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Corporate Governance and Earnings Management: The Impact of Board Independence and Audit Committee Effectiveness

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A R T I C L E I N F O

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A B S T R A C T

This study aims to explain the influence of independent board of commissioners and audit committee effectiveness on real earnings management. The population of this study is manufacturing companies that have been listed on the Indonesia Stock Exchange (IDX) for the period 2015-2022. The sampling technique used in this study is purposive sampling, namely a sampling technique with certain considerations or criteria. The data analysis technique used is descriptive statistical testing and multiple regression using data processing software. The findings reveal that both the independence of the board of commissioners and the effectiveness of the audit committee play a significant role in mitigating real earnings management. Specifically, these governance mechanisms are shown to have a negative and statistically significant influence on the extent to which firms engage in real earnings management.

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INTRODUCTION

Earnings management is an issue that has attracted much attention from academics and practitioners in recent years. Earnings management practices have serious effects on investors and practitioners, more generally for stakeholders (Chih, Shen, & Kang, 2008). Managers engaging in earnings management may alter the figures presented in financial statements in a manner that complies with financial accounting standards, yet potentially leads to a misleading representation of the company's actual performance (Healy & Wahlen, 1999).

the recent practice of managing earnings at a number of state-owned businesses and businesses that are listed on the Indonesia Stock Exchange (IDX). The case of PT Kimia Farma Tbk in 2001 was the first to draw attention to Indonesia's earnings management methods. The management of the corporation declared a net income of IDR 132 billion at that time. But according to the Capital Market Supervisory Agency (Bapepam) and the Ministry of State-Owned Enterprises, the number was unreasonably high and suggestive of manipulation. A closer look showed that the real net profit was just IDR 99.56 billion, which represents a decrease of IDR 32.6 billion, or roughly 24.7%. A number of inaccuracies were blamed for the disparity, including inflated inventory of IDR 23.9 billion in the central logistics unit and overstated sales of IDR 2.7 billion in the raw material production unit, as well as further overstatements in inventory and sales of IDR 8.1 billion and IDR 10.7 billion, respectively. In 2003, there was another case of earnings management at PT Indofarma Tbk. Bapepam's inquiry revealed infractions of capital market laws, specifically pertaining to the company's presentation of accurate and trustworthy financial statements (Sandria, 2021).

Indonesia's high earnings management practices are significant because the country is part of a group of nations with inadequate investor protection (Leuz et al., 2003). Earnings management is still present in the financial statements of businesses that are listed on the Indonesian stock exchange (Adiasih & Kusuma, 2012). Up to 82% of Indonesian manufacturing firms engaged in earnings management in 2011 (Dwiadnyana & Jati, 2014). Small investors are unable to defend themselves against the dominance of majority shareholders due to a lack of legislative protection, high levels of concentration, and family ownership structures (Lukviarman, 2001). Information asymmetry can occur under such capital market settings, and if it results from capital hazard, it may lead to opportunistic earnings management techniques (Scott, 2012).

Management manipulates company profits which biases financial reports, thus misleading stakeholders. This action results in differences in interests between agents, in this case the company's management, and principals, namely stakeholders. Management has more information than stakeholders, which ultimately results in information asymmetry, so that management tends to do things that benefit themselves compared to the interests of stakeholders, resulting in agency conflict (Jensen & Meckling, 1976).

Conflicts caused by information asymmetry can be minimized by implementing good corporate governance practices. Companies that implement good corporate governance can limit the occurrence of information asymmetry, thereby suppressing the practice of corporate earnings management. The corporate governance principles established by the Organization for Economic Co-operation and Development (OECD) highlight, among other aspects, the critical importance of openness and transparency in public companies. Specifically, these principles advocate for corporate governance systems that guarantee "timely and accurate disclosure of all material matters regarding the corporation, including its financial condition, performance, ownership structure, and governance practices. (OECD, 2015).

A board of commissioners oversees the execution of the company's policies and strategies as part of corporate governance (Napitupulu et al., 2023). To raise the standard of financial reporting and transparency, the board of commissioners establishes an audit committee (Kusumawati & Hermawan, 2013). The quality of financial reports and the transparency of their disclosures can be enhanced by an independent audit committee with financial experience (Salehi et al., 2018; Q. Wu et al., 2007). According to Wu and Li (2015), board independence can lessen the frequency of transactions and associated infractions such asset theft and financial statement fraud. The effectiveness of a well-run audit committee and the independence of the board of commissioners can both raise the caliber of the business's financial reporting (Safari, 2017). A corporation can reduce the possibility of financial statement inaccuracies by increasing the number of audit committees (Lin et al., 2006). According to Wu and Li (2015), board independence can lessen the frequency of transactions and associated infractions such asset theft and financial statement fraud. The effectiveness of a well-run audit committee and the independence of the board of commissioners can both raise the caliber of the business's financial reporting (Safari, 2017).

