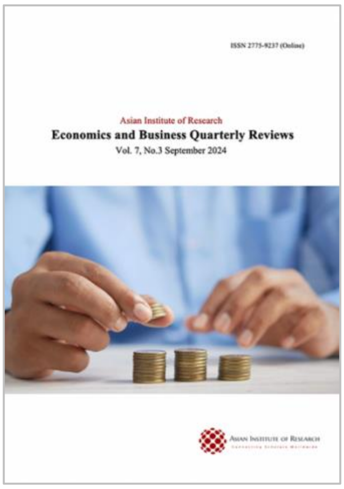

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The Impact of Company Size, Leverage, and Free Cash Flow on Earnings Management and Company Value in LQ45 Companies Listed on the Indonesia Stock Exchange in 2018-2022

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Abstract
The aim of this research is to examine the effects of firm size, leverage, and free cash flow on earnings management and firm value. The population for this study consists of all companies listed on the LQ45 index at the Indonesia Stock Exchange from 2018 to 2022. The sample was selected using purposive sampling, resulting in 22 companies. This study employs a quantitative approach, utilizing IBM SPSS 23 for data analysis, with hypothesis testing conducted through Structural Equation Modelling (SEM). The results indicate that the proportion of firm size has a negative and insignificant effect on earnings management and firm value. Conversely, leverage growth and free cash flow have a positive and significant impact on both earnings management and firm value.

Keywords: Firm Size, Leverage, Free Cash Flow, Earnings Management, Firm Value

1. Introduction

A higher company valuation will enhance investor confidence, not only in the current performance of the company but also in its future prospects. For companies that issue shares for public sale, the company's value can be observed in the stock price traded on the Stock Exchange. The higher the stock price, the greater the wealth of shareholders (Darmawan & Firdausy, 2021).

Earnings management involves the application of accounting principles that allow managers the flexibility to choose appropriate procedures when making assumptions and estimates regarding their business scope (Fadhilah & Kartika, 2022). Based on existing realities, nearly all users of financial statements tend to focus solely on information concerning the company's profits without considering how those profits are achieved. This can motivate company management to take certain actions that benefit themselves. This situation may occur when a company faces conditions where management fails to meet the established profit targets, leading management to exploit the flexibility provided by accounting standards to modify the reported earnings in financial statements. Management is motivated to demonstrate good performance in creating value or maximizing profits for the company, thus tending to select and apply accounting methods that can produce more favourable profit information (Setiawati et al., 2019).

Next, we discuss free cash flow and leverage. Based on company size, larger firms tend to have greater sales, higher stability, and engage more stakeholders. This provides a stronger incentive for companies to engage in earnings management. Company size is measured using the Log of Natural Total Assets (Setiawati et al., 2019). The next factor influencing earnings management practices is leverage. This ratio is used by investors to assess a company's ability and risk. Excessive debt can threaten a company's sustainability, as it may lead the firm into a cycle of debt that is difficult to repay. Leverage is measured by the Debt to Asset Ratio (DAR) to evaluate the efficiency of debt usage in managing the company's assets. Another factor related to earnings management is free cash flow. Free cash flow is used to measure growth, financial performance, and the stability of a company. It provides investors with an insight into the number of dividends they can expect, as well as reflecting the company's ability to endure in the future (Natalia Wijaya & Hendriyeni, 2021).

Based on previous research journals, there are discrepancies in findings among different studies. This inconsistency in results motivates the researcher to conduct a study titled "The Influence of Company Size, Leverage, and Free Cash Flow on Earnings Management and Company Value in LQ45 Companies Listed on the Indonesia Stock Exchange from 2018 to 2022." This research aims to provide empirical evidence regarding the impact of company size, leverage, and free cash flow on the practices of earnings management and the value of LQ45 companies listed on the Indonesia Stock Exchange.

The hypotheses in this study are as follows:

a) Earnings quality has an impact on earnings management.
b) Leverage has an impact on earnings management.
c) Free cash flow has an impact on earnings management.
d) Earnings quality has an impact on firm value.
e) Leverage has an impact on firm value.
f) Free cash flow has an impact on firm value.

2. Method

This research employs a causal associative quantitative research method aimed at demonstrating the existence of an influence relationship between two or more variables. The population studied in this research consists of companies listed on the LQ45 index on the Indonesia Stock Exchange (IDX). The data utilized is secondary data obtained from annual financial statements over five consecutive years, specifically from 2018 to 2022, covering a total of 64 companies.

