

Influence of Financial Performance, Board Size, and Audit Committee on Sharia Profit Management

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Abstract

Investment interest in the Indonesian capital market continues to experience significant growth, reaching 9,540,027 investors in August 2022, an increase compared to the previous year. Data shows that Indonesia's stock market capitalization ranks 27th in the world with a value reaching 9,300 trillion in the same year. The growth of the stock market is also reflected in the increase in the Jakarta Composite Index (IHSG) by 5.02% and the Indonesian Sharia Stock Index (ISSI) which grew by 6.02% in June 2022. The study utilizes a quantitative approach, analyzing data from Sharia companies listed on the Jakarta Islamic Index (JII) over the period 2021-2023. Findings reveal that financial performance significantly influences earnings management, with larger board sizes showing a smaller positive impact, while larger audit committees have a negative impact on earnings management.

Introduction

Financial statements play a vital role in corporate decision-making and are an important medium for external users. However, the practice of earnings management is often carried out by company managers to achieve the profit targets desired by investors, which sometimes leads to an unclear presentation of the company's condition. Attention to earnings management has increased with the increasing number of cases occurring in the business world. One example is the case of financial statement manipulation involving PT. Garuda Indonesia in 2019. This case has become a serious concern because it is related to the recording of net income that is inconsistent with the company's actual condition (Khairani et al., 2022). Islamic economics plays a crucial role in Indonesia's development, positively impacting various sectors. As a country with a Muslim majority, Islamic businesses are experiencing growth through products and services, strengthening people's purchasing power (Ajustina & Nisa, 2024; Wartyo & Samsuri, 2020).

This growth opens up new investment opportunities, advancing sectors such as sharia tourism and the halal industry (Bank Indonesia, 2023; Azam & Abdullah, 2020; Yazid et al., 2020; Ladiqi et al., 2018). Investment interest in the Indonesian capital market continues to experience significant growth, reaching 9,540,027 investors in August 2022, an increase compared to the previous year. Data shows that Indonesia's stock market capitalization ranks 27th in the world with a value reaching 9,300 trillion in the same year. In addition, the growth of the stock market is also reflected in the increase in the Jakarta Composite Index (IHSG) by 5.02% and the Indonesian Sharia Stock Index (ISSI) which grew by 6.02% in June 2022, indicating a positive trend in stock investment (Otoritas Jasa Keuangan, 2022). The Sharia market in Indonesia is also experiencing encouraging development. Data from the OJK shows

that the number of Sharia stocks has continued to increase from 2017 to 2022, with a total jump in shares reaching 44.53% (Putri et al., 2023).

While the total number of investors in the Indonesian capital market has grown significantly, only a small portion invest in Sharia stocks. This suggests that understanding of Sharia investment still needs to be improved. It also indicates that the practice of earnings management regulated by companies in their financial statements plays a significant role in influencing investor perception of company performance (Khairani et al., 2022). The development of Sharia business in Indonesia reflects a striking economic phenomenon. With a majority Muslim population, the potential for developing Sharia business is enormous. The increase in Sharia company assets in 2022 shows growth of 15.87% from the previous year (Pahlevi & Solekah, 2023). The halal industry is also on the rise, reaching \$184 billion in transactions in 2020 (Otoritas Jasa Keuangan, 2022). Earnings management plays a significant role in corporate finance, encompassing strategies and decisions to manipulate financial statements for specific purposes (Setiawati et al., 2024; Xu et al., 2007; Man & Wong, 2013; Ghaleb et al., 2024; Arian et al., 2024).

The influence of financial performance, board of commissioners size, and audit committee on earnings management of Sharia companies in Indonesia is highly relevant in the context of realizing good corporate governance (GCG) and maintaining the integrity of Sharia companies. First, it is necessary to understand that Sharia companies play a crucial role in building a just and prosperous Sharia economy in Indonesia. To achieve this goal, the implementation of GCG principles is very important. GCG principles, which include transparency, accountability, and responsibility, are the main foundation in running the operations of Sharia companies. By implementing good GCG, companies can increase investor and public confidence in the company's integrity and sustainability. Here is a table chart of companies included in the JII Index with their Free Float levels.