According to sound corporate governance principles, the audit committee's job is to support the board of commissioners by offering insights and opinions on issues that arise within the organization concerning accounting policies, overseeing internal and external controls, and the financial reporting process (Arun et al., 2015; Bédard & Gendron, 2011; Sun et al., 2011; Zalata et al., 2018). In addition, the audit committee is in charge of resolving conflicts of interest and managing the company's profits (Al-absy, Ismail, & Chandren, 2018).

THEORETICAL REVIEW

Agency theory

Agency theory contains an explanation of economic actors, namely principals and agents who have conflicting interests with each other. Agency relationships arise when the principal, in this case stakeholders, gives authority to the agent, in this case the company's management, to fully make decisions that have an impact on the company. Conflict occurs when management does not act in accordance with the orders of stakeholders, so that the decisions taken only benefit management (Jensen & Meckling, 1976).

Teori Bundle of Governance

Aguilera et al. (2012) revealed several studies trying to develop a configuration approach to corporate governance with different identifications. The research consistently connects the company's internal to its environment, not a set of universal relationships that apply to all organizations. The research aims to explore the mechanisms of corporate governance interacting and substituting or complementing each other in the practice of a bundle of governance. The concept of complementarity provides a basis for understanding how various elements of an organization's strategy, structure, and process are interrelated.

Hypothesis development

In the context of Indonesia's corporate governance structure, the Board of Commissioners holds the highest managerial authority and is primarily responsible for overseeing the company's operations (Darmadi, 2013). To effectively fulfill its supervisory responsibilities, the Board of Commissioners may establish subordinate bodies, such as the audit committee. The audit committee serves a critical function in supporting the implementation of good corporate governance within the organization. A company is said to be good if good corporate governance is in accordance with the OECD standards applicable in Indonesia (Ariningrum & Diyanty, 2017). Fama & Jensen (1983) found that board independence as one of the characteristics of the effective function of the supervisory board, provides a mechanism for effective supervision and control. The independence of the board of commissioners and the effectiveness of a well-organized audit committee can improve the quality of the company's financial reporting (Safari, 2017) and reduce misstatements in the financial statements through the supervisory function. Board independence can reduce the occurrence of related violations such as fraud in financial statements, and misappropriation of assets (Wu & Li, 2015). With the increasing number of independent commissioners, supervision of financial reports will be tighter and more objective, so that it can reduce opportunistic behavior by managers and the practice of taking over company resources.

H1: Independent commissioners have a negative effect on real earnings management

Audit committees with financial expertise are able to limit earnings management actions by management (Bedard & Johnstone, 2004; Dhaliwal et al., 2010; Xie et al., 2003) This finding is supported by other studies that found that audit committees with accounting/finance expertise are able to reduce the tendency of fraud (Abbott et al., 2004) and earnings restatement (Agrawal & Chadha, 2005). Meanwhile, Farber (2005) found that companies that commit fraud or overstate their earnings (Defond & Jiambalvo, 1994) tend to have a larger number of audit committees. Abbott and Parker (2000) investigated the relationship between audit committee meeting frequency and the selection of auditor industry specialization. Their findings indicate that a higher frequency of audit committee meetings is positively associated with the appointment of

higher-quality audit firms. This suggests that audit committees that convene more regularly are more inclined to prioritize industry expertise when selecting external auditors. Similarly, Knapp (1987) contends that audit committees comprising members with auditing or accounting expertise are more likely to support the auditor during disputes with management, in contrast to committees composed of members with non-accounting backgrounds.

Through the oversight function, a well-functioning audit committee can decrease financial statement misstatements and enhance the integrity of the company's financial reporting (Safari, 2017). The audit committee is crucial to the supervision and tracking of the financial reporting procedure. The management that creates the financial statements is actively overseen and monitored by the audit committee (Qamhan et al., 2018). The audit committee can enhance business monitoring to reduce real earnings management, and it also plays a significant role in preventing real earnings management (Broye & Johannes, 2023).

H2: The effectiveness of the audit committee has a negative effect on real earnings management

METHODOLOGY

This study uses a quantitative methodology. Insurance firms that were listed between 2015 and 2022 on the Indonesia Stock Exchange (IDX) make up the study population. Purposive sampling is the sampling technique used, which chooses samples according to predetermined standards pertinent to the study's goals. The following criteria were applied for choosing the sample: manufacturing firms that were listed between 2015 and 2022 on the IDX,

1. The business financial report data and data for variable calculations for the 2015–2022 reporting years are fully available,

2. as are the annual reports for the 2015–2022 period.

