

Earnings Management: Boon or Bane for Growth in Indonesia Consumer Sector?

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Abstract

This study investigates the relationship between earnings management and financial risk on company growth in the Primary Consumer Goods Industry sector listed on the IDX from 2017 to 2021. The findings show that earnings management practices positively and significantly impact company growth, indicating that companies implementing management profits tend to experience higher growth (Growth Companies). Enhancing positive and efficient earnings management practices can improve company performance and overall business growth. The statistically significant effect indicates that this relationship is not coincidental, emphasizing the strong relationship between earnings management and firm growth. However, financial risk does not significantly affect company growth and cannot moderate the relationship between earnings management and company growth. This observation highlights the complexity of the impact of financial risk on corporate growth, which various unmeasured factors, including changes in interest rates, market fluctuations, and credit risk, may influence. Other internal and external factors that affect the relationship between financial risk and firm growth may not be considered in this regression model, limiting its ability to capture the subtleties of this relationship fully. Nonetheless, this study shows that Financial Risk and Earnings Management significantly affect the dependent variable, Company Growth. The results show that companies that apply better earnings management practices in their financial reporting experience better or higher growth. However, this study had limitations, and future research should explore a different sector, as this may yield different results. In addition, future research may consider including control variables such as firm size, liquidity, leverage, industry growth, and other economic factors to understand their impact on firm growth better.

Keywords: Company Growth, Earnings Management Practices, Financial Risk, Agency Theory

JEL CODES: G32, M41, L21

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1. Introduction

In recent years, the field of accounting and finance has witnessed a growing interest in understanding the factors that influence earnings management practices within companies (Zeff & Dyckman, 2020; Cokins, 2016). Earnings management refers to the manipulation of financial information by managers to meet specific objectives, such as smoothing reported earnings, avoiding earnings declines, or maximizing executive compensation (Hemmer & Labro, 2019; Wilson, 2015). It is a complex phenomenon with significant implications for financial reporting quality, investor decision-making, and overall market efficiency (Easton, 2015).

One crucial aspect that has garnered considerable attention in the literature is the impact of company growth on earnings management practices. Company growth, characterized by increases in sales, assets, market share, or expansion into new markets, is often seen as a positive signal of firm performance and prospects (Bertomeu et al., 2021). However, the relationship between company growth and earnings management remains controversial and requires further investigation (Callao et al., 2014; Bereskin et al., 2018).

The consumer goods industry includes companies producing, distributing, and selling consumer products, including food and beverages, personal care goods, household goods, and retail products. Consumer goods companies often pursue a growth strategy by expanding into new markets or introducing new product lines to capture a more extensive customer base. This growth can incentivize managers to engage in earnings management practices to meet performance expectations, secure investor confidence, or support fundraising efforts (He et al., 2022; Sax and Andersen, 2019). Earnings management becomes especially relevant as companies navigate the complexities of market expansion in the consumer goods industry (He et al., 2022). In addition, this sector often relies on complex supply chains involving multiple suppliers and distribution channels. Managing inventory levels, procurement costs, and supplier relationships can influence financial performance. There may be instances where companies engage in earnings management practices to mitigate the impact of supply chain-related challenges or to present an excellent financial picture to stakeholders (Gomez-Mejia et al., 2021). Exploring the relationship between supply chain management, financial risk, and earnings management provides valuable insights into the consumer goods industry (He et al., 2022; Gomez-Mejia et al., 2021).

The uniqueness of this study lies in its focus on the interaction between company growth, financial risk, and earnings management. By assessing the role of financial risk, the study aims to uncover how the level of risk exposure within a firm's financial structure influences the relationship between company growth and earnings management. Financial risk, encompassing leverage, liquidity, and volatility, is crucial in shaping a firm's financial decisions and strategies (Lotfaliei, 2021; Elkhail, 2019). Understanding how financial risk interacts with company growth to influence earnings management practices can provide valuable insights into the underlying mechanisms (Chakraborty et al., 2021; Elshandidy and Zeng, 2022).

Previous research on earnings management has predominantly concentrated on various determinants such as firm size, industry-specific characteristics, corporate governance, and external monitoring mechanisms (Callao et al., 2014; Cudia et al., 2021). However, limited attention has been given to the interplay between company growth, financial risk, and earnings management. Consequently, this study aims to fill this research gap by assessing whether

company growth significantly impacts earnings management and investigating the potential moderating role of financial risk.

