How Financial Distress Influences Earnings Management

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Abstract. This research is to analyze the influence of financial distress on earnings management in banking companies listed on the Indonesia Stock Exchange for the 2018-2024 period. The sample in this study was determined using purposive sampling. The sample size is 80 company annual reports. Data collection uses documentation. Data analysis uses regression by SPSS. Financial distress is proven to influence earnings management. This means that when a company faces financial difficulties, management will tend to carry out earnings management to cover up the financial difficulties faced so that it looks good in the eyes of stakeholders. The contribution given by independent variables to earnings management variables is small, so it is recommended that further research add independent variables outside this research and use other sectors as a basis for further research. This research provides practical benefits to banking company management to avoid earnings management practices.

Keywords: Influence, Financial Distress, Earnings Management.

INTRODUCTION

Public interest in investing in the capital market in the current era is increasing. One of the reasons an investor invests in the capital market is to make a profit. For investors, profit information is an important aspect that needs to be considered in investment decisions in the capital market. Information regarding profits can be obtained through financial reports. The purpose of financial reporting by business companies is that financial reporting must provide information that is useful for investors and other users to make investment, credit and decisions rationally. (Kieso, 2017) .

In (Ikatan Akuntan indonesia, 2015), it is stated that financial reports function to provide information regarding profit and loss reports, reports of changes in equity or capital, reports of financial position (balance sheet), cash flow reports, and notes to financial reports whose information must be presented fairly. based on existing facts without adding or subtracting. Information in financial reports can also be used as a basis for stakeholders to assess the performance of a company based on management's ability to manage resources and generate profits. From this, managers make every effort to create certain strategies so that the financial reports produced are in line with expectations and attract the attention of stakeholders/investors, one of which is by earnings management.

Good earnings quality describes how relevant characteristics are possessed by reported earnings, because it is used as a benchmark for decision making (Darmansyah, 2016). Information obtained from financial reports cannot be taken for granted. There have been many cases related to the credibility of a financial report. A series of cases related to earnings management can be seen as follows:

Table 1 Cases Of Earnings Management In Indonesia

Number	Company	Case
1	PT. Cakra Mineral Tbk. (NN, 2016)	For more than two years, CKRA directors have claimed that CKRA has owned 55% of shares in Murui since August 2014, but it turns out that CKRA was never registered as a shareholder in Murui. Directors of PT.

		Cakra Mineral Tbk. (Boelio Muliadi) has deliberately inflated the value of assets and exaggerated the value of capital that has been paid in
2	PT Bank Bukopin, Tbk (E Janrosl & Lim, 2019)	OJK's findings regarding restated financial reports revised net profit in 2016 from IDR 1.08 trillion to IDR 183.56 billion, which was the largest decrease in the portion of fees and commission income which was income from credit cards.
3	PT Tiga Pilar Sejahtera Food (TPS) Tbk	The financial reports of PT Tiga Pilar Sejahtera Food (TPS) Tbk for the 2017 financial year were restated in 2020, including the 2018 and 2019 financial reports which had not been reported at that time. Based on published financial reports, TPS Food recorded a net loss for 6 months last year or as of June 2019 of IDR 61.17 billion, a decrease of 40% from June 2018 which had a loss of IDR 101.18 billion. Meanwhile, throughout 2018, AISA posted a net loss of IDR 123.43 billion, a drastic reduction of 98% from 2017, namely a net loss of IDR 5.23 trillion. The company's revenue fell 19% to IDR 1.58 trillion, from the previous IDR 1.95 trillion. This confirms PT Ernst & Young Indonesia's allegations and proves that there were earnings management practices carried out by the company's old management, namely by increasing reported profits (decreasing losses) from actual profits (losses) so that the losses experienced by the company looked bigger small
4	PT Lippo Karawaci Tbk (Caesario, 2018)	PT Lippo Karawaci Tbk financial report. reflects the occurrence of earnings management practices carried out by Lippo Group officials in the financial statements in the first semester of 2018. This means that incidents of alleged earnings management cases involving Lippo Group officials have not been reflected there. As well as the company's prestigious project, namely Meikarta. However, this drastic increase in net profit was caused by profits from the deconsolidation of PT Mahkota Sentosa Utama (MSU) or the developer of Meikarta, an indirect subsidiary of the issuer with the ticker PT Lippo Karawaci Tbk. (LPKR), with a net profit of Rp. 1.3 trillion.
5	PT. Asuransi Jiwasraya (Putri, 2020)	in 2019 PT. Jiwasraya Insurance has polished sales data for JS Saving Plan instruments and placed funds from the savings plan in low quality stock instruments. The BPK assesses that there was engineering carried out during share buying and selling transactions. As a result, the price of the shares purchased does not reflect the actual price.
6	PT. Waskita Karya Tbk (Forddanta, 2023)	PT. Waskita Karya Tbk. The company with the stock code WSKT is suspected of manipulating financial reports so that it gives the impression that the company has been profitable for years. In reality, cash flow from WSKT has never been positive.

