CHAPTER I

INTRODUCTION

1.1 Background of the Study

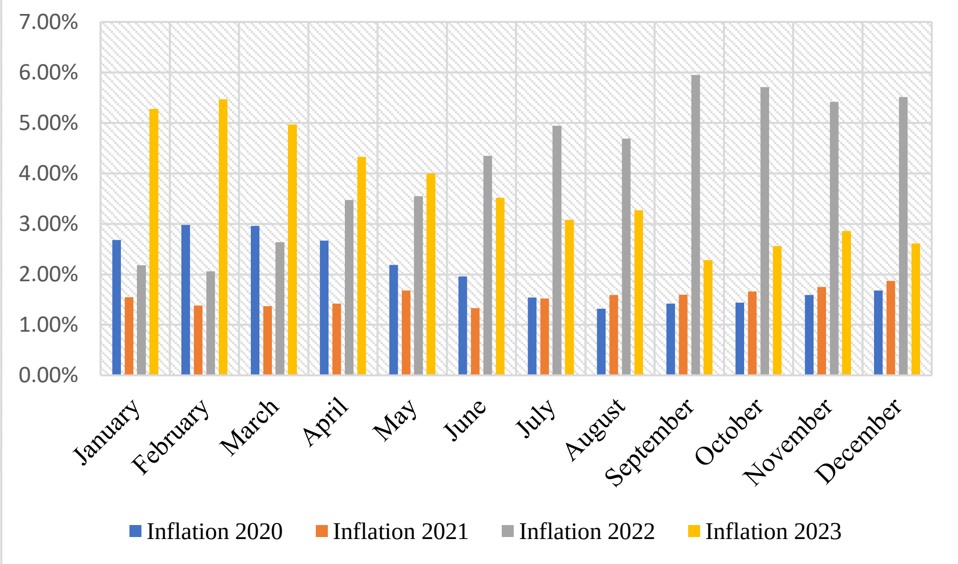
The financial statements represent formal annual reports that detail the financial information related to a company's operational activities. The company's management prepares these reports for external users, including government bodies, shareholders, and tax authorities, delivering them promptly at the end of each quarter or fiscal year (NCERT, 2024). The information includes assets, liabilities, equities, earnings, and other financial performance for a specific period. The data presented must be transparent, in-line with applicable accounting standards, enabling readers to assess and predict the company's performance during the fiscal year (Prekazi, 2022). Changes in financial statements, such as a decline in financial performance, can indicate possible financial distress (Putri & Naibaho, 2022). According to Kristyaningsih et al., (2021), financial distress refers to a situation where a company faces weakened financial conditions, particularly in its inability to meet debt obligations on time. If this situation continues, it may result in corporate bankruptcy, as financial distress within a corporation can be categorized into four primary types: failure, insolvency, bankruptcy, and default (Habib et al., 2020). Although financial distress does not necessarily mean that a distressed firm will ultimately fail, it poses significant risks of financial loss to investors and creditors. Shareholders rely on profit figures not only to evaluate a company's past performance but also to forecast future cash flows, making it essential for stakeholders to identify any potential indicators of upcoming financial difficulties to protect their interests effectively. For this reason, it is crucial for a company to maintain a strong financial report to uphold its positive image and demonstrate financial stability.

According to Fisher et al., (2019), managers tend to manage financial statements because of 2 conditions: to present a positive performance or to influence contractual outcomes. Managers may adjust income, either increasing or decreasing it, to ensure that creditors continue to view the company's viability but still provide the necessary liquidity support. Presenting a positive performance typically occurs when managers are required to meet or exceed revenue targets, particularly when the company is experiencing financial distress. Managers of companies facing financial distress are more inclined to inflate operating income, making them more likely than managers of financially stable companies to meet or surpass revenue targets (Ezrien & Sarah, 2021). However, these two conditions greatly encourage managers to carry out earnings management by setting profits based on motivation.

