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Financial Distress and Earnings Management: The Role of Internal Control as Moderating Variable

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ABSTRAK

Berbagai jenis potensi risiko seperti pandemi COVID-19 yang sedang kita hadapi pada akhirnya akan mempengaruhi keberhasilan kinerja bisnis. Oleh karena itu, dalam upaya menutupi permasalahan tersebut, manajer terkadang melakukan berbagai upaya untuk menjaga citra perusahaan, salah satunya adalah manajemen laba. Tindakan manajemen laba seringkali dipandang sebagai perilaku oportunistik yang merugikan banyak pihak terutama investor. Menggunakan sampel perusahaan manufaktur yang terdaftar di Bursa Efek Indonesia periode 2017-2019, penelitian ini menyelidiki pengaruh financial distress terhadap perilaku manajemen laba dan selanjutnya menyelidiki peran pengendalian internal sebagai moderasi. Hasil penelitian menunjukkan bahwa perusahaan yang mengalami tekanan financial distress yang tinggi cenderung memiliki manajer yang melakukan manajemen laba untuk menutupi kinerja yang buruk. Selain itu variabel kontrol leverage memiliki pengaruh terhadap manajemen laba. Pengendalian internal mampu memoderasi hubungan financial distress dengan manajemen laba. Penelitian ini memberikan tambahan informasi mengenai manajemen laba dan peran pengendalian internal bagi perusahaan yang mengalami financial distress. Selain itu, penelitian ini juga berimplikasi kepada regulator mengenai pentingnya standar pengendalian internal bagi perusahaan.

ABSTRACT

Various types of potential risks, such as the COVID-19 pandemic we are currently facing, will ultimately affect the success of business performance. Therefore, in an effort to cover up these problems, managers sometimes make various efforts to maintain corporate image, one of which is earnings management. Earnings management actions are often seen as opportunistic behavior that harms many parties, especially investors. Using a sample of manufacturing companies listed on the Indonesian Stock Exchange for the period 2017-2019, this study investigates the effect of financial distress on earnings management behavior and further investigates the role of internal control as moderation. The results show that companies under higher financial distress pressure tend to have managers practice earnings management to cover up poor performance. In addition, the leverage control variable has an influence on earnings management. Internal control able to moderate the relationship between financial distress and earnings management. This study provides additional information on earnings management and the role of internal control for companies with financial distress. Furthermore, this research also has implications for regulators regarding the importance of internal control standards for companies.

1. INTRODUCTION

The rapid development of the business world has caused companies to often be faced with various kinds of potential risks in achieving effective performance (Kaunang, 2013; Nuriasari, 2018). Performance itself is basically the result of utilizing company resources and one of the benchmarks is profit in the financial statements (Joo & Lee, 2017; Prasetyo et al., 2021). Financial reports as a communication media and at the same time a means of management accountability to interested parties must be presented according to financial accounting standards in order to reflect the actual condition of the company (Fuadah & Setiyawati, 2020; Mulyanti & Rahma, 2020). Various types of potential risks, such as the COVID-19 pandemic we are currently facing, will ultimately affect the success of business performance (Amri, 2020;

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Rosmadi, 2021). Therefore, in an effort to cover up this affair, managers sometimes make various efforts to maintain corporate image, one of which is earnings management. Earnings management actions are often seen as opportunistic behavior that harms many parties, especially investors.

Earnings management itself is the art of changing numbers in financial statements that aim to improve financial performance and ultimately it does not reflect the true state of the business (Damayanti & Kwedar, 2018; Jaya & Narsa, 2020). Earnings management behavior is aimed at increasing the company's prospects and company value. However, earnings management often leads to negative consequences in the future such as restatements, law enforcement actions, litigation, to executive dismissal (Chen & Hung, 2021; Kim et al., 2017). Earnings management behavior is one of the factors that affect the integrity of financial statements. Earnings management is considered as the effect of the emergence of agency problems due to the asymmetry of information.

Financial distress is a condition where the company needs funds both for financing its operational activities, paying debts or investing. This situation sometimes results in managers being under pressure so that it affects the decision-making process and their behavior. Financial distress has a positive effect on earnings management. This implies that the higher the financial distress pressure, the higher the tendency for companies to practice earnings management (Ariesanti, 2015; Campa, 2015). Financial distress basically occurs when the liquidation of the total assets of the company is less than the total claims of creditors, this situation can occur at any stage of the life cycle of the company, which can at in turn have an impact on the future performance of the business. Financial distress requires corrective action or turnaround so that the company avoids the risk of bankruptcy (Ariesanti, 2015; Li et al., 2020). Companies experiencing financial difficulties will generally issue additional shares (SEO), this is done by companies experiencing liquidity problems and requiring additional funds both to finance operational activities, to invest and to pay debts that will come due.