Data sources processed by researchers, 2024

From these cases, it can be said that even though the company has gone public there is no guarantee that high profits will also mean high quality. Companies listed on the Indonesia Stock Exchange (BEI) prepare financial reports using the accrual basis (Sutapa & Suputra, 2016). The accrual basis was chosen in preparing financial reports because it is more rational and fair in reflecting the company's real financial condition. The basic advantage of accrual is that it is in the same time unit. However, the use of the accrual basis makes it possible to modify financial reports to produce the desired amount of profit (earnings). Management can freely determine the method for preparing financial reports as long as they are in accordance with applicable standards. Earnings management occurs as a result of opportunities obtained by managers who have flexibility in choosing accrual-based accounting methods (Veno & Sasongko, 2017). Management will choose certain methods to obtain profits that suit their motivation (Hapsoro & Hartomo, 2016).

Management's opportunities arise because management (agents) have more information than owners (principals), or what is usually called information asymmetry. Managers can take advantage of information asymmetry to carry out profit management actions (Veno & Sasongko, 2017). The existence of information asymmetry will encourage management to present information that is not true, especially if the information is related to measuring manager performance (Dhaneswari & Widuri, 2013). Profit management is carried out due to several motivations, including financial distress.

Financial distress is considered one of the factors that may have the most influence on earnings management. Financial distress is a company's inability or unavailability of funds to pay its maturing obligations (Yuyetta, 2015). Companies experiencing financial distress will immediately take action to respond to these conditions. Companies experiencing financial difficulties tend to carry out profit management practices to always provide a good signal in the eyes of investors. Profit management behavior increases as the financial difficulties experienced by the company increase. Previous researchers said that financial distress influenced management to carry out earnings management practices. If earnings management has occurred, the resulting financial reports will have low earnings quality.

Generally there are two ways for managers to carry out earnings management when financial distress occurs, namely firstly reducing profits by delaying income and recognizing costs early until they are at a loss and saving profits for the future and secondly increasing profits by recognizing income early and postponing costs for shows that the quality and performance of the company remains good when facing difficulties (Chairunesia et al., 2018). Many studies reveal that financial distress has a significant positive effect on earnings management (Damayanti & Kawedar, 2 and (Paramita, N. N., Sujana, E., & Herawati, 2017), but there is also research which states that financial distress has no effect on earnings management (Kristyaningsih et al., 2021).

Banking companies are one of the sectors supporting the country's economy whose contribution is very large. The banking sector is one of the sectors that plays an important role in developing a country's economy. In (*Undang-Undang RI Nomor 10 Tahun 1998 Tentang Perbankan*, 1998) concerning Banking, Banks are stated as business entities that collect funds from the public in the form of savings and distribute them to the public in the form of credit and/or other forms in order to improve people's living standards. Banks function as financial intermediary institutions that channel funds from parties who have funds to parties who need funds. Banks also play a role in channeling funds to the business sector to encourage economic growth and expand employment opportunities so that banks have become institutions that play an active role in the development of the country's economy with this role. Apart from being intermediaries, banks also act as institutions providing services in the financial sector such as savings, deposits, current accounts and other payment traffic.

There are still inconsistencies in the results of previous research regarding financial distress and management practices, thus encouraging researchers to conduct research again to look at the influence of financial distress on earnings management practices.

Literature Review and Hypotheses

Signal Theory

According to (Spence, 1973), signaling theory is a signal given by management to convey information regarding relevant financial reports so that it is used for decision making by external parties. This theory emphasizes giving signals by management to reduce asymmetric information by discussing the positive and negative signals company management conveys to shareholders (Lo, 2012). However, there are various actions taken by internal parties to deliberately convey information so that it cannot be directly observed by external parties (Butar, 2014).

