Impact of Audit Committee Characteristics on the Earnings Quality

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Abstract
The objective of this paper is to explore the characteristics of the Audit Committee (AC) (namely: audit committee independence, and number of meetings) in the public companies listed on the Amman Stock Exchange (ASE), and then look at their impact on the quality of earnings expressed in the continuity of earnings in the future. So, in the past years, the role of the Audit Committees as an institutional governance mechanism has increased, which aims to protect the interests of the shareholders and preserve the rights of companies, after the failures financial and administrative of many foreign and local companies.
Keywords: *Independence, Meetings, Financial Leverage, Quality of Earnings, Amman Stock Exchange*

1. Introduction

The main objective of this paper is to examine the audit committee on the quality of earnings. The concept of audit committees varies according to the objectives, functions, and responsibilities assigned to them (Ahmed Haji & Anifowose, 2016). However, the need to determine the impact of the audit committee on the quality of earnings has become a growing concern among accountants, academics, researchers, and investors (Al Daoud, Ismail, & Lode, 2015). With recent accounting and financial scandals, investors have become interested in managing earnings and began demanding earnings quality to enhance the quality of the financial statement (Alves, 2013). The high quality of earnings and the transparency of financial reports are important to gain the trust of investors and other stakeholders. Al-Rassas and Kamardin (2015) the Audit Committee is one of the pillars of accountability because it supports the role of the Boards to monitor the financial reporting process and is responsible for assessing the quality of earnings and financial reporting (Abdullatif, Ghanayem, Ahmad-Amin, Al-shelleh, & Sharaiha, 2015).

Auditing plays a key role in corporate governance. The Jordanian Association of Certified Public Accountants (JACPA) adopted the International Standards on Auditing (ISA) in 1990. "An audit committee should also ensure the soundness of the internal control procedures in detecting and preventing errors, frauds, and malpractices (Puat Nelson & Devi, 2013)". An audit committee is the most important and challenging sub-committee of any company's board of directors. It is seen as the guardian of a company's financial integrity. The safety of published financial statements of companies under the presence of audit committees, emanating from the boards of these companies management and audit committees become more effective in overseeing the process of preparing the financial statements (Ojeka, Iyoha, & Obigbemi, 2014), (Iyer, Bamber, & Griffin, 2012).

As well as Gerayli, Yanesari, and Ma'atoofi (2011) note the role of function internal audit and audit committees in the management and improvement of earnings, and ensure the quality of earnings number and financial information; it is one of the most important committees on which they depend on departments in the companies in the taking of decisions. In addition Kibiya, Che-Ahmad, and Amran (2016) it has affected cases of fraud and manipulation and theft suffered by the major companies in the world and the collapse of these companies on the confidence the users of financial reports, including the American Enron at the end of the year (2001) and it is one of the most prominent companies that have fallen as a result of the lack of ethics and business where they fell this company with assets estimated to be worth (63.4) billion dollars the failure and collapse of the company as a result of the failure and weak oversight and corporate governance principles, which made the formation of audit committees, due to the weakness of internal oversight in the companies (Amin, Lukviarman, Suhardjanto, & Setiany, 2018).

Jordan is a developing country with a centralized state system. It is very attractive for foreign investments. It seeks to afford a safe environment for its listed securities at the same time as protecting the rights of the investors (Abdullatif et al., 2015). Therefore, the Jordanian government mandated the establishment of audit committees in Jordanian public shareholding companies to facilitate improving the quality of Jordanian financial reporting, the audit committee consisting of three non-executive members from the company's board of directors (Al-Khaddash, Al Nawas, & Ramadan, 2013), (The Jordanian Corporate Governance Codes (JCGC), 2009).

Therefore, this study seeks to fill the gap in previous studies to study the laws and legislation of the audit committees and verify their application by Jordanian public companies to determine their effect on the earnings quality level. As a result, the focus has not only been on the formation of audit committees, but also the effectiveness of audit committees in improving stakeholders' confidence in financial statements (T. Lin, Hutchinson, & Percy, 2015), (Elijah & Ayemere, 2015), (Amiram et al., 2018).