Consumer staples refer to companies that engaged in the production of critical primary goods, including food, beverages, and household items, which are crucial for both the economy and the daily lives of consumers. The prices of these products generally remain stable due to consistent consumer demand. Significant price fluctuations are typically avoided, as they could negatively impact consumer purchasing power. When prices rise, consumers tend to quickly compare prices with alternative products from competing companies. Consequently, these companies often face challenges in increasing their profit margins, as they are subject to pressures from rising raw material costs, market fluctuations, and broader economic conditions. As stated in Campa, (2019), heightened competition, economic crises, and management strategies contribute to declines in financial performance and increase the likelihood of financial distress.

Economic crises frequently pose significant challenges for companies striving to sustain a healthy financial performance. The global economic downturn precipitated by the pandemic has had a significant impact on Indonesia. According to Nurmasari, (2020), the first case of the pandemic in Indonesia was reported on March 2, 2020, aligning with the introduction of stay-at-home orders that month. This situation presents considerable difficulties for certain companies, resulting in a reduction in both production and sales. According to data from Bank Indonesia, the Indonesian Rupiah exchange rate increased to 16,824.71 within one month following the report of the first case. A weakening exchange rate escalates the cost of imports and foreign debt obligations, thereby exerting downward pressure on the margins of companies' dependent on these financial factors. In 2020, Indonesia's economic growth rate contracted sharply by -2.07% (Iriyadi & Purba, 2022), signifying a decline in key economic activities such as production, consumption, export and import As discussed by Oskouei & Sureshjani, (2021), when the economy is experiencing slow growth or contraction, companies adopt different strategies for expansion and production compared to when the economy is performing strongly. However, inflation has not exhibited significant variation, indicating a reduction in domestic demand without a corresponding increase in producer prices. Companies will struggle to offset rising costs due to exchange rates with product prices that cannot be raised.

Figure1.1 Inflation Rate



Source: Bank Indonesia (2024)

Despite the ongoing impact of the pandemic, Indonesia is also suffering from geopolitical tensions that have caused the price of wheat for feed and food to increase by around 21-35% (Andriansyah & Irwandi, 2023). On the other hand, there is also an increase in the price of vegetable oil due to disruptions in the supply of sunflower seed oil which is a substitute for crude palm oil (Nugroho & Salsabila, 2022). With the rise of these two issues, inflation occurred in September 2020, reaching a rate of 5.95%. The transportation sector experienced an increase of 1.08%, serving as evidence of the challenges in moving products from factories to producers or ultimately to consumers. Thus, global economic challenges and disruptions make it difficult for companies to have healthy financial performance and increase the potential for financial difficulties.In such scenarios, speculation often arises around companies facing financial distress. The table below lists companies that have been in financial distress for four consecutive years, from 2020 to 2023.

Table 1. 1 The Phenomenon of Financial Distress towards Earnings Management

Company Name	Year	Z-Score	DA
PT Morenzo Abadi Perkasa Tbk (ENZO)	2020	2.6248	0.4759
	2021	**4.7218**	**1.6145**
	2022	**2.3781**	**-1.8854**
	2023	1.8971	-0.0963
PT Wahana Pronatural Tbk (WAPO)	2020	4.5435	-0.3912
	2021	**7.5698**	**1.7312**
	2022	**9.2043**	**0.1108**
	2023	**3.6027**	**1.2344**
PT Estika Tata Tiara Tbk (BEEF)	2020	-1.5454	9.6723
	2021	-1.2802	12.7892
	2022	**-1.4301**	**15.4326**
	2023	**2.0611**	**19.8578**

Source: Prepared by The Writer (2024)

Table 1.1 illustrates a notable phenomenon marked by PT. Morenzo Abadi Perkasa Tbk. (ENZO) which in 2021 shifted from a Z-score of 4.46 to 2.39 and moved into the gray area by 2022. This change of approximately 116.78% resulted in negative earnings management for ENZO, indicating that the company engaged in downward earnings management. Subsequently, WAPO experienced improved financial health from 2021 to

2022 and saw a reduction in earnings management to the point where it could be said the company was not engaging in earnings management as its discretionary accruals (DA) approached zero. Following this, the company faced a decline in financial condition with its Z-score dropping from 9.20 to 3.60 and an increase in earnings management of 1.12 between the 2022 and 2023 period. In contrast, BEEF demonstrated an improvement by transitioning from the distress area to the gray zone between 2022 and 2023 with a change in earnings management to 19.86.

