



**INTERNASIONAL CONFERENCE & CALL FOR PAPER**

**ECONOMICS, BUSINESS, INNOVATION AND CREATIVITY (EBIC), 16<sup>th</sup> May 2023**

**Vol: 1 No.: 1**

**No. E- ISSN: 3025-4086**

**The effect of profitability, debt policy, company size, and free cash flow on earnings management**

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**ABSTRACT**

*This study aims to explain the effect of Profitability, Debt Policy, Company size, Free cash flow on earnings management, Studies on Non-Cyclicals Main Consumer Sector companies listed on the Indonesia Stock Exchange in 2017 – 2021. The population taken for this research is registered companies on the Indonesia Stock Exchange (IDX) in 2017-2021. The research sample is the Main Consumer Non Cyclicals company, a company that produces goods and services which is considered a company with stable growth because its products are always in demand and needed by consumers. The analysis uses E-views version 12. Based on the calculation results, it can be seen from the coefficient of determination R obtained is 12%, this means that the variables Profitability, Debt Policy, Company size, Free cash flow have a simultaneous effect on earnings management. For 88% influenced by other factors.*

*Keywords: Company Size, Debt Policy, Earnings Management, Free Cash Flow*

**1. INTRODUCTION**

When you want to invest, investors, creditors, and other external parties in a company have many considerations when deciding to invest in shares or lend money to the company. One of the considerations is the annual financial statements of the investment object company. One of the components in the financial statements is the income statement which is one of the main focuses of users of financial statements, where the income statement describes the company's performance in a certain period of time. Therefore, the income statement is one of the parts that is the target of manipulation activities carried out by management with the aim of obtaining unilateral profits but on the other hand it will be detrimental to other parties such as investors and creditors or others.

Until now, profit management is still a common phenomenon among companies. In the last five years, there have been several companies involved in cases related to the implementation of profit management, namely the companies PT Tiga Pilar Sejahtera Food in 2017, Garuda Indonesia in 2018 and PT, Envy Technologies Indonesia Tbk in 2019 (source: Cnbcindonesia.com). The case illustrates that the application of profit management in a company is often carried out, besides that it will also harm other external parties who have an interest in the company, investors one of them. The population used in this study is the main consumer non cyclicals companies listed on the Indonesia Stock

Exchange (IDX) in 2017 – 2021. The main consumer non-cyclicals company is a company that produces goods and services that are always in demand and needed by consumers.



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Research on earnings management has been carried out several times. The independent variables used vary, but from several research results on the variables of profitability, debt policy, company size, free cash flow, there are still inconsistencies in the results of the research. Like the research conducted by Rianita and Pramaesti (2021) states that the level of profitability affects earnings management actions. Meanwhile, Sari and Khafid's (2020) states that profitability has no effect on earnings management. Research conducted by Cahyani and Suryono (2020) states that the level of debt policy has a positive effect on earnings management. Meanwhile, the research by Arthawan and Wirasedana states that company size has no effect on earnings management and research conducted by Kodriyah and Fitri (2017) states that free cash flow has a significant effect on earnings management, this means companies with high free cash flow tend to practice earnings management by increasing reported earnings to cover the actions of managers who are not optimal in utilizing the free cash flow. Researchers are motivated to do this research to re-examine the consistency of the results of previous studies. Based on the description and several previous studies, there are differences in research results between several studies regarding the effect of profitability, debt policy, company size and free cash flow.

## **2. LITERATURE REVIEW**

The theory used in this research is agency theory. The agency theory explains that if a company is in a state or in poor financial performance, then there is a possibility that the management will hide it by increasing profits, reducing profits or smoothing profits. In this study, researchers used several literatures as a basis for understanding earnings management and other variables. one of them is Rianita and Pramaesti (2021), Kodriyah and Fitri (2017), Cahyani and Suryono (2020), these three studies conducted studies related to earnings management, profitability, debt policy, company size and free cash flow the results of the variables used by them have varied results on profitability, debt policy, free cash flow have an effect on earnings management, while company size has a negative impact on earnings management.

