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# THE FACTORS THAT INFLUENCE EARNINGS MANAGEMENT: EVIDENCE ON BASIC MATERIALS SECTOR

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**Abstract:** Earnings management is an action to modify accounting records so that there is intervention in the financial statements while complying with applicable accounting standards. This study aims to determine the relationship between earnings management with tax incentives, tax avoidance, and financial distress in basic materials sector companies listed on the Indonesia Stock Exchange for the period 2016 – 2021. This research can suggest the companies or investors regarding the factors that influence earnings management practices in a company so that it can be more efficient in making business decisions in order to maintain the stability of the company. The sample selection technique in this study used purposive sampling. The resulting samples were 13 companies and 78 observational data. The analysis technique used is panel data regression using Eviews 12 software. The results show that tax incentives, tax avoidance, and financial distress simultaneously affect earnings management. Partially tax incentives have a negative influence on earnings management, while tax avoidance and financial distress have a positive influence on earnings management.
**Keywords:** Earnings Management, Tax Incentives, Tax Avoidance, Financial Distress

## INTRODUCTION

Earnings management is a practice that is often found in financial accounting activities that utilize the accounting structure (Khairunnissa et al., 2020). This practice has become a corporate culture because it made an effort to intervene in financial reports to support the company's operational conditions (Sulistyanto, 2018). The company's management takes advantage of this practice to avoid reporting losses so as to reduce reputational decline and negative stock prices so that can make it in line with investor expectations (Scott, 2015:445). In addition, this practice can be used to keep tax payments to a minimum. However, there is an opinion which states that earnings management practices are one of the factors that cause financial statements is no longer reflect the actual condition of the company's financial operations because there have been modifications in them (Afrizal et al., 2020). Financial statements manipulation activities carried out by companies can cause harm to several parties, such as investors who receive financial information that is no in accordance with the actual situation so that it misleads them in making decisions (Sebrina et al., 2019). In addition, this practice can be detrimental to the state if the purpose of its implementation is to reduce the actual tax expense so that it can reduce state revenue. Earnings management practice which is against the accounting standards will have a serious effect on the stability and sustainability of the corporate.

Earnings management in this study is measured by discretionary accruals from the modified Jones Model. Jones interprets that in addition to cash flow, accruals are the net

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effect of all operating events recorded in the financial statements during the year (Scott, 2015:452). The concept of discretionary accruals describes that management can manipulate accrual income so as to achieve the desired target (Sisdianto et al., 2019). Positive discretionary accruals indicate that the company is indicated to increase in profit value. Meanwhile, negative discretionary accruals show that the company is indicated to decrease the value of profits.

This study used basic materials sector companies listed on the Indonesia Stock Exchange for the period 2016 – 2021. The research object was selected based on the growth rate of Gross Domestic Product. The growth rate of Gross Domestic Product shows that the basic material sector is classified as more stable compared to other sectors. In 2017 Gross Domestic Product growth in the basic materials sector increased by 14.3% from 2016. In 2018 this sector experienced an insignificant increase in Growth Domestic Product 2017, which was 1.91%. In 2019 the basic materials sector decreased by 0.44% from 2018. During the Covid-19 pandemic, Indonesia's economic growth experienced a significant decline. However, Gross Domestic Product growth shows that manufacturing companies in the basic materials sector remain positive despite being under pressure from the Covid-19 pandemic. This is inversely proportional to the other three sectors of manufacturing companies which show negative Gross Domestic Product growth, namely consumer non-cyclicals sector, consumer cyclicals sector, and industrials sector so this indicates that basic materials sector companies are suspected of intervening or managing their company's profits because they are still able to maintain the company's economic performance when under economic pressure.

This earnings management practice allegedly occurred in several companies in the basic materials sector. As in PT Argha Karya Prima Industri Tbk. It is known that during January to September 2020 the net profit of PT Argha Karya Prima Industri Tbk (AKPI) experienced a drastic increase of 105.40% from the previous year (Julian, 2020). However, this increase was not supported by an increase in sales because in that year the company's net sales decreased by 2.71 yoy, from 1.71 trillion rupiah to 1.66 trillion rupiah due to the pressure of the Covid-19 pandemic. The increase in revenue was allegedly due to the emphasis on spending on cost of goods sold as well as administrative and general expenses carried out by the management of PT Argha Karya Prima Industri Tbk (Julian, 2020). So that in this case the management of PT Argha Karya Prima Industri is able to control the company's net profit.

