The Effect of Good Corporate Governance and Financial Distress on Earnings Management

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Abstract. The objective of this research is to investigate the impact of managerial ownership, institutional ownership, audit committee, independent commissioners, and financial distress on earnings management within the manufacturing sector of businesses listed on the Indonesia Stock Exchange over the year of 2020-2021. The assessment is grounded on the theoretical framework of Agency Theory. The study's sample consists of 32 manufacturing enterprises, and data analysis is conducted using the method of multiple linear regression analysis. The possibilities proposed in the research are: The presence of managerial ownership has a notable adverse impact on the practice of earning management. 2) The presence of institutional ownership has a noteworthy favorable impact on earnings management. 3) The impact of the audit committee on earnings management is not considerable. 4) The presence of independent commissioners has a notable adverse impact on the practice of earning management. The impact of financial crisis on earnings management is not shown to be statistically significant..

Keywords: Managerial ownership, Institutinal ownership, Audit comittee, Independent Commisioners, Financial distress, Earning Management

1 Introduction

One important component in the financial statements is profit. Profit is a component that is often used as a benchmark for principals in measuring company performance. Profit information is used internally to assist decision making and development of policies within the company.

Meanwhile, for external parties, profit information is used as a reference for consideration in making decisions whether a company is worthy of receiving and being able to manage the investment provided. Profit is often regarded as a significant determinant for investors and is commonly used as a benchmark for investment pursuits. The act of manipulating financial gains is sometimes referred to as earnings management.

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Earnings management refers to the purposeful actions undertaken by managers to alter financial reports within the boundaries allowed by accounting rules. The objective of such manipulation is to offer false information to readers of financial statements, ultimately benefiting the managers themselves. [1].

Earnings management is also an attempt by managers to maximize firm value by directing profit reporting at a certain level to maximize personal welfare. It is on this basis that profit is often assessed as a reflection of a manager's opportunistic behavior in beautifying their financial statements (fashioning accounting reports). This perspective is in line with agency theory which states that company management and separation of ownership will encourage each party to try to maximize their respective welfare. [2]..

There are several instances pertaining to the practice of earnings management. One aspect of inquiry is to the circumstances surrounding PT Tiga Pilar Sejahtera Food Tbk. The findings of an inquiry undertaken by Ernst & Young Indonesia into the financial accounts of PT Tiga Pilar Sejahtera Food Tbk in 2017 revealed suspected inflation in accounting items amounting to IDR 4 trillion, along with many other charges. In 2017, the financial statements of PT Tiga Pilar Sejahtera Food Tbk had an audit conducted by the Public Accounting business (KAP) Amir Abadi Jusuf, Aryanto, Mawar & Rekan, which maintains an affiliation with RSM International, a prominent global audit, tax, and consulting business. (accounting.binus.ac.id)

Another earnings management case is at PT Kimia Farma Tbk. where in 2001 management posted a net profit that should have been Rp.99.56 billion but was reported at Rp.132 billion which means 24.7% more than the profit that should have been. In addition, total assets that should have been Rp. 1.151 trillion were reported at Rp. 1.188 trillion. PT Kimia Farma's financial statements were previously audited by KAP Hans Tuana kotta & Mustofa (HTM) on December 31, 2001 and then re-examined by Bapepam on June 30, 2022. As a result, KAP Hans Tuana kotta & Mustofa (HTM) was fined Rp.100 million because has neglected to find errors in the recording of the financial statements. (kompasiana.com)

1.1. Agency Theory

According to agency theory, also known as agensy theory, the practice of earnings management is influenced by the presence of a conflict of interest between management (agent) and capital owners (principles). This conflict of interest arises as a result of the fact that both parties are working toward the accomplishment of goals that are in direct opposition to one another, specifically those goals that are associated with the receipt of management bonuses. The agency theory approach serves as the foundation for understanding difficulties related to profit management..

1.2. The Effect of Good Corporatw Governance on Earning Management

Jensen and Meckling (1976) also argued that expanding management ownership in a business would make it feasible to resolve conflicts of interest or conflicts of interest between agents and principals in the firm. This is because increasing managerial ownership in a company will result in more managerial ownership. In this situation, the agent will attempt to bring the interests of both parties into alignment, and there will be no major knowledge gaps between the agent and the principal. The presence of management ownership is also meant to strengthen oversight of the firm, develop rules that do not benefit just one party, and perhaps lower risks that may emerge inside the organization. These goals may be accomplished by the establishment of policies that benefit several parties.

An efficient monitoring procedure gives institutional ownership the power to exert influence over the administration of the company. Because the presence of institutional ownership may enhance oversight of the performance of management and give encouragement so that management does its job effectively, the presence of institutional ownership can reduce earnings management activities carried out by management [3]. In other words, institutional ownership can improve supervision of the performance of management and offer encouragement so that management does its job properly.

