The Effect of Financial Distress on Earnings Management with Managerial Ownership as Moderating Variable

I Komang Sutrisna Adi Natha[1]
I Gde Ary Wirajaya[2]
[1,2]Fakultas Ekonomi dan Bisnis Universitas Udayana, Indonesia
**Correspondences*: sutrisna.adi20@student.unud.ac.id

ABSTRACT

This study sought to gather empirical evidence about the effect of financial distress on earnings management moderated by managerial. The study conducted on transportation and logistics firms listed on the IDX during the period from 2020 to 2022. The sample determining method used nonprobability sampling through total sampling with 60 observations as sample. Moderated Regression Analysis (MRA) was utilized as the data analysis technique. The result showed that manager would take advantage of asymmetric information and were encouraged to take earnings management actions in order to minimize the impact of financial distress. Furthermore, managerial ownership weakened the influence of financial distress on earnings management. When faced with conditions of financial distress, management owned the firm shares would act in harmony with principal.

Keywords: Earnings Management; Financial Distress; Managerial Ownership.

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Pengaruh Financial Distress pada Manajemen Laba dengan Kepemilikan Manajerial sebagai Pemoderasi

ABSTRAK

Penelitian ini bertujuan untuk mendapatkan bukti empiris mengenai pengaruh financial distress pada manajemen laba dimoderasi oleh kepemilikan manajerial. Penelitian ini dilakukan pada perusahaan transportasi dan logistik yang terdaftar di BEI selama periode 2020 sampai 2022. Metode penentuan sampel menggunakan nonprobability sampling melalui total sampling dengan jumlah observasi sebanyak 60 amatan sebagai sampel. Moderated Regression Analysis (MRA) digunakan sebagai teknik analisis data. Hasil penelitian menunjukkan bahwa manajer akan memanfaatkan asimteri informasi dan terdorong untuk melakukan tindakan manajemen laba untuk mengurangi dampak financial distress. Selanjutnya, kepemilikan manajerial memperlemah pengaruh financial distress pada manajemen laba. Ketika menghadapi kondisi financial distress, manajemen yang memiliki kepemilikan saham akan bertindak selaras dengan prinsipal.

Kata Kunci: Manajemen Laba; Financial Distress; Kepemilikan Manajerial.

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INTRODUCTION

During a crisis such as the COVID-19 pandemic (Coronavirus Disease), a firm will face various challenges related to the firm's performance and survival (going concern). These challenges include hampered operational activities, high liabilities, risk of default, and risk of bankruptcy. Firms will experience pressure, especially try to survive amidst business competition. Management will tend to take actions such as earnings management. According to Scott (2015:445), earnings management action is managers' choices on accounting policies or real activities that can influence earnings to reach specific purposes from the reported earnings. Earnings management is carried out as an effort which chooses accounting policies and methods that adhere to Generally Accepted Accounting Principles. (Ghazali et al., 2015; Setiawan & Dwiana Putra, 2019).

Earnings management is carried out by managers due to the importance of information in financial statements. As to the Statement of Financial Accounting Standards (PSAK) No. 201 of 2024 (Institute of Indonesia Chartered Accountants, 2024), in order to provide the benefits to most of financial statements users on making economic decisions, financial statements are meant to provide information about the entity's financial position, financial performance, and cash flow. One important component of financial reports is earnings (Purnami Putri & Wirakusuma, 2022). When making decisions, users are primarily concerned with earnings information, which represents the firm's performance. Earnings not only shows the success of the firm, but also the managers' accountability and their performance with regard to corporate resources.

Agency theory served as the theoretical foundation for this study. According to this theory, there may be a connection between two parties in a corporation, where one person manages the firm as an agent while the other serves as a principle which are owner and shareholders (Jensen & Meckling, 1976). Both parties try to put their own interests above the firm's interests. As an agent, managers are responsible for recording the best possible amounts on financial reports in order to optimize the owner's profits. However, managers prioritize their own well-being. In addition, managers will have better internal information and firm prospects than owners. With this asymmetric information, it can increase managers' tendency to take earnings management actions, especially when facing the COVID-19 pandemic.

The phenomenon of earnings management indications during the COVID-19 pandemic in Indonesia could be found at PT Garuda Indonesia. Quoted from the Directorate General of State Assets website, PT Garuda Indonesia experienced several times the risk of liquidation and bankruptcy lawsuits. According to the firm's notes to the financial statements, the operating loss for the 2021 period was USD 2.6 billion, while for the 2022 period it was USD 2.5 billion. However, in the 2021 period there was impairment of non-financial assets of USD 1.4 billion and early lease contract termination of USD 887.9 million. Furthermore, there was a drastic increase in net income from a net loss of USD 4.2 billion in the 2021 period to a profit of USD 3.7 billion in the 2022 period.

