

The Influence of Capital Structure and Financial Performance on Earnings Management

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ABSTRACT

Objective: This research aims to analyze the influence of capital structure and financial performance on earnings management practices in non-cyclical consumer sector companies listed on the Indonesia Stock Exchange. **Method:** This research uses a quantitative method, involving 118 samples of annual report data for the period 2021-2022. **Results:** The results of the analysis indicate that capital structure has a significant negative impact on earnings management. On the other hand, financial performance has a significant positive impact on earnings management. Although both variables have a significant simultaneous effect, the coefficient determination shows that most of the variation in earnings management is influenced by other factors, such as regulation and corporate governance. **Novelty:** The novelty in this research lies in the use of the Stubben formula to measure earnings management, which provides a deeper perspective on the practice of earnings manipulation within companies.

INTRODUCTION

In a tight competition, companies face complex challenges that encourage the use of creative techniques, such as earnings management. In the book "Earnings Management" by Joshua Ronen and Varda Yaari, it is explained that managers often exploit the flexibility of accounting standards for favorable decisions, even though it does not always reflect the actual financial condition (Ronen and Yaari 2008). Earnings management practices often occur in Indonesia, such as the PT Tiga Pilar Sejahtera Food Tbk scandal, where two former directors were proven to have manipulated the 2017 financial statements to raise the stock price to Rp 2,360 per share. However, the company defaulted on a Rp 300 billion ijarah sukuk and Rp 600 billion bond interest in April 2018, with an Ernst & Young audit revealing a Rp 1.78 trillion fund flow to affiliated parties (Wulandari 2022). Then in 2018, PT Garuda Indonesia (Persero) Tbk reported a net profit of USD 809.85 thousand, reversing a loss of USD 216.5 million in 2017. However, this report was rejected by two commissioners because it was considered not in accordance with accounting standards. After an investigation by the OJK and the Ministry of Finance, the report was revised to a loss of USD 175 million (Sugianto 2019). Recently, in 2023, PT Waskita Karya Tbk (WSKT) was allegedly manipulating reports since 2016. PT Wijaya Karya Tbk (WIKA) also reported a loss of IDR 7.12 trillion, up from IDR 59.59 billion in 2022. This case reflects the weak transparency in financial reporting of state-owned construction companies in Indonesia (Melani 2023).

Based on agency theory, there is a potential conflict of interest between managers as agents and shareholders as principals, where managers often prioritize personal interests over the overall interests of the company (Jensen and Meckling 1976). In

consumer non-cyclicals (CNC) sector companies listed on the Indonesia Stock Exchange, earnings management practices can be used by managers to manipulate financial statements to achieve certain targets, such as increasing bonuses or maintaining managerial positions. This is in line with the research by Novitasari and Utami (2023), which shows that CNC company managers tend to engage in earnings management when there is pressure to meet market expectations or maximize the company's market value. Thus, earnings management practices become one of the managers' efforts to reduce information asymmetry between them and the shareholders.

Based on positive accounting theory, company managers tend to choose accounting policies that maximize their utility within the existing constraints (Watts and Zimmerman 1986). In CNC sector companies, earnings management practices are often associated with the bonus hypothesis, where managers choose accounting methods that increase profits to obtain larger bonuses. This is reinforced by the findings of Astriah et al. (2021), which state that CNC companies with performance-based bonus structures tend to be more active in earnings management to meet profit targets. Thus, positive accounting theory provides a framework for understanding why managers at CNC companies make certain decisions in their financial reporting.

Earnings management is influenced by various factors, including capital structure and financial performance. Research by Undrian and Yanti (2023) shows that capital structure has a significant positive influence on earnings management, where an increase in the capital structure ratio encourages managers to manage earnings to create a positive image and enhance stakeholder confidence. Aldona and Listari (2020) added that earnings management is often used to maintain image when facing the threat of liquidation. However, Sitorus and Silaban (2023) found that leverage, as a measure of capital structure, does not always have a significant impact on earnings management, especially when companies have alternative funding sources such as issuing shares.

