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The effect of financial distress on accounting misstatements during the COVID-19 pandemic

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ABSTRACT

This study aims to examine the effect of financial distress on accounting misstatements and to find out whether the COVID-19 pandemic moderates the relationship between financial distress and accounting misstatements. This study uses data from property and real estate companies listed on the Indonesia Stock Exchange (IDX) for the period from 2017 to 2021. The total research sample is 145 entities. The statistical methodology used in this study is panel regression analysis with the following steps: selecting the best regression model, classical assumption testing, and regression testing to determine coefficient values and significance levels. The results of this study show that financial distress has no significant effect on accounting misstatements. This study also finds empirical evidence that the COVID-19 pandemic does not moderate the relationship between financial distress and accounting misstatement. Although accounting misstatements have been a research topic for many years, little attention has been paid to their impact on companies experiencing financial distress and crises. Further research still needs to be carried out regarding the impact of the COVID-19 pandemic on the relationship between financial distress and accounting misstatement using a sample of companies that have a high multiplier effect. It is hoped that the results of this study can provide additional references to prove that agency theory and prospect theory can explain accounting misstatements.

ABSTRAK

Penelitian ini bertujuan untuk menguji pengaruh financial distress terhadap salah saji akuntansi dan untuk mengetahui apakah pandemi COVID-19 memoderasi hubungan antara financial distress dan salah saji akuntansi. Penelitian ini menggunakan data dari perusahaan properti dan real estate yang terdaftar di Bursa Efek Indonesia. Datanya berkisar tahun 2017 hingga 2021, dan sampel penelitiannya berjumlah 145 entitas. Metodologi statistik yang digunakan dalam penelitian ini adalah analisis regresi panel. Langkah pertama dalam teknik ini adalah memilih model regresi terbaik, dilanjutkan dengan uji asumsi klasik, dan terakhir uji regresi untuk menentukan nilai koefisien dan tingkat signifikansi. Penelitian ini telah menentukan bahwa tidak ada dampak signifikan dari kesulitan keuangan terhadap terjadinya salah saji akuntansi. Studi ini juga menemukan bukti empiris yang menunjukkan bahwa pandemi COVID-19 tidak memediasi hubungan antara financial distress dan accounting misstatement. Meskipun accounting misstatement telah menjadi topik penelitian selama bertahun-tahun, pengaruhnya terhadap perusahaan yang mengalami financial distress dan krisis hanya mendapat sedikit perhatian. Masih perlu dilakukan penelitian lebih lanjut mengenai dampak pandemi COVID-19 terhadap hubungan financial distress dan accounting misstatement dengan menggunakan sampel perusahaan yang memiliki multiplier effect tinggi. Hasil penelitian ini dapat memberikan referensi tambahan untuk membuktikan bahwa teori agensi dan teori prospek dapat menjelaskan accounting misstatement.

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1. INTRODUCTION

Accounting misstatements often occur in companies experiencing financial distress, especially during crises, such as the COVID-19 pandemic. Company executives take advantage of existing opportunities by making accounting misstatements in order to obtain compensation or incentives from the government. The government provides a lot of compensation or incentives to the business world, especially companies that have a significant multiplier effect and must be saved as soon as possible to restore national economic conditions (CNBC Indonesia, 2022). Compensation or incentives provided by Bank Indonesia to companies are in the form of an appropriate loan to value ratio and an extension of the government's value added tax. This is intended to encourage companies to grow and contribute to national economic growth more quickly (Bisnis.Com, 2022). However, the government's great support for companies during the COVID-19 pandemic has also encouraged companies, especially those experiencing financial distress, to take advantage of this opportunity.

Previous research results show that management of companies experiencing financial distress deliberately makes accounting misstatements to maintain the company's position and reputation (Campa & Camacho-Miñano, 2015; Lara et al., 2009; Li et al., 2020; Xu et al., 2021). The results of research conducted by Agrawal & Chatterjee (2015) and Habib et al. (2013) show that companies experiencing financial distress make accounting misstatements by decreasing their company's profits. The results of several existing studies show that financial difficulties have an impact on accounting misstatements, both positively and negatively. During a crisis, some investors do not expect the company's performance to be superior, but there are also companies that take a "big bath" by reducing profits to get compensation and incentives from the government (Dimitras et al., 2015; Heba Ali et al., 2022; Kumar & Vij, 2017; Oskouei & Sureshjani, 2021; Strobl, 2013). The results of research conducted by Rahman et al. (2022) show that accounting misstatement tends to increase during the COVID-19 pandemic.