In addition, another case example is found in PT Aneka Tambang Tbk, which is a basic materials sector company listed on the Indonesia Stock Exchange. In the first semester of 2021 PT Aneka Tambang Tbk was able to achieve a net income of IDR 1.16 trillion, while in the previous year the company recorded a loss of IDR 159.40 billion (CNBC Indonesia, 2021). This shows a significant and unreasonable increase in net profit so that PT Aneka Tambang Tbk is suspected of practicing earnings management.

This research is in accordance with the agency theory which shows that there is a relationship between the agent and the principal (owner of the entity). Agency theory is a branch of game theory that studies contract design with the aim of being able to rationally motivate agents to act on behalf of the principal when the agent's interests contradict with those of the principal (Scott, 2015:358). Agency theory is a theory regarding business activities that are not managed directly by the owner of the entity but the management is handed over to the agent (Hoesada, 2020). The principal party in this case, namely the investor, wishes to obtain financial statements that reflect the actual condition of the

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company. Meanwhile, the agent, namely the manager who is under pressure from the principal, wants to get a bonus so that when the company is in a complicated condition, the manager will try to manage the company's profits so that it can still show positive performance. The main motivation of company's management in practicing earnings management is to describe the condition and financial performance of the company as desired to fulfill group or company goals. Based on several previous studies, there are several factors that may influence management, including tax incentives, tax avoidance, and financial distress.

Tax incentives are a tool of the taxation system that can be used with the aim of influencing economic activity (Pohan, 2016:233). Tax incentives aim to attract investors to invest by deviating from general provisions in the form of reducing the company's tax expense. A lower tax expense will attract more investor attention so that it can increase and support a company's production to expand employment, which in turn aims to increase the country's Gross Domestic Product (Pohan, 2016:235). Tax incentives can be provided in several forms, such as by providing deferrals, discounts, preferential rates, exclusions, and discounts (Pohan, 2016:234). Tax incentives issued by the government cause tax revenues that are not in accordance with the target, thus indicating the possibility that there are indications of practices to minimize the tax expense (Pakpahan & Kurnia, 2022). This study measures tax incentives using indicators of deferred tax expense and tax planning.

Deferred tax expense can arise when there is recognition of deferred tax assets or deferred tax liabilities in the recording of the company's financial statements. Deferred tax expense can be used as a variable to indicate the possibility of profit manipulation with consider into the results of the fiscal corrections. Based on previous research, there is a statement stating that deferred tax expense has a significant influence on earnings management (Chahyani, 2021). The results of this study are in line with other studies which state that deferred tax expenses have a positive influence on earnings management (Baraja et al., 2019). This is because the higher the difference between fiscal and commercial recording, the higher the deferred tax expense. And if the company's deferred tax expense increases, the higher the probability that the company will practice earnings management in recording its financial statements. However, there is also research which states that deferred tax expense has a negative effect on earnings management (Saputra, 2021) In this study, the measurement of deferred tax expense will be weighted by the value of the company's assets in order to obtain proportionally calculated results. Deferred tax expense is thought to have a positive effect on earnings management. This is supported by a statement from (Baraja et al., 2019) which states that deferred tax expense has a positive effect on earnings management.

Tax planning is an effort to be able to minimize the value of taxes by preparing a strategy in managing company financial accounting that does not violate tax regulations and remains tax compliant (Pohan, 2016:18). Based on previous studies, there are research results which state that tax planning has a significant positive value on earnings management, thus indicating that these variables affect earnings management disclosure (Baraja et al., 2019). Meanwhile, other studies state that tax planning has no influence on earnings management (Chahyani, 2021). Tax planning is measured using the tax retention rate (TRR) which aims to analyze the effectiveness of tax management in a financial report (Alfian Bunaca Nurdayadi et al., 2019). Based on this, tax planning is thought have a positive effect on earnings management. This statement is in line with previous research which revealed that tax planning has a positive influence on earnings management (Baraja

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et al., 2019).

