

Analysis of Opportunistic Behavior, Monitoring Mechanisms and Financial Distress on Earnings Management: Evidence from Indonesia

Dian Agustina^{a,1,*}, Nur Anita^{b,2}

^a Universitas Gadjah Mada, Indonesia

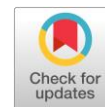
^b Universitas Gadjah Mada, Indonesia

¹dianagustina@mail.ugm.ac.id; ²nuranita@mail.ugm.ac.id;

*Corresponding Author

ABSTRACT

This study aims to examine the relationship between opportunistic behavior, monitoring mechanisms, and financial distress on earnings management. The population of this study is 796 companies listed in the Indonesia Stock Exchange year 2015-2019. Fourty three sample companies were selected using purposive sampling method, resulting 215 firm-year observation data. Using ordinary least square (OLS) regression as the main data analysis, the study observed that monitoring mechanism variable proxied by leverage has a positive effect on earnings management. However, there is no correlation between opportunistic behavior proxied by free cash flow and profitability as well as financial distress proxied by Altman Z-Score on earnings management. A robustness test using additional data of the samples companies during the COVID-19 pandemic was carried out. The test provides evidence that the results of this study's are robust. This study contributes empirically to the literature on the relationship between opportunistic behavior using free cash flow and profitability proxies, monitoring mechanisms using leverage, financial distress, and earnings management. It also provides valuable information for stakeholders to observe the quality of firm's financial statements.



KEYWORDS

Earnings management,
Financial distress,
Monitoring mechanism,
Opportunistic behavior.



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Introduction

This study investigates the relationship between opportunistic behavior, monitoring mechanisms, and financial distress on earnings management. Several previous empirical studies have examined earnings management through discretionary accruals (Vagner et al., 2021). However, few studies focus on investigating the relationship between opportunistic behavior, monitoring mechanisms, and financial distress on earnings management. Financial statements are the primary sources internal and external parties use to make decisions. Managers have the control to present the company's financial statements that are most in line with company or personal profits so that it can lead to opportunistic behavior. In addition, when financial distress occurs, there is a possibility that the company will suffer losses which can cause managers to act to hide poor financial performance. However, a monitoring mechanism is expected to prevent managers from taking these actions (Ghazali et al., 2015). The main question in this study is whether earnings management is related to opportunistic behavior, monitoring mechanisms, and financial distress.

This study is critical because of the tendency of managers to manage earnings, such as the scandals that surfaced related to WorldCom and Enron, which were seen from the point of view of opportunistic behavior and financial distress. This study uses free cash flow (CFC) and profitability as proxies for opportunistic behavior variables (Lehn & Poulsen, 1989), while the financial distress variable is measured

using the Altman Z-Score model (Maina and Sakwa, 2012). It also tries to see whether the monitoring mechanism prevents managers' actions in carrying out earnings management from another point of view. Leverage is used as a proxy for monitoring mechanisms (Kim & Yoon, 2008).

Previous empirical research concluded various inconsistent results. Several previous studies have found that earnings management is positively related to opportunistic behavior (Cardoso et al., 2014; Marfou and Hassanzadeh, 2021; Susanto and Pradipta, 2020). On the other hand, Ghazali et al. (2015) as well as Wimelda and Chandra (2018) found the opposite findings. Ghazali et al. (2015), Susanto and Pradipta (2020), and also Wimelda and Chandra (2018) found that earnings management was positively related to monitoring mechanisms, while Ghazali et al. (2015) reported otherwise. Previous studies found that financial distress was positively related to earnings management (Campa and Camacho-Miñano, 2015; Ghazali et al., 2015), while Agrawal and Chatterjee (2015) found the opposite. Additionally, previous research in Indonesia such as Wimelda and Chandra (2018) used data from a relatively short period of 2013-2015 and focused on manufacturing companies. Therefore, this study seeks to fill the research gap.

The main contribution of this research is to provide empirical evidence and to expand the literature on the relationship of opportunistic behavior using free cash flow and profitability proxies, monitoring mechanisms using leverage, financial distress, and earnings management. In addition, this study provides valuable information for potential investors and investors, and regulators responsible for observing the quality of the company's financial statements.

