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# Audit Committees' Power and Financial Expertise on Earnings Management during COVID-19

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**ABSTRACT**

As many companies do earnings management during COVID 19, it is crucial to know whether audit committees (whose function is to guarantee corporate financial transparency) can reduce earnings management during COVID 19. This paper focus on audit committees' power and financial expertise. In this research, manufacturing companies listed on the Indonesia Stock Exchange during COVID-19 were used as samples, resulting in 363 observations. This study employs the statistical technique of multiple linear regression using the software program SPSS. It is found that financial expertise has positive effect on earnings management and audit committees' power has no effect on earnings management. Based on the available evidence, it may be inferred that audit committees may not serve as an effective monitoring instrument for mitigating earnings management in the context of the COVID-19 pandemic. However, the audit committee composed of financial experts advocates for the practice of earnings management as a means for corporations to enhance their perception of profitability. This study is one of the first studies to show that audit committee is ineffective in mitigating earnings management practice during COVID 19.

**KEYWORDS -** earnings management, audit committees' power, audit committees' financial expertise, COVID 19

## 1. INTRODUCTION

During periods of COVID 19 crisis, the effectiveness of corporate governance procedures assumes utmost importance. The audit committee serves as a crucial component in guaranteeing financial transparency and holds a central position in fulfilling this responsibility [1]. The global COVID-19 epidemic has served as a comprehensive evaluation of enterprises on a global scale, highlighting the importance of examining how audit committees, with their distinct blend of authority and financial knowledge, handle the intricate challenges associated with earnings management.

Earnings management refers to the deliberate actions used by management to manipulate reported income and profits in order to present a distorted view of the true financial conditions [2]. The management of the corporation will employ diverse strategies to uphold the credibility of the organization. This phenomenon may incentivize management to manipulate the reported profit statistics in order to provide favorable financial accounts for the company.

Audit committee has a responsibility to reduce earnings management. According to agency theory, audit committee acts as supervisor to monitor company's profit. Seeing the importance of the role of the audit committee in earnings management. So, a deeper understanding of the role of the audit committee needs to be investigated further.

From all characteristics of audit committee, the most important characteristics are audit committees' power and financial expertise. Audit committees should have bigger power than management to control earnings management made by managers [1], [3], [4]. By having more power, their monitoring role will run effectively. Audit committee should also have financial expertise to discover earnings management made by companies [3], [5]. Financial experts possess a higher level of accounting and financial expertise in comparison to a typical member of an audit committee. They possess a heightened comprehension and supervision of the financial reporting procedure, enabling them to more efficiently observe and restrict management's actions aimed at manipulating earnings.

According to Broye and Johannes [6], the presence of high-power audit committee chairs can enhance the effectiveness of audit committees for several reasons. Firstly, high-power audit committees have the ability to expand the pool of skills and connections available to the committee. Additionally, these high-power committees are motivated to safeguard their reputation, which in turn leads to an increased focus on enhancing monitoring effectiveness.

The power of the audit committees stems from their elevated standing and esteemed reputation. The influence exerted by the audit committee is contingent upon its knowledge and quality as an auditor [7]. In the context of auditing, it has been argued by that prestige serves as an indicator of an auditor's ability and credibility [6]. The position of the audit committee can have an impact on the financial outcomes of a corporation, particularly in operations that involve a high degree of uncertainty.

Previous literatures exert various results. Broye and Johannes [6] find negative effect of audit committee's power on earnings management. According to the study conducted by Dewi and Mita [7] and Siagian and Siregar [8], it was found that audit committee's power does not exert any influence on earnings management. However, the findings of Badolato et al. [9] differ with the current argument, since their research suggests that the position of the audit committee has a positive impact on accrual earnings management.

According to scholarly research, it has been suggested that individuals with financial understanding and a background in accounting are more proficient in fulfilling the monitoring responsibilities of an audit committee [10], [11]. The responsibilities assigned to audit committee members encompass intricate accounting matters, with a greater emphasis placed on the significance of members with accounting experience compared to those who lack such proficiency. According to DeZoort [12], members of audit committees perceive accounting financial competence as a crucial factor in enhancing the effectiveness of the committee. It is anticipated that accounting financial expertise audit committee, due to their possession of more advanced knowledge compared to non-accounting financial expertise audit committee, exhibit superior abilities in evaluating intricate accounting matters.