Tax avoidance is an effort by management to streamline the company's tax expense by avoiding tax imposition through certain transactions (Putra, 2019:42). Tax avoidance is carried out by exploiting the gaps and weaknesses of existing tax provisions (Suryani, 2022). This indicates that the practice of tax avoidance is related to earnings management because management try to intervene in the company's pre-tax profit. Previous research stated that tax avoidance has a positive effect on earnings management (Karjalainen et al., 2020) and (Larastomo et al., 2016). However, other studies state that tax avoidance partially has no effect on earnings management (Afrizal et al., 2020). In this study, tax avoidance is measured using the cash effective tax rate (CETR) according to previous study (Kurnia et al., 2010). A low cash effective tax rate (CETR) describes a high level of tax avoidance by companies. On the other hand, the higher the cash effective tax rate (CETR) of a company, the lower the company's practice of tax avoidance (Afrizal et al., 2020). Based on this, tax avoidance is thought have a positive effect on earnings management. This statement is in line with previous research which revealed that tax avoidance has a positive effect on earnings management (Sebrina et al., 2019).

Financial distress is a condition of a company where the value of debt is greater than the size of the company, profitability, and composition of its assets because the company's ability to generate income decreases and cash flow from operating activities is inadequate (Schmuck, 2013:28). Financial distress occurs when a company's cash flow is insufficient to pay its obligations, current assets, and current liabilities are not appropriate (Li et al., 2020). Financial distress describes a bad company condition that puts pressure on management because investors and creditors are possibility to get big losses (Damayanti & Kawedar, 2018). The decline in the value of the company puts pressure on management because investors and creditors will demand their returns to avoid and reduce the losses they will get. So based on this description, financial distress can trigger management to practice earnings management with the aim of maintaining bonuses and reputation (Irawan & Apriwenni, 2021). Based on previous research, it is said that financial distress has a significant influence on earnings management (Damayanti & Kawedar, 2018). The statement above is in line with previous research which stated that financial distress has a negative effect on earnings management (Miftakhunnimah & Juanda, 2020). And there is also research which states that financial distress has no effect on earnings management (Irawan & Apriwenni, 2021). In this study, financial distress was measured using the Z-Score method by Altman. The modified Z-Score method is used to represent a healthy company's finances (Li et al., 2020). Z-Score method is considered better than other measurement indicators because it shows a prediction accuracy rate of 95% (Irawan & Apriwenni, 2021).

This study using deferred tax expense and tax planning as an indicator for tax incentive. Those indicators are rarely used by other studies. The purpose of this study is to analyze how deferred tax expense, tax planning, tax avoidance, and financial distress affecting earnings management. Based on the theory above, there are several hypotheses in this study, including the following:

**$H_{1a}$** **:** Deferred tax expense has a positive influence on earnings management.
**$H_{1b}$** **:** Tax planning has a positive influence on earnings management.
**$H_2$** **:** Tax Avoidance has a positive influence on earnings management.
**$H_3$** **:** Financial distress has a negative influence on earnings management.

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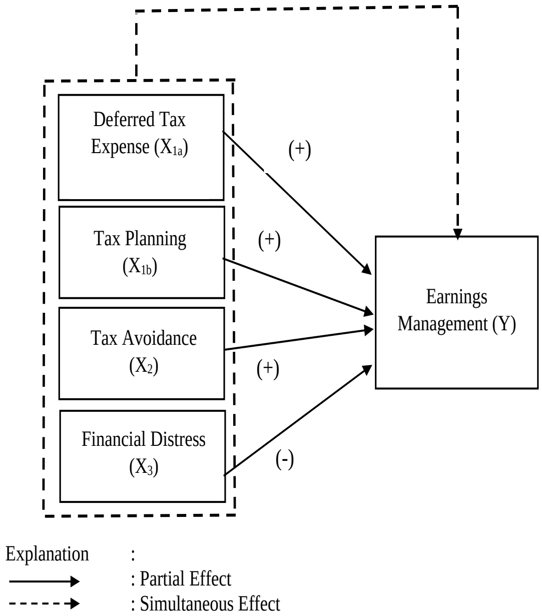


