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The Influence of Good Corporate Governance, Free Cash Flow and Leverage Factors on Earnings Management with Audit Quality as Moderating Variable

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ABSTRACT

The purpose of this study is to amass data on the impact of good corporate governance, free cash flow, and debt on profit management, with audit quality serving as a moderating variable. Thirteen firms were included in the sample, and data were acquired through judicious selection and documentation. (1) The data are evaluated for normality, multicollinearity, heteroscedasticity, and autocorrelation using traditional assumption tests. (2) hypothesis testing entails doing an F-test and a T-test concurrently. The audit committee's capacity, institutional support, and management ownership all serve as indicators of good corporate governance in this study. Audit quality moderates the role in the business world effect of audit committee size, independent commissioner share, and leverage. It is impossible to reduce the influence on profit management of institutional ownership, managerial ownership, and free cash flow. While free cash flow and leverage do not affect profit management, the changing percentage of independent commissioners does.

***Keywords**: Good Corporate Governance, Free Cash Flow, Leverage.*

1. INTRODUCTION

Financial statements serve as a vehicle for communicating financial information to persons outside the corporate organization. They are the consequence of its operational operations and performance, which must be reported to both internal and external parties [1].

The manager's job and power as an agent designated by the principal entails a significant deal of responsibility to utilize the company's resources effectively. Thus, managers must improve or sustain corporate earnings overtime to build company value.

Profit management is a shortened version of a financial statement. Managers frequently have to adapt fast to changing scenarios and conditions inside the organization in order to adopt appropriate actions, solutions, strategies, and the correct choice to restore normalcy. As a result, many managements consider changing the company's financial statements to safeguard the company's reputation and keep its worth.

Profit management tactics are not new in Indonesia, as various instances demonstrate. PT Garuda Indonesia Persero Tbk is one of them. The IDX conducted an assessment in response to the company's unusual financial reporting in 2018. Fakhri Hilmi, Deputy Commissioner of OJK Capital Markets, stated that the company recognized revenue from the collaboration between the Group and PT Mahata Aero Teknologi for the fees that Mahata was required to pay following the signing of the agreement to provide in-flight connectivity and entertainment. As a result, the revenue recognition of USD 239 million or Rp 3.5 trillion has impacted the company's profit and loss statements, resulting in a loss. Thus far, a loss of USD213 million in 2017 has been transformed into a profit of USD5 million the following year.

Then it was revealed that two of PT Garuda Indonesia Persero Tbk's commissioners did not sign the company's 2018 annual report. However, neither this result nor its rationale is explained in the annual report. The condition is deemed to breach the OJK's guidelines. (source: release of the Ministry of Finance).

Several factors may influence how corporations manage their profits: effective corporate governance, free cash flow policies, and leverage ratio. Corporate governance principles have grown in lockstep with public desires for a clean and responsible corporate life [2], which is also a response to the rising number of deviation occurrences in organizations globally.

Numerous researchers have undertaken investigations of a similar nature. However, further research into this area is necessary given the inconsistent findings. According to one study [3], effective corporate governance has a negligible influence on profit management. By contrast, leverage does not affect management, whereas free cash flow has a considerable yet deleterious effect. Another study [4] found that examining free cash flow in isolation has a deleterious influence on profit management, whereas the other two components had no effect. The concurrent study's findings reveal that these three variables significantly influence profit management.

Economic growth has slowed due to the Covid-19 epidemic, creating an opportunity for every business to exercise profit management. The study is unique because it incorporates an audit quality evaluation tool as a moderator and uses a representative sample. The sample picked is a manufacturing firm identified on the BEI for 2018-2020.

This study aims to determine the influence of the previously mentioned components, including audit quality, on the reasonable variable of profit management quality. It highlights the critical nature of effective corporate governance, free cash flow, and leverage in profit management, with audit quality as a moderating factor. As a result, it is labeled Influence of Factors.

