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The Effect of Financial Distress, Leverage, and Firm Size on Earnings Management

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Abstract Earnings management is a common practice among companies to adjust financial reports to achieve specific objectives. Factors such as financial distress, leverage, and firm size are suspected to influence earnings management practices. This study aims to analyze the effect of financial distress, leverage, and firm size on earnings management in infrastructure companies listed on the Indonesia Stock Exchange for the 2020-2022 period. This research uses secondary data in the form of annual reports, with a total sample of 78 companies. The analysis method employed is panel data regression to examine the relationship between independent variables and earnings management as the dependent variable. The results indicate that financial distress has no effect on earnings management, leverage has no effect on earnings management, and firm size also has no effect on earnings management. These findings imply that these factors are not the primary determinants of earnings management practices in Indonesian infrastructure companies, highlighting the need for further research by considering other more relevant variables.

Keywords: Financial Distress; Leverage; Firm Size; Earning Management

Introduction

Companies, in carrying out their business activities, expect results in the form of profit, which is used to maintain their business continuity. Profit acquisition can be used to measure a company's financial performance by analyzing and evaluating its financial statements. The preparation of financial statements aims to provide information regarding the financial position, performance, and cash flow changes of a company, which are useful for a wide range of users in making economic decisions (PSAK No. 1, 2015:3). Financial statements serve as a source of information for investors to assess financial performance and predict a company's financial health. Earnings information is often used as a basis for tax calculations, policymaking, investment decisions, and dividend payments to shareholders. Therefore, earnings information frequently becomes a target for manipulation through opportunistic actions by corporate management, who are motivated to demonstrate better performance by creating corporate value (maximizing shareholder wealth) through Earnings Management. Earnings Management can occur due to significant pressure on management to achieve targeted profits. Many company managers, acting as agents, attempt to "embellish" financial statements so that their performance is perceived favorably by shareholders (investors) to attract investment into their company. However, Earnings Management practices can be detrimental to financial statement users and indirectly harm the company itself, as management provides earnings information

that does not reflect the actual financial condition and is driven by opportunistic behavior.

A phenomenon of Earnings Management practices in Indonesia includes the cases of PT Waskita Karya and PT Wijaya Karya. Indications of financial statement manipulation in these companies surfaced when banks became suspicious of discrepancies in invoices during the credit restructuring process. The manipulation tactic involved falsifying bookkeeping records by concealing a pile of vendor invoices since 2016. The absence of these liabilities artificially reduced debt burdens, creating the illusion of financial health despite both companies facing financial distress. In 2020, Wijaya Karya (WIKA) reported a net profit of IDR 322 billion, which later declined to IDR 214 billion in the following year and dropped further to IDR 12.5 billion in 2022. Meanwhile, Waskita Karya recorded a net loss reduction from IDR 9.28 trillion in 2020 to IDR 1.67 trillion in 2022 (Majalah Tempo, 2023). Several factors influence a company's decision to engage in Earnings Management practices, including Financial Distress, Leverage, and Firm Size. Financial distress is a condition in which a company's operating results are insufficient to meet its obligations, meaning the company faces financial difficulties in repaying its debts (Pratiwi et al., 2022). Platt and Platt (2002) define financial distress as a stage of financial decline occurring before bankruptcy or liquidation.

Research by Putri & Naibaho (2022) and Dewi & Khomsiyah (2023) found that financial distress significantly influences earnings management. Similarly, Mulyati & Kurnia (2023) concluded that financial distress affects earnings management. Ratih et al. (2023) also discovered a significant positive impact of financial distress on earnings management, suggesting that the higher a company's financial distress, the greater its earnings management activities. A high level of financial distress motivates company management to engage in Earnings Management to maintain business continuity by "beautifying" financial statements, making their financial performance appear healthy in the eyes of investors. Research by Jacoby et al. (2019) states that companies experiencing financial distress are more likely to engage in earnings management than financially stable companies. However, Christina & Alexander (2020) and Kristyaningsih (2021) found that financial distress does not significantly impact earnings management. Similarly, Sucipto & Zulfa (2021) concluded that financial distress does not significantly affect earnings management. In running its business, a company relies not only on its own capital but also on third-party funding (loans or debt). According to Ross, Westerfield, and Jordan (2017, p.509), leverage refers to the use of debt in a company's capital structure, where the greater the company's debt, the higher its financial leverage, increasing the potential returns for shareholders. A high level of leverage means the company has more debt obligations, leading to higher interest expenses that must be covered by company profits. This situation often pressures management to engage in Earnings Management practices to present a positive company performance and maintain its reputation (Minarti & Syahzuni, 2022). Research by Alfina & Sambuaga (2021) found that leverage positively influences earnings management. However, Tualeka (2020) suggested that financial leverage could have a negative impact on earnings management. Minarti & Syahzuni (2022) found that financial leverage does not affect earnings management. A study by Joe & Ginting (2022) revealed that leverage has a positive influence on earnings management, indicating that high leverage encourages management to manipulate earnings to avoid violating debt agreements. Similarly, Anugerah (2022) found a significant relationship between leverage and earnings management. However, other studies, such as Saputri & Dewi (2024), reported that leverage does not significantly impact earnings management. In addition to financial distress and leverage, another factor influencing Earnings Management is Firm Size. Firm Size represents the scale of a company,