**Figure 1. Framework**
Source: Author (2023)

## METHODS

This research method used quantitative method to apply an intervention style by manipulating a situation and condition of the independent variables using predetermined research (Hardani et al., 2020:237). The population in this study are basic material sector companies listed on the Indonesia Stock Exchange for the period 2016 – 2021. This study used a purposive sampling technique. Purposive sampling is taking and determining samples according to the required criteria (Harsojuwono & Arnata, 2020:79). The research sample was taken from 13 companies with a total of 78 data observations. The collected data from using a documentation technique usually is secondary data (Hardani et al., 2020:237) This study used secondary data taken from the financial reports of basic material sector companies listed on the Indonesia Stock Exchange (IDX) for the period 2016 – 2021, previous research journals, scientific books, and the official website. The data analysis technique used in this study is panel data regression analysis. Panel data is a combination of cross section and time series data (Napitupulu et al., 2021:115). This research used Eviews 12 software to manage data in panel data regression analysis. In this study, cross sections and time series are describe by the financial reports of basic materials sector companies listed on the Indonesia Stock Exchange for the 2016 – 2021 period. The research variables consist of one dependent and three independent variables.

The panel data regression equation in this study can be formulated as follows:

$$Y_{i,t} = \alpha + \beta_1 DTE_{1,i,t} + \beta_2 TRR_{2,i,t} + \beta_3 CETR_{3,i,t} + \beta_4 Z\text{-}SCORE_{4,i,t} + \varepsilon$$

Explanation:

$Y_{i,t}$ =Earnings management at company i year t
$\alpha$ =Constant

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| | |
|---|---|
| $DTE_{1,i,}$ | =Deferred tax expense at company i year t |
| $TRR_{2,i,t}$ | =Tax retention rate at company i year t |
| $CETR_{3,i,t}$ | =Cash effective tax rate at company i year t |
| $Z\text{-}SCORE_{4,i,t}$ | =Financial distress at company i year t |
| $\beta_1\beta_2\beta_3\beta_4$ | =Regression coefficient of each variable |
| $\varepsilon$ | =Residual error |
| *i* | =The type of company |
| *t* | =Time |

## RESULTS AND DISCUSSION

The variables used in this descriptive statistical research use a ratio scale consisting of earnings management, deferred tax expense, tax planning, tax avoidance, and financial distress in basic material sector companies for the period 2016 - 2021 which is measured by calculating the mean, minimum, maximum, and standard deviation. This research analysis technique uses Eviews 12 software.

**Table 1. Descriptive Statitiscal Test Results**

| | Dait | DTEit | TRRit | CETR | ZScore |
|---|---|---|---|---|---|
| Mean | -0.044702 | 0.002327 | 0.777840 | 0.296736 | 5.282353 |
| Median | -0.035983 | 0.001498 | 0.740401 | 0.240348 | 3.924865 |
| Maksimum | 0.075996 | 0.035770 | 6.548389 | 2.901143 | 15.69399 |
| Minimum | -0.246220 | -0.019366 | 0.131999 | 0.003071 | 0.684190 |
| Std. Devias | 0.063730 | 0.007101 | 0.677267 | 0.336447 | 4.105094 |
| Obesrvation | 78 | 78 | 78 | 78 | 78 |

Source*:* data that has been processed by the author (2023)

Based on table 1, the mean of earnings management is less than the standard deviation value. The average value of earnings management is -0.044702, while the standard deviation value is 0.063730. This shows that the data is heterogeneous or varied. The deferred tax expense variable based on table 1 has an average value that is smaller than the standard deviation value. The average value of deferred tax expense is 0.002327 while the standard deviation value is 0.007101. This shows that the data is heterogeneous or varied. The tax planning variable in table 1 has an average value of 0.777840 which is greater than the standard deviation value of 0.677267. This shows that the data is homogeneous or not vary. The tax avoidance variable in table 1 shows an average value of 0.296736 which is smaller than the standard deviation value of 0.336447. This shows that the data is heterogeneous or varied. The financial distress variable based on table 1 has an average value of 5.282353 which is greater than the standard deviation value of 4.105094. This shows that financial distress data is homogeneous or does not vary.