Profitability, as an indicator of financial performance, plays an important role in earnings management practices. Rianita and Pramesti (2021) found that profitability has a significant impact on earnings management, as investors monitor profitability to assess the potential return on investment. Sholichah and Kartika (2022) noted that high profitability tends to reduce earnings manipulation. However, some studies show that the impact of profitability is not always significant. Anggraeni and Widjaja (2021) state that financially stable companies do not feel the need to manipulate profits, focusing more on reputation and long-term stability. Maulidiana et al. (2023) support this finding, showing that companies with consistent performance are more focused on operational sustainability than aggressive profit management. Thus, other factors, such as financial stability and sustainability commitment, also influence earnings management decisions.

This study aims to analyze the influence of Capital Structure and Financial Performance on Earnings Management. This research is expected to provide in-depth insights into accounting and management literature, as well as practical guidance for company management in optimizing capital structure and financial performance to avoid detrimental earnings management practices.

RESEARCH METHOD

The method in this study uses a quantitative approach with secondary data. The variables used in this study are proxied by independent variables, namely leverage and profitability. Meanwhile, the dependent variable is proxied by earnings management calculated using the Stubben formula. Based on the description above, here is the theoretical framework for this research:

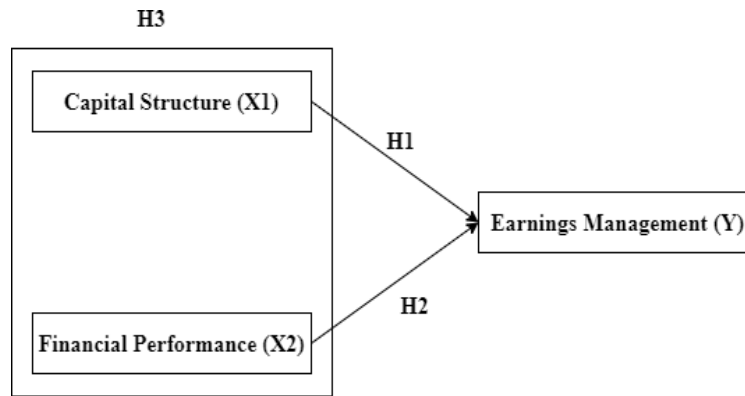


Figure 1. Theoretical Framework.

The research model uses multiple linear regression analysis to measure the causal relationship between independent variables and the dependent variable. The population used in this study is companies in the consumer non-cyclicals (CNC) sector. The sampling method used is purposive sampling based on specific criteria, with the sample consisting of CNC companies listed on the IDX for the two-year period from 2021-2022. The sample data used in this study are based on the specified criteria, as follows:

Table 1. Population and Sample Criteria.

| No | Sample Criteria | Total |
|----|--|-------|
| 1 | The number of CNC sector companies listed on the IDX | 129 |
| 2 | CNC sector companies listed below the 2021 period | (16) |
| 3 | CNC sector companies that publish complete AR | (23) |
| 4 | CNC sector company that is experiencing losses | (29) |
| 5 | CNC sector company with AR in dollar units | (2) |
| | Total companies that meet the criteria | 59 |
| | Research period | 2 |
| | Number of data: 59 x 2 years | 118 |

Before conducting regression analysis testing, classical assumption tests are first carried out, including (a) data normality test with Kolmogorov Smirnov to assess whether the research data is normally distributed, (b) heteroscedasticity test using the Glejser test, (c) multicollinearity test with tolerance test and VIF test to assess whether the independent variables are correlated, and (d) autocorrelation test with Durbin's Watson test on time series data. Then, deterministic experiments were conducted to evaluate the

influence of the variables on the research model. This testing was followed by a multiple linear regression test with a t-test (partial test) that compared the calculated t-value and the table t-value as the basis for decision-making regarding the research hypothesis.

