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The role of corporate governance in moderating the influence of financial distress on earnings management

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Abstract

Purpose – This research is to analyze the influence of financial distress on earnings management and analyze the role of Good Corporate Governance as proxied by independent commissioners in moderating the influence of financial distress on earnings management in banking companies on the Indonesia Stock Exchange for the 2018-2024 period.

Design/methodology/approach – The sample in this study was determined using purposive sampling. The sample size is 150 company annual reports. Data collection uses documentation. Data analysis uses multiple regression and moderated regression analysis (MRA).

Findings – Financial distress is proven to influence earnings management. This means that when a company faces financial difficulties, management will usually carry out earnings management to cover up the financial difficulties faced so it looks good in the eyes of stakeholders. With the implementation of independent commissioners as supervisors and givers of advice who come from outside the company, it will weaken the relationship between financial distress and earnings management. This means that earnings management will go down along with the implementation of good corporate governance as proxied by independent commissioners.

Research limitations/implications – The contribution presented to the independent variable on the profit-related variable is in a small group, so that there are suggestions for further studies to add related variables to this external study area and apply other sectors for future studies.

Practical implications – This research provides practical benefits to banking company management to avoid earnings management practices by implementing independent commissioners.

Originality/value – Previous research linking the influence of financial distress on earnings management with independent commissioner moderation has not been widely conducted and the results are still varied.

Keywords: financial distress, independent commissioner, earnings management

Introduction

Public interest in investing in the capital market in the current era is going up. One of the reasons an investor invests in the capital market is to make a profit. For investors, profit information is an important part that needs to be considered in investment decisions in the capital market. Information regarding profits can be obtained through financial reports. The purpose of financial reporting by business companies is that financial reporting must provide information that is useful for investors and other users to make investment, credit and decisions rationally (Kieso et al., 2017).

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Profit in financial statements is one of the good indicators to measure the performance of a company, so that profit will affect the value of a company. The high profit obtained by the company will attract investors to invest because the company has a higher level of profit. This can move the company's management to act opportunistically such as carrying out profit management to show satisfactory profits even though they do not follow the actual conditions of the company (Putri & Huda, 2024. Earnings management attempts to manipulate accounting information to meet certain goals, such as meeting market expectations, maintaining a company's image, or securing performance-based compensation (Dechow et al., 2012). This practice can harm investors and damage the integrity of the capital market if not properly controlled.

Companies on the Indonesia Stock Exchange (BEI) prepare financial reports using the accrual basis (Sutapa & Suputra, 2016). The accrual basis was chosen in preparing financial reports because it is more rational and fair in reflecting the company's real financial condition. The basic advantage of accrual is that it is in the same time unit. However, using the accrual basis makes it possible to change financial reports to produce the desired amount of profit (earnings). Management can freely determine the method for preparing financial reports if they follow applicable standards.

Earnings management occurs because of opportunities obtained by managers with flexibility in choosing accrual-based accounting methods (Veno & Sasongko, 2017). Management will choose certain methods to obtain profits that suit their motivation (Hapsoro & Hartomo, 2016). Management's opportunities arise because management (agents) have more information than owners (principals), or what is usually called information asymmetry. Managers can take advantage of information asymmetry to carry out profit management actions (Veno & Sasongko, 2017). The existence of information asymmetry will encourage management to present information that is not true, especially if the information is related to measuring manager performance (Dhaneswari & Widuri, 2013).

Generally there are two ways for managers to carry out earnings management when financial distress occurs, namely firstly reducing profits by delaying income and recognizing costs early until they are at a loss and saving profits for the future and secondly increasing profits by recognizing income early and postponing costs for shows that the quality and performance of the company remains good when facing difficulties (Chairunesia et al., 2018). Many studies reveal that financial distress has a significant positive effect on earnings (Anagnostopoulou et al., 2021; Damayanti & Kawedar, 2018; Paramita et al., 2017; Sabaruddin et al., 2022), but there is also research which states that financial distress does not affect earnings management (Kristyaningsih et al., 2021).