Existing research on earnings management has focused on factors such as firm size, industry-specific characteristics, corporate governance, and external monitoring mechanisms (Szudejko, 2015). However, limited attention has been given to the interplay between company growth, financial risk, and earnings management (Srivastava, 2014; An, 2017). As a result, this study seeks to address this research gap by addressing whether company growth positively and significantly affects earnings management while investigating the potential moderating role of financial risk.

By exploring this relationship, this research will contribute to the existing literature on earnings management by shedding light on the specific conditions under which company growth affects earnings management practices. Moreover, including financial risk as a moderating factor will provide a more nuanced understanding of the complex dynamics involved.

Ultimately, the findings of this study will not only advance theoretical knowledge but also have practical implications for financial managers, auditors, regulators, and investors. By identifying the factors that influence earnings management practices, stakeholders can better assess the reliability and transparency of financial statements, make informed investment decisions, and design suitable policies and guidelines to mitigate earnings management practices.

2. Literature Review

Jensen and Meckling (1976) define the agency relationship as a relationship between the company's owner (principal) and the agent, who delegates decision-making authority to the agent. The principal and agent may have conflicting interests in an agency relationship. Shareholders demand increased corporate profitability and dividends. At the same time, managers are agents who are motivated to maximize the fulfillment of economic and psychological needs. Based on the agency and principal relationship, management is encouraged to perform earnings management in presenting financial statements. For this reason, one way that can be used to monitor contractual issues between management and investors and limit management's opportunistic behavior is through the implementation of Good Corporate Governance (Nagar and Schoenfeld, 2021).

Earnings management refers to companies' discretionary manipulation of financial statements to achieve specific financial goals or influence stakeholders' perceptions about the company's performance (Marinakis, 2011; Zhao, 2000). It is an area of concern as it can distort the accuracy and reliability of financial information, potentially misleading investors and other stakeholders. Understanding the factors contributing to earnings management is crucial for investors, regulators, and researchers (Dechow and Skinner, 2000). One crucial factor that may influence earnings management is company growth. Earnings management is a complex and multidimensional phenomenon widely studied in accounting and finance literature. Researchers have examined various motivations and techniques used by companies to manage earnings, including income smoothing, income-increasing or decreasing strategies, and discretionary accruals (Healy, 1985; Dechow et al., 1995; Cohen et al., 2008; Roychowdhury, 2006; McNichols, 2000). The consequences of earnings management can range from distorted financial statements to reduced investor confidence and increased agency costs (Young, 2015).

Company growth is an essential factor that can influence earnings management practices. Growing companies often face pressure to meet financial expectations and maintain favorable

growth rates (Madhogarhia et al., 2009; Lee et al., 2011). In this context, managers may manage earnings to portray a favorable financial performance and meet market expectations. Previous studies have found mixed results regarding the relationship between earnings management and company growth (Marinakis, 2011; Gunny, 2011; Bisogno and Donatella, 2021; Gurendrawati, 2015). The relationship between earnings management and company growth has been a subject of interest in academic literature (Giosi et al., 2017). Companies experiencing rapid growth may face increased pressure to demonstrate consistent financial performance and meet market expectations (Lee et al., 2011). As a result, managers may be tempted to engage in earnings management to portray a positive image of the company's financial health. However, the impact of earnings management on company growth is only sometimes straightforward, and conflicting findings exist in the literature.

Financial risk, encompassing factors like leverage, liquidity, and solvency, is crucial in shaping a company's decision-making process. High levels of financial risk can lead to more significant financial uncertainty, making earnings management more enticing for managers seeking to mitigate the risk of financial distress or covenant violations (Khlif and Hussainey, 2016). Conversely, low financial risk may encourage transparent financial reporting to build investor trust and reduce agency costs. The relationship between financial risk and earnings management is complex and context dependent. Financial risk as a mediator in the relationship between earnings management and firm growth has gotten little attention in the research (Gunny, 2011; Lee et al., 2011).

Nonetheless, it is reasonable to assume that financial risk can influence how earnings management impacts company growth. For example, companies with high financial risk may be more susceptible to negative growth consequences if uncovered earnings management practices reduce investor confidence (Kanodia and Sapra, 2016). Understanding the moderating role of financial risk can provide valuable insights into the interplay between earnings management and company growth.

