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The Effect of Financial Distress, Ownership Structure, and Other Factors on Profit Management

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A R T I C L E I N F O

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A B S T R A C T

This research aims to obtain empirical evidence regarding the effect of financial distress, managerial ownership, institutional ownership, audit quality, firm age, firm size, profitability, and leverage on earnings management. The research object in this study consists of all manufacturing companies listed on the Indonesia Stock Exchange (IDX) during the period of 2022 to 2024. The sample was selected using the purposive sampling method, and the data was analyzed using multiple linear regression. From this process, 70 companies with a total of 210 observations successfully met the research criteria. The results of this study indicate that audit quality has a negative effect on earnings management. A high level of audit quality is considered capable of increasing public confidence in the reliability of financial statements, thereby reducing the possibility of earnings management practices. Meanwhile, financial distress, managerial ownership, institutional ownership, firm age, firm size, profitability, and leverage are found to have no effect on earnings management.

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INTRODUCTION

Financial statements are an essential tool for a company to present financial information to stakeholders. The purpose of financial statements is to provide information regarding the entity's financial position, financial performance, and cash flows that is useful to most users of financial statements in making economic decisions (IAI 2024). Transparency is a crucial factor in the presentation of financial statements to maintain investor confidence and capital market stability.

Profit is a key element in financial statements for assessing company performance and serves as the basis for financial projections. High corporate profits can attract investors and facilitate access to external funding. Earnings management is a practice employed by companies to make financial reports appear more attractive to investors and stakeholders. This is done to achieve specific management goals. Earnings management practices can be implemented through methods such as accelerating or delaying revenue and expense recognition, or by changing existing accounting policies to achieve earnings results that align with market expectations.

This research replicates previous research conducted by Nugrahanti and Nugroho (2022). The study by Nugrahanti and Nugroho (2022) covered all companies listed on the Indonesia Stock Exchange (IDX) for the 2017-2019 period. This study, however, focuses on manufacturing companies listed on the Indonesia Stock Exchange (IDX) for the 2022-2024 period.

Research conducted by Nugrahanti and Nugroho (2022) used four independent variables: political connections, managerial ownership, institutional ownership, and audit quality. In this study, the researchers used three independent variables based on the research by Nugrahanti and Nugroho (2022): managerial ownership, institutional ownership, and audit quality. However, the researchers added financial distress (Farida and Sugesti 2023), firm age, firm size, profitability, and leverage (Hutauruk et al. 2022).

This study aims to obtain empirical evidence regarding the influence of financial distress, managerial ownership, institutional ownership, audit quality, firm age, firm size, profitability, and leverage on earnings management.

LITERATURE REVIEW

Agency Theory

Agency theory was first proposed by Jensen and Meckling (1976), who stated that there is a relationship between the principal (owner/shareholder) and the agent (manager) in a company. In practice, agency conflicts arise because agents have personal interests that do not necessarily align with the interests of the principal.

Nguyen et al. (2021) state that agents may conduct business in accordance with their personal interests, rather than the interests of the principal, due to information asymmetry and uncertainty. This information asymmetry can encourage managers to engage in earnings management (Nugrahanti and Nugroho 2022). Through earnings management, managers will naturally maximize their own welfare rather than the welfare of the company's owners.

Agency conflicts can be anticipated through agency costs and monitoring mechanisms for managers. Agency theory serves as a foundation for understanding agent behavior in managing a company and how monitoring mechanisms can be used to minimize these conflicts.

Signaling Theory

Signaling theory explains how a party with more information (the signal sender) can convey that information to a party with less information (the signal receiver) through an observable signal (Spence 1973). Signaling theory in a company can emerge through the relationships between managers and shareholders and between the company and investors. Managers can conceal signals given by the company, resulting in losses for both shareholders and investors.

Companies with poor performance tend to be reluctant to convey negative signals to the public because it could damage the company's reputation. This can encourage managers to engage in earnings management practices in annual reports to conceal true performance for the benefit of the company (Millenia and Tjhai 2021).

Earnings Management

Scott (2015) in Hutauruk et al. (2022) states that earnings management is an effort by managers to maximize revenue or improve company welfare by selecting appropriate accounting procedures. Earnings management is an action taken by company management to increase or decrease profits before financial statements are reported to maximize management interests (Felicya and Sutrisno 2020). Although earnings management is carried out to benefit a company, excessive earnings management practices can harm shareholders and damage the credibility of financial statements. Therefore, companies can implement transparent accounting practices in accordance with applicable accounting standards to maintain stakeholder trust.