Previous research results show that both financially stable and unstable companies make accounting misstatements when experiencing a crisis. Company management uses this opportunity to persuade the government to provide various existing compensation and incentives, such as tax breaks or debt relief. Several previous studies related to accounting misstatements also provide different perspectives regarding management's motivation for conducting accounting misstatements. The main goal is to maintain the company's position and reputation. When experiencing financial difficulties, company management manipulates financial reports to artificially increase company profits in order to hide the real situation. This is motivated by management's desire to maintain the company's reputation and position, as disclosure of financial difficulties could cause reputational damage and the potential loss of their position (Campa & Camacho-Miñano, 2015; Lara et al., 2009; Li et al., 2020; Xu et al., 2021).

In crisis conditions, management deliberately informs stakeholders that the company they manage is experiencing financial difficulties. This will attract the interest of stakeholders, especially the government, to save the company, considering that if the company goes bankrupt, the country's economy will decline. Therefore, the government is encouraged to provide support to companies by providing compensation and incentives so that they do not go bankrupt. Therefore, during a crisis, management often takes advantage of this opportunity to obtain compensation and incentives from the government to improve company performance after the crisis (Dimitras et al., 2015; Heba Ali et al., 2022; Kumar & Vij, 2017; Oskouei & Sureshjani, 2021; Strobl, 2013). Based on existing research results, under normal circumstances, it is only companies experiencing financial difficulties that manipulate their financial reports. However, during a crisis, both companies experiencing and not experiencing financial distress tend to make accounting misstatements.

This study aims to expand current academic knowledge by investigating the effect of the COVID-19 pandemic on the relationship between financial distress and accounting misstatements. The COVID-19 pandemic provides an excellent opportunity for company executives, especially those operating in the property and real estate sector, to receive government compensation and incentives. They would inform the government that their companies are in financial distress to obtain better compensation and incentives (Dimitras et al., 2015; Heba Ali et al., 2022; Kumar & Vij, 2017; Oskouei & Sureshjani, 2021; Strobl, 2013). This study focuses on analysing the effect of the COVID-19 pandemic on the relationship between financial distress and accounting misstatements. It is hoped that the results of this study will provide a deeper understanding of the motivation and objectives of company management in making accounting misstatements, thereby enabling stakeholders to make better decisions regarding the compensation and incentives provided to companies affected by the COVID-19 pandemic.

Financial distress is a nightmare for stakeholders, especially investors and creditors, because both of them will experience the biggest losses. As a result, investors will agree to a deal with management in the form of relatively large incentives. These large incentives are expected to motivate and encourage management to exert its best efforts to facilitate sustainable company growth and mitigate the risk of financial distress. However, some managers sometimes even make bad decisions that endanger the company financially. Apart from causing a company to go bankrupt, financial distress can also cause damage to management's reputation, reduced bonuses and loss of position due to being replaced by new management who has better performance (Liberty & Zimmerman, 1986).

2. THEORITICAL FRAMEWORK AND HYPOTHESIS

According to Rosner (2003), when a company is in financial distress, the management will carry out earnings management by increasing revenue. This is also supported by Y. Chen et al. (2010); Campa & Camacho-Miñano (2015); Li et al. (2020); and Xu et al. (2021) that companies experiencing financial distress tend to carry out earnings management by increasing revenue to avoid delisting and special government supervision. Bartov et al. (2001) state that the information provided by management must meet investors' expectations. Financial distress is a heavy pressure for management. This requires management to consistently strive to convey information that is in line with investors' expectations. Management must ensure that it can get a good response from investors. Otherwise, management will have to bear very high costs (Graham et al., 2005). As a result, the company's management will likely make an accounting misstatement. However, according to Agrawal & Chatterjee (2015) and Habib et al. (2013), when the company is in financial distress, the company's management will carry out earnings management by reducing profit. This statement is also supported by Charitou et al. (2007) that companies in financial distress will reduce their income before declaring bankruptcy. Although previous studies have provided conflicting results, several studies have concluded that financial distress has an effect on accounting misstatements. Therefore, the first hypothesis proposed in this study is:

H_1: Financial distress has a significant effect on accounting misstatements.

