

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

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## ABSTRACT

The purpose of this research is to analyze the effect of financial distress and corporate governance toward earnings management. The samples of this research consist of 131 non-financial companies that are listed on the Indonesia Stock Exchange from the years 2014 to 2017 by using purposive sampling method. The hypothesis was tested by using multiple regression analysis with REVIEWS. The results of the research showed that financial distress, managerial ownership, institutional ownership and auditor independence had no influence on earnings management.

**Keywords:** *Financial Distress, Corporate Governance, Earnings Management*

## 1. INTRODUCTION

The goal of a company is to earn profits. These goals can be achieved by utilizing company's resources and managing company's finance appropriately. One of the results of management's accountability in managing financial and company resources is the financial statements. The contents of financial statements are the descriptions of information on performance and achievement of the company in a certain period. The financial statements prepared by management will become a reference for shareholders in making decisions. Therefore, relevant and reliable financial reports are needed to facilitate decision-making [2]

[14] Earnings information in financial statements is a good indicator to measure a company's performance. If a company's profits increase, it will attract investors to buy more shares and invest in the company. This motivates the management to manipulated earnings, so they are always in a profitable position while at the same time describing the performance of the company that looks good. Generally, the manipulation done by management is called earnings management. Many research has been done related to financial distress, corporate governance, and earnings management. These studies showed different results. This became the motivation for researchers to conduct this research.

### 1.1 Agency Theory

Business management of a company is usually carried out by other parties who are not the owners. In this case, the company's management (agent) acts as business manager, while the shareholders (principal) as the owner of the company are bound in an agency relationship. Agency relationship is a contract in which one or more people (principal) involves another person (agent) to delegate the principal in the company's business decision-making [5]. However, sometimes the agent acts not in accordance with

the expectations desired by the principal. This results in the agency problems.

### 1.2 Financial Distress and Earnings Management

[8] provide a definition of a company that experiences financial distress as a term that is used when an agreement or contract between a company and its creditors is not as expected or is in a difficult time. Financial distress is also commonly called the bankruptcy prediction model. Financial distress is carried out to measure a company's ability to pay long-term debt [15]. According to [9], financial distress is a condition in which corporate finance is weak and has a sign of bankruptcy. When companies are in distress position, the more earnings management are carried out. From the explanation above, the first hypothesis is:

H<sub>1</sub>: Financial distress has negative effect on earnings management.

### 1.3 Managerial Ownership and Earnings Management

[3] stated that the managerial ownership structure is a percentage of shares owned by directors and commissioners. According to Pujiati and Arfan (2013), managerial ownership is one of the factors that has an influence on earnings management. If management has ownership in the company, then management will act in accordance with the interests of shareholders, because the management also has an interest in it. According to [7], managerial ownership is a supervisory mechanism that aims to align various interests within the company. From the explanation above, the second hypothesis is:

H<sub>2</sub>: Managerial ownership has negative effect on earnings management

**1.4 Institutional Ownership and Earnings Management**

Institutional ownership is an ownership of shares of a company owned by an institution. The actions taken by management to manage earnings can be limited by the monitoring from stakeholders, especially the institutional shareholders [2]. According to [10], institutional ownership is a mechanism that can be done to monitor the performance of management in managing the company, so that the ownership of other institutions is expected to reduce earnings management behaviors. From the explanation above, the third hypothesis is:

H<sub>3</sub>: Institutional ownership has negative effect on earnings management.

**1.5 Auditor’s Independence and Earnings Management**

According to [11], independence means that auditors must not take sides and are not biased towards the audited financial statements or the users of the financial statements.

Independence also means that the auditor is not biased towards the opinions issued. According to [1], auditor’s independence is an auditing ethical standard regarding morals and behavior that must be possessed by the auditing firms. The more independent the auditor, the more irregularities they will be able to find, that occur in the financial statements. From the explanation above, the fourth hypothesis is:

H<sub>4</sub>: Auditor’s independence has negative effect on earnings management.

**2. RESEARCH METHODS**

**2.1 Sample Selection**

The population used in this study were all non-financial companies listed on the Indonesia Stock Exchange (IDX). The sample selection technique used in this study was purposive sampling technique. The procedure for selecting research samples can be seen in Table 1 below:

**Table 1:** Sample selection procedure

Sample Criteria	Total Data
Non-financial companies that listed on the Indonesia Stock Exchange (IDX) from 2015 to 2017	1.176
Non-financial companies that do not present financial report ended on December 31st	(36)
Non-financial companies that do not use IDR in their financial report	(228)
Non-financial companies that do not have managerial and institutional ownership	(526)
Data used in this research	386

