khamoussi, 2016).

The audit profession has contributed significantly to the development of societies for their services in the field of investment protection, clarification of cases of wasteful, and reduces the likelihood of errors in financial and accounting treatment of companies (Martinov-Bennie, Soh, & Tweedie, 2015) to serve stakeholders and ultimately serve the national economy. The main objective of this study is to shed light on the extent to which Jordanian companies apply the accepted internal auditing standards, compare them with the internal audit standards issued by the Institute of Internal Auditors in the United States of America, and the effect of the audit committees on earnings and financial information in Jordanian companies (Alzoubi, 2016).

Also; Badolato, Donelson, and Ege (2014) found that an audit committee would be stronger in the process of controlling financial statements and reduce the differences between the management and the external auditor. According to, the American Institute of Certified Public Accountants (AICPA) this study focused on how the audit committee plays an influential role in preventing and detecting fraud.

Also, (Puat Nelson & Devi, 2013) suggested that the audit committee shall review the financial reports with both management and external auditor, the audit committee shall, on instructions from the exchange, issue a report to be attached to the financial reports, and to discuss the quality of accounting policies and principles with management and the external auditor (Rochmah Ika & Mohd Ghazali, 2012). The role of audit committees in confirming the quality, credibility, transparency of financial reports, and the role of these committees in the face of earnings management methods (Vuko, Maretić, & Čular, 2015).

According to (Vuko et al., 2015); (Soliman & Ragab, 2014) effective audit committee good corporate governance mechanism reduces the potential conflicts of agencies resulting from the separation of ownership between the shareholders and management system is considered. However as per (Elijah & Ayemere, 2015), the existence of independent audit committee may protect the interest of shareholders. Also, their audit committee reduces earnings management, (Gerayli, Yanesari, & Ma'atoofi, 2011) found that audit committee independence is negatively related to earnings management, (Lam & Lee, 2012) this result suggests that independent audit committees are able to effectively control earnings management practices.

Therefore, the size of an audit committee, experience and efficiency of members, a degree of their independence, and meetings (Al-Mousawi & Al-Thuneibat, 2011). Many studies (Gerayli et al., 2011) were interested in audit committees as one of the tools of governance.

Audit Committees

These committees aimed to improve financial reports and earnings through consolidating their role, also audit committee characteristic in order to have an active audit committee; such qualities include the size of an audit committee, experience, and efficiency of members, a degree of their independence and meetings (Al-Mousawi & Al-Thuneibat, 2011). Many studies (Gerayli et al., 2011), (Fülöp, 2013) were interested in audit committees as one of the tools of governance. Previous studies have indicated that the effectiveness of audit committees depends to a certain extent on the characteristics of the commission (Herdjiono & Sari, 2017).

For the Audit Committee to be effective in controlling the conduct of managers, it must have sufficient members to carry out its responsibilities with sufficient resources. As for the relationship between audit quality and improving the quality of earnings (Hamdan, Mushtaha, & Musleh Al-Sartawi, 2013) found that the quality of audits of audit offices in Jordan did not contribute to the reduction of profit management practices in the Jordanian industrial companies subject to review. These offices have never played a role in increasing the profitability of Jordanian industrial companies.

An audit committee plays an important role in monitoring the company financial reporting process. However, (Elijah & Ayemere, 2015) the presence of an independent audit committee may protect the interest of shareholders. Also, their audit committee function reduces earnings management (Gerayli et al., 2011) found that audit committee independence is negatively related to earnings management (Lam & Lee, 2012). This result suggests that independent audit committees are able to effectively control earnings management practices.

Many researchers have identified the role of the audit committee in ensuring the credibility of the financial statement. The audit committee is a subcommittee of the Board that specializes in ensuring the accuracy and reliability of financial statements submitted by management (Habbash, Sindezingue, & Salama, 2013).

Audit Committees Size of Members

The number of members of the committee varies from one company to another and from one country to another according to the size of the board of directors and the size of the company and the nature of its activity, and not to reduce this committee in a way that may change the functioning of the committee for its work efficiently and effectively (Binti & Khairi) the optimal number of members of the audit committee is between three and five to seven members, in order to ensure the independence of the committee as in the United States of America, Britain, and Australia. Accordingly, (Li, Mangena, & Pike, 2012) discussed the formation of the audit committees and the number of members of these committees it turns out that these committees make up mostly board members of at least three members of public companies so that its members are independent (non-executive) at least one of its members has a financial or accounting background, the role of audit committee size is correlation to high earnings quality (Ghafran & O'Sullivan, 2013).

