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THE EFFECT OF LEVERAGE, FREE CASH FLOW, AND PROFITABILITY ON EARNINGS MANAGEMENT
(Empirical Study of Infrastructure Sector Companies Listed on the Indonesia Stock Exchange in 2021-2023)

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Abstract. Earnings information plays an important role for investors and potential investors in assessing managerial performance. Managerial intervention in the preparation of financial statements to influence earnings for the benefit of the company is known as earnings management. The purpose of this study was to obtain empirical evidence of the effect of leverage, free cash flow, and profitability on earnings management. This research was conducted at infrastructure sector companies listed on the companies that are active on the IDX and listed from 2021 to 2023. Determination of the number of samples using purposive sampling technique and obtained a sample of 131 observations. The data analysis technique is multiple linear regression analysis. The results of this study indicate that leverage has a positive effect on earnings management, free cash flow has a negative effect on earnings management, and profitability has no effect on earnings management.

Keywords: Earnings Management; Leverage; Free Cash Flow; Profitability

I. INTRODUCTION

The era of globalization, accompanied by the acceleration of digitalization, has driven businesses into an increasingly dynamic phase of competition. One of the factors contributing to this heightened competition is the significant growth in the number of investors. According to data from the Indonesian Central Securities Depository (KSEI), the highest surge in Indonesian capital market investors occurred in 2021, with an increase of 92.99% compared to the previous year. By the end of 2023, the number of investors had reached 12,168,061. This situation requires companies to adopt superior managerial strategies, particularly in financial aspects, as reflected in their financial statements (Purba & Setiana, 2022).

Financial statements are the main source of information for investors in making decisions because they contain predictions regarding the company's future prospects (Arthaningrum et al., 2017), while also serving as a medium for management accountability to external parties (Aburisheh et al., 2022). PSAK No. 201 of 2024 emphasizes that the purpose of financial statements is to provide relevant information regarding an entity's financial position, performance, and cash flows for economic decision-making (Ikatan Akuntan Indonesia, 2024).

One of the key pieces of information in financial statements is profit. Profit reflects management performance and is a crucial indicator for stakeholders, including investors and creditors, in assessing the feasibility of investment and the ability to generate future earnings (Elsa & Wirawati, 2019; Emanuel et al., 2023). However, when a company is in poor financial condition, the accrual basis used in financial reporting provides management with room to select accounting methods that align with their interests. Although these choices comply with accounting standards, such flexibility opens the potential for manipulating profit information for specific interests (Sutapa & Suputra, 2016; Sutadipraja et al., 2019). Managers may utilize discretionary accrual adjustments to present financial reports that do not fully reflect reality, especially due to pressure from investors who use profit as the primary basis for decision-making (Ash-Shiddiqy, 2019).

This behavior is known as earnings management. Earnings management refers to actions taken to manipulate profit figures to align with managerial objectives, using accounting methods recognized under standards, but aimed at influencing perceptions of company performance (Putri & Wirawati, 2023; Setiawan & Dwiana, 2019). This phenomenon can be explained using agency theory, which states that conflicts of interest between agents (management) and principals (owners) arise due to information asymmetry, which drives agents to act opportunistically (Gayatri & Wirasedana, 2021; Dharma & Wirama, 2020). In addition, positive accounting theory also explains that earnings management practices can be predicted and understood through the bonus plan hypothesis, debt covenant hypothesis, and political cost hypothesis, as outlined by Watts & Zimmerman (1986).

Earnings management is highly likely in the infrastructure sector due to its unique characteristics, such as large-scale projects, long-term contracts, and high funding needs. These projects typically use the percentage-of-completion method for revenue recognition, which allows flexibility in project progress calculations. This flexibility

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presents opportunities for management to engage in earnings management, especially when estimates or recordings are inaccurate (Subagja & Pradipto, 2019). Furthermore, the sector has high leverage levels due to its reliance on debt financing, which can increase the incentive for management to practice earnings management to appear financially viable (Maharani & Leon, 2022; Dharma & Wirama, 2020).