Samples in this study were selected using purposive sampling techniques, where samples were chosen based on specific considerations. After aligning with the sample selection criteria, there are 22 sample companies that became the subjects of this research, resulting in a total of 110 observations. The results of this selection are detailed in a table.

The data for this research was sourced from secondary data using a non-participant observational data collection method, meaning that the researcher did not directly engage in the operational activities of the companies. This method involved observing and recording the necessary data from LQ45 companies listed on the Indonesia Stock Exchange (IDX). The data obtained consists of the annual financial statements of LQ45 companies downloaded from the website www.idx.co.id.

Structural Equation Modeling (SEM) is a statistical method capable of exploring patterns of relationships between latent variables and their indicators, as well as between one latent variable and another, including measurement errors directly. With SEM, we can conduct analyses that directly involve several exogenous and endogenous variables. This study includes five latent variables tested using AMOS software. This test aims to provide answers regarding the hypotheses being tested, determining whether they are accepted or rejected (Pramudita et al., 2020).

3. Result

The criterion used in this hypothesis testing is to evaluate the significance value of the variables. If the significance value (sig) is less than 0.05, the hypothesis is accepted. Conversely, if the significance value is greater than 0.05, the hypothesis is rejected. The significance level used in this study is 5% (0.05), which means the margin of error in this research is 5%, or in other words, the confidence level is 95%. A total of six hypotheses are tested. The results of the data from these hypotheses will be presented in the table below.

Table 1: Test Result

Hypothesis	**Path**	**Estimate**	**P**	**Result**	***R-Square***
H_1	Y1 ← X1	-0,287	0,169	Rejected	
H_2	Y1 ← X2	0,000	0,577	Rejected	0,432
H_3	Y1 ← X3	0,000	***	Accepted	
H_4	Y2 ←X1	-1,164	0,186	Rejected	
H_5	Y2 ← X2	0,004	0,016	Accepted	0,050
H_6	Y2 ← X3	0,000	0,012	Accepted	

Based on the results of the hypothesis testing in the table above, it can be concluded that the impact of company size, leverage, and free cash flow collectively on earnings management shows an R-squared (R') value of 0.432. This indicates that the coefficient of determination is 43.2%. This figure signifies that the simultaneous influence of company size, leverage, and free cash flow on earnings management accounts for 43.2%, while the remaining 56.8% is influenced by other factors. According to the table above, the effect of company size, leverage, and free cash flow collectively on company value shows an R-squared (R') value of 0.050. This indicates that the coefficient of determination is 5.0%. This figure means that the simultaneous effect of company size, leverage, and free cash flow on company value is 0.50%, while the remaining 90.5% is affected by other factors. In addition to the collective (simultaneous) effects, individual impacts of each variable can also be summarized as follows:

1. The estimate value in H1 explains that the path coefficient for variable X1 (size of the company) in relation to variable Y1 (earnings management) is -0.287, which indicates a negative value, meaning that company size negatively affects earnings management. The P-Value for variable X1 (size of the company) in relation to variable Y1 (earnings management) is 0.169, which signifies a significance level greater than 0.05. Therefore, it can be concluded that variable X1 (size of the company) has a negative and insignificant effect on variable Y1 (earnings management).
2. The estimate value in H2 indicates that the path coefficient for variable X2 (leverage) in relation to variable Y1 (earnings management) is 0.000, which indicates a positive value, meaning that leverage positively affects earnings management. The P-Value for variable X2 (leverage) in relation to variable Y1 (earnings management) is 0.577, which also signifies a significance level greater than 0.05. Thus, it can be concluded that variable X2 (leverage) has a positive but insignificant effect on variable Y1 (earnings management).
3. The estimate value in H3 illustrates that the path coefficient for variable X3 (free cash flow) in relation to variable Y1 (earnings management) is 0.000, indicating a positive value, which means that free cash flow positively affects earnings management. The P-Value for variable X3 (free cash flow) in relation to variable Y1 (earnings management) is ***, indicating a significance level less than 0.05. Therefore, it can be concluded that variable X3 (free cash flow) has a positive and significant effect on variable Y1 (earnings management).
4. The estimated value in H5 indicates that the path coefficient of variable X2 (leverage) with respect to variable Y2 (firm value) is 0.004, which is positive. This suggests that leverage positively influences firm value. Furthermore, the P-Value for variable X2 (leverage) concerning variable Y2 (firm value) is 0.016, indicating a significance level below 0.05. Therefore, it can be concluded that variable X2 (leverage) has a positive and significant impact on variable Y2 (firm value).
5. The estimate value in H6 indicates that the path coefficient for variable X3 (free cash flow) in relation to variable Y2 (firm value) is 0.000, which is positive. This means that free cash flow has a positive influence on firm value. Additionally, the P-Value for variable X3 (free cash flow) concerning variable Y2 (firm value) is 0.012, indicating a significance level of less than 0.05. Therefore, it can be concluded that variable X3 (free cash flow) has a positive and significant effect on variable Y2 (firm value).