which can be measured using total sales, total assets, or market capitalization (Safitri & Kurnia, 2021). Larger companies tend to have greater financial stability, stronger business capabilities, and higher-quality human resources compared to smaller firms. Additionally, large companies receive more attention from stakeholders, compelling them to provide high-quality accounting information and reliable financial statements. However, this attention also pressures management to select accounting methods that reduce reported earnings.

Thus, Firm Size can influence Earnings Management, where larger firms have a greater tendency to engage in earnings management, while smaller firms have a lower likelihood of doing so. Research by Astuti, Joe, & Ginting (2022) found that firm size positively affects earnings management. Minarti & Syahzuni (2022) reported a negative relationship between firm size and earnings management, whereas Hetami & Wahyudi (2021) concluded that firm size has no effect on earnings management. Previous studies have shown mixed results. Atmamiki & Priantinah (2023) found that firm size positively affects earnings management, while Adityaningsih & Hidayat (2024) reported no significant effect. This study focuses on infrastructure companies, which include businesses involved in road construction, toll roads, stadiums, bridges, building construction, power grids, dams, and other physical infrastructure projects.To achieve their targeted goals, companies in the infrastructure sector require significant capital to support their operational needs. This is often done by issuing and selling shares to the public. Therefore, company managers must provide accurate information to users of financial statements. However, due to the pressures faced by these companies, management may act opportunistically by manipulating earnings to present a strong financial performance. Based on the explanations above, the conflicting results from previous studies make the author interested in conducting research on the influence of Financial Distress, Leverage, and Firm Size on Earnings Management in infrastructure companies listed on the Indonesia Stock Exchange for the 2020–2022 period.

Method

This quantitative study follows a positivist approach using a causal research design to examine the impact of financial distress, financial leverage, and firm size on earnings management. Financial distress is measured by the Altman Z-score, leverage by the Debt to Asset Ratio, and firm size by Ln (Total Assets), while earnings management is proxied by Discretionary Accruals (DA) using the Modified Jones Model, all on a ratio scale. Using secondary data from annual reports and financial statements of 62 infrastructure companies listed on the Indonesia Stock Exchange (IDX) for 2020–2022, purposive sampling selected 26 companies, yielding 78 observations over three years. Analysis includes descriptive statistics and panel data regression (CEM, FEM, and REM) using EViews 12, with model selection via Chow, Hausman, and Lagrange Multiplier tests. Classical assumption tests ensure model validity, while Goodness of Fit tests (F-test & R^2) assess model suitability. Hypothesis testing via t-tests evaluates the impact of independent variables on earnings management at a 0.05 significance level (Basuki & Prawoto, 2015).

Result and Discussion

A. Research Object Description

This study examines infrastructure companies listed on the Indonesia Stock Exchange (IDX) from 2020 to 2022. Using purposive sampling, a total of 26 companies were selected, resulting in 78 observations. The data used consists of financial figures from annual reports,

obtained from www.idx.co.id or the respective company websites.