A real case of suspected earnings management occurred at PT. Waskita Karya Tbk (WSKT). According to information from katadata.co.id, the Ministry of State-Owned Enterprises and the Financial Services Authority (OJK) are investigating alleged financial statement manipulation by the company, which is suspected to have taken place over several years. Although the reported profits were positive, the company's operating cash flows consistently showed negative figures. In 2017, profits rose dramatically by 131.7%, but from 2019 to 2023, the company experienced significant losses, including during the COVID-19 pandemic, with a loss of IDR 9.4 trillion in 2020 and a drastic decline in revenue. A similar situation also occurred at PT. Wijaya Karya Tbk (WIKA), which recorded a sharp drop in net profit from IDR 322 billion in 2020 to IDR 12.5 billion in 2022, with negative operating cash flow conditions. These two cases highlight that earnings management issues in the infrastructure sector are serious concerns requiring special attention (Nabil & Dwiridotjahjono, 2024).

One factor influencing earnings management is leverage. Leverage reflects the proportion of debt in a company's capital structure. When leverage is high, pressure from creditors may drive management to manipulate financial statements to appear financially healthy. Studies by Mamu & Damayanthi (2018), Bailaen & Nugroho (2023), and Putri & Wirawati (2023) suggest that leverage positively affects earnings management. However, different results were found by Dharma & Wirama (2020), Putri & Setiawati (2021), who showed a negative effect. Meanwhile, Asyati & Farida (2020), and Kristiana & Rita (2021), stated there is no significant effect.

The second factor is free cash flow, which refers to cash available without affecting operational activities or future cash flow potential (Brigham & Houston, 2019). When free cash flow is large and poorly managed or supervised, managers may use it for personal gain, including by presenting inaccurate financial reports (Iqbal & Darsono, 2020). Research by Irawan & Apriwenni (2021), Putri & Wirakusuma (2022), and Yusrawati et al. (2024) concluded that free cash flow has a positive influence on earnings management. Meanwhile, Tualeka et al. (2020), Sagala & Simbolon (2021), Fadhilah & Kartika (2022) found a negative influence, and Thyas et al. (2022), Natalie & Pratiwi (2023) stated no influence.

The third factor is profitability, which indicates a company's efficiency in generating profits from its assets. High profitability typically reflects good performance and can motivate managers to sustain it by manipulating earnings to remain attractive to investors (Purnama & Nurdiniah, 2019). Kalbuana et al. (2022), Putri & Naibaho (2022), and Alafiyah (2024) found that profitability positively influences earnings management. However, Hardiyanti et al. (2022) found a negative influence, while Wirawan (2020) and Purnama & Taufiq (2021) reported no influence.

Research Objective:

Based on the background and previous research findings that indicate inconsistencies in the influence of leverage, free cash flow, and profitability on earnings management, this study aims to partially examine the influence of each of these variables on earnings management. The novelty of this research lies in the selection of the sector and the observation period. The infrastructure sector is a new classification on the Indonesia Stock Exchange and was selected due to its characteristics of large-scale projects, high funding requirements, and flexible revenue recognition. These factors have the potential to encourage earnings management behavior but have rarely been studied specifically in this sector and with these three variables. Moreover, the observation period from 2021 to 2023 reflects the post-COVID-19 pandemic conditions, during which many companies are likely facing financial pressures and changes in business strategies, thus expected to provide a more current depiction of earnings management behavior in companies.

Conceptual Framework

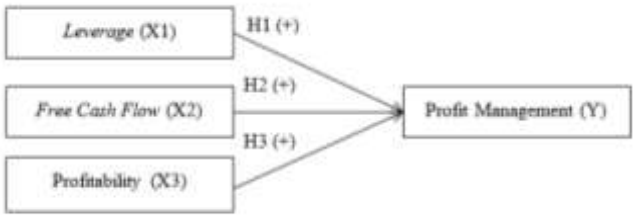

Figure 1. Conceptual Framework

Research Hypothesis

H1: Leverage has a positive effect on earnings management in infrastructure sector companies listed on the IDX for the 2021-2023 period.

H2: Free cash flow has a positive effect on earnings management in infrastructure sector companies listed on the IDX for the 2021-2023 period

H3: Profitability has a positive effect on earnings management in infrastructure sector companies listed on the IDX for the 2021-2023 period.

