

# The Influence of Free Cash Flow, Financial Distress, and Investment Opportunity Sets on Profit Management (Studies in Transportation Companies Registered at Indonesia Stock Exchange Period 2019 - 2022)

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## Article Info

Received June 15, 2023

Revised June 20, 2023

Published June 22, 2023

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**Keywords :** *Earnings management, Free cash flow, Financial Distress, Investment Opportunity Set*

## Abstract

Fiscal reports used to measure profit operations results. Reported profits are very useful for stakeholders and investors to encourage company management to execute strategic plans and produce reports that stakeholders expect to be referred to as profit management. The study aims to identify profit management practices in transport companies listed on the Indonesia Stock Exchange period 2019–2021 as a result of free cash flow, financial distress and investment opportunity set. The sampling method uses Purposive sampling with the criteria that have been selected, so that 44 samples from 11 companies are obtained. The study is quantitative with the Regression Analysis method with SPSS 29.0 software aids. The results of the test showed that the Investment opportunity set has a significant positive value for profit management, while for free cash flow and Financial distress have no significant value for profit management.

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## INTRODUCTION

Financial reports are a source of information that provides external parties with reports on the condition and performance of the company. These monetary reports incorporate data relating to the monetary position, execution, and changes in the monetary position of an organization. The information contained in these financial reports is very important and useful for various stakeholders in making economic decisions. The company's financial statements are the main source of concern for stakeholders such as investors, creditors, government, and others.

The mistake of an important element in the financial statements used to measure management performance is profit. Reported profits are of great help to the stakeholders and investors consulted when researching and evaluating investments, or when concluding

contracts and assessing the viability of a company (Sally Irawan *and* Prima Apriweni, 2021) To maximize management satisfaction, opportunities to manipulate profit information are often targeted. Accounting policies are used to take opportunistic actions, which can harm shareholders or investors by allowing profits to be controlled as desired. This phenomenon is known as earnings management, in which management's attitude is made to manage earnings according to their expectations. (Ghozali *and* Chariri, 2007)

A manager can engage in earnings management by manipulating financial statements for his own benefit or the company's benefit. Using discretionary accrual (DA) proxies is one way earnings management is measured. Optional accumulation refers to the portion of collection related to the principal arrangement, in which the manager mediates in the accounting disclosure cycle. (Anisah Fitri, 2017)

PT. Kimia Farma (Persero) Tbk, a state-owned company in the consumer goods and transportation industry sector, is facing a case related to earnings management. In 2020, the company recorded a profit for the year of IDR 17.63 billion which is attributable to the parent owner. This marked a significant change from the loss of IDR 12.72 billion experienced in the previous year, namely in 2019. Kimia Farma noted that net sales rose 6.38 percent (yoy) to IDR 10 trillion in 2020. One of the factors for this increase in revenue was at Kualanamu Airport, Deli Serdang, sales of used COVID-19 antigen rapid test kits to prospective passengers. The company's revenue also increased from IDR 215.28 billion in 2019 to IDR 330.18 billion in 2020, an increase of 53.37 percent (yoy) (Muhammad, 2021) ([www.kompas.com](http://www.kompas.com)). In addition, PT Garuda Indonesia Tbk, which also operates in the same sector, is facing a case related to earnings management. In 2018, the company engaged in financial statement manipulation by changing the net income by USD 809.84 (\$11.33 billion). The business suffered a significant loss of USD 216.5 million in the previous year. It turns out that the revenue of \$239.94 million recorded in 2018 cannot be fully recognized because it is still bound by a contract with PT. MAT (Hesti, 2019)([www.cnnindonesia.com](http://www.cnnindonesia.com)). This case prompted the authors to lead research into the possible effects on board revenues, particularly in the transport sector as there is still much to be explored further. Earnings management practices that involve inflating profits, as happened in the case of PT Garuda Indonesia Tbk, can cause investors to sell their shares. This indicates that business people often use earnings management practices to improve company performance by taking advantage of various available opportunities. (Ludovicus Sensi W, 2007: 72)

Companies are often encouraged to prove good quality and performance, as well as the existence of certain interests that can encourage competition. As a result, managers can

achieve their goals by taking actions that may or may not be appropriate. Any information contained in the financial statements must be carefully considered by investors and related parties. Information that reflects actual conditions and is not manipulated or changed by financial reports is information that comes from good management. (Sally Irawan, 2021)

In the practice of earnings management there are several factors, one of which is free cash flow, the high free cash flow of the company gives the ability for earnings management to be implemented by management. there are organizational problems (Hastuti et al, 2018). As said (Anisah Fitri, 2017) and (Reksa, 2018) show that earnings management has a positive relationship with free cash flow. This shows that managers tend to apply earnings management when the company's free cash flow value is high. This is because managers tend to be motivated to control benefits by expanding salaries in fiscal summary to hide sluggish organizational performance. However, the findings of this study are different from the previous ones. (Ramadhani et al., 2017) and (Nisa Nazalia, 2018) state that earnings management is not affected by free cash flow. This implies that high or low value free income in an organization will not affect the board's tendency to control profits.

