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Factors Affecting Earning Management

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Abstract

This study aims to examine the factors that affect profit management practices in 49 non-cyclical consumer sector companies listed on the Indonesia Stock Exchange during the 2021–2023 period. This research uses a quantitative approach by utilizing secondary data in the form of annual company reports. The analysis was carried out using the Fixed Effect Model (FEM) on the regression of panel data processed through STATA version 17 software. The results of testing and analysis show that financial distress has a negative effect on profit management, while leverage has a positive influence, while company size has no significant influence on profit management.

Keywords: *Profit Management, Financial Distress, Company Size, Leverage*

1. Introduction

Financial statements are one of the important indicators used by stakeholders to assess the company's status, determine investment policies, and evaluate target achievements. This report also reflects management's responsibilities in managing the company's assets (Panjaitan & Muslih, 2019). However, the pressure to perform well often encourages managers to engage in profit management practices, both legally and illegally (Rumah & Sunarto, 2022).

Profit management is an effort to influence profit figures in financial statements, which can be done through modification of accounting methods or data manipulation (kaltim.bpk, 2024). This practice aims to give the impression of better financial conditions to stakeholders, but can mislead them in decision-making. Cases such as the manipulation of PT Indofarma Tbk's financial statements show how profit management can harm stakeholders and damage public trust in the company (kaltim.bpk, 2024).

Fianancial Distress is a situation where a company experiences an unhealthy financial condition. When a company is in a state of *Financial Distress*The managers are forced to practice all means to maintain the company's reputation. One of the ways managers do this is profit management (Kurnia & Mulyati, 2023). By practicing profit management, managers can beautify the company's visible financial performance *Smooth* from the previous conditions, so that it is expected to increase the trust of stakeholders and maintain the stability of the company's reputation in the midst of difficult circumstances

The size of the company has a significant impact on profit management tactics. This is because large companies tend to have more resources, more complex operational structures, and greater attention from various stakeholders, including investors and regulators (Al-Faraby et al., 2023). Larger companies also have easy accessibility to a wide range of financial tools and strategies to manage profits. In addition, large companies may have greater pressure to meet stakeholder demands and maintain their positive reputation in the eyes of investors (Aguarelia et al., 2023). This condition can encourage management to make quick decisions, such as performing profit management, in an effort to achieve more profitable profit targets. As a result,

the possibility of using profit management techniques to maintain a company's financial stability and attractive to investors increases with the size of the company.

Last *Leverage*. *Leverage* is one of the many financial indicators where the ratio can be calculated to find out the amount of operations of the company financed using debt (BUI & LE, 2021). *Leverage* It also indicates that the company may have entered into long-term debt agreements to increase profits, by utilizing such debt funds in investments or expansions that are expected to increase profits (Al-Faraby et al., 2023). However, if *Leverage* Too high, a large debt burden can squeeze a company's cash flow and profitability, which ultimately leads to a high level of bankruptcy risk if the company is unable to meet its debt obligations (Aguarelia et al., 2023). To reduce liquidity risk, companies may adopt profit management practices. Liquidity risk occurs when a company faces difficulties in meeting its short-term obligations, such as paying debts or operating costs. To ensure that financial statements remain stable and reduce the impression of risk to investors or creditors, company managers may use profit management (Aguarelia et al., 2023).

In the theory of agency relations between principals and agents, there is a problem of causality that arises due to the difference in information between principals and managers (agents). This information imbalance encourages management to manage profits for its benefit (Apriliana et al., 2024) And if in a distressed condition, agency costs will increase significantly. When a company is in financial distress where the company is experiencing financial difficulties, the managers have to do a lot to maintain the company's name, profit management being one of the many possible ways for managers to do (Kurnia & Mulyati, 2023). By conducting profit management such as the selection of accounting policies to increase or minimize income depending on the level of financial distress that occurs, managers can make the company's financial performance look better than the previous condition, so that it is expected to increase the trust of stakeholders and maintain the stability of the company's reputation in the midst of difficult circumstances. This information imbalance will cause agency problems

In line with research conducted by (Kurnia & Mulyati, 2023) When financial distress is high, the company becomes unable to pay its financial obligations and can be the beginning of bankruptcy. This debuted gives managers a high chance of being able to practice profit management, so that the company looks healthy and gains the trust of stakeholders.

The agency theory states that if the size of the company is large, the agency that will be issued will be larger. The larger a company, the greater the risks that will be incurred, such as reputation, operations, finance, information, and regulations (Anindya & Yuyetta, 2020). Based on the statement, managers manage assets to reduce the risk of increased agency costs. In this case, the size of the company is defined as the number of assets owned by the company. The size of the company has a significant impact on profit management practices. This is because large companies tend to have more resources, more complex operational structures, and greater attention from various stakeholders, including investors and regulators (Al-Faraby et al., 2023). Larger companies also have easier access to a wider range of financial tools and strategies for managing profits. In addition, large companies may have a greater burden of meeting stakeholder demands and maintaining their positive reputation in the eyes of investors (Aguarelia et al., 2023). This condition can encourage management to make quick decisions, such as performing profit management, in an effort to achieve more profitable profit targets. As a result, the possibility of using profit management techniques to maintain a company's financial stability and attractive to investors increases with the size of the company.

