The Effect of *Financial Distress* and Free Cash Flow on *Earnings Management* with Quality of Audit as a Moderator

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Abstract. This study aims to provide empirical evidence of the relationship between *financial distress* with modified Altman z-score model and *free cash flow* on *earnings management* with audit quality as moderating. This study uses a sample of manufacturing companies listed on the Indonesia Stock Exchange in 2016–2020. The results showed that *financial distress* with the modified Altman z-score model had a negative effect on accrual earnings management. This implies that companies experiencing *financial distress* will perform accrual earnings management. The hypothesis that *free cash flow* has a negative effect on earnings management is supported which provides evidence that large *free cash flows* will tend to reduce accrual earnings management in fulfilling contractual commitments with company owners. Meanwhile, the hypothesis of audit quality moderating the relationship between *financial distress* and *free cash flow* on earnings management is supported. This shows that a quality audit will be able to reduce accrual earnings management in the company.

Keywords: Financial Distress · Free Cash Flow · Audit Quality and Earnings Management

1 Introduction

Financial statements, especially income statements and cash flow reports presented by a company, are the main source of information for company stakeholders to obtain information regarding the performance and financial condition of a company. One of the most important information in a financial report is profit information. The company's external parties will use earnings information to assess the company's performance and then provide appropriate rewards for management. This reward motivation encourages management to display profits in accordance with the expectations of the company's external parties so that earnings management is chosen by managers to do [1]. The general view regarding earnings management is fraudulent financial reporting by management. However, earnings management is not fraud or fraud but only managerial engineering [2].

This earnings management action has led to several cases in accounting reporting that are widely known, such as PT Kimia Farma Tbk, PT Katarina Utama Tbk, and

M. I. Ferdiansyah et al. (Eds.): ICAME 2022, AEBMR 239, pp. 144–159, 2023.
https://doi.org/10.2991/978-94-6463-146-3_15

PT Garuda Indonesia Tbk. The case of earnings management does not only occur in Indonesia but also in other countries. Like the case of Enron and Toshiba. Earnings management practices will inevitably harm both internally and externally. Earnings management practices will affect *going concern* and will also harm investors and the government in general. The practice of earnings management in the long term will result in the company going bankrupt [3].

In public companies, the termination of stock trading by the regulator gives an indication of the bankruptcy of a company which will then be delisted from the stock exchange. Companies that are delisted from the stock exchange are companies that have been abolished or excluded from the list of companies whose shares are traded on the stock exchange. Meanwhile for companies that do not go public, bankruptcy is marked by the company's failure to pay off or pay the company's obligations. The risk of the bankruptcy of a company, whether it is a public company or a company that does not go public, will be borne by investors and creditors. So that investors and creditors will make predictions regarding the possibility of a company going bankrupt.

Various models have been developed for bankruptcy prediction purposes such as Altman Z-Score, Zmijewski, Grover and Springate. This model has been tested by research to test the accuracy of each of these models. However, there is no single model that can accurately predict the bankruptcy of a company. In addition, research is also conducted to assess the behavior of company managers who experience financial distress or *financial distress.* Managers in companies experiencing financial distress will practice earnings management through income-decreasing compared to healthy companies [4]. Types of earnings management policies by managers when experiencing financial difficulties tend to use real earnings management more often than accrual earnings management [5, 6]. However, management in companies experiencing financial problems actually managed accrual earnings compared to real earnings management [7].

In addition to the *financial distress* that the company faces, which makes management perform *earnings management*, another factor that has been researched and shows inconsistent results is *free cash flow (FCF).* FCF or free cash flow is cash flow generated by the company from the normal operations of the company and is free to be used to pay dividends or shareholders without affecting the company's operations. FCF is a factor that influences the behavior of corporate earnings management because one of the performance measures other than profit is often used by investors and creditors. *FCF* has a positive effect on earnings management [8, 9] but FCF can reduce earnings management behavior [1, 10].