Indication of earnings management also occurred at PT Airasia Indonesia. According to the firm's notes to the financial statements, the firm had operating revenues of IDR 1.6 trillion in the 2020 period and IDR 626 million in the 2021

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period. However, the firm actually experienced a loss before income tax of IDR 3.07 trillion in the 2020 period and IDR 1.9 trillion in the 2021 period. This drastic difference occurred because in the 2020 period there was impairment losses of other receivables of IDR 310.77 billion, impairment losses of assets of IDR 250 billion, and loss on sale of fixed assets of IDR 33 billion. By recognizing these losses, PT Airasia Indonesia could reduce its losses in the 2021 period.

Previous research such as Wilamsari et al. (2022), Damayanti & Nugrahanti (2022), and Aljughaiman et al. (2023) showed that financial distress was the element regarded to have the greatest effect on earnings management. Before things like bankruptcy or liquidation happened, a firm's financial performance was declining, and this was known as financial distress. (Platt & Platt, 2002). According to Lassoued & Khanchel (2021), the firm would experience financial distress during the COVID-19 pandemic due to limited operational activities. Limited operational activities were reflected in the declining contribution of all the firms to economic growth.

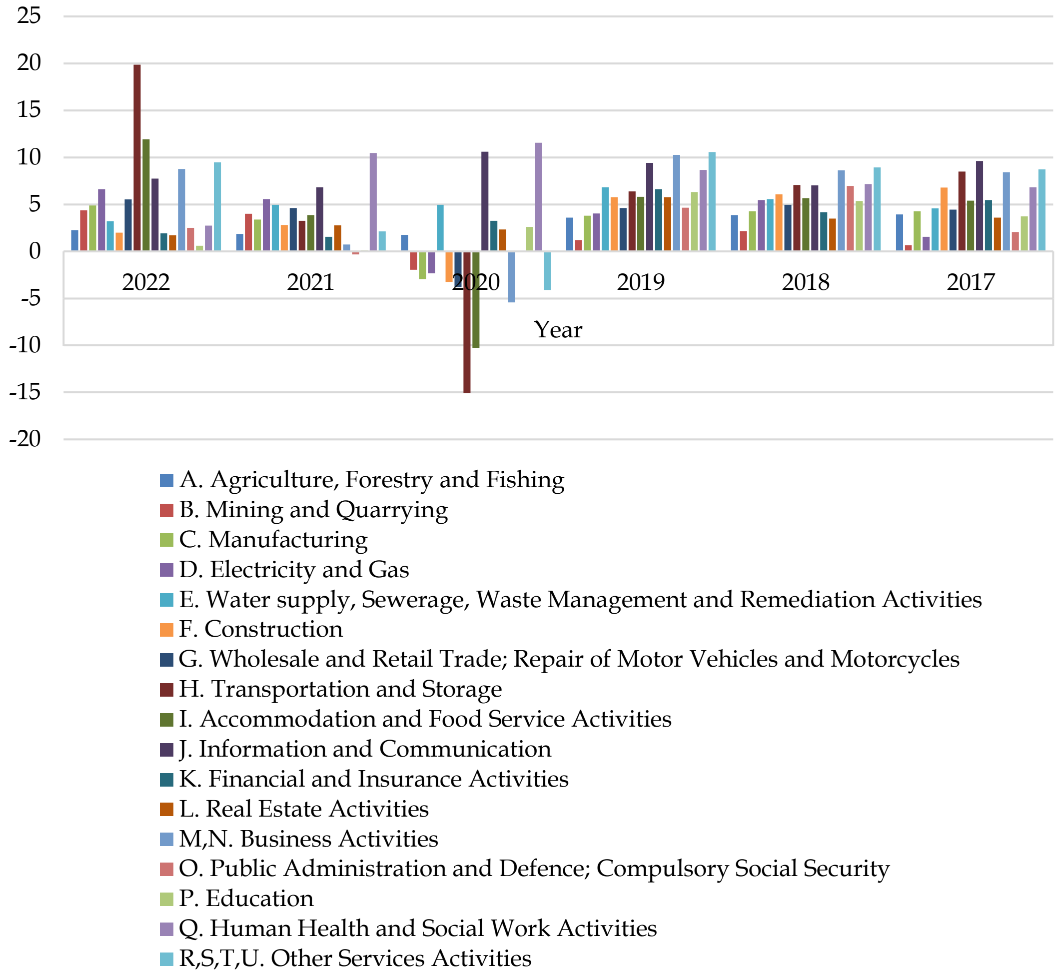

Figure 1. Contribution of All Firm Sectors to Indonesia's Economic Growth Rate for the 2017-2022 Period (Percent) (y-on-y)

