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UNMASKING EARNINGS MANAGEMENT: REVEALING WHAT'S BEHIND FROM THE PERSPECTIVE OF CONSERVATISM, DISTRESS, AND OWNERSHIP

Dewi Sarifah Tullah[1*], Bambang Pamungkas[2], Nikita Meishanda Putri[3], Jan Febrian[4], Budi Firmansyah[5]

[1,2,5] Master of Accounting Program, Institut Bisnis dan Informatika Kesatuan, Indonesia
[3,4] Accounting Study Program, Institut Bisnis dan Informatika Kesatuan, Indonesia
[*]Email corresponding author: dewisarifah@ibik.ac.id

Abstract

This study examines the contribution of accounting conservatism, financial distress, and foreign ownership on earnings management, with firm size as a moderating variable, using panel data from Indonesian manufacturing firms during 2020–2023. Employing the Kothari model for earnings management estimation and panel regression analysis via EViews 13, the study explores both direct and interaction effects among variables. The findings reveal that financial distress has a significant positive impact on earnings management, indicating that firms under financial pressure tend to manipulate earnings to maintain favorable performance impressions. In contrast, foreign ownership significantly reduces earnings management, supporting its role as an effective external governance mechanism. However, accounting conservatism does not have a significant effect. The results further show that firm size mitigates the connection between financial distress and managerial earnings manipulation but unexpectedly strengthens the effect of accounting conservatism. No moderating effect is found between firm size and foreign ownership. These results highlight the need for differentiated governance strategies that consider both financial and structural characteristics of firms. The study adds value to the existing body of knowledge through offering a comprehensive assessment of the way in which governance mechanisms and firm attributes interact to influence earnings quality in an emerging market context.

Keywords: earnings management, financial distress, foreign ownership, accounting conservatism, firm size.

INTRODUCTION

High-quality financial reporting is essential to ensure transparent communication between firms and external stakeholders. Financial reports are essential tools that convey the enterprise's financial results and status, enabling users such as external users to assess financial viability accurately (Ahadiyah et al., 2023; Putri & Naibaho, 2022). Among these statements, the income statement—particularly earnings figures—plays a central role, since it demonstrates the organization's profitability potential and indicates management performance (Afrizal et al., 2020; Krismiaji & Astuti, 2020; Purnamasari & Fachrurrozie, 2020). The relevance and faithful representation of earnings information are crucial for decision-making, yet the accrual basis used in preparing financial statements allows room for subjective estimates and accounting discretion (Andriani et al., 2021). This flexibility provides managers the opportunity to influence earnings presentation, often without immediate detection by external parties (Anjarningsih et al., 2022; Isnawati et al., 2023). Consequently, earnings information becomes a key target for manipulation, especially when managerial incentives or reputational concerns are involved (Agustin & Widiatmoko, 2022; Jennifer et al., 2024).

The practice of managing earnings diminishes the reliability of financial information and poses significant risks to stakeholders. Although technically permitted under the framework of applicable financial reporting regulations, earnings management reduces the credibility and decision-usefulness of financial reports (Ahadiyah et al., 2023). Managers may adjust accounting methods or recognition timing to meet performance targets or external expectations, which leads to reports that do not reflect the genuine fiscal position of the company (Feni et al., 2022; Putri & Naibaho, 2022). This behavior stems from agency conflicts, where the separation between ownership and control creates opportunities for opportunistic actions, particularly under conditions of information asymmetry (Afrizal et al., 2020; Feni et al., 2022). Consequently, manipulated earnings may mislead investors, impair firm valuation, and distort resource allocation in the capital market (Lara et al., 2020; Le & and Nguyen, 2023). Moreover, when financial performance is overstated, trust in the company's integrity diminishes, creating broader concerns about transparency and ethical governance in financial reporting (Nguyen et al., 2021; Tran et al., 2023).

Earnings management is not merely a theoretical risk but a widespread and measurable phenomenon in both global and emerging markets. A comprehensive survey of 3,000 of the largest publicly listed firms in the United States uncovered that 26.8% of top managers admitted to manipulating earnings through at least one approach over the past five years (Cade et al., 2025). Among the various types, real earnings management was the most commonly practiced, reported by 18.0% of respondents, followed by disclosure obfuscation (8.8%), accrual-based earnings management (6.6%), and material omissions (3.9%). Interestingly, no executives directly admitted to accounting fraud (0.0%), reinforcing the idea that more severe forms of manipulation are typically concealed or denied. These findings demonstrate that earnings management is not incidental but represents a deliberate and strategic response to internal targets and external stakeholder pressures. Supporting this, (Durana & Bacik, 2021) documented systematic trends of EBITDA manipulation in 3,853 firms across Slovakia, the Czech Republic, Poland, and Hungary—highlighting that such practices are not exclusive to developed markets like the U.S., but are globally embedded across various institutional environments.