Earnings management behavior carried out by management can be done by choosing accounting policies or procedures that are in accordance with their expectations, known as *discretionary accruals.* In addition, managers can also manage real profits by manipulating the company's real activities such as sales and production. The ability of users of external financial statements to detect this behavior is very limited, so an auditor's services are needed to ensure that managers do not carry out earnings management in the preparation of financial reports presented to users of financial statements. Auditor reputation has a negative effect on earnings management behavior [11]. While Firm size cannot reduce accrual earnings management but reduces real earnings management behavior [12]. However, Big4 clients actually record higher real and accrual earnings

management [13]. Meanwhile, audit quality is negatively related to earnings management [14]. Conducted a study to test whether audit quality can be a moderating variable and the results of their research cannot prove that audit quality is a moderating variable on earnings management [15].

Based on the description above, it is deemed necessary to determine whether the condition of *financial distress* and *free cash flow* can affect the behavior of accrual earnings management with audit quality as a moderating variable. It is important to provide empirical evidence, especially audit quality as a moderating variable to reduce *earnings management* in the company's financial statements.

2 Literature Review

2.1 Agency Theory

Agency theory was first proposed by [16]. This theory discusses the relationship or contract between shareholders and managers. The main principle of this theory states that there is a working relationship between the party giving the authority, namely the shareholder, and the party receiving the authority, namely the manager, in the form of a cooperation contract. Agency theory has the assumption that each individual is solely motivated by his own interests, thus creating a conflict of interest between managers and shareholders. This is due to the separation of ownership and control of the company. Agency theory develops into two streams in subsequent research. Include: (1) Positive Theory of Agency, the focus of this theory is the identification of situations when conflicts occur between shareholders and managers and there are government mechanisms that can limit self-saving in managers. (2) Principal Agent Literature, the main focus of this principle is the relationship between managers and shareholders in an effort to optimize contracts in terms of behavior and results [16].

Management seeks to obtain maximum welfare by reducing various agency costs. These costs arise in agency relationships because of information asymmetry between the principal and the agent. Managers or agents as managers and report makers have various choices of accounting policies and procedures in presenting financial reports. This causes efficient contracts to occur so that the relationship between agents and principals is always based on information asymmetry. Verification of the information presented by the agent is very difficult to do so that the agent's behavior is very difficult to observe. Thus, the opportunity for agents to maximize their own interests or their wealth by carrying out actions that are not in accordance with the contract.

The role of the external auditor (public accountant) as an independent party is needed to reduce the agency relationship conflict between the principal and the agent. The external auditor examines the company's financial statements to assess the fairness of management's performance whether it is in accordance with the contract agreed between the manager and the shareholders. Shareholders and potential investors expect the external auditor to provide early warning regarding the condition of the company, especially regarding business continuity. Audits conducted by public accountants with unqualified opinions will increase the confidence of investors and other users of financial statements in the company' financial statements presented by management [17].

2.2 Financial Distress

Financial distress is a condition of the company's inability to provide working capital or cash to operate normally so that it affects the continuity of the company's business. This condition is one of the factors that causes a company to go bankrupt. The company's inability to carry out normal company operations thereby reducing the ability to generate profits is an early indication of bankruptcy for a company. Bankruptcy is also often called company liquidation or company closure or insolvency. Define bankruptcy as a failure in several senses [18]:

a. Economic failure (*economic failure*). This means the company failed in investment. Investments, generally financed by loans, are expected to increase the company's profits and cash inflows. However, the investment was not able to generate the expected profit and cash flow. The income is much less than the operating costs incurred to get that income. Likewise, the expected cash flow is less than the obligations to be paid. This condition results in the company experiencing financial losses and failure to pay its obligations. The main factor is the failure of investments made by the company where the results of the investment are not as expected.
b. Financial Failure is interpreted as insolvency which differentiates between cash flow basis and stock basis. There are two forms of insolvency on the basis of cash flows, namely:

    1. Technical insolvency, namely a company can be considered a failure if the company cannot fulfill its obligations when they fall due. Even though total assets exceed total debt, financial failure will occur if the company is unable to fulfill the provisions in its debt contracts such as the current ratio or debt to equity ratio that has been set or required.
    2. Insolvency in terms of bankruptcy is defined as negative net worth or negative equity in the company's statement of financial position or cash flow that is smaller than liabilities.

