Risk Model and Quality of Audit Committee towards Quality of Financial Reporting in Indonesia

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***Abstract*—Accounting scandal has become a very complex problem in the manufacturing industry. This study aims to determine the effect of the litigation risk, the risk of distrust of investors, the risk of default and the effect of legal expertise of the audit committee on the quality of financial reporting. Data taken from the population of manufacturing companies listed in Indonesia Stock Exchange (BEI). Test Moderated Regression Analysis (MRA) was used to test the research hypothesis. The results of the study informed that the risk of investor distrust affects the quality of financial reporting, while the litigation risk, default risk and audit committee of legal knowledge does not affect the quality of financial reporting. The results also informed that the legal knowledge of the audit committee as moderating variables that influence the risk of strengthening relations investor distrust of the quality of financial reporting. This study contributes to the regulator in Indonesia to make regulations that protect and guarantee investor confidence in the quality of financial information company.**[1]

***Index Terms*—the risk of litigation, the distrust of investors, leverage, legal knowledge and the quality of financial reporting**.

I. Introduction

Accounting scandals that occurred in the last period to make the focus of attention of the litigation factor to the quality of corporate financial reporting and the preparation process is increased. The financial statements are generally intended to provide information about the financial position, performance and cash flows of the company[1]. The quality of financial reporting is an important contributor to the company's information environment[2]. The risk of litigation into one of the external factors that drive the behavior of managers in the work. Litigation may occur due to company accounting practices do not comply with existing laws and regulations [2].

Investor protection is identified as a key determinant of the development of financial markets, capital and ownership structure and dividend policy [3]. When investors buy stocks, they automatically get certain rights or authority that is protected by laws and regulations.

The quality of financial information allegedly still be one of the causes distrust of investors in the capital market is weak. The essence of the risk of distrust of investors is when the absence of a protection guarantees for investors, that investors will be able to invest in the capital market with the position and situation fair to parties other relevant, especially in terms of getting access to information on the market situation, the conditions issuers and bonds [8]. The quality of financial information is also affected by the risk of default of the company. Vulnerability company to utilize capital from third-party funds in the form of loans will likely have a strong motivation for management to make financial information quality management [9]. This is done so that the quality of financial information reported to creditor to look favorable and deserves to be funded. Bank Indonesia regulation no. 8/4 / PBI / 2006 on Implementation of Good Corporate Governance for Banks that one of the members of the audit committee must have expertise in law or banking. This is very different to the treatment in manufacture companies in Indonesia which is still voluntary. The audit committee with a legal background make other audit committee members to be more careful of the increasing risk of litigation which can degrade the quality of reporting[7] and [8]. The purpose of this study was to determine the effect of litigation risk, distrust of investors and the risk of default on the quality of financial reporting. The study also aimed to test the moderating variable legal expertise of the audit committee.

II. Theoretical Framework

A. Quality of Financial Reporting

Agency theory was first coined by Jensen and Meckling in 1976. The agency theory to explain the relationship between the principal and agent in a contracting process. Principal can measure, assess and simultaneously supervising agent performance through financial statements to the extent to which the agent has acted to maximize the welfare of principal [4]. Financial reporting has a wider meaning than the financial statements. Financial reporting is a process of providing information to users of financial statements external such as creditors, investors, and other users who have an interest [5]. Financial reporting includes not only

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financial statements but also other information delivery media, relating directly or indirectly to the information provided by the accounting system.

B. Litigation Risk relationship with Quality of Earnings

Litigation is the process by which an individual or entity to bring the dispute, the case to court or complaint and the settlement of claims for damage or replacement [5]. Lawsuits and litigation may be due to the financial statements that do not correspond to the actual conditions to the detriment to the parties concerned. Litigation risk will be higher when a decline in the quality of financial statements [2]. Previous research says that greater expected legal penalties facing companies do not always make the management are becoming increasingly wary of reporting, but instead could increase the misreporting [5]. It can be seen that the condition of the company at risk of litigation is high, it will make the lower the quality of financial reporting. Thus, on the premise hypothesis is formulated as follows:

H_1: litigation risk affects the quality of financial reporting

C. Investor Distrust Risk on the Quality of Financial Reporting.

Investor distrust identified as a key determinant of financial market development, ownership and capital structure and dividend policy. When investors buy stocks, they automatically get authority that is protected by laws and regulations. Conversely, if the condition of uncertainty guarantee of rights and investor protection is weak, there will be the risk of distrust of investors. Risk of high investor distrust caused by poor financial reports [3]. This can happen when some of these powers, including the disclosure and accounting rules that provide quality information needed investors become blocked and there is no clarity from regulators, the company will likely do a decline in the quality of financial reporting.

