

The influence of leverage, company size, audit committee, free cash flow, and managerial ownership on earnings management

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ABSTRACT

This research analyzes the influence of leverage, firm size, audit committee, free cash flow, and managerial ownership on earnings management, which is the objective of this study. The sample selection method uses purposive sampling techniques on the Indonesia Stock Exchange (IDX) during the 2020-2022 period. The sample consists of 130 companies with a total of 390 data points. The data analysis technique used is multiple linear regression with SPSS version 25. The results of the study provide empirical evidence that firm size and managerial ownership affect earnings management, while leverage, audit committee, and free cash flow do not affect earnings management.

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1. Introduction

Financial statements are crucial records of information that provide an overview of a company's financial performance over a specific period. A good financial statement should provide relevant, reliable, and fair information to stakeholders. Financial statements serve as a means of communication linking the company to its stakeholders. Financial statements must be presented correctly in accordance with Financial Accounting Standards (FAS) Statement No. 1 (2021). The financial statements consist of the balance sheet, income statement, statement of changes in equity, cash flow statement, and notes to the financial statements. These reports help stakeholders evaluate the company's performance, make investment decisions, and assess the company's capabilities.

The variables Leverage, Company Size, Audit Committee, Free Cash Flow, and Managerial Ownership are selected for their significant roles in influencing financial reporting practices, particularly in earnings management. Higher leverage may incentivize management to engage in earnings management to meet debt covenants and avoid default. Larger companies often face greater scrutiny and possess more resources for earnings management, influencing how financial results are reported. An effective audit committee can provide strong oversight and reduce the likelihood of earnings management through rigorous review and control mechanisms. Companies with excess free cash flow may engage in earnings management to present a stable and positive financial outlook. Higher managerial ownership aligns manager interests with shareholders, potentially reducing incentives for earnings management to manipulate stock prices.

Profit information in financial statements provides an overview of how well a company has succeeded in generating profit from its business activities. Profit information is essential for stakeholders in making decisions, such as investors and company management in making strategic decisions and evaluating the financial performance of an entity. This encourages company management to take actions known as earnings management.

Sarah et al., (2023) define earnings management as efforts made by managers to manipulate financial statements with the aim of deceiving stakeholders about the company's performance and condition. Therefore, earnings management actions represent managerial intervention in the financial reporting process with self-serving objectives, such as receiving bonuses for perceived good managerial performance.

One case of earnings management in accounting reporting occurred with PT Tiga Pilar Sejahtera Food Tbk (AISA). In the 2017 financial statements, Joko and Budhi overstated receivables, inventory, and fixed assets to impress an increase in the company's sales, making the fundamentals of PT Tiga Pilar Sejahtera Food Tbk appear to be growing. An investigative audit conducted by Ernst and Young found an overstatement of IDR 4 trillion. This overstatement occurred through transactions with affiliated parties. Overstatements were also found in revenue by IDR 662 billion and in earnings before interest, tax, depreciation, and amortization (EBITDA) by IDR 329 billion (cncbindonesia.com).

Previous research has discussed several factors that influence earnings management, both financial and non-financial. This research focuses on five factors: leverage, firm size, audit committee, free cash flow, and managerial ownership.

The first factor influencing earnings management in a company is leverage. Sarah et al., (2023) explain that leverage is a source of funding obtained from external parties in the form of debt. To determine whether a company has good performance, it can be seen from the amount of debt it holds. The greater the debt, the higher the risk faced by investors. The higher the company's debt, the greater the desire of managers to manipulate earnings by increasing revenues to make the company appear to be in good condition. Studies by Apriliani et al (2019) and Sari & Susilowati (2021) provide empirical evidence that leverage affects earnings management.

Another factor influencing earnings management is firm size. Sari & Susilowati (2021) state that smaller companies have greater pressure to show positive performance, which may lead to earnings management because smaller companies want to present their condition as always good. Conversely, larger companies have more financial resources that can minimize pressure in earnings management practices because they can rely on their operational performance and stronger monitoring structures that help detect suspicious financial activities. Studies by Fajriana, (2023) and Susanti et al., (2022) provide empirical evidence that firm size affects earnings management.