Indonesia mirrors this global pattern, with high-profile corporate scandals drawing attention to the real-world consequences of earnings manipulation. The eFishery case, for instance, involved alleged earnings inflation of up to USD 600 million (IDR 9.74 trillion) within a nine-month period ending September 2024. While the firm reported a profit of USD 16 million, internal investigations revealed a net loss of USD 35.4 million and revenues overstated nearly fivefold—from USD 157 million to USD 752 million—raising major doubts about the company's operational scale and financial transparency (Syafei & Assifa, 2025). Similarly, PT Sri Rejeki Isman Tbk (Sritex), once the largest textile manufacturer in Southeast Asia, collapsed under a combination of operational losses, debt mismanagement, and alleged financial reporting irregularities. From a USD 85 million profit in 2020, the firm plummeted to a USD 1.08 billion loss in 2021, prompting a debt restructuring filing of IDR 12.9 trillion and revealing inflated liabilities that reached IDR 24.5 trillion by late 2024. The Attorney General's Office later uncovered potential corruption in the approval of over IDR 3.58 trillion in regional bank credit to Sritex, further implicating executives and lending institutions in a web of financial misconduct (Setiawati, 2025). These cases underscore that earnings management in Indonesia is no longer a hidden or marginal issue—it has materialized into systemic failures with far-reaching consequences for labor, investors, and national financial integrity.

Both accounting conservatism and financial distress play critical roles in shaping a firm's earnings management behavior. Although accounting conservatism is traditionally associated with prudence in financial reporting, it can also serve as a channel for income-decreasing earnings management. By accelerating the recognition of expenses or losses, firms may intentionally suppress reported profits in the current period as part of income-smoothing strategies or to defer earnings for future performance periods (Anjarningsih et al., 2022; Krismiaji & Astuti, 2020). This aligns with positive accounting theory, which suggests that managers may adopt conservative reporting under pressure from ownership expectations or regulatory scrutiny, particularly to reduce tax burdens or avoid political costs (Anjarningsih et al., 2022). On the other hand, under financial pressure often resort to income-enhancing accrual manipulations as a means of concealing poor performance or avoiding covenant violations (Farida & Sugesti, 2023; Feni et al., 2022). In line with the signaling perspective, organizations in financial difficulty may manipulate earnings to signal financial strength and confidence to shareholders and creditors about their stability and viability (Maya Putri, 2022). Moreover, in line with agency theory, disparities in information access between managers and owners enables opportunistic actions by managers to protect their reputation, maintain control, or avoid replacement (Mellennia & Khomsiyah, 2023; Viana Jr et al., 2022). In both cases, managerial discretion is exercised not only to manage reported performance but also to respond strategically to organizational and market pressures.

As a contextual characteristic, firm size may moderate how company-specific factors relate to the extent of earnings manipulation. Large-scale enterprises tend to be subject to greater scrutiny from investors, regulators, and the public, which increases the transparency of financial disclosures and reduces the opportunity for managerial discretion in reporting (Adyastuti & Khafid, 2022; Taufiq, 2022). From the perspective of signaling theory, large companies are more motivated to provide credible financial information to maintain market confidence, since they are more visible and reputationally exposed (Purnamasari & Fachrurrozie, 2020). The availability of public information and stronger internal control mechanisms in larger firms can act as a deterrent to opportunistic earnings manipulation. Consequently, firm size may function as a moderator that reduces the effect of internal pressures—such as financial distress—or accounting discretion on the tendency to manage earnings.

While previous variables such as accounting conservatism and financial distress reflect internal managerial conditions, this study adds a novel external governance dimension through the inclusion of foreign ownership. This refinement responds to prior scholarly suggestions to incorporate ownership structure into earnings management research (Atmamiki & Priantinah, 2023; Isnawati et al., 2023; Mellennia & Khomsiyah, 2023). Foreign investors, who are generally independent from internal management, tend to impose stricter demands on transparency and financial discipline, thereby enhancing corporate oversight (Pham et al., 2022; Tran et al., 2023). Their presence reduces information asymmetry and reinforces governance practices, which limits managerial discretion in manipulating earnings. Empirical findings further confirm that firms with higher foreign shareholder presence tend to engage less in earnings manipulation due to reputational concerns and their reliance on credible financial disclosures (Abubakar et al., 2020; Le & and Nguyen, 2023). By shifting the focus toward external shareholder influence, this study offers a fresh theoretical and empirical contribution to understanding the governance-based constraints on the practice of managing earnings, with a focus on emerging economies.

In addition to expanding the perspective to external governance, this study addresses key methodological and temporal gaps identified in previous research. Several scholars have highlighted the need to extend the observation period beyond 2022 to better capture current financial behavior in post-crisis contexts (Al-Matari, 2025; Elvina, 2024). This study responds by covering the 2020–2023 period, incorporating both pandemic and recovery phases to enhance relevance and robustness. Methodologically, this research also advances prior work by responding to critiques on the limitations of traditional accrual-based models. Pham et al. (2022) noted that many studies rely solely on the modified Jones model despite the availability of more refined techniques, while Isnawati et al. (2023) encouraged the use of alternative earnings management measurements to improve accuracy. To address these concerns, this study employs Kothari's approach, which adjusts for firm performance by including ROA in the estimation model, thereby reducing estimation bias and enhancing the detection of discretionary accruals (Acar & Coskun, 2020; Sundkvist et al., 2023). This dual contribution—updating the study period and applying a performance-adjusted accrual model— reinforces the credibility of the empirical evidence and responds directly to pressing methodological critiques in the literature.

