

The Influence of Financial Distress, Leverage, and Free Cash Flow on Earnings Management

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ABSTRACT

This study aims to determine the effect of financial distress, leverage, and free cash flow on earnings management in non-bank state-owned companies listed on the Indonesia Stock Exchange (IDX) in 2020-2023. The population in this study were non-bank state-owned companies listed on the Indonesia Stock Exchange in 2020-2023. The sampling method used was the purposive sampling method, obtaining a sample of 18 companies with 4 years of observation. The independent variables in this study are financial distress, leverage, and free cash flow and the dependent variable in this study is earnings management. The data collection method uses secondary data taken from the annual financial reports from the official IDX website www.idx.co.id. This study uses a quantitative approach, and the data analysis method used is statistical analysis and multiple linear regressions using the SPSS computer program. The results of the study indicate that earnings management is influenced by financial distress, leverage, and free cash flow simultaneously. The results of the study indicate that financial distress does not have a significant effect on earnings management, leverage does not have a significant effect on earnings management, and free cash flow has a significant effect on earnings management.

INTRODUCTION

Financial reports are a form of report that describes the financial condition of a company during a desired time period and functions as a medium for conveying information regarding the company's movements, especially in the financial sector as a form of accountability to external parties (Kartika et al., 2023). Financial Accounting Standards Statement Article 1 Paragraph 1 (2015) "Financial statements are a structured presentation of the financial position and financial performance of an entity. This report presents the history of the entity in the form of monetary values. An important element in financial statements to assess management performance is profit information. Profit information is the main focus in evaluating management performance, which can encourage manipulation of financial statements commonly known as profit management (Manurung and Isyuardhana, 2016).

Managers that alter financial reports for their own or the company's advantage are said to be engaging in earnings management (Dianty, 2021). When utilized as a foundation for decision-making, earnings management practices have the potential to undermine the reliability of financial reports. Earnings management is one method of altering the company's financial reports for managers and outside parties (Kodriyah and Fitri, 2017).

Earnings management is often used by Indonesian companies, even state-owned ones. Article 1 paragraph 2 of Law No. 19 of 2003 concerning State-Owned Enterprises states that the Republic of Indonesia owns all or at least 51% of the shares in state-owned enterprises, which are limited liability companies, with the main objective of generating profits, therefore the management of state-owned companies is often involved in earnings management.

The practice of profit management in state-owned companies occurred at PT Waskita Karya Tbk, which is suspected of manipulating its financial reports. Deputy Minister of SOEs II, Kartika Wirjoatmodjo, in a working meeting of Commission VI of the Indonesian House of Representatives on June 6, 2023, stated that the financial report of PT Waskita Karya Tbk did not reflect the actual conditions. The company's financial report shows that it is always profitable, even though the company's cash flow has never been positive. BPKP suspects that the manipulation of PT Waskita Karya's financial reports has been carried out for a long time. It is said that there have been unreasonable financial reports since 2016. The alleged manipulation of Waskita has been investigated by the Ministry of SOEs, if manipulation does occur, the SOE will provide guidance to the management that reports the financial reports for that period (cnnindonesia.com, 2023).

A fake project worth IDR 10.5 billion contracted by Waskita Beton's subcontractor for the construction of the Sheikh Mohammed bin Zayed toll road, the Jakarta-Cikampek (Japek) elevated toll road, and the Cikunir-Karawang Barat Elevated Section II showed manipulation of Waskita's financial reports. Waskita Beton Precast's operational director, Bambang Rianto, claimed that the fake project worth IDR 10.5 billion was created in response to a request from the Financial Supervisory Agency (BPK), which at

that time found several problems with the MBZ toll road construction project. In 2021, the fake project was completed by repairing the toll road (Kompas.com, 2024).

The case of profit management that occurred in state-owned companies can reflect that the practice of profit management in Indonesia is still relatively high, especially in state-owned companies, because by having a high public burden, state-owned companies are required to achieve profits, thus presenting a major challenge in maintaining a balance between profits and social responsibility (Christabel and Bangun, 2020).