**Table 2. Classic Assumption Test Result**

| Test | Results | Decision |
|---|---|---|
| Heteroscedasticity | Prob. > 0.05 | Free |
| Multicollinearity | VIF < 10 | Free |

Source*:* data that has been processed by the author (2023)

Table 2 shows that the results of classic assumptions test from the data. The

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heteroscedasticity test is a test that assesses whether there are variance dissimilarities from the residuals for all observations used in the linear regression model (Napitupulu et al., 2021:5). The heteroscedasticity test can be concluded that there is no heteroscedasticity because the probability value is more than 0.05. So, the results of the research regression model used are correct.

The multicollinearity test is a method for detect whether there are multicollinearity problems in a regression model (Napitupulu et al., 2021:5). If there is a strong correlation between the independent variables, it will cause the regression coefficient cannot be estimated and if the coefficient becomes infinite, it will produce a standard error value. The multicollinearity test between the independent variables. Based on the table above, it can be concluded that in this study there is no correlation between the independent variables (multicollinearity) because the correlation value of each independent variable is less than 0.9. So that the results of the research regression model used are correct.

**Table 4. Research Model Test**

| Test | Results | Decision |
|---|---|---|
| Chow | Prob. 0.4101 | CEM |
| Hausman | Prob. 0.9230 | REM |
| Langrange Multiplier | Prob. 0.2608 | CEM |

Source*:* data that has been processed by the author (2023)

Table 4 shows the model test results. Based on the test of Chow, Hausman, and Langrange Multiplier, the selected model is Common Effect Model (CEM).

**Table 5. Common Effect Model**

| | Coef. | Std. E. | t-Stat. | Prob. |
|---|---|---|---|---|
| C | -0.0428 | 0.0127 | -3.3572 | 0.0013 |
| DTEit | -2.1991 | 0.9270 | -2.3722 | 0.0203 |
| TRRit | -0.0639 | 0.0184 | -3.4743 | 0.0009 |
| CETR | 0.1028 | 0.0367 | 2.7985 | 0.0066 |
| ZScore | 0.0042 | 0.0016 | 2.7005 | 0.0086 |
| Adj. $R^2$ | 0.2245 | | | |
| F-Stat. | 0.5730 | | | 0.0001 |

Source*:* data that has been processed by the author (2023)

The panel data regression equation in this study can be formulated as follows:

$Y_{i,t}$ = -0.042787 – 2.199122DTE$_{1,i,t}$ – 0.063890TRR$_{2,i,t}$ + 0.102843$CETR_{3,i,t}$ – 0.004237Z$SCORE_{4,i,t}$ + ε

An explanation of the panel data regression equation above is as follows:

1. A constant value of -0.042787 indicates that if the independent variables in the regression, namely deferred tax expense, tax planning, tax avoidance, and financial distress are zero, then the value of discretionary accruals (earnings management) is worth 0.042787 units. Negative discretionary accruals indicate that there are indications of earnings management practices by reducing earnings.

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2. Deferred tax expense has a regression coefficient of -2.199122, which means that for every increase in deferred tax expense by 1 unit, the value of discretionary accruals will decrease by 2.199122 units.
3. Tax planning has a regression coefficient of -0.063890, which means that for every increase in tax planning by 1 unit, the value of discretionary accruals will decrease by 0.063890.
4. Tax avoidance has a regression coefficient of 0.102843, which means that for every increase in tax avoidance by 1 unit, then the value of discretionary accruals will increase by 0.102843.
5. Financial distress has a regression coefficient of 0.004237, which means that for every increase in financial distress by 1 unit, the value of discretionary accruals will increase by 0.004237.

Based on Table 5, the coefficient of determination's results can be seen from the Adjusted R-Squared value of 0.2245 or 22.45%. This shows that deferred tax expense, tax planning, tax avoidance, and financial distress have an influence on the dependent variable, namely earnings management by 22.45%. While the remaining 77.55% is influenced by other variables.

