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**EFFECT OF PRUDENCE AND FREE CASH FLOW ON EARNING
QUALITY**

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ABSTRACT

This study aims to determine the effect of prudence and free cash flow on earnings quality in consumer non-cyclical manufacturing sub-sector companies listed on the Indonesia Stock Exchange (IDX) during 2016-2021. This type of research is associative quantitative research with a total sample of 13 companies. for 6 years so that a total of 78 observations were studied. The sampling technique used in this research is the purposive sampling method. The analysis technique used is panel data regression analysis. Data processing using Eviews version 9. The results of this study indicate that Based on the results of the T test it is known that (1) Prudence and Free Cash Flow on Earnings Quality, (2) Prudence has a significant effect on Earnings Quality, (3) Free Cash Flow has a significant effect on Earnings Quality.

Keywords: Prudence, Free Cash Flow, Earning Quality

INTRODUCTION

Financial statements are records of the business's financial data from a given accounting period that are used to assess the success of the business. As stated by Priyatma & Holiawati (2015) financial statements are an important product for parties who have an interest (stakeholders) in a company where financial statements contain information needed by those interested parties to assess a company. The profits quality is one of them. Earnings quality is one way to evaluate the earnings data that the company's management has provided. According to Subramanyam (2017), a company's earnings are considered to be of high quality if its financial statements accurately reflect its business operations.

The low coal price in the first three quarters of 2020 managed to strengthen at the end of the year. From September last year to February this year, the reference coal price continued to rise from US\$ 49.42 in September to US\$ 87.79 in February. In early March, the reference coal price experienced a slight correction, down to US\$ 84.49 per ton. (cnbcindonesia.com) so that earnings quality is often a problem that arises in companies in Indonesia, there are fluctuations in profits. In addition, the purpose of doing earnings quality practices is to increase the trust of directors to managers and entice investors to place money in the company.

based upon the cases that have occurred, there are internal and external aspects that may have an impact on a company's earnings. This study describes several internal factors that can affect earnings, including Prudence and Free Cash Flow. Watts (2003) in Savitri (2016) in Holiawati, Rizky, Ruhiyat (2022) defines Prudence as a form of prudence in reporting financial statements in recognizing and measuring assets and profits and immediately recognizing losses and debts that are likely to occur. defines accounting conservatism as a form of prudence in reporting financial statements in recognizing and measuring assets and profits and immediately recognizing losses and liabilities that may occur. In deciding a decision to invest, of course, investors also assess the a company's capacity to manage its finances. The business capability to control finances can be seen from how the company presents reports on assets and profits. In presenting the two reports,



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of course, the company applies the concept of prudence. Ayem and Lori's (2020) research states that the accounting conservatism variable has a strong favorable impact on earnings quality. However, this research is not in line with Padi's (2015) research that conservatism does not make earnings quality but on the contrary will make earnings quality decline.

According to Brigham and Houston (2006) in Nugrahani and Retnani (2019), cash flow is accessible for payment to investors following the company invests in fixed assets, new company products, and working capital (equity) needed by the company to maintain operating operations. ongoing. Even though it is called free but this free cash flow cannot be used by management freely using the remaining cash flow calculations generated from the company's cash flows at the end of the financial period after paying salaries, bills, debts and interest, and capital expenditures for business development. The research of Yasa, Wirakusuma, and Suaryana (2020) states that there is a significant effect of free cash flow on earnings quality. High free cash flow in the company shows the company has cash for growth, debt payments, and dividend payments. Managers in companies with high free cash flow tend to avoid using the accrual policy. Many previous studies on earnings quality have been carried out, but no consistent results have been found. Based on the background, the authors are interested in conducting research entitled The Effect of Prudence and Free Cash Flow on Earnings Quality.

LITERATURE REVIEW AND HYPOTHESES

Positive Accounting Theory

According to Watts and Zimmerman (1986:5), the originators of Positive Accounting Theory, states that the purpose of accounting theory is to explain (to explain) and predict (to predict) accounting practices. The meaning of explaining is to provide reasons for accounting practices that can be observed, while the meaning of predicting is that accounting theory can predict unobservable phenomena. connecting concepts in the form of hypotheses to be tested. In accordance with previous research, the effect on earnings quality of these variables is Prudence and free cash flow.

Earnings Quality (Y)

According to Ashma and Rahmawati (2019) Earnings quality is a measurement taken by a company to make comparisons regarding the plans that have been previously planned whether it is in accordance with the profits generated at this time or not, because quality earnings can reflect performance of the company (Ashma and Rahmawati, 2019).