Numerous studies have been conducted to investigate the efficacy of the audit committee, specifically in relation to its financial expertise, in the supervision of the financial reporting accuracy of publicly traded corporations. Previous researches have indicated a negative correlation between the financial expertise of audit committees and the practice of earnings management [13], [14], [15]. Additional study provides evidence to support the assertion that the inclusion of both accounting and non-accounting professionals on an audit committee can yield advantages in terms of the quality of earnings [16], [17]

The objective of this study is to offer significant insights into the impact of audit committees' power and the financial expertise on earnings management during the exceptional circumstances brought about by the COVID-19 epidemic. Previous researches have analyzed the effect of audit committees' power on earnings management [1], [7] or the financial expertise on earnings management [3], [5], [7]. However, they do not analyze their effects on earnings management during COVID-19. It is argued that the effect of audit committees on earnings management may not be the same as before pandemic. As companies are struggling financially during COVID-19, audit committees may be less effective to reduce earnings management.

Existing scholarly research has demonstrated that nations characterized by inadequate corporate governance structures experienced more pronounced negative impacts during periods of economic crises, in contrast to those countries that possess well-established and effective governance procedures [18]. In country with inadequate corporate governance structures, the effect of corporate governance to companies' financial condition is more prevalent. Indonesia is one of the countries with inadequate corporate governance structures [18]. Thus, it is crucial to analyze the effect of audit committees on earnings management in Indonesia.

## 2. RESEARCH METHOD

The researchers employed purposive sampling as the sampling method in this investigation. This research sample will focus on the manufacturing companies listed on the Indonesia Stock Exchange (IDX) over a period of two years, spanning from 2020 to 2021, which have complete annual report and publish data for audit committees' background. This research uses secondary data from companies' annual reports. The data are analyzed using SPSS.

Earnings management was measured using the Kothari model. Based on this Kothari et al., [19] the model to estimate accrual earnings management is as follows:
For the total accruals:
Tat = NCAt - CLt
For measured NDA (non-discretionary accrual):
$NDAt = \alpha_0 + \alpha_1 \left(\frac{1}{At\text{-}1}\right) + \alpha 2 \left(\frac{\Delta Revt\text{-}\Delta ARt}{At\text{-}1}\right) + \alpha 3 \left(\frac{PPEt}{At\text{-}1}\right) + \alpha_4\, Roa_t\text{-}1 + \varepsilon$
For Discretionary Accrual (DA) measured as follows:
$DA_t = \left(\frac{Tat}{At\text{-}1}\right) - NDA_t$

Audit committees' power is measured following Dewi and Mita [7]'s measurement. The steps are as below:
1. To determine the overall score of each member of the audit committee and board of directors at a given company for a specific year, various variables are taken into account during the calculation process.
   a. If an individual has had or now holds employment in organizations listed in the Business Ethics Index (BEI), they will receive a score of 1; otherwise, the score will be 0.
   b. If individuals have had or presently hold employment within the intra-industry of BEI listed companies, the assigned score is either 1 or 0, depending on the circumstances.
   c. If individuals have had or now hold employment in the financial companies listed on the BEI or in financial institutions, their score will be assigned a value of 1; otherwise, it will be assigned a value of 0.
   d. If individuals have had or now hold employment in the government sector, they will receive a score of 1; otherwise, they will receive a score of 0.
   e. A degree obtained from prestigious educational institutions, as determined by the List of Universities from Indonesia Endowment Fund for Education (LPDP) Scholarship in 2022, holds significant value. The scoring methodology employed in this study is consistent with previous research conducted by Dhaliwal et al. [20]. Specifically, the scoring system is as follows:
   a. A score of 2 is assigned if the individual holds a bachelor's, master's, or doctoral degree from an institution that is included in LPDP's List of Foreign Universities.
   b. A score of 1 is assigned if the individual holds a bachelor's, master's, or doctoral degree from an institution that is included in LPDP's List of Domestic Universities.
   c. A score of 0 is assigned for all other cases.
2. Calculate the mean score for each company within a given year, which is determined by summing the total scores obtained in Step 1. Next, the average score is normalized across all companies within a given year.
3. Calculate the mean score and standard deviation of companies over a given year, based on the scores obtained in Step 2.
4. Calculate the index for each firm in a given year by subtracting the average score of each company in that year (as determined in Step 2) from the overall average score in that year (as determined in Step 3). Next, the data was divided by the standard deviation for each year, as calculated in Step 3.
5. In this analysis, we will compare the index in order to generate a dummy variable. The variable's value is assigned as 1 when the status index of the audit committee surpasses the status index of the board of directors; otherwise, it is assigned as 0.

