Journal of Public Auditing and Financial Management | eISSN: 2798-4737

Published by LPMP Imperium. Journal homepage: https://ejournal.imperiuminstitute.org/index.php/JPAFM
Vol 5 No. 1, 2025. 39-48. DOI: https://doi.org/10.36407/jpafm.v5i1.1646

Original Article Open Access

The influence of the number of audit committee, profitability and leverage on profit management

Subjects
Accounting and Auditing

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ABSTRACT

Purpose: This study aims to examine the effect of audit committee size, profitability, and leverage on earnings management in retail industry sector companies listed on the Indonesia Stock Exchange (IDX) from 2017 to 2020.

Methods: The research employs a descriptive quantitative approach, utilizing purposive sampling, to select retail industry companies listed on the IDX between 2017 and 2020. Data were collected using the documentation method through the official IDX website (www.idx.co.id), and hypothesis testing was conducted using the t-test.

Findings: The results show that the number of audit committees has no significant effect on earnings management. However, profitability and leverage have a considerable influence on earnings management in retail companies listed on the IDX from 2017 to 2020.

Practical implications: These findings suggest that companies need to carefully monitor their profitability and leverage levels, as both can influence the likelihood of earnings management practices. Strengthening internal control and governance mechanisms is essential to ensure transparent and reliable financial reporting.

Article History:
Received: 11 Jun 2025
Revised: 13 Jul 20255
Accepted: 18 Agu 2025
Online: 06 Okt 2025

Keywords
Number of Audit Committees, Profitability, Leverage, Earnings Management

Reviewing Editor
Muljanto Siladjaja

Journal of Public Auditing and Financial Management

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Abstrak

Tujuan: Penelitian ini bertujuan untuk menganalisis pengaruh ukuran komite audit, profitabilitas, dan leverage terhadap manajemen laba pada perusahaan-perusahaan sektor ritel yang terdaftar di Bursa Efek Indonesia (BEI) periode 2017 hingga 2020.

Metode: Penelitian ini menggunakan pendekatan kuantitatif deskriptif dengan metode sampling purposif untuk memilih perusahaan-perusahaan sektor ritel yang terdaftar di BEI antara tahun 2017 dan 2020. Data dikumpulkan menggunakan metode dokumentasi melalui situs web resmi IDX (www.idx.co.id), dan pengujian hipotesis dilakukan menggunakan uji t.

Temuan: Hasil menunjukkan bahwa jumlah komite audit tidak memiliki pengaruh signifikan terhadap manajemen laba. Namun, profitabilitas dan leverage memiliki pengaruh yang signifikan terhadap manajemen laba pada perusahaan ritel yang terdaftar di IDX dari tahun 2017 hingga 2020.

Implikasi praktis: Temuan ini menyarankan bahwa perusahaan perlu memantau dengan cermat tingkat profitabilitas dan leverage mereka, karena keduanya dapat mempengaruhi kemungkinan praktik manajemen laba. Penguatan mekanisme pengendalian internal dan tata kelola sangat penting untuk memastikan pelaporan keuangan yang transparan dan dapat diandalkan.

Kata kunci: Jumlah Komite Audit, Profitabilitas, Leverage, Manajemen Laba

1. Introduction

Technological developments in Indonesia are progressing rapidly, intensifying competition among companies. This is because there are no geographical boundaries in the field of technology, and any country can easily enter and exit the market competition. In this era of globalization, to achieve goals or maximize profits, companies need to be more competitive by demonstrating various advantages to dominate the world market. The existence of a tendency to focus on earnings in a company's financial statements is, of course, based on management. The efforts made by company managers in this situation are aimed at improving company performance, as evident in the financial statements.

Financial statements are information that describes the financial position of a company. Financial reports are a crucial component of achieving accountable financial management for the public. To achieve the profit target, management typically selects specific accounting policies that allow the company's profit to be adjusted. The selection of accounting policies is intended to enable companies to change their reported earnings in accordance with management's needs and desires, so that the company's financial statements appear favorable to users. This method is called earnings management.

