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# The Relation between CEO Reputation, Financial Distress, Internal Control, and Earnings Management.

*by* Edi Edi

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## The Relation between CEO Reputation, Financial Distress, Internal Control, and Earnings Management

Edi Edi<sup>a</sup> Venorika<sup>b</sup>

<sup>15</sup>  
<sup>a</sup> Universitas Internasional Batama, Department of Accounting, Faculty of Business and Management, edi.king@uib.ac.id

<sup>15</sup>  
<sup>b</sup> Universitas Internasional Batam, Department of Accounting, Faculty of Business and Management, 1942165.venorika@uib.edu

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### Abstract

**Purpose:** The purpose of this research is to analyze the effect of internal control and financial distress on earnings management<sup>19</sup> and add the CEO's reputation as a moderating variable. The object of this study is to determine the companies that listed on Indonesia Stock Exchanges between 2019 and 2020. The research data were tested and analyzed using panel regression analysis on SmartPLS<sup>8</sup> software. **Methodology:** The research sample is chosen using the purposive sampling technique. Data analysis for the study employed the SmartPLS program. This research used accrual earnings management to measure the earnings management, springate model to measure financial distress, internal control index to measure internal control and CEO's reputation index is used to measure CEO's reputation.

**Findings:** The research results found that financial distress and internal control positively affect earnings management. In addition, this<sup>18</sup> search results also found that a CEO's reputation can have a moderately significant and positive effect on the relationship between financial distress and earnings management.

**Originality/Value:** This research finding is helpful for corporate governance in maximizing investment strategies. The consideration of the value of internal control is also a reference when investing. As such, it tends to assist company management in executing investment strategies to see the value of the CEO's reputation and internal controls. The novelty research provides new insight into how CEO's reputation moderates the relationship between financial distress and earning management.

## Introduction

The outbreak of the coronavirus (commonly referred to as Covid-19) has severely impacted healthcare, the economy, transportation, and other sectors across industries and regions. Covid-19 can spread very quickly (Mukhlis & Karminingtyas, 2021), so the government has implemented a policy of limiting direct interaction and maintaining physical distance from each other. Driven by the coronavirus, there has been a demand for work-from-home, homeschooling, e-commerce, telehealth, no-interaction delivery, and more.

<sup>30</sup> Covid-19 has a negative impact not only on the health sector but also on the economic sector due to reduced public demand due to the impact of business activities at a time when community activities are restricted (Festiana *et al.*, 2022). These changes will affect the <sup>26</sup> decline in the company's financial performance, resulting in the ineffective presentation of <sup>39</sup> the company's financial statements. When a company has financial problems, its earnings may not meet investors' expectations, causing the company's share price and value to drop. Consequently, the act of concealing or manipulating corporate financial statement profits is increasingly being considered by companies to maximize financial statement profits.

<sup>37</sup> Earnings management occurs when managers use profits from financial statements to structure transactions or company operations to demonstrate superior company performance. The survival of a company also depends on the external environment or resources. As a result, the relationship between corporate governance and corporate value will be strengthened by supporting the CEO's reputation (Kho & Edi, 2021). A company's CEO must be able to maximize the company's internal environment. Hold the company's CEO responsible for disclosing several matters related to internal control that add value to the company in the corporate governance annual report.

Earnings management is a problem formulation that attracts researchers and is also widely commented on by researchers. Earnings management is profit adjustment aimed at achieving the targets determined by previous management. <sup>11</sup> Earnings management acts as a dark area where accounting is at a disadvantage, and