II. RESEARCH METHODS

This research method uses a quantitative approach with an associative design. According to Sugiyono (2019: 16–17), quantitative methods are based on the philosophy of positivism and are used to test hypotheses on certain populations or samples, through data collection with instruments which are then analyzed statistically. Meanwhile, the associative research design, as explained by Sugiyono (2019: 65), aims to determine the relationship between two or more variables. This study analyzes the effect of leverage, free cash flow, and profitability on earnings management, which acts as the dependent variable. The data used are secondary data in the form of annual financial reports of infrastructure sector companies listed on the Indonesia Stock Exchange (IDX) during the period 2021–2023.

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Sample selection was carried out using purposive sampling, which according to Sugiyono (2024: 138), is a sampling technique based on certain criteria that are relevant to the research objectives. The criteria include companies that are active on the IDX and listed from 2021 to 2023, present complete financial reports for the period 2021–2023, and use the rupiah currency and the reporting period ends December 31.

The object of this study is earnings management, with leverage, free cash flow, and profitability as predictors. Earnings management is measured using discretionary accruals with the modified Jones Model, as developed by Dechow et al. (1995), because this model is considered capable of detecting accrual manipulation practices accurately. Leverage is proxied by the Debt to Equity Ratio (DER) (Ruwanti et al., 2019), free cash flow is calculated based on the remaining cash after deducting capital expenditures and working capital (Mulyati & Kurnia, 2023), while profitability is measured using Return on Assets (ROA) (Purnama & Nurdiniah, 2019), which reflects the efficiency of asset use in generating profit.

The type of data used is quantitative data, namely numerical data that can be calculated directly (Syafina & Harahap, 2019: 26), and is sourced from financial reports available on the IDX website and each company. Data collection techniques are carried out through documentation and literature studies, by downloading financial reports and reading related references from books, journals, and scientific articles.

In data analysis, the SPSS application is used to process data statistically. The initial stage of analysis includes descriptive statistics, to describe the characteristics of the data (Sugiyono, 2024: 226). Before the regression is carried out, a series of classical assumption tests are applied, including normality tests (Kolmogorov–Smirnov), multicollinearity (VIF and tolerance), autocorrelation (Durbin-Watson), and heteroscedasticity (Glejser test), as explained by Ghozali (2021).

Furthermore, multiple linear regression analysis is carried out to determine the direction and strength of the relationship between the independent variables and the dependent variable, with the model:

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \varepsilon,$$

where Y is earnings management, and X1, X2, and X3 are leverage, free cash flow, and profitability, respectively.

Then, a determination coefficient test (R^2) was conducted to determine how much variation in earnings management can be explained by the three independent variables (Syafina & Harahap, 2019: 75). The F test is used to assess the feasibility of the overall model, while the t test is conducted to test the effect of each independent variable on earnings management partially (Syafina & Harahap, 2019: 76–78). Thus, the overall method used in this study follows a systematic and measurable quantitative approach, supported by theories and models that have been tested in academic literature.

III. RESULTS AND DISCUSSION

Description of Data Related to Research Variables

Table 1. Descriptive Statistics Results

	N	Minimum Value	Maximum Value	*Mean*	Standard Deviation
Manajemen Laba	131	-0,46	0,36	-0,1383	0,14291
Leverage	131	0,07	6,05	1,4110	1,27799
Free Cash Flow	131	-0,89	0,86	-0,0800	0,27687
Profitabilitas	131	-0,35	0,24	0,0178	0,08159

Source: Processed Secondary Data, 2025

Earnings Management (Y)

The earnings management variable has a minimum value of -0.46. Meanwhile, the maximum value is 0.36. The earnings management variable has a mean value of -0.138 which is close to the maximum value. The negative earnings management mean indicates that on average companies tend to carry out earnings management with a pattern of decreasing profits (income decreasing). The earnings management variable also has a standard deviation value of 0.14291 which is greater than the mean value. This shows that the distribution of earnings management data is heterogeneous.

Leverage (X1)

The leverage variable (DER) has a minimum value of 0.07. Meanwhile, the maximum value is 6.05. The leverage variable has a mean value of 1.4110 which is close to the minimum value. The leverage variable has a standard deviation of 1.27799 which, although smaller than the average value, is still quite large and the data range is very wide. This shows that the data distribution still tends to be heterogeneous.

