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Corporate Governance Mechanism Towards Earnings Management: Does Financial Distress Could Make It Better?

Wiwi Idawati*

Dr., Lecturer, *Department of Accounting,* STIE Indonesia Banking School , Indonesia,
https://orcid.org/0000-0002-0242-8268

Sugeng Pranoto
SE., Reserchear, Department of Accounting, STIE Indonesia Banking School, Indonesia,
https://orcid.org/0009-0008-2210-6814

Hayu S. Prabowo
Dr. Hayu S. Prabowo is lecturer at the STIE Indonesia Banking School, Indonesia,
https://orcid.org/0009-0007-3564-3910

*Corresponding author: wiwi.idawati@ibs.ac.id

Abstract : *The aim of this research is to analyze the effect of institutional ownership, managerial ownership, board size, and audit committee size on earnings management with financial distress as an intervening variable. The causality research design used secondary data from the annual financial reports of State-Owned Enterprises listed on the Indonesia Stock Exchange for the 2017 – 2021 period which includes 20 companies, purposive sampling technique was used to collect a sample of 11 companies, the data processing and analysis was carried out using path analysis and t-test with the IBM SPSS 25 analysis tool. The result of this research indicate that managerial ownership has a negative effect on financial distress, and audit committee size has a positive effect on financial distress, institutional ownership and board size have no effect on financial distress. Financial distress has an effect on earnings management and is able to mediate the effect of audit committee size on earnings management but is unable to mediate the effect of institutional ownership, managerial ownership, board size on earnings management. Implementation good corporate governance in company can reduce earning managements practice and prevent companies from financial distress.*

Keywords*: institutional ownership, managerial ownership, size of board of directors, audit committee size, financial distress, earnings management.*

Introduction

State-Owned Enterprises (BUMN) are business entities whose capital is wholly or partly derived from the provision for state assets with capital participation of at least 51% (fifty one percent). SOEs play a role as development agents through their direct and indirect involvement in national strategic projects. SOEs seek profits that are used to carry out their operations, and

maximum profits will be able to provide information to interested parties that the companies are in good health financially.

In compiling financial reports, company management must apply the principles of financial reporting. However, several companies manipulate their financial reports, especially those related to earnings management. This practice causes losses to parties interested in the financial statements due to information asymmetry. One of the causes of information asymmetry is that management has more information than shareholders so that management can manage reported earnings.

Earnings management prevents financial reports from providing actual information regarding the company's financial condition. Demands for companies to achieve predetermined profit targets play an important role in forcing companies to carry out earnings management. The financial statements of PT Waskita Karya (Persero) Tbk for the 2004-2007 financial year recorded an excess of around IDR 400 billion in net profit, an amount that should have been recognized as profit in the following year. This finding was obtained when a re-examination was carried out for the issuance of initial shares.

The Ministry of State-Owned Enterprises issues regulations so that SOEs implement good corporate governance. Good corporate governance is a monitoring tool for companies in carrying out their business activities thereby reducing the risk of companies practicing earnings management. The ministry has determined that SOEs implement good corporate governance, but several SOEs have not implemented it optimally. The bribery case involving Wisnu Kuncoro, Director of Technology and Production of PT Krakatau Steel (Persero) Tbk was the result of not optimally implementing governance in SOEs. Wisnu Kuncoro was arrested by Indonesia's Corruption Eradication Commission on charges of criminal acts of corruption, giving or receiving gifts and promises in the procurement of goods and services in 2019.

Based on the Law of the Republic of Indonesia Number 19 of 2003 concerning State-Owned Enterprises, the board of directors is an organ of an SOE that is responsible for managing the SOE for the interests and objectives of the SOE as well as representing the SOE both inside and outside the court. Regulation PER-01/MBU/2011 concerning the Implementation of Good Corporate Governance in State-Owned Enterprises requires the Board of Directors to report their share ownership and/or their family's share ownership in the relevant SOE or other companies.

The operating capacity value for companies that are not experiencing financial distress is above the average for companies that are in financial distress. Companies that are not experiencing financial distress have the same total assets and total liabilities and have a high profit level (Idawati, 2020).