The next factor influencing earnings management is the audit committee. Perdana (2019) explains that the audit committee is expected to maintain better corporate governance and maximize the financial statement review process, thus protecting the owners and other stakeholders. The audit committee prevents managers from manipulating financial statements, leading to biased or inaccurate financial information. The audit committee plays a role in enhancing the transparency and accountability of the company regarding earnings management. Studies by (Sari & Susilowati, 2021) and (Perdana, 2019) provide evidence that the audit committee affects earnings management.

Another factor influencing earnings management is free cash flow. Free cash flow represents the extent to which a company can generate cash flow from its operational activities. Companies make efforts to enhance their image by manipulating earnings through changes in expense estimates, sales, and assets. This can harm the company because the financial statements are not managed wisely, creating discrepancies between reported earnings and actual cash flow. Studies by (Putriquitha & Vivianti, 2023) and (Hardirmaningrum et al., 2021) provide empirical evidence that free cash flow affects earnings management.

The last factor influencing earnings management is managerial ownership. (Riska Astari & Suputra, 2019) explain that managerial ownership represents shares of the company owned by top management. Managers with significant shareholdings will manage earnings to appear higher, potentially increasing the value of their shares and providing significant incentives. Conversely, low managerial ownership may engage in earnings management to meet performance targets. The study by (Riska Astari & Suputra, 2019) provides empirical evidence that managerial ownership negatively affects earnings management.

This research is a development of the study by (Susanti et al., 2022). This updated research adds three independent variables: audit committee, free cash flow, and managerial ownership. The addition of the audit committee variable is due to its role in minimizing the risk of earnings management and enhancing corporate transparency and accountability. The inclusion of free cash flow is to check whether earnings management is conducted to improve actual cash flow or to create a better performance. The addition of the managerial ownership variable is because managers as internal supervisors promote transparency and accountability. Managerial ownership acts as an internal supervisor between shareholders and management, potentially increasing the integrity of financial reporting and reducing earnings management practices. The second novelty of this research is expanding the observation scope to non-financial companies listed on the Indonesia Stock Exchange (IDX) during the 2019-2021 period.

2. Research Methods

This research adopts a quantitative approach with a statistical framework. The study utilizes secondary data sourced from financial statements accessed through www.idx.co.id. The statistical analysis employs multiple linear regression analysis facilitated by the SPSS (Statistical Product and Service Solution) software. The research population comprises all non-financial companies listed on the Indonesia Stock Exchange during the period from 2020 to 2022. The sample selection employs purposive sampling. The selection of the period from 2020 to 2022 was influenced by several factors. Regulatory changes, economic conditions, and technological developments during this period may have significantly impacted earnings management practices among listed companies. The study includes tests such as classical assumption tests, hypothesis testing, and determination of coefficients (R^2) to analyze the data.

Operational Definition of Variables and Their Measurement

Table 1. Variable measurement

Variable	Indicator	Reference
Dependent Variable Earning Management	$DACit = \frac{TACit}{TAit - 1} - NDACit$	(Susanti et al., 2022)
Variabel	Indikator	Sumber Referensi
Leverage	$LEV = \frac{\text{Total Liabilities}}{\text{Total Asset}}$	(Kusumawati et al., 2018)
Company Size	$UK = \ln \times \text{Total asset}$	(Pramana & Setyadi, 2021)
Audit Committee	$KA = \text{Number of Audit Committee Members}$	(Solihah & Rosdiana, 2022)
Free Cash Flow	$FCF = \frac{\text{Net Operating Cash Flow} - \text{Net Investing Cash Flow}}{\text{Total Asset}} \times 100\%$	(Hardirmaningrum et al., 2021)
Managerial Ownership	$KM = \frac{\text{Number of Shares Owned by Management}}{\text{Number of Shares Outstanding}} \times 100\%$	(Riska Astari & Suputra, 2019)

3. Result and Discussion

The results of sample selection based on predetermined criteria can be seen in the table below:

Table 2. Sampling process

Information	Total
Non-financial companies listed on the IDX in 2020-2022	608
The company did not present financial reports for 2020-2022	(56)
Non-financial companies that experienced losses in the research period	(295)
Companies that do not present information on each variable for the research period	(126)
Total sample for one year	130
Total sample for three years	390
Outliers	(37)
Total samples for three years were processed	353

Source: 2024 Data Analysis Results

The population in this study includes all non-financial companies listed on the Indonesia Stock Exchange (IDX) from 2020 to 2022. The sample selection was based on predetermined criteria, resulting in 130 companies sampled each year, with a total of 390 samples over the period 2020 to 2022. The sample data did not pass the multicollinearity test, so 37 outliers were removed using the Excel correlation formula, eliminating correlations exceeding 0.95. Thus, the data that met the research criteria amounted to 353 samples.

