Human Capital's Mediating Effect on the Effectiveness of Audit Committees and Real Earnings Management

Sri Layla Wahyu Istanti[1,2](✉), Anis Chariri[1], and Agung Juliarto[1]

[1] Department of Accounting, Universitas Diponegoro, Semarang, Indonesia
laylawahyu2@gmail.com
[2] Department of Accounting, STIE YPPI Rembang, Rembang, Indonesia

Abstract. The goal of this paper is to look at the impact of human capital on the relationship between audit committee effectiveness and meeting frequency and independent audit committees with actual earnings management. This article is the result of quantitative research using data from manufacturing companies listed on the Indonesia Stock Exchange in 2018–2020. The data were tested using path analysis. The results of the research in the article explain although audit committee meeting frequency has a considerable impact on human capital, an independent audit committee has no impact on human capital. This study also found that real earnings management was solely affected by audit committee sessions, while real earnings management was not affected by the independent audit committee or human capital.. Furthermore, it has been shown that human capital has a significant impact on the number of audit committee meetings and the independent audit committees with genuine profits management. The study's primary contribution to originality is the role of human capital as a mediation in the relationship between audit committee effectiveness and real earnings management.

Keywords: Number of audit committee meetings · Independent audit committee · Human capital · Real earnings management

1 Introduction

Competitive advantage is one of the keys to maintaining the company's survival. Companies that are able to maintain their viability have managerial capital based on knowledge. Some companies have a heavy dependence on knowledge as capital to increase competitive advantage that gives rise to various innovations. The existence of product innovations resulted in the company being able to compete and be able to create maximum profits. Profit is one of the goals of establishing a company. Large profits reflect the company's better performance and increasing shareholder wealth.

Agency theory explains that the use of earnings as a performance parameter motivates managers as agents to modify accounting numbers [1]. Engineering accounting numbers made by managers aims to increase the prosperity of shareholders and increase the welfare of managers as agents. The behavior of managers who abuse their authority by

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manipulating accounting information in presenting earnings in financial statements is known as earnings management [2]. In earnings management there are two approaches, namely the accrual approach and the real approach [3].

Accrual earnings management which tends to shift towards real earnings management that occurred after the American SOX (Sarbanes-Oxley) act of 2002 [4]. The shift towards real earnings management is also due to the strong motivation of managers to carry out real activities rather than making changes to accrual accounting because if managers make changes to accrual accounting, the private costs incurred are greater than committing fraud in real activities [5]. Cases of earnings management that occurred in Indonesia include the credit card business of Bank Bukopin, resulting in a revision of earnings in the 2015 financial statements, 2016 and 2017 [6].

Agency conflicts triggered by earnings information in financial statements indicate company performance that can attract investors' attention to invest, so managers tend to do earnings management [7]. This article is very important to study because the implications of real earnings management on the company have a bad influence on the long-term survival of the company. Weak investor protection in Indonesia causes earnings management practices to be higher than in countries with strong investor protection [8]. Earnings management practices can trigger agency conflicts which can be reduced by supervision by the audit committee.

This study examines the audit committee's meeting frequency and effectiveness as variables affecting real earnings management. Audit committee meetings have previously been studied in relation to actual profits management, but diverse findings have been found. The results of research Devi [9] and Susanto [10] state that effectiveness of audit committee hurts real earnings management. This study contradicts others Thi [11] which states real earnings management improves when the audit committee is effective. The results of different studies are very interesting to be re-examined because they create new gaps to add mediating variables that may be able to clarify the direction of the research relationship.

Human capital mediates the relationship between audit committee meetings and independent audit committees, with real earnings management as the dependent variable. To better understand the link between the audit committee's performance and the management of actual earnings in Indonesian manufacturing businesses listed in 2018–2020, this study examines human capital as a mediator. The position of human capital in this article is expected to reduce the behavior of managers in practicing real earnings management.. After the introduction, this article will discuss the objectives that explain the background theory and the development of hypotheses. The next section of this article is method and result. This paper concludes with a discussion that also includes conclusions, limits, and recommendations for further research.

