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The Influence of ESG Performance and Financial Distress on Earnings Management Practices

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Abstrak

Hasil penelitian menunjukkan bahwa terdapat hubungan yang cukup besar antara *ESG performance*, *financial distress*, dan manajemen laba. Nilai rata-rata kinerja ESG adalah 0,59, sedangkan nilai rata-rata *financial distress* adalah 8,30, yang menunjukkan kondisi keuangan yang baik. Dalam bidang manajemen laba, korporasi yang bergerak di sektor energi dan migas melakukan praktik manipulasi hasil keuangan sehingga mengakibatkan penurunan laba masing-masing sebesar 16% dan 76%. Sebuah penelitian dilakukan untuk menyelidiki dampak *ESG performance* dan krisis keuangan terhadap manajemen laba dengan menggunakan analisis regresi linier berganda. Temuan ini menunjukkan adanya hubungan negatif antara skor kinerja lingkungan, sosial, dan tata kelola (ESG) yang lebih besar dan manajemen laba. Selain itu, peningkatan kinerja sosial dikaitkan dengan penurunan penyisihan kerugian pinjaman, yang mengakibatkan peningkatan pendapatan dan pengurangan aktivitas penghindaran kerugian. Krisis keuangan dapat berdampak pada manajemen laba, karena organisasi mungkin melakukan strategi untuk meningkatkan neraca keuangan mereka guna menarik investor dan meningkatkan keuntungan.
Kata Kunci: *ESG Performance, Financial Distress, Manajemen Laba*

Abstract

The findings of the study indicate that there is a considerable relationship between ESG performance, financial distress, and earnings management. The mean ESG performance value is 0.59, whereas the mean financial distress value is 8.30, suggesting a favorable financial state. Within the realm of earnings management, corporations operating in the energy and oil and gas sectors engage in the practice of manipulating their financial results, resulting in a reduction of profits by 16% and 76%, respectively. A study was undertaken to investigate the impact of ESG performance and the financial crisis on earnings management using multiple linear regression analysis. The findings indicate a negative relationship between greater environmental, social, and governance (ESG) performance scores and earnings management. Additionally, improved social performance is associated with a decrease in loan loss provisions, resulting in enhanced earnings and a reduction in loss avoidance activities. A financial crisis can have an impact on earnings management, as organizations may engage in strategies to enhance their financial accounts to attract investors and bolster profits.
Keywords: *ESG Performance, Financial Distress, Earnings Management*

INTRODUCTION

Indonesia, an archipelagic country with a population of over 270 million people spread across 34 provinces in Southeast Asia, has been severely affected by the COVID-19 pandemic (Statista, 2022). The World Health Organization (WHO) announced the virus in December 2019, leading to over 10 million deaths worldwide and 500,000 deaths due to increased contact between humans and animals (Platto et al., 2021). To prevent and mitigate the spread of the virus, the Indonesian government implemented a Large-Scale Social Restrictions (PSBB) policy, which was regulated in Government Regulation (PP) Number 21 of 2020.

The policy has had a significant impact on supply chain performance and the Composite Stock Price Index (IHSG), which experienced a decline of 10.75% in March 2020. The six most affected commodities were accommodation, food, beverages, services, transportation and storage, construction, processing industry, and trade. Energy, particularly petroleum, is the commodity most affected by the stabilization of economic activity.

In 2018, 875 million BOE (barrel oil equivalent) were used to produce energy, with gasoline, kerosene, aviation fuel, avgas, diesel oil, and diesel oil contributing 39% of total fuel energy consumption. The transportation sector is the largest user of energy, with 40% of the total being gasoline. The industrial sector uses 38% and focuses on coal, while the household sector relies on 15% electrical energy (Hilmawan & Sugiyono, 2020)

The demand for air travel will rise by 6%, causing aviation fuel demand to increase from 4.5 MTOE in 2018 to 27.6 MTOE in 2050. Truck energy demand will also increase by an average of 5% to 43% in 2050. Natural gas and coal energy are needed more in industrial sectors, contributing 87% of total energy consumption. Commercial sectors consume 60% to 70% of total energy, with the home industry occupying the fourth position and consuming the most energi (Suharyati et al., 2019).

The Indonesian government has been actively working to protect, maintain, and increase economic capacity due to the COVID-19 pandemic. The National Economic Recovery Program (PEN) focuses on health intervention, survival supplies, and structural reforms through Job Creation Law No. 11/2020. The available APBN is allocated to various sectors, including 22% of the PEN budget, IDR 699.43 trillion for health, IDR 176.30 trillion for social support, IDR 184.83 trillion for MSMEs and corporations, IDR 58.46 trillion for business incentives, and IDR 122.44 trillion for priority programs (Departemen Komunikasi Bank Indonesia, 2021).