Prudence (X₁)

in Savitri (2016) and Holiawati, et al (2022), defines Prudence as a form of prudence in reporting financial statements in recognizing and measuring assets and profits and immediately recognizing losses and debts that are likely to occur.

Free Cash Flow (X₂)

Free cash flow is cash flow that the business can really distribute to all investors. once the business has invested all of its funds in fixed assets, fresh products, and the operating capital required to continue its operations, namely shareholders and debt owners.

HYPOTHESIS DEVELOPMENT

The Effect Prudence and Free Cash Flow on Earnings Quality

Financial statements contain information that is needed by parties with an interest in the company for decision making. Earnings quality is reflected by the existence of financial reporting in accordance with the characteristics determined by financial accounting standards. The appropriateness of the profit's statistics disclosed in the

company's financial statements is evaluated using the earnings quality metric. The level of quality earnings is earnings that can reflect sustainable earnings in the future, The accrual and cash components, which might represent the company's actual financial performance, decide this. (Djameluddin et al., 2008). The principle of prudence in financial reporting is referred to as Prudence. The precautionary principle in question is that the company is not in a rush to identify, quantify, and use earnings and assets right away perceives potential losses and debts (Watts, 2003).

Free cash flow can be interpreted as once the company has made investments in the assets required for the continuation of the business, cash flow that is available for distribution to shareholders or owners. The cash comes from investors, so that what is not used tends to be used to pay obligations to third parties. As a result, free cash flow shows that the business has extra funds that it uses for things like growth, product development, share repurchases, and dividend payments. Higher free cash flow equals higher profits quality.

With the precautionary principle of prudence in recognizing income, it will provide insight in the form of information to investors on the existence of an effective income result in the future, because this income can affect dividend income, if the income is higher, the quality of earnings will be better automatically Free Cashflow in the financial statements will be high, this will affect the distribution of dividends and be attractive to investors.

H₁: Prudence and Free cash flow positively impacts the earnings quality.

The Effect Prudence on Earnings Quality

principle of prudence in financial reporting is referred to as Prudence. The precautionary principle in question states that the business quickly acknowledges potential losses and obligations and does not rush to evaluate assets and earnings (Watts, 2003). With the precautionary principle in financial reporting (Prudence) does not include unrealized profits or income in a period there will be more effective income results in the future so that Prudence will produce good quality earnings for the company. The use of Prudence can reduce the value of assets and can increase Earnings Quality.

Research by Ayem and Lori (2020) states that the variable accounting conservatism has a significant positive effect on earnings quality, this shows that the higher the value of accounting conservatism, the earnings presented by management in the company's financial statements will be of higher quality because of prudence in prudence will generate an effective profit/revenue for the company.

H₂: Prudence has a positive effect on earnings quality

The Effect Free Cash Flow on Earnings Quality

According to Brigham and Houston (2006) in Nugrahani & Retnani (2019) is the cash flow available for distribution to investors following the company's investment in fixed assets, new goods, and necessary operating capital (equity). by the company to maintain ongoing operations. Even though it is called free but this free cash flow cannot be used by management freely using the remaining cash flow calculations generated from the final financial flows of the business of the financial period after paying salaries, bills, debts and interest, and capital expenditures for business development.

According to Yasa, Wirakusuma, and Suaryana's (2020) research, free cash flow has a considerable impact on profits quality. A high free cash flow level for the business demonstrates that there is money available for dividends, debt repayment, and development. Managers prefer to steer clear of the accrual strategy in businesses with significant free cash flow.



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In order to keep the financial statements credible and earn investors' favor, this is done.

H₃: Free cash flow has a positive effect on earnings quality

METHODS

This study is an associative quantitative study, meaning it seeks to understand the link between two or more variables (2013:57). This study uses a causal link as its basis. In a causal relationship, there are independent factors (influenced variables) and dependent variables (influenced variables), Sugiyono (2013:59). independent variables in this study are Prudence (X₁) and Free Cash Flow (X₂), the dependent variable in this study is Earnings Quality (Y).