Financial Distress and Earnings Management

Research conducted by Farida and Sugesti (2023), Putri and Naibaho (2022), and Dzulfikar and Firmansyah (2022) found that financial distress has a positive effect on earnings management. These studies explain that companies experiencing financial distress generally engage in earnings management practices to maintain their reputation among investors and creditors. This is due to the pressure to consistently meet short-term obligations and maintain stock price stability. Meanwhile, research by Khalik and Sylvia (2022) revealed that financial distress has no effect on earnings management. Based on the above description, the following hypothesis is proposed:

H_1: Financial distress has an effect on earnings management.

Managerial Ownership and Earnings Management

Research conducted by Nugrahanti and Nugroho (2022) and Thio and Steven (2022) found that managerial ownership negatively impacts earnings management. This is because share ownership by managers aligns the interests of both owners and managers, thereby reducing financial statement manipulation. When managers own shares, they strive to maintain the company's reputation and performance.

However, research by Alzura and Djashan (2023) and Nufus and Almalita (2023) revealed conflicting results, indicating that managerial ownership had no impact on earnings management. Based on the above discussion, the following hypothesis is proposed:

H2: Managerial ownership impacts earnings management.

Institutional Ownership and Earnings Management

Research conducted by Alexander (2021) and Mardianto (2020) indicates that institutional ownership has a positive effect on earnings management. This finding may occur because institutional owners often have the power to influence managerial decisions, such as creating financial statements that appear stable. In some cases, pressure from institutional investors to generate profits can encourage management to engage in earnings management practices.

Research conducted by Nugrahanti and Nugroho (2022) indicates that institutional ownership has a negative effect on earnings management. Conversely, research by Alzura and Djashan (2023) states that institutional ownership has no effect on earnings management. Based on the above description, the following hypothesis is proposed:

H3: Institutional ownership has an effect on earnings management.

Audit Quality and Earnings Management

Research conducted by Khairani and Siahaan (2024) and Alzura and Djashan (2023) shows that audit quality negatively influences earnings management. This means that auditors with a high reputation and independence generally perform audit procedures rigorously and professionally, thus detecting financial statement manipulation. Good audit quality can provide confidence that financial statements are prepared in accordance with applicable accounting standards and prevent earnings management practices.

However, research conducted by Farida and Sugesti (2023) yielded different results, namely that audit quality has no effect on earnings management. Based on the above description, the following hypothesis is proposed:

H_4: Audit quality influences earnings management.

Company Age and Earnings Management

Research conducted by Ayuni et al. (2024) and Kalbuana et al. (2022) revealed that company age has a positive effect on earnings management. In general, long-established companies are more experienced in preparing and understanding financial reports and strive to maintain their reputation, making them more likely to engage in earnings management.

However, research by Hutauruk et al. (2022) and Maricar and Almalita (2022) found a different finding, indicating that company age has a negative effect on earnings management. This is because long-established companies typically have better internal control systems and corporate governance, which can prevent earnings management practices. Furthermore, another study by Khairani and Siahaan (2024) showed that company age has no effect on earnings management. Based on the above discussion, the following hypothesis is proposed:

H_5: Company age has an effect on earnings management.

Company Size and Earnings Management

Research conducted by Agustina and Anita (2022) shows that company size has a positive effect on earnings management. Large companies typically have complex operations and high market expectations, which can encourage management to engage in earnings management practices to maintain financial statement stability and achieve targets.

Conversely, research by Ayuni et al. (2024) and Maricar and Almalita (2022) found that company size has a negative effect on earnings management. This is because large companies are often in the public spotlight and therefore exercise greater caution in preparing financial statements. Meanwhile, research conducted by Alzura and Djashan (2023) shows that company size has no effect on earnings management. Based on the above description, the following hypothesis is proposed:

H_6: Company size has an effect on earnings management

Profitability and Earnings Management

Research conducted by Nufus and Almalita (2023) and Khairani and Siahaan (2024) showed that profitability has a positive effect on earnings management. Companies with high profitability are motivated to maintain their performance and reputation with investors and creditors, which can trigger earnings management practices. However, research by Alfina and Sambuaga (2021) and Ayuni et al. (2024) showed that profitability has a negative effect on earnings management. Companies with high profitability typically do not engage in earnings manipulation because their performance is sufficiently convincing to stakeholders. Meanwhile, research by Sarah and Hernawaty (2023) found that profitability has no effect on earnings management. Based on the above description, the following hypothesis is proposed:

H_7: Profitability has an effect on earnings management.

