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The Effect of Free Cash Flow and Leverage on Earnings Quality

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Abstract

This study aims to examine the relationship between free cash flow and leverage on earnings quality, this research is a type of quantitative research using secondary data from the Indonesian stock exchange, based on the criteria obtained from 41 banking companies that meet the aspects as a research sample. Based on the results of multiple regression analysis, it was found that free cash flow had a significant positive effect on earnings quality in banking sector companies listed on the IDX. This study also shows that leverage has a negative and significant effect on earnings quality in banking sector companies listed on the IDX.

INTRODUCTION

The economic competition in the Society 5.0 era, the financial health of a company is a determining factor in whether the company will be able to compete with competitors or not. The financial health of a company will be reflected in the financial statements presented in one accounting period. The Indonesian Institute of Accountants (2019) defines financial statements as a presentation of the structure of the financial position and performance of an entity. In presenting financial statements following SAK (Financial Accounting Standards) that apply in Indonesia, a manager is allowed to determine accounting policies that are under the situation and conditions of his company. However, in practice, managers often abuse this authority, one of which is by carrying out earnings management, where earnings management is an attempt by management to manipulate financial reports for personal gain, (Hapsoro & Annisa, 2017).

Problems regarding earnings management often occur in Indonesia, one of the cases is earnings management carried out by PT. Indofarma which increased the company's net profit to Rp. 28.78 billion which has an impact on Overstated (excess) HPP funds in the company, (Putra et. al, 2018). Next is the case of PT.

Bank Bukopin, which originally reported a profit of Rp. 1.08 Trillion but revised back to Rp. 183.53 billion because after an audit was carried out there was an improper record on the credit card income side (Dwiantika, 2018).

The number of earnings management cases that have occurred resulted in the quality of the company's earnings being doubted, therefore this research is needed to provide information to the public, especially investors so that they can find out which companies have good earnings quality, and what factors can influence managers to do so. earnings management actions thereby reducing the quality of earnings in banking sector companies listed on the IDX, where based on the 2 cases above it is possible to carry out earnings management to cause the quality of the profits generated to decrease.

There are several theories as well as previous research which indicate the effect of Free Cash Flow and Leverage on Earnings Quality, this statement is reinforced by research conducted by Putra and Yusra, (2019) where in their research stated that free cash flow is a surplus that occurs in cash flow in one of the companies obtained from funding activities with a positive NPV. It is assumed that high free cash flow in a company will cause managers to be opportunistic and use it for personal gain rather than being distributed in the form of dividends (Herlina and Damayanthi, 2016).

A study conducted by R. Rahmawati, et. al (2020) states that Leverage is one of the financial ratios to increase potential profits owned by shareholders by using the assets and sources of funds owned by the company. but in practice companies with high levels of leverage indicate that companies have good profitability, but conversely a high leverage ratio also increases the risk of bankruptcy of a company (Wati & Putra, 2017). To prevent bankruptcy, company managers will try to fulfill debt agreements to get good feedback from creditors, this incident can result in managers taking wrong accounting policies by carrying out earnings management so that the quality of profits generated by the company decreases, (Winingsih, 2017).

Based on the background described above, the researcher is interested in conducting further research on the relationship between Free Cash Flow and Leverage variables on Earnings Quality which focuses on phenomena that occur in companies in the financial services sector, the banking sub-sector, and the Indonesia Stock Exchange.

LITERATURE REVIEW

Agency Theory

Agency theory is a contract between the manager (agent) and the owner (principal). For this contractual relationship to run smoothly, the owner will delegate decision-making authority to the manager (Jensen & Meckling, 1976). However, managers generally tend to make decisions that are considered to benefit themselves, which in turn triggers agency conflict. those owned by the principal and those owned by the agent are not equal (Scott, 2015). Thus, to reduce the effect of agency conflict, the company is assessed as having to incur agency costs, one of which is in the form of bonding costs, namely the costs borne by the agent including time and effort in preparing financial reports as accountability to the principal (Jensen & Meckling, 1976).

Free Cash Flow

Brigham and Houston (2010) state that Free Cash Flow means cash flow that is available to be paid to all investors after the company has placed all of its investments in fixed assets, new products, and working capital needed to maintain ongoing operations. According to Khushi, et al., (2020) the principle of free cash flow shows that managers tend to act in a way that maximizes income. Adequate free cash flow can reduce earnings management so that earnings quality increases because it shows a healthy company condition to investors and creditors. Conversely, if the level of free cash flow is low, it will increase earnings management so that the quality of the profits generated decreases. This can occur because managers do not want to violate contracts with creditors and investors (Hartono et al, 2020).