### **Earnings Management**

Agency theory states that earnings management can occur because of different interests between owners and managers. According to Subramanyam (2017), "earnings management (Earnings Management) is an intervention with a specific purpose by management in the process of determining profits, usually to fulfill its own goals. Techniques for engineering profits can be grouped into 3 groups, namely taking advantage of opportunities to make accounting estimates, changing accounting methods, and shifting periods of costs or income (Siallagan, 2020). Earnings management behavior is a form of creative accounting action from managers, of course it does not appear by itself, but there is an extrinsic motivation behind this behavior (Sulistiawan, 2016).

### **Profitability**

Profitability is a company's ability to generate profits for a certain period by using all its capabilities and resources, both from selling activities, using assets, or using capital (Hery, 2017) By calculating the value of profitability, companies can find out the level of profit earned in a period, find out the progress of profits from one period to the next, find out the level of productivity of all funds used, and so on. According to Kasmir (2018) the



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profitability ratio is a ratio for assessing a company's ability to make a profit. This ratio also provides a measure of the effectiveness of a company's management. The Bonus Plan Hypothesis states that if in a certain year the actual performance is below the requirements for obtaining a bonus, the manager will carry out earnings management so that his profit can reach the minimum level to obtain a bonus. Conversely, if in that year the performance obtained by the manager is far above the amount required to obtain a bonus, the manager will manage and arrange so that the reported profit is not too high. This statement is supported by research by Rianita and Pramaesti (2021) and research by Nathaly and Yuniarwati (2021) in the results of their research which states that the greater the level of profitability, the greater the occurrence of earnings management or it can be said that profitability has a positive effect on earnings management. Based on this, the hypothesis proposed by the study is as follows:

H1: Profitability affects earnings management

### **Debt policy**

The definition of Debt Policy according to Brigham and Houston (2017) is "Debt policy is a policy regarding decisions taken by companies to carry out their operations using financial debt". Meanwhile, according to Kasmir (2018) "Debt policy is a policy used to measure the extent to which company activities are financed with debt". A low DER indicates that the company does not have a maximum profit increase, so the company must produce an optimum DER calculation as a fundamental analysis of investing in company shares (Hery, 2018). In the debt agreement hypothesis that managers will make accounting choices to reduce the likelihood of their company would violate the debt agreement. This statement is supported by the research of Cahyani and Suryono (2020) in their research which states that debt policy has a positive effect on earnings management. Then Arthawan and Wirasedana (2018) support the findings with the result that debt policy has a negative effect on earnings management. Based on this, the hypothesis proposed by the study is as follows:

H2: Debt policy affects earnings management

### **Company size**

Company size is a scale where the size of the company can be classified, measured by total assets, number of sales, share value and so on (Nathaly & Yuniarwati, 2020). Company size can be seen from the number of assets owned by the company. Large companies receive more attention from external parties such as investors, creditors, and the government. Therefore, the larger the company, the risk it has is also greater than that of a small company. Companies that have large total assets indicate that the company has reached the maturity stage where at this stage the company's cash flow is positive and is considered to have good prospects in a relatively long period of time (Lumoly et al., 2018). Large companies are often the concern of many investors, so they often get demands to have better profit information. These demands often make management try to report higher earnings, so management takes earnings management actions to manipulate earnings to attract investors. This statement is supported by the research of Muiz and Ningsih (2018) and Nathaly and Yuniarwati (2021) in their research results which state that company size has a positive and significant effect on earnings management. Based on the description above, the hypothesis in this study is:

H3: Firm size has an effect on earnings management



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**Free cash flow**

Information on the entity's cash flows is useful in providing users of financial statements with a basis for assessing the entity's ability to generate cash and assessing the entity's need to use those cash flows (PSAK no 2). Companies that tend to have high free cash flow values provide opportunities for management to manage earnings. This happens because of an agency problem (Hastuti et al. 2018). The use of inefficient free cash flow is overcome by carrying out earnings management, namely covering losses by increasing profits (Irawan & Apriwenni, 2021). With this increased profit, managers hope that incentives and bonuses will be received. The action of managers who carry out earnings management on the basis of getting bonuses is called the bonus plan hypothesis. The measurement of this variable uses the Brigham & Houston formula (2016). Companies that tend to have high free cash flow values provide opportunities for management to manage earnings. This happens because of an agency problem (Hastuti et al. 2018). This statement is supported by research by Kodriyah and Fitri (2017) in their research which states that free cash flow has a significant effect on earnings management, this means that companies with high free cash flow tend to practice earnings management by increasing reported profits to cover the actions of managers. which are not optimal in utilizing the company's assets. Then Sunaryo et al (2021) support the findings with the results that free cash flow has a negative effect on earnings management. Based on the description above, the hypothesis in this study is:

H4: Free cash flow affects earnings management

The framework created from all these hypotheses is as follows:

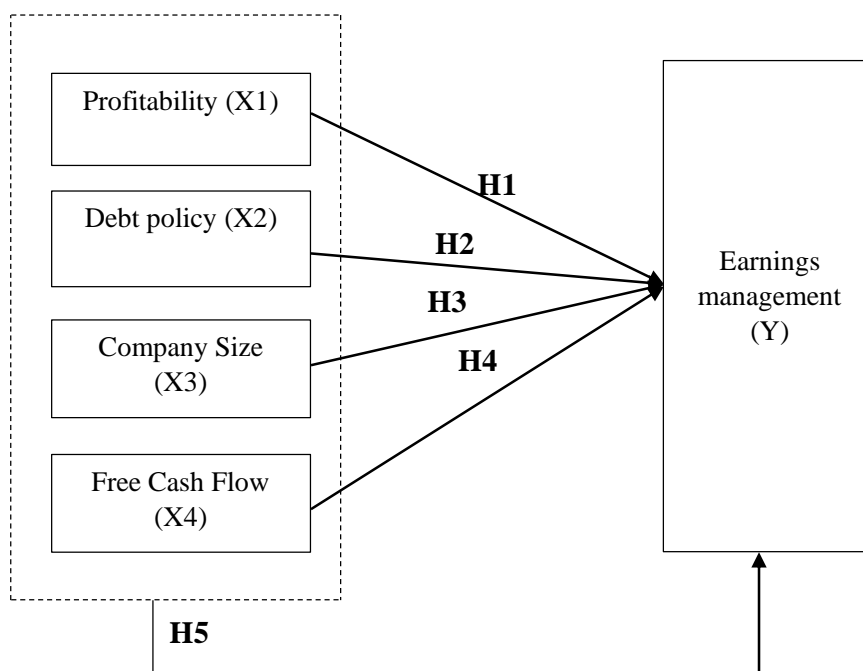


Figure 1. Research Framework



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**3. DATA AND RESEARCH TECHNIQUE ANALISYS**

The data collection technique used in this study is the documentation method using secondary data which can be obtained from the financial reports of major non-cyclical consumer companies listed on the Indonesia Stock Exchange from 2017 to 2021. Secondary data in this study can be collected and obtained from the website [www.idx.co.id](http://www.idx.co.id). There are 57 companies listed in the Indonesia Stock Exchange (IDX) in the Primary Consumer Non-Cyclicals sector. The total population used was 39 companies with an observation year of 5 years 2017-2021. The number of samples used in this study totaled 195 samples, there were 55 samples that became the outlier data. So that the number of samples used in this study was 140. Outlier data is data with unique characteristics, so that observations in the form of extreme values can show very large differences (Ghozali, 2018). Outliner data is excluded because the data is not normally distributed. Based on the sample results on predetermined criteria, a total of 31 companies were obtained with a total sample of 140 samples that the researchers used in the analysis process.

**Data analysis**

In this study the analytical method used to examine the relationship between the independent variable and the dependent variable used the EViews version 12 software application. The functional relationship between the dependent variable and the independent variable can be carried out by means of a data regression test. The panel data regression test is used to determine the relationship between the independent variables consisting of profitability, debt policy, company size, and free cash flow to the dependent variable earnings management. So, the researchers used the panel data regression method. There are several data analysis techniques in this study including the regression model estimation method using panel data which can be carried out through three approaches, including: Common Effect Model, Fixed Effect Model and Random Effect Model (Muna, 2019). Selection of panel data regression models, to describe the data. To select the most appropriate model, there are several tests that can be carried out, including: using the Chow Test, Hausman Test, or Lagrange Multiplier Test (Muna, 2019). Descriptive analysis, classic assumption test and hypothesis test.