A more accurate bankruptcy prediction will benefit many parties, especially creditors and investors. Bankruptcy analysis is a way to provide early warnings of bankruptcy (early signs of bankruptcy). Early bankruptcy prediction will benefit management because it will provide opportunities to make improvements earlier. For creditors and shareholders, early bankruptcy prediction will give them time to make preparations to deal with various bad possibilities [19].

2.3 Free Cash Flow

Free cash flow (FCF) is cash available in the company that can be used to pay dividends or pay interest on loans. FCF is important because it is one of the indicators to assess the company's performance by external parties. Conflicts of interest between managers and shareholders often occur in the use of this FCF. The management tends to want to use FCF for investment in business development, but shareholders tend to want this FCF to

be distributed in the form of dividends so that it will improve the welfare of shareholders [20].

A large FCF in a company will create a moral hazard for management to use in activities that benefit them. In addition, a large FCF without supervision in the use of investment by management can result in losses for the company. Many cases have been evidence of how the wrong investment will result in the bankruptcy of a company like the one experienced by the PT Teh Sosro. The use of company cash is expected to increase company profit but in reality the use of cash does not have effect that is in accordance with expectations so that management needs to manipulate profit (earnings management) to meet these expectations.

The use of FCF is very important because it has implications for the company's ability to maintain operations or to grow and investors' trust. The use of FCF that is too large for investment will increase the company's ability to grow in the future but will reduce investor confidence. Conversely, the use of large FCFs to pay dividends will reduce the company's ability to maintain operations or to grow in the face of competition. Kodriyah and Fitri (2017) *Free cash flow* must also always be available to be paid to all investors after the company has placed all its investments, both fixed assets, new products, and working capital needed to maintain ongoing operations. However, companies that are able to distribute higher dividends will increase their share prices because they are seen by investors as companies that have excess cash. Companies that hold their excess cash (not distribute it as dividends) actually tend to lower their stock prices because investors think that the excess funds will be used to finance investments that are less profitable. A company manager will maintain and increase free cash flow because free cash flow is one of the important indicators used by investors in determining the value (stock price) of a company [1].

2.4 Earning Management

Earnings management as a means by which managers can choose accounting policies from a set of policies with which they can maximize their own utility or the market value of their company [21]. From this definition, it can be interpreted that earnings management is a choice of accounting policy by managers with the aim of maximizing their personal interests or company value. So basically, the accounting policy chosen by the manager is not for the benefit of the owner of the company but for the benefit of the manager. Managers can enjoy direct benefits from earnings management in the form of bonuses from the company or indirectly benefit from the increase in the value of the company's shares so that managers who own shares will increase their wealth.

Earnings management as an intervention by managers with a specific purpose in the process of preparing financial reports to maximize the interests of managers [22]. In other words, earnings management practices are opportunistic behavior of managers to maximize their wealth. So this definition shows that earnings management behavior is an action planned by managers by influencing the process of preparing financial statements or intervention. Interventions can be with changes in accounting policies or methods used or with changes in accounting estimates in financial reporting.

Earnings management practices by managers can be in the form of increasing or decreasing profits by changing accounting policies. Managers' accrual policies are

related to incentives to report income from their bonus payment contracts and changes in accounting policies that managers make [23]. This is related to the payment limit for adopting or modifying their bonus plan. Through this article, Paul M Healy shows with a simulation that managers who are not able to reach the income limit to get bonuses, they will tend to reduce reported profits with the aim that the following year they will enjoy a take a bath or in other words will enjoy abundant income this year. Next. The same thing will be done by the manager if the profit before earnings management is already above the bonus calculation limit, the manager will reduce the profit close to the bonus payment limit profit if there is no bonus payment for the reported excess revenue.