administrators have reduced elements to their liking. Hence, the income statement represent <sup>11</sup> management's desires rather than the actual financial status of the organization (Dang & Tran, 2020). Manipulating financial data or transactions is one technique to manage earnings. The second method is based on managing operational tasks that directly impact the cashflow of business. This action is <sup>24</sup> a temporary increase in sales by providing excessive price discounts and decreasing or increasing discretionary costs (Mughal *et al.*, 2021). Earnings management is carried out to make the company's financial statements seem more compelling. This is because investors frequently read or examine financial statement when evaluating a company. In general, investors are more attracted to the company's financial capabilities and estimate opportunities that will occur in the future by using the company's reported earnings in that period (Hasudungan, 2020). <sup>4</sup> Earnings management can be classified into two categories, namely, real earnings management and accrual earnings management. Real earnings management uses accelerating revenue by changing some of the company's business activities. Earnings management means managing earnings using accounting principles provided by GAAP. Earnings management can be measured through discretionary accruals. Discretionary accruals are used to issue more informative financial statements, which means issuing financial statements that reflect the actual condition of the company. <sup>4</sup> Earnings management is not achieved by overhauling the underlying operational activities of the company but by the choice of accounting methods and accounting estimates used to represent these activities, on the contrary real earnings management relates to changes in the company's basic operations to increase current period revenues (Johanes Simamora, 2019).

## Literature Review

### Earnings Management

<sup>9</sup> Earnings management (EM) was used as the dependent variable. According to the discussion above, <sup>13</sup> there are two types of earnings management, accrual earnings management and real earnings management. In this research uses accrual categories for data collection, which can be adjusted as follows:

$$TA_{it} = \frac{1}{A_{i,t-1}} + \Delta S_{it} + PPE_{it} + ROA_{it(or\ it-1)}$$

Description:

TA<sub>it</sub> = Total accrual

A<sub>i,t-1</sub> = Total asset year t-1

ΔS<sub>it</sub> = Changes in Sales year i and i-1 / Total asset year i-1

PPE<sub>it</sub> = Fixed asset year i / Total asset year i-1

ROA<sub>it /it-1</sub> = Value of return on asset year i or i-1

### Financial Distress

This research uses the Springate model measures to analyze how financial distress on accounting affect for earnings management. According to the Springate model equations, a corporation is classed as insolvent if its Z-value is less than 0.862, and Z-value > 0.862, the corporation is classified as a healthy company. It is evident from Edi & Tania, (2018) that the measurement for the best predictive model compared to other models is the Springate model. As a result of the assertion above, the following financial distress formula can be drawn:

$$S_{i,t} = 1,03X_1 + 3,07X_2 + 0,66X_3 + 0,4X_4$$

Description:

X<sub>1</sub> = Working capital/Total aset

X<sub>2</sub> = Net income before taxes and interest/Total aset

X<sub>3</sub> = Net profit before tax/Current liabilities

X<sub>4</sub> = Sales/Total aset

### Internal Control

Arisandi *et al.*, (2022) pointed out that the control environment, risk assesment, control activities, communication information, internal control, internal control weaknesses, and evaluation of external and internal parties are the eight pieces of internal control information that need to be disclosed. Company's annual report. The study of internal control variables cites the measurement of the Internal Control Disclosure Index, which is based on the Indonesian annual report disclosure standard set out in Regulation No. X.K.6 of 2012 on the obligation to file annual

reports for issuers and listed companies. The criteria for submitting information cited in the annual report are as follows:

**Figure 1: Internal Control Index**

<b>Audit Committe</b>	<b>Internal Audit Unit</b>
<ol style="list-style-type: none"> <li>1. Committe Name</li> <li>2. Position history, work experience and basis of appointment</li> <li>3. Educational History</li> <li>4. Term of Position</li> <li>5. Disclosure of Independece</li> <li>6. Disclosure of company policies and their implementation related to the frequency of meetings and the extent to which they participate</li> <li>7. A brief description of the activities during the</li> </ol>	<ol style="list-style-type: none"> <li>1. Internal Audit Name</li> <li>2. Poision history, work experience and recuitmen basis</li> <li>3. Qualification and cetification as a profession of Internal audit</li> <li>4. Structure position</li> <li>5. The duties and responsibilities of internal audit are as stated in the charter</li> <li>6. A brief description of the implementation of tasks in the financial year</li> </ol>
<b>Internal Control System</b>	<b>Risk Management System</b>
<ol style="list-style-type: none"> <li>1. Compliance with financial and operational controls and other laws and regulations</li> <li>2. Evaluation or review of the effectiveness of the internal control system</li> </ol>	<ol style="list-style-type: none"> <li>1. An overview of the company's risk management</li> <li>2. Types of risks and how to manage them</li> <li>3. Review the effectiveness of the company's risk management system</li> </ol>