The total population used in this study is 102 Non-Cyclical Consumer that are shown on the Indonesia Stock Exchange (IDX), there are 13 companies that meet the criteria. The research period is 6 years, so the total research data is 13 x 6 = 78 technical data. used in this study is purposive sampling, with the determination of the sample based on the criteria desired by the researcher. The determination of the criteria for the sample selected in this study are:

1. Sector Companies Non-Cyclical Consumer listed on the Indonesia Stock Exchange (IDX) since 2016 – 2021.
2. Sector Companies Non-Cyclical Consumer that report consecutive financial statements for 2016 – 2021 for the year ended December 31.
3. Sector Companies Non-Cyclicals Consumer that did not suffer losses throughout the 2016-2021 period.
4. Companies that present financial statements using Rupiah.

In this study, to test the hypothesis, the linear regression data method was used using the Eviews Version 9 application.

Operational Variable

Earning Quality

Quality Earnings Quality is the dependent variable in this study Earnings quality is the ability to accurately evaluate current performance and utilize that information to anticipate future success a company. In this study, the measurement of the Penman (2001) approach was used in Aristiani, Suharto, and Sari (2017). where earnings quality is evaluated using the ratio between cash flow from operations divided by net income. The smaller the ratio indicates the better the quality of earnings and vice versa, the larger the ratio indicates the worse the earnings quality. This approach is used because it directly compares net income which will also affect the size of a profit.

$$\text{Earning Quality} = \frac{\text{Operating Cash Flow}}{\text{Net Income}}$$

Prudence

Agustina et al. (2015) states that Prudence is a pessimistic principle because costs are disclosed first compared to revenue, because of . 's attitude or prudence in recognizing profits or revenuesThe profit or income will be recognized when the profit/revenue is actually realized. Givoly and Hayn (2000) measure prudence using four methods, namely the accrual approach taken from operating accruals and non-operating accruals, related to income, slope and variability of the spread data relative to cash flows, and MTB (Market to Book Value) ratio. Givoly and Hayn (2002) in Laoli & Herawaty (2019) that Prudence can be calculated using the formula:

$$\text{Prudence} = \frac{\text{Net Income} - \text{Operating Cash Flow} - \text{Depreciation}}{\text{Total Assets}} \times (-1)$$

Free Cash Flow

Free cash flow can alternatively be seen as cash flow available for distribution to owners or shareholders following an investment in fixed assets and working capital required for the firm to maintain its business continuity. Free cash flow shows that a business has the resources to grow, create new goods, buy back shares, pay dividends, or pay down debt. After The business invests all of its funds on working capital, new goods, and fixed assets to support ongoing operations, while the remaining free cash flow is distributed to all the debt owners and shareholders (Toto, 2012: 220). In Nugrahani and Retnani's research (2019), free cash flow is measured using a ratio:

$$\text{Ratio Free Cash Flow} = \frac{\text{Free Cash Flow}}{\text{Total Assets}}$$

Calculated by:

Free Cash Flow = Operating Cash Flow - Capital Expenditure

Capital Expenditure = Increase in Fixed Assets + Depreciation

Data analysis technique

The methods of data analysis employed in this study include:

Descriptive Statistics Test

Descriptive statistical tests were carried out to see the data for each variable's minimum, maximum, average, and standard deviation.

Classic assumption test

Classical A test of assumptions is run to ensure that the regression model is in accordance with the standard, so that the results of the hypothesis test are relevant and reliable. The requirements for a good regression model are if the regression model is normally distributed, there is no multicollinearity, there is no autocorrelation, and there is no heteroscedasticity.

Panel Data Regression Test

The same cross section unit is measured at several dates in a panel data regression analysis, which combines cross section data and time series data.

$$Y = \alpha + \beta x_1 + \beta x_2 + e$$

Information:

Y = earnings quality

α = constant number

β = regression coefficient

X1 = prudence

X2 = free cash flow

e = other factors that affect the dependent variable (Y)

Coefficient of Determination Test (R²)

The proportion of the percentage of X1, X2, and Y contributions viewed using evIEWS is the coefficient of determination (R²), which assesses the precision or compatibility of the panel data regression.