2.5 Audit Quality

Research on audit quality has been carried out by many researchers. Audit as an activity to reduce the information gap between internal and external parties of the company which is carried out by an independent party that provides an assessment of the fairness of a financial report [24]. A quality audit is expected to detect fraud and errors in financial reports. So that audit quality is one important factor in improving the quality of a company's financial reporting. Therefore, a quality audit process in a company will make investors more confident in the company's financial reports.

Audit quality is the central point of external control which is one of the key factors in earnings management. High audit quality is considered to be able to limit the opportunistic behavior of earnings management by managers. Based on agency theory, earnings management practice is triggered by information asymmetry. Managers as agents have more information than shareholders, because as managers of companies, managers know more about the real situation. The misalignment of information between agents and principals can be reduced by external supervision by qualified auditors [9].

So that in a company it is necessary to have an active role of an auditor to produce reliable financial reports. An auditor must have its own qualifications when conducting an audit of the financial statements or activities of a company. A quality audit process in auditing financial statements will also produce higher quality information when compared to information produced by an audit process that is not of high quality. A quality audit process is of course carried out by a qualified auditor as well. The more qualified an auditor, the action to carry out earnings management will not occur in a company. The Public Accounting Firm is a proxy for reputation to measure audit quality, because we can assume that the reputation of the firm will affect the results of an audit conducted by an auditor [25].

Audit opinions issued by Public Accounting Firms that increase the reliability of the company's financial statements indicate high audit quality. The quality of the opinion issued by the firm is influenced by the quality control system in a Public Accounting Firm. The size of the Public Accounting Firm will guarantee that the quality control system runs effectively. In addition, large public accounting firms have many clients and large fees so that they are able to maintain a high level of independence so that they are able to detect earnings management behavior by managers. Big four (Big4) as an international Public Accounting Firm which has an extensive network in many countries in the world is believed to have a more perfect quality control system compared to non-big

four Public Accounting Firms. Audit quality can reduce earnings management behavior [26].

2.6 Relationship of Financial Distress with Earnings Management

The bankruptcy prediction model is widely used by capital market analysts to analyze financial statements, especially regarding the potential for bankruptcy of a company. As stated that information about the bankruptcy of a company if it is known early will provide an opportunity for management to make improvements [19]. Not only that, it is also useful for investors to prevent losses on their investment. In addition, *financial distress conditions* also encourage managers to manage earnings. Management performs earnings management to fulfill contracts with principals and avoid problems with creditors.

Financial distress has no effect on the behavior of accrual earnings management but conversely financial distress can affect real earnings management [5]. This shows that in conditions of financial difficulty, management will not engineer financial statements but rather on engineering real activities such as sales and production. Management chooses real income management for the purpose of improving operations and ultimately improving the appearance of financial statements.

Financial distress provides incentives for directors to manipulate earnings [4]. Management will perform real earnings management when experiencing *financial distress* compared to accrual earnings management [6]. However, Research in China showing different results, namely managers will carry out accrual earnings management in *financial distress conditions.* This shows that the direction of the influence of earnings management has not been consistent. FCF can reduce earnings management behavior [1, 10]. Based on the explanation above, the first hypothesis in this study is:

H_1: *Financial distress* has a negative effect on earnings management.

2.7 Relationship Free Cash Flow and Earnings Management

Free cash flow (FCF) is assumed to be flexible in the company's finances, and can also be a picture of cash in the company that can be allocated to creditors or shareholders, and the cash is of course cash that is not intended for working capital or investment in fixed assets. Free cash flow is cash that is not used in company operations or working capital or is used for investment in assets to increase the company's ability so that it can be distributed to shareholders and investors [20]. So that the existence of the cash will cause conflict in its use between management and shareholders. Management prefers the cash to be reinvested in projects that can generate profits, because this policy will increase their wealth. On the other hand, shareholders expect the remaining funds to be distributed so that it will increase their welfare.