RESULTS AND DISCUSSION

Results

Normality Test

Based on the normality test conducted, the following results were obtained:

Table 2. Results of the normality test (One-Sample Kolmogorov-Smirnov Test).

| | | Unstandardized Residual |
|----------------------------------|----------------|-------------------------|
| N | | 118 |
| Normal Parameters ^{a,b} | Mean | ,0000000 |
| | Std. Deviation | ,10112615 |
| Most Extreme Differences | Absolute | ,044 |
| | Positive | ,044 |
| | Negative | -,034 |
| Test Statistic | | ,044 |
| Asymp. Sig. (2-tailed) | | ,200 ^{c,d} |

Based on the results of the normality test using the Kolmogorov-Smirnov Test, it shows that the normality assumption has been met with an Asymp. Sig. (2-tailed) value of 0.200, where the significance value is more than 0.05 ($\alpha > 0.05$), which can be concluded that the data is normally distributed.

Multicollinearity Test

The VIF values for capital structure and financial performance are 1.006 each, with a tolerance value of 0.994. Because the VIF value < 10 and tolerance > 0.1 , it can be concluded that there is no multicollinearity problem among the independent variables in the regression model.

Table 3. Multicollinearity Test Results.

| Colinearity Statistics | | |
|------------------------|-----------|-------|
| Model | Tolerance | VIF |
| Capital Structure | ,994 | 1,006 |
| Financial Performance | ,994 | 1,006 |

Dependent Variable: Earnings Management

Heteroscedasticity Test

Based on the conducted Glejser test, the significance values obtained for the capital structure variable were 0.368 (> 0.05) and for financial performance were 0.898 (> 0.05). This indicates that both independent variables do not have a significant effect on the

absolute residual value (ABS_RES), thus there is no heteroscedasticity in the regression model.

Table 4. Heteroscedasticity Test Results.

| | Model | t | sig |
|----|-----------------------------|------|------|
| 1 | Capital Structure | ,905 | ,368 |
| | Financial Performance | ,129 | ,898 |
| a. | Dependent Variable: ABS_RES | | |

Autocorrelation Test

Based on the results of the autocorrelation test with Durbin-Watson, if $DU < DW < 4 - DU$ or $1.560 < 2.301 < 2.4056$, then there is no autocorrelation in the regression model. Because the DW value of 2.301 falls within that range, it can be concluded that there is no autocorrelation (either positive or negative) in the residuals of the regression model. This indicates that the assumption of residual independence has been met, making the regression model valid for further analysis.

Table 5. Autocorrelation Test Results.

| Model | Durbin Watson |
|-------|---------------|
| 1 | 2,301 |

a. Predictors: (Constan), Financial Performance, Capital Structure

b. Dependent Variable: Earnings Management

F-Test

Table 6. F-Test Results.

| | Model | Sum of Square | df | Mean Squares | F | Sig. |
|---|-------------|---------------|-----|--------------|-------|-------------------|
| 1 | Rregression | ,621 | 2 | ,310 | 6,587 | ,002 ^b |
| | Residual | 5,419 | 115 | ,047 | | |
| | Total | 6,039 | 117 | | | |

a. Dependent Variable: Earning Management

b. Predictors: (Constants), Financial Performance, Capital Structure

The F-test results show an F value of 6.587 with a significant level of 0.002 (< 0.05). This indicates that the regression model used is significant, so the capital structure and financial performance together have a significant impact on earnings management.

T-Test

Table 7. T-Test Result

| | Beta | t | Sig | Results |
|----------------|------|---|-----|---------|
| DER, ROA -> ML | | | | |

| | | | | |
|-----------|--------|-----|-----|-----------------------|
| DER -> ML | -1,192 | - | ,03 | Influential (-) on ML |
| | 2,168 | 2 | | |
| ROA -> ML | ,243 | 2,7 | ,00 | Influential (+) on ML |
| | 39 | 7 | | |

Based on the results of the partial test conducted, it can be concluded that for the capital structure variable (X1), a t-value of -2.168 was obtained with a significance value of $0.032 < 0.05$, meaning that the capital structure has a significant negative effect on earnings management. Next, the financial performance variable (X2) obtained a t-value of 2.739 with a significant value of $0.007 < 0.05$, meaning that partially, financial performance has a significant positive effect on earnings management.