Financial distress is one of the problems that can affect earnings management Mustika et al. (2020) the financial status of a company that worsens from year to year is generally referred to as financial distress. Delays in paying debts to banks and other financial institutions or declining product quality are examples of this condition assessment. Earnings management is the company's main strategy to overcome financial difficulties. Company management is under pressure to increase revenue in order to get out of the current financial situation. According to a number of previous studies, financial distress has an impact on earnings management (Mustika et al., 2020; Tsaqif & Agustiniingsih, 2021; Damayanti & Krisnando, 2021). Research conducted by Sucipto & Zulfa (2021), Irawan & Apriwenni, Melinda & Widyasari (2019), shows that earnings management is not affected by financial distress.

Leverage or the ratio of total liabilities to total assets of the company, is another factor that may influence earnings management decisions. A high debt ratio will have an impact on earnings management strategies. High leverage levels are caused by excessive debt relative to the Company's assets (Sulfitri & Radyansah, 2024). Leverage has an impact on earnings management, according to research by Musdjalifah et al. (2024), Radyansah and Sulfitri (2024), and Hakim et al. (2023). Different from research by Christi et al. (2022) and Nirmalasari et al. (2022), showing that leverage has no effect on earnings management.

One of the elements influencing earnings management is free cash flow. After accounting for investments in new fixed assets and increases in working capital required to sustain the company's growth, free cash flow is the amount of money that remains available to be disbursed to investors, including shareholders and bondholders. Businesses having a lot of free cash flow are more likely to be able to increase reported profits through earnings management Dianty (2021). Free cash flow has an impact on earnings management, according to research by Putrquitha & Vivianti (2023), Dianty (2021), Christi et al. (2022), and Watriani & Serly (2021). According to research by Radyansah and Sulfitri (2024) and Valencia and Trisnawati (2022), free cash flow has no effect on earnings management.

LITERATURE REVIEW

Agency Theory

Jensen and Meckling (1976) developed agency theory to explain the contractual relationship between management (agent) and company shareholders or investors (principals). Earnings management activities can be

explained by agency theory. Agency theory explains the relationship between agent and principal, which arises when there is a contract in which the principal employs another party (agent) to perform a service. This theory highlights the dynamics in the relationship between the agent, who acts on behalf of the principal, and the principal himself, who has expectations of the agent's behavior in carrying out his duties (Melinda & Widayarsi, 2019).

Agency theory can be interpreted as the concept of the relationship between the principal in the form of shareholders and agents in the form of managers who organize a job. Decisions made by company management can be influenced by differences in interests between shareholders and management (Sari et al., 2023). More information tends to be owned by agents than principals because management is directly involved in managing the company. Management has greater access to internal company information, this can cause an imbalance of information, known as information asymmetry (Arthawan & Wirasedana, 2018).

Earnings Management

One management practice that might affect the profit numbers in a business's financial statements is earnings management (Ambarsari, 2021). One management practice that might affect the profit numbers in a business's financial statements is earnings management (Valencia & Trisnawati, 2022). The actions of company management in manipulating the size of company profits are aimed at obtaining personal gain and gain for the company (Yuliani Almalita, 2022). There are two views on earnings management. Some consider it a form of fraud, while others argue that it cannot be called fraud because the changes made are in accordance with applicable accounting standards. This practice can encourage opportunistic behavior in order to obtain compensation and bonuses, avoid political costs and debt contracts, and influence the capital market by taking advantage of the flexibility of available information (Irawan & Apriwenni, 2021).

There are several patterns and techniques in carrying out profit management, including (Taking a Bath) recognizing costs in the future period in the current period, (Income Maximization) maximizing profits with the aim of getting a large bonus, (Income Minimization) minimizing profits when the company's profitability is very high and (Income Smoothing) reporting a stable profit growth trend (Prasadhita & Intani, 2017).

Financial Distress

Financial distress is a condition where a company is in a declining financial condition, and if this condition is not handled well, there is a high possibility that bankruptcy will occur in a company (Putri & Huda, 2023). Most companies in Indonesia will definitely face a difficult financial situation because they do not have enough income to run their activities and fail to meet their financial obligations (Tsaqif & Agustiningsih, 2021). The increasingly severe level of financial distress requires companies to continue to evaluate their management performance and if it is assessed that management performance in dealing with this condition is getting worse, the company will rotate or replace

management (Mustika et al., 2020). Companies experiencing financial distress make management carry out profit management to protect the interests of shareholders (Tsaqif & Agustiniingsih, 2021). Excessive profit management without considering the negative impacts in the future will cause the company's quality to decline (Sari et al., 2023).