The output results from SEM AMOS showing both direct and indirect effects on each variable are presented in the following path diagram:

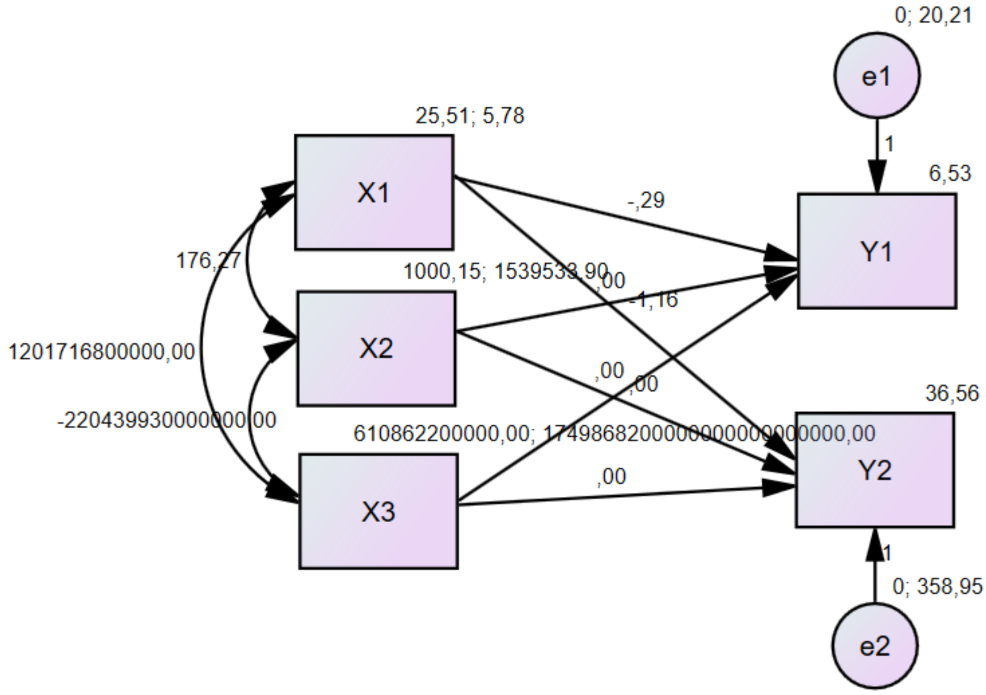

Figure 1: Structural Model

Figure 1 illustrates the proposed structural model for hypothesis testing. This model meets the established criteria. The results of the first path analysis indicate that firm size (X1) can directly affect earnings management (Y1), with a direct effect size of -0.29. The second path analysis shows that leverage (X2) can directly impact earnings management (Y1), with a direct effect size of -1.15. The third path analysis reveals that free cash flow (X3) can also directly influence earnings management (Y1), with a direct effect size of 0.00. The fourth path analysis indicates that firm size (X1) can directly affect company value (Y2), with a direct effect size of 0.00. The fifth path analysis suggests that leverage (X2) can directly impact company value (Y2), also with a direct effect size of 0.00. Finally, the sixth path analysis shows that free cash flow (X3) can directly influence company value (Y2), with a direct effect size of 0.00.