This literature review sheds light on the relationship between earnings management and company growth, specifically focusing on the role of financial risk. Earnings management refers to a complex practice that can impact a company's growth prospects, both positively and negatively. The interplay between earnings management, company growth, and financial risk is an area that requires further investigation and can provide valuable insights for investors, regulators, and company stakeholders. By understanding the implications of earnings management on company growth, researchers can contribute to the ongoing discussions on transparent financial reporting practices and promote sustainable growth strategies for businesses. The hypothesis is, therefore, as follows:

- H1: There is a significant positive relationship between earnings management practices on company growth in the consumer noncyclical industry.
- H2: There is a significant positive relationship between financial risk on company growth in the consumer noncyclical industry.
- H3: Financial Risk and earnings management practices simultaneously affect Company Growth
- H4: Financial risk moderates the influence of earnings management on company growth.

3. Research Method

This study adopts a quantitative research design to examine the relationships between corporate growth, financial risk, and earnings management in the consumer noncyclical industry sector. The research design allows the collection of numerical data to test hypotheses and draw statistical inferences. The data for this study is secondary data sourced from financial reports of manufacturing companies in the primary consumer goods industry sector listed on the Indonesia Stock Exchange. The study population comprises all manufacturing companies in the primary consumer goods sector that were publicly listed and operational from 2017 to 2021. The study employs a purposive sampling technique to select companies that meet specific criteria. Companies in the sample must have published financial reports successively throughout the study period (2017-2021) and not reported any losses. This sampling technique ensures that the selected companies have consistent financial reporting practices and stable financial performance, reducing the potential for biased results. The final sample size in this study is 110 manufacturing companies in the primary consumer goods industry sector that meet the defined criteria. The sample size is sufficient to achieve statistically meaningful results and increase the study's generalizability. A conceptual model will be developed to illustrate the relationships between the key variables of interest: corporate growth, financial risk, and earnings management. The model will be a theoretical framework for data analysis and hypothesis testing. The collected data will be analyzed using statistical software, specifically SPSS 26, to explore the relationships outlined in the conceptual model. Descriptive statistics will be used to summarize the characteristics of the sample.

Measurement of earnings management uses the discretionary accrual model proposed by (Healy, 1985). It is designed to estimate the level of discretionary accruals, which are non-cash accounting adjustments that managers can use to manipulate reported earnings. This model is based on the idea that specific changes in current assets and liabilities are expected to be driven by regular business operations and tend to be influenced by managerial discretion. On the other hand, changes in other accounts, such as inventories, receivables, accounts payable and certain reserves, are more likely to be subject to managerial manipulation. Models can represent the following:

$$\text{Discretionary Accruals} = \Delta \text{Current Assets} - \Delta \text{Cash} - \Delta \text{Current Liabilities}$$

Where:

$\Delta \text{Current Assets}$ = Change in current assets from the previous period to the current period

ΔCash = Change in cash from the previous period to the current period

$\Delta \text{Current Liabilities}$ = Change in current liabilities from the previous period to the current period.

To measure financial risk, this study uses the Altman Z-score method. This model is an analytical model used to predict the potential for bankruptcy of a company with a relatively reliable level of accuracy. Therefore, this analysis can be used to measure a company's financial risk level (Liu et al., 2021). The Altman Z-Score model consists of five financial ratios, each weighted according to its relative importance in predicting bankruptcy risk. The Altman Z-Score model consists of five financial ratios, each weighted according to its relative importance in predicting bankruptcy risk. The formula for calculating the Z-Score is as follows:

$$\text{Z-Score} = 1.2A + 1.4B + 3.3C + 0.6D + 1.0E$$

Where:

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A = Working Capital / Total Assets
 B = Retained Earnings / Total Assets
 C = Earnings Before Interest and Taxes (EBIT) / Total Assets
 D = Market Value of Equity / Total Liabilities
 E = Sales / Total Assets

The Asset Growth Ratio is a financial metric used to measure a company's growth in total assets over a specific period. It provides insights into the expansion or contraction of a company's asset base and is often used to assess the company's overall growth trajectory (Ferliana and Agustina, 2018). The formula for calculating the Asset Growth Ratio is as follows:

Asset Growth Ratio = (Total Assets in Current Period - Total Assets in Previous Period) / Total Assets in Previous Period

Where:

Total Assets in Current Period = Total assets of the company at the end of the current period.

Total Assets in Previous Period = Total assets of the company at the end of the previous period (e.g., the previous year or quarter).

4. Findings and Discussions

Descriptive statistics is used to provide descriptions or descriptions of research variables which include maximum values, minimum values, mean, and standard deviation.