2. Literature Review and Hypotheses Development

Previous studies reported mixed results on the relationships between audit committee characteristics and earnings quality (Kallamu & Saat, 2015), (Khlif & Samaha, 2016). Several studies have investigated the relationship between audit committees and earnings quality, financial reporting (Abdullatif et al., 2015) there is an increasing regulatory attention to the role of the Audit Committee in the preparation of financial reports, the reliable signal has a study by (Adel & Maissa, 2013) the financial statements and the fairness and efficiency of corporate credibility depends on the audit committees emanating from the boards of directors, a highly efficient and effective so that these statements be of high efficiency are reliable in make decisions.

An audit committee plays an important role in monitoring the company financial reporting process. However, Elijah and 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 control earnings management practices effectively. According to Braiotta Jr, Gazzaway, Colson, and Ramamoorti (2010), the Audit Committee's mission is to provide guidance to management, external auditors, and investors, and ensure that financial information is complete and accurate. According to Y. C. Lin, Wang, Chiou, and Huang (2014), the American Institute of Certified Public Accountants (AICPA) outlines specific steps to avoid fraud in risk management. Audit committees re-emerged as a strategic tool for preventing fraud and ensuring sound financial management in business scandals (Miko & Kamardin, 2015).

2.1 Audit Committees

Most of the professional bodies interested in the audit committees, whether international or local, focused on the importance of establishing audit committees and the need to have a number of characteristics that enable them to perform the tasks entrusted to them (Haddad, Sbeiti, & Qasim, 2017). Ahmed Haji and Anifowose (2016) these committees up to the highest administrative level, the editor and be free of any responsibility for operational, and it is considered one of the important conditions to be met in the most, and the credibility and transparency, objectivity and neutrality, also Wang and Huynh (2013) you must enjoy full independence in the existence of Corporate Governance, which focuses on the importance of audit committees in public shareholding companies.

The audit committee has been defined in different ways. For example, (Al-Mahamid & AL-Saeed, 2011) defined it as the competency with which the audit committee loadout its specified observation responsibilities. On the other hand, Kibiya et al. (2016) stated that an effective audit committee is the one that executes its responsibilities. Moreover, Miko and Kamardin (2015) audit committee is a central mechanism of corporate governance; it is a sub-committee of the Board of Directors.

The audit committees improve the quality of accounting and control by promoting the credibility of the financial reports. Al-Mahamid and AL-Saeed (2011) The results showed that effective audit committees have a positive effect on improving internal control. (Ahmed Haji, 2015) also, the audit committees are a powerful tool that enhances the reliability and transparency of financial information. (Ojeka et al., 2014) confirm that the aim of establishing an audit committee is to minimize fraudulent in the companies. In the case of financial manipulation, the Audit Committee is responsible for this, through their role in overseeing the financial reporting process, (Cohen, Hoitash, Krishnamoorthy, & Wright, 2013).

2.1.1 Independence of the Audit Committee

An effective audit committee to improve earnings quality to meet the various responsibilities including, comment and approve accounting policies, reviewing of financial statements and adequacy of internal controls (Habbash, Sindezingue, & Salama, 2013). An important element that will ensure the effectiveness of the Audit Committee is that members of the Commission are independent or free from the influence and pressures of top management (Carcello, Hermanson, & Ye, 2011). Although the results of previous studies on this relationship are inconclusive, an independent audit committee works better than a less independent committee, the former being more likely to provide better control through its ability to resist pressure from managers (Al-Matari, Al-Swidi, & Fadzil, 2013), (Kallamu & Saat, 2015). In addition, audit committees chaired by independent directors are positively linked to high-quality financial reports and minimum fraudulent reporting, (Teitel & Machuga, 2010). The results of previous studies show that the independence of the Audit Committee is effective in controlling the financial statements (Aldamen, Duncan, Kelly, McNamara, & Nagel, 2012). Independence of the Audit Committee to encourage and improve the quality of financial reports of financial statement information (Mahrous, 2014). The independence of the audit committee linked to earning quality (Baxter & Cotter, 2009).

