THE EFFECT OF FINANCIAL DISTRESS AND PROFITABILITY ON EARNING MANAGEMENT

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ABSTRACT

The aim of this research is to provide the empirical evidence that is related to the effect of financial distress and profitability on earnings management. Earnings management is measured by Jones Modified Model. Financial distress is measured by the Grover Model. Profitability is proxied by profit margin, return on assets, return on equity, and earnings per share. The research sample of this study is a consumer goods industry which is listed in Indonesia Stock Exchange 2015-2017. Purposive sampling is used as a sampling method and obtained 108 samples. The analysis technique used is panel regression analysis with Stata 14. The results of this study indicate that each of financial distress, return on equity, and earnings per share has an effect on earnings management while profit margin and return on assets have no effect on earnings management.

1. Introduction

The financial report is a summary of the process of recording financial transactions that occurred during the relevant financial year prepared by management (Baridwan, 2010). SFAC No.1 explains that financial reporting must provide information that is useful for investors, creditors and other stakeholders in making decisions. When submitting financial reports, it is still found that financial reports present several values that are not true. Stakeholders use profit information as a benchmark in assessing management performance (Tehupiring, 2017). Profit is also used as a measure in assessing the success of a company (Ghozali & Chariri, 2007).

Companies try their best to maintain their performance so that they always look good in the eyes of stakeholders, but companies often face unexpected situations such as financial distress. According to Farooq et al. (2018), financial distress is divided into three stages, namely PR (profit reduction), ML (mild liquidity), and SL (severe liquidity). Nagar and Sen (2017), Agrawal and Chatterjee (2015), Ranjbar and Amanollahi (2018), Habib et al. (2013), Xu and Ji (2016), and Hasan et al. (2018) stated that financial distress influences earnings management practices.

However, Humeedat (2018) and Ghazali et al. (2015) they state that financial distress does not affect earnings management.

Profitability is a company's ability to earn profits. Profit is used as a reference or benchmark for stakeholders, especially investors in investing their funds and creditors in lending their funds. The higher the level of profitability, the better management performance in operating the company, and the lower the earning management behavior. This is following research by Humeedat (2018), Abu-Jebbeh and Al-Thuneibat (2017), Sholikhah and Worokinasih (2018), Indrawan et al. (2018), and Ghazali et al. (2015) which states that profitability influences earnings management. Gunawan et al. (2015), Agustia and Suryani (2018), Prasojo and Fatayati (2018), Widayati and Fadah (2015) state that profitability does not affect earnings management actions. Consumer goods industry companies in 2015-2017 were chosen because this company sector tends to experience quite tight competition, plus the emergence of various new products from entertainment actors (artists) in the form of food, cosmetics, etc. where we know that the artists already have a "name" or are well known to the public so they do not need more effort in carrying out promotions to attract consumers compared to other business entities.

2. Theoretical Framework and Hypothesis

Jensen and Meckling (1976) define an agency relationship as a contract in which one or more principals involve another person, namely an agent, to perform some service on their behalf or in other words involves the delegation of authority in decision making to the agent. Jensen and Meckling (1976) state that if both parties enter into a utility-maximizing relationship with different interests, it will cause problems that the agent

does not always act in the best interests of the principal. They prioritize personal interests over common interests. carry out earnings management.

Financial distress is one of the reasons managers carry out earnings management because when a company experiences financial distress, managers will of course experience various losses, such as reducing bonuses or even not getting bonuses. This causes managers (agents) who tend to have a self-absorbing nature to be inspired to utilize their authority in making earnings management policies. On the other hand, when the company's profits are stable or increasing, the manager is considered to have performed well so that the profits obtained increase and earnings management policies are not needed.

Signaling theory is used to describe behavior when two parties (individuals or organizations) have access to different information (Connelly et al., 2011). This is similar to Ross (1977) stating that internal parties (managers) in the company have more complex information

than external parties (stakeholders) so for external parties (stakeholders) only the company's financial reports provide information or signals. Signal
is fundamentally related to reducing information asymmetry between the two. Financial distress is a negative signal of "bad news" for external parties (stakeholders), while stable or increasing profits are a positive signal of "good news" for external parties (stakeholders).