Addressing the financial distress encountered by consumer staples companies is imperative and requires immediate attention. When a company experiences financial distress, management must identify the sources of the crisis and seek ways to rectify it. Managers encounter considerable risks during periods of financial distress, which can lead to diminished bonuses, damage to their professional reputations, and even the possible termination of their employment (Türegün, 2020). Managers can manage the reported earnings by selecting accounting policies that either increase or decrease the company's profit, in accordance with their objectives. This research employs accrual earnings management as an action from managers for this problem. Accrual earnings management involves accelerating the recognition of revenue while delaying the recognition of expenses (Oskouei & Sureshjani, 2021). Given that accrual adjustments are relatively easy to implement, cost-effective, does not change operational decisions, and offer greater flexibility; but at the same time, it is easily detected by auditors

(Türegün, 2020). Furthermore, as indicated in (Kliestik et al., 2020), this earnings management presents an opportunity to generate higher revenue at a certain cost, thereby enhancing profits. As a result, during periods of financial distress, managers may have stronger incentives to engage in earnings management.

The phenomenon of earnings management is prevalent in today's business environment and often leads to adverse consequences and losses for multiple stakeholders. During periods of economic and financial crisis, corporate managers may resort to manipulating accounting earnings, motivated by capital market pressures or contractual incentives (Oskouei & Sureshjani, 2021). In 2020, PT Tiga Pilar Sejahtera Food Tbk, referred to hereafter as AISA, reissued its financial statements after being found guilty of earnings manipulation. The root of this issue can be traced back to actions by two of AISA’s subsidiaries, which engaged in fraudulent labeling practices. PT Indo Beras Unggul and PT Jati Sari Rezeki misrepresented government-subsidized medium-quality rice as premium rice, leading to a deterioration in the company's reputation and causing its stock price to decrease by 56 percent, reaching 905 per share (Priambudi & Wijayati, 2023). This situation disrupted the company’s liquidity, resulting in an inability to meet financial obligations. These aspects greatly affect a company's financial distress, encouraging managers to carry out earnings management. PT Ernst & Young Indonesia released a statement in 2019, which was later confirmed to be accurate, containing allegations of an overstatement of funds by AISA. Following the findings of the investigation, there was an undue increase in accounting items amounting to 4 trillion in receivables, inventory, and fixed assets. As a result, the manipulated financial report showed a loss of 551.9 billion, whereas it should have reached 4.6 trillion (Arista & Serly, 2023). According to Christian & Jullystella, (2021) that AISA had committed a shenanigans violation by recognizing revenue before it was received by customers or unconditional delivery. Another example is the scandal that was charged in September 2021 by the Securities and Exchange Commission (SEC) to the Kraft Heinz company. According to the SEC, the 2016 and 2017 financial statements required reissue because fictitious cost savings of $208 million were found. Kraft Heinz has overvalued goodwill and other intangible assets on the balance sheet, resulting in an impairment charge of $15.4 billion and a loss of $10,254 million in revenue write-offs in 2018 (Grossman et al., 2023). By postponing the recognition of expenses, companies can present higher earnings in earlier periods, thereby portraying a stable financial performance to investors.

The excessive use of earnings management practices to enhance the appearance of financial statements can lead to significant negative consequences. The Association of Certified Fraud Examiners' Nations Reports for 2020 and 2022 identify financial statement manipulation, including earnings management, as the most costly form of fraud globally. Indonesia reported the highest number of cases in the Asia-Pacific region, totaling 36 incidents, during 2020 (Association of Certified Fraud Examiners, 2020). In such situations, managers may have the incentive to conceal actual performance declines through earnings manipulation strategies. The manipulation of accounting information is often an economic response to financial distress (Habib et al., 2020). The opportunistic behavior hypothesis is applicable in this context, suggesting that publicly listed companies have greater motivation to manipulate their earnings due to increased pressure from the market and stakeholders to meet performance expectations (Campa, 2019). Therefore, addressing earnings management in times of financial distress presents a highly compelling and relevant topic for further research.