Financial distress can also be a factor in earnings management practices. Financial problems, financial difficulties, corporate bankruptcy and third stage bankruptcy are his second choice. As said (Fathonah, 2017) the condition in which the company is running cannot be separated from problems with a marked decline in the financial condition of the company before bankruptcy occurred. What is predicted using Altman's Z-Score model step, is a formula that uses financial ratios to determine when a company will go bankrupt, and the specific number is called a prediction. Previous research conducted by (Paramitha Ni Nyoman et al., 2017) with (Nisa Nazalia, 2018) showed the results of the research conducted by (Ghazali et al., 2015) the results were not in line with the statement that profit management is profitable when someone experiences financial difficulties. . Even though the greater the level of financial difficulties experienced by the organization, it is inevitable that there will also be greater income training executives. revealed that earnings management suffers from financial difficulties in this arrangement. At the point when an organization faces financial difficulties, the impact can be significant on the company's economic performance. It can also cause investors and creditors to suffer large financial losses. In situations like this, company management may focus more on efforts to recover finances and fulfill financial obligations, rather than manipulating profits. In addition, the investment opportunity set (IOS) is also a factor related to earnings management. IOS refers to investment choices that are available or may be made by a company, with the hope that it will

provide greater returns in the future. IOS can affect management decisions in reporting earnings. For example, if the company has a promising investment opportunity, management may tend to maintain or increase profits to obtain the necessary sources of funds. Conversely, if IOS is limited or low, management may tend to manipulate earnings to create a better perception of company performance. As the results of the research conducted (Agustina et al, 2015) with (Nurlis, 2016) which has consequences from the review show that there is a critical positive relationship between the set of speculation opportunities (IOS) and board profits. That is, managers are more likely to apply earnings management when the company's IOS level is higher. Conversely, if the level of earnings management is low, it is likely that the company's investment opportunity set is also low.

## **LITERATURE REVIEW**

The theory from Jansen, M., C., (1976:308) can explain that earnings management performance is applied because the interests of the business owner (principal) are different from those of the business manager (agent). According to (Anisah Fitri, 2017) "Earnings Management is an activity of a manager to manipulate financial statements so that they are used so that the goal is useful for himself (manager) or the bottom line of the company (company profit)".

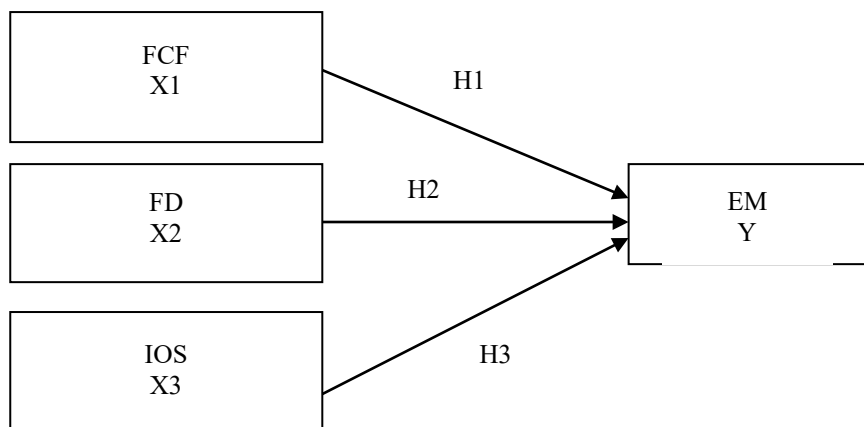
Theory from Brigham & Houston, (2018:49) Free cash flow is cash that can be distributed to all investor shareholders and debt owners and invest all fixed assets, new items, and working capital needed to continue sustainable operations. According to (Dewi, R.P., & Priyadi, 2016) (FCF) Free Cash Flow is an important term in value-based management, which was recently formed using value creation methods for the prosperity of shareholders. strong free cash flow will affect the increase in firm value, which will be reflected in strong company performance, so that the company's stock price will be high.