This study is a replication of research by Riadiani and Wahyudin (2015) which states that good corporate governance has no effect on earnings management; financial distress has a negative effect on earnings management; institutional ownership, managerial ownership and board size has a negative effect on earnings management after being mediated by financial distress; and the audit committee has no effect on earnings management. Based on this background, this research is entitled The Effect of Good Corporate Governance Mechanism on Earnings Management with Financial Distress as an Intervening Variable. This research is expected to provide: (1) academic benefits, in which it can become reference material for future research regarding the effect of good corporate governance on earnings management with financial distress as an intervening variable; (2) practical benefits, in which it can provide information to company management that maximum implementation of good corporate governance can produce quality profits and prevent companies

from potential bankruptcy. For the regulators, this research is useful in increasing supervision of the implementation of good corporate governance in SOEs so that its implementation becomes more optimal and reduces the occurrence of earnings management practices.

Research Problem

Companies facing financial difficulties are motivated to practice earnings management in order to provide satisfactory information to interested parties. The financial statements of PT Garuda Indonesia (Persero) Tbk for the 2018 fiscal year contain earnings management practices. The company applies accounting treatment that is different from the generally accepted Statement of Financial Accounting Standards. The Financial Services Authority as a regulatory party gave a written order for PT Garuda Indonesia (Persero) Tbk to restate its 2018 financial statements. The new financial statements were published on July 26 2019, and showed that a profit of US$ 5.018 million in the previous financial statements was loss of US$ 175.028 million. PT Garuda Indonesia (Persero) Tbk's total debt in the 2020 fiscal year was recorded at US$ 12 billion, exceeding its total assets of US$ 10 billion, thereby affecting the company's ability to fulfill its obligations to lenders and vendors. Earnings management is a choice of management in accounting policies that have an impact on profits to achieve specific goals for reported earnings (Scoot, 2015).

Research Focus

Based on the background, the problems related to profit management are that some State-Owned Enterprises show increased profits but still carry out profit management practices, furthermore State-Owned Enterprises have implemented good corporate governance but there are still companies that have not implemented maximum corporate governance in accordance with the Regulation of the Minister of SOEs, as well as financial difficulties in some State-Owned Enterprises causing The company conducts profit management practices.

Research Aim and Research Questions

Based on the background of the problem, the formulation of the problem in the study is as follows: Does institutional ownership, managerial ownership, audit committee affect *profit* management then does *financial distress mediate* institutional ownership, managerial ownership, audit committee on *profit management.*

Research methods

The study was conducted to determine and examine the effect of institutional ownership, managerial ownership, the size of the board of directors, and the size of the audit committee on profit management and its effect if through *financial distress*. The object of this study is non-financial State-Owned Enterprises listed on the Indonesia Stock Exchange

Sample

The population in this study are State-Owned Enterprises that are listed on the Indonesia Stock Exchange and have complete data availability for the 2017 – 2021 research period. A purposive sampling technique was used, with available sample of 11 SOEs. The following are the sample selection criteria in this study: (1) Non-financial industry State-Owned Enterprises listed on the

Indonesia Stock Exchange in the period of 2017 – 2021; (2) The company has complete data availability during the study period. The causality research design was used in this study with the aim of examining causal relationships between variables. Research data comes from secondary data obtained indirectly or through documentation. This study uses annual data for non-financial SOEs for the 2017-2021 period. Data collection was carried out via the internet by accessing the www.idx.co.id page and the website of each SOE.

Variable measurement

This study consists of three variables: earnings management as the dependent variable (Y); institutional ownership (X1), managerial ownership (X2), board size (X3), and audit committee size (X4) as independent variables (X); and financial distress as intervening variable (Z). The operational definitions and measurements of each variable are as shown in Table 1.