The company's ability to earn profits within a specified period is referred to as its profitability. The value of a company's profitability can be used to assess its performance. When a company performs well, its ability to generate more profits increases, and when it does not perform well, its ability to create profits decreases. Therefore, the relationship between profitability and earnings management is that when a company is less profitable for a specific period, it triggers the company to carry out earnings management by increasing the income earned to show a positive performance and retain existing investors. Research conducted by Purnama (2020), Dewi (2018), Ramadhan (2017), and Dewi (2020) states that profitability has a positive effect on earnings management. Although research by Bestivano (2018) suggests that profitability has no impact on earnings management because investors tend to ignore information on return on assets (ROA), management also tends to overlook profitability. In contrast to research conducted by others, this study utilizes the variable profitability to demonstrate the actual impact of profitability on earnings management.

The accompanying factor related to earnings management is leverage. Leverage refers to the use of assets and funding sources by companies to utilize their funds (fixed costs) and increase the profit potential of shareholders (Novianus, 2018). Companies with high leverage have the momentum to manage their profits effectively, thereby avoiding debt breaches. Leverage concerns the utilization of costs resulting from debt. Utilization of these costs will result in fixed costs, namely interest and dividends. If its own funds cover all these costs, the company does not want to be bound by a fixed obligation to make periodic cash payments.

Interest and dividends are fixed costs that must be paid regardless of the company's profit level. This will end badly for common shareholders. Because with an increase in funds, the uncertainty of the level of net income to be obtained by ordinary shareholders will also increase. The relationship between leverage and earnings management variables, as examined in Astuti et al. (2022), Rahayu (2018), and Arlita et al. (2019), indicates that leverage has a positive impact on earnings management. Meanwhile, further research by Anggraeni and Wardhani (2017) suggests that leverage has a detrimental effect on earnings management.

2. Theoretical Framework & Hypotheses

Agency Theory provides the foundational framework for understanding the motives behind earnings management. This theory describes the relationship between principals (shareholders or owners) and agents (managers who run the company). The principal's interest lies in maximizing profitability and prosperity, while the agent is tasked with achieving these objectives, often through compensation contracts. However, the interests of these two parties can diverge. Principals desire genuine performance, whereas agents may be motivated to meet their contractual targets to secure bonuses or maintain their reputation. This conflict of interest is what drives agents to engage in earnings management (Hadi & Afriyenti, 2022).

Earnings management occurs when the principal's monitoring is weak, allowing managers to manipulate financial information to make the company's performance appear better than it actually is (Kardhianti & Srimindarti, 2021). At its core, earnings management is the practice of influencing profits by exploiting the flexibility in financial reporting to achieve specific objectives, such as obtaining bonuses, influencing investors, or avoiding debt covenant violations (Supriyono, 2018; Scott in Renaldo et al., 2022).

Within this context, the Audit Committee serves as a crucial monitoring mechanism to mitigate agency conflict. According to Indonesian Financial Services Authority Regulation No. 55/2015, the audit committee is formed by and responsible to the Board of Commissioners to assist in its oversight duties. Its primary function is to ensure the independence of auditors from management pressure and to enhance the credibility of financial statements (Effendi & Ulhaq, 2021). Therefore, the presence and effectiveness of an audit committee are expected to constrain managers' opportunities for accounting manipulation.

Two financial variables are frequently linked to the motivation for earnings management: profitability and Leverage. Profitability, measured by profitability ratios, indicates a company's ability to generate earnings from its assets and financing (Brigham & Houston, 2018). Companies with high profitability may engage in earnings management to smooth their income and appear stable, while those with low profitability may do so to avoid breaching debt agreements. Meanwhile, the leverage ratio, or debt-to-equity ratio, illustrates the extent to which a company is financed by debt (Brigham & Houston, 2018). High Leverage creates pressure for management as they strive to meet debt obligations and avoid violating credit covenants. In unusual situations, a company may even take on more debt to secure new income (Hadiwardoyo, 2020), which can ultimately lead to earnings management practices that make the financial condition appear healthier than it truly is.