Financial distress is a company's inability or unavailability of funds to pay its maturing obligations (Radifan & Yuyetta, 2015). Companies experiencing financial distress will immediately respond to these conditions. Companies experiencing financial difficulties usually carry out profit management practices to always provide a good signal in the eyes of investors. Profit management behavior goes up as the financial difficulties experienced by the company increase. Previous researchers said that financial distress influenced management to carry out earnings management practices. If earnings management has occurred, the resulting financial reports will have low earnings quality.

One way that can be done to reduce the level of earnings management in a company is to implement a good corporate governance system. Corporate governance is an idea put forward to improve company performance through tracking management performance which at the same time ensures management accountability towards stakeholders (Hapsoro & Hartomo, 2016). Agency theory views the differences in the interests of the principal and agent, each trying to maximize their interests (Jensen & Meckling, 1976). If a company implements GCG, the potential for a manager to carry out earnings management actions can be controlled (Veno & Sasongko, 2017). One of the mechanisms for implementing corporate governance is the implementation of independent commissioners. This study explores independent commissioners as a moderating factor in the relationship between financial distress and earnings management. The interaction variable between financial distress and corporate governance studied by (Hapsoro & Hartomo, 2016) has a significant negative effect on earnings management. Meanwhile, research conducted by Fatiha and Usman, (2024), shows the results that GCG cannot act as a moderator of the influence of financial distress on earnings management.

The differences in the results indicate that there is still uncertainty in the role of independent commissioners in this context. So this study further analyzes the effect of financial distress on earnings management by considering the moderating role of independent commissioners.

This study examines the moderating role of independent commissioners on the relationship between financial distress and earnings management in the banking sector. The banking sector has different features compared to other industrial sectors, especially in terms of regulation, business models, and financial structure. In this study, banking companies become very relevant and strategic objects to analyze because banks are financial intermediary institutions with a important role in the economy. When banks experience financial pressure or engage in earnings management practices, the impact can be systemic and disrupt the stability of the national financial sector. So financial governance and transparency practices in banks are the main concerns of regulators (Zhou et al., 2022). Bank financial reporting involves complex estimates such as loan loss provisions, financial asset valuation, and market risk, which provide greater flexibility for management to manipulate accounting (Hussain et al., 2023). The banking sector usually has a stronger and more formal corporate governance structure, compliance with OJK and Bank Indonesia regulations, and the active involvement of institutional shareholders. This makes this sector ideal for testing the role of independent commissioners as a moderating variable. Despite being closely monitored, banks are not immune to the risk of financial distress. In unstable macroeconomic conditions or when there is a spike in non-performing loans, banks' financial performance can deteriorate and encourage management to carry out earnings management to maintain an image of financial stability.

Literature Review and Hypotheses

Agency Theory

According to Jensen and Meckling, (1976) agency theory is a relationship involving two parties, namely the agent and the principal. Agents have the task of carrying out several services for the principal by delegating authority, for example: decision making. Agency theory emphasizes that managers will focus on themselves because they act opportunistically to achieve a certain goal. A conflict of interest (agency problem) causes agents or managers to run the company not to make the principal prosperous, but to prosper the interests of the agent himself. More costs (agency costs) must reduce and reduce this conflict of interest. Agency costs are costs associated with tracking management to make sure management consistently follows the company's contractual agreements with creditors and shareholders (Van Horne & Wachowicz, 2005).

Signal Theory

According to Spence, (1973), signaling theory is a signal given by management to convey information regarding relevant financial reports so it is used for decision making by external parties. This theory emphasizes giving signals by management to reduce asymmetric information by discussing the positive and negative signals company management conveys to shareholders (Lo, 2012). However, there are various actions taken by internal parties to deliberately convey information so it cannot be directly observed by external parties (Butar, 2014).