Leverage

The ability of the business to pay off short- and long-term debts and financial commitments is demonstrated by the leverage ratio. A business is considered to have a high level of leverage if it has more debt than capital (Sulfitri & Radyansah, 2024). High risk and leverage are indicators of high return expectations that financial managers need to carefully assess. Leverage ratios are used by businesses, among other things, to assess their current state in relation to their debts to creditors. Evaluating the company's capacity to fulfill fixed commitments, like loan instalments with interest, is the second goal. to determine the extent to which the company's assets are financed by debt (Dambe et al., 2023).

Free Cash Flow

The amount of cash available after a business has invested in additional assets and working capital needed for growth is called free cash flow. This free cash flow can be given to investors such as shareholders and bondholders (Dianty, 2021). Companies that have free cash flow can overcome difficult situations because they have the ability to invest and bear capital expenditures that ensure the continuity of the company's operations. Strong free cash flow also provides a positive signal to investors because it indicates good performance and greater availability of funds for dividend payments (Yuliani Almalita, 2022). Companies that have high free cash flow tend to be considered to have better performance compared to other companies. The excess cash can be used for various purposes that support the growth and stability of the Company (Grimonia & Destriana, 2023). Conversely, the smaller a company's free cash flow, the worse investors see it because the income earned or revenue from business activities is smaller than expenses.

Theoretical Framework

Based on a review of the literature and previous research, the framework of thought in this research is:

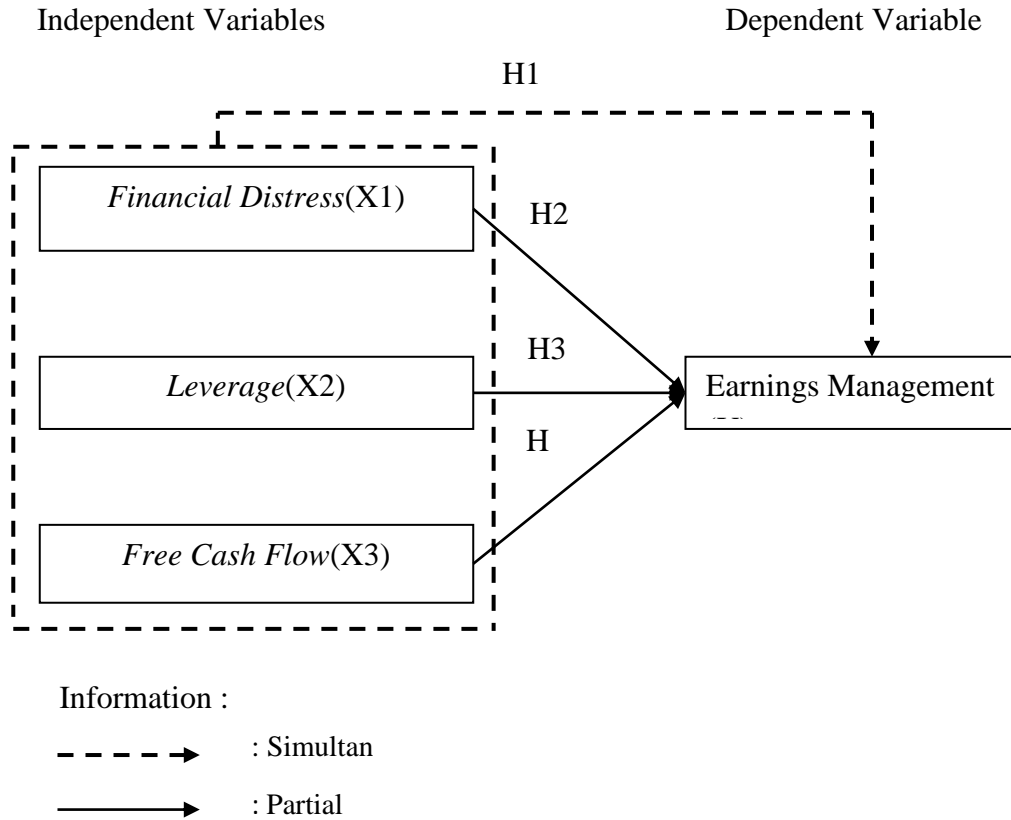


Figure 1. Theoretical Framework

METHODOLOGY

This quantitative study included non-bank state-owned enterprises that were listed on the Indonesia Stock Exchange between 2020 and 2023. Purposive sampling was used to choose samples from 18 companies over the course of four years of observation. For the sample, the following standards were applied:

Table 1 Purposive Sampling Method

No.	Information	Amount
1.	Non-Bank State-Owned Companies listed on the Indonesia Stock Exchange in the 2020-2023 period.	20
2.	Non-Bank BUMN companies that do not consecutively present financial reports in the 2020-2023 period.	(0)
3.	Non-Bank BUMN companies that do not have complete information regarding the variables tested in the study.	(2)
	Number of samples selected	18
	Observation for 3 years (18 x 4 years)	72

Source: Processed data, 2024

RESEARCH RESULT

Transformed and outlier data were used in this study. The amount of data used was reduced to 69 after removing outlier data.

Table 2. Descriptive Statistics
Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
Profit Management	69	-.28	.42	-.0048	.10563
Financial Distress	69	-8.86	7.14	1.5303	2.75573
Leverage	69	.00	1.35	.6419	.25098
Free Cash Flow	69	-.22	.57	.1029	.13274
Valid N (listwise)	69				

Source: SPSS Output

The following is an explanation of each variable:

1. The earnings management variable (Y) has a standard deviation of 0.10563 and an average of -0.0048. PT Garuda Indonesia recorded the highest value of 0.42 in 2022, while PT Telekomunikasi Indonesia recorded the lowest value of -0.28.
2. The financial distress variable (X1) has a mean value of 1.5303 and a standard deviation of 2.75573. In 2022, it had a minimum value of -8.86 at PT. Waskita Beton Precast and a maximum value of 7.14 at PT. Bukit Asam.
3. The leverage variable (X2) has an average value of 0.6419 and a standard deviation value of 0.25098. The minimum value is 0.00 at PT. Gas Negara in 2020, and the maximum value is 1.35 at PT. Waskita Beton Precast in 2022.
4. The free cash flow variable (X3) has a minimum value of 0.22 at PT. Jasa Marga in 2020. The maximum value is 0.57 at PT. Bukit Asam 2021. The average value is 0.1029 with a standard deviation of 0.13274.

Normality Test

To ascertain whether the regression model's residuals have a normal or nearly normal distribution, the normality test is performed. Relatives with a normal or nearly normal distribution and a significance probability value greater than 0.05 are indicative of a solid regression model. The Kolmogorov-Smirnov (KS) test is used to analyze the data for the normalcy test.

Table 3. Normality Test
One-Sample Kolmogorov-Smirnov Test

		Unstandardized Residual
N		69
Normal Parameters ^{a,b}	Mean	.0000000
	Std. Deviation	.04188188
Most Extreme Differences	Absolute	.101
	Positive	.075
	Negative	-.101
Test Statistics		.101
Asymp. Sig. (2-tailed)		.079c

Source: SPSS Output

The Kolmogorov-Smirnov test findings are displayed in Table 3 with the 2-tailed Asymp. Sig. value of 0.079 greater than 0.05. This demonstrates the normal distribution of the data and the validity of the data normalcy test.

Multicollinearity Test

Table 4. Multicollinearity Test

Model		Collinearity Statistics	
		Tolerance	VIF
1	(Constant)		
	Financial Distress	.468	2.136
	Leverage	.556	1,800
	Free Cash Flow	.782	1,279

Source: SPSS Output

According to Table 4, the independent variables utilized have a VIF < 10 and a tolerance value ≥ 0.10. This demonstrates that the regression model does not have a multicollinearity issue.

Heteroscedasticity Test

The Glejser Test was used to perform the heteroscedasticity test in this investigation. Heteroscedasticity issues are not present in the regression model if the variable's significance probability value is more than 5% (sig > 0.05).

Table 5. Heteroscedasticity Test
Coefficientsa

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	.136	.081		1,682	.097
	Financial Distress	.003	.010	.053	.295	.769
	Leverage	.012	.028	.069	.424	.673
	Free Cash Flow	-.102	.072	-.195	-1.414	.162

Source: SPSS Output

As shown in Table 5, there is no heteroscedasticity problem in the regression model because the independent variables have significance values above 0.05.