Sudrajat & Wijayanti (2019) Financial distress usually the result of various sequences or indirectly. Prior to a company failure, indicators of financial distress can often be identified by means of ratio analysis. Financial ratio analysis is still used to estimate the possibility of financial problems. According to Rodoni and Ali (2016:189) financial distress is the evil of the company's business. Financial distress can be useful as "early warning" system for the company, indicating a problem. Companies with a lot of debt tend to experience financial difficulties more quickly than companies with little debt. However, with the presence of a signal financial distress emerge earlier, companies have more opportunities to take restructuring and reorganization actions proactively. One of the causes of monetary

problems is bad organizational business administration (blunders).

Nisa et al. (2018:557) revealed that the availability of a set of investment opportunities is an opportunity to take advantage of the company's resources in order to expand and manage human resources as best as possible. This will affect the perception of managers, investors, and creditors towards the value of the company. According to Nurlis (2016) Company information presented to outside parties is to reflect profit in financial accounts. Earnings management is done by increasing profits to provide a series of high investment opportunities, which can reveal profitable company growth prospects in the future and benefit investors.

### Design framework



**Figure 1. Design framework**

### Research Hypothesis

H1 :Free Cash Flow effect on Earnings Management

H2:Financial Distress effect on Earnings Management

H3:Investment Opportunity Set effect on Earnings Management

## RESEARCH METHODS

### Types of research

On scientific work research. Writers who use causal-explanatory research (causal-explanatory). With a quantitative approach, the population and sample that has been determined will be studied. The object of the test is a transportation company listed on the Indonesia Stock Exchange for the 2019-2021 period, based on financial information collected from [www.idx.co.id](http://www.idx.co.id) Because previously there was a case of earnings management in the

transportation sector.

#### Population and Sample

The population of this study consisted of 11 companies. The researcher chose the sample, with the purposive sampling approach currently used, the selection was based on criteria set by companies that met certain requirements. Regarding the selection criteria in particular:

1. There are 11 companies in the transportation sector listed on the Indonesia Stock Exchange.
2. Transportation sector companies that have complete financial reports for the 2019-2022 period
3. The number of samples selected were 11 companies
4. The number of companies that became the observation data was 44 which was obtained from the results of 11 companies x 4 years period = 44 samples.

#### Variable Operational Definitions

Profit Management (Y) as discretionary accruals serves as a proxy for the dependent variable. Discretionary accruals (DA) are anomalous accrual levels caused by management policies that manipulate earnings according to their wishes.

$$AND_t = TAt/At-1 - NDA_t$$

Free cash flow (X1) is defined as the cash flow generated by the company at the end of each period after all operational costs, including liabilities and capital expenditures, have been paid.

$$FCF = NOPAT - \text{Net investment in operating capital}$$

Financial Distress (X2) vices of the company's business. Financial difficulties can serve as an "early warning" system for a company. The Z-Score Modified Altman Model is used to assess financial distress. Using the Z -Score Modified in this study because (Z) in this variable to calculate the score determined from the standard calculation times the financial ratio which will indicate the level of bankruptcy probability of the company.

$$\text{Altman Modified Z-Score}$$

$$Z = 6,56 X1 + 3,26 X2 + 6,72 X3 + 1,05 X4$$

Investment Opportunity Set (X3) represents the extent of a company's growth or investment prospects. The ratio of market value to company growth value (MVBVA) is used to evaluate investment opportunities.

$$\frac{\text{Total asset} - \text{total ekuitas} + \text{number of shares outstanding} \times \text{closing price}}{\text{Total Company Assets}}$$

**Total Company Assets**

Data Collection Techniques

The results used in this study are secondary data collected from financial reports on the subjects studied and certain research years. In addition to the data obtained through literature study and visits to the official IDX website and linked company websites.

Data analysis technique

IMB SPSS Version 29.0 was used for descriptive statistics and multiple regression analysis. This study used the classic assumption test which combines the normality test, heteroscedasticity test, multicollinearity test, and autocorrelation test. The next research process, partial test (t test) and coefficient of determination test (R2) are used to test the hypothesis.