2. LITERATURE REVIEW

2.1. Agency theory

This approach might be used in an employment contract by allocating each party's rights and duties while still considering the aggregate benefit. The employment contract is composed of regulations that govern the operation of mechanisms that both the principal and agent have approved. A successful one would satisfy the following criteria: (1) The information obtained by the agent and the principal is symmetrical: the agent and the principal obtain the same quality and quantity of information. (2) The agent's risk regarding the fee is relatively low, implying that the agent has a high degree of certainty regarding the rewards he would receive.

2.2. Good Corporate Governance

The concepts of gcg have evolved in tandem with public aspirations for a clean and responsible company life [2], which is also a response to the growing number of deviation instances in businesses worldwide [2]. According to the Center for European Policy Studies, another definition of strong corporate governance is "the whole system of rights, processes, and limitations created inside and outside management to safeguard the interests of stakeholders."

2.3. Free Cash Flow

It is described as a form of cash that can be remunerated to all investors if the whole corporation's investments are made to safeguard continuing projects. It is a cash flow that is available for investor remuneration if the firm has raised its fixed assets and increased the required capita to continue growing [5].

2.4. Leverage

Leverage is a term that relates to how businesses leverage their assets and funding sources. As defined by [6], leverage is the amount of debt utilized to fund the acquisition or financing of assets. Companies having a higher debt-to-equity ratio are considered to have a high level of leverage.

2.5. Profit Management

Profit management is a term that refers to the process of managing earnings through managerial methods. Profit management strives to grow (lower) recorded income, and managers are accountable for the long-term financial benefit of the economy.

2.6. Audit Quality

The audit is crucial to the business's operations since it substantially influences them. The auditing process is defined as generating trustworthy financial information about a corporation. In this situation, the audit is conducted by a competent person, namely the auditor. Auditor participation and decision-making are critical components of the audit process and decision-making [7].

The audit quality is determined by the inputs, procedures, and results. The authors assess the quality in this example by examining the audited financial statement, which is a component of audit output. The higher the quality of earnings shown in financial statements, the higher the audit quality.

2.7. Hypothesis Development

2.7.1. How Audit Committee Size Affects Profit management

The audit committee is a body that performs overseeing and controlling tasks to ensure that the qualities remain on track, as the qualities provide the foundation for producing more accurate financial reports [2].

According to [3], the committee's size has no impact on profit management. However, another study [8], [9] produced a different conclusion: it has been demonstrated to have a detrimental effect on profit management. As a result, the following hypotheses were developed to ascertain how these factors affect profit management, one by one. The first hypothesis is as follows:

H1: The size of the audit committee influences profit management positively

2.7.2. Proportion of Independent Commissioners

According to [2,] the independent board of commissioners is responsible for ensuring the monitored firms' effective business strategies in scheduling, budgeting, effectiveness, and regulatory compliance.

According to the research findings of [10] and [11], size has little effect on profit management. Similarly, [3]'s study supports this position. However, [12], who conducted studies by collecting samples from each industrial sector, discovered harmful consequences. As a result, the second hypothesis is as follows:

H2: The proportion of independent commissioners affects profit management positively

2.7.3. Institutional Ownership

Institutional ownership may affect profit management practices so that its percentage is inversely proportionate to managers' proclivity to engage in profit reporting abuse [13]. Otherwise, according to research by [14], institutional ownership characteristics have little effect on profit management. As a result, the third hypothesis is as follows:

H3: Institutional ownership affects profit management

2.7.4. Managerial Ownership

Profit management may be favorably affected by managerial ownership [15]. However, opportunistic management tactics may become prevalent if the manager's ownership is lacking. If the manager is also an owner, this alleviates some of the current issues, as managerial ownership of company stock decreases outside shares held by management. Profit management can benefit from managerial ownership, as managerial ownership is closely related to opportunistic profit management behaviors [16]. However, [3] says that managerial ownership has a negligible impact on profit management. As a result, the following is the fourth hypothesis:

H4: Managerial ownership affects profit management.