The data analysis method in this study uses panel data regression with the STATA version12 application.

Operational Definition of Variables

Using real earnings management as a proxy, earnings management is the study's dependent variable. According to Roychowdhury (2006), real earnings management is the difference between actual operating cash flow and cash flow. In order to achieve specific profitability goals, real earnings management strategies include selling products at a discount, offering low-interest credit, allowing for flexible credit terms, producing more than the market demands, and cutting back on discretionary expenses. The first independent variable is the independent board of commissioners, which is measured by a board of commissioners that is unrelated to shareholders, the board of directors, or other board members.

According to Lin et al. (2008), an audit committee is considered effective if it complies with the obligations to safeguard the interests of shareholders by ensuring accurate financial reporting, internal control, and risk management through rigorous supervisory efforts. the efficacy of the audit committee through the use of an effectiveness checklist that has 15 criterion points and is divided into three categories: the audit committee's structure and makeup, performance, and accountability. Leverage, return on assets, and firm size are the study's control variables.

The analytical methods employed in this study consist of descriptive statistical analysis and hypothesis testing. Descriptive statistics provide an overview of the characteristics of the research data, including minimum and maximum values, mean, and standard deviation. The first hypothesis is tested using multiple linear regression analysis, which is conducted with the assistance of the Stata 14 software.

$$REM_{it} = \alpha_0 + \beta DKI_{1it} + \beta_2 EFFAC_{it} + \beta_3 ROA_{it} + \beta_4 SIZE_{it} + \beta_5 LEV_{it} + e_{it}$$

REM: Abnormal CFO - Abnormal Production + Abnormal Discretionary Expense,
DKI: Independent Board of Commissioners,
EFFAC: Effectiveness of Audit Committee,
LEV: Proportion of total debt divided by total sales in the previous year,
ROA: Operating income after tax divided by total assets,
SIZE: Natural logarithm of total assets,
e: Term Error.

Variable description presents a general overview of the variables resulting from descriptive statistical processing. The results of statistical processing presented include minimum and maximum values, average values, and standard deviations. Variables that are the main subject of study in research require descriptive presentation. The purpose of descriptive presentation is to obtain a general overview of the characteristics and values of the variables studied. The researcher explains the profile of each variable and its dimensions, before discussing the results of hypothesis testing, so that it will provide a more precise perspective of understanding. Each descriptive statistical value is presented in the following table 1:

Table 1 Description of Research Variables

No	Variabel	Obs	Mean	Stnd Deviasi	Min	Max
1	CFO[a]	1000	0.0769812	0.3041328	-1.763286	1.723846
2	DISC[b]	1000	0.4515865	0.766485	-2.783516	2.608525
3	PROD[c]	1000	0.0254284	0.2402109	-.7569026	2.711802
4	REM[d]	1000	-0.3491715	0.7771677	-2.828604	2.573492

5	DKI[f]	1000	0.4238373	0.1227671	0.1666667	0.8
6	EFFAC[e]	1000	0.82000	0.083023	0.5555556	0.9777778
7	ROA[i]	1000	0.1080738	0. 209529	-1.049839	0.9626271
8	LEV[j]	1000	0.0799467	0.1067248	0.0001914	0.7981971
9	SIZE[k]	1000	28.39161	1.928402	15.58156	33.49453

Real earnings management is assessed using three key indicators: operating cash flow, discretionary expenditures, and production costs. Indicators of real earnings management include unusually low levels of cash flow from operating activities, reduced discretionary spending such as general administrative and research and development expenses, and inflated production costs management (Cohen et al., 2008).

In this study, descriptive analysis of the earnings management variable, which is proxied by real earnings management and measured using the formula Abnormal CFO – Abnormal Production + Abnormal Discretionary Expenses, yields an average (mean) of -0.3491715 with a standard deviation of 0.7771677. The minimum observed value is -2.828604, while the maximum value is 2.573492. These results suggest that higher values of real earnings management are associated with lower earnings quality, whereas lower values indicate higher-quality earnings.