**RESULTS AND DISCUSSION**

1. Classical Assumption Test

**Table 1. Normality Test**

<b>One-Sample Kolmogorov-Smirnov Test</b>		Unstandardized Residual	
N		44	
Normal Parameters <sup>a,b</sup>	Mean	.0000000	
	Std. Deviation	2.77062244	
Most Extreme Differences	Absolute	.195	
	Positive	.136	
	Negative	-.195	
Test Statistic		.195	
Asymp. Sig. (2-tailed) <sup>c</sup>		.187	
Monte Carlo Sig. (2-tailed) <sup>d</sup>	Sig.	.195	
	99% Confidence Interval	Lower Bound	.185
		Upper Bound	.205

Sumber : Output SPSS, 2023

If Asmpy sig is correct, the normality test is used to see whether the regression model used in this study is normally distributed. Normality testing in research if Asmpy sig. 2-tailed > 0.05, from the significant results of this study it produces a value of 0.187 > 0.05. This means that the residuals are normally distributed.

**Table 2. Multicollinearity Test**

Coefficients <sup>a</sup>							
Model	Unstandardized Coefficients		Standardized Coefficients	t	Say.	Collinearity Statistics	
	B	Std. Error	Beta			Tolerance	VIF
1 (Constant)	400.877	218.798		1.832	.074		
FCF (X1)	.000	.000	-.047	-.294	.770	.962	1.039
FD (X2)	-.213	.530	-.063	-.402	.690	.993	1.007
IOS (X3)	.000	.000	-.142	-.886	.381	.956	1.046

a. Dependent Variable: EM (Y)

**Sumber : Output SPSS, 2023**

To see whether the regression model finds a relationship between the independent variables, a multicollinearity test is used. The test above has a tolerance value ( $> 0.10$ ) and VIF ( $< 10.0$ ), which means that if the tolerance value is above 0.10 or the VIF value is below 10.0, the classical assumption of multicollinearity has been fulfilled or there are no symptoms of multicollinearity.

**Table 3. Heteroscedasticity Test**

Coefficients <sup>a</sup>						
Model	Unstandardized Coefficients		Standardized Coefficients	t	Say.	
	B	Std. Error	Beta			
1 (Constant)	400.877	218.798		1.832	.074	
FCF	-5.484E-12	.000	-.047	-.294	.770	
FD	-.213	.530	-.063	-.402	.690	
IOS	-1.294E-10	.000	-.142	-.886	.381	

a. Dependent Variable: EM

**Sumber : Output SPSS, 2023**

The heteroscedasticity test uses the Park test which produces a significance value for each variable more than 0.05, which means that there is no heteroscedasticity symptom.

**Table 4. Autocorrelation Test**

Model Summary <sup>b</sup>						
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson	
1	.716 <sup>a</sup>	.513	.461	841.65244	1.951	

a. Predictors: (Constant), FCF , FD , IOS

b. Dependent Variable: EM

**Sumber : Output SPSS, 2023**

The autocorrelation test determines whether there is a relationship in the linear regression model between the t-period confounding errors and the t-1 (previous) period confounding errors. Durbin Watson (DW) testing is used for testing. Table 4 displays the test results which show a DW value of 1.981, for the Durbin-Watson table using a specification



of 5% or (0.05), the number (N) for the Durbin-Watson table is 44, and the number (K) or variable is 3, so that a Durbin Upper (DU) is 1.6547 and Durbin-Lowes (DL) is 1.3749, for values of  $4-Du = 2.3353$ ,  $4-DL = 2.6251$ . The calculation results are as follows:  $DL < Du < DW < 4-Du < 4-DL = 1.3749 < 1.6647 < 1.951 < 2.3353 < 2.6251$ , which shows that the DW value is in the range of dU to 4-Du. There is no proven autocorrelation in the research results.

## 2. Multiple Linear Regression Analysis

**Table 5. Multiple Linear Regression Analysis**

Model	Coefficients <sup>a</sup>		Standardized Coefficients Beta	t	Sig.
	Unstandardized Coefficients B	Std. Error			
1 (Constant)	1033	140.439		7.358	<.001
FCF	.000	.000	-.263	-1.813	.077
FD	-.393	.340	.165	1.154	.255
IOS	.000	.000	-.378	-2.602	.013

a. Dependent Variable: EM (Y)

Sumber : Output SPSS, 2023

The results of the Multiple Linear Regression Equation research are shown in the following research results using the SPSS 29 program:

$$EM = 1,033 + 0,000 fCF - 0,393 FD + 0,000 IOS$$

Explanation of the multiple regression analysis decision equation in the above equation model, which has the following results:

1. The constant of the multiple linear regression equation is 1.033 with a positive sign. Assuming that FCF, FD, and IOS are all worth 1, earnings management is worth 1.033
2. The regression coefficient of FCF is 0.000, with a positive sign. That is, for every 1% FCF growth, there will be an increase in earnings management of 0.000. When FCF is down by one unit, earnings management is down by one unit.
3. The regression coefficient for FD is -0.393 with a negative sign. Assuming that all other independent factors remain the same, this indicates that there will be a loss of earnings management of -0.393 for every one percent increase in the value of the Z-score.
4. With a positive sign, the IOS regression coefficient is 0.000. This indicates that a 0.000% increase in IOS will result from a 1% increase. on earnings management values, provided the other independent variables are held constant.

