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Earning Management: The Role of Corporate Governance, Reputation and Financial Distress

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ABSTRACT

This study is motivated by the importance of implementing Good Corporate Governance (GCG) and maintaining a strong corporate reputation in managing earnings, particularly when companies are experiencing financial distress. The primary objective of this research is to examine the effects of GCG and corporate reputation on earnings management, as well as to investigate the moderating role of financial distress in these relationships. A quantitative approach was employed using panel data, with a sample consisting of 28 consumer non-cyclical sector companies listed on the Indonesia Stock Exchange (IDX) during the period 2020–2023. The data analysis technique used was panel data regression with moderation testing. The results indicate that both GCG and corporate reputation have a significant effect on earnings management, with significance levels below 5%. Moreover, financial distress was found to weaken the influence of GCG on earnings management, while strengthening the impact of corporate reputation on earnings management practices. These findings suggest that a company's financial condition plays a crucial role in determining the effectiveness of GCG and corporate reputation in influencing earnings management behavior. The conclusion of this study highlights the critical importance of adhering to sound governance principles and cultivating a strong corporate reputation, especially when facing financial pressure.

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INTRODUCTION

Earnings management is a practice that raises serious concerns regarding the reliability of a company's financial statements. This practice has a direct impact on the quality of financial information, which serves as a fundamental basis for economic decision-making by various stakeholders. In the modern corporate environment, the implementation of Good Corporate Governance (GCG) principles and the establishment of a strong corporate reputation are essential instruments in safeguarding the integrity of financial reporting particularly amidst increasing business complexity and market pressure.

The Consumer Non-Cyclicals sector in Indonesia has garnered attention due to its relatively stable characteristics, even under global economic pressures. As such, the issue of earnings management within this sector has become a focal point of concern.

The central research problem addressed in this study is the extent to which Good Corporate Governance and corporate reputation contribute to constraining or potentially facilitating earnings management practices. Furthermore, under conditions of financial distress, how changes in a company's financial position moderate these relationships is also of critical interest. The complexity of these interactions has not been fully explored in previous studies, highlighting a scholarly need to re-examine them within the context of different sectors and more recent time periods. Investigating these dynamics is crucial for enhancing both theoretical understanding and practical insights into the control of financial reporting manipulation, which ultimately harms stakeholders

LITERATURE REVIEW

Earnings management represents a form of financial information distortion that undermines the transparency and accountability of financial reporting. According to Scott (2015), earnings management refers to the selection of accounting policies by managers with the intent to achieve certain profit targets. This practice is often explained within the framework of agency theory, which posits that information asymmetry between managers and company owners leads to opportunistic behavior by management (Jensen & Meckling, 1976; Mayanisa & Priyadi, 2019).

Good Corporate Governance (GCG) plays a critical role in mitigating the risks associated with earnings management. GCG principles—such as transparency, accountability, responsibility, independence, and fairness—are expected to limit opportunities for financial statement manipulation (Tjatriani, 2019). Research by Firmansyah (2021) indicates that the application of GCG principles can reduce managerial tendencies toward earnings manipulation. Specifically, GCG indicators such as public ownership, board size, and board meeting frequency have been widely examined. Utami et al. (2021) found that public ownership is negatively associated with earnings management practices, suggesting that greater public scrutiny can constrain manipulation.

However, findings regarding board size remain inconclusive. For instance, Alden Riyadh et al. (2019) found that board size does not significantly affect the reduction of earnings management, while Puni and Anlesinya (2020) argued that larger boards may enhance oversight and reduce information asymmetry.

With respect to board meeting frequency, it is viewed as a mechanism for enhancing managerial oversight. Studies by Kankanamage (2016) and Chouaibi et al. (2018) support the hypothesis that the number of board meetings is negatively related to the level of earnings management. However, Buraik and Idris (2020) reported that meeting frequency does not always have a significant effect on earnings manipulation.

Financial distress has the potential to weaken a firm's internal control environment. Gupta and Suartana (2018) suggested that financial distress encourages managers to adopt more aggressive earnings management practices, consistent with signaling theory as proposed by Brigham and Houston (2014). Under distress conditions, companies may seek to send positive signals to the market by artificially enhancing the appearance of their financial performance.

Beyond GCG, corporate reputation is also an important factor influencing managerial behavior. Chun et al. (2019) defined corporate reputation as the perception of external stakeholders based on past actions that shape future expectations. Research by Pinata and Kristanto (2020) demonstrated that earnings management negatively affects corporate reputation. In contrast, Purwitasari (2020) found no significant relationship between earnings management and corporate reputation, suggesting that the impact may be context-dependent and influenced by industry or capital market conditions.

Given the mixed findings in prior studies and the strategic importance of the Consumer Non-Cyclicals sector in Indonesia, further investigation is warranted to examine the relationship among GCG, corporate reputation, and earnings management, with financial distress as a moderating variable.