**4. RESULT AND DISCUSSION**

Analysis of the results of this study will be in the form of an outline in table 1 to table 6:

**Panel Data Regression Model Selection**

One of the best regression models chosen for use in this study was based on the results of testing the three panel data regression models used in this study, namely the Hausman test.

**Table 1. Hausman Test Results**

Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section random	7.435	4	0.115

Based on the results of the Hausman test above, it can be seen from the random cross-section probability value of 0.1146. This value is greater than 0.05, rejected



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so that the results obtained are using the Random Effect Model. Thus, the normality test of this study as follow:

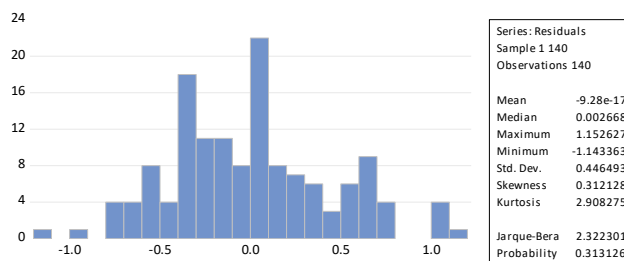


Figure 2. Normality Test Results

From the results of the normality test it can be seen that the Jarque Bera value is 2.322301 with a probability of 0.313126 > of 0.05, which means that the data in this study are normally distributed.

Table 3. Multicollinearity Test Results

Variable	Coefficient Variance	Uncentered VIF	Centered VIF
C	1.736	1,183.920	NA
ROA	0.006	3.162	1.150
LOG(DER)	0.009	1.155	1.155
SIZE	0.058	1,183.053	1.056
FCF	0.000	2.031	1.064

Source: Data processed 2022

Based on the multicollinearity test presented in table 4.9 above, it can be seen that the Centered VIF value of all independent variables is less than 10, namely the Profitability variable (X1) is 1.149998 <10, the debt policy variable (X2) is 1.154656 <10, the company size variable (X3) is 1.055697 <10 and the free cash flow variable is 1.064290 <10, so it can be concluded that the regression model does not contain multicollinearity problems.

**Heteroscedasticity Test**

Table 4: Heteroscedasticity Test Results

Statistic Measures	Value
F-statistic	1.312
Obs*R-squared	17.935
Scaled explained SS	15.912
Prob. F(14,125)	0.210
Prob. Chi-Square(14)	0.210
Prob. Chi-Square(14)	0.319

Source: Data processed 2022



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Based on the results of the white heteroscedasticity test above, it shows that the probability chi-square value for Obs\*R-Squared is  $0.2097 > 0.05$ . So it can be concluded that there is no heteroscedasticity in the regression model tested.

**Autocorrelation Test**

The results of the autocorrelation test show that the Durbin-Watson value (DW-test) is 1.7833. With  $n = 140$ ,  $k = 4$ , we get  $DL = 1.6656$  and  $DU = 1.7830$ . So the value of  $4-DU = 2.217$  and  $4-DL = 2.3344$ . This test obtained a value of  $1.7830 < 1.7833 < 2.217$  which means  $DU < DW < 4-DU$ . So in this study there was no autocorrelation problem.

Test the coefficient of determination ( $R^2$ )

Table 5: Test Results Coefficient of determination ( $R^2$ )

<b>Statistic Measures</b>	<b>Value</b>
Root MSE	0.230
Mean dependent var	-0.100
S.D. dependent var	0.248
Sum squared resid	7.411
Durbin-Watson stat	1.783
R-squared	0.122
Adjusted R-squared	0.096
S.E. of regression	0.234
F-statistic	4.681
Prob(F-statistic)	0.001

Source: Data processed 2022

Based on table 4.12, the R-Squared value is 0.121803. This value means that profitability, debt policy, company size and free cash flow can influence earnings management by 12%, while the remaining 88% is explained by other factors outside the variables studied.