Strobl (2013) claims that earnings management tactics will increase during an economic downturn. According to Cohen & Zarowin (2010), Dimitras et al. (2015); Heba Ali et al. (2022); Kumar & Vij (2017); and Oskouei & Sureshjani (2021), most businesses usually earn relatively high profits when economic conditions run smoothly. It leads investors to believe that some company management may have the opportunity to commit accounting fraud by increasing income so that the management receives optimal incentives. Despite this assumption, investors choose not to question the integrity of financial statements in good business conditions. However, during a crisis or bad economic conditions, such as the Asian financial crisis in 1997, management also makes accounting misstatements by reducing company revenues. The management can renegotiate the debt, obtain better-term loans, and receive government assistance. In times of crisis, stakeholders will tolerate a decline in company profits, so management will take advantage of this opportunity to take a "big bath" so that the company can report a significant increase in performance after the crisis. Chia et al. (2007) support this statement by stating that management performs earnings management by reducing revenue during the crisis.

Moreover, implementing a strategic accounting practice during an economic downturn can allow management to present a substantial surge in profitability after the crisis, thereby enabling them to uphold their esteemed standing. As a result, under normal economic conditions, the management of companies in financial distress would make accounting misstatements by increasing income. In a crisis, the management of companies experiencing and not experiencing financial distress will reduce their company's income to apply the "big bath" concept. The second hypothesis proposed in this study is:

H_2: The COVID-19 pandemic moderates the effect of financial distress on accounting misstatements.

3. RESEARCH METHOD

The primary objective of this study is to examine the effect financial distress on accounting misstatement and to find out whether the COVID-19 pandemic is able to moderate the relationship between financial distress and accounting misstatement. The hypotheses mentioned above are examined through quantitative and statistical methodologies. This study uses three distinct types of variables: accounting misstatement as the dependent variable, financial distress as the independent variable, and the COVID-19 pandemic as the moderating variable. The accounting misstatement is quantified using the F-Score model introduced by Dechow et al. (2011), which draws upon the scholarly work of Beneish (1999). The primary factor under consideration is financial distress, which is evaluated using the Z-score model established by Altman (1968). In this study, the COVID-19 pandemic is assessed using a binary variable. This variable is assigned a value of 1 for firm-year observations that fall within the designated COVID-19 pandemic period (specifically, 2020-2021) and 0 for observations outside of this period. It was hypothesized that the financial statements for the period of 2020-2021 would exhibit the impact of the COVID-19 pandemic, as indicated by the Indonesian government's announcement of the initial COVID-19 suspect on March 2, 2020 (Ratna Nuraini, 2020). This study includes several control variables such as company size, leverage, operating cash flow, audit quality, owner concentration, and sales growth. The purpose of using control variables is to manage and take into account potential factors that influence the relationship between variables, thereby ensuring the objectivity and integrity of research findings.

Table 1
The Definition of the Variables

Variables	Measurement	Previous Study
Dependent variable:		
Accounting Misstatement	Probability= $\frac{e(\text{Predicted Value})}{(1+e(\text{Predicted Value})}$ e= 2.71828183 Predicted Value= -7.893 + 0.790 × (RSSTAccrual) + 2.518 × (ch_{rec}) + 1.191 × (ch_{inv}) + 1.979 × (soft assets) + 0.171 × (ch_{cs})-0.932×(ch_{ROA}) + 1.029 × (issue)	(Dechow et al., 2011)
Independent variable:		
Financial Distress	Z-score=(1.2×X1)+(1.4×X2)+(3.3×X3)+(0.6×X4)+(1.0×X5)	(Altman, 1968)
Moderating variable:		
COVID-19 pandemic	Coded 1,if the firm period observation during Covid-19 pandemic are 2020 and 2021,0 otherwise	(Chintrakarn et al., 2018)
Control variables:		
Company Size	Logarithm natural of total assets	(Dechow et al., 1996)
Leverage	Lev=(Total Debt)/(Total Assets)	(Dechow et al., 1996)
Operating Cash Flow	OCF=(Operating Cash Flow)/(Total Assets)	(Rusmin et al., 2014)
Audit Quality	Audit quality coded 1 if the firm observations are audited by Big 4 auditors, 0 otherwise	(Sumiadji et al., 2019)
Owner Concentration	A dummy variable coded 1 if the percentage of shareholding by the top shareholder exceeds 50 percent, 0 otherwise	(He, 2012)
Sales Growth		(Alia et al., 2020)