Table 1. Variable measurement

Variable	Label	Measurement	Reference
		Independent variable	
Institutional ownership	IO	IO = TSI / TOS X 100	(Kolsi and Grassa, 2017)
Managerial ownership	MO	MO = TSM / TOS X 100	(Anggana and Prastiwi, 2013)
Size of board of directors	BD	Total number of members of the board of directors	(Riadiani and Wahyudin, 2015)
Audit committee size	AC	Total number of audit committee members	(Kolsi and Grassa, 2017)
		Dependent variable	
Earnings management	EM	DACit = (TACit/ At-1) – NDAit	(Dechow et al., 1995)
		Intervening Variable	
Financial distress	FD	Z = 1.03A + 3.07B + 0.66C + 0.4D	(Springate, 1978)

Source: results of processed data by the authors, 2022

Data Analysis

Path analysis

This study uses the panel data regression analysis method in which panel data of several companies is observed over a certain period of time (Ghozali, 2018). Path Analysis is an extension of multiple linear regression analysis which is used to estimate the causality relationship between variables that has been previously determined based on theory (Ghozali, 2018). The regression equations in this study are:

Equation 1:

$$FD_{it} = \beta_0 + \beta_1 IO_{it} + \beta_2 MO_{it} + \beta_3 BD_{it} + \beta_4 AC_{it} + \epsilon_{it} \quad (1)$$

Equation 2:

$$EM_{it} = \alpha_0 + \alpha_1 IO_{it} + \alpha_2 MO_{it} + \alpha_3 BD_{it} + \alpha_4 AC_{it} + \alpha_5 FD_{it} + \omega_{it} \quad (2)$$

Research Results

The results of this descriptive statistical analysis provide information and descriptions of the mean, median, standard deviation, maximum and minimum values for each variable which were calculated based on the overall data. Table 2 shows the results of descriptive statistics in this study.

Table 2. Descriptive statistic result

Variable	EM	IO	MO	BD	AC	FD
Mean	0.00047	0.93271	0.00006	6.18	4.07	0.64709
Maximum	0.01966	0.99425	0.00023	9	9	1.56981
Minimum	-0.01557	0.82280	0.00000	5	5	-0.22874
Std. dev.	0.00797	0.05110	0.00006	1.06	0.92	0.37551
Observers	55	55	55	55	55	55

Source: reprocessed IBM SPSS 25 output, 2022

Table 2 shows; Profit management is the dependent variable used in this study, based on table 4.3. shows that the profit management variable has a minimum value of -0.01557 originating from PT Waskita Karya (Persero) Tbk in 2020, the maximum value of 0.01966 comes from PT Semen Baturaja (Persero) Tbk in 2017, the average value of BUMN profit management for the 2017-2021 period is 0.00047. The standard deviation of the profit management variable is 0.007968740912075 which means that the study sample has profit management with a deviation of 0.00797 from its average value. This study used 2 (two) of model regression analysis so that a partial test is carried out on that 2 (two) equations. This study accept the hypothesis if the probability value is greater than the significance value (0.05). Based on the Table 3 and Table 4, the results of the following regression equation are obtained:

Table 3. Model regression analysis I

Coef.	Coefficient	Std. Error	t-Statistics	Sig.	Conclusion
(Constant)	-0.121	0.858	-0.141	0.888	-
IO	0.088	0.943	0.093	0.926	Rejected
MO	-1515.436	721.742	-2.100	0.041	Accepted
BD	0.022	0.050	0.445	0.658	Rejected
AC	0.157	0.058	2.723	0.009	Accepted
		Adjusted R-Squared			0.214
		R-Squared			0.272
		R			0.522

Source: reprocessed IBM SPSS 25 output, 2022

Table 3 shows that the institutional ownership variable has a significant value of 0.926 > 0.05, meaning that institutional ownership has no effect on financial distress, so H1 is rejected. Research shows that no matter how large share ownership by institutions is, it does not reduce the possibility of financial distress, because share ownership by institutions that is centralized and not spread causes shareholder control over management to be weak, so they do not have sufficient ability to control management to make decisions that benefit management. The results of the research are in accordance with the research of (Purba, 2019; Sastriana and Fuad, 2013; Widyasaputri, 2012) which state that institutional ownership does not affect financial distress, meaning that no matter how large the percentage of institutional ownership is, it can prove there is a possibility of financial distress.