Moreover; Rochmah Ika and Mohd Ghazali (2012), Li et al. (2012) discussed of the relationship of the characteristics of the audit committee, independence, financial expertise and size of the audit committee, the study found a negative relationship between the size, independence, expertise and efficiency of the committee and the possibility of managing earnings (Aldamen, Duncan, Kelly, McNamara, & Nagel, 2012). According to the theory of dependence on resources, the larger audit committee means that members can bring more resources to the company, resulting in a high quality of earnings. Thus, we hypothesize that:

H1: The size of the audit committees is positively correlated with earnings quality.

Audit Committees Experience and Efficiency

Several studies indicate that the knowledge or expertise of the Audit Committee members is directly related to the effectiveness of the Audit Committee and argue that the main task of the Audit Committee is to oversee the financial reporting and auditing processes and therefore its members must have the ability to understand the issues being examined (Aldamen et al., 2012). Also; Hamid and Aziz (2012) suggested that there should be a significant positive impact on the company's performance when the audit committee has accounting and financial backgrounds. Financial expertise is very important for the effectiveness of the Audit Committee to enhance the quality of financial reporting. (Hamdan et al., 2013) (Rochmah Ika & Mohd Ghazali, 2012) discussed the influence of independent and effective audit committees on earnings quality and quality of financial reporting, that there is a direct relationship between the members of the independent audit committee who have financial expertise and meet periodically and the quality of earnings. As well as, the Audit Committee function that has a positive effect on the financial information and reporting quality (Rochmah Ika & Mohd Ghazali, 2012).

In particular, several aspects of the Audit Committee act as their independence, resources in terms of the size of the Audit Committee and activities and experiences, enhance the quality of financial reports (Inaam & Khamoussi, 2016). Based on the agency's theories and dependence on resources, we say that the experience of the Audit Committee reduces discretionary accrual and enhances the quality of earnings. Thus, we hypothesize that:

H2: Audit Committees experience is positively correlated with earnings quality.

Financial Leverage

Most economies around the world suffered financial setbacks and disasters due to the global financial crisis of 2008, this crisis led to the bankruptcy of many public companies. The ASE also suffered from the 2008 global financial crisis, the loss of confidence in investment activity coupled with the poor performance of the economy has resulted in significant losses in the value of public companies in Jordan after 2008 (Gevurtz, 2010), (Afrasine, 2009).

Financial Leverage is the degree to which a company uses fixed income securities such as debt and preferred property rights. The greater the debt financing used by the company, the greater the financial leverage. High leverage means high-interest payments, which negatively impact the company's core earnings (Aldamen et al., 2012).Thus, we hypothesize that:

H3: There is significant positive relationship between financial leverage and earnings quality.

H4: Financial leverage mediates the relationship between audit committees size and the earnings quality.

H5: Financial leverage mediates the relationship between audit committees experience and the earnings quality.

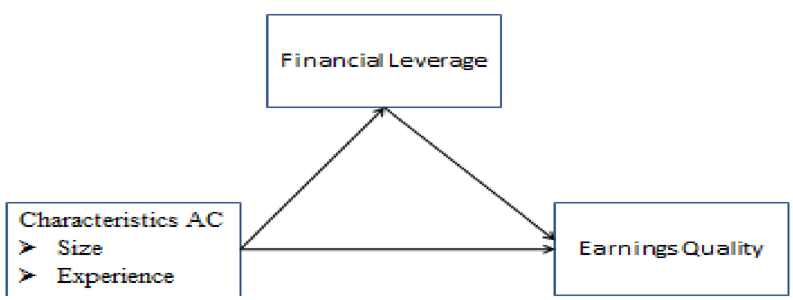
Earnings Quality

According to García, Barbadillo, and Pérez (2012), investors worry with earnings quality increased during the last decade after many companies announced non-authentic earnings, thus investors became more careful in considering net earnings. In other words (Siagian & Tresnaningsih, 2011) the earnings quality is the ability of the present earnings to provide a real picture about the company and its ability to survive in the future, the significance of earnings quality stems from the earnings on which many parties depend when they take their decision. Moreover; Inaam and Khamoussi (2016), Vuko et al. (2015) believe that earnings quality is considered an important factor in the financial statement and is used as a guide to decision making, earnings quality plays an important role in the process of financial analysis, (Hamdan et al., 2013) earnings quality help financial analysts in analyzing three basic sides of information, these are the present functional performance of the company, future functional performance, and value of the company.