Free Cash Flow (X2)

The free cash flow (FCF) variable has a minimum value of -0.89. Meanwhile, the maximum value is 0.86. The free cash flow variable has a mean value of -0.0800 which is close to the minimum value. The free cash flow variable has a standard deviation of 0.27687 which is greater than the mean value. This shows that the distribution of free cash flow data is heterogeneous.

Profitability (X3)

The profitability variable (ROA) has a minimum value of -0.35. Meanwhile, the maximum value is 0.24. The profitability variable has a mean value of 0.0178 which is close to the maximum value. The profitability variable has a standard deviation of 0.08159 which is greater than the mean value. This shows that the distribution of profitability data is heterogeneous.

Analysis Results of Research Data

Classical Assumption Test

Normality Test

In this study, the normality test was conducted using the one-sample kolmogorov smirnov normality test. Data is normally distributed if Asymp. Sig. (2-tailed) is greater than or equal to a significance level of 0.05. The following are the results of the normality test in this study.

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Table 2. Normality Test Results

One-Sample Kolmogorov Smirnov	
	Unstandardized Residual
N	131
Asymp. Sig (2-tailed)	0,200

Source: Secondary data processed, 2025

This study used a sample of 153 observations. However, based on the results of the normality test, it showed that there was data interference so that the data was not normally distributed. To overcome this problem, the researcher eliminated outlier data in anticipation of interference during statistical testing. The number of observations after eliminating outlier data was 131 observations. Based on the results of the normality test in Table 2, the Asymp. Sig. (2-tailed) was 0.200 which is greater than the significance level of 0.05. This value indicates that the data in this study is normally distributed.

Multicollinearity Test

Table 3. Multicollinearity Test Results

Model	Collinearity Statistic	
	Tolerance	VIF
Constant		
Leverage	0,813	1,230
Free Cash Flow	0,859	1,164
Profitability	0,942	1,061

Source: Secondary data processed, 2025

Based on the test results in Table 3, it can be seen that the tolerance value for each variable is greater than 0.1 and the VIF value is less than 10. These values indicate that the regression model is free from multicollinearity problems.

Autocorrelation Test

Table 4. Autocorrelation Test Results

Model	Std. Error of The Estimate	Durbin Watson
	0,12359	1,801

Source: Secondary data processed, 2025

Based on the results of the autocorrelation test in Table 4, it shows that the Durbin-Watson (DW-test) value is 1.801 with 131 observations and 3 independent variables (k-3), then the dL value = 1.6682 and dU = 1.7617, so that the value of 4 - du = 2.2383 is obtained. So, the criteria dU < DW <4 - dU can be formulated, namely 1.7617<1.801<2.2383, this indicates that the data used in this study does not show symptoms of autocorrelation.

Heteroscedasticity Test

Table 5. Heteroscedasticity Test Results

Model	Sig.
(Constant)	0,000
Leverage	0,492
Free Cash Flow	0,410
Profitabilitas	0,537
Dependent Variable: RES2	

Source: Secondary data processed, 2025

Based on the results of the heteroscedasticity test in Table 5, the significance value of the leverage variable is 0.492. Meanwhile, the significance value of the free cash flow variable is 0.410 and the significance value of the profitability variable is 0.537. All three values are greater than the significance level of 0.05. Based on the results of the test, it can be concluded that the regression model does not show symptoms of heteroscedasticity.

Multiple Linear Regression Analysis

Table 6. Results of Multiple Linear Regression Analysis

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
	(Constant)	-0,192	0,019		-10,145	0,000
	Leverage	0,021	0,009	0,189	2,250	0,026
	Free Cash Flow	-0,289	0,042	-0,559	-6,832	0,000
	Profitabilitas	0,053	0,137	0,030	0,386	0,700
F		=15,611		R *Square*		= 0,269
F Sig. (ANOVA)		= 0,000		*Adjusted* R *Square*		= 0,252

Source: Processed secondary data, 2025

Based on the results in Table 6, the following regression equation can be made.