The Securities and Exchange Commission (SEC) in 2003 established a definition for the financial expertise of an audit committee. According to this definition, an individual can be considered an expert in finance if they possess the following qualifications: (1) they have received the necessary education and have gained experience serving in roles such as principal accounting officer, principal financial officer, auditor, or public accountant, and (2) they have acquired at least one or more relevant experiences in these positions. The requirements for this position include: (1) possessing a similar job role; (2) having prior experience in overseeing key accounting personnel such as the main accounting officer, main financial officer, auditor, or public accountant, with at least one or more instances of fulfilling the same function; (3) having experience in evaluating or supervising the assessment of financial statements; and (4) possessing any other pertinent experience. In line with SEC definition, this paper calculates financial expertise by calculating the percentage of audit committee members with financial or accounting background.

This paper also uses some control variables following previous literatures [1], [7], [9]. The control variables are company size, growth, leverage, and operating cash flow.
Regression model that used in this research are:
$DACCit = \beta_0 + \beta_1 EXPit + \beta_2\, STATDIFit + \beta_3\, SIZEit + \beta_4\, LEVit + \beta_5\, GROWit + \beta_6\, CFOit + \varepsilon i.t$
Where:
DACCit: earnings management (Accrual discretionary of the i company on the t period)

$\beta_0$ : Constant.
$\beta_1$- $\beta_6$ : Regression coefficient.
EXPit : audit committees' financial expertise (Percentage of the financial expertise of audit committee in the i company on the t period)
POWERit : audit committees' power (Comparison of audit committee's power and board of directors' power on the i company on the t period (the dummy variable, the score is 1 if status of audit committee's power is higher than the board of directors', 0, if else).
SIZEit : company size (Natural logarithm value of the total asset of the i company on the t period)
LEVit : leverage (Ratio of total debt to the total asset of the i company on the t period)
GROWit : growth (Growth of company asset of the i company on the t period)
CFOit : operating cash flow (Operational cash flow at the beginning of the year of the i company on the t period)
eit : Error.

## 3. RESULT AND DISCUSSION

Purposive sampling results in 363 observations. Table 1-3 shows that there are no classical assumption problems exist in the data. Table 4-6 describe the results of descriptive statistics. Table 4 shows that samples are companies with high growth, have less operating cash flow and more equity than debt. Table 5 shows that there are more audit committees with financial expertise than non-financial expertise. Table 6 shows that there are more audit committees with higher power than management.

Table 1 Multicollinearity Test Result

| Variable | Tolerance | VIF | Conclusion |
|---|---|---|---|
| EXP | 0,999 | 1,004 | There is no multicollinearity |
| STATDIF | 0,927 | 1,078 | There is no multicollinearity |
| SIZE | 0,945 | 1,058 | There is no multicollinearity |
| LEV | 0,938 | 1,066 | There is no multicollinearity |
| GROW | 0,986 | 1,014 | There is no multicollinearity |
| CFO | 0,947 | 1,055 | There is no multicollinearity |

Source: Processed data by SPSS (2023)

Table 2 Heteroscedasticity Test Result

| Variable | Sig. | Conclusion |
|---|---|---|
| EXP | 0,728 | There is no heteroscedasticity |
| STATDIF | 0,506 | There is no heteroscedasticity |
| SIZE | 0,231 | There is no heteroscedasticity |
| LEV | 0,299 | There is no heteroscedasticity |
| GROW | 0,088 | There is no heteroscedasticity |
| CFO | 0,431 | There is no heteroscedasticity |

Source: Processed data by SPSS (2023)

Table 3. Autocorrelation Test Result

| Variable | Sig | Conclusion |
|---|---|---|
| RES_3 | 0,069 | There is no autocorrelation |

Source: Processed data by SPSS (2023)

Table 4. Descriptive Statistics

| **Variable** | **N** | **Minimum** | **Maximum** | **Mean** | **Standard Deviation** |
|---|---|---|---|---|---|
| DACC | 363 | -0,99654 | 1,50925 | 0,5229398 | 0,30322165 |
| EXP | 363 | 0,0000 | 1,0000 | 0,784536 | 0,2272276 |
| POWER | 363 | 0 | 1 | 0,51 | 0,501 |
| SIZE | 363 | 25,3108 | 33,53723 | 28,4181499 | 1,60161178 |
| LEV | 363 | 0,00345 | 2,82104 | 0,4608363 | 0,27943025 |
| GROW | 363 | 0,00044 | 6,94937 | 0,9199426 | 0,62395761 |
| CFO | 363 | -0,27985 | 6,80986 | 0,0929492 | 0,37108021 |