B. Descriptive Statistic Test Results

Descriptive statistics explain the characteristics of each variable in the study from 2020 to 2022, including minimum, maximum, mean, and standard deviation values. The descriptive statistics test was conducted using EViews 12. Based on Table 4.1, the total sample (N) is 78, with the dependent variable Earnings Management (Y) and independent variables Financial Distress (X1), Financial Leverage (X2), and Firm Size (X3), as shown in the table below:

Table 1. Descriptive Analysis

	EM	FD	L	FS
Mean	-0.022051	4.420769	0.458590	24.83141
Median	-0.040000	2.990000	0.460000	26.25500
Maximum	2.150000	20.55000	0.890000	31.68000
Minimum	-0.630000	-1.060000	0.070000	12.42000
Std. Dev.	0.300118	4.478468	0.232176	5.127428
Skewness	4.799443	1.654118	-0.024012	-0.658106
Kurtosis	36.72261	5.372218	1.874190	2.503919

Source: Output EViews 12

1. Earnings Management (Y)
   The minimum value is -0.63, observed in PT XL Axiata Tbk (EXCL) in 2022, indicating a low level of earnings management. The maximum value is 2.15, recorded by PT XL Axiata Tbk (EXCL) in 2021, suggesting a higher level of earnings management compared to other companies. The mean value is -0.02, with a standard deviation of 0.30. Since the mean is lower than the standard deviation, it indicates that the data is heterogeneous or highly variable.
2. Financial Distress (X1)
   The minimum value is -1.06, observed in Tower Bersama Infrastructure T (TBIG) in 2020, indicating that the company was in financial distress and at risk of bankruptcy. The maximum value is 20.55, recorded by Tower Bersama Infrastructure T (LCKM) in 2022, suggesting that the company was not at risk of bankruptcy. The mean value is 4.42, with a standard deviation of 4.47. Since the mean is lower than the standard deviation, it suggests that the financial distress variable is heterogeneous or highly varied.
3. Leverage (X2)
   The minimum value is 0.07, recorded by Tower Bersama Infrastructure T (LKCM) in 2022, indicating that the company had not fully utilized debt for its operations. The maximum value is 0.88, recorded by PT XL Axiata Tbk (EXCL) in 2022, meaning the company had maximized its debt usage. If the debt ratio exceeds 0.5, it suggests that most of the company's assets are financed through debt. The mean value is 0.45, with a standard deviation of 0.23, indicating that the leverage data is homogeneous or less varied.
4. Firm Size (X3)
   Firm size is measured using the natural logarithm (LN) of total assets, representing the company's size based on its total assets. A higher LN total asset value indicates a larger company, while a lower value indicates a smaller company. The minimum value is 12.41, recorded by Telkom Indonesia (Persero) Tbk (TLKM) in 2020, showing that it had the lowest total assets among the sample companies. The maximum value is 31.68, recorded by PP (Persero) Tbk (PTPP) in 2022, making it the company with the largest assets. The

mean value is 24.83, with a standard deviation of 5.12, indicating that the firm size data is homogeneous or less varied.

C. Selection of Panel Data Regression Model

In panel data regression, three simple regression models are tested: Common Effect Model (CEM), Fixed Effect Model (FEM), and Random Effect Model (REM). To determine the most appropriate model for interpretation, three estimation tests are conducted: Chow Test, Hausman Test, and Lagrange Multiplier Test.

1. Common Effect Model

   The common effect model combines time-series and cross-sectional data, assuming that companies behave similarly over different periods by ignoring time and individual effects. Parameter estimation is conducted using the Ordinary Least Squares (OLS) method.

2. Fixed Effect Model

   In the fixed effect model, the constant varies for each individual, although the coefficients (slopes) of independent variables remain the same. The estimation method used in this approach is Least Square Dummy Variable (LSDV).

3. Random Effect Model

   In panel data regression, parameter estimation requires the error components model, also known as the random effect model. The appropriate method for this approach is Generalized Least Square (GLS).

To determine the best regression model, further analysis using the Chow Test and Hausman Test is required. The results of the panel data regression model selection tests are presented below:

1. Chow Test

Table 2. Chow Test

Effects Test	Statistic	d.f.	Prob.
Cross-section F	1.251952	(25,49)	0.2461
Cross-section Chi-square	38.526885	25	0.0411

Source: Output EViews 12, (2024)

The proposed hypotheses are:

- H_0: The common effect model is used.
- H_1: The fixed effect model is used, and further testing with the Hausman test is required.

Decision-making guidelines for the Chow Test:

a) If Prob. F > 0.05, then H_0 is accepted, indicating that the common effect model is appropriate.

b) If Prob. F < 0.05, then H_0 is rejected, meaning the fixed effect model is used, followed by the Hausman Test to determine whether to use the fixed effect or random effect model.

Table 4.6 shows that the Prob. cross-section F is 0.2461, which is greater than α (0.05),

meaning H_0 is accepted. Therefore, the common effect model is the most suitable regression method.

