The Impact of Financial Distress, Free Cash Flow, Information Asymmetry, and Firm Size on Real Earnings Management

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ABSTRACT

Companies sometimes experience unfavourable situations, prompting managers to involve themselves in preparing financial reports to engage in earnings management practices. The existence of earnings management practices arises due to the influence of several factors. This research aims to examine the influence of financial distress, free cash flow, information asymmetry, and firm size on real earnings management. The population of this study comprises consumer non-cyclicals companies listed on the Indonesia Stock Exchange from 2020 to 2022. Purposive sampling was utilized as the sampling technique, resulting in a total sample of 64 companies. Multiple linear regression was employed as the analysis technique. The results of this research indicate that financial distress and free cash flow do not have a positive effect on real earnings management. Meanwhile, information asymmetry and firm size have a negative effect on real earnings management.

Keywords: *Information Asymmetry , Financial Distress, Firm Size, Free Cash Flow, Real Earning Management.*

Dampak Kesulitan Keuangan, Arus Kas Bebas, Asimetri Informasi, dan Ukuran Perusahaan terhadap Manajemen Laba Riil

ABSTRAK

Perusahaan terkadang mengalami situasi yang kurang menguntungkan sehingga mendorong manajer untuk melibatkan diri dalam penyusunan laporan keuangan hingga melakukan praktik manajemen laba. Adanya praktik manajemen laba muncul karena adanya pengaruh beberapa faktor. Penelitian ini bertujuan untuk menguji pengaruh financial distress, free cash flow, information asymmetry, dan firm size terhadap real earnings management. Populasi penelitian ini adalah perusahaan consumer non-cyclicals yang terdaftar di Bursa Efek Indonesia tahun 2020 sampai dengan 2022. Teknik pengambilan sampel yang digunakan adalah purposive sampling sehingga diperoleh total sampel sebanyak 64 perusahaan. Teknik analisis yang digunakan adalah regresi linier berganda. Hasil penelitian ini menunjukkan bahwa financial distress dan free cash flow tidak berpengaruh positif terhadap real earnings management. Sedangkan information asymmetry dan firm size berpengaruh negatif terhadap real earnings management.

Kata Kunci: *Information Asymmetry , Financial Distress, Firm Size, Free Cash Flow, Real Earning Management.*

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INTRODUCTION

Financial reports are the output of the accounting process, used as a tool to communicate financial data and activities. They also serve to assess a company's performance, with financial performance measures often based on profits (Yanti & Setiawan, 2019). Profit is a key indicator influencing decision making by stakeholders such as investors, creditors, and the public (Khairiyahtussolihah et al. 2022) . An example of profit management in the consumption sector is seen in PT. Tiga Pilar Sejahtera Food, Tbk. (AISA) on March 12, 2019. An audit by Ernst & Young, a public accounting firm, revealed violations committed by previous AISA management against the 2017 financial report, leading to conflicts between old and new leadership. The 2017 financial report allegedly underwent manipulation by the old management, including inflated income and EBITDA figures and the misallocation of funds to affiliated parties (Lavina & Destriana, 2023).

Earnings management occurs when a company faces adverse circumstances, prompting managers to manipulate financial reports and accounting data to misrepresent the company's true situation (Yanti & Setiawan, 2019). Several factors contribute to earnings management practices, including financial distress, which incentivizes management to manipulate profits to avoid liquidation and potential losses by Krisnando & Damayanti (2021).

The second factor contributing to earnings management practices is the presence of free cash flow, often referred to simply as "free cash flow." Research by Christi et al. (2022) suggests that companies with available free cash flow tend to engage in earnings management to inflate reported profits, potentially to cover up managerial actions that have not optimally utilized the company's resources. Thirdly, information asymmetry is another factor driving earnings management practices. Information asymmetry occurs because managers possess more detailed information about the company than shareholders, allowing managers to make profit-oriented modifications (Nurhayati et al., 2022).

