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Financial Distress, Institutional Ownership, and Earnings Management: Evidence from the Energy Sector

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ABSTRACT

This study seeks to analyze the effect of financial distress on earnings management, focusing on institutional ownership as a potential moderating variable. Employing a quantitative research approach, this study utilizes secondary data sourced from the financial statements of energy industry sector companies listed on the Indonesia Stock Exchange (IDX) and the companies' official websites during the period 2019–2023. The purposive sampling technique was used to select a representative sample, ensuring relevance and data quality. The findings reveal that financial distress positively influences earnings management, indicating that companies experiencing financial difficulties are more likely to engage in earnings management practices, possibly as a strategic response to mitigate the appearance of financial instability. However, the study also finds that institutional ownership does not moderate the relationship between financial distress and earnings management. This suggests that the presence of institutional investors does not significantly alter or mitigate the impact of financial distress on a company's propensity to engage in earnings management. These results provide important insights for stakeholders, including regulators and investors, by highlighting the implications of financial distress on corporate reporting behavior and the limited role of institutional ownership in curbing earnings management practices.

Keywords: Earnings Management; Energy Sector; Financial Distress; Institutional Ownership; Investors

INTRODUCTION

Earnings management is a manager's choice of accounting policies or actual actions to influence earnings in order to achieve certain profit objectives (Scott, 2015). According to Yahaya et al. (2020), earnings management is carried out to influence earnings reports using certain accounting methods, accelerating transactions, or other means that affect short-term profits. This action aims to change financial statements to reflect company performance or affect the outcome of contractual agreements. Earnings management is often used to attract investors, who pay attention to financial conditions such as financial distress, which is a situation when a company has difficulty meeting its financial obligations. Financial distress encourages management to carry out earnings management in order to maintain the company's image and avoid consequences such as falling stock prices and difficulty obtaining funding. Institutional ownership plays an important role in corporate governance, with institutional investors able to monitor management actions, including earnings management practices, and moderate the effect of financial distress on these practices.

PT Petrosea Tbk (PTRO), a mining company owned by Prajogo Pangestu, experienced a decline in performance in 2023 with net profit falling 70.18% to US$ 12.20 million, even though its revenue increased 21.26% to US$ 577.61 million. The decline in profit was due to an increase in operating and administrative expenses and a 166.8% jump in interest expense, reflecting high debt and funding costs. PT Petrosea generates its main revenue from coal mining, construction, and sales services, with several large clients including PT Kideco Jaya Agung and PT Freeport Indonesia. In addition, PT Petrosea earns revenue from related party transactions that have the potential to impact financial reporting.

PT Kreasi Jasa Persada, a subsidiary of PT Petrindo Jaya Kreasi Tbk (CUAN), is now the new controller of PT Petrosea after acquiring 34% of its shares. The company is planning a long-term strategy to strengthen business lines, develop new projects, and improve efficiency, which is expected to overcome financial distress. Based on the 2024 Work Plan and Budget (RKAB), PT Petrosea's coal production is approved at 1.19 million tonnes per year until 2026. This study focuses on the effect of financial distress on earnings management with institutional ownership as a moderating variable, given the uncertainty of previous research results regarding the role of financial distress in earnings management. The objectives of this study are (1) to empirically examine the effect of financial distress on earnings management, and (2) to analyze institutional ownership influence on financial distress on earnings management.

LITERATURE REVIEW

In agency theory, the relationship between agents and owners is the basis of corporate earnings management. The leader gives the agent the authority to manage the company and is responsible for his actions. A conflict of interest can occur when there is an information imbalance between the two. Although they are tasked with optimizing profits for the principal, agents also have self-interest that drives them to manage profits for their own benefit. During difficult times, managers may be more compelled to alter financial statements to preserve the company's reputation. Since institutional shareholders tend to have the ability to monitor and reduce earnings management practices, institutional ownership plays a role in controlling managers' behavior, according to agency theory. Overall, agency theory is relevant to examine the effect of financial distress on earnings management with institutional ownership as a moderating variable, due to the conflict of interest between managers and shareholders.

