

Audit Committee's Cash Compensation and Earnings Management: The Moderating Effects of Institutional Factors

Abstract

This paper investigates the relationship between the audit committee's cash compensation and accrual earnings management. Using a sample of Chinese listed firms over the period 2007 to 2017, findings show a positive association between cash compensation of the audit committee and accrual earnings management. It suggests that high cash compensation to audit committee directors compromises their monitoring role related to financial reporting quality, and high cash compensation to audit committee's directors leads to an alignment in the audit committee's interests with those of managers. We also examine the implications of ownership structure and institutional environment on this relationship. Results show that state-ownership significantly moderates the association between the audit committee's cash compensation and accrual earnings management. We also investigate whether this relationship is influenced by the regional development level or not. Results reveal no difference in this positive association for firms located in more versus less developed regions. Our findings can be of broad interest to regulators in improving corporate governance.

Keywords: Audit Committee; Cash Compensation; Earnings Management; State Ownership; Regional Development.

1. Introduction

This study investigates the effect of the audit committee's cash compensation on earnings management in China. The concept of the agency problem gives rise to that of earnings management (Xie et al., 2003), where agents may expropriate owners' wealth by inflating earnings (Wu et al., 2016). To mitigate earnings management problem, theorists and scholars recommend such tools as an optimal compensation contract to executives and independent bodies on the board to ensure their function as effective monitors (Fama & Jensen, 1983; Jensen & Meckling, 1976). Despite these key tools, earnings manipulation persists; thus, a demand continues for incremental governance mechanisms such as setting an audit committee to oversee financial reports, select external auditors and discuss the audit report (T. W. Lin, 2004; Z. J. Lin et al., 2008).

However, the question concerning why some audit committee members are effective and some are not has led researchers to call for explorations of whether the audit committee's financial compensation affects its