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Hypothesis test

To find out the results of Simultaneous Test Results (F Test) and Partial Test Results (t Test)

RESULT AND DISCUSSION

RESULT

Statistical Analysis Results Description

Tabel 4. 1 Statistical Analysis Results Description

	Earning Quality	Prudence	Free Cash Flow
Mean	1.648582	0.066158	0.083724
Median	1.327973	0.059961	0.073455
Maximum	61.87197	0.307023	0.457438
Minimum	-8.451.541	-0.195416	-0.271174
Std. Dev.	7.945866	0.080663	0.120897

- Earnings Quality in this study, the mean 1.648582, the maximum is 61.87197 from the Midi Utama Indonesia Tbk company in 2019 and the minimum value is -84.51541 from the Sekar Bumi Tbk company in 2019, the standard deviation is 7.945866
- Prudence in this study has a mean of 0.066158, a maximum 0.307023 Midi Utama Indonesia Tbk 2019 and a minimum value of -0.195416 Bisi International in 2018, standard deviation of 0.080663, a sum 13.09921, and a skewness 0.321336, and kurtosis of 3.797342
- Free cash flow in this study has a mean of 0.083724, the maximum of 0.457438 comes from the Tunas Baru Lampung Tbk company in 2018 and the minimum value of -0.271174 comes from the PP London Sumatra Indonesia Tbk company in 2018, the standard deviation is 0.120897

This research has gone through a panel data regression test, the model chosen is the Commont effect model (CEM), and has gone through the classical assumption test, and depending on the outcomes, the regression has a model normal distribution, there is no multicollinearity, there is no autocorrelation, and there is no heteroscedasticity. the result is as follows:

Simultaneous Test Results (F Test)

Tabel 4. 2 Simultaneous Test Results (F Test)

R-squared	0.787899	Mean dependent var	1.191.820
Adjusted R-squared	0.782243	S.D. dependent var	0.590647
F-statistic	1.393.027	Durbin-Watson stat	1.757.575
Prob(F-statistic)	0.000000		

As for determining the magnitude of F_{tabel} it is sought with the provisions of the significant level (α) = 5% and $df1$ ($k-1$) = (3-1) = 2 and $df2$ ($n-k$) = (78-3) = 75, F_{tabel} of

3.12. Based on table 4.2, the results obtained are $F_{count} > F_{tabel}$ ($139.3027 > 3.12$) and it is also shown that the probability value is smaller than the significant level of 0.05 ($0.000000 < 0.05$), so H_1 is accepted and it can be concluded that prudence and free cash flow simultaneously affect Earnings Quality.

Tabel 4. 3 Partial Test Results (t Test)

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.742755	0.045782	1.622.366	0.0000
X1_Prudence	1.087.172	0.695906	1.562.240	0.0000
X2_Free Cash Flow	-0.824921	0.337634	-2.443.240	0.0169

Partial Test Results (t Test)

As for determining the magnitude of the t_{tabel} sought using the formula $\alpha = 5\%$, df (nk) = $(78-3) = 75$, then the t-table is 0.67778. Based on table 4.3, the results of t-count Prudence (X_1) are 15.62240 t-table = 0.67778 so that $t_{count} > t_{table}$ ($15.62240 > 0.67778$), this is reinforced by a probability value smaller than the significance level or ($0.0000 < 0.05$), H_2 that it can be concluded that Prudence affects earnings quality, which means that prudence affects the size of the occurrence of earnings quality in the company.

Based on table 4.3, the results of t count free cash flow (x_2) is 2.443240 t table = 0.67778 so that $t_{count} > t_{table}$ ($2.443240 > 0.67778$), this is reinforced by a probability value smaller than the significance level or ($0.0169 < 0.05$), H_3 is accepted so it can be concluded that free cash flow affects the quality of earnings, which means that free cash flow affects the size of the occurrence of earnings quality in the company.

DISCUSSION

The Effect Prudence and Free Cash Flow Earnings Quality

Based on table 4.2 shows that the value of the F-statistic is 139.3027 while with a level of $\alpha = 5\%$, df ($k-1$) = $(3-1) = 2$ and df (nk) = $(78-3) = 75$ so that is 3.12. Thus, the F-statistic $> F_{table}$ $139.3027 > 3.12$ and the value of Prob (F-statistic) < 0.05 ($0.000000 < 0.05$) it can be concluded that H_1 is accepted. So that it can be explained that the independent variables in this study consisting of prudence and free cash flow have an influence on Earning Quality, thus it can be said that Earnings Quality is very influential on the progress or future of the company, because quality earnings reflect the company's future and show performance. the company's operations.

Prudence and Free Cash Flow affect earnings quality because to avoid conflicts of interest between investors and profit manipulation, where the application of Prudence principles Prudence are in Favor of investors by tending to protect investors from investing mistakes due to errors in analysing company profit information, and prevent excessive dividend distribution to investors, as well as Free Cash Flow with cash flow that has been deducted from operating expenses and capital expenditures for business development, The remaining cash is to be paid to investors in the form of dividends if the operating cash flow generated by the company If it is high, it will cover capital expenditures for the company's business development so that it also shows where the higher the free cash flow in a company, the healthier the company is so as to produce good profit quality and interesting for investors in the future.