2.7.5 Free Cash Flow

According to [17], it has had a harmful material influence on profit management, whereas [18] provides more evidence that its value capacity has a negligible effect on profit management. As a result, the fifth hypothesis is as follows:

H5: Free cash flow affects profit management

2.7.6. Leverage

Leverage has a beneficial effect on profit management [14]. Both are immediately proportionate to one another in a business, which is consistent with [16], which said that leverage directs profit management well, implying that leverage is directly proportional to opportunistic profit management methods. As a result, the following theories were advanced:

H6: Leverage affects profit management positively

2.7.7. Audit Quality for Moderating Effect of Audit Committee

The audit committee's independent features, followed by the audit quality generated by independent auditors, are intended to improve the audit committee's effectiveness in identifying abnormal activity by management, hence reducing profit management in the organization. [19] demonstrates empirically that audit quality can operate as a barrier between the audit committee's independence and the quality of its earnings as evaluated by profit management activities. The audit committee members' grasp of the financial reports' structure, followed by the independent auditor's audit quality, is intended to support the committee's efforts to suppress profit management actions. As a result, the following hypothesis is developed:

H7: Audit quality reinforces effects of audit committee size on profit management

2.7.8. Audit Quality for Moderating Effect of the Proportion of Independent Board of Commissioners

Independent commissioners are an integral component of the company, charged with overseeing managers in their financial reporting performance and the effective implementation of corporate solid governance system requirements in organizations. Independent commissioners must be able to operate independently. They are elected directly by the corporation's members at the General Meeting of Shareholders (GMS). Their role is to supervise auditors in auditing financial statements and the production of well-standardized audits. As a result, a theory is advanced below:

H8: Audit quality can strengthen the independent commissioners' proportion on profit management

2.7.9. Audit Quality as Moderating Effect of Institutional Ownership

The institution is described as a party that wields the most influence on decision-making due to its majority shareholder status; also, institutional ownership is the party that oversees the company's financial policies. According to [20], the party decides the number of shares held by institutions that may act as a buffer against interest conflict in a business. On this basis, a hypothesis is established:

H9: Audit quality lowers the institutional ownership effects on profit management.

2.7.10. Audit Quality as Moderating Effect of Managerial Ownership

Managerial ownership refers to the power to govern a business, which company directors and other managerial parties often exercise. Managerial ownership is inversely linked to the profitability of the business. Similar to [21], the data indicate that managerial ownership relationships with profit management are seen as detrimental since they are negatively related. According to [22], a well-standardized audit may examine the corporation's financial report's trustworthiness by obtaining audit views indicating that management and managerial ownership have a substantial positive relationship. As a result, a theory is advanced:

H10: The effect of managerial ownership is reinforced by audit quality on profit management

2.7.11. Audit Quality as Moderating Effect of Free Cash Flow

Free cash flow is defined by [23] and [24] as monies available for distribution. Brigham and Houston remarked that the firm would like to invest extensively in fixed assets, new items, and the necessary operating capital to maintain old projects.

Without consistent monitoring, excessive free cash flow may occur if managers do not optimize their use of available cash or spend it on personal perks. Such an event would influence the upgrading of profit management for profit reporting, allowing for the coverage of inefficient cash usage [25]. As a result, the following hypothesis is applicable:

H11: The effect of free cash is reinforced by audit quality flow

2.7.12. Audit Quality as Moderating Effect of Leverage

Leverage is a term used to describe a corporation's reliance on creditors to fund its assets. Risks associated with funding are signs of funding challenges. Minimum oversight of the financial reporting process may result in excessive indebtedness and the need to strengthen profit management techniques in order to maintain performance on track in front of shareholders.

Argues from [26] that managers would tend to minimize profit management because a trained auditor may discover customers engaging in profit management. The study's conclusions corroborate those of [14], who asserted that audit quality negatively influenced profit management. The following hypothesis is:

H12: Audit quality may weaken the effect of leverage on profit management.

2.8. Framework of thinking

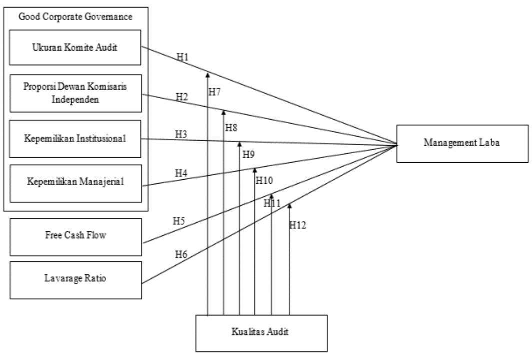

Figure 1. Research Model

3. RESEARCH METHOD

3.1. Population and Sample

Using financial report data for four years enables more precise and superior outcomes to precisely illustrate the aspects affecting profit management. The data source for this research is the financial statements of manufacturing businesses posted on IDX's official website from 2017 to 2020. Because, according to an IBS study published on bps.go.id, manufacturing enterprises in Indonesia witnessed volatility during that period. Certain businesses saw a fall in production (negative growth), while others increased.