D. Multiple Linear Regression Analysis Results

Table 3. Multiple Linear Regression Analysis

Variable	Coefficient	Std. Error	t-Statistic	Prob.
FD	-0.011719	0.012804	-0.915277	0.3630
L	-0.364899	0.249856	-1.460439	0.1484
FS	4.917993	6.827598	0.720311	0.4736
C	0.074973	0.217238	0.345120	0.7310

Source: Output EViews 12

The regression equation in this study, using the Common Effect Model, is presented as follows:

$$EM = 0.074 - 0.011\ FD - 0.364\ L + 4.917\ FS + \varepsilon$$

Description:

- EM = Earnings Management
- β_0 = Constant
- β_1, β_2, β_3 = Coefficients of independent variables
- FD = Financial Distress
- L = Leverage
- FS = Firm Size
- ε = Error Term
- i = Company data
- t = Time period data

Based on the regression equation, the interpretation is as follows:

1. The constant (α) is 0.074, meaning that if financial distress, leverage, and firm size are constant or zero, earnings management is 0.074.
2. Financial distress has a regression coefficient of -0.011, indicating a negative relationship between financial distress and earnings management. If financial distress increases by one unit, earnings management decreases by 0.011, assuming leverage and firm size remain constant.
3. Leverage has a regression coefficient of -0.364, indicating a negative relationship between leverage and earnings management. If leverage increases by one unit, earnings management decreases by 0.364, assuming financial distress and firm size remain constant.
4. Firm size has a regression coefficient of 4.917, indicating a positive relationship between firm size and earnings management. If firm size increases by one unit, earnings management increases by 4.917, assuming financial distress and leverage remain constant.

E. Hypothesis Testing Results

Based on the panel data regression model selection, this study uses the Common Effect Model (CEM) to address the research problem. The next step is hypothesis testing, which includes the coefficient of determination test, simultaneous test (F-test), and partial test (T-test). The explanation of each test is as follows:

1. Coefficient of Determination Test
   This test measures how well independent variables explain the dependent variable. A panel data regression model is considered appropriate if the coefficient of determination (R^2 test) value is close to one. However, if the R^2 value is close to zero, the panel data regression model is less suitable for evaluating the research. Below are the results of the coefficient of determination test in this study:

Table 4. Coefficient of Determination

Root MSE	1.422394	R-squared	0.032612
Mean dependent var	-0.022051	Adjusted R-squared	-0.066070

Source: EViews 12 Output

Based on Table 4.11 (Coefficient of Determination), the Adjusted R-squared value is -0.06. This means that financial distress, financial leverage, and firm size explain only -6% of earnings management, while the remaining percentage is influenced by other variables not examined in this study.

2. F-Test (Simultaneous Test)
   The F-test is conducted to determine whether the regression model is appropriate and to examine the simultaneous effect of independent variables (financial distress, financial leverage, and firm size) on the dependent variable (earnings management). The results of the F-test are presented in the table below:

Table 5. F-Test Results (Simultaneous Test)

Hannan-Quinn criter.	0.535608	F-statistic	0.831535
Durbin-Watson stat	3.617820	Prob(F-statistic)	0.480752

Source: EViews 12 Output

The F-test results in Table 4.12 indicate that the Prob (F-Statistics) value is 0.48, which is greater than 0.05. This means that the independent variables do not significantly influence the dependent variable, and the model does not have a good fit.

3. T-Test (Partial Test)
   The T-test (partial test) is conducted to examine the individual effect of each independent variable on the dependent variable. The results of the T-test in this study are presented in the following table:

Table 6. T-Test (Partial Test)

Variable	Coefficient	Std. Error	t-Statistic	Prob.
FD	-0.011719	0.012804	-0.915277	0.3630
L	-0.364899	0.249856	-1.460439	0.1484
FS	4.917993	6.827598	0.720311	0.4736
C	0.074973	0.217238	0.345120	0.7310

Source: EViews 12 Output

Based on Table 4.13, the hypothesis test results are as follows:

1. The p-value of the FD variable is greater than α (0.05), specifically 0.36. This indicates that FD has no effect on earnings management. Based on these statistical results, the first hypothesis is rejected.
2. The p-value of the L variable is greater than α (0.05), specifically 0.14. This indicates that FL has no effect on earnings management. Based on these statistical results, the second hypothesis is rejected.
3. The p-value of the FS variable is greater than α (0.05), specifically 0.47. This indicates that FS has no effect on earnings management. Based on these statistical results, the third hypothesis is rejected.