Source: Central Bureau of Statistics (Research Data), 2024

Based on Figure 1, the firm sector most affected was transportation and logistics (storage). This sector experienced limited operational activity, which led to poor performance. In this case, limited operational activities caused decreasing operating cash flow so the firm's ability to pay off its obligations would also decrease. Financial distress conditions would occur if the firm had difficulty paying off the debts and other obligations (Setiawan & Dwiana Putra, 2019). The firm would be in financial distress where the firm has a high risk leverage ratio, default risk, and bankruptcy risk. Furthermore, firms would be encouraged to carry out earnings management (Campa & Miriano, 2015).

Previous studies had shown inconsistent results. Research by M. Putri & Naibaho (2022), Puri & Gayatri (2018), Putri & Rachmawati (2019), Wilamsari et al. (2022), Damayanti & Nugrahanti (2022), Prameswari et al. (2022), Kurnia & Mulyati (2023), and Aljughaiman et al. (2023) obtained that financial distress positively affected earnings management. However, Ghazali et al. (2015), Oktrivina (2022), Fitriza et al. (2021), and Bin Mohamad Kamal & Binti Khazalle (2021) found that financial distress had a negative effect on earnings management. Meanwhile, Chrisantha & Suhartono (2022), Mahardhika & Surjandari (2022), and Tandiawan (2023) obtained the following results that earnings management didn’t affected by financial distress.

The Inconsistencies in research results can be overcome through an approach, namely contingency (Govindarajan, 1986). This approach was carried out by adding other variables that might act as moderating variables. Tsafiq & Agustiningsih (2021), Wandi (2022), and Damayanti & Nugrahanti (2022) revealed that managerial ownership was most strongly suspected as a moderating variable. According to Rofiananda et al. (2019), managerial ownership is the ownership share in which a percentage of shareholders are actively involved in the decisions and actions of the firm, particularly when the firm is facing financial issues or on decisions making. Therefore, this study added managerial ownership as a moderating variable.

Due to asymmetric information, there will be agency problems between agents and principals while the firm is in financial distress (Jacoby et al., 2019). Managers will have better information than owners, so that asymmetric information is utilized by managers to take certain actions. In order to declare strong financial performance and lessen the effects of financial distress, managers would be urged to take actions such as earnings management.

The research result of Chairunnisa et al. (2021) was consistent with the agency theory, which postulated that managers attempted to conceal firm performance by doing earnings management when they were in a financial crisis. According to Jacoby et al. (2019), public firms that had problems with financial performance would be encouraged to carry out earnings management action to avoid this occurrence (default). Firms that were in financial distress had a strong urge to carry out earnings management (Campa & Miriano, 2015). In addition, the firm with financial distress condition tended to do accrual earnings management (Li et al., 2020). Research M. Putri & Naibaho (2022), Puri & Gayatri (2018), Putri & Rachmawati (2019), Wilamsari et al. (2022), Damayanti & Nugrahanti (2022), Prameswari et al. (2022), Kurnia & Mulyati (2023), and Aljughaiman et al. (2023)

shown that earnings management was positively affected by financial distress. The hypothesis proposed based on theoretical and empirical studies was:

H_1: Financial distress has a positive effect on earnings management.

Jensen & Meckling (1976) in agency theory explained that differences in interests and also asymmetric information can cause managers as agents to carry out deviant actions. Managers could adjust reported earnings to justify their actions (Kazemian & Sanusi, 2015). To overcome this agency problem, the priorities of both parties need to be aligned, one of which is through managerial ownership. Managerial ownership is able to place managers not only acting as agents, but also as principals. When faced with conditions of financial distress, managers as administrators will have information and act in harmony with the interests of shareholders. This will reduce agency problems when dealing with conditions of financial distress.