Literature Review

Earnings Management

Accounting is classified into two categories, which are internal and external accounting, depending on users' needs for information. Internal accounting is helpful for internal parties such as managers and employees, while external accounting is helpful for external parties such as creditors, lenders, and regulators for decision making. Managers are authorized to prepare and report the company's financial statements. Managers are considered people who understand the current state of the company. Accounting information will be helpful if the information submitted is reliable and relevant. However, there is a possibility of information asymmetry. Managers can report untruths and report information that is beneficial to themselves, otherwise known as earnings management actions (Ghazali et al., 2015; Schipper, 1989). Healy and Wahlen (1999) argue that earnings management occurs when considerations and changes in financial statements can mislead stakeholders into making decisions related to company performance. In addition, earnings management can be done through changes in accounting estimates and accounting policies (Yaping, 2005).

One way to manage earnings is through accruals, non-discretionary accruals, and discretionary accruals. Many previous studies used discretionary accruals as earnings management proxies (Abd. Rahman & Mohamed Ali, 2006). Ratsula (2010) states that there are four earnings management techniques. First, using the "taking a bath" technique means that management tends to report more losses to increase the likelihood of reported earnings in the future. Second, minimize income. Companies with high profits will tend to practice this technique to avoid political pressure and income tax reflection. The third technique is to maximize revenue. Usually, this is done for the manager's benefit, not for the company. Finally, income smoothing reduces the volatility of reported earnings. In this study, it is assumed that management tends to manage earnings to avoid reporting losses. This study adopts the 2005 Khotari model for earnings management proxies.

Opportunistic Behavior

Opportunistic behavior can be one of the leading causes that motivate managers to engage in earnings management actions. It means that there is an indication of the manager's dishonesty in reporting performance for personal gain (Ghazali et al., 2015). In this study, the manager's opportunistic behavior uses a proxy of free cash flow and company profitability. High free cash flow can open up opportunities for managers to manage earnings and create agency problems. It is in line with the research results of Cardoso et al. (2014); Marfou & Hassanzadeh (2021); Susanto & Pradipta (2020) namely that free cash flow and earnings management are positively correlated. Managers will try to put a high cash flow value under their control so that it can encourage earnings management (Susanto & Pradipta, 2020). However, other studies state that free cash flow and earnings management are empirically negatively correlated (Ghazali et al., 2015; Wimelda & Chandra, 2018). Having sufficient free cash flow for companies creates confidence in financial performance and tends to take on earnings management.

This study also uses profitability as a proxy for earnings management. Investors need profitability information to assess company performance and make investment decisions. In addition, profitability is one of the managers' performances appraisals. Fluctuating and declining profitability can encourage managers to engage in earnings management activities and show the company's future profitability (Ghazali et al., 2015). Based on the arguments above, this study proposes the first hypothesis that is:

H1. There is a positive relationship between opportunistic behavior and earnings management.

Monitoring Mechanism

Monitoring mechanism could be in term of internal monitoring or external monitoring. Internal monitoring comes from parties within the company, such as the internal audit committee and the board of directors. The internal monitoring aims to avoid any opportunistic behavior of management to control earnings. In their research, Van de Poel & Vanstraelen (2007) explain that high internal monitoring can result in lower levels of abnormal accruals. On the other hand, external monitoring comes from lenders, shareholders, and institutional monitors. Bilimoria (1997) explains that the existence of external lenders limits the ability and freedom of management to utilize company assets to maximize personal profits.

Efficient control mechanisms using leverage can be used to avoid earnings management. A high leverage ratio indicates the company is at risk of default, bankruptcy, and financial difficulties (Andrade & Kaplan, 1998). Thus, a high debt ratio impacts the company's risk because debt causes the company to pay a higher interest rate (Steklá & Gryčová, 2015).

In their article, Aman *et al.* (2006) show that leverage does not correlate with earnings management as referred to in the period after the 1997 economic crisis. On the other hand, according to Stulz (1990), debt will discipline management in making payments to avoid debt covenant failures and demands from lenders. Lenders will pay more attention to their clients and monitor them, so managers avoid earnings management practices (Balsam et al., 2002; Siregar & Utama, 2008). Based on these arguments, this study proposes the second hypothesis as follow:

H2. There is a positive relationship between the monitoring mechanism and earnings management.

Financial Distress

Financial distress is a term used to indicate when the agreement or contract with the company's creditors does not work as expected or is a difficult stage (Binti & Ameer, 2010a). In this case, the company is usually under high enough pressure to have the potential to go bankrupt or be reorganized. Hu & Ansell (2005), in their article, defines a distressed firm as a company that has a debt ratio greater than one (>1) or an exciting cover ratio (based on cash flow) that is less than one (<1).