Based on table 5 the probability value of the F-Statistic is 0.0001 less than 0.05. This shows that deferred tax expense, tax planning, tax avoidance, and financial distress simultaneously affect earnings management. $X_1$ in this study is tax incentives which are measured using two indicators, they are deferred tax expense and tax planning.

**The Effect of Deffered Tax Expense on Earnings Management**

The partial test results of deferred tax expense show a regression coefficient of -2.199122 and a probability value of 0.0203 is less than 0.05, so that partially deferred tax expenses have a negative effect on earnings management. The results of this study are in line with previous studies which state that deferred tax expenses have a negative influnce on earnings management (Saputra, 2021). This shows that the higher the deferred tax expense, the lower the probability that the company is indicated to practice earnings management. This is because the higher the deferred tax expense, the higher the possibility of a correction by the tax examiner. therefore, the possibility that there is intervention from management on corporate's profit to be smaller. However, this research is not in line with $H_{1a}$ which states that deferred tax expense has a positive effect on earnings management.

**The Effect of Tax Planning on Earnings Management**

Tax planning has a regression coefficient value of -0.063890 and a probability value of 0.0009 which is less than 0.05, thus indicating that partially tax planning has a negative influence on earnings management. The results of this study are consistent with previous research which states that tax planning has a negative influence on earnings management (Devitasari, 2022). This means that the higher the tax planning, the lower the company is indicated to practice earnings management. On the other hand, the results of this study are not in accordance with $H_{1b}$ which states that tax planning has a positive influence on earnings management. Therefore, it can be concluded that tax incentives as measured by deferred tax expense and tax planning have a negative influence on earnings management.

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**The Effect of Tax Avoidance on Earninigs Management**

Tax avoidance has a regression coefficient value of 0.102843 and a probability value of 0.0066 less than 0.05, indicating that partially tax avoidance has a positive influence on earnings management. This is in line with previous research which states that tax avoidance has a positive effect on earnings management (Karjalainen et al., 2020). This means that the higher the tax avoidance, the higher the company is indicated to practice earnings management because the company try to intervene in the recording of company tax expenses. So the results of this study are in accordance with $H_2$ which states that tax avoidance has a positive influence on earnings management.

**The Effect of Financial Distress on Earnings Management**

Financial distress has a regression coefficient value of 0.004237 and a probability value of 0.0086 less than 0.05, indicating that partially financial distress has a positive influence on earnings management. The results of this study are in line with previous research which states that financial distress has a positive influence on earnings management (Damayanti & Kawedar, 2018). This shows that the higher the level of financial distress of a company, the higher the probability that the company will practice earnings management because of the pressure received from the owner or investor (principal) to management (agent). However, the results of this study are not in line with $H_3$ which states that financial distress has a negative effect on earnings management.

## CONCLUSION

This research was conducted with the aim of knowing the effect of the independent variable, such as tax incentives as measured by deferred tax expense and tax planning, tax avoidance, and financial distress on earnings management in basic material sector companies listed on the Indonesia Stock Exchange (IDX) for the period 2016 – 2021. Based on the results of the analysis and discussion, it can be concluded that tax incentives, tax avoidance, and financial distress simultaneously affect earnings management in basic material sector companies listed on the Indonesia Stock Exchange (IDX) for the period 2016 – 2021. Partially, deferred tax expense and tax planning as indicators of tax incentives have a negative effect on earnings management, while tax avoidance and financial distress have a positive effect on earnings management. Tax incentives have a negative influence on earnings management because the higher the tax incentive, the higher the accuracy in examining a company's financial records due to fiscal corrections so that the possibility of earnings management practices is getting smaller. Meanwhile, tax avoidance and financial distress have a positive influence on earnings management due to the possibility of modifications to the financial statements which are higher because of the pressure received by the company's management.

So, based on the results of this study, it is suggested that companies should avoid earnings management practices by intervening in company accounting records that contradict with accounting standards, either with the aim of increasing or decreasing company profits, because this can threaten the stability of the company. And investors are expected to be more careful in making decisions by paying attention to factors that can impact the corporate's earnings management practices. In addition, it is advisable for further research to be able to develop research objects and variables related to earnings management practices in a company, so that the company can confirm the rules for

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earnings management practices in a company by considering the factors that can influence it.

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