Finansial Distress

Financial distress is a condition where operating cash flow is no longer sufficient to meet the company's various current obligations, for example interest costs and others (Wruck, 1990). (Ajeng Rizka Riadiani, 2015) explain that financial distress is a deviant event and a financial pressure that leads to bankruptcy. If conditions like this are allowed to continue, the company will go bankrupt. Financial distress is the stage of decline in financial condition experienced by a company, which occurs before bankruptcy or liquidation. This condition is usually characterized by delays in delivery, decreased product quality and delays in bill payments from banks, etc. Financial distress can be measured using the Altman Z-score (Celli, 2015).

$Z' = 1{,}200\ Z1 + 1{,}400\ Z2 + 3{,}300\ Z3 + 0{,}600\ Z4 + 1{,}000\ Z5$

Information :

Z’ = Overall index of bankruptcy

Z1 = Working Capital to Total Assets

Z2 = Retained Earnings to Total Assets

Z3 = EBIT to Total Assets

Z4 = Market Value Equity to Book Value of Total Debt

Z5 = Sales to Total Assets

The criteria used to predict company bankruptcy in this model are that companies with a Z score > 2.99 are classified as healthy companies, while companies with a Z score < 1.81 are classified as potential bankrupt companies. Furthermore, a score between 1.81 and 2.99 is classified as a company in the gray area (Peter & Yoseph, 2011)

Earnings Management

Earnings management is a form of managing income (cash inflow) and expenditure (cash outflow) carried out by management to obtain the desired level of profit for the benefit of the company or even a party. Earnings management is one of the variables that can damage the credibility of financial reports, this action adds bias to financial reports and can confuse consumers or investors who believe that engineered profit figures are the same as non-engineered profit figures. Earnings management occurs when financial report information related to a transaction is exploited and manipulated by managers to influence contract conclusions, obscuring the company's true economic performance from stakeholders (Healy & Wahlen, 2005). Earnings management carried out by manipulating actual facts regarding excessive costs or recognition of unreal income will increase the value of profits and influence investor perceptions (Senjaya et al., 2021).

According to (Windharta, S. W., & Ahmar, 2014) earnings management is formed because there are principals and agents who are trying to obtain maximum welfare for their own desires. Because of this, the agent also takes actions that disregard the interests of the principal. This shows information asymmetry within a company. If information asymmetry is very high in the company, the principals do not have the opportunity to supervise or control the actions carried out by the agents, so in this case the managers/agents have the opportunity to carry out earnings management (Medyawati, 2016)

Earnings management is measured by a modification of the Jones (1991) model. Companies with high discretionary accruals show low quality profits. Likewise, companies with low discretionary accruals show high quality company profits. There is a formula used to determine earnings management from the Modified Jones model (1995), namely:

a. Determine the total accruals score
   TACit = NIit – CFOit
b. Determining the accruals score is estimated with the OLS regression equation:
   TACit/(Ait-1) =ß1(1/(Ait-1)) + ß2((REVit-REVit-1)/(Ait-1))+ ß3(PPEit/(Ait-1))+ε
c. Determining the Non-discretionary accrual (NDA) score
   NDAit = ß1(1/(Ait-1)) + ß2((REVit-REVit-1)/(Ait-1)-(RECit-REcit-1)/(Ait-1))+ ß3(PPEit/(Ait -1))+ε
d. Calculate the DA (discretionary accruals) value which is a measure of earnings management using the formula:
   DAit = TACit/(Ait-1) - NDAit
   Where :
   TAit-1: Total assets in company i in year t-1
   NDAit: Nondiscretionary accrual at company i in year t
   TACit : Total Accruals at company i in period t
   REVit-1: Revenue at company i year t-1
   Nit: Net profit in company i year t
   DAit : Discretionary accrual at company i in year t
   PPEit: Fixed assets in company i year t
   CFOit: Operating cash flow in company i year t
   RECit-1: Receivables from company i in year t-1
   RECit: Receivables from company i in year t
   REVit: Revenue at company i year t

Research Hypothesis

According to (Jacoby et al., 2019) publicly traded companies with financial problems will be encouraged to participate in earnings management activities to avoid default. This shows that company executives who experience financial distress try to do well to obtain funds from third parties and to get bonuses and other forms of payment. The agency theory explains that the company's level of financial distress causes managers to be motivated to cover up the company's true condition by carrying out earnings management. Managers have more information than shareholders. Previous research by (Mustika et al., 2020) and (Chairunesia et al., 2018) found that financial distress has a positive effect on earnings management. This means that managers will increasingly carry out earnings management if the company experiences higher levels of financial distress. Based on this description, it can be concluded that when a company is in a financial crisis, managers will carry out earnings management as a means of protecting their jobs and keeping the company afloat while trying to perform well.

