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Audit Committee and Audit Quality Reduction Behavior (A Literature Study)

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Abstract: This study aims to review the literature related to the impact of audit committee characteristics on audit quality and identify research gaps in this area. The phenomenon of audit-quality reduction behavior is a significant issue in the audit world, where this behavior can reduce the quality of the resulting audit. This study reveals that audit committee characteristics such as committee size, frequency of meetings, and financial expertise of members play an important role in determining the resulting audit quality. The findings show that larger audit committees that meet more frequently tend to produce higher quality audits. In addition, the financial expertise of audit committee members has been proven to improve the committee's ability to detect and prevent errors or fraud in financial statements. This study also supports the Theory of the Firm which states that the main objective of the firm is to maximize value for shareholders by minimizing agency costs and increasing operational efficiency. These findings have important implications for the development of better corporate governance policies and practices.

Keyword: Audit Committee, Audit-Quality Reduction Behavior, Corporate Governance, Theory of The Firm

INTRODUCTION

High-quality audits are essential in ensuring the reliability and integrity of an organization's financial statements. The phenomenon of audit-quality reduction behavior is a significant issue in the audit world, where this behavior can reduce the quality of the resulting audit. Audit committee characteristics, such as committee size, frequency of meetings, and financial expertise of committee members, play an important role in determining the resulting audit quality. This study aims to review the literature related to the impact of audit committee characteristics on audit quality and identify research gaps in this area.

Audit quality-reducing behavior occurs when auditors do not effectively apply audit procedures, which is often influenced by time pressure, work stress, and work-family conflict. Inadequate audit committee characteristics, such as small committee size or low meeting frequency, may exacerbate this problem. Research shows that larger committee size and more frequent meetings tend to improve audit quality due to diverse perspectives and increased oversight. In addition, the financial expertise of audit committee members enables the detection and prevention of errors or fraud in financial statements.

Research on the effect of audit committee characteristics on audit quality has been an important topic in the accounting and auditing literature over the past decade. Audit committees are considered a key element in effective corporate governance, which aims to improve the transparency and reliability of financial statements. Abbott et al. (2005) found that audit committee characteristics, such as size, meeting frequency, and financial expertise, significantly affect audit quality. This study suggests that larger and more frequently meeting audit committees tend to produce more accurate and reliable financial statements.

Cohen et al. (2002) examined the relationship between corporate governance and the audit process, finding that an active and knowledgeable audit committee can improve audit effectiveness. This study highlights the importance of financial expertise in audit committees to detect errors and fraud in financial statements. In addition, Bedard & Gendron (2010) examined the oversight role of audit committees in the financial reporting process, emphasizing that effective audit committees can reduce adverse earnings management behavior.

Further research by Carcello et al. (2011) shows that an independent and experienced audit committee can improve audit quality by reducing management pressure on auditors. Ghafran & O'Sullivan (2017) revealed that the frequency of audit committee meetings has a positive correlation with audit fees, which is an indicator of greater efforts in ensuring quality audits. This study supports the view that a more active audit committee can reduce the risk of financial reporting errors.

In addition, Salehi and Shirazi (2016) found that audit committee financial expertise is positively related to financial reporting quality and earnings management. Azizkhani et al. (2023) in their study in the public and private sectors, found that higher audit committee size and meeting frequency are associated with improved audit quality. Huzaimi (2023) reinforce these findings by showing that larger audit committees that meet more frequently tend to have greater ability to oversee and evaluate the audit process.

In the Indonesian context, there are several examples of audit quality reduction behavior: 1) PT Garuda Indonesia reportedly recorded profits from transactions that should not have been recognized to improve their financial statements. The Financial Services Authority (OJK) and professional accounting organizations sanctioned the company and its external auditor for engaging in actions that reduced audit quality (Karen et al., 2022); 2) PT Asuransi Jiwasraya was involved in inflating financial statements to cover large losses. Auditors examining the reports failed to detect and report these discrepancies, allowing significant state losses and leading to several executives and auditors involved being prosecuted (Hapsari & Nurhayati, 2021); 3) PT SNP Finance allegedly falsified financial statements to obtain bank loans. The external auditor who declared the financial statements to be fair eventually became the subject of an investigation by Bank Indonesia and OJK after the company was declared bankrupt (Aghnia, 2021).

Audit Committee and Theory of the Firm

Theory of the Firm states that the main objective of the firm is to maximize value for shareholders by minimizing agency costs and increasing operational efficiency (Jensen & Meckling, 1976). In this context, audit committees play an important role as a corporate governance mechanism that aims to reduce conflicts of interest between management and shareholders. An effective audit committee can improve the transparency and accountability of financial statements, which in turn can reduce agency costs. According to research by Abbott et al. (2005), audit committee size, frequency of meetings, and financial expertise of committee members have a significant impact on supervisory effectiveness and audit quality. This research suggests that a larger and more active audit committee can improve the credibility of financial statements and shareholder confidence.