**2.2 Earnings Management**

According to [13], earnings management is an effort made deliberately by the company’s management and usually aims for personal gain. In this study, earnings management is measured by using proxy performance-matched discretionary accruals. Performance matched discretionary accruals are a model developed by [6].

$$TA_{it} = NI_{it} - CFO_{it} \tag{1}$$

$$\frac{TA_{it}}{A_{it-1}} = \beta_0 + \beta_1 \left( \frac{1}{A_{it-1}} \right) + \beta_2 \left( \frac{\Delta REV_{it} - \Delta REC_{it}}{A_{it-1}} \right) + \beta_3 \left( \frac{PPE_{it}}{A_{it-1}} \right) + \beta_4 (ROA_{t-1}) + \varepsilon \tag{2}$$

TA<sub>it</sub> = total accrual  
 ΔREV<sub>it</sub> = changes in revenue  
 ΔREC<sub>it</sub> = changes in receivables

PPE<sub>it</sub> = net plant, property and equipment  
 ROA<sub>it-1</sub> = return on assets prior year  
 A<sub>it-1</sub> = total asset prior year  
 ε = residual error

**2.3 Financial Distress**

[8] stated that companies that experience financial distress have a condition in which an agreement or contract between the company and creditors is not as expected or in a situation of financial difficulties. Financial distress in this study was measured using the Altman Z-score:

$$FD = 6,56 (X1) + 3,26 (X2) + 6,72 (X3) + 1,05 (X4) \tag{3}$$

X1 = Working Capital / Total Asset  
 X2 = Retained Earnings / Total Asset  
 X3 = Earnings before interest and tax / Total Asset  
 X4 = Market value of equity / Total Liabilities

With discriminant zones:

If the Z-score > 2.90, the company is not distressed

If the Z-score is 1.23-2.90, the company is in grey area

If the Z-score < 1.21, the company is in distress.

## 2.4 Managerial Ownership

[3] states that the managerial ownership structure is a percentage of shares owned by directors and commissioners.

$$MO = \frac{\text{Shares owned by Managerial}}{\text{Total Outstanding Shares}} \quad (4)$$

## 2.5 Institutional Ownership

According to [12], institutional ownership represents the percentage of shares owned by insurance companies, financial and investment institutions, banks, government companies and other parts of the country.

$$IO = \frac{\text{Share owned by Institutional Investor}}{\text{Total Outstanding Shares}} \quad (5)$$

## 2.6 Auditor's Independence

Auditor's independence in this study was measured by using a nominal scale with a dummy variable in accordance with the research of [4]. With 0 is used for companies that use the same auditor for less than 3 years, this means the auditor has an independent attitude. The number 1 is used for companies that use the same auditor for more than 3 years, which means that the auditor does not have an independent attitude towards the opinion of the audited financial statements.

In this research, we also used control variabel which were free cash-flow measured by the difference between operating cash-flow and investing cash-flow divided by total assets, leverage measured by debt-to-assets ratio, and firm-size measured by the logarithm of total assets and current ratio.

## 3. RESULT

Table 2 and Table 3 shows the descriptive statistic the hypothesis test results of each variables:

**Table 2 : Descriptive Statistic Results**

	N	Minimum	Maximum	Mean	Std. Deviation
EM	386	-0,5317	0,6857	-0,004245	0,0934370
FD	386	-20,1406	48,7150	4,883289	7,7085069
MO	386	0,0000	0,8944	0,058576	0,1225448
IO	386	0,0196	0,9848	0,622816	0,1975739
IA	386	0	1	0,13	0,342
FCF	386	-0,5327	0,7460	0,106632	0,1298839
LEV	386	0,0335	1,9228	0,488958	0,2352364
SIZE	386	10,8136	14,4708	12,476201	0,7497438
CR	386	0,0337	15,1646	2,104322	2,0701286

**Table 3 : Hypothesis-Test Results**

	B	t	sig
(Constant)	0,3429	3,2557	0,0012
FD	-0,0012	-1,5048	0,1332
KM	0,0204	-0,3753	0,7076
KI	0,0113	0,3525	0,7246
IA	0,0016	1,1214	0,2628
FCF	0,1019	144,79	0,000*
LEV	-0,0046	-0,1565	0,8757
SIZE	-0,0191	-2,4832	0,0134*
CR	0,0034	-1,1084	0,2684
Adj R <sup>2</sup>			0,0982
F			0,0000

From Table 3, it can be seen that financial distress, managerial ownership, institutional ownership and auditors' independence do not affect earnings management. This means that whether companies in bankruptcy condition or not, they will do earnings management and this action cannot be detected by corporate governance.

#### 4. CONCLUSION

The objective of this research is to obtain the empirical evidence of the effect of financial distress and corporate governance towards earnings management. The results showed that financial distress and corporate governance had no effect on earnings management.

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