A number of studies have found a significant positive correlation between the independence of the Audit Committee and the quality of the financial reports (Varma & Patel, 2012), (Aldamen et al., 2012). However, other studies have found an insignificant correlation between the independence of the Audit Committee and financial and non-financial reports (Li, Mangena, & Pike, 2012). In addition Rochmah Ika and Mohd Ghazali (2012), García, Barbadillo, and Pérez (2012) that the Audit Committee with the majority of independent members can effectively control management and reduce the chance of reporting fraud because there is less intervention from management. Also, Hamdan, Mushtaha, and Musleh Al-Sartawi (2013) say the independence of a review committee leads to high-quality financial reporting (Yunos, 2011), (García et al., 2012). From the perspective of the Agency's theory, the effectiveness of the Audit Committee is based on its characteristics (Rochmah Ika & Mohd Ghazali, 2012). In order for the Audit Committee to function, its members must be independent of management. Thus we hypothesize that:

H1: The independence of an audit committee is positively associated with earnings quality.

2.1.2 Meetings of the Audit Committee

According to Hamdan et al. (2013), the audit committee usually meets three or four times each year. Audit committee meetings generally on the subject of financial reporting and audit cycle, before finalization of the interim and final end of the year. The audit committee meeting is intended to ensure that the performance of the audit committee achieves the desired objective (Baxter & Cotter, 2009). Several studies showed different results (Chandrasegaram, Rahimansa, Rahman, Abdullah, & Mat, 2013) study showed that the frequency of audit committee meetings not negatively correlated with the size of earnings management. The frequency of audit committee meetings is not enough to deter earnings management practice in public companies (Habbash et al., 2013).

According Har Sani Mohamad, Majdi Abdul Rashid, and Mohammed Shawtari (2012), (Yassin & Nelson, 2012) a number of researchers believe that the frequency of Audit Committee meetings is an indicator of the Committees effectiveness and effective guidance (Li et al., 2012), (Ahmed Haji, 2015). Also, Mishra and Malhotra (2016) find that the regularly convened audit committees have sufficient time to carry out their essential roles effectively. Audit committees that meet more frequently are better informed about the company's conditions (Al-Matari et al., 2013) and provide a more effective monitoring mechanism for financial activities. The frequency of meetings of audit committees reflects their effectiveness (Zaman, Hudaib, & Haniffa, 2011). In terms of earnings, quality finds evidence that the frequency of audit committee meetings is associated with high quality of earnings (Habbash et al., 2013).

Moreover Habbash et al. (2013) the role and function of the public company audit committee, this study discussed the effect of the collapse of major companies as a result of fraud and manipulation by the departments of these companies and dispense with the services of thousands of employees, especially in view of the collapse of Enron. As well as (Y. C. Lin et al., 2014) found that earnings management has a negative relationship with independence and experience and the meetings of the Audit Committee (Surbakti, Shaari, & Bamahros, 2017) provided evidence of the relationship between audit quality and earnings quality. Based on the theory of the agency, we expect that the independent audit committee that meets consistently will be able to monitor management behavior. So we hypothesize that:

H2: Audit Committees meetings are positively correlated with earnings quality.

2.3 Financial Leverage

Financial Leverage is one of several financial measures that look at the amount of capital that comes in the form of debt (loans) or assess the ability of the company to meet its financial obligations (Gevurtz, 2010). The leverage ratio is important as companies rely on a combination of stocks and debt to finance their operations and knowing how much debt they hold is useful in assessing whether they can repay their debts when they fall due (Har Sani Mohamad et al., 2012). Too much debt can be dangerous to the company and its investors. However, if the company's operations achieve a higher rate of return than the interest rate on its loans, debt helps to boost earnings growth, (Mahrous, 2014).