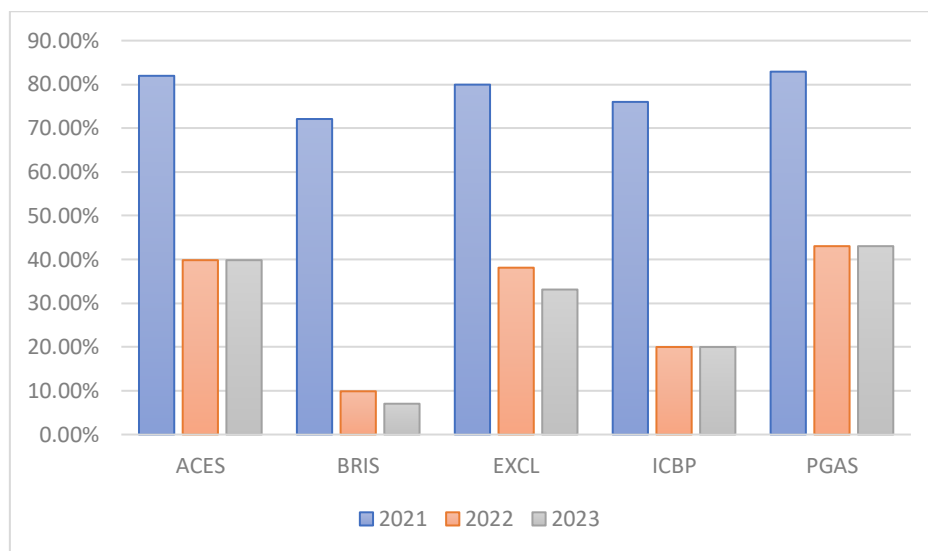


Figure 1. Financial Performance Free Float JII Index Top 5

Based on the chart above, it can be seen that the financial performance of the Top 5 Free Float JII has been fluctuating and declining, which needs to be discussed, especially for BRIS which has declined significantly from 2021. While ACES and PGAS, although declining, have experienced stagnation in the following year. This indicates that the companies are still experiencing difficulties in managing profits (earnings management).

Company financial performance is a highly relevant factor in this discussion. Good financial performance reflects the health and stability of the company. Investors and the public will tend to be more confident in companies with strong and consistent financial performance. In addition, the size of the board of commissioners and the existence of an audit committee also play an important role in maintaining GCG. A board of commissioners with optimal size, independence, and competence can improve the effectiveness of supervision over company management. Similarly, the audit committee, which plays a role in ensuring the reliability of financial statements and the company's compliance with applicable regulations (Febrina, 2022). Earnings management is an attempt by company management to manipulate financial statements to appear better than they actually are.

This can happen in various ways, such as recognizing revenue early, delaying the recognition of expenses, or changing accounting methods. However, it is important to note that this intervention of earnings management can eliminate the objectivity of financial statements and does not always reflect the actual condition of the company (Azizah & Erinosi, 2020). The influence of financial performance, board of commissioners size, and audit committee on earnings management practices of Sharia companies is important to understand. Good financial performance can help attract investors and build trust in the company (Khairani et al., 2022; Chen et al., 2023; Khan et al., 2021). An optimal size of the board of commissioners and the existence of an effective audit committee can also help prevent unethical earnings management practices. However, there are several factors to consider in analyzing this influence. Institutional ownership, company size, profit growth, leverage, and operating cash flow can all influence earnings management practices (Rahmawati & Fajri, 2021; Potharla et al., 2021).

For example, high institutional ownership can encourage tighter oversight and minimize earnings management practices. Similarly, company size can be attractive to investors, encouraging company management to be more meticulous in reporting its finances and performance (Pramudityo & Sofie, 2023; Gayatri & Wirasedana, 2021). Leverage levels can also influence earnings management practices, although there are studies that show different results. Profit growth is also an important benchmark for companies in managing earnings and for investors in evaluating company performance. However, company debt is also an important consideration in earnings management practices and efforts to build public trust (Azizah & Erinosi, 2020).

Methods

This research employs a quantitative method with an associative approach (Sugiyono, 2019). The quantitative method focuses on hypothesis testing through numerical data and statistical processing of research variables. This study utilizes a quantitative approach to examine the influence of financial performance, board of commissioners size, and audit committee size on earnings management practices in Sharia companies listed on the Jakarta Islamic Index (JII) during the period 2021-2023. Data for this research will be collected from annual financial reports published by these companies, as well as additional data from public financial databases and the official website of the Indonesia Stock Exchange. The independent variables in this study include financial performance, measured through the profitability ratio Return on Assets (ROA); board of commissioners size, measured through the total number of board members; and audit committee size, measured based on the number of audit committee members. The dependent variable is earnings management, which is estimated using the accounting model of discretionary accruals. A multiple linear regression model will be used to analyze the data and test the established hypotheses.