Company size is typically assessed based on the total value of its assets, with larger asset values indicating larger company size. However, research by Yanti & Setiawan (2019) reveals contrasting findings, suggesting that larger companies may have less motivation to engage in earnings management practices due to greater oversight by owners. Additionally, research by Burhan & Malau (2021) highlights the age of the company as another influencing factor in earnings management.

Further research is needed to re-examine the factors influencing real earnings management, particularly regarding financial distress, free cash flow, information asymmetry, and firm size, considering the development of an industrial sector classification index in the Indonesian stock market with IDX-IC. This study also incorporates company age as a control variable. Real earnings management is measured using three methods: (a) operational cash flow, (b) overproduction cost, and (c) discretionary expenditures (Roychowdhury, 2006).

The practice of earnings management cannot be separated from the insights of Jensen & Meckling (1976), who elaborated on agency theory as a framework explaining the dynamics between agents and principals in conducting operational activities within a company. An agent, in this context, refers to management or any party entrusted by shareholders to oversee company operations within the confines of delegated authority aimed at achieving the shareholders' objectives. Apart from disparities in information, differences in goals between management and shareholders engender agency problems, wherein management often pursues actions divergent from shareholders' objectives but aligned with their own interests. Shareholders endeavor to mitigate this by providing incentives to managers, thus seeking to regulate managerial conduct. In this study, agency theory serves to elucidate the interplay between the independent variables—Financial Distress, Free Cash Flow, Information Asymmetry, Firm Size—and the dependent variable, Real Earning Management.

Financial distress or financial difficulties occur due to many factors, one of which is the inability of the manager or agent to manage the company that has been entrusted by the principal or owner. Financial difficulties will trigger agency problems between the principal and agent. Agency problems occur based on the owner's distrust of the manager's performance (Irawan & Apriwenni, 2021). Companies that are in a state of financial difficulty will take several actions to overcome this condition, namely by temporarily stopping operations, postponing projects and reducing the number of workers. Another way that companies can do is manipulate the company's financial activities, namely by carrying out earnings management (Krisnando & Damayanti, 2021). The results of research state that financial distress will lead to earnings management behavior with research conducted by Li et al. (2020) on listed companies in China and the results of this research reveal that companies in financial distress are more likely to carry out earnings management. Jacoby & Li's (2019) research on non-listed companies in China shows that financial distress has a positive effect on earnings management and the research results reveal that financial distress has a positive effect on earnings management practices, so the hypothesis in this research observation is as follows.

H_1: Financial distress has a positive effect on real earnings management.

Companies that have large cash flow availability have many opportunities to compete and gain opportunities in their business development efforts. According to Christi et al. (2022) explained that the higher the level of free cash flow in a company, the company can be said to be very healthy. However, companies that have free cash flow tend to practice earnings management. This is due to the existence of large agency conflicts within the company. Agency conflict occurs between principals and managers who have different goals and interests in managing the company's cash flow. Owners have an interest in increasing their prosperity, so they want the availability of free flow to be used as dividend distribution. However, managers try to take advantage of the availability of free flow to make investments that can provide personal benefits to themselves (Thyas et al. 2022). The results of research reveal that free cash flow will lead to earnings management behavior with observations made by Kamal & Khazalle (2021) on listed companies in the Malaysian Bourse for the 2016-2017 period and from the results of these observations it was found that there is a relationship between free cash flow and earnings management practices. . This shows that free cash flow will give rise to earnings management behavior so the hypothesis in this research is as follows.

H_2: Free cash flow has a positive effect on Real Earning Management.