Earnings Management

Earnings management refers to a manager's deliberate choice of accounting policies or real actions aimed at achieving specific reported earnings objectives. According to Scott (2015), various motivations drive earnings management. One common motivation is bonus purposes, where managers, aware of the company's profitability, act opportunistically to inflate current profits and secure larger bonuses. Political motivation plays a role in public companies, as managers often reduce reported earnings to avoid public scrutiny and stricter government regulations. Another key driver is taxation or tax-saving motivation, where companies adopt accounting methods to minimize income tax liabilities. CEO turnover also influences earnings management, as retiring CEOs may inflate earnings to enhance bonuses or safeguard their positions during poor company performance. Additionally, in Initial Public Offerings (IPO), earnings management may be employed to inflate share prices due to the absence of a base value. Lastly, providing favorable information to investors motivates financial reporting practices that portray a positive image of the company.

Scott (2015) also outlines specific patterns of earnings management. "Taking a bath" involves significant profit declines or increases in a given period compared to others. Income minimization reduces reported earnings below actual figures, while income maximization inflates them. Income smoothing, on the other hand, ensures consistent profit trends by maintaining stability in financial reports, reflecting desired profit levels over time.

Financial Distress

According to Sumajow et al. (2022), Financial distress is a condition where a company is having financial difficulty. According to Sari and Hermi (2023), financial distress is the initial symptom of bankruptcy in a company as evidenced by a decline in financial condition. This begins with the company's inability to pay off obligations in the company, such as liquidity obligations, as well as obligations in the solvency category.

Altman et al. (2019) mentioned four terms related to financial distress, namely (1) Failure occurs when the return on capital is lower than similar standards, or income is insufficient for cost, (2) Insolvency means debt exceeds assets, so real wealth is negative, (3) Default is a breach of payment promises to creditors, and (4) Bankruptcy occurs when debts exceed the value of assets, and the company is declared bankrupt by the court. This condition can be caused by a temporary lack of liquidity or cash flow.

Institutional Ownership

According to Tumiwa and Mamuaya (2018), institutional ownership is the ownership of shares of companies owned by institutions and institutions such as insurance companies, banks, and investment companies. Institutional ownership has significance in monitoring or monitoring management actions. The existence of institutional ownership will encourage more optimal supervision. Institutional ownership is important for keeping an eye on management activities. The presence of institutional ownership will promote better oversight.

Table 1. Previous Studies

Author, Year	Variable	Research Results
Sari & Hermi (2023)	Independent Variable: Financial Distress Dependent Variable: Earnings Management Moderating Variable: Institutional Ownership	Financial Distress has a negative effect on earnings management. The Institutional Ownership variable has a negative impact on Earnings Management.

		Institutional ownership, which is proxied by institutional ownership, weakens the effect of financial distress and leverage on earnings management.
Putri & Naibaho (2022)	Independent Variable: Financial Distress Dependent Variable: Earnings Management	Financial distress has a positive effect on earnings management
Khairin & Suryana (2022)	Independent Variable: Financial Distress Dependent Variable: Earnings management	Financial distress has a strong effect on earnings management
Li et al. (2020)	Independent Variable: Financial Distress Dependent Variable: Earnings management	Financial distress has a positive effect on earnings management
Chairunnisa et al. (2021)	Independent Variable: Financial Distress Dependent Variable: Earnings management	Financial distress has a positive effect on earnings management
Mustika et al. (2020)	Independent Variable: Financial Distress Dependent Variable: Manajemen Laba	Financial distress has a positive effect on earnings management

Hypotheses Development

The Effect of Financial Distress on Earnings Management

Financial distress is when a company faces significant financial difficulties, which if not handled properly can lead to bankruptcy. In such a situation, the company is usually under intense scrutiny from creditors, investors, auditors, and regulators, which may reduce the business's chances of making a profit. In addition, financial distress can also reduce the amount of resources available to management so that they may focus more on saving the business than on earnings management. Mustika et al. (2020) say that financial distress occurs when a company is no longer able to fulfill its obligations that should be paid, thus disrupting its operational conditions. However, when a company faces financial problems, management usually uses earnings management to improve financial reports to become more attractive to new investors and avoid liquidation.