**F Test (Simultaneous Test)**

Based on the results of the F test in table 4.13 above, it is known that the calculated F value is 4.681023. Meanwhile, the value of the F-table ( $\alpha = 0.05$ ,  $df_1 = 4$  and  $df_2 = 135$ ) is 2.44. Thus, the calculated F value is greater than the table F value ( $4.681023 > 2.44$ ). In addition, when viewed from the probability value, it shows a number of 0.001436, which means it is smaller than the significance value (0.05). So it can be concluded that the variable profitability, debt policy, company size and free cash flow together have a significant influence on earnings management.



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**T Test (Partial Test)**

Table 6: T Test (Partial Test)

Variable	Coeff	Std.Err	t-Stat	Prob
C	0.115	0.978	0.117	0.907
ROA	0.180	0.067	2.679	0.008
LOG(DER)	0.135	0.081	1.665	0.098
SIZE	- 0.134	0.179	- 0.744	0.458
FCF	0.000	0.000	2.471	0.015

Source: Data processed 2022

The conclusions obtained from the table above are the profitability variable based on the results of the hypothesis testing that has been carried out, indicating that profitability has a significant value of 0.0083 ( $0.0083 < 0.05$ ). Profitability can influence managers to manage earnings. Because if the profitability of the company is low, managers will generally take earnings management actions to save their performance in the eyes of the owner. This is closely related to the manager's efforts to display the best performance from the company he leads.

Debt policy variable Based on the results of the hypothesis testing that has been done, it shows that the debt policy has a significant value of 0.0983 ( $0.0983 > 0.05$ ). Based on these results it can be concluded that the size of the debt policy ratio does not have an influence that the management will not practice earnings management. Vice versa that the low ratio of a company's debt policy does not affect the company's management to be more flexible in carrying out earnings management. High debt will increase the risk of default for the company, but earnings management cannot be used as a mechanism to avoid default, because the fulfillment of debt obligations cannot be avoided with earnings management.

Firm size based on the results of hypothesis testing that has been carried out, shows that firm size has a significant value of 0.4580 ( $0.4580 > 0.05$ ) indicating that there is no partial effect of firm size on earnings management. Company size is not the only consideration for investors to consider in making investment decisions, because there are other factors that are more important to consider in making investment decisions such as profit levels, the company's business prospects in the future and so on (Pramudhita, 2017). So the bigger or smaller the company does not affect the level of earnings management.

Free cash flow Based on the results of the hypothesis testing that has been done, it shows that profitability has a significant value of 0.0147 ( $0.0147 < 0.05$ ) indicating that there is a partial influence between free cash flow on earnings management which is acceptable. Agency theory according to Jensen and Meckling (1976) is that there is a conflict of interest between the agent and the principal. The principal wants the free cash flow to be distributed in the form of dividends to maximize his welfare, while the manager prefers to use the free cash flow to be reinvested, even though the end result of the investment made does not provide a profit for the





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company. Even though this action can increase the size of the company, the company experiences losses or decreases in profits due to the misuse of free cash flow by this manager. This then encourages managers to carry out earnings management to cover losses due to inefficiencies in the use of free cash flow.

### **5. CONCLUSION**

This study aims to determine the effect of the variable profitability, debt policy, company size and free cash flow on earnings management in non-cyclicals primary consumer sector companies listed on the Indonesia Stock Exchange in 2017 - 2021, a total of 31 companies that meet the criteria. Based on the description and analysis that has been presented previously, the results show that the variable profitability and free cash flow have a significant effect on earnings management, while debt policy and company size have no significant effect on earnings management. The research was not conducted on all consumer non-cyclicals sector companies, only the main consumer non-cyclicals sector, so the research results cannot be generalized to other industries. For future researchers, it is hoped that they can add a sample of companies that are not limited to just one sector or sub-sector so that the data processed is more diverse. Further researchers are also advised to add other variables that do not exist in this study.

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