Table 1. Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Dev
Earning Management	110	-.24	.22	-.0361	.07597
Financial Risk	110	1.24	22.53	6.2788	4.72712
Growth Company	110	-.16	.41	.0753	.09544
Valid N (listwise)	110				

Source: Data Process

Table 1 shows variable Earnings Management has 110 valid data. The average value (mean) of this variable is -0.0361. The standard deviation (std. deviation) of 0.07597 indicates that the data tends to be close to the average because the standard deviation is relatively small. The range of values from -0.24 to 0.22 shows a relatively small variation. The average Earnings Management is -0.0361, which means that overall, companies tend to have lower profits than expected or desired. However, the variation in earnings between firms is also relatively small, indicating that the firms in the dataset tend to have similar or consistent earnings management practices. The average Financial Risk is 6.2788, which indicates that the companies in the dataset tend to have a relatively high level of financial risk. A large standard deviation indicates significant variation in risk levels between companies. The wide range of scores indicates companies with low financial risk (value of 1.24) and companies with high financial risk (value of 22.53).

The average (mean) of this variable is 0.0753. The standard deviation (std. deviation) of 0.09544 indicates considerable variation between the values in this variable. The range of values from -0.16 to 0.41 shows a wide variation in the data, with the lowest values below zero and the highest values exceeding zero.

The average Growth Company is 0.0753, which shows that overall, companies tend to have positive growth, but with low growth rates. A relatively high standard deviation indicates significant variation in growth performance between firms. A wide range of values indicates that there are companies with negative growth (value -0.16) and companies with relatively high growth (value 0.41).

Table 2. Coefficient

		B	Std. Error			Tolerance	VIF
1	(Constant)	.101	.015	6.768	.000		
	Earning Management	.433	.114	3.806	.000	1.000	1.000
	Financial Risk	-.002	.002	-.902	.369	1.000	1.000
	Moderation_FR	-.059	.032	-1.831	.070		

Table 2 shows the constant (intercept) has a B value of 0.101 in this regression model. The constant represents the value of the dependent variable Growth Company when all predictor variables in the model are at zero values. The t value of 6,768 indicates that the constant significantly affects the dependent variable with a significance value (Sig.) of 0,000.

The Earnings Management variable has a B value of 0.433. The Beta (Standardized Coefficient) value of 0.344 indicates that every one unit increase in the Earnings Management variable is associated with an increase of 0.344 units in the dependent variable Growth Company. The t value of 3.806 indicates that the variable Earnings Management statistically affects the dependent variable with a significance value (Sig.) 0.000. Tolerance and VIF are 1,000, indicating no collinearity problem (multicollinearity) between the predictor variables in the model. Companies that do-good earnings management tend to have higher growth (Growth Company). Improvements in positive and efficient earnings management practices can contribute to improved company performance and overall business growth. In addition, the statistically significant effect indicates that this relationship does not occur by chance, and there is a strong relationship between earnings management and company growth. The results of this study are in accordance with previous studies which showed the same results (Giosi et al., 2017; Marinakis, 2011; Gunny, 2011; Bisogno and Donatella, 2021; Gurendrawati, 2015). This result also follows Madhogarhia et al. (2009) paper, where this research finds that developing companies tend to manage their earnings up and down more aggressively than value-added companies.

In the context of agency theory, earnings management practices can positively and significantly influence company growth due to conflicts of interest between shareholders (principals) and company management (agents) (Healy, 1985; Bisogno and Donatella, 2021). In order to increase share value and meet shareholder expectations, company management may practice earnings management to improve their financial statements. Some examples of earnings management practices include changing accounting policies, delaying revenue recognition, or hiding certain expenses. The goal of this earnings management practice is to create the appearance of better-than-actual performance, which can attract new investors and support higher stock prices. In agency theory, earnings management practices can have a positive and significant effect on company growth because they create the impression of better performance in the eyes of investors. However, the downside is the potential for reputational and legal risks if this practice is disclosed and reduces the trust of stakeholders.

The Financial Risk variable has a B value of -0.002. The Beta (Standardized Coefficient) value

of -0.082 indicates that every one unit increase in the Financial Risk variable is associated with a 0.082 unit decrease in the dependent variable Growth Company. The t-value of -0.902 indicates that the Financial Risk variable has no statistically significant effect on the dependent variable because the significance value (Sig.) is greater than the commonly used significance level (usually $\alpha = 0.05$). Tolerance and VIF are 1,000, indicating no collinearity problem between the predictor variables in the model.