Unequal ownership causes a lack of transparency of company funds and balance between interests, making shareholders unable to control management properly, so that management takes policies that only benefit themselves. This research is not in line with Aritonang (2013) which states that the positive relationship between institutional ownership and financial distress can be explained if the company is owned by institutional investors, indicating that management is considered unable to hide the losses experienced, which triggers financial distress.

The managerial ownership variable has a significant value of 0.041 < 0.05, indicating managerial ownership has a negative effect on financial distress, which means that H2 is accepted. The increase in managerial share ownership is able to reduce the potential for financial distress because management does not only act as the party that runs the company's operations but also owns company shares so that management acts more carefully and responsibly in making policies for the company. The results of this study are in line with the research of (Hanifah and Purwanto, 2013; Maryam and Afri Yuyetta, 2019) which state that managerial ownership has an effect on financial distress, which indicates that the greater the managerial ownership, the smaller the potential for financial distress to occur. The results of this study are not in line with (Cinantya and Merkusiwati, 2015; Sastriana and Fuad, 2013) which state that managerial ownership does not affect financial distress, which means that managerial ownership is a symbol that is used to attract investors' attention so that they think that company value is increasing along with managerial ownership. If the managers of the company own a portion of the company's shares, then the agency problem between the owner and the managers of the company can be resolved and the managers will maximize the value of the company.

The board of directors size has a significant value of 0.658 > 0.05, which indicates that the size of the board of directors has no effect on financial distress, so H3 is rejected. Regardless of the number of the board of directors, it does not reduce the potential for financial distress to occur because the board of directors has limitations in managing the company. Research conducted by (Arrum and Wahyono, 2021; Cinantya and Merkusiwati, 2015; Vionita and Lusmeida, 2019) state that the size of the board of directors does not affect financial distress, which means that it is consistent with the results of research which states that the board of directors has limitations in making decisions because policies must be decided at the General Meeting of Shareholders. This means that the large number of directors does not affect the occurrence of financial distress. This study is not in line with the research conducted by (Hanifah and Purwanto, 2013; Sastriana and Fuad, 2013) which stated that the size of the board of directors has a significant negative effect on financial distress because the existence of a board of directors is one of the corporate governance mechanisms, so the larger the size of the board of directors, the smaller occurrence of financial distress in the company.

The audit committee has a significant value of 0.009 <0.05 so that the size of the audit committee has a positive effect on financial distress, which means H4 is accepted. Financial distress can be avoided or reduced when the company has a small audit committee size because the committees become effective and participate in focusing on monitoring internal audit activities. The results of this study are consistent with the research of (Damayanti and Kusumaningtias, 2020; Haziro and Negoro, 2017) which state that the more members of the audit committee, the higher the potential for financial distress due to the ineffectiveness of the committee in carrying out its duties. However, the results of this study are not in line with Masak and Noviyanti (2019) which state that audit committee size has a negative effect because large audit committee sizes, with their knowledge and work

experience, can improve the quality of internal control to reduce financial distress.

Table 4. Model regression analysis II

Coef.	Coefficient	Std. Error	t-Statistics	Sig.	Conclusion
(Constant)	-0.037	0.017	-2.214	0.039	-
IO	0.049	0.019	2.549	0.014	-
MO	55.083	15.338	3.591	0.001	-
BD	-0.001	0.001	-0.828	0.412	-
AC	-0.003	0.001	-2.424	0.019	-
FD	0.010	0.003	3.359	0.02	Accepted
		Adjusted R-Squared			0.276
		R-Squared			0.343
		R			0.585

Source: reprocessed IBM SPSS 25 output, 2022

Table 4 shows that the financial distress variable has a significant value of 0.005 <0.05 so that financial distress affects earnings management, which means H5 is rejected. Increased financial distress also causes an increase in earnings management carried out by the company. Shareholders have a desire for the company to achieve maximum profit while the company's management cannot always fulfill the wishes of shareholders, resulting in agency conflicts that can cause information asymmetry. Management's interest in making the company look healthy causes earnings management behavior to arise, preventing shareholders from getting real information about the condition of the company. The results of this study are in line with (Farhad and Amini, 2016; Paramita et al., 2017) which state that companies experiencing increased financial distress will have an increased possibility of earnings management. The results of this study are not in line with Ghazali et al. (2015) which states that financial distress has a negative effect on earnings management, which means that companies do not practice earnings management when conditions are depressed. Companies in a depressed condition are not involved in earnings management because management has run out of ways to manipulate earnings.