Source: Various Literature (2022)

This study uses secondary data obtained from the company's financial statements and stock price information sourced from the Yahoo Finance website. The study aims to analyze various factors that may impact financial performance in accounting. These factors include accounting misstatement, financial distress, company size, leverage, operating cash flow, audit quality, owner concentration, and sales growth. The data about these factors will be collected and analysed to gain insights into their influence on financial outcomes. This study uses a regression model to examine the proposed hypotheses. The model is subjected to statistical procedures, with the initial step involving an assessment of the accuracy of the regression model. The classical assumption test is conducted after selecting an appropriate regression model and is followed by the execution of regression analysis. The regression models presented are as follows:

Model 1:

$$AMit= \beta0+\beta1FD_{it}+\beta2SIZE_{it}+\beta3LEV_{it}+\beta4OCF_{it}+\beta5AQ_{it}+\beta6OC_{it}+\beta7SG_{it}+\varepsilon_{it}$$

Model 2:

$$AMit= \beta0+\beta1FD_{it}+\beta2COV_{it}+\beta3(FD_{it}*COV_{it})+\beta4SIZE_{it}+\beta5LEV_{it}+\beta6OCF_{it}+\beta7AQ_{it}+\beta8OC_{it}+\beta9SG_{it}+\varepsilon_{it}$$

The dependent variable in this study is accounting misstatement of company i in year t (AMit), while the independent variable is financial distress of company i in year t (FDit). The moderating variable is COVID-19 pandemic period of company i in year t (COVit). The control variables are size of company i in year t (SIZEit), leverage of company i in year t (LEVit), operating cash flow of company i in year t (OCFit), audit quality of company i in year t (AQit), owner concentration of company i in year t (OCit) and sales growth ratio of company i in year t (SGit).

The population of this study is property and real estate companies listed on the Indonesia Stock Exchange (IDX). Sample selection is carried out using the purposive sampling method. The following criteria are used to select samples using the purposive sampling method:

4. DATA ANALYSIS AND DISCUSSION

Based on Table 3a, the average value of accounting misstatements is 0.67 or below 1.00. This indicates that on average the entities included in the sample experience a reduced risk of accounting misstatement. Based on observations, the level of accounting misstatements in Metro Realty Tbk for the 2021 period is relatively low with a value of 0.13, less than 1.00. Metro Realty Tbk experienced financial distress from 2017 to 2019, or before the outbreak of the COVID-19 pandemic. However, from 2020 to 2021 the company was proven to consistently maintain a value below 1.22. The highest accounting misstatement of 1.58 (between 1.00 – 1.85) occurred at Fortune Mate Indonesia Tbk in 2017. This means that the accounting misstatement that occurred at Fortune Mate Indonesia Tbk in 2017 was above the risk normal, indicating that the company had consistent financial stability before and during the COVID-19 pandemic. Specifically, the company's financial difficulty level remained consistently above 2.99 from 2017 to 2019 and from 2020 to 2021. Fortune Mate Indonesia Tbk has managed to avoid financial distress for the last five years.

The average value of financial distress is 1.75 (between 1.22 and 2.99) which indicates that the average sample company is classified in the "grey" zone. The lowest financial distress value is 1.00 (< 1.22), and companies with this value are classified as in the "safe" zone. In 2017 there were 15 companies, in the 2018 period

Table 2
Sample Selection

Criteria of Sample Selection	Total
Properties & Real Estate companies listed on IDX as of December 31, 2021	81
Subtract:	
IPO between January 1, 2017, and December 31, 2021	(32)
companies' data is not suitable for this research	(20)
Total sample companies	29
Total samples during the observation period (5 years)	145

Source: Processed Data (2022)

there were 14 companies, in 2019 there were 15 companies, in 2020 there were 13 companies, and in 2021 there were 16 companies. Based on these findings, a value of 3.00 (higher than the threshold of 2.99) indicates the most severe level of financial distress. Companies with this level of financial difficulty can be categorized in the "distress" zone. In the period before the pandemic (from 2017 to 2019), there were six companies experiencing financial difficulties. However, a significant increase occurred during the COVID-19 pandemic from 2020 to 2021, with ten companies facing this pressure. Interestingly, the company that experienced the most severe financial distress in this research was Star Pacific Tbk in 2020. However, this company had a low risk of accounting misstatement. In this research, Roda Vivatex Tbk is also in the safest zone from financial distress and has a low risk of accounting misstatements.