The object of this research is Sharia companies listed on the Jakarta Islamic Index (JII) during the period 2021-2023. This period was chosen to provide the latest data on corporate governance practices and earnings management in a dynamic and challenging economic environment. This research will focus on companies with complete financial reports and published audits over the past three years, enabling longitudinal analysis of trends and changes in earnings management practices. Selecting Sharia companies provides an opportunity to explore how Sharia finance principles, which emphasize transparency and business ethics, influence earnings management practices. This research is expected to reveal insights into the influence of good corporate governance and financial performance on earnings management in the Sharia finance sector, which is traditionally considered to have high ethical standards.

Results and Discussion

Classic Assumption Test

Normality Test

Table 1. Normality Test Results

One-Sample Kolmogorov-Smirnov Test		
		Unstandardized Residual
N		63
Normal Parameters ^{a,b}	Mean	.0000000
	Std. Deviation	.01510603
Most Extreme Differences	Absolute	.099
	Positive	.099
	Negative	-.072
Test Statistic		.099
Asymp. Sig. (2-tailed)		.200 ^{c,d}

Based on the Normality Test results shown in Table 1 the Asymp. Sig. (2-tailed) obtained is 0.200. This value indicates that the data has a normal distribution because the significance value is greater than 0.05. This indicates that the distribution of variables in the regression model approaches a normal distribution.

Multicollinearity Test

Table 2. Multicollinearity Test Results

Collinearity Statistics			
Variable	Tolerance	VIF	Information
X1	0.892	1.121	Multicollinearity free
X2	0.790	1.266	Multicollinearity free
X3	0.835	1.198	Multicollinearity free

These results confirm that there is no significant multicollinearity between independent variables, so the proposed model is believed to not have information redundancy problems that could affect parameter estimates.

Heteroscedasticity Test

Table 3. Heteroscedasticity Test Results

Variable	Significant	Information
X1	0.485	Heteroscedasticity free
X2	0.113	Heteroscedasticity free

X3	0.239	Heteroscedasticity free
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Table 3 shows the results of the Heteroscedasticity Test for variables X1, This indicates that there is no significant heteroscedasticity in the model, indicating that the variance of the residuals in the regression model is constant. These results ensure that the regression model provides efficient and unbiased estimates.

Autocorrelation Test

Table 4. Autocorrelation Test Results

Model Summary ^b	
Model	Durbin-Watson
1	2.279
a. Predictors: (<i>Constant</i>), X1, X2, X3	
b. Dependent Variable: Y	

Table 5. DW-DU Calculation

Durbin-Watson Stat					2.279
N	K	dL	dU	4-dU	4-dL
63	3	1.4943	1.6932	2.3068	2.5057

These results indicate that there is no significant positive or negative autocorrelation between the residuals. This ensures that the regression model residuals are independently distributed, increasing the reliability of hypothesis testing in research.

Multiple Linear Regression Model

Table 6. Multiple Linear Analysis Model

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(<i>Constant</i>)	0.058	0.008		7.243	0.000
	X1	0.148	0.030	0.544	4.872	0.000
	X2	0.002	0.001	0.336	2.828	0.006
	X3	-0.003	0.002	-0.237	-2.049	0.045
a. Dependent Variable: Y						

From these coefficients, it can be concluded that financial performance plays a more significant role in influencing earnings management compared to structural factors such as the size of the board and audit committee. The consistency of these results with classical assumptions that have been checked and met the requirements (no significant multicollinearity, heteroscedasticity or autocorrelation) confirms that this regression model is quite strong and can provide valid insight into the influence of the variables studied on earnings management.

Hypothesis Testing

Table 7. T Test Results

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(<i>Constant</i>)	0.058	0.008		7.243	0.000
	X1	0.148	0.030	0.544	4.872	0.000

	X2	0.002	0.001	0.336	2.828	0.006
	X3	-0.003	0.002	-0.237	-2.049	0.045
a. Dependent Variable: Y						

In conclusion, it can be deduced that financial performance (X1) significantly and positively influences earnings management practices, while the board of commissioners' size (X2) also has a significant albeit smaller impact compared to financial performance. On the other hand, the audit committee size (X3) shows a negative impact on earnings management, indicating that a larger audit committee can reduce such practices. Therefore, these findings support the notion that financial performance, board size, and audit committee size play different but significant roles in influencing earnings management in companies.