**Source:** Arisandi *et al.*, (2022)

The point criteria above represent all the information that stakeholders expect to describe. The ICDI measurements are obtains as follow:

$$IC = \frac{\sum x_{ij}}{n_j}$$

Description:

$x_{ij}$  = the number of items disclosed by the company

$n_j$  = total number of items diclosed

### CEO Reputation

One of the external environmental aspects is CEO's reputation. The survival of a company depends on the external environment or resources. Therefore, the CEO's reputation will help strengthen <sup>9</sup> the relationship between corporate governance and firm value. The measure applied to measure the value of a CEO's reputation is the CEO's Reputation Index, as shown in the following table (Kho & Edi, 2021):



Index	Description
<b>CEO qualification</b>	
1	Diploma or lower
2	Bachelor's degree
3	Post graduate qualification
<b>Participation in a professional body</b>	
1	None
2	Membership of one professional body
3	Membership of more than one professional bodies
<b>CEO tenure</b>	
1	Not more than one year
2	Not more than three years
3	More than three years
<b>CEO experience</b>	
1	had previous management experience, but not as a company's president director or CEO
2	had previous management experience, as a company's president director or CEO of a non-listed company
3	had previous management experience, as a company's president director or CEO of a listed company

**Figure 2: CEO's Reputation Index**

**Source:** Kho & Edi (2021)

### **Earnings Management and Financial Distress**

<sup>2</sup> This relationship between financial distress and earnings management is the main topic of this research. Managers will be concerned about carrying out earnings management to increase revenue in situations involving financial distress. In addition, the results of the research also concluded that with financial problems registered companies tend to be more involved in increasing income than unlisted companies (Campa, 2019). The company is in an early stage of financial distress, so management tends to start increasing the profitability and liquidity values beforehand (Nagar & Sen, 2016). Usually, companies want to display healthier conditions than they are to be seen as a high performing company, because healthy financial reports and high performance can attract potential investors to invest in the



company and use investment funds to fund the company's business operations (Ranjbar & Amanollahi, 2018; Selahudin *et al.*, 2014). Increasing profits according to accounting are earnings management that increases profits without having to increase costs interrelated with corporate taxes, proving that tax motivation does not affect earnings management practices (Hasudungan, 2020).

According to significant and negative results from this research regarding internal control with earnings management, improved internal control quality reduces earnings management. On the other side, corporate earnings management would be hampered by the firm size <sup>12</sup> and the higher quality of the external audit. Conversely, <sup>3</sup> the higher the value of the liability scale, the larger motivation for companies to practice earnings management. The company's behavior in managing its earnings is thus restrained by internal control (Xu & Kim, 2021). Companies implementing high <sup>3</sup> internal control improvements can reduce earnings management effectively. This is because if as <sup>3</sup> the company's internal control effectiveness increases, <sup>3</sup> the restraint of an effective internal control system on earnings management will likewise increase (Guo & Liu, 2015).

A large amount of published research illustrates that when a public firm tends to enhance its earnings management procedures when experiencing financial distress. This will decrease stock prices and company value due to income that cannot meet investor expectations. Financial distress will likewise increase more cost for companies to issue debt and make increasing debt financing distress (Y. Li *et al.*, 2020).

Earnings management is carried out to increase companies' growth opportunities with excess cash flow. Then the company can maximize profits without increasing the costs associated with corporate taxes (Deeb & Ramadan, 2020; Hasudungan, 2020; Kurniawati & Ria Panggabean, 2020). Practicing earnings management will prevent the sustainability of the situation of financial problems and risks that arise from the company (Ranjbar & Amanollahi, 2018). According to the statement <sup>3</sup> above, <sup>3</sup> the first hypothesis in this research is:

<sup>5</sup>  
H<sub>1</sub> : There is a significant and positive relationship between financial distress and earnings management.