2 Objective

Agency theory serves as the theoretical foundation for this research, which analyze the relationship between real earnings management and audit committee performance [1]. The investor as the principal authorizes the manager as the agent to manage the company by focusing on profit and dividend distribution. Differences in interests that occur between principals and agents motivate managers to act according to the wishes of the principal by manipulating accounting information in financial statements. Corporate governance that triggers agency conflicts requires a board-formed audit committee that acts independently to resolve agency difficulties.

The primary objective of real earnings management is the manipulation of sales results through the company's operational operations in order to change sales reports through the use of the sales method, surplus production, discretionary costs, and profits from the sale of the company's assets [3, 12, 13]. The behavior of managers who practice earnings management increases the emergence of agency conflicts, because financial statements are manipulated to deceive investors about the financial health of a firm.

Audit committee effectiveness is measured by the number of meetings and independent audit committees in corporate governance. The audit committee when carrying out its duties, among others, holds regular meetings to monitor and assess the performance of managers in accordance with applicable regulations. The existence of monitoring and evaluation activities carried out by the audit committee when holding regular meetings aims to reduce agency problems that arise between investors and managers, and can suppress real earning management practices [14]. To be effective, an audit committee must be impartial and have several meetings. The necessity of the audit committee since it can monitor financial statement information effectively [15].

Every resource has the potential to generate a product innovation that can compete with distinctive and unusual traits that are difficult to replicate, according to the resource-based perspective theory [16]. Product innovation is the basis for competitive advantage for companies owned by science-based human resources. In resource-based perspective theory, human resources competence determines a company's competitive advantage [17].

Hypothesis Development

The audit committee meeting aims to discuss and evaluate the company's performance and oversee corporate governance. Human capital is a human resource asset owned by the company to be able to create superior products [18]. Regular audit committee meetings can evaluate the company's financial information, including information about the performance of human capital [19].

The independent audit committee consists of independent individuals who are capable of being neutral in analyzing financial information. If the independent audit committee does not have ties to management, it will increase the effectiveness of the audit committee, thereby improving human capital performance.

The independent audit committee consists of independent individuals who are capable of being neutral in analyzing financial information. If the independent audit committee does not have ties to management, it will increase the effectiveness of the audit committee, thereby improving human capital performance [20]. Managing real earnings is a strategy used by managers to mislead investors about the financial health of a company. There is a direct correlation between human capital and the reduction of actual profits management.

In order to ensure that management does not manipulate financial facts in order to serve their own interests, the audit committee should hold regular meetings. This committee also monitors and evaluates financial reporting to make sure it adheres to the company's established accounting standards. The existence of human capital as a human resource asset owned by the company based on science is expected to be able to mediate real earnings management and audit committee.

3 Method

Studies have evaluated the influence of audit committee effectiveness on actual earnings management, incorporating human capital and audit committee meetings as a mediating variable. Using a purposive sample technique, the study's participants are manufacturing companies that will be listed on the Indonesian stock exchange between 2018 and 2020 as part of the findings. This study relies on data from the Indonesian stock market's financial reporting of manufacturing companies.

Real earnings management is the behavior of managers by manipulating the normal activities of the company by presenting incorrect financial information to shareholders [5]. Real earnings management is measured in three ways, namely:

Abnormal operating cash flow (AbnCFO)

$CFOt/At\text{-}1 = \alpha 0 + \alpha 1(1/At\text{-}1) + \beta 1(St/At\text{-}1) + \beta 2(\Delta St/At\text{-}1) + \epsilon t$

Abnormal Discretionary Expenses (AbnDISEXP)

$DISEXPt/At\text{-}1 = \alpha 0 + \alpha 1(1/At\text{-}1) + \beta(St\text{-}1/At\text{-}1) + \epsilon t$