Although the manufacturing sector has been widely studied in prior earnings management literature, it remains a highly relevant context for the present study. Previous research has explored earnings manipulation within manufacturing firms due to their operational complexity, high inventory levels, and greater flexibility in accrual estimation (Agustin & Widiatmoko, 2022; Feni et al., 2022; Purnamasari & Fachrurrozie, 2020). The sector's capital intensity also makes it more susceptible to financial distress, especially during economic fluctuations (Choudhry, 2022), which may increase the pressure on managers to smooth earnings or present stable financial results. Furthermore, manufacturing firms often attract foreign investment due to their scale and export potential (Jovanovic & Morschett, 2022), making foreign ownership a pertinent factor in shaping governance dynamics and reporting transparency. The typically large size of manufacturing firms also introduces variation in monitoring intensity and disclosure quality (Handoyo et al., 2023), providing a suitable setting to explore the moderating function of firm size. Thus, while prior studies have covered this sector, its structural attributes and sensitivity to the tested variables justify its continued relevance as a focal industry for examining earnings management behavior.

This research seeks to empirically investigate the effects of accounting conservatism, financial distress, and foreign ownership on earnings management in manufacturing firms listed in Indonesia from 2020 to 2023, while also testing the moderating role of firm size. By incorporating both internal (conservatism and distress) and external (foreign ownership) governance factors, the research offers a comprehensive view of the determinants of managerial discretion in financial reporting. Firm size is introduced as a moderating variable based on the notion that larger firms tend to face higher scrutiny and possess more robust internal controls, which may reduce the extent to which internal pressures lead to earnings manipulation. The use of the Kothari model enhances the robustness of accrual-based earnings management measurement by controlling for firm performance, while the extended post-pandemic timeframe allows for more relevant and contextual insights. The results are assumed to play a role in shaping the advancement of positive accounting, agency and signaling theories, and present meaningful guidance for regulatory bodies, investors, as well as corporate governance advocates in strengthening reporting quality within capital-intensive sectors.

LITERATURE REVIEW AND HYPOTHESIS FORMULATION

Accounting Conservatism and Earnings Management

Accounting conservatism, which entails the asymmetric recognition of economic losses over gains, has traditionally been viewed as a governance mechanism that enhances the credibility and verifiability of financial reporting (Lara et al., 2020). Recent studies, however, have shown that this principle may also facilitate income-decreasing earnings management practices. By accelerating the recognition of expenses or losses, managers can intentionally understate current profits as part of income-smoothing strategies or to defer earnings to future periods (Anjarningsih et al., 2022; Krismiaji & Astuti, 2020). This behavior corresponds to positive accounting theory, which posits that executives act in response to owner expectations or external scrutiny, particularly to minimize tax obligations or avoid political costs (Anjarningsih et al., 2022).

Conservative companies are inclined to employ accrual-based income-decreasing strategies more frequently, often to present stable financial conditions or manage future performance targets (Casciello et al., 2021; Elvina, 2024). Khalik & Sylvia (2022) further supports this by noting degree of conservative accounting practices correlate with lower levels of reported earnings, aligning closely with discretionary accrual techniques. Hence, while conservatism may ostensibly enhance financial reliability, it also provides room for strategic manipulation of earnings within the permissible boundaries of accounting standards.

H1: Accounting conservatism has a positive effect on earnings management.

Financial Distress and Earnings Management

Financial distress denotes a state wherein a firm encounters difficulty or inability in meeting its debt and financial commitments, often due to high fixed costs, illiquid assets, or revenue instability, signaling a deteriorating financial position (Luu Thu, 2023). In such conditions, managers often face intense pressure to improve the appearance of the firm's financial outcomes, thereby increasing the likelihood of earnings management (Farida & Sugesti, 2023; Feni et al., 2022). According to signaling theory, firms in distress may attempt to send positive signals to investors, creditors, or regulators by inflating earnings figures, aiming to sustain market confidence or avoid breach of covenants (Putri & Naibaho, 2022). This behavior reflects a strategic use of financial information to influence stakeholder perceptions despite operational weakness.

In the context of agency theory, financial distress amplifies agency conflicts between managers and shareholders. Managers, who possess superior information, may act opportunistically by engaging in accrual-based earnings management to protect their positions, delay unfavorable outcomes, or meet contractual obligations tied to financial ratios (Mellennia & Khomsiyah, 2023; Viana Jr et al., 2022). Empirical evidence from emerging markets consistently confirms an observed alignment between financial distress and the strategic use of accruals to boost reported income, highlighting the tactic as a common reaction to financial underperformance and regulatory pressure (Aljughaiman et al., 2023; Li et al., 2020). Thus, financial distress does not only indicate economic challenges but also acts as a catalyst for earnings manipulation under opportunistic motives.
H2: Financial distress has a positive effect on earnings management.

Foreign Ownership and Earnings Management

The presence of foreign investors acts as a significant mechanism for external oversight that can mitigate managerial discretion in financial reporting (AL-Duais et al., 2022). From the perspective of agency theory, foreign ownership contributes significantly to reducing agency problems by enforcing stricter oversight and demanding higher transparency, which in turn limits the potential for earnings manipulation (Al-Matari, 2025). Their independence and objectivity enable them to align managerial actions with shareholder interests, fostering a more accountable corporate environment (Tran et al., 2023). Empirical findings demonstrate that firms with substantial foreign ownership are less likely to engage in either upward or downward earnings manipulation, primarily due to increased scrutiny and expectations for reliable disclosures (Le & and Nguyen, 2023).