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The Effect of Prudence on Earnings Quality

Based on table 4.3 shows that the size of the partial test (t test) of the research results for the X_1 variable, namely Prudence 15.62240, while the t_{table} with level $\alpha = 5\%$, $df (n-k) = (78-3) = 75$, then $t_{table} 0.67778$. Thus, the t -Statistic Prudence $> t_{table} 15.62240 > 0.67778$ and the value of Prob. $0.0000 < 0.05$, it can be concluded that Prudence in this study has an effect on Earning Quality.

Based on the results of the t statistical test, the Prudence has an effect on Earnings Quality. prudence will increase the quality of the profits generated by the company because of the precautionary principle in recognizing profits or gains and assets and immediately admitting losses and debts that will protect investors from investing errors due to errors in analysing company profit information, so that it will generate income more effectively in the future.

This research is in line with the research of Ayem, Lori (2020) which states that Prudence effect on Earning Quality. This shows that the higher the Prudence value, the more quality the earnings presented by management in the company's financial statements and research by Safitri & Afriyenti (2013), the accounting conservatism variable, has a positive and significant impact on the quality of company earnings. The higher the accounting conservatism, the profit. The quality produced by the company is getting better. Positive and significant effect, indicating that manufacturing companies that have a high level of application of the principle of conservatism can improve the quality of company earnings. However, this study is not in line with Padmi's (2015) research that conservatism does not make earnings quality but on the contrary will make earnings quality decline.

In this study, the higher the level of Prudence applied, the higher the quality of profits generated by the company. This is evidenced by a significant level of Prudence. The principle of prudence or conservatism is an important consideration for the company to implement because the company's activities are surrounded by uncertainty and the opportunistic nature of managers poses risks to company stakeholders, including investors. Prudence is one of the factors that can affect the quality of profits generated by the company. Where earnings quality is defined as the level of performance by managers and company reporting in accordance with actual conditions. Based on the results of the research that has been done, it can be concluded that the higher the level of Prudence applied, the higher the quality of profits generated by the company.

The Effect of Free Cash Flow on Earning Quality

Based on table 4.3, it shows that the magnitude of the t -test of research results for the X_1 variable, namely Free Cash Flow, is 2.443240, while t_{table} with a level of $\alpha = 5\%$, $df (n-k) = (78-3) = 75$, then $t_{table} 0.67778$. Thus the t -Statistic Free Cash Flow $> t_{table} 2.443240 > 0.67778$ and the value of Prob. $0.0169 < 0.05$, it can be concluded that Free Cash Flow in this study has an effect on Earnings Quality.

Based on the results of the t statistical test, the Free cash flow has an effect on Earning Quality. Companies that have large free cash flow are said to be healthy because the company has available cash for company growth, expanding the company, developing company products or activities, paying company debt, and dividends in the future.

This research is in line with the research of Nugrahani and Retnani (2019), which states that free cash flow has an effect on Earning Quality. This shows that free cash flow is an important determinant (factor) in determining the value of the company so that managers are more focused on efforts to increase free cash flow. and Yasa, Wirakusuma, and Suaryana (2020) state that there is a significant effect of free cash flow on earnings quality. High free cash flow in the company shows the company has cash for growth, debt

payments, and dividend payments. Managers in companies with high free cash flow tend to avoid using the accrual policy.

Free cash flow is cash flow that is distributed to investors after deducting operating expenses and capital expenditures for business development needed to maintain the continuity of the company's operations. Companies with high free cash flow values tend not to manipulate earnings, because in this case most investors are temporary owners of companies that focus more on company free cash flow information that shows how the company's ability to pay dividends is so with high quality free cash flow. profit is getting better.

CONCLUSION

Conclusion

Based on the results of the analysis and discussion above, the following conclusions can be drawn:

1. Prudence and Free Cash Flow simultaneously affect Earning Quality in Consumer Non-Cyclicals.
2. Prudence partially affects Earning Quality in Consumer Non-Cyclicals.
3. Free Cash Flow has an effect on Earning Quality partially companies Non-Cyclical Consumer

Research Limitations Researchers

experienced limitations in this study that can be taken into consideration in decision making for future researchers. The limitations of this study include the following:

1. The population in this study is only non-cyclical consumer listed on the IDX.
2. The research period is only 6 years, namely from 2016-2021

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