A number of literature related to the earnings management behavior of companies experiencing financial difficulties have provided mixed evidence. Beneish et al. (2001), DeFond & Jiambalvo (1994), and Rosner (2003) explain that company managers who are in financially tricky conditions tend to adjust earnings upwards. It is due to the motivation to report higher earnings to avoid the possibility of bankruptcy and debt covenant violations. In this case, the manager only focuses on the short-term viability of the company (Charitou et al., 2007). In contrast, DeAngelo et al. (1994) argue that managers of companies experiencing financial difficulties do not increase profits. However, from these findings, there are similarities that financial distress causes company profits to shift downwards.

The choice of discretionary accruals that increase income or decrease income depends on financial difficulty (Jaggi & Lee, 2002). If financial difficulties are expected to be temporary, the company's management is likely to use discretionary accruals that increase earnings and vice versa. However, given the inconclusive evidence regarding the relationship between financial distress and earnings management strategies, this study proposes the third hypothesis, which is:

H3. There is a positive relationship between financial distress and earnings management.

In short, the theoretical framework and hypotheses formulation of this study is depicted in Figure 1.

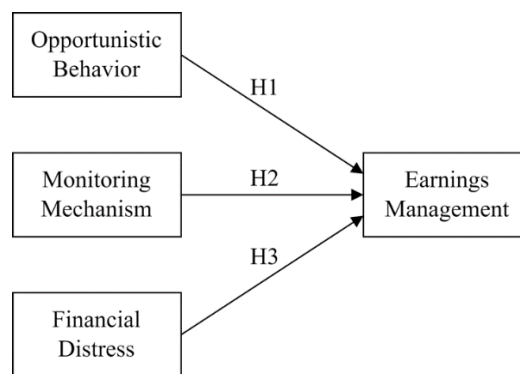


Figure 1. Conceptual Framework

Research Method

Data of this study were gathered from companies listed in the Indonesia Stock Exchange (IDX) from 2015-to 2019. This study does not use data for 2020 to 2021 to avoid bias because there was considerable economic turmoil due to the Covid-19 pandemic. However, to prove the robustness of the research results, the researchers conducted a robustness test using a combined sample between the period before and during the COVID-19 period, namely 2015-2021. It is to prove whether the research results remain consistent or not. This study uses secondary data downloaded from the Thompson DataStream. The total population of the study consisted of 796 companies or 3,980 company year observations. However, using purposive sampling method, 753 companies were excluded from the study as they did not provide the data related to the variables being investigated. Thus, the final sample of the study is 43 companies, resulting in 215 company-year observations. Table 1 present the process of sample selection based on the purposive sampling.

Table 1. Sample Selection Process

Description	Total
Companies listed in the IDX in 2021	796
Companies with incomplete data during 2015-2021	753
Final Sample Companies	43
Total data being observed from 2015 to 2019 (firm-year observation data)	215

Source: Secondary data processed (2022)

This study adopts the 2005 Kothari model to measure earnings management. The use of the 2005 Khotari model is in line with several previous studies that have been carried out by Abdul Rahman & Wan Abdullah (2005), Ahmad-Zaluki *et al.* (2011), Ali *et al.* (2008), Antle *et al.* (2006), Caramanis and Lennox (2008), Joubert & Fakhfakh (2012). Furthermore, management usually uses its authority to apply discretionary accruals in the financial reporting process. The application of discretionary accruals is motivated by certain motives from the company's management. Discretionary accruals are widely used in research because they can capture the quality of accounting information (Choi *et al.*, 2010).

The proxy for measuring opportunistic behavior in this study uses Free Cash Flow (FCF) and Profitability. It is by the research conducted by Lehn & Poulsen (1989). Several previous studies have also proven that company profitability is closely related to cash flow from operations and return on assets (ROA). This study follows Rahman & Ali (2006), who uses ROA to measure company performance with operating profit or earnings before interest and taxes (EBIT) divided by total assets. Furthermore, the proxy monitoring mechanism in this study uses leverage as measured by the Debt to Asset Ratio (DAR). DAR is calculated using the formula for total debt divided by total assets. This calculation is under the research conducted by Kim & Yoon (2008).

This study uses the Altman Z-Score model to measure the company's financial condition. This model has been widely used to measure financial distress by several previous studies (Agrawal & Chatterjee, 2015; Maina F.G & Sakwa, 2012). Companies with a z-score less than 1.81 will be classified as companies experiencing financial difficulties. On the other hand, companies with a z-score greater than two will be considered financially healthy.