Finansial Distress

Financial distress is a condition where operating cash flow is no longer enough to meet the company's various current obligations, for example interest costs and others (Wruck, 1990). Riadiani and Wahyudin, (2015) explain that financial distress is a deviant event and a financial pressure that leads to bankruptcy. If conditions like this may continue, the company will go bankrupt. Financial distress is understood as a phase or stage of financial decline that occurs in a company, known to occur before bankruptcy or related to liquidity or liquidation. This condition is generally characterized by delays in the shipping process, decreased production quality, late payments on bank bills, and other related matters. This difficulty can be measured by applying Altman Z-score (Celli, 2015).

$$Z' = 1{,}200\ Z1 + 1{,}400\ Z2 + 3{,}300\ Z3 + 0{,}600\ Z4 + 1{,}000\ Z5$$

Information:
"Z' = Overall index of bankruptcy
Z1 = Working Capital to Total Assets
Z2 = Retained Earnings to Total Assets
Z3 = EBIT to Total Assets
Z4 = Market Value Equity to Book Value of Total Debt
Z5 = Sales to Total Assets

The criteria used to predict company bankruptcy in this model are that companies with a Z score > 2.99 are classified as healthy companies, while companies with a Z score < 1.81 are classified as potential bankrupt companies. A score between 1.81 and 2.99 is classified as a company in the gray area (Peter & Yoseph, 2011).

Corporate Governance

Companies should realize that the company's survival needs to be maintained, one of which is through good corporate governance. According to the National Committee for Governance Policy (KNKG), Good Corporate Governance (GCG) is one of the pillars of the market economic system. Corporate governance is closely related to trust in both the company that implements it and the business climate in a country. Implementing Good Corporate Governance (GCG) encourages the creation of healthy competition and a conducive business climate (KNKG in (Pratama & Rahardja, 2013). GCG implicitly states that a company is not a profit-making machine for its owner, but an entity to create added value for all interested parties. KNKG also created five GCG principles in the 2006 General Guidelines for Indonesian Good Corporate Governance, namely (KNK, 2006):

1. Transparency. To maintain objectivity in conducting business, companies must provide material and relevant information in a way that is easily accessible and understood by stakeholders.
2. Accountability. Companies must be able to account for their performance transparently and fairly. Companies must be managed correctly, measurably and under the interests of the company while still considering the interests of shareholders and other stakeholders.
3. Responsibility. Companies must follow statutory regulations and carry out their responsibilities towards society and the environment so that business continuity can be maintained in the long term and receive recognition as a good corporate citizen.
4. Independence. To help with the implementation of GCG principles, companies must be managed independently so that each company organ does not dominate each other and cannot be intervened by other parties.
5. Fairness and Fairness. In carrying out its activities, companies must pay attention to the interests of shareholders and other stakeholders based on the principles of fairness and equality.

Independent Commissioner

Corporate governance mechanisms refer to a set of mechanisms that influence decisions taken by managers when there is a separation between ownership and control, one example is the existence of independent commissioners. Under Indonesia's National Law (Law No. 40/2007 of the Republic of Indonesia Concerning Limited Liability Companies, 2007) about Limited Liability Companies, the Board of Commissioners is a company organ tasked with carrying out general and/or specific supervision under the articles of association and advising to the directors under the Company's interests and under the Company's goals. According Pratama and Rahardja, (2013), the effectiveness of the Board of Commissioners is necessary because the commissioner's task is business oversight. To create effectiveness of the Board of Commissioners, one of the factors is the ideal proportion of Independent Commissioners in the ranks of the Board of Commissioners. In order to implement good corporate governance, the company must have free or independent commissioners with a proportional number of shares owned by investors who act as non-controllers. With the presence of related provisions on the number of free or independent commissioners with a minimum percentage of 30% of commissioners concerned (Wedari, 2004).