Leverage and Earnings Management

Research conducted by Thio and Steven (2022) and Nufus and Almalita (2023) shows that leverage has a positive effect on earnings management. Companies with high levels of debt are under pressure to meet their obligations and maintain financial ratios in accordance with debt covenants. This encourages management to engage in earnings management to maintain a favorable financial report and avoid violating debt covenants.

However, research conducted by Mardianto and Chintia (2022) and Theiri et al. (2022) revealed that leverage has a negative effect on earnings management. This may occur because companies with high debt are subject to stricter scrutiny by creditors, making it difficult for management to engage in earnings management due to limited room for maneuver. Conversely, research conducted by Khairani and Siahaan (2024) found that leverage has no effect on earnings management. Based on the above description, the following hypothesis is proposed:

H_8: Leverage has an effect on earnings management.

Research Model

The following is the research model that will be used to explain the relationships between the variables in this study:

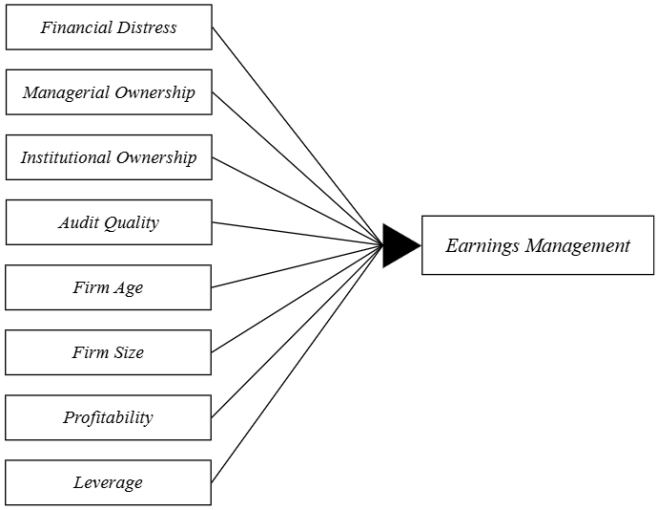

Figure 1. Research Model

METHODOLOGY

The subjects of this study were manufacturing companies listed on the Indonesia Stock Exchange (IDX) for a three-year period, from 2022 to 2024. The sampling method used in this study was purposive sampling. Purposive sampling is a sampling method limited to specific individuals or parties deemed capable of providing information relevant to the research.

This occurs either because they are the sole source of the required information or because they meet specific criteria previously determined by the researchers (Bougie and Sekaran 2020, 233). Based on the criteria used in the purposive sampling method, 70 companies, totaling 210 data points, were selected as samples.

Table 1. Sample Selection Results

No.	Sample Criteria	Number of Companies	Amount of Data
1.	Listed manufacturing companies in a way consistent on the Indonesia Stock Exchange (IDX) during period 2021 to 2024.	273	819
2.	Manufacturing companies that did not consistently publish financial reports during the period 2021 to 2024.	(24)	(72)
3.	Manufacturing companies that compile report finance with currencies other than Rupiah during period 2021 to 2024.	(40)	(120)
4.	Manufacturing companies that have year book besides ends on December 31 during period 2021 to 2024.	(3)	(9)
5.	Manufacturing companies that do not in a way consistent get profit during period 2022 to 2024.	(77)	(231)
6.	Manufacturing companies that do not in a way consistent own ownership managerial during period 2022 to 2024.	(52)	(156)
7.	Manufacturing companies that did not consistently have institutional ownership during the period 2022 to 2024.	(7)	(21)
	Number of Research Samples	**70**	**210**