Research by Wandi (2022) showed that managerial ownership could reduce managers opportunistic behavior and reduced agency problems. Chen & Steiner (1999) argued that managerial ownership could be assumed as a tool monitoring internally to resolve agency problems. Previous studies such as Mahariana & Ramantha (2014), Pramesti & Budiasih (2017), Arthawan & Wirasedana (2018), Mardnly et al. (2021), Nugrahanti & Nugroho (2022), Le & Huu Anh (2023), Putra et al. (2023), and Sari et al. (2023) showed that earnings management could be declined by managerial ownership. In addition, research by Tsafiq & Agustiningsih (2021) and Damayanti & Nugrahanti (2022) showed that managerial ownership was able to weaken the effect of financial distress on earnings management. Low managerial ownership would encourage and increase the tendency to carry out earnings management when facing poor performance (O'Callaghan et al., 2018). The hypothesis proposed based on theoretical and empirical studies was:

H_2: Managerial ownership weakens earnings management action affected by financial distress.

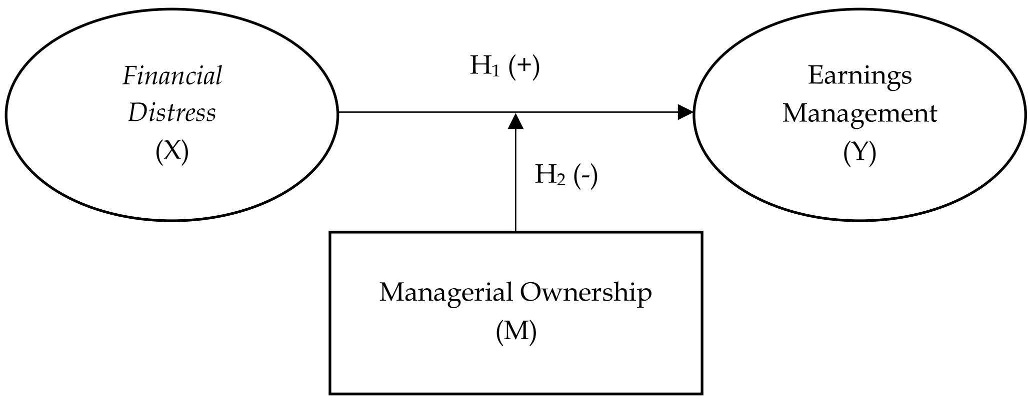

Figure 2. Research Conceptual Framework
Source: Research Data, 2024

RESEARCH METHODS

This study used an associative quantitative method. The study area included transportation and logistics firms listed on the IDX during the period from 2020 to 2022, with access to both the Indonesia Stock Exchange website and the firm's website. Transportation and logistics firms were used in this research because they were the most affected sector during the COVID-19 pandemic. The independent variable (X) was financial distress and the earnings management as dependent variable (Y), with a moderating variable (M) represented by managerial ownership.

In this study, accrual earnings management was identified as a detection of earnings management. The measure of accrual earnings management utilized was discretionary accruals, determined through the Modified Jones model developed by Dechow et al. (1995). Discretionary accruals calculation in Kurnia & Mulyati (2023) are as follows:

Calculate the total accruals (TAC)

$$\mathrm{TAC}_{it} = \mathrm{NI}_{it} - \mathrm{CFO}_{it} \quad \ldots(1)$$

Calculate the total value of accruals estimated using the regression equation.

$$\frac{\mathrm{TAC}_{it}}{\mathrm{TA}_{it-1}} = \alpha_1\left(\frac{1}{\mathrm{TA}_{it-1}}\right) + \alpha_2\left(\frac{\Delta\mathrm{Rev}_{it}}{\mathrm{TA}_{it-1}}\right) + \alpha_3\left(\frac{\mathrm{PPE}_{it}}{\mathrm{TA}_{it-1}}\right) + \varepsilon_{it} \quad \ldots(2)$$

Calculate the nondiscretionary accruals

The value of each coefficient is obtained after carrying out a regression which is then enters into the equation below to calculate the value of nondiscretionary accruals (NDA).

$$\mathrm{NDA}_{it} = \alpha_1\left(\frac{1}{\mathrm{TA}_{it-1}}\right) + \alpha_2\left(\frac{\Delta\mathrm{Rev}_{it} - \Delta\mathrm{Rec}_{it}}{\mathrm{TA}_{it-1}}\right) + \alpha_3\left(\frac{\mathrm{PPE}_{it}}{\mathrm{TA}_{it-1}}\right) + \varepsilon_{it} \quad \ldots(3)$$

Calculate the discretionary accruals

Discretionary accruals (DAC) is the difference between total accruals (TAC) and nondiscretionary accruals (NDA).