Independent commissioners have an important role in implementing corporate governance mechanisms. According to FGCI (2011) the Board of Commissioners is tasked with ensuring the implementation of the company's strategy, supervising management in managing the company and accountability must be implemented. Basically, the board of commissioners is a mechanism to supervise, provide guidance and provide direction to company management. Independent commissioners are mediators between managers in the company in the event of disputes and supervise management performance and advise management so that independent commissioners are in the best position to carry out the tracking function

Independent Commissioners can be measured using the formula, (Sutino & Khoiruddin, 2016):

$$KI = \frac{Number\ of\ independent\ commisioners}{Number\ of\ commisioners}\ 100\%$$

Earnings Management

Earnings management is a form of managing income (cash inflow) and spending (cash outflow) carried out by management to obtain the desired level of profit to benefit the company or even a party. Earnings management is one of the variables that can damage the credibility of financial reports, this action adds bias to financial reports and can confuse consumers or investors who believe that engineered profit figures are the same as non-engineered profit figures. Earnings management occurs when financial report information related to a transaction is exploited and manipulated by managers to influence contract conclusions, obscuring the company's true economic performance from stakeholders (Healy & Wahlen, 1999). Earnings management carried out by manipulating actual facts regarding excessive costs or recognition of unreal income will increase the value of profits and influence investor perceptions (Senjaya et al., 2021).

According to Windharta and Ahmar, (2014) earnings management is formed because there are principals and agents trying to obtain maximum welfare for their own desires. Because of this, the agent also takes actions that disregard the interests of the principal. This shows information asymmetry within a company. If information asymmetry is high in the company, the principals do not have the opportunity to supervise or control the actions carried out by the agents, so the managers/agents have the opportunity to carry out earnings management (Medyawati, 2016).

Earnings management is measured by a modification of the Jones (1991) model. Companies with high discretionary accruals show low quality profits. Likewise, companies with low discretionary accruals show high quality company profits. There is a formula used to determine earnings management from the Modified Jones model (1995), namely:

1. Determine the total accruals score
   TACit = NIit – CFOit
2. Determining the accruals score is estimated with the OLS regression equation:
   $\frac{TACit}{Ait-1} = ß1(\frac{1}{Ait-1}) + ß2(\frac{REVit-Rev\ it-1}{Ait-1}) + ß3(\frac{PPEit}{Ait-1}) + ε$
3. Determining the Non-discretionary accrual (NDA) score
   $NDAit = ß1(\frac{1}{Ait-1}) + ß2(\frac{REVit-Rev\ it-1}{Ait-1} - \frac{RECit-RECit-1}{Ait-1}) + ß3(\frac{PPEit}{Ait-1}) + ε$
4. Calculate the DA (discretionary accruals) value which is a measure of earnings management using the formula:
   $DAit = (\frac{TACit}{Ait-1})$ - NDAit

Where:

TAit-1 : Total assets in company i in year t-1
NDAit : Nondiscretionary accrual at company i in year t
TACit : Total Accruals at company i in period t
REVit-1 : Revenue at company i year t-1
Nit : Net profit in company i year t
Dait : Discretionary accrual at company i in year t
PPEit : Fixed assets in company i year t
CFOit : Operating cash flow in company i year t

RECit-1 : Receivables from company i in year t-1
RECit: Receivables from company i in year t
REVit : Revenue at company i year t

Research Hypothesis

According to Jacoby et al., (2019) publicly traded companies with financial problems will be encouraged to take part in earnings management activities to avoid default. This shows that company executives who experience financial distress try to do well to obtain funds from third parties and to get bonuses and other forms of payment. The agency theory explains that the company's level of financial distress causes managers to be motivated to cover up the company's true condition by carrying out earnings management. Managers have more information than shareholders. Previous research by Mustika et al., (2020); Mellennia and Khomsyah, (2023); Farukha and Suwarno, (2024); Kurnia and Mulyati (2023) and Chairunnisa et al., (2021) found that financial distress improves earnings management. This means that managers will increasingly carry out earnings management if the company experiences higher levels of financial distress. Based on this description, it can be concluded that when a company is in a financial crisis, managers will carry out earnings management to protect their jobs and keeping the company afloat while trying to perform well.
H_1: Financial distress improves earnings management practices