Autocorrelation Test

Test Autocorrelation in this study uses the Durbin Watson test, which states that there is no autocorrelation if $du < dw < 4 - du$.

Table 6. Autocorrelation Test
Model Summaryb

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.380a	.145	.105	.04284	2,078

Source: SPSS Output

The DW table with 3 independent variables and 69 samples is compared, showing that the dl value is 1.5205, the du value is 1.7015, the 4-du value is 2.2985, and the DW value is 2.078, so it can be concluded that there is no autocorrelation problem in the regression model ($1.7015 < 2.078 < 2.2985$).

Multiple Linear Regression Test

Table 7. Multiple Linear Regression Test
Coefficients^a

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	1,560	.116		13,422	.000
	Financial Distress	.004	.014	.042	.250	.803
	Leverage	-.022	.040	-.086	-.556	.580
	Free Cash Flow	-.296	.104	-.372	-2.864	.006

Source: SPSS Output

1. The constant is 1.560, which means that if the independent variable has a value of 0, then earnings management has a value of 1.560.
2. The regression coefficient of the financial distress variable is 0.004, indicating that every one level increase in the financial distress variable will increase earnings management by 0.004.
3. The regression coefficient of the leverage variable is -0.022 (negative), indicating that every one level increase in the leverage variable will reduce earnings management by 0.022.
4. The regression coefficient of the free cash flow variable is -0.296 (negative), indicating that every one-level increase in the free cash flow variable will reduce earnings management by 0.296.

F Test (Simultaneous)

Table 8. F Test (Simultaneous)
ANOVA

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	.020	3	.007	3,660	.017b
	Residual	.119	65	.002		
	Total	.139	68			

Source: SPSS Output

The simultaneous impact of financial hardship, leverage, and free cash flow on earnings management is demonstrated in Table 8; the significance value of 0.017 is less than 0.05, and the F-count value of 3.660 is higher than the F-table of 2.746 (H1 is accepted).

T-Test (Partial)Table 9. t-Test (Partial)
Coefficients^a

Model		Unstandardized Coefficients		Standardized	t	Sig.
		B	Std. Error	Coefficients Beta		
1	(Constant)	1,560	.116		13,422	.000
	Financial Distress	.004	.014	.042	.250	.803
	Leverage	-.022	.040	-.086	-.556	.580
	Free Cash Flow	-.296	.104	-.372	-2.864	.006

Source: SPSS Output

1. The financial distress variable (X1) has no influence on earnings management because the t-value is 0.250 and the significance value is $0.803 > 0.05$ (H2 is rejected).
2. The leverage variable (X2) has no influence on earnings management because the t-count value is -0.556 with a significance value of $0.580 > 0.05$ (H3 is rejected).
3. The free cash flow variable (X3) on earnings management is -2.864 with a significance value of $0.006 < 0.05$. It can be concluded that free cash flow has an effect on earnings management (H4 is accepted).

Coefficient of Determination (R²)

Table 10. Determination Test

Model Summary				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.380a	.145	.105	.04284

Source: SPSS Output

The variables of financial distress, leverage, and free cash flow can influence 10.5% of the amount of earnings management, according to Table 10's Adjusted R Square value derived from the coefficient of determination of 0.105. 10.5%, or 89.5%, of the total was accounted for by other factors that were not part of the regression analysis employed in this study.

DISCUSSION***The Influence of Financial Distress, Leverage, and Free Cash Flow on Earnings Management***

According to the test findings in Table 7, the significance value is $0.017 < 0.05$ and the F-count value is 3.660. These findings suggest that, in non-bank state-owned enterprises listed on the Indonesia Stock Exchange between 2020 and 2023, the variables of financial distress, leverage, and free cash flow all significantly impact earnings management at the same time. PT. Indofarma in 2023 is the company with the highest amount of leverage and financial distress (bankrupt) situations, according to the data collected. High leverage means that the company has a large amount of debt, and financial distress suggests that the

company's financial situation is deteriorating. High-leverage companies in financial crisis (bankruptcy) will motivate management to make changes to earnings in order to preserve the company's image. This study is in line with research (Putri & Syamsul Huda, 2023) And (Sagala & Simbolon, 2021).