Effect of the number of audit committees on earnings management

Damayanti et al. (2018:4) argue that for an audit committee to perform its duties effectively, it must consist of a sufficient number of members, specifically a minimum of three. An appropriately sized audit committee protects shareholders' interests by enabling them to monitor and control the company's activities effectively. The greater the number of audit committee members, the more oversight there is on the company's management performance. This increased oversight leads to more careful decision-making and actions by management. Based on this description, the following hypothesis can be formulated:

H1: The number of audit committees affects earnings management.

Effect of profitability on earnings management

The study by Full Moon (2018:3) indicates that profitability has a significant positive effect on earnings management. As a company's profitability increases, so does the likelihood of earnings management actions. This trend is driven by management's desire to maintain investor confidence and satisfaction. Investors, who are shareholders, are typically more attracted to companies with higher profitability, as this suggests good financial and operational efficiency. Consequently, management may present financial reports that contain favorable information to enhance investor satisfaction. This approach involves efforts to improve the returns reflected in financial statements, thereby ensuring that investors have confidence in management's ability to oversee the company's operations in the future.

Conversely, when a company's profits are low, management tends to avoid engaging in earnings management. In such cases, financial statements are presented accurately, without alterations, as a way for management to demonstrate accountability to investors over time. Other studies that support these findings include Purnama (2018:7), Sunarto (2018:6), and Fatmasari (2018:6), all of which indicate that profitability has a significant positive effect on earnings management. Therefore, based on the explanations provided above, the following hypothesis is proposed:

H2: Profitability affects earnings management.

Effect of leverage on earnings management

According to Indarti & Nurdhiana (2021:68), leverage refers to the ratio that measures the extent to which a company relies on debt, represented by the relationship between the company's debt and its capital or assets. Companies often report higher profits to maintain a positive public image. This practice is critical because high leverage ratios can make it challenging to secure additional funding from external sources, as these sources may view the company as having a higher risk of defaulting on its debts. Supporting this view, research by Agustia & Suryani (2018:72) indicates that leverage has a positive effect on earnings management. Based on this information, we can formulate the following hypothesis:

H3: Leverage affects earnings management.

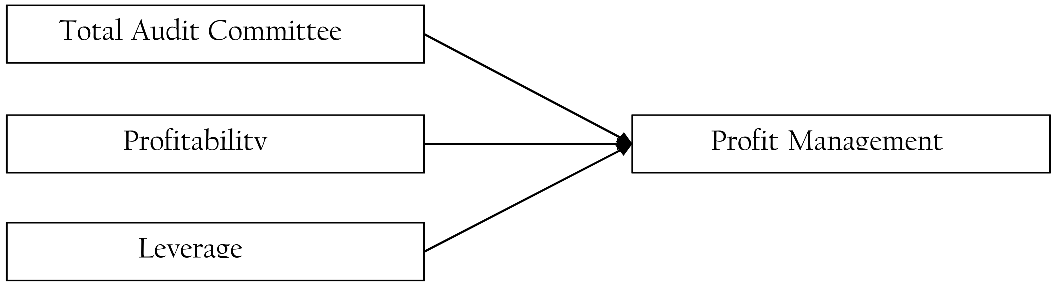

Figure 1. Thinking Framework

3. Methods

This research employs a quantitative approach, utilizing secondary data. The study aims to investigate the impact of audit committee size, profitability, and leverage on earnings management in retail companies listed on the Indonesia Stock Exchange from 2017 to 2020. The quantitative method produces numerical data that enables accurate data classification and hypothesis testing through statistical techniques.

Population and Sample

The population of this study consists of all retail companies listed on the Indonesia Stock Exchange (IDX). The total population comprises 27 companies observed over the 2017-2020 period. This study employs a purposive sampling technique to select a representative sample from the population. The sampling criteria are as follows:

1. Retail companies listed on the Indonesia Stock Exchange during the 2017-2020 period.
2. Companies that have complete and audited financial statements for the entire 2017-2020 period.

The application of these criteria resulted in a final sample of 17 companies. With data collected from four years of financial statements (2017-2020), the total number of observations for this study is 68 data points.

Data Analysis Method

Data analysis was conducted using quantitative methods with EViews 10 software. The process began with descriptive statistics to summarize the data, followed by classical assumption tests to validate the regression model. Hypothesis testing was then performed using t-tests to examine the individual impact of each independent variable on earnings management. The coefficient of determination (R^2) measured the model's overall explanatory power. This approach ensured that the study yielded accurate and reliable results.