$$Y = -0,192 + 0,021\ X1 - 0,289\ X2 + 0,053\ X3 + \varepsilon \quad \text{.....(9)}$$

Keterangan:
Y = Profit management
α = constant
β = coefficient
X_1 = Leverage
X_2 = Free cash flow
X_3 = Profitability
ε = standard error

Based on the regression equation (9), the following things can be explained.

a. The constant value of -0.192 indicates that if leverage, free cash flow, and profitability are all equal to zero, then earnings management will decrease by 0.192 units.
b. The regression coefficient for leverage is 0.021, indicating that if leverage increases by one unit, earnings management will increase by 0.021 units, assuming other variables remain constant.
c. The regression coefficient for free cash flow is -0.289, indicating that if free cash flow increases by one unit, earnings management will decrease by 0.289 units, assuming other variables remain constant.
d. The regression coefficient for profitability is 0.053, indicating that if profitability increases by one unit, earnings management will increase by 0.053 units, assuming other variables remain constant.

After conducting multiple linear regression analysis, the study also obtained results related to the quality and feasibility of the regression model, as well as the significance level and strength of relationships between variables in the model through the coefficient of determination (R^2) test, F-test, and t-test.

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Coefficient of Determination (R^2) Test

The coefficient of determination (R^2) is used to measure how well all the independent variables explain the variance of the dependent variable. In this study, the coefficient of determination is represented by the adjusted R square value. According to Table 6, the adjusted R square is 0.252. This indicates that 25.2% of the variance in earnings management among infrastructure companies listed on the IDX from 2021 to 2023 can be explained by leverage, free cash flow, and profitability, while the remaining 74.8% is influenced by other factors not included in the regression model.

Model Feasibility Test (F-Test)

The F-test aims to determine whether the regression model is feasible to be used in the study. The decision is based on the significance value from the ANOVA output. Based on Table 6, the F-statistic is 15.611 and the significance value is 0.000. Since the significance value is less than the 0.05 threshold, it indicates that the regression model is appropriate for use. This result also shows that, simultaneously, leverage, free cash flow, and profitability significantly affect earnings management among infrastructure companies listed on the IDX from 2021 to 2023.

Hypothesis Testing (t-Test)

The t-test aims to test each hypothesis or determine the partial effect of each independent variable on the dependent variable, assuming other variables are held constant (Ghozali, 2021:148). The t-test in this study is conducted with a 5% significance level or 0.05. Based on Table 6, the results of the t-test for each hypothesis are as follows:

a) **First Hypothesis Test (H1)**

According to Table 6, the leverage variable has a t-statistic value of 2.250 with a significance value of 0.026. Since this value is less than 0.05 and the coefficient direction is positive at 0.021, it can be concluded that leverage has a positive effect on earnings management. Therefore, the first hypothesis is accepted.

b) **Second Hypothesis Test (H2)**

According to Table 6, the free cash flow variable has a t-statistic value of -6.832 with a significance value of 0.000. Since this value is less than 0.05 and the coefficient direction is negative at -0.289, it can be concluded that free cash flow has a negative effect on earnings management. Therefore, the second hypothesis is rejected.

c) **Third Hypothesis Test (H3)**

According to Table 6, the profitability variable has a t-statistic value of 0.386 with a significance value of 0.700. Since this value is greater than 0.05 and the coefficient direction is positive at 0.053, it can be concluded that profitability does not affect earnings management. Therefore, the third hypothesis is rejected.

Effect of Leverage on Earnings Management

The results show that leverage has a positive effect on earnings management, meaning the first hypothesis (H1) is accepted. The higher the level of leverage, the greater the tendency for management to engage in earnings management. This is due to the increased risk of difficulties in meeting debt covenants when the debt proportion rises. In such situations, companies are under pressure to present strong financial performance to maintain investor confidence and ensure continued funding. As a result, management may act opportunistically, such as manipulating earnings, to avoid potential sanctions for covenant breaches and maintain a positive corporate image.

This finding is consistent with studies by Mamu and Damayanthi (2018), Asim & Ismail (2019), Bailaen & Nugroho (2023), Christina et al. (2020), and Putri & Wirawati (2023), all of which show that leverage positively influences earnings management. It is also supported by Mahawyahrti & Budiasih (2016) and Indracahya & Faisol (2017), who state that the lower the leverage, the less likely managerial intervention in earnings occurs.