In line with research conducted by Tamara et al., (2022) If large companies will also have a high probability of doing profit management, it is because large companies maintain high profits to gain the trust of investors to invest capital that can maintain the company's resilience.

The use of debt on a company's capital structure is known as leverage, and this has a huge influence on managerial choices, such as how to manage profits. High leverage puts pressure on management to meet principal and interest payment deadlines(Al-Faraby et al., 2023). Pressure will come from creditors and investors which can reduce the level of confidence due to the high risk.

In Agency Theory, it is stated that company managers with high averages often manipulate profits in order to avoid violating debt agreements and maintain the company's reputation in the eyes of investors and creditors. In order for managers to show that the business can pay off its debts, profit management is done to keep the reported profits stable. However, this would be contrary to the goal of creditors and investors who do not get transparent reporting data (Hakim et al., 2023).

In line with the results of the studies studied Aguarelia et al., (2023) Where the research explains that leverage arises when a company uses debt as a source of funds, which results in fixed costs. When leverage is high, the rate of profit management is also higher, because managers are encouraged to maintain the company's profits to meet debt obligations. The problems in this study are formulated as follows:

1. Is there an effect of *Financial Distress* on Profit Management
2. Is there an influence of Company Size on Profit Management
3. Is there an influence *of leverage* on profit management

2. Research Methods

This study uses a quantitative method. This study uses the population of *the non-cyclical consumer* sector listed on the IDX in 2021-2023, with a total of 49 companies. The data obtained is secondary data obtained from the official website of the IDX, and the official website of the company. Purposive sampling is used in this study, by providing special criteria as requirements for the sample to be used by the researcher. The purposive sampling methods used in this study are as follows:

Operational definition and measurement of variables

Profit management is a behavior carried out by management with the aim of influencing the amount of company profit, legally or illegally. Legal profit management practices involve attempting to modify income statements without violating the reporting rules set forth by Accounting Standards, such as by changing accounting methods or moving income and expense recognition periods (Rumah & Sunarto, 2022). In this study, a modified Jones model was used to calculate profit management, which is a dependent variable. This model's ability to minimize measurement errors on discretionary accruals makes it more reliable than other models when it comes to detecting profit management. The modified Jones model estimates non-discretionary accruals during the period of earnings management. The modified Jones model is measured as follows:

a) Calculating TAC (*Total Accrual*)
   Net profit in year t subtracted by the operating cash flow of year t:

$$TACit = NIit - CFOit$$

   Then, the TA (*Total Accrual)* is assessed with *the Ordinary Least Square* :

$$TAC_{it}/A_{it-1} = B_1\left(\frac{1}{A_{it-1}}\right) + B_2\left(\frac{\Delta REV_{it}}{A_{it-1}}\right) + B_3\left(\frac{PPE_{it}}{A_{it-1}}\right) + e$$

b) Using the same regression theory as above, to NDA (*Non-Discretionary accruals*) is calculated with the following formula:

$$NDA_{it} = B_1\left(\frac{1}{A_{it-1}}\right) + B_2\left(\frac{\Delta REV_{it} - \Delta REC_{it}}{A_{it-1}}\right) + B_3\left(\frac{PPE_{it}}{A_{it-1}}\right) + e$$

c) Finally, DA (*Discretionary Accruals*) as a measure of profit management is calculated by the following formula

$$DA_{it} = \left(\frac{TAC_{it}}{A_{it-1}}\right) + NDA_{it}$$

Information:
THE TRUTH = *Discretionary accrual*
NDAit = *Non-discretionary accrual*
TACit = *Total accruals*
LITTLE = *Net income*
CFOit = Cash flow from operating activities
Ait-1 = Number of assets for the period t-1
B = Regression coefficient
ΔREVit = Change in income
ΔRECit = Change of receivables
PPEit = *Fixed assets*
e = Error

Financial Distress is a situation where the company has financial problems, which mentions the condition of the company is unhealthy or in crisis. *Financial distress* occurs as a result of the company not being able to maintain and regulate financial performance, and this is one of the signs of the company's bankruptcy (Nurulita & Utami, 2024). However, it must be underlined if *Financial Distress* This is not the same as bankruptcy but it is one of the many aspects of bankruptcy. So it does not mean that all companies are detected *Financial Distress* will go bankrupt. In this study, the modified Altman Z-Score Model (III) was used in this study. This altman model varies greatly in different sectors and industries (Kurnia & Mulyati, 2023). The Altman Z-Score model is arranged as follows:

$$Z - Score = 6{,}56X_1 + 3{,}26X_2 + 6{,}72X_3 + 1{,}05X_4$$

Information:
X1 = *Working Capital / Total Assets*
X2 = *Retained Earning / Total Assets*
X3 = *Earning Before Interest and Taxes / Total Assets*
X4 = *Book Value of Equity / Book Value of Total Liabilities*