FCF which is an indicator of manager performance appraisal, thereby providing motivation for managers to carry out earnings management to meet the expectations of external parties. A low FCF will motivate management to carry out earnings management to increase FCF and vice versa a large FCF makes management unnecessary to carry out earnings management to meet shareholder expectations. The earnings management

option that the manager will choose to meet the expectations of external parties when the FCF condition is low is accrual earnings management. However, in conditions of excess FCF, managers will carry out real earnings management to maximize their personal profits.

Another goal is for managers to practice earnings management when the company is in surplus cash flow will take the maximum profit for their personal needs [27]. Managers prefer that these funds be reinvested in profitable projects, because this alternative will increase the incentives they receive.

A high company FCF requires strict or adequate supervision to prevent managers from making investments that are not optimal for company growth. When the use of FCF is not efficient and effective, so that the FCF becomes down, it will provide incentives for managers to manage accrual earnings to cover this. Based on this, the second hypothesis in this study is

H_2: *Free cash flow* has a negative effect on earnings management

2.8 Moderating Variable (Audit Quality)

To increase the trust of users of financial statements, good audit quality is highly expected. However, it cannot be denied that the quality of auditors is not the same for all so that the quality of the audited company's financial statements is not always at a high level. In this case, high-quality auditing is a variable that can prevent effective earnings management, because earnings manipulation found by auditors will damage management's reputation and can reduce company value. Even the most perfect earnings management practices will be detected by the implementation of high quality auditors.

Research related to audit quality uses various proxies to measure the effect of audit quality. Auditor reputation can reduce earnings management behavior [11]. Whereas the size of a Public Accounting Firm does not affect the behavior of accrual earnings management but can reduce the behavior of real earnings management [12]. However, Big 4 clients actually record higher real and accrual earnings management [13]. Meanwhile, A quality audit can reduce earnings management behavior [14]. Audit quality can moderate the earnings management relationship and their research results cannot prove that a quality audit can affect the relationship of other variables with earnings management [15]. Based on this, the third and fourth hypotheses in this study are

H3: The relationship between financial distress and earnings management can be moderated by audit quality
H4: The relationship between free cash flow and earnings management can be moderated by audit quality

3 Research Methods

3.1 Population and Sample

The population in this study are all manufacturing companies listed on the IDX. While the sample in this study is a manufacturing company listed on the IDX based on certain criteria as follows:

a. Manufacturing companies listed on the IDX in 2016 – 2020.
b. Companies that are not *delisted* during the observation period.

3.2 Data Source

The data used is data on the annual financial reports of public companies (manufacturing) from 2016 to 2020 available on the Indonesian Capital Market Directory (ICMD) and the official IDX website at www.idx.co.id or each company.

3.3 Hypothesis Test

Multiple regression analysis is used to examine the relationship or influence of the independent variables on the dependent variable. The formula for testing the relationship and influence of the independent variables on the dependent variable is as follows:

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \varepsilon \quad (1)$$

Information:
Y= Earnings management
α= Constant
X_1= *Financial Distress*
X_2= *Free cash flow*
$\beta_1 - \beta_2$= Multiple regression coefficient
ε= Error *term*

Linear regression is used specifically to determine the relationship between the two variables that are influenced by the third variable, so a moderation regression analysis is used. The moderating variable is an independent variable that influences the relationship between other independent variables and other dependent variables, either strengthening or weakening the relationship. Testing the moderating variable can be done in three ways, namely; interaction test, absolute difference value test and residual test.

This study uses the absolute difference value test, with the following equation:

$$Y = \alpha + \beta_1 ZX_1 + \beta_2 ZX_2 + \beta_3 ZX_3 + \beta_4 [ZX_1 - ZX_3] + \beta_5 [ZX_2 - ZX_3] + \varepsilon \quad (2)$$

Information:
Y: Earnings Management
α: Konstanta
ZX_1: Standardized *Financial Distress*
ZX_2: Standardized *free cash flow*
ZX_3: Standardized Quality audit
[ZX_1–ZX_3]: The interaction between ZX1 and ZX3 is measured by the difference in absolute values
[ZX_2–ZX_3]: The interaction between ZX1 and ZX3 is measured by the difference in absolute values
β_1–β_5_: Regression coefficient
ε: Error *term*

