International Journal of Trend in Scientific Research and Development (IJTSRD)
Volume 9 Issue 3, May-Jun 2025 Available Online: www.ijtsrd.com e-ISSN: 2456 – 6470

Antecedents of Earnings Management: An Investigation on Construction and Building Companies Registered in Public Companies in Indonesia

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ABSTRACT

Earnings management is an effort to influence earnings figures by management by increasing, decreasing or equalizing profits in the financial reporting process in order to meet certain goals or interests. This research was conducted to empirically test and analyze the effect of free cash flow, leverage and company size on earnings management in construction and building companies listed on the IDX during the period 2022-2024. Earnings management in this research is proxied using the Stubben Model. The type of research used by researchers is quantitative research with secondary data from the publication of construction and building company financial reports for 2022-2024 which are accessed officially on the Indonesia Stock Exchange website, namely www.idx.co.id. Sampling used a purposive sampling method with sample results obtained from 63 firm-years. Furthermore, data analysis was carried out using multiple linear regression. The test results in this study stated that free cash flow and leverage doesn't have a significant effect on earnings management, while company size has a significant effect on earnings management with a negative effect.

KEYWORDS: *firm size; earnings management; free cash flow; leverage*

How to cite this paper: Aulia Rahmadiani Negoro | Nur Hisamuddin | Rochman Effendi "Antecedents of Earnings Management: An Investigation on Construction and Building Companies Registered in Public Companies in Indonesia" Published in International Journal of Trend in Scientific Research and Development (ijtsrd), ISSN: 2456-6470, Volume-9 | Issue-3, June 2025, pp.1009-1014, URL: www.ijtsrd.com/papers/ijtsrd88500.pdf

IJTSRD88500

INTRODUCTION

The financial report itself is one of the liaison instruments between parties interested in the company and contains a description of the company's condition. One of the important elements in the financial report is profit information which is used as one of the measures in assessing the company's performance and becomes a consideration in making decisions by various parties [1]. For investors, profit information is one of the factors to consider in making investment decisions to maximize the profits obtained. Meanwhile, for creditors and the government, profit information is used to assess the company's eligibility to obtain credit and is one of the components in assessing the tax burden. Therefore, in order for the information in the financial report to function properly, the financial report information should not be presented only to benefit a handful of parties and harm other parties who have different interests.

However, there is a tendency for principals (investors and other external parties) to often focus on profit information without paying attention to the procedures used to produce the profit information and the emergence of information gaps, considering that managers have greater control over the reporting and collection of certain company information than external parties, thus triggering opportunities for managers to intervene to unilaterally regulate profits in the form of profit management. Profit management is an effort made by managers to influence reported profits in order to achieve certain interests or benefits themselves, namely the manager/company concerned, by choosing and changing accounting policy methods within limits that do not violate GAAP [2]. Although indirectly this profit management action is still within the permitted limits, this action has an impact that can affect investment decision making or the results of contracts between stakeholders and companies that depend on the accounting figures presented. So it has the potential to make users of financial statements wrong in making misguided decisions. Investors can fail to interpret company performance, resulting in inaccurate allocation of funds to companies that are truly prospective to companies that are less prospective. Meanwhile, for creditors, it can cause errors in making decisions about granting credit to companies [3], [4].

Free cash flow is the amount of remaining cash in a company that can be distributed to investors after the company meets operational needs and payments for investments in its assets needed to maintain current production capacity [5]. The existence of free cash flow will provide an opportunity for managers/companies to use it in several investments and if the investment turns out to be inappropriate it will result in losses for the company. Companies can be encouraged to carry out earnings management when there is excess free cash flow, so that the less than optimal use of free cash flow by managers can be covered. Research by [6] revealed that free cash flow has an effect on earnings management. Meanwhile, research by [7] actually revealed that free cash flow has no effect on earnings management. According to Harahap (2018), leverage is a ratio that shows how much a company is funded using debt with the company's ability as seen from the size of assets or capital. A high leverage value will make it difficult for the company to pay its debts. The use or proportion of debt can also cause companies to tend to carry out earnings management [8]. [9] research revealed that leverage has an effect on earnings management.

Companies that are large or small, their managers will be under pressure to carry out earnings management in order to attract more investors or for other reasons to reduce corporate tax costs. [10], [11] revealed that firm size affects earnings management.

Construction and building companies are a mainstay industry as an important contributor to economic growth in Indonesia. The rise of the tagline for accelerating infrastructure development in the era of the Joko Widodo administration through the National Strategic Project Program (NSPP) has made the construction and building industry one of the potential sectors and has long-term investment value. In addition, Indonesia itself is the top construction market in Southeast Asia, with the potential for a population that continues to grow will affect the construction of housing, public facilities, shopping center apartments, and also office buildings [12]. Reported from the Ministry of Investment/BKPM Indonesia (2023), the realization of investment in the construction sector until the fourth quarter of 2022 reached 13.0 billion. This amount increased by 28.7% compared to 2021 which was 10.1 billion.