A company does not always develop as well as expected, companies often experience failure (Sudana, 2015). The failure of a company begins with financial difficulties. If financial distress is not handled immediately, it will have an impact on company restructuring and even bankruptcy. Companies experiencing financial distress tend to carry out earnings management. According to Healy (1985) and Watts and Zimmerman (1986) in Sulistiawan et al. (2011) several things motivate individuals or business entities to take these actions, such as bonus motivation, debt motivation, tax motivation, CEO turnover, and political motivation. This is by research conducted by Nagar and Sen (2017), Agrawal and Chatterjee (2015), Ranjbar and Amanollahi (2018), Habib et al. (2013), Xu and Ji (2016), and Hasan et al. (2018) which states that financial distress conditions influence earnings management practices. Based on the description above, the following hypothesis is formulated:

H_1: Financial distress affects earnings management

Profit is used as a reference or benchmark for stakeholders, especially investors in investing their funds and creditors in lending their funds. According to Kasmir (2010), the ultimate goal that a company wants to achieve is to obtain maximum profit or gain because by obtaining maximum profit or profit as targeted, the company can improve the prosperity of the owner, employees and can improve product quality and make new investments. Therefore, company management is required to be able to meet the targets that have been set. However, the fact is that companies do not always experience increased profits, they also often face decreased profits and even losses. This is the reason or motivation for managers to carry out earnings management. This is following research by Humeedat (2018), Abu-Jebbeh and Al-Thuneibat (2017), Sholikhah and Worokinasih (2018), Indrawan et al. (2018), and Ghazali et al. (2015) which states that profitability influences earnings management. Based on the description above, the following hypothesis is formulated:

H_{2a}: Profit margin influences earnings management

H_{2b}: ROA (Return on Assets) influences earnings management

H_{2c}: ROE (Return on Equity) influences earnings management

H_{2d}: EPS (Earnings per Share) influences earnings management

3. Research Methodology

The regression analysis used in this research is panel regression. Earnings management can be measured using the Jones Modified discretionary accrual model developed by Dechow et al in 1995. Financial Distress is a condition where a company is experiencing financial difficulties, if not handled immediately it can result in bankruptcy. Companies experiencing financial distress are measured using the Grover model. According to Prihanthini and Sari (2013), the Grover model is a financial distress prediction model with the highest level of accuracy. A company is categorized as experiencing distress if the score is ≤ -0.02 and is categorized as safe if the score is ≥ 0.01. The research sample consisted of 108 observations with the criteria listed in Table 1.

Table 1

Research Sample

No	Criteria	Year		
		2015	2016	2017
1	Industrial consumer goods companies listed on the IDX in 2015-2017	38	37	47
2	Consumer goods industry companies that were not consistently listed on the IDX in 2015-2017	(2)	(1)	(11)
3	Consumer goods industry companies that didn't publish audited annual financial reports for 2015-2017	(0)	(0)	(0)
4	Consumer goods industry companies that didn't present required data research	(0)	(0)	(0)
Total		36	36	36

Profitability is a ratio used to measure a company's ability to generate profits. There are various types of ratios used, including: profit margin, ROA, ROE, and EPS. The data in this research is in the form of financial reports of consumer goods industry companies listed on the Indonesia Stock Exchange for the 2015-2017 period.

4. Results and Discussion

Based on the data in Table 2, it is known that earnings management has the lowest value of -0.145345. Financial distress has an average value of 0.9840612. Profit margin has the lowest value of -0.239752 and the highest value of 0.390021. Return on assets has the lowest value -0.154838 and the highest value is 0.526704. Return on equity has the lowest value -0.248705 and the highest value 1.381172. Earnings per share have the lowest value -263.0986 and the highest value is 4030.661.

Table 2

Descriptive Statistics

	Min	Max	Mean	Std Dev
FD (X1)	-0.686	2,404	0.984	0.549
PM (X2a)	-0.239	0.390	0.066	0.096
ROA (X2b)	-0.154	0.526	0.087	0.111
ROE (X2c)	-0.248	1,381	0.182	0.304
EPS (X2d)	-263,098	4030,661	310,320	726,874
E.M. (Y)	-0.145	0.489	0.051	0.100

Source: Stata

Based on the Chow test in table 3, the F-restricted Prob is 0.0142, which means the value is smaller than 0.05, it can be concluded that the fixed effect model is the best model to use rather than the common effect model. However, it is not finished at that stage, but if the selected model is a fixed effect model, then the Hausman test must be carried out. Based on the Hausman test in table 3, by looking at Prob Chi2, a value of 0.000 is obtained, which means the value is smaller than 0.05, so the fixed effect model is indeed the best model chosen to be used rather than the random effect model.

Based on the tests that have been carried out, it shows that financial distress affects earnings management. Company managers who experience financial distress are proven to carry out earnings management. Earnings management is a policy taken by managers to manipulate profits for specific purposes in financial reporting (Scott, 2009). Earning management carried out by managers can mislead stakeholders, especially in decision-making. The resulting research has important implications for creditors and investors to be wary of earnings management actions used by companies to hide their true financial condition. Earnings management predictions are also useful for auditors in identifying the level of manipulation in financial statements. level of manipulation in financial statements. The results of this research are in line with research conducted by Hasan et al. (2018), Agrawal and Chatterjee (2015), Xu and Ji (2016), Nagar and Sen (2017).