3.4 Operational Definition of Variables and Measurement

Independent Variable

1. *Financial distress* is a financial condition in a company that shows a problematic financial condition and indicates bankruptcy. The model used in this study is the Modified Altman Z-Score model, namely:

$$Z = 6.56X_1 + 3.26X_2 + 6.72X_3 + 1.05X_4$$

Information:

Z: score of financial distress if $Z < 1.23$ means experiencing financial distress or bankruptcy, $1.23 < Z < 2.9$ means gray area company and $Z > 2.9$ does not experience financial distress or bankruptcy

X_1: Ratio of working capital to total assets (Current Assets – current liabilities/Total assets)

X_2 : Retained Earnings/Total Assets

X_3 : EBIT/Total Assets

X_4 : Book value of equity/total book value of liabilities

This variable is measured using a dummy variable

2. Free Cash Flow

The scale of measurement of free cash flow uses the measure proposed by Rahdal. 2017 is:

$$FCF = \frac{CFO - NetCapitalExpenditure - NetBorrowing}{Equity}$$

Dependent Variable

Accrual earnings management variable as measured using the modified Jones method:

a. Calculating total accruals

TAC it = NI it – CFO it

b. Calculating the accruals value using a simple regression equation

$TAC_{it}/TA_{it-1} = 1(1/TA\ it\text{-}1) + 2(\Delta Rev\ it/TA\ it\text{-}1 + 3(PPE\ it/TA\ it\text{-}1) + \varepsilon$

c. Menghitung *non discresionary accrual*

$NDA\ it = \beta 1\ (1/TA\ it\text{-}1) + \beta 2\ (\Delta Rev\ it - \Delta Rec\ it)/TA\ it\text{-}1 + \beta 3\ (PPE\ t/TA\ it\text{-}1)$

d. Menghitung *discresionary accrual*

DA it = TAC it/TA it – NDA it
Keterangan:
DA it: *Discresionary Accruals* company i pada periode t
NDA it: *Non Discreionary Accruals* company i pada periode t
TAC it: *Total Accruals* company i pada periode t
NI it: *Net Income* company i pada periode t
CFO it : *Cash Flow Operating* company i in period t
TA it : *Total Assets* of company i in period t
REV it : Change in income of firm i in period t
REC it : Changes in accounts receivable of company i in period t
PPA it : Total fixed assets of company i in period t
ε: error

Moderating Variables
The moderating variable is audit quality as measured using a dummy variable, namely 1 for Big4 public accounting firm auditors and 0 for non-Big4.

4 Result

4.1 Descriptive Statistic

The following are the results of descriptive statistical tests using SPSS version 22 which are presented in Table 1.

Table 1 presents descriptive statistics for each research variable. Financial distress variable shows a minimum value of 0.83 and a maximum of 13.21 with a mean of 5.77 and a standard deviation of 3.079. The free cash flow variable shows results with a minimum value of −0.58 and a maximum of 0.40 with a mean of 0.048 and a standard

Table 1. Descriptive Statistic

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
Financial Distress	−,002	,013		−,191	,849
Free Cash Flow	−,025	,008	−,358	−3,283	,002
Audit Quality	−,047	,006	−,674	−8,304	,000
Earnings Management	,001	,006	,012	,137	,891
Valid N (listwise)	,021	,009	,258	2,446	,017*
	−,015	,008	−,156	−1,893	,062**

deviation of 0.19. The audit quality variable with results with a minimum value of 0.00 and a maximum of 1.00 with a mean of 0.4 and a standard deviation of 0.492. While the earnings management variable shows results with a minimum value of −0.14 and a maximum of 0.28 with a mean of 0.01 and a standard deviation of 0.07.

4.2 Partial Regression Test (t Test)

The following is a partial regression test in Table 2.