Table 5. Sobel test results

Hyphotesis	Path	Sobel Test Statistic	Result
H6	IO → FD → EM	0.093	Not Accepted
H7	MO → FD → EM	-1.776	Not Accepted
H8	BD → FD → EM	0.043	Not Accepted
H9	AC → FD → EM	2.101	Accepted

Table 5 show t-value < t-table (0.093 < 1.96), meaning that financial distress is unable to mediate the effect of institutional ownership on earnings management, so H6 is rejected. Institutional ownership that focuses on the last profit earned by the company causes management to increase short-term profits through earnings management. Large institutional ownership increases the utilization of company assets thereby reducing the occurrence of financial distress. The results of this study are consistent with Sari and Fanani (2016) who state that public companies in Indonesia tend to be centralized, resulting in a lack of transparency in the use of company funds and balance of interest between company management, controlling shareholders and minority shareholders. As a result, shareholders do not have sufficient ability to control management, potentially resulting in

management taking advantage that benefits a certain party. Research by (Ewanto et al., 2014; Fathoni et al., 2014) state that institutional ownership makes companies bound to meet profit targets set by investors, causing management to tend to do earnings management. Issuers with large shareholdings reflect power so that they have the ability to intervene in the company's operations and prepare financial reports. Earnings management arises from the desire of company owners to save the company from financial distress. This research is not in accordance with Riadiani and Wahyudin (2015) who state that an increase in firm value which indicates a decrease in the level of corporate bankruptcy will lead to a decrease in earnings management by managers.

Table 5 show t-value < t-table (-1.776 < 1.96), which means that financial distress is unable to mediate the effect of managerial ownership on earnings management, so H7 is rejected. Financial distress in the company is not triggered by the size of managerial share ownership but is more influenced by management's ability to manage the company's operations and finances, influencing management to make earnings management decisions in the company. This research is consistent with Sari and Fanani (2016) which state that the majority of public companies in Indonesia originate from family companies so that managerial share ownership worsens the company's condition because it triggers the possibility of misappropriation by management for personal gain. This means that the health of a company is not only caused by the size of the shares owned by the board of directors and the board of commissioners, but is also influenced by the ability of the board of directors to manage the company. This research is not in line with Riadiani and Wahyudin (2015) who stated that managerial ownership pressures earnings management in order to give good signals to investors after financial distress.

Table 5 show t-value < t-table (0.043 < 1.96), which means that financial distress is unable to mediate the effect of board size on earnings management, so H8 is rejected. The larger the size of the board of directors, the lower the level of supervision over decisions taken by the directors in the company's operations, causing the use of funds that are not in accordance with their functions and earnings management that only benefits certain parties. This research is in accordance with Sari and Fanani (2016) which state that the large size of the board of directors reduces its effectiveness in carrying out its functions, making it difficult to control. Public companies in Indonesia generally start as family companies so that the owner of the company also acts as a director, giving rise to the possibility of abuse by the board of directors for personal gain. This research is inconsistent with Riadiani and Wahyudin (2015) who state that strict supervision and control of the board of directors will improve performance and reduce earnings management practices by the board of directors.

Table 5 show t-value > t-table (2.101 > 1.96), which means that financial distress is able to mediate the effect of audit committee size on earnings management, so H9 is accepted. Financial distress in a company is not caused by the size of the audit committee if the audit committee is only a formality to comply with the provisions issued by the regulator. Companies that experience financial distress with audit committees that are a formality in nature give rise to earnings management practices in companies. This study is consistent with (Ewanto et al., 2014; Riadiani and Wahyudin, 2015) which stated that the appointment of an audit committee that is not based on adequate competence and capability can result in the audit committee not working professionally, thus triggering earnings management in the company. This research is inconsistent with Sari and Fanani (2016) which states that the existence of an audit committee in Indonesia is mandatory and its competence is limited so that financial difficulties are unavoidable.