Institutional investors that own a significant number of shares will have a strong enough motivation to collect information, monitor management activities, and push for improved performance. When institutional investors have a relatively limited share ownership, they have less motivation to watch the opportunistic activities of management since they do not feel personally invested in the company. Institutional investors have a significant impact on the activities of profits management. This is due to the fact that the bigger the number of institutional shareholdings, the less probable it is that managers would manipulate earnings reporting by using certain accounting techniques. When there is a larger degree of institutional ownership of shares, there is also a higher level of earnings management in the company's financial statements. The process of creating financial reports that is carried out by managers is affected by the high degree of institutional ownership. As a result, managers are able to submit reports that are more or less satisfying.

Because the presence of an audit committee and independent commissioners in a company aims to supervise the course of company activities in the pursuit of company goals, the existence of an audit committee and independent commissioners has been shown to be effective in preventing earnings management practices [4]. This is because the existence of an audit committee and independent commissioners in a company aims to prevent earnings management practices. The presence of an audit committee in a corporation has the potential to curb earnings management techniques that are the direct consequence of opportunistic activities taken by managers. An audit committee that is equipped with knowledge and skills in the areas of finance and accounting will be in a better position to carry out effective monitoring, which will result in a decreased likelihood of false financial reporting by management [5].

The fact that public businesses often engage in business dealings that are fraught with potential conflicts of interest highlights the need of having independent commissioners on the scene. It is envisaged that the interests of minority owners as well as the interests of other stakeholders may be safeguarded with the presence of independent commissioners. The existence of an independent board of commissioners will tighten oversight of all business operational operations. Profit management actions will be reduced in proportion to the percentage of an independent board of commissioners that is present; conversely, the proportion of an independent board of commissioners that is present will increase. [6].

1.3. Financial Distress On Earnings Anagement

Financial distress occurs when a company experiences a lack of cash flow to fulfill its debt obligations, resulting in failure to return on investment, payment difficulties and violations of debt agreements and leading to bankruptcy. Managers, as one of the parties who are responsible for the sustainability of the company, will certainly try to maintain the company's financial performance during financial distress so as not to lose investors. One of the actions taken by managers is earnings management. This is explained in agency theory which states that the existence of information asymmetry that arises due to differences in interests will provide an opportunity for managers to change the information contained in financial reports to maintain financial performance that looks good in the eyes of investors [7].

2. Research Method

The study made use of a method called multiple regression analysis when it came to analyzing the data. This research included a total of 32 different manufacturing organizations, and it was conducted between the years 2020 and 2021. In addition, the researcher employed a sampling procedure that included purposive sampling in order to establish the total number of samples that should be included in this investigation. In this research, path analysis was used to find the causal link and to explain the direct and indirect impacts of a set of factors as causative variables. The variables that were utilized in this study to determine the causal relationship are listed below..

3. Result

3.1. Normality Test

An Asymp sig value of 0.200 was obtained, which demonstrates that the Asymp sig value (2-tailed) was more than 0.05 (Asymp sig 0.200 > 0.05). These findings may be seen in table 4.2, which contains the results of the normality test.

The results of the normality test with the Normal P-P Plot of regression standardized residual show that the data spreads around the diagonal line and follows the direction of the diagonal or the histogram graph. As a result, it is possible to draw the conclusion that the data is normally distributed and satisfies the normality assumption because the data appears to be normally distributed..

3.2. Autocorrelation Test

The statistical value of Durbin Watson (D-W) is calculated to be 1.4732 when using the software SPSS 25.0, and the results of these calculations are shown below. Because the D-W figure, which is now 1.4732, is within the range of -2 to +2, it may be concluded that there is no autocorrelation. Therefore, the autocorrelation test may be considered successful..

3.3. Multicollinearity Test

According to the criterion that multicollinearity does not exist if the VIF value is below 10 or the tolerance is over 0.10, it is known that the SPSS findings suggest that there is no multicollinearity, and this is because the values for the VIF and tolerance indicate that there is no multicollinearity. Therefore, the model with multiple regression lines that was used is suitable..

3.4. Heteroscedasticity Test

The heteroscedasticity test is based on the picture of the scatterplot, which demonstrates that the data does not follow a specific pattern or trend line, and instead is spread about the number 0 (located on the Y axis). As a result, one might conclude that the data exhibit homoscedasticity; alternatively, one can conclude that there is no heteroscedasticity and that the heteroscedasticity test has been satisfied..