Asymmetry Information is a situation where managers have access to information about the company's prospects that is not owned by parties outside the company. Referring to agency theory that if both groups (agent and principal) seek to maximize their utility, then the agent will not act in the best interest of the principal (Jensen & Meckling, 1976). Richardson (1998) argues that there is a systematic relationship between information asymmetry and the level of earnings management. The existence of information asymmetry will encourage managers to present information that is not true, especially if the information is related to measuring the manager's performance. Management's flexibility to carry out earnings management can be reduced by providing higher quality information to outside parties. The occurrence of information asymmetry in a company can influence the level of earnings management practices carried out by company management (Rini & Amelia, 2022). The tendency of management to tinker with the size of the company's profits for the purpose of maximizing value so that it looks like the company is in good condition. The results of the research state that the situation of Information Asymmetry will give rise to earnings management behavior so that the hypothesis proposed in this research is as follows.

H_3: Asymmetry Information has a negative effect on Real Earning Management.

Company size shows how big and strong the company is and the aim of this research is to find out whether there is a relationship between the size of a company and the earnings management actions it takes. Based on agency theory, in managing a company, the agency and principal give duties and responsibilities to managers in large companies to account for the resources they have. The larger the size of a company, the greater the company's responsibility to provide as much information as possible which is useful for reducing agency costs, because in general large companies have greater agency costs than small companies (Jensen and Meckling, 1976). In conveying as much information as possible, large companies are likely to carry out smaller earnings management practices, while small companies are likely to carry out greater earnings management practices. The results of previous research by Fadhilah and Kartika, 2022 show that company size has a negative effect on earnings management, so the hypothesis in this research observation is as follows.

H_4: Firm Size has a negative effect on Real Earning Management.

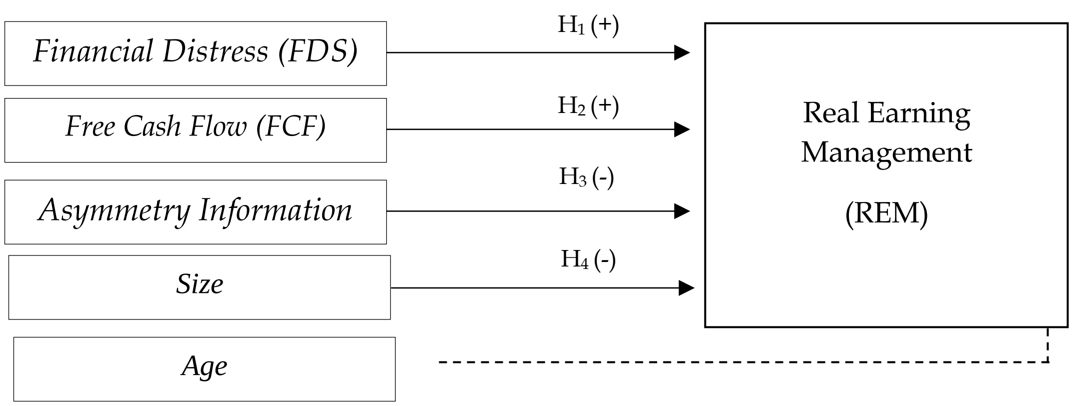

Figure 1. Research Model

Source : Research Data , 2024

The framework depicted herein aims to provide a comprehensive overview of the interrelationships among the variables under investigation in this study. This framework is presented in Figure 1.

RESEARCH METHODS

The population for this research comprises companies listed on the Indonesia Stock Exchange (BEI) during the 2020-2022 period. The sample consists of consumer non-cyclicals companies listed on the Indonesia Stock Exchange (BEI) from 2020 to 2022. The sampling technique employed in this research is purposive sampling, whereby samples are selected based on their adherence to specific criteria. These criteria include: 1) Companies operating in the consumer non-cyclicals sector listed on the Indonesia Stock Exchange (BEI); 2) consumer non-cyclicals sector companies that regularly publish audited financial reports for the period 2020-2022 and have complete data available according to the specified criteria.