Managers have different incentives regarding earnings management actions both to improve the quality of financial reporting and even to alter its reliability, particularly if the company is experiencing a financial crisis due to poor performance pressures (Campa, 2015). A significant and persistent decline in the financial performance of the company ultimately leads to bankruptcy, and investors and creditors suffer huge financial losses (Habib et al., 2013). The tendency of earnings management practices will be greater when the company admits to being in serious financial difficulty. Previous study indicate that financial distress (FD) has a significant positive effect on earnings management (EM) (Chen & Hung, 2021; Sari & Meiranto, 2017). FD has a significant impact on EM behavior. This means that EM actions are more likely to be taken when the company is under financial pressure to cover up poor performance, maintain company credibility and at the same time try to avoid bankruptcy (Damayanti & Kwedar, 2018; Jaya & Narsa, 2020).

Considering the risk opportunities that the business can encounter in each life cycle, every component and activity contained in an organization requires a system called internal control. It's nothing more than making sure that both things can work as expected. Internal controls are generally designed and implemented to ensure that organizational objectives are achieved. In addition, along with the development of the industry, the establishment of an effective internal control system will create a competitive advantage for the company. The company's financial condition is often a determinant of the effectiveness of CI, CI can help monitor business processes, secure assets including human resources, information systems and other resources, and can affect various aspects of the business, such as production, sales, expenses and others (Doyle et al., 2007; Li et al., 2020). Companies in financial difficulty tend to invest less in IC due to limited financial resources and time management, so they are unable to pick up signals of IC weakness.

Effective IC forces manager to honestly report profits or, in other words, avoid manipulation (Marinovic, 2013). Weak internal control is indicated as the main cause of scandals and opportunistic behavior, thus attracting the attention of regulators and stakeholders (Wang et al., 2016). The more widely publicized corporate bankruptcies and fraud cases become, the more companies will be encouraged to put more emphasis on establishing an effective internal control system (Länsiluoto et al., 2016). The quality of internal control can affect management behavior through the number of discretionary accruals, the prudence of earnings, and the accuracy of management forecasts (Chalmers et al., 2019). IC has a moderating effect on the relationship between financial distress and EM by focusing on AEM and REM practices in companies in FD situations (Li et al., 2020). In Indonesia, similar studies related to the effect of internal control effectiveness on revenue quality have also been conducted, which indicate that IC has a significant negative effect on earnings. discretionary adjustments. In other words, effective IC can improve the quality of earnings (Wijayani & Hermawan, 2015). Empirically, this study aims to examine the relationship between financial distress (FD) and earnings management (EM) in manufacturing companies in Indonesia.

2. METHODS

The sample consists of 303 company year observations from company annual reports published on the Indonesia Stock Exchange (IDX) and obtained from the Indonesia Stock Exchange website period 2017–2019. Table 1 show sample selection results based on criteria, out of a total of 178 manufacturing companies selected as many as 101 companies. So that, the total sample selected is 303 years of company observation.

Table 1. Sample Selection

Sample Selection Criteria	Number of Firms	Number of Firm Years
Number of firms listed on BEI over the period 2017-2019	178	534
Less :		
Firms doesn't publish financial statements and annual	66	(198)
reports in full during the observation period	11	(33)
The data needed is incomplete.	-	-
Firm's financial statements have been audited		
Final Sample	**101**	**303**

The dependent variable in this study is earnings management. We use discretionary accruals to proxy for accrual earnings management. We use modified jones model to detect the existence of earnings management practices in the company. The independent variables in this study are financial distress. Financial distress is proxied by Altman z score re-estimated model. Internal control as a moderating variable is measured by the internal control index (Ge et al., 2021). While the leverage control variable is calculated by the following formula for the ratio of the company's total debt to the company's total assets. The research model is presented in the following statistical equation:

$$DAi,t = \alpha + \beta 1DISTRESSi,t + \beta 2Levi,t + e\ i,t \quad (1)$$

$$DAi,t = \alpha + \beta 1DISTRESSi,t + \beta 2ICQi,t + \beta 3DISTRESSi,t \times ICQi,t + \beta 4Levi,t + e\ i,t \quad (2)$$

Equation (1) is used to answer the formulation of the first research problem, and equation (2) is used to answer the second research problem. To test the hypothesis on the second statistical model, this study uses panel data regression. Where to determine the best model estimation is carried out through various tests including the Chow test, Hausman test, and Lagrange multiplier test.

3. RESULTS AND DISCUSSIONS

Results

Table 2 provides descriptive statistical results of all research variables. The mean and median of financial distress (FD) is 2.399 and 2.112. The internal control (IC), on average is 0.812 and its median is 0.815. While for varibel earnings management, the mean and median is 0.001 and 0.000, the average and the median of leverage (LEV) as the control variable is 0.477 and 0.446.