Overall, the literature indicates that corporate governance mechanisms and external reputation are key factors in controlling earnings management practices. However, financial distress may compromise the effectiveness of these mechanisms.

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Research Hypotheses

1. Public ownership has a negative effect on earnings management.
2. The size of the board of commissioners has an effect on earnings management.
3. The frequency of board of directors meetings has an effect on earnings management.
4. Corporate reputation has a negative effect on earnings management.
5. Financial distress weakens the effect of public ownership on earnings management.
6. Financial distress weakens the effect of board of commissioners size on earnings management.
7. Financial distress weakens the effect of board of directors meeting frequency on earnings management.
8. Financial distress weakens the effect of corporate reputation on earnings management.

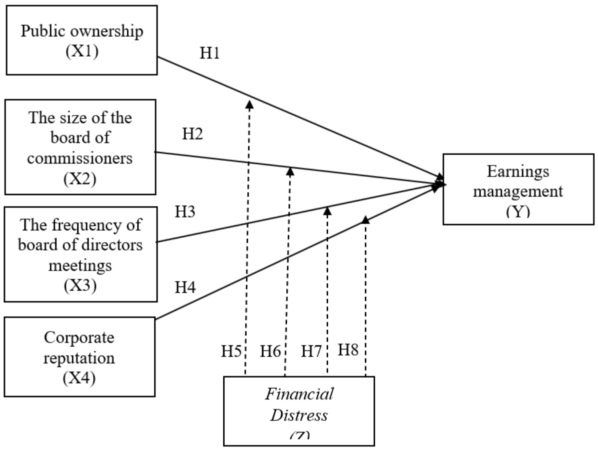

Figure 2. Conceptual Framework
Source: Author's data processing

METHOD

This study employs a quantitative approach with a causal-comparative research design to examine the relationship between Good Corporate Governance, corporate reputation, and earnings management, as well as the moderating role of financial distress. The data used in this study are secondary data derived from the annual financial statements of Consumer Non-Cyclicals sector companies listed on the Indonesia Stock Exchange (IDX) for the period 2020–2023.

The sample was selected using purposive sampling based on the following criteria:

1. Companies in the Consumer Non-Cyclicals sector that published annual financial consistently from 2020 to 2023.
2. Companies with complete data related to the research variabels, and
3. Companies that were not delisted during the observation period.

A total of 28 companies met the criteria and were included in the sample.

The data analysis technique used was panel data regression analysis with moderation testing. The analysis was conducted using panel data-based statistical software such as Eviews.

Table 1. Operationalization of Variables

Variables	Indicators
Earnings Management (Y)	Ratio of working capital accruals to sales (ΔAL–ΔHL–ΔCash)/Sales
Public Ownership (X1)	Percentage of public share ownership
Board of Commissioners Size (X2)	Number of board of commissioners members
Board of Directors Meeting Frequency (X3)	Number of annual board of directors meetings
Corporate Reputation (X4)	Total Shareholder Return (TSR)
Financial Distress (Z)	Altman Z-Score

Regression Equation Formula
Direct Relationship Regression:

$$Y=C + \beta 1X1 + \beta 2X2 + \beta 3X3 + \beta 4X4 + e$$

Information:
- Y = Earnings Management
- C = Constanta
- β1,β2,β3,β4 = Coefficient Regression
- X1 = Public Ownership
- X2 = Board of Commissioners Size
- X3 = Board of Directors Meeting Frequency
- X4 = Corporate Reputation
- e = Error term

Moderation Relationship Regression:

$$Y = C+ \beta 1X1 + \beta 2X2 + \beta 3X3 + \beta 4X4 +\beta 5Z+\beta 6(X1\times Z)+\beta 7(X2\times Z)+\beta 8(X3\times Z)+\beta 9(X4\times Z)+e$$

Additional information:
- Z = Financial Distress (moderator)
- X1× Z, X2 × Z, X3 × Z, X4 × Z = The interaction of moderation of each independent variable with financial distress

RESULT

This study investigates the influence of Good Corporate Governance and corporate reputation on earnings management, with financial distress serving as a moderating variable. The data were analyzed using a panel data regression approach, employing EViews 10 statistical software.

Table Model Selection Tests: Chow Test, Hausman Test, and Lagrange Multiplier (LM) Test

Test	Probability	Decision
Chow Test	0,0000	Fixed Effects Model selected
Hausman Test	0,0556	Random Effects Model selected
Lagrange Multiplier Test (LM)	0,0000	Random Effects Model selected

Conclusion: Based on the test results, the best-fitting model is the Random Effects Model.