Table 1. Sample Selection Results with Purposive Sampling

Criteria	Amount
Consumer non-cyclicals companies listed on the Indonesia Stock Exchange (BEI)	124
Consumer non-cyclicals companies who publish audited financial reports regularly for the 2020-2022 period and have complete data available according to specified criteria	(60)
Research Sample	64
Year of Study	3
Number of Research Samples	192
Outliers	(1)
Total units of analysis during three processed years	191

Source : Research Data , 2024

Real earnings management detects earnings management actions through manipulation of real activities conducted by companies. Roychowdhury (2006) utilizes the model of Dechow et al. (1998) and focuses on three manipulation methods, proxied into cash flow operations (CFO), discretionary costs (DISC), and production costs (PROD).

Financial distress is a condition experienced by a company when it encounters financial difficulties (Krisnando & Damayanti, 2021). In this research, financial distress is calculated using the Springate model, with the formula as follows:

$S = 1{,}03\,A + 3{,}07\,B + 0{,}66\,C + 0{,}4\,D$..(1)

Where:

A = Working capital / Total assets
B = Net profit before interest and taxes / Total assets
C = Net profit before taxes / Current liabilities
D = Sales / Total assets

Free cash flow represents the company's level of financial flexibility, indicating the availability of cash that can be distributed to creditors or shareholders after accounting for working capital and investment in fixed assets (Mulyati & Kurnia, 2023). According to Trisnawati et al. (2018), the formula for calculating free cash flow is as follows:

$$\mathrm{FCF} = \frac{\mathrm{CFO}-\mathrm{CFI}}{\mathrm{TOTAL\ ASET}} \quad (2)$$

Where:
FCF = Free Cash Flow
CFO = Operating Cash Flow
CFI = Cash Flow Investment

Information asymmetry can be quantified using the bid-ask spread. The bid-ask spread is the difference between the highest selling price and the lowest bid or buying price for a particular share. Rini & Amelia (2022) describe the bid-ask spread as follows:

$$\mathrm{SPREADi.t} = \left(\frac{aski.t - bid.t}{aski.t + bidi.t}\right)/2\mathrm{x}100 \quad (3)$$

Where:
ask i,t : highest ask price share company i which occurred in year t
bid i,t : lowest bid price share company i which occurred in year t

In this study, company size is measured using the natural logarithm (Ln) of the company's total assets. This metric reflects that a larger logarithmic value corresponds to a larger company size or a greater volume of assets owned by the company (Burhan & Malau, 2021). Company age is defined as the duration from its founding until it becomes operational. For the purposes of this research, company age is calculated using the formula provided by Burhan & Malau (2021): Company Age=Year of Study−Year of Establishment

This study examines the influence of financial distress, free cash flow, information asymmetry, and firm size on real earnings management. The regression model employed is described as follows:

$$\mathrm{REM} = \beta_0 + \beta_1\mathrm{FDS} + \beta_2\mathrm{FCF} + \beta_3\mathrm{AI} + \beta_5\mathrm{SIZE} + \beta_6\mathrm{AGE} + \mathrm{e} \quad (4)$$

Information:
REM = Real Earnings Management
FDS = Financial Distress
FCF = Free Cash Flow
AI = Information Asymmetry
SIZE = Company Size
AGE = Company Age

RESULTS AND DISCUSSION

The analysis of descriptive statistics provides a general overview of the factors affecting the level of real earnings management in consumer non-cyclicals during the 2020-2022 period. The results from the descriptive statistical tests are presented in Table 2 as follows:

Table 2. Descriptive Statistics

	N	*Minimum*	*Maximum*	*Mean*	*Standard. Deviation.*
REM	191	-4,191	1,181	-0.435	0.078
FDS	191	-5,301	10,854	1,241	0.201
FCF	191	-2,868	0.422	0.034	0.152
AI	191	-40,864	5,725	0.663	0.200
SIZE	191	25,251	32,826	29,128	0.297
AGE	191	11,000	117,000	0.777	0.995