Table 3. Descriptive statistics results

Variable	N	Minimum	Maximum	Mean	Std.Dev
Earnings Management	353	-1,6509	0,3349	-0,2230	0,3078
Leverage	353	0,0019	0,8881	0,3812	0,1874
Company size	353	24,9015	33,6551	28,9915	1,7761
Audit Committee	353	3,0	7,0000	3,1270	0,4922
Free Cash Flow	353	-29,2325	2311,5324	25,0242	129,9311
Managerial ownership	353	0,0001	2411,8066	36,1230	215,2409

Source: 2024 Data Analysis Results

Based on Table 2, the descriptive statistical analysis with a sample size of 353 companies over the period 2020-2022 shows a minimum value of -1.6509 and a maximum value of 0.3349, with a standard deviation of earnings management of 0.3078. The average value of earnings management, calculated using the Modified Jones Model, is -0.2230. This indicates that, on average, non-financial companies listed on the Indonesia Stock Exchange during the period 2020-2022 engaged in earnings management practices to manipulate profits by suppressing earnings to meet market expectations or internal targets and maintain stable profit positions.

Leverage, calculated using the debt-to-assets ratio (DAR), shows an average leverage of 0.3812, indicating that, on average, non-financial companies listed on the Indonesia Stock Exchange from 2020-2022 have debt comprising about 38.12% of their total assets. This can also be interpreted as every 0.3812 rupiah in debt being backed by one rupiah in total assets. The size of the company, calculated with the natural logarithm of total assets, shows an average value of 27.9192, indicating that the average size of non-financial companies is Rp 65,251,759,675.00.

The audit committee, measured by the number of audit committee members, shows that, on average, non-financial companies listed on the Indonesia Stock Exchange from 2020-2022 have three members in their audit committees. This complies with the regulations set forth in OJK Regulation No. 55/POJK.04/2015, which mandates a minimum of three members in the audit committee. Free cash flow, measured by the ratio of net cash flow to total assets, shows an average positive free cash flow of 25.0242. This indicates that, on average, non-financial companies listed on the Indonesia Stock Exchange from 2020-2022 have positive free cash flow, with a positive difference between net operating cash flow and net investment cash flow.

Managerial ownership, calculated by the proportion of shares owned by management to the total outstanding shares, shows an average managerial ownership of 36.1230%. This indicates that, on average, non-financial companies listed on the Indonesia Stock Exchange from 2020-2022 have 36.1230% of their shares owned by management.

Classic assumption test results

The normality test is considered normal if the p-value (asyp.sig) is greater than 0.05 or 5%. The One Sample Kolmogorov-Smirnov test used in this study resulted in a p-value of 0.000, which is less than 0.05, indicating that this test does not meet the normality assumption. However, the researcher applied the Central Limit Theorem (CLT), which states that if the number of companies studied is more than 30, the results tend to be more normal. This study involved data from 353 companies, indicating that the data is normally distributed.

The multicollinearity test results were assessed using tolerance values and variance inflation factor (VIF). All variables had tolerance values greater than 0.10 and VIF values less than 10. Based on these multicollinearity test results, it can be concluded that there is no multicollinearity among the independent variables.

The heteroscedasticity test used the Glejser test, where significance values greater than 0.05 indicate that the assumption of homoscedasticity is acceptable. The autocorrelation test results were obtained using the Durbin Watson test. The Durbin Watson value was 0.722. With five independent variables and a total sample size of 353, a Durbin Watson value of 0.722 falls between -2 and +2, indicating no signs of autocorrelation in this study.