However, different results were found in other studies. Dharma and Wirama (2020) and Putri and Setiawati (2021) found that leverage negatively affects earnings management, indicating that companies with high debt are more cautious and avoid manipulation to maintain long-term credibility.

The findings of this study support agency theory, which states that pressure to comply with accounting-based covenants in debt contracts motivates managers to choose accounting procedures that accelerate income recognition from future periods to the present to avoid violations (Watts and Zimmerman, 1986). It also supports the debt covenant hypothesis in positive accounting theory, which explains that the higher the debt level, the stronger the managerial incentive to manage earnings in order to meet investor expectations and maintain market trust.

Effect of Free Cash Flow on Earnings Management

The analysis shows that free cash flow has a negative effect on earnings management, thus the second hypothesis (H2) is rejected. This means that the lower the free cash flow, the higher the tendency for managers to engage in earnings management. Low free cash flow indicates limited funds to support growth, meet obligations, or pay dividends, potentially reducing investor confidence. In this context, managers are more likely to engage in earnings management to create the impression of financial stability.

This finding aligns with the research of Tualeka et al. (2020), who stated that the higher the free cash flow, the lower the manager's motivation to act opportunistically since the company's financial performance is already strong. This result is also supported by Padmini and Ratnadi (2020), Sagala and Simbolon (2020), Hardirmaningrum et al. (2021), and Fadhilah and Kartika (2022), who all concluded that free cash flow negatively affects earnings management.

However, this finding differs from the results of Irawan & Apriwenni (2021), Putri & Wirakusuma (2022), and Aburisheh et al. (2022), who found that free cash flow positively influences earnings management.

This study does not support Jensen and Meckling's (1976) agency theory, which asserts that high free cash flow increases the chances of earnings manipulation, especially under weak oversight. On the contrary, the findings show that higher free cash flow is associated with a lower tendency for earnings management.

Effect of Profitability on Earnings Management

The analysis shows that profitability has no effect on earnings

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management, so the third hypothesis (H3) is rejected. In this study, profitability was measured using the ROA (return on assets) ratio, but it was found not to influence managers' tendency to manage earnings. High profitability reflects good company performance, boosts market confidence, and provides benefits for managers, such as incentives or bonuses. With these benefits already in place, managers are more likely to maintain transparency in financial reporting and feel less motivated to manipulate earnings.

This finding is in line with Agustia and Suryani (2018), who argued that high profitability sends a positive signal and reduces the pressure to manage earnings since both shareholders and managers are already enjoying returns. This is also supported by Wirawan (2020), Purnama and Taufiq (2021), Wardoyo et al. (2023), Naue et al. (2023), Adityaningsih and Hidayat (2024), and Winata and Simon (2024), who all concluded that profitability does not influence earnings management.

However, this result differs from the findings of Bangun (2019), Kalbuana et al. (2022), and Putri and Naibaho (2022), who found that profitability positively affects earnings management.

This study does not support the bonus plan hypothesis in positive accounting theory, which states that managers tend to engage in earnings management to meet profitability targets and earn bonuses. On the contrary, the findings show that the level of profitability, whether high or low, does not influence managerial decisions to manipulate earnings.

IV. CONCLUSION

Based on the results of the analysis and discussion that have been carried out, several conclusions were obtained as follows: 1) Leverage has a positive effect on earnings management. The higher the company's leverage level, the greater the tendency of management to carry out earnings management, in line with agency theory and the debt contract hypothesis in positive accounting theory. 2) Free cash flow has a significant negative effect on earnings management. The results of the study indicate that the smaller the free cash flow owned by the company, the higher the tendency of managers to carry out earnings management practices. This shows that limited cash flow encourages managers to intervene in profits in the interests of maintaining the company's image in the eyes of investors. 3) Profitability does not affect earnings management actions in the company. When the company has achieved a high level of profitability, managers tend not to be encouraged to take opportunistic actions such as earnings management. This is because the manager's performance objectives have been met and the company's reputation has been well maintained.

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