Table 8. F Test Results

ANOVA ^a						
Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	.007	3	.002	10.280	.000 ^b
	Residual	.014	59	.000		
	Total	.022	62			
a. Dependent Variable: Y						
b. Predictors: (<i>Constant</i>), X3, X1, X2						

The F Test results show an F value of 10,280 with a Sig value. 0.000, which confirms that the overall regression model is significant. This value indicates that at least one of the independent variables significantly influences the dependent variable, in this case earnings management. This indicates that the model has good predictive power and the selected variables are relevant to explain variability in earnings management. So Hypothesis 4 is accepted.

Test of the Coefficient of Determination R²

Table 9. Coefficient of Determination Test Results (R²)

Model Summary ^b			
R	R Square	Adjusted R Square	Std. Error of the Estimate
0.586	0.343	0.310	0.015149

From Table 9, the R Square value is 0.343, which means that 34.3% of the variability in earnings management can be explained by the independent variables included in the model. The slightly lower Adjusted R Square value of 0.310 takes into account the number of predictors in the model and provides a more conservative estimate of the explained variability. This indicates that although the model is quite good at explaining earnings management, there is still 65.7% of variability that is not explained by the model, which may be caused by other factors not included in this analysis.

Impact of Financial Performance on Earnings Management

This research reveals that financial performance has a significant influence on earnings management practices in companies. The t-test results show a positive coefficient with a significant value, indicating that an increase in financial performance tends to be followed by an intensification of earnings management activities. The hypothesis that financial performance is positively related to earnings management is proven, consistent with findings in the literature that indicate that companies may use earnings management to maintain or enhance their positive image regarding financial performance (Mismiwati et al., 2022). In this

context, management may feel motivated to adapt financial reporting to reflect more favorable results, in order to meet or exceed market and stakeholder expectations.

In the context of Sharia issues, financial performance is defined as the company's ability to generate profits and manage its assets efficiently in accordance with Sharia principles (Md Zain & Shafii, 2018). Good financial performance is often seen as a key indicator of a company's economic health and operational effectiveness. However, in practice, significant increases in financial performance can encourage management to engage in earnings management practices. Earnings management is the act of manipulating financial statements to create a more positive picture or meet certain targets set by the company or stakeholders (Febrina, 2022). In the context of Sharia, such practices contradict the principles of transparency and fairness that are embraced in Islamic economics. Therefore, while strong financial performance is a primary goal, strict oversight is needed to ensure that it does not compromise Sharia principles.

Impact of Commissioners on Earnings Management

The analysis shows that the size of the board of commissioners also has a significant impact on earnings management, with a relatively smaller positive coefficient. These results suggest that the larger the size of the board, there is a small but significant tendency towards an increase in earnings management practices. This can be interpreted that larger boards of commissioners may not always be effective in overseeing earnings management practices due to the higher complexity of coordination and decision-making. Previous studies have indicated that large boards may find it difficult to reach consensus or manage discussions effectively, which in turn can weaken their oversight functions (Pramudityo & Sofie, 2023). Therefore, these findings support the understanding that the optimal board size needs to be reviewed to minimize earnings management practices.

The board of commissioners in Sharia companies has a more complex role because they are not only responsible for overseeing management, but also for ensuring compliance with Sharia principles. A larger size of the board of commissioners could introduce challenges in coordination and decision-making effectiveness (Aras & Kazak, 2022). This could indirectly increase the risk of earnings management, as less effective oversight could provide room for management to engage in practices that deviate from Sharia principles. While large boards of commissioners have the potential to provide a diverse range of expertise and perspectives, in practice they must be able to manage their composition and internal dynamics effectively to reduce the risk of earnings management.

Impact of the Audit Committee on Earnings Management

The results of the analysis, the size of the audit committee shows a negative impact on earnings management, indicating that larger audit committees tend to reduce earnings management practices. This negative effect suggests that stronger audit committees with a larger number of members can be more effective in overseeing financial reporting and thus can reduce opportunities for earnings management. These findings are unfortunately inconsistent with the literature that states that effective audit committees play a crucial role in positively enhancing the transparency and accuracy of financial reporting (Pramudityo & Sofie, 2023; Khairani et al., 2022). Optimal audit committee size, which is not too small or large, may be more effective in managing the focus and participation of its members, thereby minimizing earnings management practices.

The audit committee in Sharia companies not only oversees financial reporting, but also ensures that company transactions and operations are in accordance with Sharia law. An effective audit committee is key to improving the transparency and accuracy of financial reports, and its size is often directly proportional to its effectiveness (Khairani et al., 2022). A

larger committee may have more resources to audit and review Sharia compliance, which can significantly reduce earnings management practices. The effectiveness of the audit committee in reducing earnings management highlights the importance of having competent and sufficiently numerous members to conduct thorough oversight, which in turn supports financial integrity and Sharia compliance in company operations.