Moreover, foreign investors often introduce international best practices in financial governance, improving the overall quality of corporate reporting. Pham et al. (2022) highlights that the presence of foreign investors is positively linked to improved accounting standards, as foreign shareholders typically require accurate, timely, and standardized financial information. Ahmed & Iwasaki (2021) also reports a significant negative correlation between lagged foreign investor presence and earnings manipulation practices, underscoring that sustained foreign presence can constrain opportunistic behavior over time. Across markets that exhibit relatively weaker institutional frameworks, including transitional or developing economies, the monitoring role of foreign investors becomes even more pronounced, acting as a substitute for underdeveloped internal controls and legal enforcement mechanisms.
H3: Foreign ownership has a negative effect on earnings management.

Firm Size as a Moderating Variable

Firm size has been widely recognized as a critical driver of firm-level financial conduct, including the tendency to engage in earnings management. According to signaling theory, larger firms have a stronger incentive to convey credible financial information to external stakeholders due to their visibility and reputational concerns (Andriani et al., 2021; Purnamasari & Fachrurrozie, 2020). The availability of extensive public information and rigorous external monitoring in larger firms tends to reduce information asymmetry and managerial discretion in financial reporting (Adyastuti & Khafid, 2022; Taufiq, 2022). Moreover, larger firms are subject to more intensive scrutiny from regulators, investors, and the public, which fosters better internal control systems and enhances transparency (Wawo, 2023).

From an agency theory perspective, this heightened oversight mitigates opportunistic behaviors by managers and limits the scope for earnings manipulation Ahmed & Iwasaki (2021). Empirical evidence in the Indonesian context confirms that companies with greater scale are typically less engaged in earnings manipulation due to their motivation to maintain investor trust and safeguard their corporate reputation (Panjaitan & Muslih, 2019; Taufiq, 2022). As such, the scale of the firm is projected to demonstrate a negative relationship with the level of discretionary accruals used in earnings management.

H4: Firm size has a negative effect on earnings management.

While accounting conservatism provides flexibility in income-decreasing reporting, its role in shaping earnings management practices might be contingent upon firm size. Larger firms, due to heightened public visibility and reputational risk, are more inclined to present reliable financial statements to avoid stakeholder backlash (Adyastuti & Khafid, 2022; Wawo, 2023). As a result, in large firms, the opportunistic use of accounting conservatism for earnings manipulation may be more constrained compared to smaller firms, where external monitoring is weaker (Andriani et al., 2021). Empirical evidence supports that conservatively reporting entities exhibit a reduced likelihood of earnings management practices by either accrual or real methods to meet earnings targets (Lara et al., 2020). Furthermore, Afrizal et al. (2020) argues that higher conservatism reflects managerial intent to avoid overstating profits, especially under reputational pressure in larger firms. Therefore, the constraining effect of accounting conservatism on earnings manipulation practices tends to be more pronounced in sizable companies with more robust monitoring and lower tolerance for opportunistic financial behavior.

H5: Firm size weakens the effect of accounting conservatism on earnings management.

Similarly, organizations under financial pressure often resort to earnings manipulation strategies to present favorable performance and retain access to external financing (Feni et al., 2022; Putri & Naibaho, 2022). However, the ability of managers to manipulate earnings under such pressure may be constrained in larger firms due to stronger governance structures and more comprehensive internal controls (Taufiq, 2022; Wawo, 2023). Moreover, as highlighted by (Oliver et al., 2022), large firms are more likely to attract media attention, which intensifies external monitoring and further constrains managerial opportunism in financial reporting. Boli & Ferdian (2025) adds that during financial distress, managers may refrain from continued earnings manipulation either because prior manipulation has exhausted discretionary options or because they perceive diminished benefits from doing so. As such, larger firms are expected to reduce the strength of the relationship between financial distress and earnings manipulation.

H6: Firm size weakens the effect of financial distress on earnings management.

Furthermore, the presence of foreign investors has been associated with improvements in oversight functions and reduce earnings manipulation by demanding greater transparency and disclosure quality (Ahmed & Iwasaki, 2021; Pham et al., 2022). However, the effectiveness of foreign equity holders in curbing managerial earnings discretion may vary depending on the firm's size. In larger firms, the presence of foreign shareholders may be more impactful due to their influence on corporate policies and audit quality, supported by institutional capacity (Le & and Nguyen, 2023; Tran et al., 2023). Therefore, the negative effect of foreign ownership on earnings management is likely to be more pronounced in larger firms.

H7: Firm size weakens the effect of foreign ownership on earnings management.