According to Chairunnisa et al. (2021), using agency theory, namely, when companies experience higher levels of financial distress, earnings management behavior will increase, while when companies experience lower levels of financial distress, earnings management behavior will decrease. This theory is in accordance with the research results of Chairunnisa et al. (2021), which found that earnings management is profitable when facing financial difficulties. This suggests that managers are more likely to use earnings management when the company faces increasing financial distress because they want to maintain good financial performance.

H1: Financial distress has a positive effect on earnings management

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The Relationship Between Financial Distress and Earnings Management with Institutional Ownership as a Moderating Variable

According to agency theory, when directors appoint agents to provide services and authorize decision-making, this is called an agency relationship. Institutional ownership is very influential in decision-making by managers regarding earnings management and when financial distress occurs.

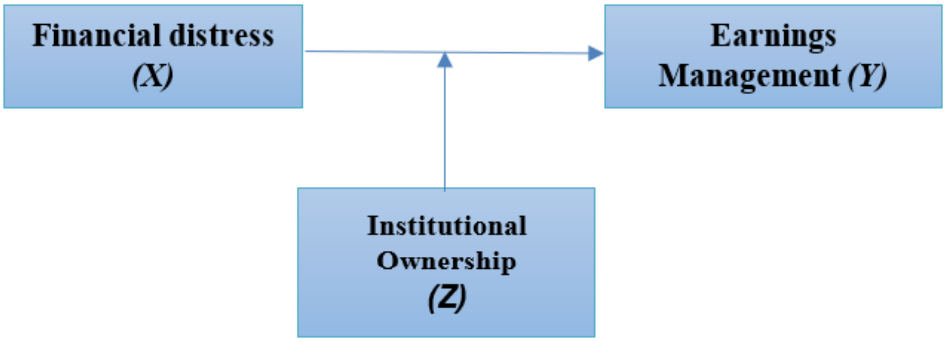
Financial distress and earnings management are important aspects that are interrelated in the world of finance and accounting. Financial distress describes the financial condition of a company that is experiencing difficulties in fulfilling its obligations, while earnings management is an attempt by management to influence financial statements in order to achieve certain goals. Companies in financial distress are required to show better financial performance than their actual condition in order to continue to attract investors and creditors, thus encouraging management to carry out earnings management. Institutional ownership has an important role in moderating the relationship between financial distress and earnings management.

Sari and Helmi's research (2023) states that when corporate governance is implemented, financial distress will be smaller than earnings management because the implementation of good corporate governance is considered as a way to close all loopholes for profit manipulation that can be utilized by the business world. So that the results of the study show that institutional ownership weakens the effect of financial distress on earnings management.

H2: Institutional ownership weakens the relationship between financial distress and earnings management.

The Conceptual Framework

Figure 1. The Conceptual Framework



RESEARCH METHOD

This research uses quantitative methods that involve numerical data to analyze the relationship between variables. The goal is to test the theory or find patterns in the data. The data used is secondary data from the financial statements of energy sector companies listed on the IDX in 2019-2023, namely 52 energy companies with 260 samples, obtained through purposive sampling. The variables in this study include earnings management as the dependent variable, financial distress as the independent variable, and institutional ownership as the moderating variable.

Dependent Variable

Florencia and Susanty (2019) stated that earnings management is an action taken by company management in the selection of accounting policies for the purpose of increasing earnings, decreasing earnings, or balancing earnings reported in the financial

statements. This practice includes various strategies such as manipulating income or costs, as well as the use of aggressive or conservative estimates in financial reporting. Earnings management is often used by managers as a tool in the process of determining the amount of profit to be reported to stakeholders, such as investors and creditors.

Earnings management can be measured by accrual earnings management as indicated by discretionary accruals measured by the Modified Jones Model (Dechow et al., 1995):

a. Calculating total accruals: $\mathrm{TAcc_{it}} = \mathrm{NI}_{it} - \mathrm{OCF}_{it}$ .....(1)
b. Determine the value of accruals estimated by the Ordinary Least Square (OLS) linear regression model equation:

$$\frac{TA_{it}}{A_{it-1}} = \beta_1 \left(\frac{1}{TA_{it-1}}\right) + \beta_2 \left(\frac{\Delta REV_{it}}{TA_{it-1}}\right) + \beta_2 \left(\frac{\Delta PPE_{it}}{TA_{it-1}}\right) + \varepsilon \quad \text{.....(2)}$$