Financial distress is a condition in which a company experiences serious financial difficulties, often threatening its operational continuity (Sunanto et al., 2023). Management is often faced with pressure to create a better financial picture than it actually is, both to maintain investor confidence and to meet credit agreement requirements (Susilawati, 2021).. In situations like this, management often tries to find solutions that can help overcome these conditions, including through earnings management practices

However, Corporate governance is designed to control agency problems between owners (shareholders) and management (agents) by implementing effective tracking and control mechanisms (Handriani & Robiyanto, 2018). Good governance includes the existence of an independent board of commissioners who supervise and advise the board of directors, and make sure the company operates under laws and regulations and the principles of good corporate governance (GCG). They also play a role in protecting the interests of minority shareholders and other interested parties.

The research results Mellennia and Khomsyiah, (2023); Supardi and Asmara, (2019) and Santoso, (2023) state that implementing corporate governance can weaken the influence of financial distress on earnings management practices. Implementing good corporate governance is considered a projection that can suppress all forms of profit manipulation that can be carried out by companies. This shows that the better the implementation of corporate governance will reduce financial distress and earnings management actions.
H_2: Implementation of corporate governance as measured by independent commissioners weakens the influence of financial distress on earnings management practices

Research Methods

This study uses a quantitative approach with descriptive and verification methods to test the proposed hypothesis. The population in this study were all banking sector companies on the Indonesia Stock Exchange (IDX) during the 2018–2022 period. The sample was selected using a purposive sampling method with these criteria:

1. The company publishes complete annual reports and audited financial statements during the study period.
2. The required data is available and accessible

From this sampling, a sample of 30 banking companies was obtained with 5 years, so the sample used was 150 annual reports of banking companies. Data Collection Techniques using secondary data. Secondary data were obtained from the company's annual financial report and the company's annual report taken from the company's website or www.idx.co.id. Data analysis was carried out using multiple linear regression and moderated regression analysis (MRA) to test the role of corporate governance moderation in the influence between financial distress and earnings management. Data processing was carried out using SPSS 26 statistical software. The operational definition of variables in this research can be summarized in the table below:

Table 2. Operational definitions of variables and variable measurement

Variable	Indicator	Formula
Financial Distress	Altman Z score	Z' = 1,200 Z1 + 1,400 Z2 + 3,300 Z3 + 0,600 Z4 + 1,000 Z5
Good Corporate Governance (GCG)	Independent Commissioner	$IC = \frac{number\ of\ independent\ commissioners}{number\ of\ commissioners}\ 100\%$
Earnings management	Discretionary Accruals	$DAit = \frac{TACit}{Ait-1}$ - NDAit

Data processed by researchers, 2024

Results and Discussion

Descriptive Results

Table 3. Descriptive statistical tests

	N	Minimum	Maximum	Mean	Std. Deviation
Financial Distress	150	-0.51	3.16	0.4527	0.57901
GCG	150	0.33	0.80	0.5661	0.08773
Earning Managements	150	-3.23	6.52	-0.0085	0.73489

Source: SPSS output, 2024

Descriptive Statistics will present the average value, maximum value, minimum value and standard deviation value of each variable studied. Table 3 illustrates the results of descriptive statistical testing of the variables used in this research. Based on the output results of descriptive statistical testing from table 3, there were 150 samples used in this research.

The average Financial Distress value of 0.4527 indicates that the companies in the sample are in a relatively stable financial condition. However, a negative minimum value (-0.51) and a high maximum (3.16) indicates significant variation in the financial condition of these companies. The standard deviation of 0.57901 indicates that there is a wide spread of data from the average, suggesting that some companies are experiencing greater financial distress than others.