### <sup>3</sup> **Earnings Management and Internal Control**

The higher company's internal control measures, the fewer earnings management practices in the company. If internal control measures are not sufficiently disclosed, managers can manage earnings to deceive shareholders about the company's financial performance. Therefore, the higher the disclosure of internal control information, it will hinder the practice of earnings management (Wali & Masmoudi, 2020; Wang, 2019; Yan, 2019; Zulfikar *et al.*, 2021). Disclosure of internal control information will affect earnings management with agency costs. Improving the quality of disclosure can reduce agency costs so which will reduce earnings management (Ying, 2016). According to the statement above, the second hypothesis in this research is:

<sup>16</sup>  
H<sub>2</sub> : There is a significant and negative relationship between internal control and earnings management.

### **Earnings Management, Financial Distress, Internal Control and CEO Reputation as Moderator**

The big bath theory is the action of the management team of a corporation that willfully manipulates the company's income statement to make unacceptable report results look worse to make future performance appear better. New CEOs of companies sometimes tend to use the big bath theory to blame the company's poor performance on the previous company's CEO and take credit for improvements in the next year (Hayes, 2020). The new CEO will carry out earnings management with discretionary accruals to minimize reported earnings in the year of change of position using a big bath (Adiasih *et al.*, 2011). The theory of planned behavior is used to describe any behavior that requires planning. This theory explains that attitude towards behavior is essential for predicting an action by considering a person's attitude in testing subjective norms and measuring the behavioral control of that person's perception (Ajzen, 1991).

Based on the theory above, we can assume that a CEO will do anything to maintain his reputation. Amid a severe pandemic, they will be more special in maintaining the reputation of the CEO because the possibility of financial distress will be higher amid a pandemic. The third and fourth hypotheses can be concluded as :

H<sub>3</sub> : The reputation of the CEO can moderate <sup>2</sup> the relationship between the financial distress and the earnings management.

H<sub>4</sub> : <sup>7</sup> The reputation of the CEO can moderate the relationship between the internal control and the earnings management.

### Research Methodology

This research uses quantitative research subjects. Quantitative research subjects are used to examine populations or samples using measuring instruments or research instruments, to test the hypotheses that have been made. This study aims to determine the company listed on Indonesia Stock Exchanges between 2019 to 2020. The research data were tested and analyzed using panel regression analysis on SmartPLS (PartialLeastSquare) software. The research is aimed at 2019 to 2020 with the consideration of examining a comparison of the level of earnings management that will be practiced by company CEOs to maintain their reputation during the pandemic and before the pandemic.

### Findings and Discussion <sup>17</sup>

**Table 1: Result of Descriptive Statistics**

Variable	N	Min	Max	Mean	Std. Deviation
AM	383	-0.610	1.308	0.309	0.358
FD	383	-3.273	4.785	1.237	1.040
IC	383	0.389	1.000	0.916	0.105
CEO	383	4.000	11.000	7.266	1.320
SIZE	383	24.570	32.440	29.087	1.594
OCF	383	-0.298	0.461	0.074	0.095
OWN	383	0.227	1.000	0.731	0.154
MTOB	383	-6.818	3354.175	18.218	219.747
ROE	383	-4.112	1.939	0.011	0.425
INV	383	0.000	0.792	0.128	0.141
GROWTH	383	-96.962	125.966	-7.274	25.267
AQ	383	17.426	24.904	20.485	1.176
COVID	383	0.000	1.000	0.496	0.500

*Source: Authors calculations (2022)*

Table 1. Descriptive statistics give brief data about public companies in Indonesia that tend to be involved in earnings management practices. Averagely public companies in Indonesia have sufficient finances to carry out business processes. Other than that, averagely public company in Indonesia has implemented the company internal control quite well, or it can be said that the average public company in Indonesia has complied with management activity regulations that are set to the maximum. Averagely CEOs of publicly listed companies in Indonesia have a reputation that tends to be better for bringing a good external impact to the company.