The categories of companies that produced the assessment are as follows:
a. A Z value greater than 2.6 is classified as a healthy company category.
b. The Z value is between 1.1 and 2.6 and is included in the gray area category, because it has the possibility of financial difficulties.
c. A Z value of less than 1.1 is included in the category of companies experiencing financial distress

Company size is an indication of the ratio of a company which can be grouped into small and small groups in various ways (logarithm size, total sales, total assets, stock value, etc.) (Aguarelia et al., 2023). The size of the company is basically divided into 3 categories, *Large firm* (large corporations), *Medium size* (medium-sized company), and finally *Small Firm* (small company). In this study, the value of the company is estimated using a logarithm of the company's total assets, or Ln Total Assets. The overall value of a business's assets is indicated by the term "total assets". The size of the company can be measured in the following ways:

$$SIZE = \ln (Total\ Aktiva)$$

Information:
SIZE = Company Size
Ln = Natural logarithm

Leverage is a ratio that shows the amount of assets financed from debt. *Leverage* is a source of money with fixed expenses that must be met by the company, with the aim of getting profits that are much greater than the expenses, and the profits from investors will increase (Ramadhanty & Hariadi, 2024). *Leverage* calculated in this study using the *Debt to Equity Ratio* (DER). The extent to which the capital itself can be used as collateral for the company's debt is determined by a financial ratio called DER. The following is the formula of the DER ratio:

$$DER = \frac{Total\ Hutang}{Total\ Ekuitas}$$

The methods used in this study were descriptive statistical analysis and hypothesis testing. The tests used were the determination coefficient test (R2) and the t-test. The test stage uses the help of a soft prankat, namely *Microsoft Excel* and STATA version 17. The following equation is a double linear regression equation with two *Variable* independent:

$$Y = \alpha + \beta 1X1 + \beta 2X2 + \beta 3X3 + \varepsilon$$

Information:
Y = Profit Management
X1 = Financial Distress
β1 = Regression Coefficient for Financial Distress variable
X2 = Company Value
β2 = Regression Coefficient for Company Value variable
X3 = Leverage
β3 = Regression Coefficient for Leverage variable
α = Constant
ε = Error

3. Discussion

Table 1. Sample Criteria

Yes	Information	Sum
1.	Non-cyclical consumer *sector companies* listed on the IDX in 2021-2023	129
2.	Non-cyclical consumer *sector companies* that are not engaged in manufacturing (food and	(80)

beverages, cigarettes, pharmaceuticals, cosmetics, and household appliances)	
Company Sample Quantity	**49**
Research Year	**3**
Total research sample	**147**

Source: IDX Web processed

Table 2. Descriptive Statistical Results

Variable	*Obs*	*Mean*	*Std. Dev*
Managing Profits	147	-0.0459996	0.6307119
Financial Distress	147	4.904391	5.512191
Company Size	147	28.57195	1.752492
Leverage	147	1.358652	3.119675

Source : *STATA* Output v.17 (2024)

In the descriptive statistical results table, it shows that the average value of negative profit management is -0.0459996 and the standard deviation value is 0.6307119, which shows a greater value than this shows that the distribution and fluctuation of profit management practices is quite small. Based on the test results, it can be concluded that profit management has a relatively low variation, considering the *lower mean* value compared to the standard deviation value (-0.014861 > 0.0888114). The average *financial distress* is 4.904391, the company size is 28.57195, and the leverage is 1.358652.

Table 3. Test Table of Determination Coefficients (R2)

Information	**Test Results**
Number of Observations	147
R-Squared Overall	0.0414

Source: STATA v.17 Output Data

Based on table 4, the results of the R-Squared overall test obtained a nilia of 0.0414. It can be interpreted that the independent variables *of financial distress*, company size, and *leverage* can explain 4.14% of the dependent *variables* of profit management. The remaining 96.86% are influenced by *variables* outside the independent *variables* selected in this research model.