Concerning earnings management, Becker *et al.* (1998); Davidson *et al.* (2005); Francis *et al.* (2005); Srinidhi & Gul (2006); Sukeecheep *et al.* (2013) explained that the size and liquidity of the company have a significant effect on discretionary accruals. Thus, firm size and liquidity are used as control variables. This study will use descriptive statistics to compare the mean, median, and standard deviation between variables. Furthermore, hypothesis testing is carried out using regression analysis. The regression model in this study is as follows:

$$DACC_{it} = \beta_0 + \beta_1 (FCF)_{it} + \beta_2 (LEV)_{it} + \beta_3 (FIN_{DISTRESS})_{it} + \beta_4 (PROFIT)_{it} + \beta_5 (SIZE)_{it} + \beta_6 (LIQUIDITY)_{it} + \varepsilon_{it}$$

where:

DACC	: Discretionary accruals (Earnings Management)
FCF	: Free Cash Flow (Scale of free cash flow based on total assets)
LEV	: Leverage (Debt to Asset Ratio)
FIN_DISTRESS	: Financial distress (Z-Score)
PROFIT	: Profitabilitas (Return on assets)
SIZE	: Company Size
LIQUIDITY	: Liquidity

Results and Discussion

Table 2 presents descriptive statistical analysis for each variable. The descriptive statistical table reports the minimum, maximum, mean, and standard deviation values of the study variables. Empirical results show that the reported earnings management value is in the range of -1.72 to 121.56. At the same time, the average value of earnings management is 2.2414. This value is higher than the research results (Md Yusof, 2011) which report that the mean value of earnings management is 0.165. Furthermore, the reported value of

financial distress is in the range of 0.41 to 22.66. Then, the average value of financial distress is 4.7553. These results indicate that companies in Indonesia are generally financially healthy.

Table 2. Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
DACC	215	-1.72	121.56	2.24	14.89
FCF	215	-1.36E+13	1.97E+13	1.88E+12	4.02E+12
LEV	215	.00	.81	.23	.184
FIN_DISTRESS	215	.41	22.66	4.75	4.55
PROFIT	215	-.06	.46	.082	.08
LIQUIDITY	215	.28	7.43	1.92	1.16
Ln_SIZE	215	27.96	33.11	30.31	1.07
Valid N (listwise)	215				

Source: Secondary data processed (2022)

The research hypothesis is tested using multiple linear regression. Table 3 summarizes the results of the multiple linear regression analysis in this study.

Table 3. Multiple Linear Regression (2015-2019)

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Collinearity Statistics	
	B	Std. Error	Beta			Tolerance	VIF
(Constant)	97.424	35.227		2.766	.006		
FCF	1.464E-13	.000	.040	.468	.641	.630	1.588
LEV	-16.621	7.087	-.205	-2.345	.020	.589	1.698
FIN_DISTRESS	-.153	.425	-.047	-.361	.718	.267	3.747
PROFIT	-12.584	21.384	-.071	-.588	.557	.305	3.281
LIQUIDITY	-2.477	1.122	-.193	-2.207	.028	.587	1.705
Ln_SIZE	-2.807	1.155	-.202	-2.431	.016	.649	1.542
R Square	0.064						
Adjusted R Square	0.037						

Source: Secondary data processed (2022)

The empirical results of the study show that hypothesis 1 is not supported. There is no significant relationship between opportunistic behavior with free cash flow proxies and profitability on earnings management. This can be seen from the significance value of both $p = 0.641$ and $0.557 > p = 0.05$. The insignificant results indicate that the opportunistic behavior of corporate managers in Indonesia does not cause them to engage in earnings management actions. Managers recognize that poor utilization of free cash flow will be exposed in the future. Thus, managers will think twice about realizing their opportunistic behavior because this will impact the sustainability of their careers. The results of this study contradict the agency theory but support the stakeholder theory. Stakeholder theory assumes that management will try to increase the company's value and minimize losses that may arise for stakeholders.

On the other hand, hypothesis 2 is supported ($p = 0.02 < p = 0.05$). It means a significant relationship between the monitoring mechanism and the leverage proxy on earnings management. The coefficient value shows a negative number of -16,621. Leverage has a significant negative effect on earnings management, meaning that if the leverage in a company is high, the practice of earnings management in the company will be low. The results of this study support the view that leverage is a control and monitoring system that limits earnings management practices.

Based on the regression results, H_3 is not supported because the results show a significant value of $p=0.718$, $p>0.05$ for financial distress, which is a proxy for pressure behavior. There is no significant relationship between financial distress and earnings management. Financial difficulties do not affect managers to take earnings management actions. The results of this study do not support previous research conducted by Campa & Camacho-Miñano (2015), Ghazali et al. (2015), Marfou & Hassanzadeh (2021), and support the results of research conducted by Agrawal & Chatterjee (2015).