This ratio is used to assess the efficiency of financial policies adopted by the company's management, as well as being one of the important indicators that demonstrate the adequacy of published financial statements of public shareholding companies (Afrasine, 2009). As for the objectives of this study, the total percentage of debt to assets was used as an indicator of the financial leverage in the sample of this study (Aldamen et al., 2012). The study of Qaraqish (2009) found that companies with minimal financial leverage had earnings of higher quality. Baron and Kenny translated a mediation test suggested by (Judd & Kenny, 1981) and framework for mediation analysis has become ubiquitous in the pages of the Journal of Consumer Research, as in other social science journals. Thus, we hypothesize that:

H3: There is a significant positive relationship between financial leverage and earnings quality.
H4: Financial leverage mediates the relationship between audit committees independence and the earnings quality.
H5: Financial leverage mediates the relationship between audit committees meetings and the earnings quality.

2.4 Earnings Quality

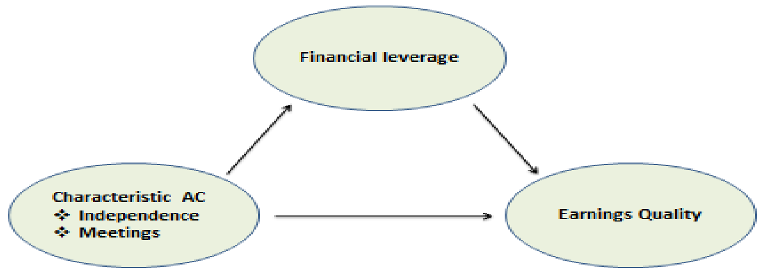
The earnings quality is the extent to which current earnings are able to present a true picture of the company's future, and its ability to continue in the future (Alzoubi, 2016). The quality of earnings is an important element of the financial statements. Improving the quality of financial reports in general and improving the quality of earnings, in particular, is considered one of the most important benefits resulting from the formation of audit committees (Amin et al., 2018). Aryan (2015) Corporate scandals and failures, such as Enron and WorldCom, have led to increased interest in audit committees to protect shareholders' interests. In this perspective, the management of exclusive profits negatively affects the quality of earnings (meaning that the more earnings management, the lower the quality of earnings) Bansal and Sharma (2016). In addition Al-Rassas and Kamardin (2015) the quality of earnings over the continuity of the flow of current earnings in future periods and the accuracy of financial information available, and the ability of current earnings and financial information that reflect the current and future performance of the company in addition to the companies' ability to reduce costs to achieve the financial returns over the long term (Narwal & Jindal, 2015)and to divide the earnings (cash flows, and accruals) the quality of earnings means continuity cash flows more than accruals the lower the percentage of receivables increased quality of earnings.

Then Alzoubi (2016) discuss audit quality and earnings management this study is to test the association between audit quality and earnings management, audit quality studies documented that accruals would reduce when the auditor is independent of the audit firm is large, the sample contained 86 companies listed on the Amman Stock Exchange from 2007 to 2010. Findings – This study revealed that there:

1) A significantly negative association between audit quality and earnings management.
2) That earnings management level is significantly lower among companies using the services of independent auditors.

2.5 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.