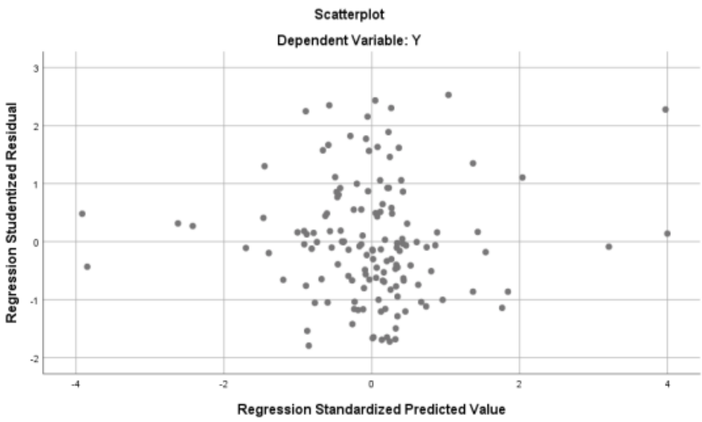

Fig. 1. Heteroscedasticity Test.

3.5 Hypothesis testing

According to the findings of the tests, a multiple linear regression analysis of the variables X1, X2, X3, X4, and X5 was able to explain the effect of 19.8% on Y (profit management), while the remaining 80.2% was affected by other factors that were not addressed in this study..

Table 1. Multiple Linear Regression Test Results and Partial Significance of Substructure 1.

Model Summary[b]				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	,445[a]	,198	,137	,0150129

a. Predictors: (Constant), X5, X2, X4, X3, X1

b. Dependent Variable: Y

Source: Output SPSS, 2023

Table 2. Partial Significance Test Result of Substructure 2.

Coefficients[a]						
Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	,102	,034		2,969	,004
	X1	-,077	,035	-,249	-2,217	,030
	X2	,014	,007	,230	2,059	,043
	X3	,000	,008	,003	,027	,978
	X4	-,029	,014	-,238	-2,154	,035
	X5	-,001	,002	-,053	-,479	,634

a. Dependent Variable: Y

Since the managerial ownership variable (X1) received a tcount of -2.217 from the ttable 1.99656 (tcount-2.217 ttable-1.99656), the relationship between (X1) and profit management (Y) is statistically significant and in a negative direction. H0 cannot be accepted. The H1 format is acceptable. The institutional ownership variable (X2) received a value of tcount of 2.059l, which is higher than ttable1.99656 (tcount2.059 ttable1.99656), indicating that the variable (X2) has a positive and substantial influence on profit management (Y). H0 cannot be accepted. H2 is permitted for use. The t value for the audit committee variable (X3) came in at 0.027, which is lower than the t table's 1.99656 value (t count 0.027 t table 1.99656) and the significance value came in at 0.978, which was higher than 0.05 (0.978 > 0.05). There is no positive or substantial influence that can be attributed to the variable (X3) on earnings management (Y). H0 has been approved. H3 is not accepted here. The independent commissioner variable (X4) received a tcount of -2.154, which was lower than ttable1.99656 (tcount-2.154 ttable1.99656), as well as a significance value of 0.035, which was lower than 0.05 (0.0350.05). The earnings management variable (Y) is significantly impacted in a negative way by the variable (X4). H0 cannot be accepted. The H4 visa is valid. The financial hardship variable (X5) received a t value of 0.479, which is lower than the t table value of

1.99656 (t count 0.479 is less than t table 1.99656) Additionally, the variable (X5) does not have a substantial impact on the management of profits (Y).

4. Conclusion

1. The findings of the hypothesis testing show that earnings management has a considerable negative influence on stock returns. This finding is in agreement with the first hypothesis (H1) that was developed for the purpose of this study and is based on the findings of the research. According to these results, the decline in stock returns that would result from corporations using earnings management strategies is inevitable. According to the agency theory, these findings may be viewed in the context of the contention that profits management in a firm emerges as a consequence of a struggle between shareholders (agents) and managers (principals).
2. the results of the testing that was done on the hypothesis that institutional ownership has a positive and substantial influence on profits management are consistent with these findings. The second hypothesis (H2) that was developed for this research states that institutional ownership does have an effect. This conclusion suggests that high levels of institutional ownership will result in an increase in earnings management activities. This is due to the fact that the presence of a larger majority shareholder increases the owner's ability to act in his or her own best interests.
3. The findings of the hypothesis testing show that the audit committee does not have a major impact on profits management, which is in line with the third hypothesis (H3) that was developed as part of this investigation and which can be found in this study. Based on these data, it seems that the audit committee does not have any impact on the degree to which profits management is increased or decreased.
4. According to the findings of the testing that was done on the fourth hypothesis (H4) that was developed for this investigation, independent commissioners have a considerable and unfavorable impact on earnings management. This finding is in agreement with the findings of the testing that was done on the hypothesis. According to these results, an increase in the number of independent commissioners in the firm will result in an improvement in the monitoring process of financial reports, which will allow for a reduction in the number of earnings management measures taken.
5. The findings of the study support the fifth hypothesis (H5) that was developed for this investigation, which states that financial strain does not have a substantial impact on earnings management. This finding is consistent with the findings of the hypothesis testing. According to these findings, the presence of a financial crisis has no impact on how profits are managed..

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