Source: Processed data by SPSS (2023)

Table 5. Financial Expertise Distribution (EXP)

| | | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|---|
| Valid | 0 | 28 | 7.7 | 7.7 | 7.7 |
| | 1 | 335 | 92.3 | 92.3 | 100.0 |
| | Total | 363 | 100.0 | 100.0 | |

Source: Processed data by SPSS (2023)

Table 6. Audit Committees' Power Distribution (POWER)

| | | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|---|
| Valid | 0 | 179 | 49,3 | 49,3 | 49,3 |
| | 1 | 184 | 50,7 | 50,7 | 100,0 |
| | Total | 363 | 100,0 | 100,0 | |

Source: Processed data by SPSS (2023)

Table 7. t-Test Result

| Variable | B | Sig. |
|---|---|---|
| (Constant) | 0,854 | 0,001 |
| EXP | 0,120 | 0,032 |
| POWER | -0,016 | 0,543 |
| SIZE | -0,016 | 0,053 |
| LEV | -0,291 | 0,000 |
| GROW | 0,140 | 0,000 |
| CFO | -0,002 | 0,962 |
| Adjusted R2 | | 0,198 |
| F | | 15,616 |
| Prob>F | | 0,000 |

Source: Processed data by SPSS (2023)

Table 7 shows that audit committee with financial expertise have positive effect on earnings management during COVID 19. The results are not consistent with previous researches [7], [9]. In contrast to the hypothesis, the result shows that audit committee with financial expertise encourage companies to do earnings management. COVID 19 pressures companies to do unethical deeds [21], [22], especially accrual earnings management [23]. In this situation, audit committees were forced to help companies to do accrual earnings management. Because Indonesia has low shareholder protection, audit committees with financial expertise dare to use their financial expertise to tell companies in which part of accounting number they can manipulate [1].

The aforementioned scenario also applies to the authority of audit committees. The power of audit committees does not have an impact on earnings management, given they share a common purpose with managers which is increasing earnings management. The results are not consistent with previous researches [8], [9]. But consistent with Dewi and Mita [7] which also use Indonesia as sample. In light of the present circumstances, it is imperative for the Indonesian government to acknowledge the significance of audit committees amidst the COVID-19 pandemic. The Indonesian government ought to establish stringent regulations and penalties for audit committees, without making exceptions even in light of the COVID-19 issue. Shareholders should also be aware of the earnings quality of companies during COVID-19 as the audit committee role is not functioning well. Higher education should also teach business students to hold ethical value no matter what the situation is [24]. It is crucial to teach ethics to business students as they are the future leaders.

## 4. CONCLUSION

### 4.1. Conclusion

Audit committee is very crucial in mitigating earnings management, especially during COVID-19. This study analyses the effect of audit committees' power and financial expertise on earnings management. It is argued that both audit committees' power and financial expertise have negative effect on earnings management. The results are quite surprising. Audit committee's financial expertise has positive effect on earnings management while audit committees' power has no effect on earnings management. The results of this study show the importance of ethics during COVID-19. The results show that the lack of shareholder power in Indonesia results in less ethics on audit committees and may leave Indonesia in despair even after COVID-19.

### 4.2. Limitation and Suggestion

The limitations of this study are as follows. First, this study exclusively focuses on the country of Indonesia. As there are many countries with low shareholder protections, the results of this study may valid in other countries. In line with previous limitation, there is significant variation in corporate governance systems and practices across different countries and regions worldwide. The study's findings may have limited generalizability to a worldwide context due to its major focus on localized locales.

Second, earnings management may be influenced by external factors that are outside the purview of audit committees, such as macroeconomic conditions or industry-specific issues. The study may not provide a full analysis of all external factors that influence financial decision-making. Next researcher can include other factors and conditions that may affect earnings management. Furthermore, this study exclusively focuses on manufacturing enterprises. Subsequent researchers may employ alternative industry as points of comparison in order to assess the findings of this study.

Third, the research centers its attention on the distinctive circumstances posed by the COVID-19 epidemic. Therefore, it is important to note that the results of this study may be contingent upon the specific circumstances in which it was conducted and may not have direct relevance to other crisis situations or times outside of a pandemic context.

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