The PEN Programmed is expected to become a benchmark for the government in sustainable development, aligning with the UN's Sustainable Development Goals (SDGs). Indonesia has been ranked 9th out of 21 countries in the East and South Asia region with a score of 77.3 and 7th out of 74 for its efforts and commitment to implementing the SDGs.

Indonesia also implements environmental, social, and governance (ESG) chosen by business actors to contribute to encouraging national development. ESG is measured using 121 indicators created by the Global Reporting Initiative (GRI) Standard, which include economic, environmental, labor practices, human rights, community, and corporate responsibility for products (World Health Organization & International Labour Organization, 2021).

Indonesia is in fourth place with a score of 28.2 and the ability to commit within 10 years (Environmental Performance Index, 2022). However, there are challenges that prevent Indonesia from continuing to participate in mitigating and preventing environmental damage. The transportation sector is responsible for increasing greenhouse gas (GHG) emissions and carbon dioxide emissions in Indonesia, particularly in Jakarta.

The government continues to work together with various parties to reduce GHG emissions by 29% to 41% by 2030 (Pribadi, 2023). Emissions decreased in 2019 by 54.4 million tons, 2020 by 64.4 million tons, 2021 by 67 million tons, and 2022 by 91 million tons.

To reduce GHG emissions, the Ministry of Environment and Forestry has implemented policies regarding permanent permits for the conversion of primary forests and peatlands, as well as expanding permits for the Peat Restoration Agency to protect and restore peatlands and mangroves.

The third pillar of ESG implementation is governance, which involves the use of accounting standards, voting on important issues, and maintaining accountabilities for all reports. The COVID-19 pandemic has directly impacted the education sector in Indonesia, with only 32 out of 100 people aged 15 years and over having completed secondary school or equivalent. This low quality of education affects the quality of life of individuals and increases the poverty rate.

Accountability is closely related to a company's attitude towards transparency, honesty, and reliability regarding company performance and financial reports. Companies with poor financial conditions may be more aggressive in managing profits, leading to conflicts of interest between principle and stakeholder. This can lead to earnings management practices, as seen in the 2009 scandal under PT Waskita Karya (Persero).

Implementing ESG based on these three pillars can have a positive impact on collective prosperity but also has a negative impact if not accompanied by good company financial quality. Companies experiencing financial difficulties will have a positive and significant effect on increasing the impact of ESG disclosure practices and earnings management. This is because companies in financial distress have a higher possibility of carrying out manipulation practices by disclosing ESG information to hide or avoid losses (Almubarak et al., 2023).

Management can manipulate financial reports to present the business in a way that appeals to creditors and investors (Dzulfikar & Firmansyah, 2022). Above, we have described several phenomena associated with earnings management strategies. These phenomena have significant effects on both internal and external stakeholders, mostly via distorting reported financial information (Healy et al., 1998). Furthermore, it exerts influence on suboptimal investment choices and a decline in corporate valuation (Roychowdhury, 2006). Furthermore, there is a potential consequence of eroded confidence among stakeholders, including investors, creditors, and the public (Burgstahler & Dichev, 1997).

The selected title is "The Impact of Environmental, Social, and Governance (ESG) Disclosure and Financial Distress on Earnings Management." The author asserts that further investigation is necessary to ascertain the potential influence of the variables under consideration on earnings management techniques. This aligns with the research purpose of acquiring a fresh comprehension of the impact of ESG performance and financial hardship on earnings management.

RESEARCH METHOD

Type and Research Data

The present study employs quantitative research methods. According to Sekaran and Bougie (2016), quantitative approaches are characterized by their adherence to the philosophical principles of positivism. The objective of this study is to analyze populations and/or samples, subsequently generating hypotheses based on statistical tests.