In the context of this model, there is not sufficient evidence to state that Financial Risk has a significant effect on the growth of the company (Growth Company). Even though the negative regression coefficient indicates a negative relationship, the statistical results show that the difference could have occurred by chance. This means that the Financial Risk variable may not be the main factor in predicting the company's growth in this model.

The Financial Risk variable is a moderator variable that measures the moderating effect on the relationship between Earning management and the Growth Company. The Beta (Standardized Coefficient) value of -0.333 indicates that the "Moderation_FR" variable contributes to reducing the effect of Earning management on "Growth Company." However, the t value of -1.831 indicates that this moderating effect is not statistically significant because the significance value (Sig.) is greater than the commonly used significance level (usually $\alpha = 0.05$).

This research shows that Financial Risk can cover many dimensions, including market, credit, liquidity, and others. Suppose the moderator variable only measures one aspect of financial risk or needs to be sufficiently complete in measuring the complexity of financial risk. In that case, its influence in moderating the relationship may be limited. The relationship between earnings management and company growth can be influenced by many factors other than financial risk. Earnings management is a company's action in manipulating financial statements to achieve specific goals. Internal and external factors influence the company's growth, such as business strategy, market, competition, and others. If the moderator variable (financial risk) cannot include all of these factors, then the impact on the relationship between earnings management and company growth may be insignificant.

In conclusion, in this regression model, the variable Earnings Management has a statistically significant effect on the dependent variable Growth Company, while the variable Financial Risk has no significant effect. The Earnings Management variable has a more excellent Beta value than Financial Risk, so Earnings Management has a more substantial influence in predicting the Company Growth variable compared to Financial Risk in the context of this model.

Table 3. ANOVA^a

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	.123	2	.062	7.598	.001 ^b
	Residual	.869	107	.008		
	Total	.993	109			

Source: Data Process

Table 3 show the regression SS value is 0.123. This indicates the amount of variability in the dependent variable Growth Company, which can be explained by the predictor variables Financial Risk and Earnings Management. The higher the regression SS value, the greater the variability in the dependent variable that the model can explain. The df value for the regression is 2. This shows that in this regression model, there are two predictors, namely Financial Risk

and Earnings Management. The Mean Square value for the regression is 0.062. Mean Square measures the mean variability in the dependent variable described by each predictor. The higher the Mean Square value, the more significant the contribution of the predictor variable to the variation in the dependent variable. The F-value of the ANOVA output is 7,598. This F value is a test statistic that measures the difference between the variability explained by the regression model and the variability not explained by the model (error). The higher the F-value, the more significant the effect of the predictor variable on the dependent variable. In this case, the F-value is 7.598, which is relatively high, indicating that the overall regression model significantly contributes to explaining the dependent variable Growth Company. The significance value is 0.001 (or 0.1%). This value indicates the probability that the observed result could have occurred by chance. In this context, a meager significance value indicates that the relationship between Financial Risk and Earnings Management with Growth Company is statistically significant. Thus, it can be concluded that this regression model significantly contributes to predicting the dependent variable Growth Company. In conclusion, from the output of the ANOVA, we can conclude that the regression model with the predictor variables Financial Risk and Earnings Management together significantly affect the dependent variable Growth Company. However, further analysis is needed on the significance and effect size of each predictor variable in the model for a more complete understanding.

5. Conclusion

Based on research conducted on companies in the Primary Consumer Goods Industry sector listed on the IDX in 2017 - 2021. Earnings management practices positively and significantly affect company growth, meaning that companies that manage earnings will tend to have higher growth companies. Improvements in positive and efficient earnings management practices can contribute to improved company performance and overall business growth. In addition, the statistically significant effect indicates that this relationship does not occur by chance, and there is a strong relationship between earnings management and company growth.

On the other hand, financial risk does not affect company growth and cannot moderate the relationship between earnings management and company growth. The effect of finance on company growth can be very complex and is influenced by many other factors that are not included in this regression model. Financial Risk variables can cover various aspects of financial risk, such as changes in interest rates, market fluctuations, and credit risk. There may also be other external and internal factors that affect the relationship between financial risk and company growth but are not measured in this analysis. Therefore, this model may not capture the complexity of this relationship fully.

However, the results of this paper show that Financial Risk and Earnings Management significantly affect the dependent variable Growth Company. These results indicate that companies with earnings management that improve their financial statements experience better or higher growth. This research is not free from limitations, and future research is expected to explore other sectors which may have different results from this study. Future research can consider control variables, such as company size, liquidity, leverage, industry growth, and other economic factors, which can affect company growth.

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