The firm size and liquidity control variables showed significant results with $p=0.028$, $p<0.05$ for firm size, and $p=0.016$, $p<0.05$ for liquidity. It shows that firm size and liquidity are significantly positively related to earnings management. Large companies are more likely to manage earnings than small companies because there is more pressure to meet or beat analyst expectations. The company's liquidity level is related to earnings management because there are indications to avoid debt covenant violations (Agrawal & Chatterjee, 2015).

Furthermore, the researchers conducted a robustness test through a linear regression test by combining samples between the period before and during the COVID-19 period, namely 2015-2021. Table 4 summarizes the robustness test through multiple linear regression analysis. Consistent results were obtained, namely hypotheses 1 and 3 were not supported, while hypothesis 2 is supported. Furthermore, the study's firm size and liquidity showed significant results as control variables.

Table 4. Robustness Check

Model	Unstandardized		Standardized	t	Sig.	Collinearity	
	Coefficients		Coefficients			Statistics	
	B	Std. Error	Beta			Tolerance	VIF
(Constant)	91.199	27.705		3.292	.001		
FCF	7.153E-14	.000	.028	.401	.688	.649	1.540
LEV	-16.733	5.897	-.217	-2.837	.005	.545	1.834
FIN_DISTRESS	-.207	.358	-.060	-.580	.562	.292	3.426
PROFIT	-9.634	16.996	-.055	-.567	.571	.339	2.950
LIQUIDITY	-2.472	.911	-.203	-2.713	.007	.565	1.771
Ln_SIZE	-2.599	.911	-.197	-2.854	.005	.666	1.502

Source: Secondary data processed (2022)

Companies in Indonesia generally have implemented a process of preparing financial statements complying with standards and avoiding manipulative practices. The information presented in the financial statements reflects the actual condition of the company. It is represented by the research findings, which show that the opportunistic behavior of corporate managers in Indonesia does not cause them to take earnings management actions. The manager realizes that the poor utilization of free cash flow will be revealed in the future and will have a destructive impact on the continuity of his career. In addition, the condition of financial difficulties in companies in Indonesia also does not affect managers to take earnings management actions. Managers in Indonesia still maintain their integrity not to take manipulative actions despite the financial crisis.

A monitoring mechanism with leverage proxy statistically has a significant negative effect on earnings management. It indicates that if the leverage in a company is high, the practice of earnings management in that company will be low. The results of this study support the view that leverage is a control and monitoring system that limits earnings management practices. If a company has high debt, creditors' supervision will be even tighter. Thus, the application of earnings management will be minimal. However, the majority of

earnings management practices are influenced by firm size. Large firms are more likely to manage earnings than smaller firms because there is more pressure to meet or beat analyst expectations. The company's liquidity level is also related to earnings management because there are indications to avoid debt covenant violations (Agrawal & Chatterjee, 2015).

Conclusion

This study examines the relationship between opportunistic behavior, monitoring mechanisms, and financial distress on earnings management for a sample of 43 companies listed in the Indonesia Stock Exchange during the 2015-2019 period. It utilizes the Khotari 2005 model to measure discretionary accruals, a proxy for earnings management. FCF and ROA are used as proxies for opportunistic behavior, while leverage is used as proxy for the monitoring mechanism variable. For financial distress, the variable was measured by Altman Z-score. Following the finding of the majority of previous studies, this study applies firm size and liquidity as control variables.

The results of the study show that of the three hypotheses offered, only one hypothesis is supported, which is hypothesis two. In other words, only the hypotheses related to the monitoring mechanism are related to earnings management. Hypothesis two shows a significant negative relationship, meaning that when the level of leverage of a company is high, the practice of earnings management within the company is low due to supervision from external parties. Meanwhile, hypotheses one and three are not supported, namely, the relationship between opportunistic behavior and financial distress on earnings management. There is no relationship between opportunistic behavior and financial distress on earnings management. The control variable shows a significant positive relationship to earnings management. In addition, the results of this study also show robust results using additional samples, namely the period 2015-2021.

This study has several limitations. First, the sample of this study only uses companies listed on the Indonesia Stock Exchange, so the study results must be generalized with caution. Second, the measurement of discretionary accruals only uses one type of accrual model, thereby reducing the robustness of the research. Third, this study uses all industrial sectors listed on the Indonesia Stock Exchange. The results may provide different findings if the study uses a specific industry sample. Future research can use a larger sample from various exchanges globally and use various accrual measurement models so that the research results are comprehensive.

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