4. Results and Discussion

Descriptive Statistical Analysis

Descriptive statistics summarize the research variables, including audit committee size, profitability (ROA), leverage (DAR), and earnings management, using minimum, maximum, mean, and standard deviation values to illustrate data distribution and variability.

Tabel 1. Descriptive Statistical Test Results

	ka	ROA	DAR	TA
Means	2.955882	-0.332603	3.782897	-673,935.4
Maximum	3,000000	0.351000	90.99400	3,316,728
Minimum	2,000000	-7.887000	0.204000	-5,471,696
std. Dev.	0.206883	1.295465	14.38583	1,422,863
Observations	68	68	68	68

Source: Results of data processing with Eviews version 10

Based on the descriptive statistics in Table 1, the characteristics of the research variables are as follows:

The Audit Committee (KA) variable shows a minimum value of 2 (PT Matahari Putra Prima Tbk, 2017-2020) and a maximum value of 3 (for all other companies). With a mean of 2.955 and a standard deviation of 0.206, the data is well-distributed as the mean is larger than the standard deviation.

The Profitability (ROA) variable ranges from a minimum of -7.887 (PT Tiphone Mobile Indonesia Tbk, 2020) to a maximum of 0.351 (PT Matahari Department Store Tbk, 2017). The mean is -0.332 with a standard deviation of 1.295, indicating poor data distribution as the standard deviation exceeds the mean.

The Leverage (DAR) variable has a minimum of 0.204 (PT Ace Hardware Indonesia Tbk, 2018) and a maximum of 90.994 (PT Global Teleshop Tbk, 2019). The mean of 3.782 is much smaller than the standard deviation of 14.385, showing poor data distribution and high variability among companies.

The Earnings Management (TA) variable ranges from -5,471,696 (PT Sumber Alfaria Trijaya Tbk, 2020) to 3,316,728 (PT Erajaya Swasembada Tbk, 2018). With a mean of -673,935 and a significant standard deviation of 1,422,863, the data distribution is poor, indicating significant variations in earnings management practices across the sample.

Uji Hypothesis

Based on the results of the Random Effect Model (REM) analysis in Table 2, it is evident that the audit committee, profitability (ROA), and leverage (DAR) have varying influences on earnings management in retail companies listed on the Indonesia Stock Exchange during the 2017–2020 period.

The regression results indicate that the audit committee (KA) variable has no significant effect on earnings management, as evidenced by a probability value of 0.7717 ($p > 0.05$). This suggests that the existence or number of audit committee members has not been optimally effective in controlling or reducing earnings management practices. In practice, this may occur because audit committees in several companies still function more formally rather than substantively in their oversight of financial reporting.

Meanwhile, the Return on Assets (ROA) variable shows a significant positive effect on earnings management with a probability value of 0.0418 (< 0.05). This implies that companies with higher profitability tend to engage in earnings management to maintain or improve their performance in the eyes of investors. In practical terms, management may use this to present a more stable profit trend and attract potential investors.

Similarly, the Debt-to-Asset Ratio (DAR) also has a significant positive effect on earnings management, with a p-value of 0.0226 (< 0.05). This result indicates that companies with higher leverage are more likely to manage their earnings to ensure they meet debt covenant requirements.

Tabel 2. Uji hypothesis

Variables	coefficient	std. Error	t-Statistics	Prob.
C	-448165.4	610022.4	-0.734670	0.4652
ka	-71595.62	245673.9	-0.291425	0.7717
ROA	311986.8	150176.9	2.077462	0.0418
DAR	23692.43	10143.24	2.335786	0.0226
Weighted Statistics				
R-squared	0.656845	Mean dependent var		-293532.6
Adjusted R-squared	0.612635	SD dependent var		1031538.
SE of regression	1025001.	Sum squared residue		6.72E+13
F-statistics	16.285784	Durbin-Watson stat		1.933003
Prob(F-statistic)	0.000000			

Source: Results of data processing with Eviews version 10

The Adjusted R^2 value of 0.6126 indicates that 61.26% of earnings management variations can be explained by the three independent variables: KA, ROA, and DAR. The remaining 38.74% is attributed to other factors not examined in this study, such as firm size, ownership structure, or audit quality.