Source : Research Data , 2024

The descriptive statistics for the study variables are as follows: The minimum value of financial distress is -5,301, with a maximum of 10.854. The average value of financial distress is 1.241, with a standard deviation of 0.201, and the mean percentage is 124.121%. For free cash flow, the minimum value recorded is -2,868, and the maximum is 0.422. The average value of free cash flow is 0.034, with a standard deviation of 0.152, and the mean percentage is 15.529%. The minimum value for information asymmetry is -40,864, with a maximum of 5,725. The average value for information asymmetry is 0.663, with a standard deviation of 0.200, and the mean percentage is 20.035%. The firm size variable has a minimum of 25,251 and a maximum of 32.826, with an average value of 0.297, a standard deviation of 0.297, and a mean percentage of 29.762%. For the control variable, company age, the minimum value is 11,000, and the maximum is 117,000. The average value of company age is 0.663, with a standard deviation of 0.200, and the mean percentage is 20.035%.

Classical assumption tests conducted in this research include tests for normality, autocorrelation, multicollinearity, and heteroscedasticity. The normality test employs the Central Limit Theorem (CLT), suggesting that if the sample size exceeds 30, the distribution is assumed normal. The autocorrelation results, obtained using the Durbin-Watson (DW) Test, show a value of 1.893, indicating that no autocorrelation is present (dU < DW < 4-dU). The multicollinearity test results show tolerance levels ranging from 0.791 to 0.982 and VIF values from 1.019 to 1.264, confirming the absence of multicollinearity. The heteroscedasticity test for each variable reveals significance values between 0.171 and 0.851, indicating no heteroscedasticity.

Table 3. Multiple Linear Regression Test Results

Variable	*Unstandardized Coefficients* B	t	Significance
Constant	4,629	4,400	0,000
FINANCIAL DISTRESS	-0.235	-5,615	0,000
FREE CASH FLOW	- 0.365	-1,409	0.160
INFORMATION ASYMMETRY	-0.037	-2,146	0.033
FIRM SIZE	-0.163	-4,433	0,000
AGE	0,000	0.053	0.957
F Value			12,147
R Square			0.247
Adjusted R Square			0.227
Significance of F			0,000

Source : Research Data , 2024

Multiple linear regression analysis is employed to examine the relationships or influences of independent variables on the dependent variable. Detailed results of the multiple linear regression, conducted using the SPSS 25 software, are presented in Table 3.

Based on Table 3, the following regression equation can be constructed to summarize the results found in the study:

REM = 4.629 - 0.235FD - 0.365FCF - 0.037AI - 0.163SIZE + 0.000AGE + e………(5)

The first hypothesis established in the research states that financial distress has a positive effect on real earnings management. From the research results, it is known that the Beta coefficient value is -0.235, the significance level for the financial distress variable is 0.000, smaller than the significance level of 0.05. Even though the significance level is below 0.05, which means that financial distress has an effect on real earnings management, the negative Beta coefficient value is not in accordance with the proposed hypothesis, so it can be concluded that the first hypothesis is rejected, which means that financial distress does not have a positive effect on real earnings management. The negative influence on the relationship between financial distress and real earnings management shows that when a company experiences of financial distress, the managers will tend not to carry out earnings management, this is because the company managers try to show the actual situation within the company so they can inform to the principal about the company's financial distress which have an impact on the business continuity, which if not resolved quickly and correctly can cause the company to go bankrupt. This result of this research is in line with research by Tsaqif and Agustiningsih (2021) which states that in conditions where companies are experiencing financial distress or financial difficulties, company management focuses more on the financial problems experienced by the company and chooses to take actions that produce reality so that financial difficulties can be overcome and bankruptcy will not occur. The use of earnings manipulation is not appropriate because it will disguise the company's operational performance and reduce the accuracy of reported earnings information. Obscuring company financial reports will create problems for policy makers and regulators because biased information provided to investors will have a negative impact on decision making and will impact the smooth functioning of financial markets.