The average GCG measured by the independent commissioner score of 0.5661 indicates that the companies in the sample have a fairly good level of implementation of independent commissioners. The range of values between 0.33 and 0.80 indicates that there is variation in the implementation of independent commissioners among these companies. The relatively small standard deviation (0.08773) indicates that most companies have independent commissioner implementation scores close to the average, suggesting consistency in the implementation of good governance as measured by the implementation of independent commissioners.

The average Earning Managements approaching zero (-0.0085) indicates that overall, the companies in the sample do not significantly manipulate earnings. However, the wide range of values from -3.23 to 6.52 and the standard deviation of 0.73489 indicate that there is a significant variation in earnings management practices among these companies. This indicates that although earnings management practices are not dominant, certain companies carry out these practices to a significant extent.

Classic Assumption Test

The classical assumption test is used to make sure the regression model built meets certain statistical requirements so the estimation results are valid, fair, and consistent. The classical assumption test in this research model is:

Normality test

The normality test is a statistical procedure used to determine whether the data in a sample comes from a normally distributed population. The normality test in this study uses one sample Kolmogorov Smirnov.

Table 4. One Sample Kolmogrov Sminov Test

Test statistic	0.070
Asymp. Sig. (2-Tailed)	0,070

Source: SPSS output, 2024

Based on table 4 above, it can be seen that the Asymp.Sign value is 0.070 > 0.05, meaning that the data distribution is normal.

Multicollinearity test

The multicollinearity test tries to detect a strong linear relationship between two or more independent variables in a regression model. A good regression is free from multicollinearity. Data is declared free from multicollinearity if the tolerance value is >0.1 and VIF <10.

Table 5. Multicollinearity Test

	Collinearity Statistics	
	Tolerance	VIF
Financial Distress	0.605	1.654
Independent Commissioners	0.605	1.654

Source: SPSS output, 2024

Based on table 5 above, it can be seen that the tolerance value for the financial distress and independent commissioner variables is 0.605 > 0.01 and the VIF value is 1.654 < 10, so the data is free from multicollinearity.

Autocorrelation test

Autocorrelation test is a statistical method to detect correlation between residuals (prediction errors) in a linear regression model, especially in time series data. Autocorrelation occurs when the residual value in a period is correlated with the residual value in the previous period. A good regression is free from autocorrelation.

Table 6. Autocorrelation Test

Model Summary	
Model	Durbin-Watson
1	2.128

Source: SPSS output, 2024

There is no autocorrelation when the Watson Durbin value lies between du and (4-du), then it means there is no autocorrelation. In this study, the du value was 1.7602. The Watson durbin value was 2.128. 4-du value = 4-1.7602=2.2398. The DW value of 2.128 is between du and 4-du (1.7602 < 2.128 < 2.2398). So the data is free from autocorrelation.

Heteroscedasticity test

Heteroscedasticity test is a statistical method to detect whether the variance of the residuals (prediction errors) in a linear regression model is constant (homoscedasticity) or not constant (heteroscedasticity). A good regression is free from heteroscedasticity.

Table 7. Heteroscedasticity test

Coefficients	
Model	Sig
Constant	0.71
Financial distress	0.861
Independent Commissioners	0.235
Dependent variable: ABS_RES	

Source: SPSS output, 2024

Based on table 7 above, it can be seen that the significance value of the financial distress variable on the absolute residual is 0.861>0.05, meaning that heteroscedasticity does not occur. Likewise, the independent commissioner variable has a significance value of 0.235 > 0.05, so heteroscedasticity does not occur.

Hypothesis Testing

Table 8. Simple regression analysis

Coefficients[a]						
		Unstandardized Coefficients		Standardized Coefficients		
Model		B	Std. Error	Beta	t	Sig.
1	(Constant)	26.427	2.569		10.287	.000
	Financial Distress	.328	.055	.437	5.905	.000

a. Dependent Variable: Management Laba

Source: SPSS output, 2024

Based on table 8 above, it can be seen that the significance value of financial distress is 0.000 <0.05 and the calculated t value is 5.905 > t table 1.97612, so it can be concluded that the financial distress variable affects earnings management. The regression coefficient is 0.328, meaning that when the financial distress variable increases by 1 unit, the earnings management variable will increase by 0.328 units. From the results it can be concluded that financial distress significantly affects earnings management, so Hypothesis 1 is accepted.