$$\mathrm{DAC}_{it} = \frac{\mathrm{TAC}_{it}}{\mathrm{TA}_{it-1}} - \mathrm{NDA}_{it} \quad \ldots(4)$$

where:

TAC_{it} = Total accruals of company i in period t
NDA_{it} = Nondiscretionary accruals of company i in period t
DAC_{it} = Discretionary accruals of company i in period t
NI_{it} = Net income of company i in period t
CFO_{it} = Operating cash flow of company i in period t
TA_{it-1} = Total assets of company i in period t-1
ΔRev_{it} = Change in sales of company i in period t
ΔRec_{it} = Change in receivables of company i in period t
PPE_{it} = Fixed assets of company i in period t
$\alpha_1, \alpha_2, \alpha_3$ = Parameter value of the regression equation
ε_{it} = Error term company i in period t

This study uses the Modified Altman Z-score model for financial distress measurement. Modified Altman Z-score formula in Sagho & Merkusiwati (2015) is:

$$\text{Z-score} = 6.56A + 3.26B + 6.72C + 1.05D \quad \ldots(5)$$

where:
A = Working Capital to Total Assets
B = Retained Earnings to Total Assets
C = Earnings Before Interest and Taxes (EBIT) to Total Assets
D = Market Value of Equity to Book Value of Total Liabilities

Managerial ownership measurement in Prasetya & Gayatri (2016) is:

$$\text{Managerial Ownership} = \frac{\text{Quantity of shares held by management}}{\text{Total outstanding shares}} \times 100\% \quad (6)$$

All of the transportation and logistics firms listed on the Indonesia Stock Exchange made up as population. Nonprobability sampling with total sampling was the approach to carry out the sampling which included all of the transportation and logistics firms listed on the IDX during the period from 2020 to 2022 as sample. In addition, nonparticipant observation was the method utilized to gather data. Meanwhile, Moderated Regression Analysis (MRA) was used as a data analysis technique. We use SPSS or the Statistical Package for the Social Sciences to analyze the data.

RESULTS AND DISCUSSION

Table 1. Determination of Research Sample

Description	Number of Firms		
	Period 2020	Period 2021	Period 2022
Transportation and logistics firms listed on the IDX	27	28	31
Elimination of outlier data	(9)	(8)	(9)
Total observations for each period	18	20	22
Total Observations		60	

Source: Research Data, 2024

Based on Table 1, the transportation and logistics firms listed on the IDX for the 2020, 2021 and 2022 periods were 27, 28 and 31 firms respectively. However, there were outlier data in the periods 2020, 2021, and 2022 9, 8, and 9 observations respectively. The outlier data were then eliminated so as not to cause interference during statistical testing. Thus, the total observations sampled were 60 observations.

Tabel 2. Statistik Deskriptif

	Number of Observations	Minimum	Maximum	Mean	Standard Deviation
Earnings Management	**60**	**-0.354**	**0.191**	**-0.028**	**0.111**
Financial Distress	**60**	**-17.561**	**24.060**	**1.899**	**8.918**
Managerial Ownership	**60**	**0.000**	**0.148**	**0.017**	**0.038**

Source: Research Data, 2024

Table 2 indicates that -0.354 was the minimum value of earnings management. Meanwhile, 0.191 was the maximum value. The earnings management variable was close to the maximum value, with a mean value of -0.028. Additionally, earnings management had a standard deviation value of 0.111

which was higher than the mean value. The variable financial distress had a minimum value of -17,561. Meanwhile, 24,060 was the maximum value. With a mean score of 1,899, variable financial distress was close to the minimum value. The standard deviation of variable financial distress was 8.918, higher than the mean value. Last, the minimum value of managerial ownership was 0.000. Meanwhile, 0.148 was the maximum value. The mean value of 0.017 for managerial ownership which was in close to the minimum value. The standard deviation value of the managerial ownership variable was 0.038, higher than the mean value.

The normality test was assessed using test normality kolmogorov smirnov. Based on the result, it was obtained Asymp. Sig. (2-tailed) was 0.057 which exceeded the significance level of 0.05 indicating that the data exhibited normal distribution. The heteroscedasticity test was assessed using the Glejser test. Based on the heteroscedasticity test, the variable significance value of financial distress was 0.134, while the managerial ownership had a significance value of 0.880. These two values were greater than significance level of 0,05, so that the regression model didn't show symptoms of heteroscedasticity. Next, the autocorrelation test was carried out using a run test. Based on the result, the Asymp. Sig. (2-tailed) was 0.118 which exceeded the significance level of 0.05. Therefore, no autocorrelation occurred.