Discussion

Research shows that no matter how large the ownership of shares by institutions does not reduce the possibility of *financial distress* because share ownership by centralized institutions and does not spread, causing shareholder control over management to be weak so that they do not have enough ability to control management to make decisions that benefit management. The increase in share ownership by managers can reduce the potential for *financial distress* because management not only acts as a party that runs the company's operations but also owns company shares so that management acts more very carefully and responsibly in making policies for the company. No matter how large the board of directors is, it does not reduce the potential for *financial distress* because the board of directors has limitations in managing the company.

Financial distress can be avoided or reduced when the company has a small audit committee size because the committee becomes effective and participates in focusing on supervising internal audit activities so that the potential for financial distress *is reduced, furthermore* Financial distress *that has increased causes an increase also in profit management carried out by the company* . Shareholders have a desire for the company to achieve maximum profit while company management cannot always fulfill the wishes of shareholders so that agency conflicts arise that can cause asymmetric information.

Institutional ownership focuses on the last profit earned by the company, causing management to take action to increase short-term profits with profit management. Large institutional ownership increases the utilization of company assets so as to reduce the occurrence of financial distress and *also some of the amount of managerial ownership does not* reduce the potential for financial distress in the company, because the potential occurs based on the ability possessed by the board of directors in managing company operations to reduce the potential for financial distress and profit management actions.

The larger the size of the board of directors, the lower the level of supervision of decisions taken by directors in company operations, causing the use of funds that are not in accordance with their functions and will carry out profit management that is useful only for personal interests.

Conclusions and Implications

Based on the results of the analysis and discussion, it can be concluded that: Institutional ownership variable has no effect on financial distress, which means that no matter how large the share ownership by the institution is, it does not reduce the possibility of financial distress; Managerial ownership variable has a negative effect on financial distress, which means that an increase in managerial ownership can reduce the potential for financial distress to occur; Size of the board of directors has no effect on financial distress, which means that the number of board of directors does not reduce the potential for financial distress; Audit committee size variable has a positive effect on financial distress, which means that financial distress can be avoided or reduced if the company has a large audit committee size; Financial distress variable affects earnings management, which means that companies experiencing financial distress do not always practice earnings management because it will result in greater losses;Financial distress variable is unable to mediate the effect of institutional ownership on earnings management, and institutional ownership which focuses on the last profit earned by the company causes management to increase short-term earnings through earnings management; Financial distress variable is not able to mediate the effect of managerial ownership on earnings management, and financial distress in companies is not due to the amount of managerial ownership but is more influenced by management's ability to manage the

company; Financial distress variable is not able to mediate the effect of the size of the board of directors on earnings management, with the larger the size of the board of directors, the lower the level of supervision of decisions taken by the directors in the company's operations; and Financial distress variable is able to mediate the effect of audit committee size on earnings management, with financial distress in a company becoming unavoidable if the size of the audit committee is only a formality.

The results of this study indicate that managerial ownership has an effect on financial distress, which means that managers can reduce the risk of financial distress along with their share ownership, encouraging them to take responsible policies. SOE managers who own shares in the company must report their share ownership in accordance with the Regulation of the Minister of State-Owned Enterprises PER – 09 /MBU/2012 concerning Amendments to the Regulation of the Minister of State-Owned Enterprises PER – 01 /MBU/2011 concerning Implementation of Governance Good Corporate in State Owned Enterprises. The audit committee has an effect on financial distress, which means that the committee can carry out its duties in a focused and effective manner in accordance with applicable regulations. SOEs must have an audit committee of at least 3 (three) people in accordance with the Regulation of the State Minister for State-Owned Enterprises PER-05/MBU/2006. The audit committee is able to mediate the effect of audit committee size on earnings management, which means that SOEs must appoint an audit committee based on appropriate background in the field. With useful knowledge and experience, the audit committee is hoped to be able to prevent companies from financial distress that trigger earnings management practices.

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