Table 2. Descriptive Statistic

Statistics	FD	IC	EM	LEV
Mean	2.399	0.812	0.001	0.477
Median	2.112	0.815	0.000	0.446
Minimum	-1.653	0.700	-0.012	0.076
Maximum	6.826	0.933	0.049	1.947
Std. Dev	1.535	0.055	0.004	0.261
Observations	303	303	303	303

The next step is the estimation and selection of research models. After selecting the model, the selected model is Fixed Effect Model (CEM) for all research model. Table 3 shows the test results from research model 1 which examines the effect of financial distress (FD) on earnings management. Variable FD have positive and significant effect on EM at a significance level of 5%, which means the first hypothesis is accepted. The coefficient is 0.001183, its means that firm with a high level of financial distress tend to practice earnings management.

Table 3. Impact Financial Distress on Earnings Management

Variable	Coefficient	t-Statistic	Prob.
Intercept	-0.004241	-4.346713	0.0000
FD	0.001183	5.951613	0.0000
LEV	0.004822	4.124424	0.0000
Observation	**303**	**303**	**303**
Adj R^2		**0.194443**	
F-Statistic		**0.000000**	

Table 4 presents the results results of testing research model 2 which examines the moderating effect of internal control (IC) variables on the relationship between FD and EM. The significant level is 0.0333 (<5%), which means the second hypothesis is accepted. In other words, IC moderate the relationship between the effect of FD on EM.

Table 4. Financial Distress, Internal Control and Earnings Management

Variable	Coefficient	t-Statistic	Prob.
Intercept	-0.018534	-2.809500	0.0053
FD	0.006155	2.645441	0.0086
IC	0.017206	2.195018	0.0289
FD*IC	0.006095	2.137765	0.0333
LEV	0.005345	4.493690	0.0000
Observation	**303**	**303**	**303**
Adj R^2		**0.108773**	
F-Statistic		**0.000000**	

Discussion

Financial distress begins with the company's inability to meet its obligations. In this case, the manager is seen as unable to manage the company's resources effectively and efficiently, resulting in poor performance. This condition encourages managers to practice performance management as an effort to cover up poor performance. The greater pressure of financial distress has the possibility of leading to earnings management practices (Li et al., 2020; Nazalia & Triyanto, 2018). Earnings management practices aim to mask the financial condition of the company and tend to be opportunistic as such behavior can negatively impact the rights and interests of shareholders (Chen & Hung, 2021). Empirical research on 12 IDX-listed banking companies during the period 2014-2018 show that financial distress has a significant positive effect on earnings management (discretionary accruals)(Kurniawati & Panggabean, 2020).

Firm with a high level of financial distress tend to practice earnings management. In other words, managers will practice earnings management when the company's financial condition is bad. The test results are consistent with the claim that FD pressure can increase the tendency of firms to practice EM. Indeed, companies in financial difficulty or in bankruptcy are more likely to manipulate financial statements in order to obtain bank credit. The results of this study are in line with previous studies (Ariesanti, 2015; Li et al., 2020). LEV as a control variable has a positive and significant effect on EM with coefficient is 0.004822. So it can be concluded that a high level of leverage will make managers tend to practice earnings management to avoid debt covenant violations. Firms with high debt levels have a higher probability of violating debt covenants, so they are more likely to engage in EM actions (Astami et al., 2017; Ghazali et al., 2015; Habib et al., 2013).

Implementing and monitoring an effective internal control and risk management system can improve the quality of earnings (Brown et al., 2014). Strong internal control should help companies achieve sound financial performance, thus avoiding financial difficulties (Ashbaugh-Skaife et al., 2009; Doyle et al., 2007). Disclosure of internal control information by companies can provide useful additional information to users to enable them to re-evaluate their economic decisions. Previous research shows that companies with weak internal control allow for earnings management actions through the use of discretionary provisions (Ji et al., 2017). Another research shows that effective IC has a moderating effect on the relationship between financial distress and EM by focusing on AEM and REM practices in companies facing FD (Li et al., 2020). The quality of internal control can affect management behavior due to the amount of discretionary accruals, earnings conservatism, and the accuracy of management forecasts (Chalmers et al., 2019). The results of this study in line with the results of research which states that companies experiencing high FD pressure tend to be more involved in AEM (Jessica, 2021; Li et al., 2020). In addition, IC provides a moderating effect by suppressing AEM behavior in companies experiencing FD. Leverage still shows its existence against EM. A strong internal control system can hold managers to account honestly for the state of the business.

4. CONCLUSION

The higher level of financial distress, the more opportunity managers have to practice managing earnings management. At the same time, internal control is able to moderate the relationship between financial distress and earnings management. This paper enriches the understanding of earnings management practices and their determinants in manufacturing companies in Indonesia. This paper also highlights the important role of effective internal control to prevent opportunistic behavior of earnings management. This finding has implications especially for regulators, where regulators must set standards that can be used as guidelines, especially for companies to carry out effective internal control practices. However, this study also has some limitations. First, the observation period is only 3 years. Second, internal control is measured by an index, the results are expected to be better if using primary data through a questionnaire. This limitation can be considered to be consideration for further research.

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