Research Framework

Based on the theoretical framework and previous studies and the objectives of the study and problems, this model was formed, which represents the variables of this study.

Figure 1 Proposed research framework



The Stakeholder-Agency Theory

Stakeholder agency theory is a synthesis of stakeholder theory and agency theory. Agency theory focuses more narrowly on how organizational success is influenced by contracts between firm's shareholders or owner (the principal) and the firm's manager (the agent) who is charged with acting on the principal's behalf (principal-agent relationships). Of relevance to the theoretical framing of this study, agency theory has been criticized for overlooking the influence and importance of firm's stakeholders, beyond its narrow, dyadic focus on principal-agent relationships (Hill & Jones, 1992).

Relative to (Freeman, 1984), (Clarkson, 1994) provided a more explanation of the agency's theory and focused on the fact that the agency's theory was important because it could help companies achieve their goals. The theory of the agency deals with individual relations. For example, the relationship between the agent (company management) and the principal manager (shareholders of the company). Most studies in earnings quality (conservatism) use agency theory as the basis for the research proposals (Ahmed & Duellman, 2007).

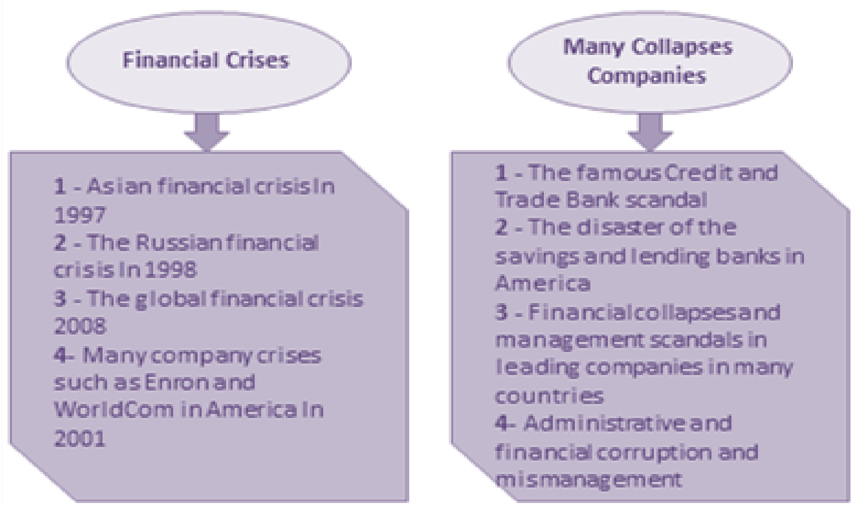
Emergence of audit committees

The idea of forming the audit committee in companies started as a result of the existence of some of the pressures that may be exercised by the management of these companies to the external auditor (Yassin & Nelson, 2012), (Li et al., 2012). And therefore which negatively affects his independence and neutrality, in particular that the administration has the power to determine the fees and the power to isolate him (Ahmed Haji, 2015) it can be said that maintaining the independence of the external auditor is the basis for the emergence of the idea of the existence of the audit committee has helped many factors to increase attention to the subject of audit committees (Kim & Yang, 2014).

1. Increasing cases of financial failure of many companies, increasing cases of fraud and manipulation and increasing the desire of these institutions to strengthen the control of their activities and ensure the proper application of accounting principles.

2. Increase the pressure on the users of the financial statements of the companies to show the result of their business and financial position in real.

Figure 2 Factors of attention to audit committees and corporate governance



CONCLUSION

The main objective of this research is to determine the correlation between the characteristics of the Audit Committee (specifically: the size of the Audit Committee and the financial expertise) and financial leverage, on the quality of earnings of companies listed on the Amman Stock Exchange in light of the financial and economic situation prevailing in the country.

Consequently, based on previous studies on the characteristics of the audit committees, as shown in the study of (Ahmed Haji, 2015); (Al-Mousawi & Al-Thuneibat, 2011); (Amin et al., 2018); (Ammer & Ahmad-Zaluki, 2017a); (Badolato et al., 2014); (Puat Nelson & Devi, 2013)there is a strong and important relationship between them in the financial markets, and thus affect the listed companies in the Amman Stock Exchange, and studied (Abdullatif et al., 2015); (Alqatamin, 2018); (Alzoubi, 2016); (Hamdan et al., 2013).

It is indicative that the quality of profits is of great importance and helps to make decisions for investors and shareholders in Jordanian companies. Therefore, we recommend focusing on the study of the quality of profits with the characteristics of the audit committees, and we also advise to study other variables that may affect the quality of profits such as corporate governance.

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