Profitability as proxied by ROE and EPS influences earnings management. Different results show that profitability is proxied by profit margin and ROA has no effect on earnings management. The research results show that the negative coefficient on profit margin does not affect earnings management, which means that profit margin is not the reason managers carry out earnings management. This indicates that companies that have low sales have reported their values correctly and appropriately without manipulation even though the profits earned are low. If a company has low sales and earns low profits, the tax burden that must be incurred is also low so that the company can save on expenses. Changes in income tax rates for corporate taxpayers in the form of public companies can also be a reason why managers do not carry out earnings management. PP number 56 of 2015 states that Corporate Taxpayers in the form of Public

Companies receive facilities in the form of reduced income tax rates by 5% lower than other Corporate Taxpayers.

Table 3

Test Results

	COEF	S.E	t	P(t)
Common effects model				
FD (X1)	0.038	0.024	1,600	0.113
PM (X2a)	-0.133	0.193	-0.690	0.493
ROA (X2b)	-0.406	0.229	-1,770	0.079
ROE (X2c)	0.189	0.050	3,750	0,000
EPS (X2d)	0,000	0,000	2,140	0.035
CONS	0.014	0.020	0.690	0.491
Prob F	0.002			
R2	0.167			
Fixed effects model				
FD (X1)	0.088	0.036	2,400	0.019
PM (X2a)	-0.164	0.445	-0.370	0.712
ROA (X2b)	-0.222	0.518	0.430	0.669
ROE (X2c)	0.425	0.081	5,220	0,000
EPS (X2d)	0,000	0,000	2,340	0.023
CONS	-0.104	0.034	-3,060	0.003
Prob F	0,000			
R2	0.425			
Random effects model				
FD (X1)	0.040	0.024	1,630	0.104
PM (X2a)	-0.121	0.198	-0.610	0.541
ROA (X2b)	-0.426	0.233	-1,820	0.068
ROE (X2c)	0.195	0.051	3,810	0,000
EPS (X2d)	0,000	0,000	2,150	0.031
CONS	0.012	0.020	0.600	0.549
Prob F	0,000			
R2	0.167			
	Prob F-Res			
Chow Test	0.0142			
Hausman Test	0.0000			

Source: Stata

This research is in line with research conducted by Prasojo and Fatayati (2018), Lee (2013), and Windriya Ramadhani (2017). Prasojo and Fatayati (2018) stated that when a company earns low profits, the tax costs incurred are also low so that the company can save on expenses, therefore managers do not need to carry out earnings management. Lee (2013) also states that profit margin does not affect earnings management because managers avoid demands for higher profits in the future.

The negative coefficient on ROA (Return on Assets) has no effect on earnings management, which means that ROA (Return on Assets) is not the reason managers carry out earnings management. This indicates that management has managed assets following established regulations, such as using one recording method consistently even though the results obtained are less than optimal. This can also happen because investors do not always look at the assets owned by the company, they only focus on returning profits on invested capital so low or high ROA does not motivate managers to carry out earnings management. This research is in line with research by Agustia and Suryani (2018), Gunawan et al. (2015), and Ramadhan (2018). Agustia and Suryani (2018) stated that companies with large or small ROA levels do not affect earnings management. This is because investors tend to ignore existing ROA information so management is not motivated to carry out earnings management. Gunawan et al. (2015) also stated that ROA does not influence earnings management because ROA is not necessarily the reason for a company's earnings management.

The results of this research are in line with research by Abu-Jebbeh and Al-Thuneibat (2017) and Humeedat (2018) which states that ROE (Return on Equity) affects earnings management. Humeedat (2018) states that ROE is an important indicator that investors look at when deciding to invest so managers tend to carry out earnings management so that the ROE displayed meets investors' expectations. It is also hoped that increasing the number of investors in companies can maintain the continuity of the company's business. The research results are in line with research conducted by Abu-Jebbeh and Al-Thuneibat (2017), and Humeedat (2018) which states that EPS affects earnings management. Humeedat (2018) states that EPS is a very important value that current investors, future investors, and related parties pay attention to when investing. Therefore, managers tend to carry out earnings management when they cannot meet investor expectations.

5. Conclusion

Financial distress affects earnings management. Return on equity influences earnings management. Earnings per share influence earnings management. Profit margin does not affect earnings management. Return on assets does not affect earnings management. The research only uses one measurement model, namely the Grover model as a measurement of financial distress and the Modified Jones model as a measurement of earnings management. Future researchers are expected to be able to add or change the measurement model for financial distress and earnings management through analysis of the best measurement model, as well as considering other factors (independent variables) that are thought to influence earnings management.

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