Based on Table 2, the estimation model is as follows

$$Y = 0.046 - 0.004X_1 - 0.249X_2 + \varepsilon \quad (3)$$

Based on Table 2, the research hypotheses, namely H1 and H2, can be interpreted for the financial distress variable to have an *unstandardized beta* coefficient of −0.004 and a significance level of 0.024 which is smaller than 0.05, so it can be concluded that H1 is supported. Meanwhile, the free cash flow variable has an *unstandardized beta coefficient* of −0.249 and a significance level of 0.00 which is smaller than 0.05, so it can be concluded that H2 is supported.

Based on the results of the absolute difference test presented in Table 3, the hypotheses H $_3$ and H_4 can be interpreted that audit quality is a moderating variable with pure moderation type. For hypothesis 3 (H_3) shows level significance of 0.017 which means it is smaller than 0.05, it can be concluded that H3 is supported. While H_4 with a significance level of 0.062 is greater than 0.05 but smaller than 0.10, it can be concluded that H_4 is supported at the 10% level.

5 Discussion

5.1 Financial Distress

Based on Table 2, which shows that the *financial distress variable* with the Altman z-score model has a negative and significant effect on earnings management. These results provide evidence that managers will reduce accrual earnings management if the company experiences financial distress. The negative relationship indicates that the more severe the financial distress experienced by the company, the manager will reduce accrual

Table 2. Partial Regression Test Results (t Test)

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	,046	,012		3,927	,000
1 Financial Distress	−,004	,002	−,183	−2,299	,024
Free Cash Flow	−,249	,029	−,676	−8,509	,000

a. Dependent Variable: Earnings Management

earnings management. Based on the results of the study, it is suspected that real earnings management will tend to be used by company managers experiencing financial distress compared to accrual earnings management [5, 6].

5.2 Free Cash Flow

Based on Table 2 which proves that the free cash flow variable reduces or has a negative effect on earnings management. These results provide evidence that if a company has a large free cash flow, the manager has no incentive or motivation to manipulate accrual earnings. This negative relationship indicates that the greater the free cash flow owned by the company, the manager reduces or does not carry out accrual earnings management. Based on the results of this study, which state that free cash flow has a negative effect on earnings management [1, 10]. This provides empirical evidence that managers will try to fulfill agency contracts by conducting earnings management when the company's free cash flow is low because free cash flow is one measure of manager performance.

5.3 Audit Quality

Based on Table 3, it provides empirical evidence that audit quality is a moderating variable on financial distress and free cash flow on earnings management. Audit quality becomes a moderating variable by strengthening the relationship between financial distress and earnings management. This shows that if the audit is of high quality, the accrual earnings management will be reduced when the company is in financial distress. While free cash flow shows different results, audit quality is a moderating variable but weakens the relationship between free cash flow and earnings management. These results

Table 3. Moderated Regression Analysis

Model	Unstandardized Coefficients		Standardized Coefficients	T	Sig.
	B	Std. Error	Beta		
(Constant)	−,002	,013		−,191	,849
Zcore: Financial Distress	−,025	,008	−,358	−3,283	,002
1 Zcore: Free Cash Flow	−,047	,006	−,674	−8,304	,000
Zcore: Audit Quality	,001	,006	,012	,137	,891
X1_M	,021	,009	,258	2,446	,017*
X2_M	−,015	,008	−,156	−1,893	,062**

a. Dependent Variable: Eranings Management
b. * signifikan at level 5%
c. ** signifikan at level 10%

do not support the research which states that audit quality is not a moderating variable between managerial ownership, leverage, profitability and dividend policy on earnings management [15].

6 Conclusion and Limitations of the Study

The results of this study provide evidence and it can be concluded that:

1. The financial condition of companies experiencing *financial distress* has a negative effect on earnings management.
2. The condition of the company's free cash flow has a negative effect on earnings management.
3. Audit Quality moderates by strengthening the relationship of *financial distress* to earnings management.
4. Audit Quality moderates by weakening the relationship of *free cash flow* to earnings management.

Limitations in this study are the number of samples used only for manufacturing companies listed on the IDX from 2016 to 2020 and earnings management used only discretionary accruals. It is recommended for further research to use two measures of earnings management, namely discretionary accruals and real earnings management.

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