**Table 2: Result of P-Value & Summary Hypothesis**

No.	IV		DV	Original Sample	P-Value	Criteria	Descp
H <sub>1</sub>	Financial Distress	→	Earnings Management	0.020	0.685	< 0,05	Not Significant
H <sub>2</sub>	Internal Control	→	Earnings Management	0.021	0.578	< 0,05	Not Significant
H <sub>3</sub>	Financial Distress * CEO Reputation	→	Earnings Management	0.106	0.001	< 0,05	Significant +
H <sub>4</sub>	Internal Control * CEO Reputarion	→	Earnings Management	0.011	0.733	< 0,05	Not Significant

Source: Authors calculations (2022)

<sup>5</sup> **H<sub>1</sub> : There is a significant and positive relationship between financial distress and earnings management.**

Based on Table 3. which presents the results is concluded that financial distress has an insignificant and positive <sup>22</sup> effect on earnings managemnt. Based on the explanation above, we can conclude that the first hypothesis (H<sub>1</sub>) is shown rejected. So, it can be inferred that if a company is in a state of higher financial distress, it will be more involved in high earnings management activities as well. Rizky Amalia *et al.*, (2021) stated that if the company is in a state of financial distress, it will anticipate financial distress by implementing earnings management practices to prevent this condition. Ghazali *et al.*, (2015) argue that the <sup>31</sup> financial distress of the company's

inability is caused by the company's poor cash flow and profitability, so that managers must be incentivized to practice earnings management to obtain funding.

Another factor, although financial distress can create <sup>27</sup> a positive effect on earnings management the practice of earnings management can maximize financial statements that aim to attract investors, the results of other studies also acknowledge an insignificant effect of financial distress on earnings management. Industrial product firm will practice earnings management when they are experiencing financial distress. This is because companies experiencing financial distress tend to have problems paying off their debts and financing and do not have the potential to grow further. It's just that earnings management is not the priority but tends to prefer to secure rescue funds (Bin Mohamad Kamal & Binti Khazalle, 2021). A different view from the results of research reveals <sup>32</sup> that earnings management practices must be applied to prevent the continuation of problematic financial situations and the risks that arise because companies need sufficient resources to continue the company operations including sufficient funds to pay creditors (Ranjbar & Amanollahi, 2018).

<sup>5</sup>  
**H<sub>2</sub> : There is a significant and negative relationship between internal control and earnings management.**

From calculation above (Table 2.), we can summarize that the direct effects of <sup>12</sup> the internal control and earnings management are positive and insignificant. Based on the explanation above, we can conclude that the second hypothesis (H<sub>2</sub>) is rejected. Maximum internal control cannot show restrictions on earnings management practices, but is more willing to picking alternative methods of aset impairment losses as other earnings management tools (Huang *et al.*, 2017). There is strong evidence that companies tend to use real earnings management practices that affect actual business activities rather than using earnings management practices to achieve the desired accounting results (S. F. Li, 2002).

Companies that willingly disclose internal control information and companies experiencing financial distress are obliged to disclose internal control information, compared to companies that voluntarily disclose internal control information.



Companies experiencing financial distress that are required to disclose internal control information tend to perform less <sup>23</sup> accrual and real earnings management (Y. Li *et al.*, 2020).

The quality of a mature company's internal control positively correlates with the quality of accruals, but for declining companies, <sup>28</sup> the quality of internal control is positively related to the quality of real earnings. Companies that grow and mature will be more selective when selecting ways to manage earnings. Compared to accrual management which is easy to detect, companies usually manipulate actual operational activities more (Chen, 2016).

<sup>25</sup>  
**H<sub>3</sub> : The reputation of the CEO can moderate the relationship between financial distress and earnings management.**

<sup>2</sup> From Table 2., summarizes the findings, the CEO reputation variable can moderate the relationship between financial distress and earnings management. Then the third hypothesis (H<sub>3</sub>) is accepted. It can be concluded that the higher the company's reputation or the lower the CEO's reputation, it can strengthen or weaken earnings management practices when the company experiences financial distress. <sup>14</sup> The results of this research are consistent with the big bath theory by Hayes, (2020) which reveals that the management team of a corporation that willfully manipulates the company's income statement to make unacceptable report results look worse to make future performance appear better. The big bath theory concludes that new CEOs in a company tend to practice earnings management more often (Adiasih *et al.*, 2011). In addition, the findings of this research are also consistent with the theory of planned behavior, which predicts an action by considering a person's attitude to test subjective norms and measure control over the person's perception of behavior (Ajzen, 1991). Therefore, companies tend to practice earnings management when experiencing increasing financial distress without reducing the value of their CEO's reputation