The essence of the protection of investors is a guarantee of protection for investors, which he would be able to invest in the capital market with the position and situation that fair to other related parties, especially in terms of getting access to information on the market situation [6]. Based on these descriptions, then the hypothesis will be tested in this study are:

H_2: Investor distrust risk affects the quality of financial reporting.

D. Default Risk relationship with Quality of Financial Reporting

Referring to previous research [7], which measures the amount of default risk (the risk of failure of the company) by the degree of leverage of the company. Financial leverage is calculated as the ratio of debt to total capital value of the company. Results of previous studies show that the risk of default negative affect on the quality of financial statements. The risk of default on the amount of debt that the enterprise will greatly affect the performance of the company, therefore, when the risk of default is high, the quality of financial reporting information enterprise captured by investors indicates a decrease in the quality of financial reporting and management in these conditions tend to perform management profit.

H_3: Default risk affects the quality of financial reporting

E. Relations between Litigation Risk, Distrust Investor Risk, Default Risk and Legal Expert of the Audit Committee on the Quality of Financial Reporting.

In accordance with Indonesia Stock Exchange Committee, the audit committee consist of at least three members who are mostly members of the audit committee are independent directors and other members of an outside party issuers and public companies. At least one of the members of the audit committee have the educational background and expertise in accounting or finance [3]. Especially for banking companies, there is a Bank Indonesia Regulation Number 8/4 / PBI / 2006 on Implementation of Good Corporate Governance for Banks that one of the members of the audit committee must have expertise in law or banking.

The risk of litigation, distrust of investors and the default is expected to strengthen its relationship with the quality of financial reporting with the audit committee with a legal background. Previous research [6] and [7] explains that the audit committee has the quality of legal knowledge will ably more careful against the possibility of legal risks that can degrade the quality of reporting. Litigation risk, the risk of distrust of investors and the default risk of companies will make reports produced by companies are of low quality. Existence of audit committee jurists could reduce the impact of this litigation risk to the quality of corporate financial reporting. Based on that idea, then the hypothesis is:

H_4: the existence of an audit committee jurist strengthen the relationship between litigation risk, distrust of investors risk, default risk and the quality of corporate financial reporting.

III. Research Methodology

The data used in this research is secondary data, in the form of annual report and the summary of the performance of the company issued a public company with a period of study in 2013, 2014 and 2015. Data were obtained from the official website of Indonesia Stock Exchange (www.idx.co id), ICMD (Indonesian Capital Market Directory). The test data was done by moderating regression analysis.

The dependent variable for this study is the quality of financial reporting that was measured by using a discretionary accruals referring to the Modified Jones Model [8]. The calculation is performed by calculating the value of non-discretionary accruals (NDACC) using regression coefficient.

The value of discretionary accruals (DACC) is inversely proportional to the quality of financial reporting. Thus, the higher the value DACC indicates the quality of corporate financial reporting is getting worse. Litigation risk in this study conducted through factor analysis to the variables: the stock return and turnover volume of stock, both of which are a proxy for the volatility of the stock;

liquidity and solvency, both of which are a proxy of financial risk; the size of the company which is a proxy of the political risk. This analysis serves to find a way of summarizing the information contained in the initial variables into a set of new dimensions (factor).

The variable was composited by factor analysis to determine the risk index litigation. Higher index value indicates a high litigation risk, and vice versa for a lower index value. Distrust of investors risk used in this research that the investor protection index issued by the World Bank in 2010. The investor protection is expressed in Strength of Investor Protection Index (IPI), which is the average index of disclosure, director liability index, and shareholder suits index. On the one hand, using the default risk, with a small investment has considerable advantage, but another condition that default risk will experience a very drastic loss if the investor do not implement proper risk management. In this study, the default risk was measured by financial leverage ratio. It is the ratio that compares the total debt to total assets of the company.