Below are the characteristics determined for the purposive sampling:

1) Manufacturing companies in the Basic and Chemical Industry sectors listed on the IDX in 2017-2020, respectively.
2) Companies with assets of more than 1 trillion
3) Has published financial reports for the period 2017-2020.
4) Companies that issue financial statements in rupiah.
5) Companies that present the required data in full for all research variables on the IDX website during the 2016-2020 period.

3.2. Variables and Measurement

3.2.1. Dependent Variable

Profit management is the dependent variable (bound). [27] describes accounting policy selection as a management activity to optimize the company's welfare. The management is evaluated using discretionary accruals following Dechow's (1995) Modified Jones Models.

1) Calculate total accruals with the formula:
   TACit=Nit-CFOit (1)
2) Calculating the accruals value is calculated using ordinary least square (OLS):
   TACit/Ait-1= 1 (1 / Ait-1) + 2 (ΔREVt / Ait-1) + 3 (PPEt/ Ait-1) + e (2)
3) With the aforementioned calculation, the non-discretionary accrual (NDA) value was estimated as below:
   NDAit = 1 (1 / Ait-1) + 2 (ΔREVt / Ait-1– RECt/ Ait-1) + 3 (PPEt / Ait-1) (3)
4) Calculate discretionary accruals with the following formula:
   DAit = TAit / Ait-1– NDAit (4)

3.2.2. Independent Variable

Independent factors include the size of the audit committee, the proportion of independent commissioners, free cash flow, leverage ratio, institutional and management ownership.

Free Cash Flow measures a company's financial flexibility, indicating how quickly available cash may be repaid to shareholders without being invested in fixed assets. The Brigham and Houston formula [23] is used to compute this variable:

Free Cash Flow = NOPAT – net investment in operating capital (5)

The ratio of a company's total debt to its total assets is leverage. The greater the leverage, the greater the risk that the firm may not make its debt repayment commitments on time, putting the company at risk of default. The ratio of total debt to total assets is used in this study.

3.2.3 Moderating Variables

The audit quality is the moderating variable in this study. The inputs, methods, and outcomes of an audit can all be used to determine the audit's quality. Here, audit quality is estimated by the audit output, namely the audited financial statements. The better the earnings quality on the financial statements, it can be said that the audit quality is getting better. The number of discretionary accruals can measure earnings quality. The greater the discretionary accruals, the more the audit quality is getting worse because it shows that the auditor cannot suppress profit management carried out by the company's management and vice versa. Discretionary accruals were measured using the Kaznik (1999) model.

Audit quality is the negative value of discretionary accruals [30].

AQ = - DACC

3.2.4 Data Analysis Techniques

(1) Conventional assumption tests such as Normality, Multicollinearity, Heteroscedasticity, and Autocorrelation are employed to analyze the data. (2) The simultaneous F-test and the Partial F-test are utilized to examine hypotheses.

4. RESULTS AND DISCUSSION

4.1 Classic Assumption Test Results

1) Normality test

Table 1. Kolmogorov-Smirnov test results

One-Sample Kolmogorov-Smirnov Test	
	Unstandardized Residual

N	52
Asymp. Sig. (2-tailed)	,184c,d

The table of Kolmogorov-Sminorv test results above shows that the Asymp sig (2-tailed) value is 0.184 > 0.05, which means that the data can be used in research.

2) Multicollinearity Test

Table 2. Multicollinearity Test

Model		Collinearity Statistics	
		Tolerance	VIF
1	(Constant)		
	KOMA	,887	1,128
	PDKI	,925	1,081
	KI	,797	1,254
	KM	,879	1,137
	FCF	,799	1,125
	LEV	,881	1,135

The preceding table indicates that this study does not exhibit multicollinearity since the tolerance value for each independent variable is more than 0.10 and the VIF value for each variable is greater than 10.