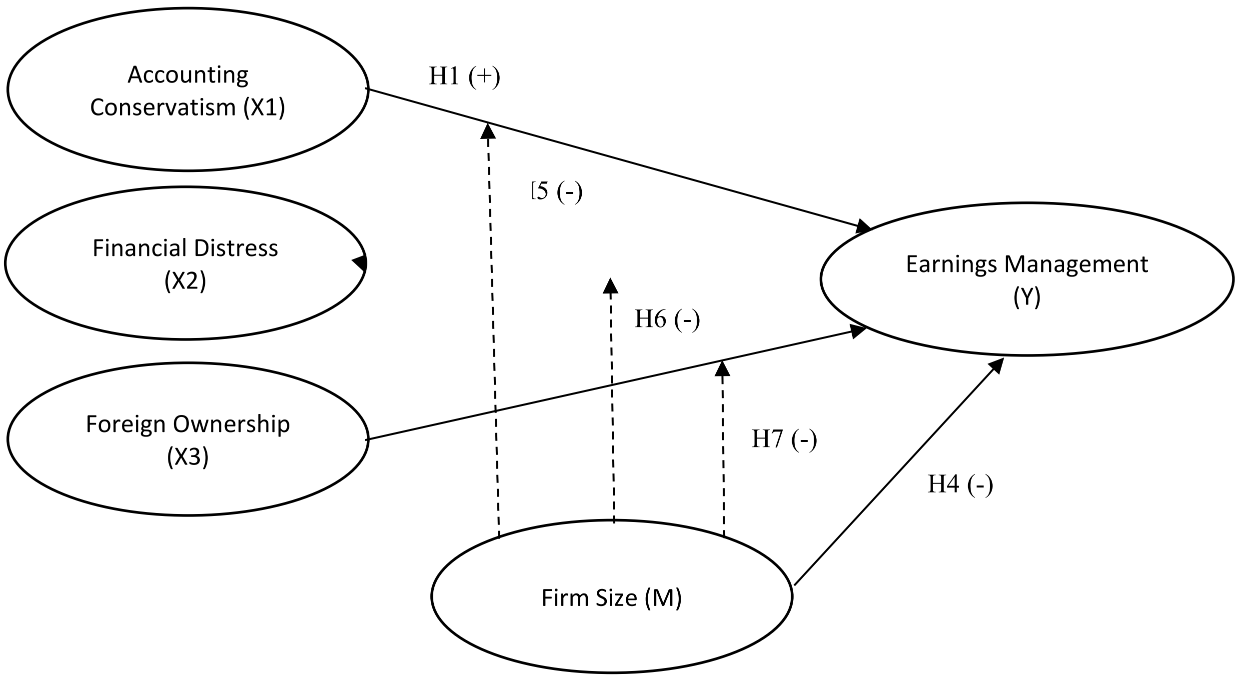

Figure 1. Conceptual Framework

RESEARCH METHODS

This research employs a quantitative explanatory approach to empirically assess the effects of accounting conservatism, financial distress, and foreign ownership on earnings management, while incorporating firm size as a moderating factor in the model. The explanatory approach is appropriate for investigating causal relationships between measurable financial indicators, grounded in theories of positive accounting, agency, and signaling.

The research population includes all manufacturing firms included in the IDX listing throughout the 2020 to 2023 timegrame. The manufacturing sector was chosen due to its capital intensity, exposure to financial distress during economic fluctuations, frequent foreign investor involvement, and typically large firm size—all of which are relevant to the study's variables on earnings management, governance, and firm-level monitoring. A purposive sampling method was employed using the following criteria:

Table 1. Table Format

Description	Total
Manufacturing companies listed on IDX	169
Less: Companies publishing annual reports for fewer than four consecutive years (2020–2023)	(29)
Less: Companies with undisclosed foreign ownership information	(8)
Less: Companies classified with capital deficiency	(7)
Final number of companies	25
Total firm-year observations (4 years)	500

Source: Indonesia Stock Exchange 2025

The study relies entirely on secondary data obtained from publicly available sources to ensure transparency and replicability, such as company annual reports, and audited financial statements. These documents provide the necessary information to construct the study variables based on established accounting and financial ratios. The operationalization and measurement techniques of each variable are summarized in the following table.

Table 2. Variable Measurement

Variable	Code	Measurement	Reasons
Earning Management	EM	Kothari Model	Controls performance via ROA to minimize estimation bias and improve discretionary accrual detection (Acar & Coskun, 2020; Sundkvist et al., 2023)
Accounting Conservatism	AC	$\frac{Net\ Income - CFO + Depreciation}{Total\ Assets}$	Reduces the effect of temporary accruals and captures the conservative nature of accounting through a long-term approach (Krismiaji & Astuti, 2020)
Financial Distress	FD	Zmijewski Model $-4{,}3 - 4{,}5 * ROA + 5{,}7 * DAR + 0{,}004 * CR$	Provides higher predictive accuracy in the manufacturing sector (Ambarwati & Sriwardany, 2021; Apsari et al., 2024)
Foreign Ownership	FO	$\frac{Shares\ owned\ by\ foreign\ investors}{Total\ Outstanding\ shares}$	Percentage-based measure captures the relative influence of foreign shareholders on governance (Pham et al., 2022)
Firm Size	FS	Natural logarithm of total assets	Log transformation of total assets captures scale effects and reduces heteroscedasticity (Wawo, 2023)

The analytical strategy adopted in this study utilizes panel data regression to evaluate the direct effects of accounting conservatism, financial distress, and foreign ownership on earnings management, while also investigating the moderating influence of firm size. Given the panel nature of the dataset, the classical assumption tests concentrated on assessing multicollinearity through the Variance Inflation Factor (VIF). The results showed that all VIF values were below 0.85, indicating an absence of multicollinearity issues. To determine the most suitable estimation model, the study compared the Common Effect Model (CEM), Fixed Effect Model (FEM), and Random Effect Model (REM). Model selection was guided by a sequence of diagnostic tests: the Chow test (comparing CEM and FEM), the Hausman test (FEM vs. REM), and the Lagrange Multiplier test (CEM vs. REM). Furthermore, interaction terms such as AC*SIZE, FD*SIZE, and FO*SIZE were included to assess the moderating influence of firm size. All statistical significance tests were conducted at the 5% level ($p < 0.05$), and the entire analysis was performed using EViews 13 software.