Correlation Test and Coefficient of Determination (R²)

Table 8. Results of Correlation Test and Coefficient of Determination (r²).

Model Summary

| Model | R | R Square | Adjusted R Square | Std. Error of the Estimate |
|-------|-------------------|----------|-------------------|----------------------------|
| 1 | ,321 ^a | ,103 | ,087 | ,21707 |

a. Predictors: (Constant), Financial Performance, Capital Structure

Based on the results of the coefficient of determination analysis, the Correlation Coefficient (R) value of 0.321 indicates that the relationship between capital structure and financial performance on earnings management is in the low category. Additionally, the Coefficient of Determination (R-squared) value of 0.103 indicates that only about 10.3% of the variation in earnings management can be explained by capital structure and financial performance. The remaining 89.7% is influenced by other factors not included in this research model.

Discussion

The Influence of Capital Structure on Earnings Management

The research results show that capital structure, measured by the debt-to-equity ratio (DER), has a significant negative impact on earnings management. This means that the higher the use of debt in capital structure, the less likely the company is to engage in earnings management practices. This may be due to stricter oversight from creditors regarding the company's financial reporting. In the context of CNC companies, this phenomenon reflects a preference for more transparent financial management to maintain stakeholder trust. The results differ from the research conducted by Undrian and Yanti (2023), which stated that there is a significant positive influence between capital structure and earnings management.

Furthermore, within the framework of agency theory, higher debt usage increases pressure from creditors to ensure transparency in financial reporting, thereby mitigating earnings management practices that could harm them as the funding providers. Creditors have an incentive to monitor the company's performance to minimize the risk of default, which ultimately reduces the managers' freedom to manipulate financial

statements. Meanwhile, positive accounting theory highlights how the accounting practices adopted by companies tend to be influenced by existing economic incentives and contractual mechanisms. In this context, companies with high levels of debt are more likely to choose conservative reporting policies to maintain good relationships with creditors and avoid higher agency costs. Therefore, the findings of this research align with the predictions of positive accounting theory that companies will adjust their accounting practices based on pressure from key stakeholders.

The Influence of Capital Structure on Earnings Management

On the contrary, financial performance, measured using return on assets (ROA), has a significant positive impact on earnings management. These findings indicate that companies with higher profitability levels tend to be more active in managing the figures in their financial statements. This can be understood as the company's effort to strengthen the positive image of their performance in the eyes of investors and the public. In the case of CNC company, the increase in ROA can motivate management to maintain that positive perception through financial reporting manipulation. This result is also in line with the research by Rianita and Pramesti (2021).

In the perspective of agency theory, the relationship between the owner (principal) and management (agent) is often colored by conflicts of interest, where management has incentives to maximize personal gains, including through earnings management practices, to meet investor expectations and enhance performance-based compensation. Meanwhile, positive accounting theory explains that accounting practices are influenced by economic motives and contractual incentives. In this context, companies with high ROA tend to engage in earnings management as a strategy to maintain the stability of performance expected by the market. Thus, the results of this study align with the perspective of positive accounting theory, which asserts that the accounting policies chosen by the company are not merely compliance with standards but are also driven by economic and contractual interests.

CONCLUSION

Fundamental Finding : This study reveals that capital structure has a significant negative impact on earnings management, while financial performance has a significant positive impact on earnings management. These results indicate that companies with high leverage tend to be more cautious in manipulating financial statements due to creditor oversight, while high profitability can encourage management to manage earnings to maintain the company's image. **Implication :** Companies need to consider an optimal capital structure and enhance the transparency of financial reporting to reduce excessive earnings management practices. Additionally, investors and stakeholders need to understand how certain financial factors can influence the company's reporting policies. **Limitation :** This research has several limitations, such as the use of a sample limited to non-cyclical consumer sector companies listed on the Indonesia Stock Exchange and a relatively short research period. **Future Research :** Therefore, further research is recommended to expand the coverage to other industrial sectors, add other

relevant variables, and use more comprehensive research methods to obtain more generalized results.

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