3) Heteroscedasticity Test

Table 3. Glesjer. test results

Model		Sig.
1	(Constant)	,685
	KOMA	,543
	PDKI	,316
	KI	,980
	KM	,347
	FCF	,258
	LEV	,090

The table above shows that the significance value is > 0.05, indicating that it has no signs of heteroscedasticity.

4) Autocorrelation Test

Table 4. Autocorrelation test

Model Summary[b]					
Model	R	R Square	Adjusted R Square	Std. An error of the Estimate	Durbin-Watson
1	,372a	,138	,023	,0010431	2,085

The table above shows the results of Durbin Watson of 2.085. The value of du based on the data is 1.8183. Value 4-du=2.1817. Therefore, the Durbin-Watson value is between du and 4-du or du<d<4-du 1.8183 <2.085 < 2.1817, so there is no autocorrelation.

4.2. Hypothesis Test Results

1) Simultaneous F Test

Table 5. Result f test

ANOVA[a]		
Model		Sig.
1	Regression	,323b

The calculated F is 1.202 with a significance value of 0.323; thus, the significant value is 0.323>0.005. This shows that the Proportion of the X1, X2, X3, X4, X5, X6 does not affect Profit management.

2) Partial Test T-test

Table 6. Result T-test

Coefficients[a]			
Model		t	Sig.
1	(Constant)	,961	,342
	KOMA	1,265	,212

	PDKI	-2,058	,045
	KI	,292	,771
	KM	,337	,737
	FCF	1,206	,234
	LEV	-,488	,628

The tests above it represent how the variables affect earnings management as elaborated below:

a) The significance level for the X1 size variable is 0.212 > 0.05, with a t count of 1.265 and a t table of 2.014. As a result, the variable has no discernible influence.
b) The significance level for the variable fraction of X2 is 0.0450, and the t count is -2.058 > the t table is 2.014, indicating that the variable has a significant effect.
c) The X3 test has a significant level of 0.771 > 0.05, a t count of 0.292, and a t table of 2.014. As a result, the variable has no discernible influence.
d) The significant level for testing management ownership is 0.737 > 0.05, with a t count of 0.337 and a t table of 2.014. As a result, the variable has no discernible influence.
e) The significance level for testing the free cash flow variable is 0.234 > 0.05, with a t-test of 1.206 and a t table of 2.014. As a result, the variable does not have a significant effect.
f) The leverage variable test is significant at 0.628 > 0.05, with a t count of -0.488 and a t table of 2.014. As a result, the variable has no meaningful influence.

The results of the t-test of the moderating variable

Table 7. Result t-test of the moderating variable

Coefficients[a]			
Model		t	Sig.
1	(Constant)	,519	,606
	KA*KOMA	-4,684	,000
	KA*PDKI	-6,373	,000
	KA*KI	-.033	,974
	KA*KM	1,868	,068
	KA*FCF	-1,405	,167
	KA*LEV	-8,170	,000

What we can sum up from the table above:

a) Testing the audit quality variable as a moderator of the effect of X1 on profit management has a significance value of 0.000 <0.05. From these results, we can conclude that the audit quality variable moderates the effect of audit committee size.
b) Testing the audit quality as a moderator of the effect of the X2 has a significance value of 0.000 <0.05. Therefore, the audit quality variable moderates the effect of the proportion of independent commissioners.
c) Testing the audit quality variable as a moderator of the effect of X3 has a significance value of 0.974 > 0.05. So, the audit quality variable does not moderate that institutional ownership effects.
d) Testing the audit quality variable as a moderator of the effect of X4 has a significance value of 0.068 > 0.05. Thus, the audit quality variable cannot moderate that effect.
e) Testing the audit quality as a moderating variable of the X5 effect gives a significance value of 0.167 > 0.05. So, the audit quality variable cannot moderate the effect of free cash flow.
f) Testing the audit quality variable as a moderator of the effect of X6 has a significance value of 0.000 <0.05. Therefore, it may moderate leverage on profit management.