MRA (Moderated Regression Analysis) Test

Table 9. MRA (Moderated Regression Analysis) Test

Coefficients[a]						
		Unstandardized Coefficients		Standardized Coefficients		
Model		B	Std. Error	Beta	t	Sig.
1	(Constant)	-5.310	18.415		-0.288	0.773
	Financial Distress	0.927	0.919	0.997	1.009	0.315
	Independent Commissioners	0.462	0.399	0.879	1.157	0.249
	Financial distress*Independent Commissioners	0.258	0.158	0.358	1.633	0.035

a. Dependent Variable: Management Laba

Source: SPSS output, 2024

Based on the results of testing with moderation, the following regression equation is obtained.

$$y = -5{,}310 + 0.927\mathrm{X} + 0.462\mathrm{M} + 0.258\mathrm{XM} + \mathrm{e}$$

From table 9 above, it can be seen that the interaction variable between financial distress and independent commissioners has a significance value of 0.035<0.05, meaning it has a significant effect. This indicates that independent commissioners can moderate the effect of financial distress on earnings management. The regression coefficient for the interaction variable between financial distress and independent commissioners is 0.258 < 0.328 (regression coefficient for financial distress without interacting with independent commissioners), this means that the position of independent commissioners weakens the influence between financial distress and earnings management. The results of the study prove that when a company's financial condition is experiencing financial difficulties, support from independent commissioners will reduce the profit management carried out.

Coefficient of determination

Table 10. Coefficient of determination model 1

Model Summary				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.437	0.191	0.185	1.212

Predictors: (constant), financial distress
Source: SPSS output, 2024

Table 11. Coefficient of determination model 2

Model Summary			
Model	R	Adjusted R Square	Std. Error of the Estimate
1	0.542	0.279	1.212

a. Predictors: (constant), financial distress* independent commissioners, independent commissioners, financial distress
Source: SPSS output, 2024

From the table above, it can be seen that for model 1 (before there are variable interactions), earnings management variability can be explained by the financial distress variable of 18.5%, while the remaining 81.5% is explained by other variables outside the research. For table model 2 (the interaction between independent commissioners and financial distress), variability in earnings management can be explained by the independent variable (plus moderation) amounting to 27.9% while the remaining 72.1% is explained by other variables. From the results of the coefficient of determination test in the second model, the independent variable financial distress and the interaction with the moderating variable (independent commissioner) contribute than model 1. This indicates that model 2 is better than model 1.

Discussion

The results prove that financial distress affects earnings management. The results follow the Agency Theory (Jensen & Meckling, 1976) that there is a conflict of interest between managers (agents) and company owners (principals). In conditions of financial distress, managers have the incentive to carry out earnings management to meet the expectations of the owners and maintain their position in the company. This is also supported by Signaling Theory (Spence, 1973). This theory states that management uses financial information as a signal to the market. In situations of financial stress, managers can carry out earnings management to provide a positive signal to investors and other stakeholders, to maintain or increase the value of the company in the eyes of the public.

Earnings management practices are aimed at maintaining funds and influenced by several other motivations, including: Debt Covenant Hypothesis. Managers usually increase profits to avoid violating debt covenants, which can trigger consequences such as penalties or harmful contract renegotiations. Earnings management can also be motivated by Debt Renegotiation. In conditions of financial distress, companies will carry out earnings management to display better financial performance to obtain more favorable terms in debt renegotiations. In addition, earnings management can also be motivated to Maintain Managerial Contracts. Managers can carry out earnings management to meet performance targets related to compensation or bonuses and to maintain their professional reputation.