Leverage

According to Brigham and Houston (2010), leverage is a ratio that measures the extent to which a company uses funding through debt (financial leverage). If the company's leverage is high, this will encourage management to take various ways to attract investors to invest, one of which is by carrying out earnings management by not reporting the company's actual financial condition, with conditions like this causing a decrease in earnings quality. Leverage explains the use of debt ratios as additional external funds for companies that have fixed expenses in the hope of generating maximum profits (Mahawyahrti & Budiasih, 2017). A high level of leverage is not a problem for investors as long as the company can maintain the persistence of the profits it generates (Supriono, 2021).

Earnings Quality

According to Utami et al. (2020), Earnings Quality or earnings quality is the ability of the information contained in the company's profit report to reflect the company's current performance and can be used to predict future company performance which ultimately influences investors' investment decisions. Profit information is used as an indicator to determine the good or bad performance of a company so that profit information is highly considered by stakeholders. According to Jannah (2019), Quality profit is profit that can reflect sustainable earnings in the future, which is determined by the accruals and cash components and can reflect the company's actual financial performance. The low quality of company profits shows an indication that there are earnings management practices carried out by company management, (Septiyani & Rasyid, 2018)

Hypothesis Development

Effect of Free Cash Flow on Earnings Quality

Free cash flow is the excess cash flow from funding all investments that generate positive net present value (NPV) (Jensen, 1986). Companies with high free cash flow will have a greater opportunity to manipulate earnings. This is because the company is indicated to be facing bigger agency problems. The relationship between free cash flow and earnings quality can be explained using the Agency Theory, where information asymmetry within the company occurs because managers and shareholders have different information and goals, shareholders certainly want excess cash in the company to be distributed in the form of dividends, while managers prefer to want the free cash in the company to be reinvested for personal gain. Research conducted by Nugrahati & Retnani, (2019) shows that free cash flow has a significant effect on earnings quality because free cash flow is an important determinant (factor) in determining firm value so managers are more focused on efforts to increase free cash flow. In addition, other studies conducted by Iman & Girsang (2019), also Kodriyah and Fitri (2017) found results that free cash flow has a positive effect on earnings quality, which indicates that this variable is a determinant of company value that motivates management to take earnings manipulation actions. which will affect the quality of earnings.

H1: Free cash flow has a positive effect on Earnings Quality

Effect of Leverage on Earnings Quality

Leverage is a ratio that can be used to measure how much a company's debt is used as capital in its operational funding activities. High leverage influences Earnings Quality, because the company will prioritize paying interest or debt expenses rather than paying dividends. Thus, the profit presented by the company is low, the use of debt that is greater than capital will cause an increase in the interest expense that will be borne by the company, and high debt can also increase the percentage of bankruptcy of the company. Based on previous research conducted by Louw (2022), Indriana & Handayani (2021), Nugrahati & Retnani, (2019), the results show that the leverage variable has a negative and significant effect on earnings quality, these results indicate that companies with high leverage ratios tend that the proportion of debt is higher than the proportion of assets owned, this will encourage managers to manipulate in the form of earnings management which will affect the quality of company earnings.

H2: Leverage has a negative effect on Earnings Quality

METHODS

This study uses quantitative data types and is classified as secondary data. The population in this study are all companies listed in the banking sub-sector that is listed on the Indonesia Stock Exchange for the 2016-2018 period. The sample selection in this study used purposive sampling, namely the selection of samples using criteria, based on the sample selection criteria used 41 companies met the criteria.

RESULT AND DISCUSSION

1. **Descriptive Statistical Analysis**

Table 1. Results of Descriptive Statistics

Variabel	N	Minimum	Maximum	Mean	Std.Deviation
Free Cash Flow	123	0,00	0,27	0,08	0,06
Leverage	123	0,09	0,93	0,80	0,13
Valid N (litwise)	123				

Source: processed data 2023

1. The variable free cash flow (X1) proxied by Ross et. al (2000) has an average of 0.08; with the highest value of 0.27; while the lowest value is 0.00; and a

standard deviation value of 0.06. The standard deviation value which is smaller than the average indicates that the free cash flow of banking companies listed on the IDX has small fluctuations.

2. The leverage variable (X2), which is proxied by the debt ratio, has an average of 0.80; with the highest value of 0.93; while the lowest value is 0.09; and a standard deviation value of 0.13. The standard deviation value which is smaller than the average value indicates that the leverage ratio of banking companies listed on the IDX has small fluctuations.

2. Normality test

Table 2. Normality test result

	Unstandarized Residual
N	123
Kolgomorov- Smirnov Z	1,33
Asymp. Sig (2-tailed)	0,06

Source: Processed data,2023

Based on the table above it is known that the Asymp. Sig (2-tailed) of the tested equation model is 0.06 which is greater than α = 5 percent or 0.05. These results indicate that the residuals of the analyzed regression model are normally distributed.