However, amidst the acceleration of development programs and the increasing interest in investment, the implementation of government regulations related to PSBB at the beginning of the pandemic in 2020 has hampered the development of a number of projects that are already operational and some of them have been delayed, resulting in a weakening and smaller GDP growth. Nevertheless, the government has provided several stimuli by allocating APBN funds to pursue delayed infrastructure development reaching 417.4 billion and establishing a Sovereign Wealth Fund (SWF) in 2021 in Indonesia which aims to increase foreign investment to finance domestic projects including building and infrastructure projects. This certainly has an impact on the company's profit acquisition becoming unstable which can trigger the possibility of construction and building companies implementing strategies to remain going concern by using accounting methods in managing their profits through profit management practices. Based on the explanation that has been presented above, it was found that the phenomenon of profit management occurred in Indonesia, including in construction and building sector companies, and the differences in the results of similar studies that had been carried out previously were the basis and considerations for conducting this study.

LITERATURE REVIEW

Earnings Management

Earnings management is an act of deliberate intervention by management in influencing a company's profits with the intention of achieving certain goals [13]. In line with this, [14]stated that earnings management occurs when managers try to influence and intervene in the information disclosed in financial reports to external parties regarding the conditions and work results achieved by the company. Because the profits generated do not represent current economic realities, this indirectly risks making the company's financial reports less credible and can mislead users of financial reports.

Free Cash Flow

According to [15], free cash flow is the amount of remaining cash in the company that can be distributed to investors after the company meets operational needs or payments for investments in its assets needed to maintain current productive capacity. This free cash flow is very important for the company because it can provide opportunities for increasing the value of the company and shareholders [6]. Based on the explanation, it can be concluded that free cash flow is the remaining excess cash that can be allocated as an addition to maintain the sustainability of the company, payments to creditors, and can be given in the form of dividend distribution to shareholders.

Leverage

According to [16], [17], leverage is a ratio that shows how much a company is funded using debt with the company's ability as seen from the amount of its assets or capital. In other words, this leverage is useful for knowing how much the company's assets depend on creditor debt. While in a broad sense, leverage reflects how the company's ability to pay off all outstanding debts in the event of liquidation (dissolution). Using too much debt proportion is likely to have a negative impact on the company because it will place the company in the extreme leverage category.

Firm Size

According to [18], firm size is a value used to represent whether a company is classified as a large or small company. Firm size can be measured through several proxies including log total assets, market capitalization, total sales, and average sales level. In addition, firm size can also be used to assess how complex the operational activities of a company are. The more complex the operational activities, the greater the possibility of the company in carrying out profit management.

The availability of excess free cash flow in a company can trigger agency problems [5]. This is in accordance with the agency theory, namely the existence of a conflict of interest between the agent (management) and the principal (shareholder) regarding the distribution of free cash flow owned by the company. The principal expects the free cash flow to be used for dividend distribution while the agent prefers to use the free cash flow to finance investment or business expansion, although sometimes the investment made does not necessarily provide profit. Therefore, free cash flow can be an important aspect for management in carrying out earnings management. This is done to cover up the suboptimal use of the free cash flow.

Referring to agency theory, an agency relationship can also occur between management and creditors. Companies with high leverage values will be at greater risk of meeting all debts and interest on time. Creditors want certainty that the company can generate profits in the future. In addition, the company is also required to comply with the rules in the debt contract that have been determined. Therefore, the motivation to avoid the possibility of the company defaulting encourages agents (management) to plan an earnings management scheme, so that they can convince creditors and even investors that the company is considered to be able to manage debt well and maintain good operational performance.

Firm size is also known as one of the causes of earnings management. Both large and small companies can have a tendency to carry out earnings management [19], [20]. Small companies are more motivated to carry out earnings management because companies always want to be seen to have good performance in order to attract more investors, while large companies are considered more critical, making companies have fewer opportunities to carry out earnings management. However, on the one hand, companies that are classified as large can also be indicated to carry out asset management. Along with the large size of the company, the company will have more investors and be better known than other companies. This makes agents tend to carry out earnings management to maintain investor expectations, or other reasons, namely to minimize tax payments by the company.

Hypothesis

H1: Free Cash Flow Affects Earnings Management
H2: Leverage Affects Earnings Management
H3: Firm Size Affects Earnings Management

RESEARCH METHODS

The data were obtained from construction and building company data sourced from the IDX page, namely www.idx.co.id. This study uses secondary data types through the publication of financial reports of construction and building companies that have been registered with the IDX during 2022-2024.

The population of the study includes all construction and building companies listed on the Indonesia Stock Exchange. Then in sampling, the researcher used a purposive sampling technique through a number of criteria. Total Sample are 63 public companies.

The data analysis method is carried out with several tests that include classical assumption tests, multiple linear regression analysis, and hypothesis tests. Classical assumption tests in the study include normality tests, multicollinearity tests, heteroscedasticity tests, and autocorrelation tests. While hypothesis testing includes determination coefficient tests, model feasibility tests (F tests), and T tests (partial).