c. Determining the value of *non-discretionary accrual* :

$$\mathrm{NDAcc_{it}} = \beta_1 \left(\frac{1}{TA_{it-1}}\right) + \beta_2 \left(\frac{\Delta REV_{it} - \Delta REC_{it}}{TA_{it-1}}\right) + \beta_2 \left(\frac{\Delta PPE_{it}}{TA_{it-1}}\right) + \varepsilon \quad \text{.....(3)}$$

d. Determining the value of *discretionary accrual:* $\mathrm{DAcc_{it}} = \left(\frac{\mathrm{TAcc}_{it}}{\mathrm{TA}_{it-1}}\right) - \mathrm{NDAcc}_{it}$ ..(4)

Description:

$\mathrm{TAcc_{it}}$	= Total accrual,
$\mathrm{NI_{it}}$	= Net income,
$\mathrm{OCF_{it}}$	= Operating cash flow,
$\mathrm{NDAcc_{it}}$	= non-discretionary accrual,
$\mathrm{DAcc_{it}}$	= Discretionary accrual,
TA_{it-1}	= Total Asset,
$\Delta\mathrm{REV_{it}}$	= Chance in revenue,
$\Delta\mathrm{REC_{it}}$	= Chance in receivable,
$\mathrm{PPE_{it}}$	= Fix asset,
β_i	= Regression coefficient,
ε	= Error term.

Independent Variable

Financial distress is a condition where the company is experiencing financial difficulties or liquidity is in a period of bankruptcy which is indicated by a decrease in the company's ability to fulfill its obligations to creditors. The cause of financial distress or financial difficulties experienced by the company is due to the decline in the company's economic activities, namely to predict the continuity or survival of the company.

The Altman Z-Score model was first introduced in 1968 and can only be applied to publicly listed manufacturing companies. In 1983, the Altman Z-Score was revised so that it could be used for manufacturing companies, both public and private.

The last change occurred in 1995 when the Altman Z-Score was modified so that it could be applied to various types of industries, both public and private. The formula for the Modified Altman Z-Score (Tania, et al., 2020) is:

$$ZSCORE = 6.56X_1 + 3.26X_2 + 6.72X_3 + 1.05X_4$$

Information:

Z-Score	= Financial Distress
X_1	= Working Capital/Total Asset
X_2	= Retained Earnings /Total Asset
X_3	= Earnings Before Interest and Tax /Total Asset
X_4	= Book Value of Equity /Total Debt

Moderation Variable
Jensen and Meckling (1976) state that institutional ownership has an important role in minimizing agency conflicts that occur between shareholders and managers. The existence of institutional investors is considered capable of optimizing the supervision of management performance by monitoring every decision made by management as company managers. Institutional ownership has an effective formula, namely:

$$\text{Institutional Ownership} = \frac{\text{Total institusional shares}}{\text{Total shares outstanding}}$$

Normality Test
According to Ghozali (2018), the normality test is used to determine whether the confounding or residual variables in the regression model have a normal distribution. As is known, the t and F tests assume that the normal distribution follows the residual values.

Multicollinearity Test
According to Ghozali (2018), the purpose of the multicollinearity test is to determine whether the regression model finds a correlation between independent variables. In other words, a good regression model should not find any correlation between independent variables.

Heteroscedasticity Test
According to Ghozali (2018), the purpose of the heteroscedasticity test is to determine whether in the regression model, there is an inequality in the variation of residuals from one observation to another.

Autocorrelation Test
According to Ghozali (2018), the purpose of the autocorrelation test is to determine whether there is a correlation between confounding errors in period t and confounding errors in periods 1-1 in a linear regression model. Autocorrelation is a problem that arises when there is a correlation. Autocorrelation occurs when successive observations over time are related to each other.

Multiple Linear Regression Testing
According to Ghozali (2018), multiple linear regression analysis is used to determine the direction and how much influence the independent variable has on the dependent variable, regardless of whether each independent variable has a positive or negative correlation. In addition, this analysis is also used to predict whether the value of the dependent variable will increase or decrease.