Hypothesis Testing Results

Multiple Regression Analysis

Multiple regression analysis is a statistical technique used to show the relationship between independent variables and a dependent variable. This technique helps identify how well the independent variables can explain the variation in the dependent variable and determine the impact of each variable. This study uses five variables: leverage, company size, audit committee, free cash flow, and managerial ownership. The multiple linear regression results were conducted using SPSS 25.

Table 4. Multiple linear regression results

Model	Unstandardized Coefficients		Standardized Coefficients	t	sig
	B	Std. Error	Beta		
(constant)	0,389	0,269		1,444	0,150
Earnings Management	0,007	0,091	0,004	0,077	0,939

Model	Unstandardized Coefficients		Standardized Coefficients	t	sig
	B	Std. Error	Beta		
Leverage	-0,022	0,010	-0,129	2,219	0,027
Company size	0,017	0,033	0,027	0,506	0,613
Audit Committee	0,000	0,000	-0,060	1,170	0,243
Free Cash Flow	0,000	0,000	-0,307	5,921	0,000

Source: 2024 Data Analysis Results

Based on the regression results in the table above, the multiple linear regression equation can be formulated as follows:

$$ML = 0.389 + 0.007LEV - 0.022UP + 0.017KA + 0.000AKB + 0.000KM + e$$

The constant value of 0.389 indicates that, with leverage, company size, audit committee, free cash flow, and managerial ownership remaining constant, the average earnings management decreases by 38.9%. The leverage regression coefficient, with a positive value of 0.007, indicates that an increase in the leverage ratio (DAR) tends to increase earnings management, while a decrease in this ratio tends to reduce it. The company size coefficient, with a negative value of -0.022, indicates that the larger the company size, the lower the tendency for earnings management, and vice versa. The positive coefficient of 0.017 for the audit committee indicates that an increase in the number of audit committee members tends to increase earnings management, while a decrease in the number of members tends to reduce it. Free cash flow with a coefficient of 0.000 and managerial ownership with a coefficient of 0.000 indicates that changes in these two variables do not affect earnings management.

The F-test shows a significance value of 0.000. Since the significance value obtained from the F-test is less than 0.05, it can be concluded that the regression model with the dependent variable of earnings management and five independent variables, namely leverage, company size, audit committee, free cash flow, and managerial ownership, is appropriate to use or is a fit regression model.

The Adjusted R Square value is 0.095 or 9.5%. This indicates that the independent variables, namely leverage, company size, audit committee, free cash flow, and managerial ownership, explain 9.5% of the variation in the dependent variable of earnings management, while the remaining 90.5% is explained by other independent variables not included in this study.

Discussion

Leverage Does Not Affect Earnings Management

The results of this study provide empirical evidence that the level of leverage, proxied by the debt to asset ratio (DAR), does not affect earnings management. This can occur if a company has a stable capital structure, so the management does not feel pressured to manipulate earnings. Leverage is an aspect of capital structure related to financing decisions, while earnings management practices are often conducted through accounting adjustments that are not directly related to the company's debt level. The desire to meet earnings targets, maintain reputation, and fulfill managerial bonuses drives earnings management practices.

Companies, in showing income stability to investors and stakeholders, focus more on accrual techniques to achieve earnings targets without considering whether the company has high or low leverage. This suggests that earnings management practices are more influenced by other factors such as profitability, operating cash flow, and market expectations rather than capital structure. This study provides empirical evidence that leverage does not affect earnings management. These findings are consistent with studies by Sarah et al. (2023), Hardirmaningrum et al. (2021), and Putriquitha & Vivianti (2023), which also found that leverage does not affect earnings management.

Company Size Affects Earnings Management

This study proves that company size affects earnings management. Larger companies tend to be more transparent and less involved in earnings management practices compared to smaller companies. Smaller companies have better growth opportunities, requiring more substantial investment funds, which drives them to engage in earnings management practices.

Larger companies face stricter oversight from various stakeholders, including regulators, external audits, and investors. The high public attention and stricter compliance requirements for large companies, along with stringent oversight, act as controls that reduce the opportunities for earnings management practices.

Large companies have reputations to maintain. Earnings management practices, if uncovered in large companies, would attract significant attention and result in substantial losses. The risk of losing trust and suffering reputational damage due to revealed earnings management practices makes large companies cautious and avoids such practices. They also have better governance systems and rigorous internal controls. This study provides empirical evidence that company size affects earnings management. These findings align with research by Fajriana (2023) and Susanti et al. (2022), which concluded that company size affects earnings management.