Table 4. Significant Test Table (t)

Variable	**Fixed Effect Model**		
	Coef	**t**	**P>|t|**
FD	-0,051103	-2,35	0,023
UP	-0,7301565	-1,60	0,116
LEV	0,1725404	3,01	0,004
_Cons	20.8322	1,60	0,116

Description : FD = *Financial Distress*; UP = Company Size; LEV = *Leverage*
Source: Data, STATA v.17 Output

Based on table 5, the results of *financial distress* with *a Cowf score* were obtained. Negative (-0.051103) and significant probability (0.023 < 0.05). It can be concluded that *variable financial distress* has a negative influence on profit management. Then the size of the company is the *value of Coef.* Negative (-0.7301565) and insignificant probability (0.116 >

0.05). It can be concluded that the *company* size variable has no influence on profit management. Lastly, leverage the *value of Coef.* Positive (0.1725404) and significant probability (0.004 < 0.05). It can be concluded that *variable leverage* has a positive influence on profit management.

The Effect of *Financial Distress* on Profit Management

The results obtained from the test stated that FD had a negative effect on profit management. This result is seen from the probability value (P>|t|) of 0.023, which shows that the probability value is smaller than the value of α (0.05) (0.023 < 0.05). These results are interpreted that the fianancial distress variable has an influence on profit management. However, the coefficient gets a negative value of -0.051103, which indicates a negative direction. So that H1 which mentions financial distress has a positive effect on profit management is rejected.

The state of companies affected by financial distress can face great external pressure, especially from creditors, investors, and regulators. Stakeholders carry out strict supervision of the company to ensure the appropriate use of funds, especially in the monitoring of financial statements. This supervision will minimize the opportunity for managers to conduct profit management so that the company's financial statements look better, because efforts for profit management can be detected faster and can provide significant risks. The results of this research hypothesis show that the higher the value of financial distress of a company, the less likely managers are to practice profit management. Therefore, companies with high levels of financial distress are more focused on maintaining stakeholder trust. Avoiding this possibility is the main problem, so companies will try to avoid profit management practices because they can damage the trust of stakeholders and increase the likelihood of the company going bankrupt.

The Influence of Company Size on Profit Management

The test results have been carried out by measuring ln (total assets) which obtained the results of company size does not affect profit management. This is based on a probability value (P>|t|) of 0.116, which indicates that the probability value is greater than the value of α (0.05) (0.116 > 0.05) and shows that the size of the company has no influence on profit management. So it can be concluded that H2 company size has a positive effect on profit management is rejected.

With companies that are large in size, companies are generally under more intense scrutiny from various parties, including regulators, auditors, and other stakeholders. Due to this high risk, the manager's room to manage profits is reduced. This more intensive oversight creates pressure to comply with transparent reporting standards, so the size of the company does not provide greater opportunities for profit management. Although large companies have more resources, such as experts and advanced technology to manage financial statements, this is not automatically utilized to carry out profit management. In contrast, large companies often have a higher incentive to maintain reputations, especially in the eyes of institutional investors who prioritize the integrity of financial statements.

The Effect of *Leverage* on Profit Management

Based on the results obtained from the test, it can be concluded that if *Leverage* has a positive effect on profit management. The result is shown from the probability number which is 0.004, where the result has a lower value than the value of α (0.05) (0.004 < 0.05), Then the value of the coefficient gets a positive value of 0.1725404, where the value shows a positive direction. based on these results, it can be concluded that H3 is *Leverage* has a positive effect on profit management received.

Companies that have a high level of leverage have significant fixed liabilities, such as interest and principal debt, that must be settled on time. In this condition, management has a

strong desire to maintain a good profit performance to ensure that creditors and investors continue to have confidence in the company to fulfill its obligations. Profit management is a strategy used to avoid violations of debt agreements, which have a negative impact on the company's reputation. In addition, high *leverage* can make companies vulnerable to fluctuations in revenue and profit, especially if economic conditions are unstable. Managers will utilize profit management techniques such as profit smoothing, to display financial stability and alleviate the concerns of creditors and investors. This technique is used to give the impression that the company has low risk compared to the real reality.

4. Conclusion

Based on the results of research that has been carried out on the influence of *financial distress*, company size, and *levreage*. With the object of research on *non-cyclical consumer* sector companies in 2021-2023. Some conclusions were obtained from this study, here are the details of the conclusions obtained:

a) *Financial distress* has a negative effect on profit management. This can be interpreted if the high level of *financial distress* in a company will minimize the practice of profit management in a company. Due to the high pressure from creditors and stakeholders and maintaining the trust of creditors and stakeholders, thus reducing the possibility of the company going bankrupt.
b) The size of the company does not affect profit management. This means that the size of a company does not have an influence on the level of profit management practices in a company. This is because large companies often have a greater incentive to maintain their reputations, especially in the eyes of institutional investors who prioritize the integrity of financial statements. As a result, the size of the company becomes irrelevant in influencing the decision to undertake profit management.
c) *Leverage* has a positive effect on profit management. It can be explained that if the leverage value of a company is high, the profit management practices carried out by a company will also increase. This is because if the company is in a *high-leverage* condition , in order to reduce the risk of bankruptcy, increase stakeholder confidence, and maintain access to external funding sources, managers often use profit management as the best option.

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