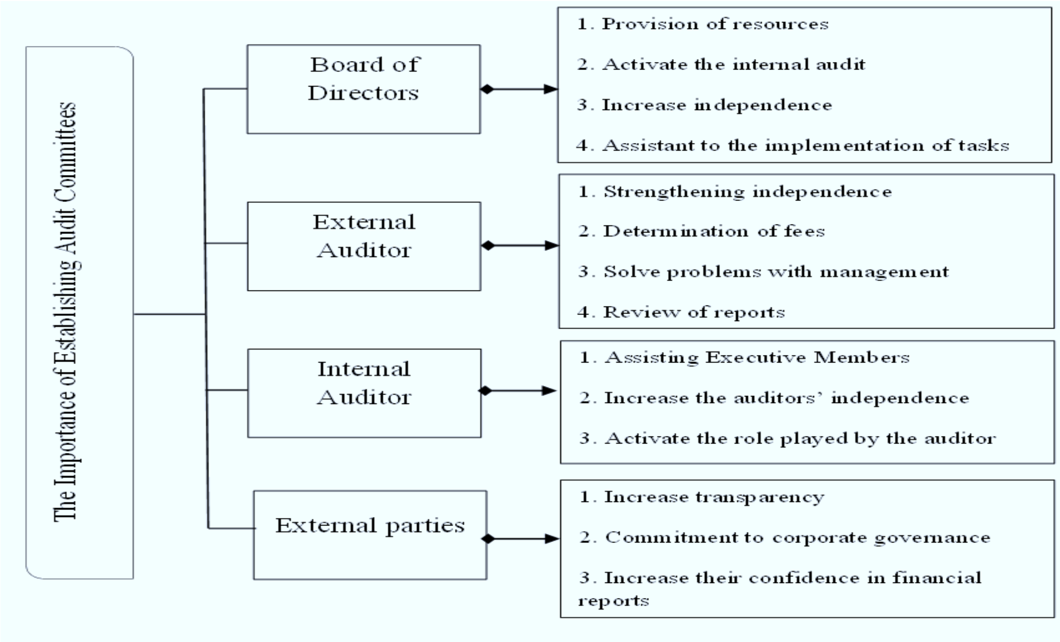
2.6 The Stakeholder-Agency Theory

Stakeholder theory and agency theory. A core premise of stakeholder theory is that the survival and success of an organization are contingent upon its ability to produce value and agreeable outcomes for a diverse range of stakeholders (Freeman, 1984) including a firms employees and customers. Hence Hill and Jones (1992) proposed stakeholder agency theory, which better explains the nature and influence of the "implicit and explicit contractual relationships that exist between firms" stakeholders .Agency theory evolved from the concept of separation of ownership from management in the modern company (Gaffikin, 2008) and highlighted the potential conflict between shareholders and management in the distribution of ownership among shareholders. Agency theorists argue that both parties will work for their personal interests that do not necessarily match. Stakeholder theorists (Freeman, 1984), (Donaldson & Preston, 1995) say that stakeholders are both affected and influenced by the institution.

2.7 Regulations of Jordanian audit committees

Jordan has tried to enact legislation to support corporate governance, one of which is the stock exchange law No (76) (2002) and its amendments in (2017) "which law obliges all Jordanian joint-stock companies to form an audit committee consisting of three non- executive members from the company's board of directors". The duties and responsibilities of such committees are determined by the instructions issued by the board which complies with the article (46). It also secures banking law No (28) 2000 which obliges all Jordanian banks to form audit committees. Articles No (32) and (33) of this law determine responsibilities and duties. "Instruction No (1) 1998 issued by the Amman Stock Exchange requested all Jordanian joint-stock companies to form audit committees, modern disclosure instructions were issued and were put into effect at the beginning of (2004) and its amendments in (2017)".

Article No (15) explained how to form the audit committee, determining its duties and responsibilities. The most recent concept of audit committees in Jordanian milieu was the one issued by the Amman Stock Exchange stating the “directory of governance rules of companies listed in Amman Stock Exchange 2017”, "which stipulates that the audit committee should consist of non-executive members of the board of directors who shouldn’t be less than three. Two of them at least should be independent members, one of whom chairs the committee; all members of the committee should be equipped with knowledge of financial and accounting affairs".



3. Conclusion

The Audit Committee is one of the corporate governance tools comprising a group of selected members of the Board of Directors. This study examines the relationship between the characteristics of the Audit Committee and the quality of earnings on Jordanian companies listed on the Amman Stock Exchange. In particular, we studied two important mechanisms to protect financial information from manipulation of earnings: the characteristics of the Audit Committee (independence and meetings). The role of the audit committees in ensuring the quality of financial reports and the earnings of the advertised companies has been subjected to scrutiny because of the recent accounting scandals and accounting management of many companies in the world or "earnings management." The Jordanian Association of Certified Public Accountants (JACPA) adopted the International Standards on Auditing (ISA) in 1990. "An audit committee should also ensure the soundness of the internal control procedures in detecting and preventing errors, frauds, and malpractices."

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