Table 2 Multiple Linear Regression Test Results

Variabel	**Coeficient**	**Std Err**	**t**	**P**
(Constanta)	2.533321	0.785611	3.22	0.001***
DKI	-1.221965	0.2444596	-5.00	0.000***
EFFAC	-2.80765	0.4702643	-5.97	0.000***
ROA	0.5887828	0.0968201	6.08	0.000***
LEV	0.8098165	0.2272477	3.56	0.000***
SIZE	-0.0035188	0.0231451	-0.15	0.879
POL	0.726559	0.1183361	6.14	0.000***
TM*POL	0.0336524	0.0168036	2.00	0.46**
Adjustes R^2	0.2035			
F-value	29.35			
Sig	0.0000			
N	1000			

Hypothesis 1, which posits that "the proportion of independent board commissioners negatively influences real earnings management," is supported by the empirical findings. The main regression analysis yields a coefficient (β1) of -1.221965 with a significance level of 0.000***, indicating statistical significance at the 1% level. The model reports an adjusted R-squared value of 0.2035, an F-statistic of 29.35, and an F-significance value of 0.000***. These results suggest

that a higher proportion of independent commissioners enhances monitoring effectiveness, thereby reducing the likelihood of real earnings management.

Hypothesis 2, which asserts that "audit committee effectiveness negatively affects real earnings management," is also empirically validated. The regression results show a coefficient (β2) of -2.80765 with a significance value of 0.000***, significant at the 1% level. The adjusted R-squared remains at 0.2035, with an F-statistic of 29.35 and an F-significance of 0.000***. These findings indicate that greater audit committee effectiveness strengthens oversight mechanisms, thus contributing to a reduction in real earnings management practices.

DISCUSSION

The first hypothesis states that the independent board of commissioners has a negative effect on real earnings management, proven empirically. The higher the ratio of independent board of commissioners, the more effective the monitoring is, so that it can reduce real earnings management. The duties and functions of the board of commissioners are as supervisors (controlling) and advisors as well as monitors (monitoring) the implementation of corporate governance, but do not act as operational decision makers who are the responsibility of the board of directors (Law number 40/2007 and OJK Regulation number 33/POJK.04/2014). The monitoring mechanism carried out by the board of commissioners is part of the concept of corporate governance. The main role and function of the board of commissioners in the context of governance is legal and includes duty of loyalty (good intentions and refraining from personal interests), duty of care (careful and careful), duty fiduciary (obedience, good faith, and fair disclosure) (Lukviarman, 2016).

Independent board of commissioners through better internal monitoring and control mechanisms so that they can influence the possibility of deviations by managers. The proportion of independent commissioners plays a role in supervising the company's performance, namely as an independent party who can minimize the occurrence of agency conflicts within the company because they have no interest in the company except for their duties to supervise the company (Maulana et al., 2022).

According to Beasley (1996) the company's independent board of commissioners can increase effectiveness in supervising management to prevent fraudulent financial statements. Independent Commissioners have a balancing role in decision making, especially in the context of protecting minority shareholders and other interested parties (Yendrawati & Asy'ari, 2017). The independent board of commissioners can provide input if there is a deviation so that earnings management can be avoided.

The effectiveness of audit committees has been shown to have a detrimental impact on actual earnings management, according to the second hypothesis. Real earnings management may be lessened by more effective monitoring, which is shown by a higher audit committee effectiveness score. Research has shown that the effectiveness of audit committees has a negative impact on earnings management (Abbott et al., 2004; Agrawal & Chadha, 2005; Bedard & Johnstone, 2004; Broye & Johannes, 2023; Dhaliwal et al., 2010; Piot & Janin, 2007; Xie et al., 2003). The results of this study, particularly for the direct effect, support this

finding. Earnings management methods can be curbed by an efficient audit committee, which is defined as one that includes independent members, accounting or financial experience, and a regular enough meeting schedule. Leverage, return on assets, and firm size are studied.

CONCLUSIONS AND RECOMMENDATIONS

According to the study's findings, the presence of an independent board of commissioners significantly contributes to a decrease in actual profits management methods. The supervisory function is stronger and can stifle opportunistic management activities when the percentage of independent boards of commissioners is larger. According to the findings of the study's second hypothesis, the audit committee's efficacy significantly contributes to the suppression of actual profits management techniques. This implies that the less probable the corporation is to engage in profits management through abnormal operational actions, the more successfully the audit committee performs its internal supervisory role.

By including empirical data on how internal and external GCG mechanisms mitigate conflicts of interest between agents (management) and principles (shareholders), this study can update or reinforce the theory. The agency theory's premise that control mechanisms are required to lessen information asymmetry and conflicts of interest is supported if the GCG mechanism is shown to be successful.

This study can serve as a guide for future research, particularly for scholars, practitioners, and researchers interested in governance-related topics. Capital market regulators may also use this data as a guide when creating guidelines to safeguard stakeholders, particularly minority shareholders. Information about corporate governance methods, particularly internal monitoring systems for corporate profit management, can be found in this research for internal companies. The findings of this study can be utilized to inform the evolution of corporate governance in Indonesian manufacturing firms.

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