Population and Research Sample

The research sample comprises a total of 83 energy sector businesses that are publicly listed on the Indonesia Stock Exchange (BEI) throughout the period of 2019 to 2022. To investigate earnings management practices, a purposive sampling strategy was employed to select the sample. The criteria used for this selection technique were as follows:

Tabel 1.Determining the Research Sample

Criteria	Total
The study investigates publicly listed energy sector companies on the Indonesia Stock Exchange from December 31, 2019, to 2022.	83
Minus: The organization has not disclosed its audited yearly financial statements from December 31, 2019, to 2022.	21
Minus: The organization is unable to provide comprehensive data on sustainability reporting and ESG performance from December 31, 2019, to 2022.	49
Companies included in the sample	**13**

Source: data is processed,2023

Total data in this study is 13 x 4 = 52 company data

Data Analysis Method

A lot of different types of analysis are used in this study, such as descriptive statistics, classical assumptions, multiple linear regression analysis, the determination coefficient test, and the goodness of fit test. Descriptive statistics describe and rate an object or event using sample data or individual participation, but they don't analyze the data or come to conclusions that can be applied to the whole population (Sugiyono, 2016). The study employed statistical measures such as standard deviations, maximum values, and lowest values to quantify the data. The second technique comprises a set of conventional assumptions, namely: (1) the normality test; (2) multicollinearity tests; (3) the heteroskedasticity test; and (4) the autocorrelation test. The third technique employed in this study is multiple linear regression analysis, which is conducted using the following formula:

$$Yit = \alpha + \beta_1 X_1 it + \beta_2 X_2 it + e\text{it} \qquad (1)$$

Notes:

Yit = Earnings Management of firm i for period t

X_1 = ESG Performance of firm i for period t

X_2 = *Financial Distress of* firm i for period t

α = Konstanta

β = Koefesien
e = error of firm i for period t

Hypothesis Development

Agency theory and positive accounting theory serve as the foundation for this investigation. Agency theory is an academic discipline that analyzes the interplay between two entities that possess divergent objectives. The agency theory concept underscores the potential conflict of interest between proprietors, commonly called principals, and managers, referred to as agents. This conflict emerges when the agent gives priority to behaviors that benefit the owner, resulting in the emergence of agency costs (Jensen & Meckling, 1976)

By virtue of their agent status, managers are intimately acquainted with all business transactions and affairs and participate in the daily operations of the organization. Shareholders, acting as principals, depend on periodic sources of information, such as annual reports and interim reports, to evaluate the performance of the company (Gitman & Zutter, 2012).

Additionally, Scott and O'Brien (Scott, 2015) provide an explanation of how agency theory functions as a conceptual structure to analyze situations in which there are conflicts between the objectives and aspirations of personnel working for the principal. The difficulty emerges due to an information asymmetry between the two entities, resulting in the agent possessing a higher level of knowledge about the organization than the principal. Asymmetric information refers to situations in which there is an unequal distribution of information. Managers possess a more comprehensive comprehension of the organizational circumstances in comparison to external stakeholders, specifically school administrators (Brigham & Houston, 2019)

Furthermore, there have been developments of international importance concerning the inadvertent endorsement of earnings management in light of the discovery of the COVID-19 virus, as formally acknowledged by the World Health Organization (WHO). The empirical support is evident in the 10.75% decline in the composite share price (IHSG). The decrease in performance has prompted agents to adopt earnings management tactics to alleviate the adverse effects of COVID-19 on the company's financial performance, which could lead to financial distress.
Managers frequently employ ESG disclosures to provide incentives for such deceitful conduct.

Almubarak et al. (2023) posit that insolvent organizations are prone to perceive that enhancing environmental, social, and governance (ESG) standards, alongside earnings management, will have a significant and positive influence. Financially challenged companies are more prone to utilizing manipulative strategies, such as disseminating environmental, social, and governance (ESG) information in a transmissive fashion, in order to conceal or alleviate losses. This tendency can be attributed to their need to enhance the company's appeal to investors and creditors.
As a strategy to enhance the company's appeal to investors and creditors, Dzulfikar and Firmansyah (2022) posit that corporate leadership might engage in the manipulation of financial statements.

The research framework model is formulated as follows, based on the explanation that has been given:

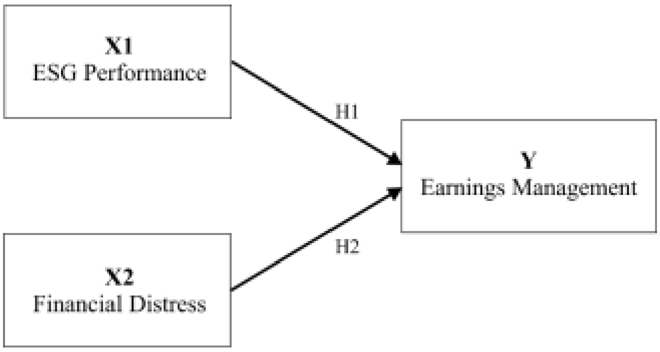

Figure 1.Conceptual Framework Diagram

The Effect of ESG Performance on Earnings Management

Numerous instances of earnings management practices implemented by managers have adverse effects on stakeholders. Managers use earnings management as a strategic tool to affect corporate profits and shape stakeholder perceptions of a company's performance (Scott, 2015).