Source: Data Processing Results

Operational Definition and Variable Measurement

Earnings management is an effort undertaken by managers to increase or decrease profits, thereby influencing reported earnings (Nugrahanti and Nugroho 2022). In this study, the measurement of earnings management variables refers to Nugrahanti and Nugroho (2022), which is measured using a proxy for discretionary accruals calculated using the modified Jones model. The proxy used is as follows:

$$TAC_{it} = NI_{it} - CFO_{it}$$

Total accruals estimated by the OLS (Ordinary Least Square) regression equation:

$$\frac{TA_{it}}{A_{it-1}} = \beta_1 \left(\frac{1}{A_{it-1}}\right) + \beta^2 \left(\frac{\Delta Rev_{it}}{A_{it-1}}\right) + \beta^3 \left(\frac{PPE_{it}}{A_{it-1}}\right) + \varepsilon$$

Nondiscretionary Accruals (NDA):

$$NDA_{it} = \beta^1 \left(\frac{1}{A_{it-1}}\right) + \beta^2 \left(\frac{\Delta Rev_{it} - \Delta Rec_{it}}{A_{it-1}}\right) + \beta^3 \left(\frac{PPE_{it}}{A_{it-1}}\right)$$

Discretionary accruals (DA):

$$DA_{it} = \left(\frac{TA_{it}}{A_{i,t-1}}\right) - NDA_{it}$$

Keterangan:
DAit: Discretionary accruals of company i in year t
NDAit: Nondiscretionary accruals of company i in year t
NIit: Net income of company i in year t
CFOit: Cash flow from operations of company i in year t
TAit: Total accruals of company i in year t
Ai, t-1: Total assets of company i in year t–1
ΔRevit: Change in revenue from year t–1 to t
PPEit: Property, plant, and equipment of company i in year t
ΔRecit: Change in accounts receivable from year t–1 to t
ε: Error term in the regression

Financial distress is a condition in which a company begins to experience a decline every year before bankruptcy (Farida and Sugesti 2023). In this study, the measurement of financial distress is based on the research of Farida and Sugesti (2023), which is proxied using the Z-score model by Altman (1968). The measurement scale used in this variable is a ratio scale. The formula used to calculate financial distress in this study is as follows:

$$Z = 1.2A + 1.4B + 3.3C + 0.6D + 0.999E$$

Keterangan:
A: (current assets – current liabilities) / total assets
B: retained earnings / total assets
C: earnings before interest and tax / total assets
D: market value of equity / book value of total debt
E: sales / total assets

Market value of equity: market price x number of shares outstanding (Zutter dan Smart 2022, 111)

Managerial ownership indicates the extent to which company management, such as the board of commissioners and the board of directors, owns shares in a company (Nugrahanti and Nugroho 2022). In this study, the measurement of managerial ownership is based on research by Nugrahanti and Nugroho (2022), which is proxied by the ratio of the number of company shares owned by management to the total number of outstanding shares. This variable is measured using a ratio scale. The formula used to calculate managerial ownership in this study is as follows:

$$MO = \frac{\textit{The Number of Company Shares Invested by Management}}{\textit{The Company's Total Outstanding Share Capital}}$$

Institutional ownership refers to the proportion of a company's shares owned by the government, financial institutions, legal entities, foreign institutions, trust funds, and other institutions (Nugrahanti and Nugroho 2022). In this study, the measurement of institutional ownership is based on research by Nugrahanti and Nugroho (2022), which is proxied by the ratio of the number of shares owned by institutions to the company's total outstanding shares. The measurement scale used for this variable is a ratio scale. The formula used to calculate institutional ownership in this study is as follows:

$$IO = \frac{\textit{The Number of Shares Invested by The Institutions in a Company}}{\textit{The Company's Total Outstanding Share Capital}}$$

Audit quality can be seen from the auditor's ability to audit financial statements related to material misstatements (Nugrahanti and Nugroho 2022). In this study, audit quality measurement is based on the research of Nugrahanti and Nugroho (2022), which is proxied using a dummy variable and a nominal scale, and is symbolized by AQ. Audit quality is classified based on the type of Public Accounting Firm (KAP) that audits the company's financial statements. If the company is audited by a KAP classified as a Big Four, it is coded as "1," while if the company is audited by a KAP other than the Big Four, it is coded as "0."

Company age reflects the length of time since the company was founded until it can consistently operate its business activities (Hutauruk et al. 2022). In this study, the measurement of company age is based on the research of Hutauruk et al. (2022), which is measured by calculating the difference between the year of the study and the year the company was founded and using a ratio scale. The formula used to calculate company age in this study is as follows:

$$\textit{Company Age} = \textit{Research Year} - \textit{The Year Firms was Founded}$$

Description:
Research Year: The year the research was conducted.
The Year Firms Was Founded: The year the company was founded.