Hiphotesis : Financial distress has a positive effect on earnings management practices

METHODS

This research design uses a quantitative approach. This research examines the influence of financial distress variables on earnings management in banking sector companies listed on the IDX for the 2018-2022 period. The reason for choosing this research location is because banking is a sector that plays a role as a collector and distributor of public funds and aims to support the implementation of national development in order to increase the distribution of development and its results, economic growth and national stability, towards improving the standard of living of many people. The population in this study are banking companies listed on the Indonesian Stock Exchange. Sample selection using purposive sampling. The samples obtained were 80. The operational definition of variables in this research can be summarized in the table below:

Table 2. Operational definitions of variables and variable measurement

Variable	Indicator	Formula
Finansial Distress	Altman Z score	Z' = 1,200 Z1 + 1,400 Z2 + 3,300 Z3 + 0,600 Z4 + 1,000 Z5
Eaarnings management	Discretionary Accruals	DAit = TACit/(Ait-1) - NDAit

Data processed by researchers,2024

The type of data in this research is secondary data. Secondary data in this research are annual reports of banking companies listed on the IDX for 2018-2022. The data collection technique in this research uses documentation studies. The data analysis method in this research uses statistical hypothesis testing. Hypothesis testing in this research uses Multiple regression by SPSS.

RESULTS AND DISCUSSION

Descriptive Results

Table 3 Results Of Descriptive Statistical Tests

Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
finansial distress	80	-.51	3.16	.4764	.63299
earning managements	80	-.22	.08	-.0365	.06663
Valid N (listwise)	80				

Source: SPSS output, 2024

Descriptive Statistics will present the average value, maximum value, minimum value and standard deviation value of each variable studied. Table 3 is an illustration of the results of descriptive statistical testing of the variables used in this research. Based on the output results of descriptive statistical testing from table 3, it is known that there were 80 samples used in this research. The dependent variable used in this research is earnings management (y) which is measured using discretionary accruals. The financial distress variable has a minimum value of -0.51, a maximum value of 3.16, the average financial distress value is 0.4764 with a standard deviation of 0.63299. The earnings management variable has a minimum value of -0.22, a maximum value of 0,08, and has an average of -0.0365 and a standard deviation of 0.06663.

Classic Assumption Test
Normality test
Table 4 One Sample Kolmogrov Sminov Test

One-Sample Kolmogorov-Smirnov Test

		Unstandardized Residual
N		80
Normal Parameters[a,b]	Mean	.0000000
	Std. Deviation	.06458382
Most Extreme Differences	Absolute	.095
	Positive	.082
	Negative	-.095
Test Statistic		.095
Asymp. Sig. (2-tailed)		.070[c]

a. Test distribution is Normal.

b. Calculated from data.

c. Lilliefors Significance Correction.

Source: SPSS output, 2024

Based on table 4 above, it can be seen that the Asymp.Sign value is 0.070 > 0.05, meaning that the data distribution is normal.

Autocorrelation test
Table 5 Autocorrelation Test

Model Summary[b]

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.246[a]	.060	.048	.06500	2.068

a. Predictors: (Constant), finansial distress

b. Dependent Variable: earning managements

Source: SPSS output, 2024

There is no autocorrelation when the Watson Durbin value lies between du and (4-du), then it means there is no autocorrelation. In this study, the du value was 1.6114. The Watson durbin value was 2.068. 4-du value = 4- 1.6114 =2.3886. The DW value of 2.068 is located between du and 4-du (1.6114 < 2.068 < 2.3886). So it is said that the data is free from autocorrelation.