Prior et al (2006) found that stakeholders are likely to have negative views and responses, which could manifest as investor pressure, regulatory punishments, professional neglect, activist boycotts, and negative media attention. It is imperative for companies to have a strategic approach to proactively anticipate and address any unhappiness among stakeholders.

Creating and sharing a company policy on how to incorporate and carry out environmental, social, and governance (ESG) principles within the company is one way to help with this. This perspective aligns with the viewpoints expressed by Velte (2019) and Almubarak et al (2023), who posit that managers can safeguard their position and sustain profitability through the implementation of various initiatives. These initiatives encompass enhancing reputation and brand value, mitigating risks, attracting capital and talent, and ensuring enduring sustainability. Managers employ environmental, social, and governance (ESG) practices as a means of monitoring compliance, ensuring legal adherence, and demonstrating organizational integrity to superiors (Kim & Lee, 2023; T. T. Li et al., 2021). By employing this approach, organizations can mitigate the adverse consequences associated with earnings management (Andriani & Arsjah, 2022).

Based on the description, the hypothesis can be expressed as follows:

H$_1$: ***The performance of environmental, social, and governance (ESG) factors has an impact on the practice of earnings management.***

The Effect of Financial Distress on Earnings Management

Stakeholders conduct an evaluation of a company's current capacity by looking at financial data (Jensen & Meckling, 1976). Stakeholder evaluations aim to mitigate issues. For instance, if a firm decides to undergo an initial public offering (IPO) during a period of financial difficulties, resulting in lower-than-expected profits, it is likely to see a decline in share prices and a decrease in its overall market capitalization.

The presence of asymmetric information gives rise to substantial agency conflicts between managers and shareholders in firms undergoing financial distress (Jensen & Meckling, 1976). When managers and shareholders don't have the same amount of information, companies may be more likely to use earnings management strategies to lessen the bad effects of financial distress (Khalid et al., 2020; Y. Li et al., 2020).

Previous studies have indicated that organizations are encountering financial challenges. According to Wiratno et al. (2023) individuals facing substantial financial challenges are more likely to engage in proactive earnings management tactics. Conversely, when a corporation has a diminished degree of financial distress, it is more inclined to abstain from engaging in earnings management activities. According to a study by Viana et al.(2022), companies that are having money problems often use earnings management to lower the risk of not being able to pay their debts, which can happen when debt covenants are broken.

Companies that are in financially vulnerable situations are more likely to engage in earnings management, as opposed to companies that are financially stable. Companies need to be able to clearly explain their financial results to stay competitive in the market, make sure they can get loans, and build trust among investors and creditors. Dzulfikar and Firmansyah (2022) say that corporate management might change financial statements to make investors and creditors think that the company is a better investment. The chance of this happening, however, can be lessened if independent commissioners play a key role in reducing the positive effects of financial stress on result manipulation. The hypothesis is formulated based on the provided description in the following manner:

H_2: The presence of financial distress has an impact on the practice of earnings management.

RESULT AND DISCUSSION

According to the data presented in desriptive statistic, the mean ESG performance score is 0.59, with a maximum score of 1.01 and a minimum score of 0.21. The standard deviation of the ESG performance scores is 0.20. This observation indicates that there exists a significant amount of data pertaining to the variables associated with ESG performance that is widely dispersed.

The present study observes that the mean value of financial distress among enterprises is 8.30, with a maximum value of 27.72 and a minimum value of 0.59. In addition, we calculated the standard deviation for this measure to be 4.78. This indicates that the company possesses a robust financial state and is unlikely to encounter financial challenges or insolvency.

Moreover, the earnings management cohort achieved a minimum value of -0.16. This implies that certain corporations within the energy industry engage in earnings management practices, resulting in a deliberate reduction of their profits by 16%. Furthermore, the maximum value reached was 0.08. This implies that certain entities within the oil and gas industry engage in earnings management practices, resulting in an 8% augmentation of their profits. The obtained mean value was -0.76. This implies that enterprises operating within the oil and gas industry tend to engage in earnings management practices, resulting in an average reduction of their profits by 76%.

To examine the impact of ESG performance and the financial crisis on earnings management, a multiple linear regression analysis was conducted. Before conducting the multiple linearity test, we performed various conventional assumption tests, including tests for normality, multicollinearity, heteroscedasticity, and autocorrelation. The obtained test findings indicated that the data exhibited normality, the independent variable did not demonstrate a linear relationship with the dependent variable, the variance of the residuals did not display any discomfort across observations, and there was no presence of autocorrelation.