Company size indicates the extent of a company's size, which can be based on various aspects, such as total assets, share value, average sales, and total sales (Nufus and Almalita 2023). In this study, the measurement of company size is based on research by Hutauruk et al. (2022), which is proxied by calculating the natural logarithm of the company's total assets. The measurement scale used in this variable is a ratio scale. The formula used to calculate company age in this study is as follows:

$$Company\ Size = Ln\ (Total\ Assets)$$

Profitability is a measure of how effectively a company manages its assets to generate profits (Millenia and Tjhai 2021). In this study, profitability is measured based on the research of Putri and Naibaho (2022), which is proxied by Return on Assets (ROA). This variable is measured using a ratio scale. The formula used to calculate company age in this study is as follows:

$$ROA = \frac{Net\ Income}{Total\ Assets}$$

Leverage can be defined as a financial ratio that indicates the extent to which a company obtains funding from external sources or debt (Hutauruk et al. 2022). In this study, leverage measurement is based on the research of Hutauruk et al. (2022), which is proxied by calculating the Debt to Asset Ratio (DAR). The measurement scale used in this variable is a ratio scale. The formula used to calculate leverage in this study is as follows:

$$DAR = \frac{Total\ Liabilities}{Total\ Assets}$$

RESEARCH RESULT & DISCUSSION

Table 2. Statistical Test Results Descriptive

Variabel	N	*Minimum*	*Maximum*	*Mean*	*Standard Deviation*
EM	210	-0,2275481	0,3563756	0,0000000	0,0628350
FD	210	-2,0233376	29,7594791	5,3901687	5,3454597
MO	210	0,0000002	0,7838775	0,0891118	0,1449331
IO	210	0,0211737	0,9714112	0,6328519	0,2048143
AQ	210	0,0000000	1,0000000	0,3714286	0,4843413
CAGE	210	6,0000000	91,0000000	38,4428571	16,3730164
CSIZE	210	25,3133045	33,7899579	29,1069448	1,6925253
ROA	210	0,0006377	0,3133954	0,0856806	0,0690372
DAR	210	0,0326609	0,9126002	0,3694751	0,1853873

Source: Data Processing Results

Table 3. Distribution Frequency Audit Quality (AQ)

Information		Frequency	Percentage
0	*Non-Big Four* KAP	132	62.86
1	*Big Four* Public Accounting Firms	78	37.14
Total		**210**	**100**

Source: Data Processing Results

This study used multiple regression analysis with a significance level (alpha) of 5% or 0.05. The results of the residual normality test indicate that the 210 data points used as the research sample are normally distributed. The classical assumption test revealed no multicollinearity, no autocorrelation, and no heteroscedasticity in the audit quality (AQ) and profitability (ROA) variables.

The correlation coefficient (R) analysis was 0.258, indicating a weak relationship between the dependent variable, earnings management (EM), and the independent variables, financial distress (FD), managerial ownership (MO), institutional ownership (IO), audit quality (AQ), firm age (CAGE), firm size (CSIZE), profitability (ROA), and leverage (DAR).

The results of the coefficient of determination analysis (adjusted R square) are 0.029 or 2.9%, which means statistically, the amount of variation in the dependent variable, namely earnings management (EM) that can be explained by the variation in the independent variables, namely financial distress (FD), managerial ownership (MO), institutional ownership (IO), audit quality (AQ), company age (CAGE), company size (CSIZE), profitability (ROA), and leverage (DAR) is 2.9%, while the remaining 97.1% is explained by other variables not included in the research model.

Table 4. t-Test Results

Variables	B	*Sig.*	Conclusion
(Constant)	-0.06781	0.51838	-
FD	0.00127	0.36657	H_1 rejected
MO	0.00706	0.87662	H_2 rejected
IO	-0.02323	0.43200	H_3 rejected
AQ	-0.02097	0.04209	H_4 accepted
CAGE	-0.00002	0.94042	H_5 rejected
CSIZE	0.00349	0.32162	H_6 rejected
ROA	0.00453	0.96242	H_7 rejected
DAR	-0.04935	0.09261	H_8 rejected

Source: Data Processing Results

Based on table 4.11, the regression equation model used in this study is as follows:

EM = -0.06781 + 0.00127 FD + 0.00706 MO – 0.02323 IO – 0.02097 AQ – 0.00002 CAGE + 0.00349 CSIZE + 0.00453 ROA – 0.04935 DAR + ε

The financial distress (FD) variable has a significant value of 0.36657, which is greater than the alpha value of 0.05. Therefore, H_1 is rejected, indicating that financial distress does not affect earnings management. Companies facing financial distress do not necessarily engage in earnings management practices because management is more concerned with the company's financial issues and takes actions that can effectively address financial difficulties (Khalik and Sylvia 2022).