RESULTS AND DISCUSSION

The empirical analysis investigates the effects of accounting conservatism, financial distress, and foreign ownership on earnings management, while also assessing the moderating role of firm size in the relationship. The discussion integrates the results with theoretical frameworks and prior research to provide interpretation and relevance.

Table 3. Multicollinearity Test

Variable	AC	FD	FO	SIZE
AC	1.000000			
FD	0.008553	1.000000		
FO	0.056340	-0.070947	1.000000	
SIZE	-0.026336	0.043283	0.148752	1.000000

Source: Processed data using EViews13

The initial diagnostic test conducted was the multicollinearity test, which assesses whether the independent variables are highly correlated and thus may distort regression estimates. As shown in Table 3, the correlation coefficients between variables are all below the commonly accepted threshold of 0.85. This indicates that multicollinearity is not a concern in this model, and each predictor variable provides unique explanatory power.

Table 4. Model Estimation Test

Regression Equation	Chow (p-value)	Hausman (p-value)	Lagrange Multiplier (p-value)	Best Model
Before Moderation	0.0000	0.2769	0.0000	Random Effect Model
After Moderation	0.0000	0.0011	0.0000	Fixed Effect Model

Source: Processed data using EViews13

As shown in Table 4, the Chow test results in a p-value of 0.0000 both before and after moderation, indicating that the Common Effect model is rejected in favor of panel models. For the model before moderation, the Hausman test yields a p-value of 0.2769 (greater than 0.05), suggesting that the Random Effect Model is more appropriate. However, for the model after moderation, the Hausman test results in a p-value of 0.0011 (less than 0.05), indicating that the Fixed Effect Model is the preferred specification. The LM test in both models shows significant results (p-value = 0.0000), confirming that pooled regression is inadequate compared to panel data models.

Table 5. Regression Results

Variable	Coefficient	Prob.	Effect	Decision
AC → EM	-0.000673	0.7244	Not Significant	Rejected
FD → EM	0.014437	0.0002	Positive Significant	Accepted
FO → EM	-0.038401	0.0350	Negative Significant	Accepted
SIZE → EM	-0.016020	0.0000	Negative Significant	Accepted
AC*SIZE → EM	0.098929	0.0000	Positive Significant	Rejected
FD*SIZE → EM	-0.021212	0.0000	Negative Significant	Accepted
FO*SIZE → EM	-0.009526	0.7154	Not Significant	Rejected

Source: Processed data using EViews13

Effect of Accounting Conservatism on Earnings Management

The empirical results reveal that accounting conservatism does not significantly affect earnings management, as indicated by a coefficient of –0.000673 and a p-value of 0.7244. This leads to the rejection of hypothesis H1, suggesting that conservative accounting practices do not serve as a decisive factor in curbing or facilitating earnings management within the observed manufacturing firms.

From a theoretical standpoint, this finding contrasts with the predictions of positive accounting theory, which argues that accounting conservatism could be used strategically by managers to shift or smooth earnings across periods (Anjarningsih et al., 2022; Krismiaji & Astuti, 2020). The logic behind this theory posits that managers may adopt income-decreasing practices—enabled by conservative principles—to meet external expectations, manage political costs, or defer tax liabilities (Anjarningsih et al., 2022). In line with this, prior studies have found that conservatism is often associated with greater use of accrual-based manipulation techniques aimed at reducing reported income (Casciello et al., 2021; Khalik & Sylvia, 2022).

However, the current findings are more aligned with empirical results reported by Dewi & Hidayati (2023), who argues that conservatism may impair the representational faithfulness of financial reports by creating a mismatch between expenses and associated revenues, thus reducing their usefulness for decision-making. Similarly, Surianti et al. (2021) found that organizations demonstrate a greater propensity toward income-increasing behavior to boost stock value and ease access to credit, rather than adhering to conservative reporting practices. This indicates a possible shift in managerial priorities from conservative transparency to profit maximization and signaling motives.

Effect of Financial Distress on Earnings Management

The findings suggest that higher levels of financial distress are positively correlated with increased earnings management behavior (coefficient = 0.014437; p = 0.0002). Such evidence points to an increased propensity for financially distressed firms to be involved in earning manipulations to maintain appearances. Accordingly, hypothesis H2 is accepted. This finding indicates that companies experiencing economic hardship are more prone to alter earnings figures to convey a stable financial outlook and avoid negative perceptions.

This behavior aligns with signaling theory, which suggests that managers attempt to send positive signals to investors and creditors in times of distress by presenting favorable earnings figures, thereby maintaining trust and access to capital markets (Farida & Sugesti, 2023; Putri & Naibaho, 2022). It is also supported by agency theory, wherein financial pressure heightens agency conflicts and motivates managers to obscure underperformance to safeguard their positions and meet contractual obligations (Mellennia & Khomsiyah, 2023).

Empirical findings reinforce this logic. Prior studies show that companies under financial distress are more inclined to manipulate earnings through accrual-based methods due to its lower cost and higher flexibility compared to real activities manipulation (Aljughaiman et al., 2023; Li et al., 2020). Moreover, the tendency to inflate profits under financial stress is well-documented in emerging markets where monitoring is weaker and bankruptcy risk is elevated (Viana Jr et al., 2022). Such behavior reflects a broader pattern wherein financial distress acts not only as a symptom of declining performance but also as a catalyst for opportunistic reporting practices.