Data from the multiple linearity test results are presented in Table 2.

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Tabel 2.Coefficients Result

Coefficients [a]

Model		Unstandardized Coefficients B	Unstandardized Coefficients Std. Error	Standardized Coefficients Beta	t	Sig.
1	(Constant)	-,027	,021		-1,300	,200
	X1	-,046	,026	-,251	-1,789	,080
	X2	-,003	,001	-,324	-2,306	,025

a. Dependent Variable: Y

Source: data is processed,2023

Based on Table 2, the multiple linear regression equation Y = -0.027 - 0.046 X_1 - 0.003 X_2 is obtained.

Next, testing was carried out to determine the significance of the regression equation using the ANOVA test. The test results are presented in Table 3.

Tabel 3.Anova Result

ANOVA [a]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	,009	2	,004	3,325	,044 [b]
	Residual	,066	49	,001		
	Total	,074	51			

a. Dependent Variable: Y

b. Predictors: (Constant), X2, X1

Source: data is processed,2023

According to the data presented in Table 3, the computed F-statistic is 3.325, with a corresponding p-value of 0.044. The obtained p-values are recognized as being less than 0.05. Therefore, we can infer the significance of the multiple regression equation Y = -0.027 - 0.046 X 1 - 0.003 X 2.

The findings of this study indicate that there is a significant relationship between environmental, social, and governance (ESG) performance and financial distress, which in turn affects the practice of earnings management. The research findings indicate a detrimental impact of ESG performance and the financial crisis on the practice of earnings management. This implies that there exists an inverse relationship between the magnitude of ESG performance and financial difficulties and the extent of earnings management.

Prior research has posited that environmental, social, and governance (ESG) factors influence earnings management, and the findings of this study align with this notion (Almubarak et al., 2023; Anderson et al., 2023; Andriani & Arsjah, 2022; Kolsi et al., 2023; Velte, 2019). This implies that there is a negative relationship between greater environmental, social, and governance (ESG) performance scores and the practice of earnings management. Furthermore, improved social performance is associated with a decrease in loan loss provisions, enhancing earnings and mitigating loss-related activities. Furthermore, it is incumbent upon enterprises to uphold their reputation and public image with external stakeholders, including the public and investors. Consequently, managers often choose to demonstrate the company's success by means of yearly reports on a comprehensive basis.

The findings of this investigation demonstrate that there exists a relationship between financial difficulty and the practice of wage management. The findings of this analysis align with prior research, which posited that financial distress exerts an influence on earnings management (Almubarak et al., 2023; Dzulfikar & Firmansyah, 2022; Khalid et al., 2020; Y. Li et al., 2020; Valaskova et al., 2021; Viana et al., 2022; Wiratno et al., 2023).

Under such circumstances, the organisation endeavours to capture the interest of potential investors by augmenting its profitability, as reflected in its financial statements. This study examines the impact of the financial distress on the practice of earnings management. This phenomenon aligns with the principles of agency theory, which posits that in organizations facing financial difficulties, management (acting as agents) often engages in upward earnings management. The inclination mentioned is shaped by the presence of unequal access to information between the organization and external entities, including investors, creditors, and stakeholders. The presence of information asymmetry provides managers with the potential to engage in the manipulation of financial reporting (Jensen & Meckling, 1976).

Agency theory and positive accounting shed light on the multifaceted interactions involving stakeholders, management, and prevailing economic circumstances, examining the intricate interplay between financial hardship and earnings management. In times of financial crisis, corporations may resort to the practice of earnings management as a strategic measure to ensure their continued existence or alleviate the adverse consequences experienced by their shareholders. Nevertheless, the implementation of excessive earnings management practices may have adverse effects on the long-term viability of the organization.

On the contrary, the results of this study are in opposition to the research conducted by Nadifah et al. (2020)which posited that CSR disclosure has no bearing on earnings management. Put simply, corporations might not have a strong incentive to engage in substantial financial report manipulation to provide support for the sustainability of ESG initiatives.

CONCLUSION

There is strong evidence that there is a link between the performance of environmental, social, and governance (ESG) factors and the occurrence of financial hardship, which in turn affects the practice of earnings management. The study also demonstrates a negative correlation between higher ESG performance scores and the implementation of earnings management techniques. Moreover, the results indicate that the presence of a financial crisis has a significant impact on the practice of earnings management, as organizations experiencing financial challenges tend to employ upward earnings management strategies. These findings are consistent with previous studies and emphasize the need for autonomous commissioners to mitigate the favorable impacts of financial distress.

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