Earnings management in the context of financial distress is an interesting topic for academics and researchers because of the many studies that have been conducted. Based on the cases above, as a company faces greater financial difficulties, there tends to be a rise in the occurrence of earnings management practices, motivated by reputation concerns or the objectives of its managers. This is empirically proven by previous studies by (Li et al., 2020), (Putri & Naibaho, 2022), and (Wilamsari et al., 2022) which stated that there was a positive significance from the test results conducted. Campa, (2019) found that there was a positive significance, but it was only at a 10% significance level and specifically with the accrual earnings management proxy. The results from (Kamal & Khazalle, 2021), (Rusci et al., 2021), and (Rakshit & Paul, 2020) indicate negative outcomes, suggesting that as a company faces greater financial distress, it is less likely to engage in earnings management due to the ease with which auditors can detect such actions. On the other hand, Kristyaningsih et al., (2021) presents a statement indicating that financial distress and earnings management show no significant impact, as the company is considered to prioritize procedures focused on addressing financial issues rather than engaging in earnings management. The variation in research findings on the impact of financial distress on earnings management indicates a gap in this research.

The consumer staples sector is studied because it is considered stable and essential, but vulnerable to global economic disruptions. The period 2020-2023 is marked by changes in global economic policies, dynamic economic growth, and fluctuations in commodity prices. Profitability, cash holdings, company size, and sales growth are selected as control variables for fundamental factors that can affect earnings management practices. Profitability and cash holdings reflect the company's ability to maintain cash flow, profit margins, and provide liquidity reserves in emergency situations. Meanwhile, company size and sales growth indicate the company's resilience in facing an economic crisis. Thus, the researcher extends this study by applying it to consumer staples companies in Indonesia which have different characteristics in organizational management, business systems, relevant accounting policies, external impacts on business operations, production processes, and economic changes. The phenomenon of economic crises and scandals involving companies further highlight the importance of this topic to be discussed. Therefore, the writer is motivated to conduct a deeper analysis, further testing, and to address this research gap.

1.2 Problem Formulation

The problem formulation of this research consists of:

1. Does Financial Distress has a partial influence on Earnings Management?

1.3 Objective of the Research

The objective of the research are as follows:

1. To provide empirical evidence of whether Financial Distress has an impact on Earnings Management .

1.4 Benefits of the Research

1.4.1 Theoretical Benefit

The purpose of this study is to provide a better understanding in the form of insight and information related to the impact of financial distress on earnings management of consumer staples sector companies listed on the Indonesia Stock Exchange (IDX). The results of this study are expected to add a deeper understanding of each variable such as earnings management, financial distress, profitability, cash holding, sales growth and firm size for economic conditions in 2020-2023. Furthermore, this study seeks to serve as a valuable reference for researchers aiming to enhance the quality of future research on the same topic, thereby addressing the limitations identified in this study.

1.4.2 Practical Benefit

The findings of this study are anticipated to assist company management in comprehending how financial distress can influence earnings management practices, thereby enabling them to formulate more prudent strategies. For investors and shareholders, this research offers valuable insights into evaluating the company's condition, facilitating more informed investment decisions. Additionally, the study can aid government agencies in monitoring the earnings management of companies experiencing financial difficulties by identifying existing patterns.

1.5 Problem Limitation

The problem limitation of this research consists of:

1. The research object is consumer staples sector companies listed on the Indonesia stock exchange from year 2020 to 2023.
2. This study focuses on analyzing earnings management, emphasizing accrual-based earnings management as the main dependent variable.
3. This study applies a linear regression model, using financial distress as the main independent factor, earnings management as the dependent variable, and profitability, cash holdings, sales growth, and firm size as control variables.