The Audit Committee Does Not Affect Earnings Management

This study provides empirical evidence that the audit committee does not affect earnings management. The number of audit committee members does not influence earnings management. This result may indicate that the audit committee may not be effective in performing its duties in overseeing earnings management actions. Although the audit committee oversees financial reporting, its role focuses more on compliance with accounting standards than detecting and preventing earnings management practices. This may be due to audit committee members lacking sufficient accounting knowledge, necessitating an improvement in their ability to oversee comprehensive accounting practices.

In overseeing financial reports, company management holds more authority in determining accounting strategies and reporting policies, limiting the audit committee's ability to prevent earnings management practices. These limitations may drive the finding that the audit committee does not affect earnings management. This study's findings are consistent with previous research by Sarah et al. (2023), which also concluded that the audit committee does not affect earnings management.

Free Cash Flow Does Not Affect Earnings Management

This study proves that free cash flow does not affect earnings management. The level of free cash flow does not impact earnings management. These results show that earnings management practices focus more on the income statement, as investors pay more attention to it in evaluating company performance.

Earnings management is more influenced by managerial incentives, such as bonuses, investor pressure, and market expectations. These factors drive management to engage in earnings management to achieve earnings targets, which may not be influenced by free cash flow.

Free cash flow comes from operating and investing activities, while earnings management is often conducted through accounting adjustments not always related to free cash flow. For example, management may accelerate revenue recognition or delay expense recognition to increase earnings in certain periods, without involving free cash flow. This indicates that free cash flow does not affect earnings management. This study's findings are consistent with previous research by Ilham et al. (2022), which also concluded that free cash flow does not affect earnings management.

Managerial Ownership Affects Earnings Management

This study proves that managerial ownership affects earnings management. The larger the proportion of shares owned by management, the more likely managers are to engage in earnings management practices. This can occur due to the incentive to improve earnings on financial reports to make them appear favorable.

Managers holding a significant number of shares receive direct incentives from rising stock prices. This incentive drives managers to manipulate financial reports to make the company's performance look better, thereby increasing stock prices and providing greater personal benefits.

Managers who can demonstrate good financial performance gain recognition and better career opportunities. By manipulating financial reports to show better performance, managers can enhance their reputation among shareholders and the board of directors, providing long-term benefits in the form of promotions and bonuses. This study's findings are consistent with previous research by Riska Astari & Suputra (2019), which also concluded that managerial ownership affects earnings management.

4. Conclusion

Based on the testing and discussion conducted in this study, the following conclusions can be drawn: Leverage does not significantly affect earnings management; the level of leverage does not exert influence on earnings management practices. Company size demonstrates a significant impact on earnings management; larger companies tend to exhibit lower levels of earnings management. The audit committee size, however, does not appear to affect earnings management practices; the number of audit committee members shows no significant influence. Free cash flow also does not affect earnings management; the level of free cash flow

does not influence the practice. Managerial ownership, on the other hand, significantly influences earnings management; higher managerial ownership correlates with increased likelihood of earnings management.

This study is limited to non-financial companies listed on the Indonesia Stock Exchange (IDX) during the specific period of 2020-2022. By expanding the scope to include all listed companies or other sectors, future research can provide a more comprehensive analysis. Additionally, the study's duration of three years may not fully capture long-term trends and variations in earnings management practices. Future studies could extend the research period to four or five years to achieve more robust and representative results over time. Moreover, incorporating additional variables such as institutional ownership, company growth rates, independent commissioners, and profitability could enrich understanding of factors influencing earnings management.

For future research aiming to explore other factors influencing earnings management, several recommendations can be proposed. Firstly, expand the scope of the study to include all sectors listed on the Indonesia Stock Exchange or consider including companies from various exchanges. Secondly, extend the research period to obtain a more comprehensive understanding of earnings management practices over time. Thirdly, include additional variables such as institutional ownership, company growth rates, independent commissioners, and profitability to capture a broader spectrum of influences on earnings management. By implementing these recommendations, it is hoped that the study can enhance the depth and validity of understanding of earnings management practices.

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