This study uses a five-year period (2017-2021), where the 2017-2019 period represents the period before COVID-19 and the 2020-2021 period represents the period during the COVID-19 pandemic. Before and during the COVID-19 pandemic, sample companies showed moderate levels of financial distress. Likewise, for accounting misstatements, both before and during COVID-19, on average there is a low risk of accounting misstatements in the sample companies.

Table 3a
Descriptive Statistic Sample for Continuous Variables

Variable	Min	Max	Mean	Standard Deviation
Accounting Misstatement	0.13	1.58	0.67	0.21
Company Size (in millions of rupiah)	69,927	28,866,081	6,456,231	6,493,279
Leverage	0.00	0.57	0.16	0.15
Operating Cash Flow	-0.10	0.43	0.03	0.06
Sales Growth	-0.91	4.36	0.02	0.65

Source: Processed Data (2022)

Table 3b
Descriptive Statistic Sample for Financial Distress Variables

Year	Healthy (Z-score > 2.9)	Grey area 1.22 < Z-score < 2.9)	Go bankrupt (Z-score < 1.22)	Total
2017	15	9	5	29
2018	14	8	7	29
2019	15	9	5	29
2020	13	5	11	29
2021	16	4	9	29
Total	73	35	37	145
Percentage (%)	50.34	24.14	25.52	100

Source: Processed Data (2022)

Table 3c
Descriptive Statistic Sample for Financial Distress Variables

Variable	Modality	Frequency	(%)
COVID-19 pandemic	0	87	60.00
	1	58	40.00
Audit Quality	0	119	82.07
	1	26	17.93
Owner Concentration	0	95	65.52
	1	50	24.48

Source: Processed Data (2022)

Based on Table 4, there is no multi-collinearity between the variables used in this study. Even though the correlation coefficient between audit quality and the mature stage is 0.26, it is still below the threshold of 0.85. This shows that there is no multicollinearity between these variables as proven by the variance inflation factor (VIF) value below the threshold of ten (10), with the highest VIF value of 4.22.

Redundant fixed effects test, Hausman test, and Lagrange multiplier test are three statistical tests used in this study to ensure that the regression model is optimal, as depicted in Table 5. Based on empirical evidence, the random effects model shows the highest level of suitability as a regression model for both regression equations: model 1 and model 2.

Based on the information in Table 6, it can be seen that financial distress has no effect on accounting misstatements in property and real estate companies in Indonesia. This means that the first hypothesis (H1) in this study is rejected. There is no real evidence that financial distress has an effect on accounting missta-tements. Many organizational executives may use accounting misstatements to opti-mize benefits obtained, such as financial remuneration and corporate image. This is confirmed by the results of research conducted by Bartov et al. (2001) that a bad reaction will occur if the financial statements fail to meet shareholder expectations. Conversely, a positive reaction will occur if the expectations are met. This provides motivation for management to consistently provide information that meets shareholder expectations, even when the company is facing financial distress, because management may try to hide the situation.

Nevertheless, the findings of this study indicate that the motivation mentioned above does not apply to property and real estate firms operating in Indonesia. Property and real estate companies are subject to heightened scrutiny by the government due to their significant multiplier effect (Turyatini, 2017). This is intended to ensure the proper functioning of these companies and protect them from the risk of bankruptcy. If property and real estate companies face indicators of bankruptcy, such as financial turmoil, the government can offer stimulus measures and financial assistance to these companies. Therefore, companies facing financial distress do not need to make accounting misstatements. Companies fa-cing financial distress will adopt a strategic approach in presenting their financial reports to increase the prospects of getting better compensation and government assistance. Therefore, in property and real estate companies, financial distress has no effect on accounting misstatements. The results of this study support the results of research conducted by Asif et al. (2023) that financial distress has no effect on accounting misstatements in property and real estate companies.