Moderation variable was is the legal expert of the audit committee. Literature [9] found that companies with an effective audit committee, less reporting back (restatement) quarterly profit. Literature [10] defines legal expertise as someone who has an educational background in law or has experience working as a lawyer, such as legal counsel and lawyers. The audit committee jurist measured by the proportion of the audit committee, the audit committee the number of legal experts divided the total number of audit committee.

IV. Discussion and Results

F-test was 167.846 with a significance value of 0.000, H_0 so that it indicates that the regression model fit to the data of the study (Table I). Adjusted R-square of 0.717 which indicates that 71.7% variations in the quality of financial reports can be explained by the research model.

TABLE I. ANOVA

Model	Sum of Squares	df	F	Sig
Regression	8.307	4	167.846	.000[a]
Residual	3.205	259		
Total	11.512	263		

Predictors: (Constant), X4, X3, X1, X2
Dependent Variable: Y

While, 28.3% is explained by other factors (Table II). T test results to inform that the risk of investor distrust affect the quality of financial reporting. The results are consistent with research [3] and [7].

TABLE II. MODEL SUMMARY

Model	R	R Square	Adjusted. R Square	Std. Error of the Estimate
1	.849[a]	.722	.717	.1112354556

Predictors: (Constant), X4, X3, X1, X2

This findings also agrees with the results indicating that the risk of distrust of investors to influence the quality of financial information company [3] and [6]. More supervision by independent board it will encourage non-occurrence of manipulation of financial statements in the company's financial statements more qualified [1]. Investors need quality financial information as a basis for decision making. In Indonesia, investors are still faced with the dilemma of weak legal protection of investors. Demontration of manufacturing labors to increase their wages or salary and complexity of bureaucratic rules that affect to the investment climate have become critical issues in Indonesia. While litigation risk, default risk and audit committee of legal expert were not affected the quality of financial reporting (Table III). This is because the manufacturing companies in Indonesia as an object of litigation is based on the view that investors and creditors are the parties with legal protection. The reality is investors do not get legal certainty is firm and strong to protect the interests of business processes.

TABLE III. COEFFICIENTS

Model	Standardized Coefficients	t	Sig.
	Beta		
(Constant)		-12.994	.000
Litigation risk_X1	.036	1.064	.288
Distrust investor risk_X2	.694	10.178	.000
Default risk_X3	-.001	-.035	.972
Legal expert of audit committe_X4	.165	2.431	.016

The uncertainty of the investment climate and the high cost of investment in Indonesia became the cause of the decline in investment in manufacturing companies that use capital from the loan relative to be a burden for the company. Default risk will experience a very drastic loss when not applying risk management. Giving a stronger role for the audit committee who has the legal expertise will accelerate recommendations to regulators to create legal certainty for investors. The results also informed that the legal expert of the audit committee as a moderating variable was strengthen relationships between distrust investor risk and the quality of financial reporting. This study contributes to the capital market regulator in Indonesia to make regulation that enhance legal protection for investor (Table IV).

TABLE IV. MODERATING TEST_COEFFICIENTS

Model	Standardized Coefficients	t	Sig.
	Beta		
(Constant)		1.976	.049
X1	.209	1.532	.127
X2	-.091	-.694	.488
X3	-.004	-.033	.974
X4	-.151	-1.738	.083
z1	-.750	-1.429	.154
z2	1.768	3.040	.003
z3	.013	.089	.929

V. Conclusion, and Limitations

This study contributes to the regulators to create rules and better legal protection for investors. Partial assay results have informed that the risk of investor distrust affects the quality of financial reporting, while the litigation risk, default risk and audit committee of legal knowledge does not affect the quality of financial reporting. The results also informed that the legal expert of the audit committee as a moderating variable which has strengthen relationships influence between distrust investor risk and the quality of financial reporting.

This research has limitations in explaining the role of the audit committee who has expertise in the field of law in professional organizations such as the Indonesian capital investment oversight agency to realize the formulation of regulations that protect the interests of investors. Suggestions for the next researcher is expected to broaden the sample and consider the implementation of good corporate governance variables to know and realize the best practice of corporate management required legal protection for investors is obvious.

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