Earnings management can be carried out with two approaches, namely by increasing profits and reducing profits. Regarding Increasing Profits, the goal is to meet performance targets, avoid violating debt covenants, or attract investors. This strategy is generally used in conditions of financial distress to show better performance than reality. While in terms of Reducing Profits, it is done to reduce the tax burden, avoid regulatory attention, or prepare profit reserves for future periods. This strategy will be used when the company wants to show stable or conservative performance.

Earnings management practices in financial distress can be carried out through two main approaches, accrual-based manipulation and real earnings management. The choice between these two approaches is often influenced by the severity of the financial distress faced by the company. In the early stages of financial distress, companies usually choose accrual-based manipulation. This strategy involves accounting changes without affecting cash flow, such as accelerating revenue recognition or delaying expense recognition. Accrual manipulation is easier to implement and does not require significant costs. However, its effectiveness is limited because auditors can detect this practice through financial statement analysis.

When a company faces more serious financial pressures, management may turn to real activity manipulation. This strategy involves real operational actions, such as giving large discounts to increase short-term sales, reducing spending on research and development, or delaying routine maintenance. Although it can immediately impact profits, real manipulation can harm the company's long-term performance.

This study determines the role of independent commissioners in suppressing earnings management practices within the framework of agency theory. However, the application of agency theory in this study is still normative and less explorative. The existence of independent commissioners can reduce earnings management because of its supervisory function. With good quality supervision, it can detect attempts to manipulate earnings that can harm stakeholders, Encourage transparency and accountability of financial reports, reduce conflicts of interest by providing objective and fair supervision of management decisions. Agency theory states that board supervision, alignment of interests between managers and shareholders, and increased transparency are ways to mitigate agency conflicts (Jensen & Meckling, 1976).

Independent commissioners, it can increase supervision of management. However, not all independent commissioners have the same effectiveness in carrying out their supervisory function. Factors such as individual competence, experience, intensity of attendance at meetings, and actual independence greatly influence the effectiveness of the commissioner's role.

Theoretical Implication and Managerial Implication

This research contributes to knowledge. First, this research provides evidence that financial distress affects earnings management carried out by management. This strengthens existing theories, from agency theory and signal theory. Judging from agency theory, where there is information asymmetry between the agent and the principal, each will act in accordance with their interests. Management will carry out earnings management in line with the financial difficulties faced, this is done to show performance as an agent for the principal. Judging from signal theory, this proves that when management conveys financial difficulties to the principal/stakeholders, it will be a negative signal for them, which will lead to a fall in company value which will have an impact on decreasing agent performance. Second, this research also proves that companies that implement independent commissioners will help reduce unethical behavior, one of which is earnings management. third, for companies, this research is useful as input and consideration. When managing a company, management must manage it well by implementing independent commissioners as a management control tool against unethical actions that will harm many parties.

Conclusion and Future Direction

1. Financial distress improves earnings management. This research proves that when a company is in financial difficulties, management will manipulate profits to cover up the situation to parties outside the company, so the company looks good in the eyes of stakeholders.
2. Independent commissioners weakens the relationship between financial distress and profit management. This proves that when a company experiences financial distress and is supported by an independent commissioner, it will reduce earnings management actions taken by management.

This study has several limitations that need to be considered. First, the earnings management approach used is still limited to accrual-based practices, so it does not fully reflect the form of earnings manipulation carried out through real activities such as sales manipulation, production expenses, or discretionary costs. Second, the study only focuses on one industrial sector, namely banking or in a limited scope, so the generalization of the findings to various other industrial sectors still has limitations. Third, other factors with the potential to influence earnings management, such as overall corporate governance, market pressure, and managerial incentives have not been fully studied.

Future Direction

The contribution given by independent variables to earnings management variables is small, so further research should add independent variables out-side this research. Future research should also be directed towards exploring real activity-based earnings management approaches and cross-industry analysis to test the robustness of the effect of financial distress on earnings management. Although this study measures corporate governance through the proportion of independent commissioners, future research is encouraged to adopt a broader governance construct, such as composite indices, to capture the multidimensional nature of corporate governance more comprehensively

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