Hypothesis Testing
The regression equation in this study is formed in a mathematical model:

$$DA_{it} = \alpha + \beta_1 FD_{it} + \beta_2 IO_{it} + \beta_3 FD^{*} IO_{it} + \varepsilon_{it}$$

Information:

DA_{it}	= Earnings Management
FD	= Financial Distress
IO	= Institutional Ownership
α	= Constant
β_{1-3}	= Regression coefficient
ε	= Residual error (error)

F Statistical Test

This test is used to determine whether the independent variable, namely financial distress, and the dependent variable, namely earnings management, have a significant influence on each other. In this study, the F test, which is often used to evaluate the overall significance of the regression model, was used with a significant level (α) of 5%. The F-test value in this study is if the probability value is less than 0.05, then the independent variable and the dependent variable have a significant effect. If the probability value is less than 0.05, then the independent variable and the dependent variable have a significant effect.

Statistical Test t

According to Ghozali (2018), basically, the classic t-test shows how far the influence of one explanatory or independent variable is on the explanation of the dependent variable. The t-test is conducted to test the significance of the effect of the independent variable, namely financial distress, on the dependent variable, namely earnings management partially.

Determination Coefficient Test

According to Ghozali (2018), the coefficient of determination (R2) is a measure of how well the model can explain variations in the dependent variable. A low R2 value indicates that the independent variables cannot provide much information about the variation in the dependent variable, and a high R2 value indicates that the independent variables cannot provide much information. Due to the large variation between individual observations, the coefficient of determination for crosssection data is usually relatively low. In contrast, the coefficient of determination for time series data is usually high.

RESULTS

Descriptive Statistics

Table 2. Descriptive Statistics Results

	N	Minimum	Maximum	Mean	Std. Deviation
Earnings Management	260	-0.44	0.39	-0.0008	0.12119
Financial Distress	260	-22.85	667.88	7.5590	55.66391
Institutional Ownership	260	8.14	99.51	63.0421	22.98029
Valid N (listwise)	260				

Based on Table 2, the earnings management variable has a minimum value of -0.44, a maximum value of 0.39, an average value of -0.0008, and a standard deviation value of 0.12119. Financial distress has a minimum value of -22.85, a maximum value of 667.88, an average value of 7.5590, and a standard deviation value of 55.66391. Institutional Ownership has a minimum value of 8.14, a maximum value of 99.51, an average value of 63.0421, and a standard deviation value of 22.98029.

Normality Test

Table 3. One-Sample Kolmogorov-Smirnov Test Results

		Unstandardized Residual
N		260
Normal Parameters[a,b]	Mean	0.0000000
	Std. Deviation	0.13815959
Most Extreme Differences	Absolute	0.051
	Positive	0.051
	Negative	-0.046
Test Statistic		0.051
Asymp. Sig. (2-tailed)		0.200[c,d]

a. Test distribution is Normal.
b. Calculated from data.
c. Lilliefors Significance Correction.
d. This is a lower bound of the true significance.

Based on the data in Table 3, it shows the Asymp Sig value of 0.200> 0.05, which means that the residual data is normally distributed.

Multicollinearity Test

Table 4. Multicollinearity Test Results

Coefficients[a]								
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Collinearity Statistics	
		B	Std. Error	Beta			Tolerance	VIF
1	(Constant)	-0.006	0.022		-0.293	0.770		
	Financial Distress	0.000	0.000	0.188	3.045	0.003	0.984	1.016
	Institutional Ownership	3.857E-5	0.000	0.007	0.118	0.906	0.984	1.016
a. Dependent Variable: Earnings Management								

Based on the data in Table 4, it shows that the tolerance value> 0.10 and VIF < 10, which means that there is no correlation between the independent variables.

Heteroscedasticity Test

Table 5. Heteroscedasticity Test Results

Coefficients[a]						
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	0.150	0.030		5.014	0.000
	Financial Distress (FD)	0.001	0.002	0.678	0.300	0.765
	Institutional Ownership (IO)	-0.001	0.000	-0.145	-1.449	0.150
	FD*IO	-8.441E-6	0.000	-0.718	-0.317	0.752
	(Constant)	0.150	0.030		5.014	0.000
a. Dependent Variable: Abs_RES						

Based on the data in Table 5, it shows a significant value (SIG)> 0.05, which means that there is no heteroscedasticity in the research model.