Audit Quality and Theory of The Firm

Audit quality is a key element in ensuring the reliability and integrity of a company's financial statements, which are critical for economic decision-making by shareholders and other stakeholders. Within the Theory of the Firm framework, high audit quality can reduce information asymmetry between management and shareholders, thereby minimizing agency costs. Cohen et al. (2002) found that an active and knowledgeable audit committee can significantly improve audit quality by conducting more rigorous oversight of the audit process. In addition, research by Bedard & Gendron (2010) shows that audit committees that have sufficient financial expertise can detect and prevent errors or fraud in financial statements, which ultimately increases the reliability of financial statements and reduces the risk of earnings management.

Audit-Quality Reduction Behavior and Theory of The Firm

Audit-quality reduction behavior refers to auditor actions that reduce effort and thoroughness in the audit process, which can have a negative impact on audit quality. In the context of Theory of the Firm, this behavior can increase agency costs because the information conveyed to shareholders becomes less reliable. Ghafran & O'Sullivan (2017) show that the frequency of audit committee meetings is positively associated with audit fees, reflecting greater effort in ensuring high audit quality. This research supports the view that a more active audit committee can reduce audit quality reduction behavior by increasing auditor oversight and accountability. In addition, Salehi & Shirazi (2016) found that the financial expertise of audit committee members is associated with reduced earnings management, which suggests that a competent audit committee can reduce the risk of audit quality reduction behavior.

These studies underscore the important role of audit committees in improving audit quality and reducing audit quality reduction behavior in the context of Theory of the Firm. Thus, the implementation of effective governance mechanisms, such as the establishment of competent and active audit committees, can help firms achieve their primary goal of maximizing shareholder value by reducing agency costs and improving operational efficiency.

METHOD

The method used in this article review is the systematic review of descriptive/qualitative method, where the author reviews the theory and influence between variables. The systematic review of descriptive/qualitative method has a foundation that reality is something subjective where every human has a different view based on their interaction with the outside world (Yüksel in Winarta et al., 2023).

RESULTS AND DISCUSSION

This study found that audit committee characteristics such as size, frequency of meetings, and financial expertise of members have a significant influence on audit quality. The data shows that larger audit committees and more frequent meetings tend to produce higher quality audits. This is consistent with research by Abbott et al. (2005) and Cohen et al. (2002) who found that larger audit committee size and higher meeting frequency are positively associated with audit quality. In addition, the financial expertise of audit committee members is proven to improve the committee's ability to detect and prevent errors or fraud in financial statements, as shown by Bedard & Gendron (2010).

The findings of this study confirm the importance of audit committee characteristics in ensuring high audit quality and reducing audit quality reduction behavior. In the context of Theory of the Firm, these results support the view that an effective audit committee can reduce information asymmetry between management and shareholders, thereby minimizing agency costs and increasing firm value. Ghafran & O'Sullivan (2017) show that a higher frequency of audit committee meetings is associated with higher audit fees, reflecting greater effort in ensuring high-quality audits. This supports the finding that a more active audit committee can improve accountability and transparency of financial statements.

In addition, the findings regarding the financial expertise of audit committee members suggest that committees with members who have strong financial backgrounds may be more effective in performing oversight functions. Research by Salehi & Shirazi (2016) found that audit committee financial expertise is associated with reduced earnings management, which suggests that a competent audit committee can reduce the risk of audit quality reduction behavior. This is important because earnings management can harm shareholders and reduce trust in the company's financial statements.

Overall, the results of this study confirm the importance of establishing a competent and active audit committee to improve audit quality and reduce audit quality reduction behavior. The implementation of effective governance mechanisms, such as a knowledgeable and frequently meeting audit committee, can help a firm achieve its primary goal of maximizing value for shareholders by reducing agency costs and improving operational efficiency.

CONCLUSION

This study shows that audit committee characteristics, such as committee size, meeting frequency, and members' financial expertise, have a significant impact on audit quality. Larger audit committees that meet more frequently tend to produce higher quality audits, which help improve the transparency and reliability of financial statements. In addition, the financial expertise of audit committee members is shown to play an important role in detecting and preventing errors or fraud in financial statements. Overall, this study supports the importance of the audit committee's role in ensuring high audit quality and reducing audit quality-reducing behavior, which in turn can maximize value for shareholders and reduce agency costs.

Based on the findings of this study, there are several suggestions that can be given to improve audit quality and audit committee effectiveness:

1) Companies are advised to consider increasing the size of the audit committee, as larger committees tend to have more perspectives and expertise that can improve supervision and audit quality.
2) Audit committees should meet more frequently to ensure that all important aspects of the audit process and financial reporting are properly discussed and monitored. This can help improve accountability and transparency.
3) Audit committee members should have a strong financial background. Additional training and certification in accounting and auditing may help audit committee members to be more effective in performing their oversight function.
4) Therefore, further research is needed to explore other factors that may affect audit quality, such as audit committee independence and gender diversity in the audit committee. This research can also expand the study to other sectors to gain a more comprehensive understanding.

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