Abnormal Production Costs (AbnPROD)

$PRODt/At\text{-}1 = \alpha 0 + \alpha 1(1/At\text{-}1) + \beta 1(St/At\text{-}1) + \beta 2(\Delta St/At\text{-}1) + \beta 3(\Delta St\text{-}1/At\text{-}1) + \epsilon t$

From the three methods above, the real earnings management formula is obtained as follows:

REM = AbnCFO + AbnDISEXP + (AbnPROD x (-1))

The Annual audit committee meetings determine the number of sessions. Independent audit committee evaluation based on proportion of outsiders to total members [21]. Human capital variable is calculated by adding up the costs incurred for salaries and wages [22]. Based on the equation analysis model as follows:

(1) $HC = \alpha + \beta 1Meetings + \beta 2Independen + e$
(2) $REM = \alpha + \beta 1Meetings + \beta 2Independen + \beta 3Human\ Capital + e$

4 Results

72 observations were made from 2018–2020 on Indonesia Stock Exchange manufacturing enterprises. First equation result:

The Table 1 shows that 2,473 audit committee sessions have a considerable beneficial impact on human capital, hence the first hypothesis can be adopted. The findings of the independent audit committee's inquiry show the inverse. The independent audit committee's t value is −0.271, indicating that it has no affect on human capital, hence hypothesis two is rejected.

Table 1. First equation result.

Coefficients[a]					
Model		Unstandardized Coefficients		t	Sig.
		B	Std. Error		
1	(Constant)	−24.658	69.683	−.354	.725
	Meetings	188.187	127.715	2.473	.045
	Independen	−5.357	19.782	−.271	.787

[a]Dependent Variable: Human Capital

Table 2. The results of the study to test the second equation.

Coefficients[a]					
Model		Unstandardized Coefficients		t	Sig.
		B	Std. Error		
1	(Constant)	8557536479.7	3394023775.262	2.521	.014
	Meetings	−9499493216.1	6311968568.008	−2.505	.017
	Independen	−341391134.0	963152096.330	−.354	.724
	Human Cap	597756.985	5858278.417	.102	.919

[a]Dependent Variable: REM

The results of the study to test the second equation can be seen from the Table 2.

The audit committee meeting negatively affects Real Earnings management, with a t value of −2.505. Independent audit committee and human capital characteristics had little effect on real earnings management, study found. Human capital doesn't affect audit committee or earnings management.

5 Conclusion

The findings of this study show audit committee meetings improve human human resource performance.. This shows that human capital performs better when the audit committee meets more frequently. The existence of regular audit committee meetings in each period facilitates coordination and evaluation carried out by the audit committee. The audit committee that evaluates the company's financial position also pays attention to the costs incurred to improve the capacity of human resources [23]. Increased human resource capabilities can motivate innovation [24]. The resulting product innovation is the key to increasing the company's competitiveness [25]. The results of this study support previous studies which state that human capital performance is boosted by audit committee sessions [18, 19].

Number of independent audit committees doesn't affect human capital performance for Indonesian manufacturing enterprises. Human resources with high scientific ability can produce a product innovation that can increase the competitiveness of the company. The independent audit committee is an independent member who does not have any affiliation with the company [26]. An independent audit committee originating from outside the company will have different interests from human resources from within the company. The existence of loyalty and the desire to increase the company's competitiveness through product innovation is more dominantly owned by human resources within the company.

The results of the next study stated that there was a Audit committee sessions hurt Real Earnings Management. This means audit committee sessions are intensifying. Regular audit committee meetings that review the company's condition cause managers to be more careful in creating financial statements to suppress Real Earnings Management practices and decrease investor-manager agency conflicts [27].

The limitation of this research is that the financial data of manufacturing companies is not consistently published in the annual reports during the three years of the study. Another limitation is that there are still companies that do not clearly measure the level of employee salaries and wages. Future study should focus more on intellectual capital performance.

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