Autocorrelation Test

Table 6. Autocorrelation Test Results

Model Summary[b]					
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	0.195[a]	0.038	0.027	0.11956	1.865
a. Predictors: (Constant), Moderation, Institutional Ownership, Financial Distress					
b. Dependent Variable: Earnings Management					

Based on the data in Table 6, it shows the Durbin-Watson value of 1.865 and then looks at the Du value of 1.779 (Ghozali, 2016) and the 4-du value of 2.221. From these results, it can be seen that the equation does not occur autocorrelation, namely Du < Durbin Watson < 4-Du or 1.779 < 1.865 < 2.221.

Determination Coefficient Test

Table 7. Determination Coefficient Test Results

Model Summary				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.220[a]	0.048	0.034	0.10272
a. Predictors: (Constant), Moderation, Institutional Ownership, Financial Distress				

Based on the data in Table 7, it shows that the Adjusted R Square value is 0.034, which means that financial distress and institutional ownership can explain earnings management by 3.4%. The remaining 96.6% is explained by other variables.

F Test of Model Appropriateness

Table 8. F Test of Model Appropriateness Results

ANOVA[a]						
Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	0.103	3	0.034	3.242	0.023[b]
	Residual	2.015	191	0.011		
	Total	2.118	194			
a. Dependent Variable: Earnings Management						
b. Predictors: (Constant), Moderation, Institutional Ownership, Financial Distress						

Based on the data in Table 8, it shows a significant F value of 0.023 <0.05, which means that financial distress and institutional ownership simultaneously affect earnings management, or the model can be said to be feasible.

T-Test

Table 9. T-Test Results

Coefficients[a]						
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	-0.009	0.072		-0.119	0.905
	Financial Distress (FD)	0.003	0.000	0.191	2.373	0.019
	Institutional Ownership (IO)	0.003	0.019	-0.002	-0.020	0.984
	FD*IO	0.004	0.007	0.052	0.583	0.560
a. Dependent Variable: Earnings Management						

$$DA_{it} = -0.009+0.003*FD_{it}+0.003*KI_{it}+0.004FD*KI_{it}$$

Based on Table 9, it can be concluded that the Financial Distress variable has a coefficient value of 0.003 with a significance level of 0.019, which is less than 0.05. This indicates that financial distress has a positive and statistically significant effect on earnings management, suggesting that as financial distress increases, the likelihood of earnings management also rises. However, the moderation model variable (FD*KI), which examines the role of Institutional Ownership in moderating the relationship between financial distress and earnings management, has a coefficient value of 0.004 and a significance level of 0.560, which is greater than 0.05. This result indicates that

Institutional Ownership does not significantly moderate the effect of financial distress on earnings management, implying that the presence of institutional ownership does not influence or alter the relationship between these variables in a meaningful way.

DISCUSSION

The Effect of Financial Distress on Earnings Management

The statistical result shows that financial distress has a positive effect on earnings management. Financial distress puts great pressure on management to display stable financial performance, even if it means manipulating financial data. This is consistent with Putri & Naibaho (2022), Li et al. (2020), Chairunnisa et al. (2021), and Mustika et al. (2020).

The Relationship Between Financial Distress and Earnings Management with Institutional Ownership as a Moderating Variable

The statistical result shows that institutional ownership does not moderate the effect of financial distress on earnings management this is not in accordance with the hypothesis. In line with agency theory which reveals that conflicts of interest between managers (agents) and owners (principals) often occur. Some institutional investors have different goals, there are institutional investors who only focus on short-term profits without regard to earnings management. This is not in accordance with the hypothesis and is not consistent with Sari and Hermi's (2023) study.

CONCLUSION

Based on the research above, it can be concluded that financial distress has a positive effect on Earnings Management. Institutional ownership does not moderate the effect of financial distress on earnings management, so the results are not in accordance with previous research. And some suggestions that can be given. First, future research samples should be added from other mining fields. Second, the research period should be extended. Third, to determine the effect of different determinant variables on earnings management, future research can also change the number of determinant variables other than this analysis.

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DECLARATION OF CONFLICTING INTERESTS

The author(s) declared no potential conflicts of interest.

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