The second hypothesis established in the research states that free cash flow risk does not have a positive effect on real earnings management. From the results of this research, the significance level for the free cash flow variable is 0.160, so the significance value is greater than 0.05 and the Beta coefficient value is -0.365. Thus, it can be concluded that the second hypothesis which states that free cash flow has a positive effect on Real Earning Management is rejected. The results of this research are in line with research conducted by Christi et al, 2022, the availability of free cash flow has no effect on real earnings management, this is because the companies that have a high level of free cash flow availability are categorized as healthy companies and are able to optimize profits by increasing the company's operational activities and tend not to carry out earnings management activities.

The third hypothesis established in the research states that information asymmetry has a negative effect on real earnings management. From the research results, the significance level for the asymmetry information variable was 0.033, so

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the significance value was smaller than 0.05 and the Beta coefficient value was -0.037. Thus, it can be concluded that the third hypothesis is accepted which states that information asymmetry has a negative effect on real earnings management. The results of hypothesis testing illustrate that the existence of information asymmetry can influence earnings management practices carried out by managers. When information asymmetry is high, shareholders do not have sufficient resources for relevant information to monitor managers' actions, which will give rise to management practices, namely reducing or increasing profits. The results of this research support research from Rini & Amelia (2022), Mulumbot & Sumanti (2020) and Ita et al. (2020).

The fourth hypothesis established in the research states that firm size risk has a negative effect on real earnings management. From the research results, the significance level for the firm size variable is 0.000, where the significance value is smaller than 0.05 and the Beta coefficient value is -0.163. Thus, it can be concluded that the fourth hypothesis is accepted which states that firm size has a negative effect on real earnings management. The results of hypothesis testing illustrate that company size may influence company management in taking earnings management actions. This is because large companies are able to carry out their operational activities without having to take profit management measures. Large companies are always careful because large companies are always watched by external parties. External parties carry out supervision of large companies indirectly and unofficially, but the impact can be felt directly by management. Large company size can minimize earnings management in a company. Based on the results of this test, the results of this research support research from Krisnando & Damayanti (2021) and Thyas et al. (2022)

The study on earnings management has significant implications for various stakeholders, including investors, regulators, and accountants. For investors, the findings of this study are expected to serve as critical material for consideration in making investment decisions. Investors should be cautious and not be easily swayed by apparently stellar financial reports without conducting a thorough analysis of the potential for earnings management practices. For regulators, the results of this study are anticipated to provide a basis for strengthening regulations related to accounting practices and financial reporting. This is crucial for preventing the manipulation of financial reports and protecting the interests of investors.

For accountants, the findings of this study should heighten awareness of the potential for earnings management practices during the financial reporting and audit processes. Accountants must consistently adhere to the applicable professional standards and enhance accounting education to inform the public about the practices of earnings management and their associated risks. Overall, research on earnings management plays an important role in improving the quality of financial reporting and safeguarding investors' interests. By understanding the implications of this study, various parties can take necessary steps to prevent earnings management practices and ensure that financial reports are accurate and truly reflective of the company's actual financial condition.

CONCLUSION

This research aims to find out whether Financial Distress, Free Cash Flow, Asymmetry Information, Firm Size, influence Real Earnings Management. Based on the results of the analysis and discussion in the previous chapter, the following research conclusions can be drawn, financial distress does not have a positive effect on real earnings management; Free cash flow has no positive effect on real earnings management; Information asymmetry has a negative effect on real earnings management; Firm size has a negative effect on real earnings management.

This research has limitations, this limitation is that the results of the Adjusted R-squared analysis are only 24.7% while the remaining 75.3% (100% - 24.7%) is explained by other variables outside the variables used in this research. For further research, it is recommended to consider alternative uses of other factors that support real earnings management. Apart from that, further research can also be carried out in other company sectors, both financial and non-financial sectors. Company age can also be used as a control variable for further research to ensure that differences in company age basically show the same real earnings management activities.

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