F. Discussion

1. The Effect of Financial Distress on Earnings Management

   The first hypothesis in this study examines whether financial distress affects earnings management. Based on the hypothesis test results, financial distress has a probability value greater than 0.05, indicating that H0 is accepted and H1 is rejected, meaning that financial distress has no effect on earnings management. This study fails to prove the existence of earnings management practices when a company experiences bankruptcy or financial distress. This occurs when corporate management seeks to avoid earnings management in addressing financial distress or bankruptcy. Instead, company management focuses more on resolving financial difficulties and takes real actions to overcome financial distress rather than manipulating earnings. Earnings manipulation is not an appropriate strategy because it would distort the company's operational performance and reduce the accuracy of reported earnings information. Concealing financial reports could cause issues for policymakers and regulators, as biased information presented to investors might lead to poor decision-making, ultimately affecting the smooth functioning of financial markets. Signaling theory explains that companies provide signals to reduce information asymmetry. When a company faces financial distress, managers are more motivated to manipulate earnings in order to reduce negative signals associated with financial distress and instead send out positive signals to stakeholders. This study aligns with Krystianingsih (2021) and Christina & Alexander (2020), who found that earnings management is not affected by financial distress. However, it contradicts Bahiy & Agustiningsih (2021) and Pratiwi et al. (2022), who found that financial distress has an effect on earnings management.

2. The Effect of Leverage on Earnings Management

   The second hypothesis examines whether financial leverage affects earnings management. The hypothesis test results show that financial leverage has a probability value greater than

0.05, meaning H0 is accepted and H2 is rejected, indicating that financial leverage does not affect earnings management. Companies with high leverage—a high proportion of total debt to total assets—face an increased risk of default, meaning they are at risk of failing to meet financial obligations. However, earnings management is not an effective mechanism to avoid default. Debt obligations must still be met, and earnings management cannot eliminate the risk of default. Most companies maintain a safe level of leverage, meaning they can comfortably repay their debts used to finance assets. In such cases, managers are not motivated to engage in earnings management. Companies in stable financial conditions do not require earnings manipulation to maintain their financial standing. This study is consistent with Minarti & Syahzuni (2022), Melinda et al. (2021), and Rismawati & Setiany (2023), who found that leverage does not affect earnings management. However, it contradicts the findings of Wilson et al. (2020) and Subhasinghe et al. (2021), who found that financial leverage influences earnings management.

3. The Effect of Firm Size on Earnings Management

   The third hypothesis examines whether firm size affects earnings management. The hypothesis test results show that firm size has a probability value greater than 0.05, meaning H0 is accepted and H3 is rejected, indicating that firm size does not affect earnings management. The lack of influence from firm size may be due to strict oversight from the government, analysts, and investors, which prevents managers from engaging in earnings management. As company size increases, earnings management becomes less prevalent. Larger companies tend to attract more scrutiny from analysts and investors, making it harder for managers to manipulate earnings. Large companies are also less likely to engage in earnings management because their operations are more complex, requiring more accurate financial reporting. These companies are more cautious in manipulating earnings and tend to report financial statements with higher accuracy. This study aligns with Hetami & Wahyudi (2021), Melinda et al. (2021), and Rismawati & Setiany (2023), who found that firm size does not affect earnings management. However, it contradicts the findings of Bahiy & Agustiningsih (2021), who found that firm size does affect earnings management.

Conclusion

The study concludes that financial distress, financial leverage, and firm size have no significant effect on earnings management. Financial distress does not influence earnings management, as companies tend to avoid such practices when facing financial difficulties. Leverage also has no impact, as debt obligations must be met regardless of earnings management. Similarly, firm size does not affect earnings management, as stakeholders in larger companies are generally more scrutinizing and critical compared to those in smaller firms. The implications of this study suggest that other factors, such as corporate governance, management incentives, and market pressures, may have a more substantial influence on earnings management practices than financial distress, leverage, and firm size. Therefore, future research should explore these additional factors and consider the role of regulatory frameworks in shaping earnings management behavior. It is also recommended that policymakers and investors pay closer attention to corporate governance mechanisms, as well as internal and external controls, to better understand and mitigate potential earnings manipulation, particularly in larger companies or firms with complex financial structures.

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