Effect of Foreign Ownership on Earnings Management

The results reveal that foreign ownership has a statistically significant negative effect on earnings management, as indicated by a coefficient of –0.038401 and a p-value of 0.0350. This indicates that greater foreign investor presence serves as an effective external governance mechanism. Thus, hypothesis H3 is accepted.

These results support the principles of agency theory, which argue that foreign shareholders act as a credible governance force capable of reducing agency problems by strengthening monitoring and insisting on greater financial transparency (Al-Matari, 2025). Unlike domestic investors who may be embedded in local networks, foreign investors often maintain a more objective stance, thereby constraining managerial discretion in financial reporting (AL-Duais et al., 2022).

Empirical studies support this mechanism. Le & and Nguyen (2023) found that greater foreign ownership lowers both upward and downward earnings management, while Ahmed & Iwasaki (2021) confirm its long-term disciplining effect. Similarly, Pham et al., (2022) and Tran et al. (2023) highlight how foreign investors enforce higher reporting standards, aligning practices with global norms.

Under these conditions, the results of this investigation confirm the efficacy of foreign ownership as a market-driven external governance mechanism. By requiring enhanced accountability and reducing the opportunity for earnings manipulation, foreign investors help improve the credibility of reported financial information and align corporate practices with global standards.

Effect of Firm Size on Earnings Management

A negative and highly significant association is observed between firm size and earnings management (–0.016020; p = 0.0000), reflecting the lower likelihood of larger firms engaging in manipulate earnings due to greater scrutiny and stronger internal controls. Hence, hypothesis H4 is accepted. Firm size appears to act as a deterrent to earnings manipulation due to its association with enhanced transparency, tighter external monitoring, and greater reputational risk. This reinforces the view that organizational scale plays a key role in shaping financial reporting integrity

From a signaling perspective, larger firms are more visible and reputationally sensitive, encouraging management to provide credible financial disclosures to maintain stakeholder confidence (Andriani et al., 2021; Purnamasari & Fachrurrozie, 2020). Their extensive public exposure increases scrutiny, thus motivating the presentation of high-quality, manipulation-free earnings as positive signals to investors (Panjaitan & Muslih, 2019).

Agency theory also supports this outcome by highlighting how larger firms typically develop more robust governance frameworks and internal control mechanisms to reduce agency costs (Taufiq, 2022; Wawo, 2023). Larger firms—often characterized by broader ownership bases and access to diverse funding sources—tend to minimize accrual-based manipulation to preserve their credibility and maintain favorable market perceptions (Ahmed & Iwasaki, 2021).

Moderating Effect of Firm Size on the Relationship between Accounting Conservatism and Earnings Management

Contrary to expectations, the interaction between accounting conservatism and firm size is positive and significant (coefficient = 0.098929; p = 0.0000), indicating that in larger firms, conservatism may not effectively reduce earnings management. Consequently, hypothesis H5 is rejected. This suggests that, rather than weakening the impact of accounting conservatism on managerial earnings manipulation, larger firms may actually amplify the use of conservative accounting as a tool for income manipulation.

While prior literature posits that firm size constrains opportunistic behavior due to enhanced oversight and reputational risk (Adyastuti & Khafid, 2022; Wawo, 2023), the findings of this study align more closely with perspectives emphasizing managerial discretion in applying accounting principles—even within large entities. In high-profile firms, conservatism may be strategically employed not to ensure transparency, but to smooth income or build "profit reserves" for future reporting periods (Anjarningsih et al., 2022; Krismiaji & Astuti, 2020).

This finding resonates with positive accounting theory, which suggests that managers will exploit available accounting flexibility—including conservative recognition rules—to serve internal objectives such as tax avoidance or bonus maximization, particularly when external pressures are high (Casciello et al., 2021; Khalik & Sylvia, 2022). It also challenges assumptions that size inherently limits earnings manipulation. Instead, larger firms—often more complex and with broader discretionary space—may engage in sophisticated accrual strategies masked under the appearance of prudent reporting.

Therefore, the influence of firm size as a moderating variable in this association appears to be non-constraining. Instead of limiting conservatism-driven earnings management, size may provide both incentive and cover for such practices—contrary to theoretical expectations. This highlights the need to reassess the assumption that firm size universally enhances reporting quality in the presence of accounting flexibility.

Moderating Effect of Firm Size on the Relationship between Financial Distress and Earnings Management

The interaction between financial distress and firm size reveals a statistically significant negative relationship (coefficient = –0.021212; p = 0.0000), suggesting that firm size effectively dampens the impact of financial distress on earnings management. Therefore, hypothesis H6 is accepted. The evidence suggests that firm size moderates the distress–manipulation link by providing structural, reputational, and institutional barriers to opportunism.

This finding supports the theoretical proposition that larger firms, due to their more robust governance frameworks and intensive public oversight, are less susceptible to opportunistic earnings manipulation during periods of financial strain (Taufiq, 2022; Wawo, 2023). According to agency theory, while financial distress amplifies conflicts between managers and shareholders, the presence of effective monitoring systems in large firms constrains managerial discretion and mitigates the agency problem (Mellennia & Khomsiyah, 2023; Viana Jr et al., 2022).