The Influence of Financial Distress on Earnings Management

Findings Table 8 demonstrates that the financial distress variable (X1), as measured by the z-score, has a t-value of 0.250 and a significance value of $0.803 > 0.05$ ($\alpha = 5\%$). These findings suggest that, among non-bank state-owned enterprises listed on the Indonesia Stock Exchange between 2020 and 2023, financial difficulty has no discernible impact on earnings management. The study's findings demonstrate the invalidity of the second hypothesis. The goal of this study is to lessen agency issues between shareholders, debtors, and management as agents, in accordance with agency theory. As a result, studies that use Altman's modified z-score as a measure of financial distress do not find that it significantly affects earnings management. This research is not in line with research conducted by (Watriani & Serly, 2021), (Mustika et al., 2020) which states that financial distress has an effect on earnings management.

The Effect of Leverage on Earnings Management

The leverage variable (X2), represented by the DAR value of -0.556, has a significance value of 0.580 and a t-count value of -0.556, both of which are greater than 0.05 ($\alpha = 5\%$). The third hypothesis is rejected, according to the study's findings. For non-bank state-owned businesses listed on the Indonesia Stock Exchange between 2020 and 2023, leverage has no bearing on how their earnings are managed. Businesses that have a lot of debt may fail, but earnings management cannot stop debt obligations from being fulfilled, hence it cannot be used to prevent default. Strict oversight by other parties might lessen the possibility that management will use earnings management. According to previous studies, Christi et al. (2022), Lestari et al. (2023), and Albert & Widyastuti (2019) found that leverage does not affect earnings management. In contrast, research conducted by Musdjalifah et al. (2024), Hakim et al. (2023), and Radyansah & Sulfitri (2024), found that leverage affects earnings management.

The Influence of Free Cash Flow on Profit Management

The free cash flow variable (X3) has a t-value of -2.864 and a significance value of $0.006 < 0.05$ ($\alpha = 5\%$), according to the test results in Table 8. These findings suggest that, among non-bank state-owned enterprises listed on the Indonesia Stock Exchange between 2020 and 2023, the free cash flow variable has a negative impact on earnings management. The fourth hypothesis is approved based on these results. Managers of businesses should work to improve their free cash flow since it plays a significant role in assessing a company's worth. Because it has more money to pay dividends and settle obligations, a company with more free cash flow is healthier. Additionally, businesses with less free cash flow are viewed as unhealthy. Companies will be more motivated to implement earnings management to show good

performance to investors when operating cash flow is low. This study is consistent with previous studies showing that free cash flow affects earnings management, as shown by (Putriquitha & Vivianti, 2023), (Yuliani Almalita, 2022), and (Christabel & Bangun, 2020). Other studies that are not in line with (Radiansah & Sulfitri, 2024) found that free cash flow does not affect earnings management.

CONCLUSION AND RECOMMENDATIONS

1. The management of earnings in non-bank state-owned enterprises listed on the Indonesia Stock Exchange between 2020 and 2023 is significantly impacted by financial distress, leverage, and free cash flow variables all at the same time. Financial distress, debt, and free cash flow can all have an impact on earnings management, according to the Adjusted R Square value of 10.5%. Other factors not covered by the regression analysis utilized in this study account for 89.5% (100%-10.5%).
2. Earnings management of non-bank state-owned enterprises listed on the Indonesia Stock Exchange in 2020–2023 is not significantly impacted by the financial distress variable. This clarifies the fact that businesses in financial trouble won't always support earnings management.
3. The management of earnings in non-bank state-owned enterprises listed on the Indonesia Stock Exchange between 2020 and 2023 is not significantly impacted by leverage variables. High debt levels will make the company more likely to default, but earnings management cannot be utilized as a way to prevent default because it cannot stop debt obligations from being fulfilled.
4. Earnings management in non-bank state-owned enterprises listed on the Indonesia Stock Exchange between 2020 and 2023 is significantly impacted by the free cash flow variable. This demonstrates how a company's desire to manipulate profits in order to provide a positive image to investors is heightened by poor operating cash flow.

ADVANCED RESEARCH

Further researchers are advised to replace the independent factors studied with other factors that can affect earnings management, such as profitability, managerial ownership, company size, and so on. Further researchers are also advised to expand their research samples to include more companies with longer observation years.

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