4.3. Discussion

4.3.1. Effect of Audit Committee Size

It is shown from H1 that the X1 affects profit management positively. From the hypothesis testing, the test of the X1 variable on profit management has a significant value of 0.212 > 0.05, and t count of 1.265 < t table of 2.014. These results concluded that the X1 variable had no significant effect on profit management, so H1 was declared rejected.

4.3.2. The Effect of the Proportion of Independent Commissioners

H2 has proven that the X2 positively affects profit management. From the testing of the effect of the X2 on profit management, it is safe to conclude that H2 is accepted because it has a significant value of 0.045 <0.05, and t count is -2.058 > t table is 2.014, we can sum up that the variable has a significant effect on X2.

4.3.3. The Effect of Institutional Ownership

H3 asserts that X3 has a noticeable effect on profit management, with a significant value of 0.771 > 0.05. With a t-test of 0.292 and a t table of 2.014, it is possible to conclude that X3 does not significantly affect profit management, and thus H3 is rejected.

4.3.4. Managerial Ownership Effect

H4 strongly influences X4, with a significant value of 0.771 > 0.05. With a t-count of 0.292 and a t table of 2.014, one may conclude that X4 has little influence on profit management, so H4 is rejected.

4.3.5. Effects of Free Cash Flow

H5 asserts that X5 has an influence; however, with a significance level of 0.234>0.05 and a t-count of 1.206 and a t-table of 2.014, it is determined that the variable has no discernible effect on X5, and therefore H5 is rejected.

4.3.6. Leverage Effects

Leverage affects profit management, as stated in H6. However, when the leverage impact on profit management is tested, a value of 0.628 > 0.05, a t-test of -0.488, and a t table of 2.014 are found. As a result, the variable has no discernible influence, and H6 is rejected.

4.3.7. Audit Quality Effect of Audit Committee Size

According to H7, X7 exacerbates the effect of audit committee size. The regression result has a significance value of 0.05, indicating that quality audit has a moderating influence on audit committee size. Therefore, H7 is accepted.

4.3.8. Audit Quality Effect of the Proportion of Independent Board of Commissioners

H8 asserts that X8 enhances the profit management effect of the proportion of independent commissioners. By examining the regression output, a significance value of 0.05 was determined. This indicates that audit quality mitigates the independent commissioners' percentage's influence on profit management, so H8 is acceptable.

4.3.9. Audit Quality Effect of Institutional Ownership

H9 asserts that X9 mitigates institutional ownership's influence on profit management. As a result, the variable cannot act as a moderator of the institutional ownership effect, and hence H9 is accepted. The regression result was statistically significant at 0.974 > 0.05.

4.3.10. Audit Quality Effect of Managerial Ownership

H10 asserts that audit quality boosters managerial ownership's influence. The regression result was statistically significant at 0.068 > 0.05. As a result, that variable cannot modulate the managerial ownership effect, and H10 is rejected.

4.3.11. Audit Quality Effect of Free Cash Flow

According to H11, audit quality bolsters the free X11. The regression output has a significant level of 0.167 greater than 0.05. As a result, the variable cannot moderate free cash flow's influence on profit management, and H11 is rejected.

4.3.12. Audit Quality as Moderating Effect of Leverage

H12 asserts that audit quality bolsters X12 on profit management. When the regression output is analyzed, it reveals a significant value of 0.05, indicating that audit quality mitigates leverage's effect, so H12 is accepted.

5. CONCLUSION

This study demonstrates that the X1, X2, X3, and external variables like free cash flow and leverage do not affect profit management. The changing percentage of independent commissioners, on the other hand, does.

Audit quality has a moderating influence on profit management only when audit committee size, the share of independent commissioners, and leverage are considered. It is incapable of mitigating the effect of institutional, managerial, and free cash flow ownership.

SUGGESTION

Further study is believed to be a call for extensive studies evaluating variables affecting profit management and the Good Corporate Governance variable to be quantified using other proxies.

Additionally, it is envisaged that the sample would be more significant, allowing investors to make informed selections prior to investing in the firm.

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