The managerial ownership (MO) variable has a significant value of 0.87662, which is greater than the alpha value of 0.05. This indicates that H_2 is rejected, meaning managerial ownership has no effect on earnings management. Therefore, the proportion of shares owned by company management has both positive and negative effects on the implementation of earnings management practices within the company.

The institutional ownership (IO) variable has a significant value of 0.43200, which is greater than the alpha value of 0.05. Therefore, H_3 is rejected, indicating that institutional ownership does not influence earnings management. This occurs because not all institutional investors possess sufficient experience and knowledge to process company information, thus unaffecting earnings management practices (Maricar and Almalita 2022).

The audit quality (AQ) variable has a significant value of 0.04209, which is less than the alpha value of 0.05. This means that H_4 is accepted, meaning that audit quality influences earnings management. Furthermore, the unstandardized coefficient (B) of audit quality is -0.02097, concluding that audit quality negatively influences earnings management. This means that high audit quality has the potential to suppress corporate earnings management practices. Auditors from Big Four accounting firms are considered to have extensive experience and strong public reputations, enabling them to detect financial statement manipulation (Rachel and Sanjaya 2022). Therefore, good audit quality can increase trust in the prepared financial statements and prevent earnings management practices.

The firm age (CAGE) variable has a significant value of 0.94042, which is greater than the alpha value of 0.05, so H_5 is rejected, indicating that firm age does not influence earnings management. Long-established companies tend to have a high reputation that must be maintained and tend to obtain capital from investors more easily without having to engage in earnings management practices, while also trying to maintain a positive image in society and public trust because they are new and less experienced in engaging in earnings management practices (Felicya and Sutrisno 2020).

The company size variable (CSIZE) has a significant value of 0.32162, which is greater than the alpha value of 0.05. Therefore, H_6 is rejected, indicating that company size does not influence earnings management. Strict stakeholder oversight makes it difficult for company management to engage in earnings management practices (Kristiana and Rita 2021).

The profitability variable (ROA) has a significant value of 0.96242, which is greater than the alpha value of 0.05. Therefore, H_7 is rejected, indicating that profitability does not influence earnings management. This indicates that

profitability does not encourage company management to manipulate financial statements, as ROA tends to be less of a concern for investors. Furthermore, company management focuses more on effective company performance and maintains strict oversight, so profitability is not a factor in earnings management (Hutauruk et al. 2022).

The leverage variable (DAR) has a significant value of 0.09261, which is greater than the alpha value of 0.05. This concludes that H_8 is rejected, meaning that leverage does not affect earnings management. With high leverage, companies tend to focus on concrete actions to address these issues and meet their obligations rather than manipulate earnings. Furthermore, companies with controlled leverage are generally less motivated to engage in earnings management because they are able to meet their obligations (Hutauruk et al. 2022).

CONCLUSIONS AND RECOMMENDATIONS

The results of the study indicate that audit quality (AQ) reduces earnings management practices. Meanwhile, financial distress, managerial ownership, institutional ownership, firm age, firm size, profitability, and leverage do not affect earnings management.

Several limitations remain in this study, including the relatively short study period of only three years (2022-2024). Second, heteroscedasticity issues exist in the audit quality (AQ) and profitability (ROA) variables. Third, the coefficient of determination is relatively low, at only 2.9%. Fourth, the F-test result of 0.082 is greater than the alpha value of 0.05, indicating that the regression model does not fit the study.

Based on the limitations of this study, several suggestions can be put forward for further research. First, extend the research period to more than three years. Second, make adjustments or transform variables to standard errors using the White method using the White macro syntax for data experiencing heteroscedasticity in subsequent research (Ghozali 2021, 185). Third, replace or add independent variables that can further influence earnings management. Fourth, expand the research object so that more company data can be examined.

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