Discussion

The influence of the audit committee on earnings management

The first hypothesis posits that the audit committee does not influence earnings management, as indicated in Table 2. This suggests that the audit committee, as measured by the number of audit committee members from outside the company, may not necessarily reduce the earnings management actions taken by management within a company. The research results are inconsistent with Natsir's (2020) findings, which suggest that audit committees can negatively affect earnings management actions. The results of this study indicate that the expertise of an independent audit committee in finance has proven effective in reducing earnings management. However, the results of this study align with those of Nasution (2013), who found that the audit committee does not affect earnings management.

Effect of return on assets on earnings management

The second hypothesis states that return on assets (ROA) has an impact on earnings management, as evident in Table 42. This shows that the greater the value of a company's ROA, the greater the company's earnings management practices. Companies with a high ROA value will typically have a high net profit, so management may practice earnings management by increasing or decreasing profits for their own benefit. These results are consistent with Ambarita's research (2019), which states that ROA affects earnings management.

However, the results of this study are not in accordance with Karina's research (2019), which found that ROA does not affect earnings management. This study found that the larger or smaller the value of a company's ROA, the less it affects the actions of company management in carrying out earnings management. This is because investors consider not only the company's ROA when investing, but also various other factors, such as inflation and interest rates.

Effect of debt to assets ratio on earnings management

The third hypothesis states that the debt-to-assets ratio (DAR) has an effect on earnings management, as shown in Table 4.13. This suggests that if a company's DAR value is high, it is likely to motivate earnings management actions, thereby increasing company profits. Management will undertake several measures to enhance asset value and reduce the company's debt. This is done to reduce the risk of eroding investor confidence in the company's future ability. The results of this study align with those of Fandriani (2019), who found that DAR has an impact on earnings management. However, the results of this study contradict Fatwigianty's (2018) research, which found that DAR did not affect earnings management.

Limitations and Suggestions

This study acknowledges several limitations that present opportunities for future research. The primary constraint lies in the limited sample size, resulting from strict sampling criteria and challenges in obtaining complete secondary data from the Indonesia Stock Exchange's official website. To enhance research outcomes, subsequent studies could incorporate additional explanatory variables such as other corporate governance mechanisms, firm size, or other relevant factors not examined in this study. Furthermore, employing different research methodologies and extending the observation period would contribute to obtaining more comprehensive and accurate findings regarding earnings management practices.

5. Conclusion

Based on the comprehensive data analysis and discussion, this study concludes that corporate governance and financial factors exert distinct influences on earnings management practices in Indonesia's retail sector. The findings demonstrate that the audit committee, as a governance mechanism, shows no significant effect on earnings management, suggesting that merely meeting the regulatory requirements for committee size is insufficient to constrain earnings manipulation. Conversely, financial factors prove to be significant drivers, with profitability (Return on Assets) exhibiting a negative relationship with earnings management, indicating that companies generating substantial genuine profits have less incentive for financial manipulation. In contrast, leverage (Debt to Assets Ratio) shows a positive relationship, revealing that companies with higher debt levels face greater pressure to engage in earnings management, likely to maintain compliance with debt covenants or present a more favorable financial position to creditors.

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Acknowledgment
the authors are grateful to the various reviewers for their constructive comments in shaping the manuscript.

Funding
Not applicable

Conflicts of interest/ Competing interests:
The authors have no conflicts of interest to declare that are relevant to the content of this article.

Data, Materials and/or Code Availability:
Data sharing is not applicable to this article as no new data were created or analyzed in this study

Publisher's Note
Imperium Research Institute remains neutral with regard to jurisdictional claims in published maps and institutional affiliations

Cite this paper:
Hermawan, M. O., & Krisnando. (2025). The influence of the number of audit committee, profitability and leverage on profit management. Journal of Public Auditing and Financial Management, 5(1), 39–48. https://doi.org/10.36407/jpafm.v5i1.1646