The results of the analysis of the earnings management variable showed a minimum value of -0.14, a maximum value of 0.18, and an average value of -0.0028 with a standard deviation of 0.05135. Second, the results of the analysis of the free cash flow variable showed a minimum value of -1.57, a maximum value of 0.74, and an average value of -0.1603 with a standard deviation of 0.29154. Third, the analysis of the leverage variable showed a minimum value of 0.12, a maximum value of 0.89, and an average value of 0.5429 with a standard deviation of 0.20412. Fourth, the analysis of the firm size variable showed a minimum value of 22.81, a maximum value of 32.27, and an average value of 28.6059 with a standard deviation of 2.10153.

Based on the results of the R2 test, the Adjusted R2 value is 0.264. This means that the variation of the independent variables of free cash flow, leverage, and firm size has an influence of 26.4% on the dependent variable of earnings management. While the rest (100% - 26.4% = 73.6%) is influenced by other independent variables outside the study.

RESULTS AND DISCUSSION

The free cash flow variable (X1) obtained a sig. level of 0.956 above 0.05. While the calculated t obtained was 0.056 <t table (2.00100). This means that free cash flow does not have a significant effect on earnings management or the first hypothesis is rejected. Then, the leverage variable (X2) obtained a sig. level of 0.083 above 0.05. While the calculated t obtained was -1.765 <t table (2.00100). This means that leverage does not have a significant effect on earnings management or the second hypothesis is rejected. Meanwhile, the independent variable firm size (X3) obtained a sig. level of 0.009 below 0.05. While the calculated t obtained was -2.688 <t table (2.00100). This means that firm size has a significant effect on earnings management or the third hypothesis is accepted.

Table 1. HYPOTHESIS TESTING RESULTS

	Beta	T Stat.	P Values
(Constant)	2.179	1.576	.120
Free cash flow	.557	.056	.956
Leverage	.958	-1.765	.083
Firm Size	.085	-2.688	.009**

*Sig. 0.05
** Sig. 0.001

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The results of the study show that the significance obtained is 0.956 more than 0.05 (0.956> 0.05), meaning that free cash flow does not have a significant effect on earnings management. This is because in conditions of high free cash flow, the company has anticipated to further increase management supervision so as not to use the available cash inefficiently or use it for overinvestment, so that the company will still be able to maintain its growth and agents also do not need to carry out earnings management to cover the decline in profits or losses due to inaccurate use of the free cash flow. In addition, the high amount of free cash flow without having to carry out earnings management will have an impact on increasing stock prices, because the principal considers that the company has more cash to be distributed as dividends and maintain the continuity of the company's business. The results of this study are in accordance with the research of S. A. Putri & NR (2023) and Sagala & Simbolon (2021) which resulted in free cash flow not having a significant effect on earnings management actions.

The results of the study show that the significance obtained is 0.083, which is greater than 0.05 (0.083 > 0.05), meaning that leverage does not have a significant effect on earnings management. This study explains that the size of the leverage does not affect managers (agents) in carrying out earnings management. When a company uses a certain amount of debt to fund its operations, the loan agreement will limit non-optimal spending on the company and the principal will have greater control to monitor the company's actions. This debt policy results in principals including creditors also requesting more reliable financial reports, increasing tighter supervision, and putting pressure on managers as the company's debt increases. This means that companies with large and small leverage have constant earnings management actions. The results show that leverage does not have a significant effect on earnings management actions.

The results of the study show that the significance obtained is 0.009 below 0.05 (0.009 <0.05), meaning that firm size has a negative and significant effect on earnings management actions. This study states that larger companies have less incentive to carry out earnings management than small companies. The larger the size of a company as seen from its total assets, the more it will attract principals.

The high interest of principals in the company also has an impact on making large companies more in the spotlight and criticism by investors, creditors, and the government regarding the financial information held by the Company. In line with this, agency theory states that the larger the company, the greater the monitoring costs and the company will try to disclose as much information as possible to reduce these agency costs. In addition, large companies are also likely to have corporate governance and internal controls systems that are much more complex than smaller companies. Thus, this can minimize the occurrence of earnings management actions carried out by managers, with published financial information becoming more complete and transparent.

In other words, the larger the firm size, the tendency to carry out earnings management will decrease. Meanwhile, companies with smaller sizes will be more encouraged to carry out earnings management because the company always wants to be seen to have good performance in order to increase principal trust and attract more principals to invest their funds in the company. The results of this study are in accordance with the research of firm size having a negative and significant effect on earnings management actions.

CONCLUSION AND SUGGESTION

Based on the results of the data testing, hypotheses, and discussions presented above, it was concluded that the free cash flow and leverage variables did not have a significant effect on earnings management, meaning that the first and second hypotheses of this study were rejected. Meanwhile, the firm size variable had a negative and significant effect on earnings management with a significance value of 0.009 <0.05. Thus, the third hypothesis in this study can be accepted. Furthermore, this study can be a reference and input for other researchers, to conduct further research by exploring other variables that also influence earnings management or other than the variables that have been used in this study, for example sales growth, profitability, tax planning, and so on; And can try to research on a wider company or use all companies listed on the IDX.

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