Heteroscedasticity Test
Table 6 Heteroscedasticity Test

Coefficients[a]

Model		Unstandardized Coefficients B	Std. Error	Standardized Coefficients Beta	t	Sig.
1	(Constant)	.933	.270		3.459	.001
	Finansial Distress	.147	.076	.215	1.948	.055

a. Dependent Variable: ABS_Res

Source: SPSS output, 2024

Based on table 6 above, it can be seen that the significance value of the financial distress variable on the absolute residual is 0.55>0.05, meaning that heteroscedasticity does not occur.

Hypothesis Testing

Table 7 Simple Regression Analysis

Coefficients[a]

Model		Unstandardized Coefficients B	Std. Error	Standardized Coefficients Beta	t	Sig.	Collinearity Statistics Tolerance	VIF
1	(Constant)	-.049	.009		-5.358	.000		
	finansial distress	.026	.012	.246	2.238	.028	1.000	1.000

a. Dependent Variable: earning managements

Source: SPSS output, 2024

Based on the results of testing with regression, the following regression equation is obtained.

$$Y = -0.049 + 0.026X + e$$

Based on the regression equation above, it can be interpreted that:

1. The constant value is -0.049. This means that when the financial distress variable does not exist, the earnings management value is -0.049

2. A regression coefficient of 0.026 for variable X implies that a one-unit increase in financial distress is associated with a predicted 0.026-unit increase in earnings management, holding all other variables constant

Based on table 7 above, it can be seen that the significance value of financial distress is 0.028 <0.05 and the calculated t value is 2.238 > t table 1.66412, so it can be concluded that the financial distress variable has an effect on earnings management. The regression coefficient is 0.026, meaning that when the financial distress variable increases by 1 unit, the earnings management variable will increase by 0.026 units. From the results of this test it can be concluded that financial distress has a positive significant effect on earnings management, so Hipothesis is accepted.

The results of this research are in accordance with agency theory (Jensen & Meckling, 1976) and signal theory which states that the existence of a contract between management (agent) and owner (principal) will give rise to information asymmetry which causes management to act in accordance with its interests, not the owner's. This research proves that when a company experiences financial difficulties (is in a state of financial distress), management will respond by carrying out earnings management (profit manipulation) so that it looks good in the eyes of the owner or other stakeholders. The results of this research support previous research conducted by (Damayanti & Kawedar, 2018) and (Paramita et al, 2017).

Coefficient of determination

Table 8 Determination Model

Model Summary[b]

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.246[a]	.060	.048	.06500	2.068

a. Predictors: (Constant), finansial distress

b. Dependent Variable: earning managements

Source: SPSS output, 2024

From the table above, it can be seen that, earnings management variability can be explained by the financial distress variable of 6%, while the remaining 94% is explained by other variables outside the research.

Discussion

The results of this research show that financial distress has a significant positive effect on earnings management. Financial distress is a situation where the income or financial income of an organization or company decreases, which can give rise to a form of bankruptcy when this condition cannot be resolved immediately by management (Octaviani & Sofie, 2019). This is supported by agency theory that there are competing interests, managers carry out earnings management under the pretext of saving the company but apart from that to save their position and interests. So that the company can be saved, management carries out earnings management when the company is experiencing financial difficulties so that it continues to get funds from third parties to fulfill its obligations and other operations. Companies experiencing financial distress have the potential to go bankrupt and create an opening for management to take opportunistic actions to carry out earnings management practices by increasing their profits, where this action manipulates the values contained in the financial statements so that the information displayed does not correspond to the actual situation. So it can be concluded that the influence in this research is significantly positive, which means that the higher the company experiences financial distress, the higher the company will carry out earnings management.

This research provides evidence that financial distress affects earnings management carried out by management. This strengthens existing theories, from agency theory and signal theory. Judging from agency theory, where there is information asymmetry between the agent and the principal, each will act in accordance with their interests. Management will carry out earnings management in line with the financial difficulties faced, this is done to show performance as an agent for the principal. Judging from signal theory, this proves that when management conveys financial difficulties to the principal/stakeholders, it will be a negative signal for them, which will lead to a fall in company value which will have an impact on decreasing agent performance.

From This Research, the contribution given by independent variables to earnings management variables is small, so it is recommended that further research add independent variables out-side this research and use other sectors as a basis for further research.

CONCLUSIONS

Financial distress has a positive effect on earnings management. This research proves that when a company is in financial difficulties, management will manipulate profits to cover up the situation to parties outside the company, so that the company looks good in the eyes of stakeholders.

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