<sup>7</sup>  
**H<sub>4</sub> : The reputation of the CEO can moderate the relationship between internal control and earnings management.**

According to Table 2. Findings, there is No. moderating effect of CEO reputation on <sup>18</sup> the relationship between internal control and earnings management. It can be concluded that the better or worse reputation of CEO cannot strengthen <sup>9</sup> the influence of internal control on earnings management practices in the company. So companies with high internal control conditions will reduce earnings management practices without being influenced by the CEO's reputation, and vice versa. Therefore, the fourth hypothesis (H4) is rejected. Another statement of the theory of planned behavior states that attitudes toward such behavior are determined by beliefs acquired about the consequences of beliefs derived from behavior or behavioral beliefs (Azjen, 1991). This means that if a company's CEO believes that exercising positive or maximum internal controls results in a positive attitude from those actions, it will not affect his CEO's reputation.

### Conclusions

This research examines how of financial distress and internal control affect earnings management in <sup>8</sup> companies listed on the Indonesia Stock Exchange, excluding the financial sector. It uses a sample period from 2019 to 2020. This research also examines the reputation ability of the CEO or president director in moderating <sup>29</sup> the relationship between financial distress and internal control with the company's accrual earnings management.

<sup>20</sup> The financial distress variable has a positive and insignificant effect on earnings management because the company will practice earnings management when experiencing financial distress. This is because companies that are experiencing financial distress tend to have problems paying off their debts and financing and do not have the potential to grow further. It's just that earnings management is not the priority but tends to prefer to secure rescue funds. <sup>33</sup> The impact of internal control variables on earnings management is insignificant because maximum internal control cannot appear to curtail the practice of earnings management but is more inclined to use the method of aset impairment loss as another tool of earnings management.



The CEO reputation variable can moderate <sup>21</sup> the relationship between financial distress and earnings management. Firms frequently use earnings management when the CEO is experiencing heightened financial distress without reducing the CEO's reputational value. Research shows that a company's management team deliberately manipulates the company's income statement to make unacceptable reported results look worse, to make that future performance appear better. In addition, the finding of this research also consistent with <sup>38</sup> the theory of planned behavior, which predicts behavior behavior by taking-into-account a person's attitude when testing subjective norms and measures the degree of control a person has over perceived behavior. The CEO reputation variable does not moderate <sup>7</sup> the relationship between internal control and earnings management, implying a firms with high internal control conditions reduce earnings management practices without being influenced by CEO reputation and vice versa.

The managerial implications of this study contribute to suggesting the management of the investor in the companies in Indonesia by looking at the value of the CEO's reputation in the process of maximizing investment strategies. When a company expands its operations by acquiring another business, it often has to consider the CEO with a high reputation because companies with a high reputation value CEO are considered likely to contain higher-earning management potential in company reports.

The research limitation is that we only include CEO seniority, professional body associations, CEO tenure, and CEO experience as measures of CEO reputation, which representing a tiny fraction of a CEO's overall reputation. Further research could also try using more precise indicators of reputation, such as the CEO's social media activity and articles published by the CEO, and the pandemic variable is controlled by the time series variable, which is limited to public companies in Indonesia so they cannot measure the real impact of pandemic on financial distress and internal controls in earnings management practice.

The recommendations given by this research are to expand to companies in various countries, not only companies in Indonesia, add the dependent variable of real

earnings management to be widely tested, increase the CEO reputation measurement index such as the CEO's social media activity, the articles that the CEO has written, the dual status of CEO positions, and the need to use different measurement methods for each variable in the next research (Kho & Edi, 2021) because research on CEO reputation still tends to be small.

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