#### 4. Hypothesis Test

**Table 6. Partial Test (t test)**

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
1 (Constant)	1033	140.439		7.358	<.001
FCF	.000	.000	-.263	-1.813	.077
FD	-.393	.340	.165	1.154	.255
IOS	.000	.000	-.378	-2.602	.013

a. Dependent Variable: EM (Y)

Sumber : Output SPSS, 2023

The results of the t statistical test obtained show that the Investment Opportunity Set variable has a significance value of <0.05, which means H<sub>3</sub> accepted, while for variables *free cash flow* and *Financial distress* produces a significance value > 0.05, so for H<sub>1</sub> and H<sub>3</sub> rejected.

**Table 7. Determination Coefficient Test (R<sup>2</sup>)**

Model Summary <sup>b</sup>					
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.716 <sup>a</sup>	.513	.461	841.65244	1.951

a. Predictors: (Constant), FCF, FD, IOS

b. Dependent Variable: EM

Sumber : Output SPSS, 2023

Testing the coefficient of determination (R<sup>2</sup>) shows that the elements of the independent variables, namely the Free cash flow, Financial distress, and Investment opportunity set variables have an influence of 0.461% on the earnings management variable.

#### Effect of Free Cash Flow on Earnings Management

Based on the test results of table 6 the Free cash flow variable has a value of 0.077. The results of this test show that the values obtained exceed the 5% significance level, which is significant *free cash flow* do not have strong enough evidence to influence earnings management. Therefore, the first hypothesis (H<sub>1</sub>) is rejected indicating that free cash flow does not have a significant effect on earnings management. based on the results of this discussion in accordance with (Ramadhani et al., 2017) together with (N Nisa, 2018) confirms that this research shows that earnings management is not affected by free cash flow. The tendency of management to manipulate profits will not be controlled by the high or low value of the company's free cash flow.

### **The Effect of Financial Distress on Earnings Management**

From the test value table 6. Variable *financial distress* produces a significance value of 0.255. The results of this test show that the value obtained exceeds the 5% significance level, which means *Financial distress* do not have strong enough evidence to influence earnings management, so the first hypothesis (H2) is rejected. Based on the results of this discussion it is not in accordance with Sari & A.R (2017) Paramitha et al. (2017) with N Nisa, (2018) show the results of profitable earnings management when someone experiences financial difficulties. The greater the monetary woes that occur in an organization, the more likely board profits will occur because managers to overcome financial problems in their organizations are expected to resolve the benefits of executives so that stakeholders will continue to invest in the company. However, in line with Fathoni et al. (2014) and Yolanda et al. (2019), which shows that earnings management results cannot be affected by financial distress.

### **The Effect of Investment Opportunity Set on Profit Management**

Based on the test results of table 6. The investment opportunity set variable has a value of 0.013. The results of this study obtained results lower than the 5% significance level, which means that the investment opportunity set in the Kegita hypothesis (H3) is accepted. The results of this test indicate that the investment opportunity set has a significant positive effect on earnings management, so the third hypothesis (H3) is accepted. Based on the results of this study in line with Agustina et al. (2015) with Nurlis (2016) which has consequences from the review showing that there is a critical positive relationship between Investment opportunity set (IOS) and earnings management. That is, managers are more likely to apply earnings management when the company's IOS level is higher. Conversely, if the level of earnings management is low, it is likely that the company's investment opportunity set is also low.

## **CONCLUSION**

Based on the research results, the conclusion that can be drawn is that earnings management is not affected by *free cash flow* and *Financial distress*, however, the investment opportunity set has a significant positive impact on earnings management. The greater the investment opportunity set owned by a company, the greater the earnings management practice is carried out, where the investment opportunity set will show the level of

opportunities and investment opportunities for the company. This study specifically examines the relationship between free cash flow, financial distress, investment opportunity sets, and earnings management. Due to the limitations of this study covering only the transportation sector, future research should aim to expand this sector. In addition, further researchers may add or choose other independent variables to use more samples and obtain new results in the hope that they will represent more general and complete conclusions.

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