Table 4
Correlation Matrix Coefficient

Variables	FD	COV	SIZE	LEV	OCF	AQ	OC	SG
FD	1.00							
COV	0.09	1.00						
SIZE	-0.12	0.01	1.00					
LEV	0.49	-0.09	0.25	1.00				
OCF	-0.36	0.03	0.33	-0.21	1.00			
AQ	-0.18	-0.01	0.31	0.10	0.03	1.00		
OC	-0.18	0.23	0.28	-0.34	0.06	0.19	1.00	
SG	0.11	0.05	0.07	0.01	0.18	-0.07	-0.04	1.00

Source: Processed Data (2022)

Table 5
Test Model Regression

Model	Redundant Fixed Effects Tests	Hausman Test	Lagrange Multiplier Test	Selected Model
Model 1	0.00	0.34	0.00	*Random Effect Model*
Model 2	0.00	1.00	0.00	*Random Effect Model*

Source: Processed Data (2022)

Table 6
Results of Regression Analysis

Variables	Model 1		Model 2	
	Coefficient	Sig.	Coefficient	Sig.
Independent variables:				
Financial Distress	0.01	0.69	0.02	0.46
Moderating Variables:				
COVID-19			-0.04	0.43
COVID-19*Financial Distress			-0.00	0.93
Control variables:				
Size	0.02	0.31	0.03	0.25
Leverage	-0.18	0.26	-0.25	0.12
Operating Cash Flow	-0.76	0.00***	-0.73	0.00***
Audit Quality	0.05	0.47	0.05	0.49
Owner Concentration	-0.06	0.32	-0.06	0.32
Sales Growth	-0.03	0.06*	-0.03	0.05**
R-square	12.12%		14.74%	
Prob(F-statistic)	0.01		0.01	
Observations	145		145	

Source: Processed Data (2022)

Based on the information in table 6, the COVID-19 pandemic is unable to moderate the relationship between financial distress and accounting misstatements. Thus the second hypothesis (H2) in this study is also rejected.

The COVID-19 pandemic is not effective in mitigating the impact of financial difficulties on accounting misstatements. Previous research suggests that during crises, organizational leadership may engage in accounting misstatements to obtain financial compensation and incentives from the government (Ahmed et al., 2008; L. Chen et al., 2018). Nevertheless, it is worth noting that the crisis caused by the COVID-19 pandemic has not caused property and real estate companies in Indonesia to make accounting misstatement. This observation applies especially to companies facing financial difficulties. The reason for the importance of the intervention strategy implemented by the government in Indonesia is the high multiplier effect demonstrated by property and real estate companies (Bank Indonesia, 2021; Kementrian Bidang Perekonomian Republik Indonesia, 2022). Before and during the COVID-19 pandemic, management of companies, especially those facing financial distress, tended to provide related financial report data. This may be due to their lack of motivation to engage in making accounting misstatements. The findings of this study can be explained through the lens of prospect theory, which states that when an entity is in favorable conditions, it tends to show risk aversion. In contrast, newly founded organizations will show a greater tendency to take risks when they are in a financial deficit (Kahneman & Tversky, 1979). Therefore, the COVID-19 pandemic does not moderate the relationship between financial distress and accounting misstatements in property and real estate companies in Indonesia.

5. CONCLUSION, IMPLICATION, SUGGESTION AND LIMITATION

This study aims to examine the effect of financial distress on accounting misstatements and to find out whether the COVID-19 pandemic moderates the relationship between financial distress and accounting misstatements. The results of this study show that financial distress has no effect on accounting misstatements. In addition, the COVID-19 pandemic does not moderate the relationship between financial distress and accounting misstatement. This suggests that the motivation of management to engage in accounting misstatements is not always to maintain their reputation in the eyes of stockholders. In companies that have a high multiplier effect, management feels that their position will be safe, whatever happens to the company they manage. This means that management does not have to hide the company's performance or conduct accounting misstatements.

It is hoped that the findings of this study can serve as supplementary academic literature regarding the motivation of management in engaging in accounting misstatements. It can also be used to explain the inconsistency of previous research results, where companies that have high bargaining power with the government will produce higher quality financial statements that are free from accounting misstatement practices. The limitation of this study is that it only uses a sample of property and real estate companies. It is recommended that further research use data from the top three company sectors that have the highest multiplier effect in Indonesia that are affected by the COVID-19 pandemic.

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