3. Multicollinearity Test

Table 3. Multicollinearity Test Result

No	Variabel	Nilai Tolerance	Nilai VIF
1	Free Cash Flow	0,94	1,06
2	Leverage	0,44	2,26

Source: Processed Data, 2023

The data above shows that the tolerance value for each independent variable is greater than 0.10 and the VIF value is less than 10, meaning that the regression model formed is free from multicollinearity.

4. Model Feasibility Test (F Test)

Table 4. Model Feasibility (f test) Result

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	0,179	5	0,036	15,000	0,000[a]
	Residual	0,279	117	0,002		
	TOTAL	0,458	122			

Source: Data Processed 2023

The table above shows the results of the calculated F of 15,000 with a significance level of 0.000 which is smaller than a significance level of 0.05 so that it can be concluded that the regression model created is feasible to use in research.

5. Coefficient of determination (*adjusted R^2*)

Tabel 5. Coefficient of determination Test (*adjusted R^2*)

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0,625	0,391	0,365	0,049

Source: Processed Data 2023

In the table above it can be seen that the results of the test for the coefficient of determination with an adjusted R2 value of 0.365, means that 36.5% of the variation in Earnings quality is influenced by variations in Free cash flow (X1), leverage (X2), as influencing variables. The remaining 63.5% is influenced by other factors outside the model.

6. Multiple Linear Regression

Table 6. Multiple Regression Test Results

Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients		
		B	Std. Error	Beta	t	Sig.
1	(Constant)	-.095	.048		-1.952	.053
	Free Cash Flow	-.202	.080	-.188	-2.529	.013
	Leverage	.137	.050	.299	2.757	.007

a. Dependent Variable: Discretionary Accruals

Source: Processed Data (2023)

The results of the multiple linear regression analysis between Free Cash Flow and Leverage on Earnings Quality can be summarized as follows:

1. The effect of Free Cash Flow on Earnings Quality

Based on the results of multiple linear regression analysis between the Effect of Free cash flow on Earnings Quality, it shows a t-value of -2.529 with a t-significance of 0.013 which is smaller than the significant level (α) used, which is 0.05. These results indicate that free cash flow has a negative effect on discretionary accruals as a proxy for earnings quality. This indicates that free cash flow has a positive effect on earnings quality so H1 is accepted. These results are supported by research conducted by Nugrahati & Retnani, (2019) which states that Free Cash Flow (FCF) has a positive effect on earnings quality. Free cash flow will be the basis for managers in determining the value of their company, this is because the value of a company's operations depends on the free cash flow expected by the company to ensure the company's future sustainability. besides that, the research conducted by Kodriyah and Fitri (2017) stated that free cash flow has a positive effect on earnings quality. From the results of the research above, it can be concluded that the greater the free cash flow available in a company, the healthier the company is because it has cash available for future company growth, paying debts, and distributing dividends. In addition, the results of this study also explain that companies with high levels of free cash flow tend to avoid earnings management practices, the aim is to maintain the credibility of financial reports and the resulting earnings quality.

2. Effect of Leverage on Earnings Quality

Based on the results of multiple linear regression analysis the Effect of Leverage on Earnings Quality shows a t value of 2.757 with a significance of t of 0.007 which is smaller than the significant level (α) used, which is 0.05. These results indicate that leverage has a positive effect on discretionary accruals as a proxy for earnings quality. This indicates that leverage has a negative effect on earnings quality so H2 is accepted. These results are in line with research conducted by Louw (2022) where the results of his research show that leverage has a negative effect on earnings quality, the same opinion was also expressed in research conducted by Marpaung (2019) and Agustia (2013). The results of this study explain that companies with high levels of leverage will have a large level of risk. Managers in companies that have high levels of leverage usually use accrual policies by carrying out earnings management so that the company's performance looks good and can generate large profits, the main goal is to gain the trust of creditors in maintaining their profitability to fulfill receivable agreements.

CONCLUSION

This study aims to determine the effect of free cash flow and leverage on earnings quality, where the results show that free cash flow has a significant positive effect on earnings quality in banking sector companies listed on the IDX in 2016-2018. High free cash flow can be an indication that the company has sufficient cash for company expansion in the future, paying debts and paying dividends, besides that it can be concluded that managers in companies with high levels of free cash flow tend to avoid using accrual policies, this action is taken to maintain the credibility of financial reports and Get good ratings from investors. This study also shows that leverage has a negative and significant effect on earnings quality in banking sector companies listed on the IDX in 2016-2018. Companies with high leverage ratios will trigger managers to take opportunistic actions in the form of earnings management, to show good performance and obtain good ratings from creditors. Earnings management carried out by managers will result in a decrease in the quality of earnings generated by the company.

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