Moreover, larger firms tend to be under the spotlight of media, regulators, and institutional investors, thereby increasing reputational risk and discouraging manipulative practices (Oliver et al., 2022). The signaling theory further suggests that while distressed firms may seek to project stability through inflated earnings, this incentive is curtailed in larger firms due to the potential reputational damage and heightened external scrutiny (Farida & Sugesti, 2023; Putri & Naibaho, 2022). Boli & Ferdian (2025) add that managers in large, distressed firms may avoid further manipulation due to prior exhaustion of accrual discretion or diminishing marginal benefits. Larger organizations, particularly in emerging markets like Indonesia, appear more resilient to financial reporting distortions under financial pressure, validating the hypothesis and enriching the broader governance discourse in accounting research.

Moderating Effect of Firm Size on the Relationship between Foreign Ownership and Earnings Management

The regression results indicate that the interaction between foreign ownership and firm size is not statistically significant (coefficient = –0.009526; p = 0.7154), suggesting that firm size does not significantly influence the role of foreign investors in constraining earnings management. Therefore, hypothesis H7 is rejected. Although foreign ownership generally serves as a beneficial external governance mechanism (as confirmed in H3), its effect on earnings management is not significantly moderated by firm size. This implies that firm size neither enhances nor reduces the effectiveness of foreign investors in performing governance functions in the sampled firms.

While prior literature highlights the effectiveness of foreign ownership in enhancing transparency and reducing managerial discretion (Ahmed & Iwasaki, 2021; Al-Matari, 2025; Pham et al., 2022), this study's findings suggest that such influence may operate independently of firm size. One plausible explanation is that the oversight role of foreign investors is often constrained by practical and structural limitations—such as geographic distance, limited access to internal operations, and restricted involvement in strategic decision-making (Agustin & Widiatmoko, 2022; Al-Haddad & Whittington, 2019). These constraints may prevent foreign shareholders from exerting a more pronounced monitoring role, especially in environments where local ownership structures dominate governance mechanisms.

Additionally, within the landscape of transitional markets, foreign investors may face institutional and regulatory barriers that reduce their ability to influence managerial behavior differentially across firm sizes. (Agustin & Widiatmoko, 2022) notes that foreign ownership often lacks direct control over managerial policy, making their governance impact less sensitive to variations in organizational scale. This may explain the insignificant moderation effect observed in this study.

Table 6. Coefficient of Determination

Regression Equation	Adjusted R-Squared
Before Moderation	0.070618
After Moderation	0.334472

Source: Processed data using EViews13

The adjusted R-squared values from the regression models offer insight into the explanatory power of the explanatory variables in relation to earnings management, prior to and following introducing the moderating variable. Prior to incorporating firm size interactions, the adjusted R-squared is relatively low at 0.070618. This suggests that accounting conservatism, financial distress, and foreign ownership, as standalone predictors, explain only about 7.1% of the differences in earnings management behavior across the observed firms.

However, when interaction terms with firm size are included, the adjusted R-squared increases substantially to 0.334472. This indicates that the expanded model, which captures the moderating role of firm size, accounts for approximately 33.4% of the variability in earnings management. The notable increase in explanatory power underscores the relevance of considering firm size as a contextual factor that influences how internal and external governance mechanisms interact with managerial behavior.

This improvement is consistent with prior research emphasizing that structural characteristics of firms, particularly their size, can alter the strength and direction of firm-level governance frameworks (Andriani et al., 2021; Taufiq, 2022). The results support the notion that structural attributes of a firm enhance the predictive validity of governance-related models. Therefore, the inclusion of moderation not only improves the robustness of the empirical model but also provides a more holistic view of the determinants of earnings management in the Indonesian manufacturing context.

CONCLUSION

This research conducts an empirical analysis of the influence of accounting conservatism, financial distress, and foreign ownership on earnings management among manufacturing firms in Indonesia, while incorporating firm size as a moderating factor. Empirical evidence suggests that firms experiencing financial distress are more likely to engage in earnings management, as indicated by a positive relationship, supporting the notion that distressed firms attempt to present favorable performance to stakeholders. Foreign ownership significantly reduces earnings management, reinforcing its role as an effective external governance mechanism. Conversely, accounting conservatism does not exert a measurable influence on earnings management practices, and firm size is shown to mitigate the impact of financial distress but unexpectedly strengthens the link between conservatism and manipulation. Additionally, firm size does not moderate the effect of foreign ownership. The inclusion of moderation substantially improves the model's explanatory power (adjusted R^2 from 0.0706 to 0.3345), highlighting the importance of firm-level context in corporate governance effectiveness.

Practically, these results offer several implications. Regulators and investors should be particularly cautious about earnings quality in financially distressed firms, especially those with limited governance oversight. The evidence additionally indicates that foreign shareholders serve as an important check on managerial opportunism, regardless of firm size. However, the unexpected positive interaction between firm size and conservatism calls for reevaluation of assumptions regarding reporting reliability in large firms. Management and policymakers should therefore not presume that size alone deters opportunistic reporting.

Despite its contributions, this study is not without limitations. First, its scope is limited to listed manufacturing firms, which may limit generalizability to other sectors. Second, this research employs only the Kothari model to quantify earnings management, which, while robust, may not capture all forms of manipulation. Third, the study does not account for institutional ownership, board characteristics, or audit quality—factors that may significantly influence earnings management behavior.

Future research should consider cross-sectoral comparisons and incorporate qualitative governance indicators to provide a more holistic understanding. Expanding the model to include other moderating variables such as institutional ownership or audit committee strength could also yield deeper insights into the mechanisms that constrain or enable earnings management in emerging markets.

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