Tabel F-Test and t-Test Results (Before Moderation)

Variable	Coeficient	t-Statistic	Probability	Conclusion
Public Ownership (X1)	-11.81178	-0.886935	0.3771	Not significant
Board of Commissioners Size (X2)	-2.996768	-2.445644	0.0161	Berpengaruh
Board of Directors Meetings (X3)	0.105924	0.321362	0.7486	Not significant
Corporate Reputation (X4)	0.000831	0.235117	0.8146	Not significant
Uji F	F-Statistic	Probability	Conclusion	
F-Statistic	2.042287	0.078554	Not statistically significant	

F-Test and t-Test Results (After Moderation with Financial Distress)

Variable	Coeficient	t-Statistic	Probability	Conclusion
Public Ownership (X1)	8.589370	1.114606	0.2676	Not significant
Board of Commissioners Size (X2)	0.305957	0.428895	0.6689	Not significant
Board of Directors Meetings (X3)	-0.053764	-0.273018	0.7854	Not significant
Corporate Reputation (X4)	0.017835	2.428968	0.0169	Significant
Financial Distress (Z)	0.052234	9.210674	0.0000	Significant
Public Ownership × Financial Distress (X1×Z)	-0.114547	-4.314873	0.0000	Significant
Board Size × Financial Distress (X2×Z)	-0.005348	-7.240856	0.0000	Significant
Board Meetings × Financial Distress (X3×Z)	2.46E-05	0.051523	0.9590	Not significant
Reputation × Financial Distress (X4×Z)	-1.71E-05	-2.207583	0.0295	Significant
F-Test	F-Statistic	Probability	Conclusion	
F-Statistic	21.92271	0.00000	Statistically significant	

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Table Model R-Squared Comparison

Model	R-Squared
Before Moderation	0.087869
After Moderation	0.659210

Source: author data processing

The R-squared value of the initial model is 0.087869, indicating that 8.79% of the variation in earnings management can be explained by public ownership, board of commissioners size, number of board meetings, and corporate reputation, while the remaining 91.21% is influenced by other factors outside the scope of this study.

After the inclusion of financial distress as a moderating variable, the R-squared value increases to 0.659210, meaning that 66% of the variation in earnings management is explained by the full set of variables in the model, while the remaining 34% is accounted for by other unexamined factors,

DISCUSSION

The results of this study indicate that public ownership does not have a significant effect on earnings management. This suggests that although public shareholding aims to enhance oversight, weak control mechanisms and information asymmetry render such monitoring ineffective. This finding supports the research of Edastami and Kusumadewi (2022), which argues that a small proportion of public ownership is insufficient to prevent earnings management practices.

The size of the board of commissioners was found to have a significant effect on earnings management. Contrary to traditional agency theory, a larger board may actually enhance the effectiveness of oversight, provided it maintains high levels of quality, independence, and diversity. This result aligns with the findings of Pricilia and Susanto (2017) as well as Obigbemi et al. (2016), who suggest that a larger board improves managerial supervision.

The number of board meetings was found to have no effect on earnings management. The frequency of meetings alone does not necessarily improve oversight unless accompanied by high-quality supervision and strong internal integrity. This is consistent with the findings of Ichsany and Husain (2019), who emphasize the importance of active participation over mere meeting frequency in financial governance.

Corporate reputation also showed no effect on earnings management, indicating that firms with good reputations may still engage in earnings manipulation when facing internal pressures. This supports the findings of Purwitasasi (2020), who argued that reputation does not always serve as a deterrent to earnings management practices.

Financial distress was found to moderate several of the relationships:

- Financial distress weakens the influence of public ownership and board size on earnings management, suggesting that under financial pressure, companies shift their priorities toward financial survival rather than compliance with governance principles.
- Financial distress does not moderate the relationship between the number of board meetings and earnings management, indicating that even under pressure, meeting frequency alone does not improve supervision.
- Financial distress weakens the influence of corporate reputation on earnings management, implying that during times of financial difficulty, firms prioritize survival over maintaining public image.

Overall, this study demonstrates that corporate governance mechanisms and firm reputation are effective in mitigating earnings management under normal conditions; however, their effectiveness diminishes during periods of financial distress.

Future research is recommended to explore additional factors such as the role of audit committees, external regulatory oversight, and performance pressure variables to provide a more comprehensive understanding of earnings management control in the face of financial pressure.

CONCLUSION

This study aimed to examine the effect of Good Corporate Governance, measured by public ownership, board size, and the frequency of board meetings, as well as corporate reputation, on earnings management, with financial distress as a moderating variable, in Consumer Non-Cyclicals sector companies listed on the Indonesia Stock Exchange for the period 2020–2023.

The findings indicate that public ownership and corporate reputation have a significant negative effect on earnings management, while board size and the number of board meetings do not show a significant effect. Furthermore, financial distress was found to moderate the effect of corporate reputation on earnings management, but not the effects of public ownership, board size, or board meeting frequency.

Based on these findings, it can be concluded that mechanisms of Good Corporate Governance and corporate reputation are effective in curbing earnings management, particularly in firms with stable financial health. However, under financial distress, external pressure may weaken internal controls, thereby increasing the likelihood of financial statement manipulation. Therefore, it is crucial for companies to strengthen the implementation of governance principles and maintain a strong reputation as part of a long-term financial risk management strategy.

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