Impact of Financial Performance of Commissioners and the Audit Committee on Earnings Management

The results of the analysis, the F-test related to H4, which states that there is a positive relationship between financial performance, the size of the board of commissioners, and the size of the audit committee simultaneously with earnings management, is supported by the results of the F-test which shows that the overall regression model is significant. These findings indicate that independent variables, such as financial performance, the size of the board of commissioners, and the size of the audit committee, jointly influence earnings management. Thus, it can be concluded that the model has good predictive power, and the selected variables are relevant in explaining the variability of earnings management in companies. This hypothesis is accepted because the model used is able to identify the significant influence of at least one independent variable on earnings management practices.

Research supporting these results is a study conducted by Azizah & Erinosi (2020), which found that the size of the board of commissioners has a positive influence on earnings management practices in companies. This research shows that the larger the size of the board of commissioners, the greater the likelihood of earnings management occurring, especially when the board is unable to effectively carry out its supervisory functions. This is in line with agency theory, which states that weak oversight can increase information asymmetry, providing opportunities for management to manipulate financial statements for personal gain or to maintain the company's image.

In addition, research by Pramudityo & Sofie (2023) also supports these findings by showing that the size of the audit committee plays an important role in influencing financial performance and earnings management. Larger audit committees, while having the potential to enhance oversight, often face challenges in terms of coordination and effectiveness. Therefore, the size of the audit committee can play a role in mitigating or even exacerbating earnings management practices, depending on the effectiveness of the oversight applied. Thus, the combination of variables such as financial performance, the size of the board of commissioners, and the size of the audit committee is indeed relevant and significant in influencing earnings management simultaneously.

Practical Implications

The practical implications of this research in the context of Sharia are very significant, especially in strengthening corporate governance and compliance with Sharia financial principles. The results of this study show the need for Sharia companies to improve the quality of internal oversight, particularly in the audit committee. By increasing the size and capabilities of the audit committee, Sharia companies can be more effective in ensuring that financial reporting practices are not only transparent but also in accordance with Sharia law. Improvements in this oversight function will also help minimize earnings management practices, which will indirectly increase investor and other stakeholder confidence in the integrity and fairness of the company's operations.

This research reveals that larger boards of commissioners may not always be effective in controlling earnings management, which calls for a review of board structure and composition. For Sharia companies, the board of commissioners not only acts as a supervisor of management

but also as a guardian of Sharia principles. Therefore, companies need to consider adjusting the optimal board size that is not only able to conduct effective oversight but also ensure Sharia compliance in all aspects of the company's activities. This may include better and more frequent training for board members on Sharia principles as well as risk management and financial reporting.

These findings suggest the importance of implementing a holistic approach to corporate governance in Sharia companies. In addition to focusing on internal oversight, companies should also strengthen external mechanisms such as independent audits and transparency in financial reporting to ensure that all operational activities are in accordance with Sharia law. This will not only reduce the likelihood of earnings management but also enhance the reputation and sustainability of Sharia companies in the eyes of the wider community and investors. The implementation of these recommendations is expected to help Sharia companies improve Sharia compliance while optimizing financial performance.

Conclusion

This research indicates that Sharia companies with good financial performance tend to engage in earnings management to maintain their reputation. While board size has a positive influence on earnings management, the effect is relatively small. Larger and more effective audit committees are shown to reduce earnings management practices, highlighting the importance of strong oversight in Sharia corporate governance. All independent variables, including financial performance, board size, and audit committee size, collectively influence earnings management. However, the research model only explains a small portion of the variation in earnings management, suggesting that other factors outside the model also play a significant role.

Based on the research findings, several practical recommendations can be made to improve Sharia corporate governance and reduce earnings management practices. Sharia companies need to optimize the size and composition of their boards of commissioners and audit committees to achieve a balance between effective oversight and flexible decision-making. Training and development focusing on Sharia principles and good governance practices can enhance the quality of oversight and reduce earnings management. Increasing transparency in financial reporting and conducting regular independent audits are also crucial to ensure compliance with Sharia standards and reduce the potential for earnings management. For future research, it is recommended to consider additional variables such as the financial expertise of board members, diversity on the board of commissioners, or the influence of external oversight to gain a deeper understanding of the factors influencing earnings management. Comparative studies between Sharia and non-Sharia companies can also provide additional insights into how Sharia principles affect governance and earnings management practices.

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