Table 3. Moderated Regression Analysis Result

Model	Unstandardized Coefficients B	t	Sig.
(Constant)	-0.042	-2.977	0.004
Financial Distress	0.006	3.984	0.000
Managerial Ownership	0.965	2.029	0.047
XM	-0.230	-2.236	0.029
Adjusted R Square	0.215		
Sig. F	0.001		

Source: Research Data, 2024

According to Table 3, the regression equation was derived as follows.

$$Y = -0.042 + 0.006X + 0.965M - 0.230XM \quad (7)$$

Earnings management had a value of -0.042 if the managerial ownership (M), financial distress (X), and the interaction between financial distress and managerial ownership (XM) all equaled zero, according to the constant value (α) of -0.042. The financial distress variable had a regression coefficient of 0.006, meaning that if other factors remained constant and the financial distress variable increased by 1 unit, it would increase the earnings management value (Y) by 0.006 units. The earnings management value (Y) would increase by 0.965 units if the managerial ownership variable increased by 1 unit, provided that all other variables remain constant because the regression coefficient of managerial ownership was 0.965. With other variables held constant, the earnings management value (Y) would decrease by 0.230 units if the interaction between financial distress and managerial ownership (XM) increased by 1 unit because the regression coefficient of managerial ownership was -0.230.

Adjusted R Square (R^2) was 0.215, or 21.5 percent, according to Table 3. This meant that financial distress (X), managerial ownership (M), and the interaction between financial distress and managerial ownership (XM) could account for 21.5

percent of the explanation of the earnings management (Y), with other factors not included in the model for the remaining 78.5 percent.

The purpose of the F test was to evaluate the regression model's suitability for use in research. The F significant value determined was 0.001 based on Table 3. This value showed that the significance level of 0.05 was not exceeded by the significance value of F. It demonstrated that the regression model in this study was well-fitting and deserved further research.

The first hypothesis (H_1) stated that financial distress had a positive effect on earnings management. The t test result based on Table 3 showed that financial distress had a positive effect on earnings management in which the significance value of 0.000 was smaller than the significance level of 0.05. Jacoby et al. (2019) stated that public firms that were problematic financially would be encouraged to do earnings management activities to avoid default. This study was in line with research M. Putri & Naibaho (2022), Puri & Gayatri (2018), Putri & Rachmawati (2019), Wilamsari et al. (2022), Damayanti & Nugrahanti (2022), Prameswari et al. (2022), Kurnia & Mulyati (2023), and Aljughaiman et al. (2023) which stated that earnings management was positively affected by financial distress.

According to the second hypothesis (H_2), managerial ownership weakened earnings management action affected by financial distress. Based on Table 3, indicated that the interaction of financial distress and managerial ownership (XM) interact negatively with earnings management. The significance level of 0.05 was exceeded by the t significant value of 0.029. This indicated that managerial ownership was able to weaken earnings management action affected by financial distress. The finding of this study was consistent with Wandi (2022) about agency problems, which suggested that managerial ownership might lessen managers opportunistic conduct and agency problems. The result was in line with Tsafiq & Agustiningsih (2021) and Damayanti & Nugrahanti (2022), which showed that managerial ownership weakened the effect of financial distress on earnings management.

The results of this study also supported the agency theory proposed by Jensen & Meckling (1976). The connection between the principle and the agent as two parties was described by agency theory. Asymmetric information and disparities in interests were the hallmarks of agency problems. Serious agency issues arise when businesses face financial distress. To lessen the effects of financial distress, managers would be urged to use earnings management strategies. Moreover, agency problems might be resolved by managerial ownership. Managerial ownership was able to place the managers not only as agents, but also as principals. Managers would have information and act in harmony with the interests of shareholders. It would reduce agency problems when facing financial distress.

CONCLUSION

Firms that went through financial distress tended to engage in earnings management. Managers would take advantage of asymmetric information and were encouraged to take earnings management actions in order to minimize the impact of financial distress. Furthermore, managerial ownership weakened the influence of financial distress on earnings management. When faced with conditions of financial distress, management owned the firm shares would act in harmony with principal.

This research had limitations. First, this research only able to explain earnings management with adjusted R Square value amounted to 21.5 percent, so that future researchers might add other variables that were not included in this study such as compensation, leverage, and firm size. This study carried in the most affected sector during the COVID-19 pandemic, namely transportation and logistics. Therefore, future researchers were expected to conduct research on other affected sectors.

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