4. Discussion

The estimated value obtained for the firm size variable (X1) is -0.287 with a P-Value of 0.169. The P-Value analysis shows a significance level greater than 0.05. Therefore, there is a negative and insignificant effect of firm size on earnings management, leading to the rejection of H1. This result contradicts the grand theory proposed by Fadhilah & Kartika (2022), which states that according to agency theory, as firm size increases, the likelihood of earnings management decreases. However, this study finds that firm size has a positive influence on earnings management. The findings align with research conducted by Anindya & Afri Yuyetta (2020) and Fandriani & Tunjung (2019), indicating that firm size has a negative and insignificant effect on earnings management. This suggests that firm size does not necessarily reduce the likelihood of earnings management, as larger firms have more assets, and there are often many assets that are not managed effectively, leading to potential misstatements in the disclosure of total assets.

The estimated value of the leverage variable (X2) is 0.000 with a P-Value of 0.577. The P-Value analysis shows a significance level greater than 0.05. Therefore, there is a positive and insignificant effect of leverage on earnings management, resulting in the rejection of H2. This finding is consistent with the grand theory by Fadhilah & Kartika (2022), which states that according to agency theory, leverage does not influence earnings management.

This is also supported by research conducted by Anindya & Afri Yuyetta (2020) and Natalia Wijaya & Hendriyeni (2021). This can be attributed to the fact that firms do not require actions that support them in certain situations. Companies find themselves in a stable or secure condition, being able to service debts used to finance their assets. The research findings are not in line with those conducted by Sitanggang & Purba (2022) and Fandriani & Tunjung (2019), which indicate that leverage has a positive and significant effect on earnings management in a partial context.

The estimated value obtained for the variable of free cash flow (X3) is 0.000 with a P-Value smaller than 0.0001, thus it cannot be defined in the testing application. The analysis results show a P-Value of less than 0.05, indicating significance. Therefore, there is a positive and significant effect between free cash flow and earnings management, leading to the acceptance of H3. This result contradicts the grand theory proposed by Fadhilah & Kartika (2022), which states that according to agency theory, free cash flow positively influences earnings management, as managers are often compensated based on company performance, particularly profit. When free cash flow is abundant, managers have stronger incentives to engage in earnings management, meaning they may manipulate accounting numbers to make profits appear better than they truly are, aiming to increase bonuses, stock options, or their personal reputation. In contrast, the study found that free cash flow negatively impacts earnings management. This finding aligns with the research of Natalia Wijaya & Hendriyeni (2021) and Christabel & Bangun (2020), which suggests that managers are responsible for managing the company and tend to engage in earnings management to secure funding from shareholders. The higher the free cash flow value, or the cash not allocated for working capital, the less pressure managers feel to modify financial reports or engage in earnings management, as their performance already appears favourable in the eyes of shareholders while the company is in a healthy condition.

The estimated value produced for the company size variable (X1) is -1.164 with a P-Value of 0.186. The analysis shows that the P-Value is greater than 0.05, indicating non-significance. Therefore, there is a negative and insignificant effect of company size on company value, leading to the rejection of H4. This finding contradicts the grand theory proposed by Nurwanto (2022), which states that according to agency theory, company size has a positive and significant influence on company value, as larger companies can reduce conflicts of interest between owners and managers. Managers of larger firms tend to focus more on long-term company goals because they hold more shares or stock options. Additionally, larger companies usually have stronger internal control mechanisms to oversee managerial performance. However, the results of the tests obtained are contradictory. Despite the differing test outcomes and agency theory, the results align with research conducted by Khoeriyah (2020) and Kadim & Sunardi (2019), which suggests that company size does not negatively and significantly impact company value. This implies that possessing a large total asset does not necessarily guarantee investors will invest or manage the company with the goal of increasing its value. Investors are less concerned with the size of total assets and more inclined to evaluate aspects demonstrating a company's performance, which can be found in its financial statements, such as the company's reputation and dividend policy, before deciding to purchase shares in that company.

The estimated value obtained for the leverage variable (X2) is 0.004 with a P-Value of 0.016. The analysis results indicate that the P-Value is less than 0.05, demonstrating sufficient significance. Thus, there is a positive and significant effect of leverage on firm value, leading to the acceptance of H5. This finding aligns with the grand theory of Nurwanto (2022), which states that according to agency theory, leverage has a positive and significant effect on firm value, explaining that the higher the leverage ratio, the larger the capital structure financed by debt to support existing equity. The use of leverage allows companies to maximize their operations, consequently increasing their profit potential. This test result differs from the research of Kadim & Sunardi (2019) and Khoeriyah (2020), which argue that leverage has a negative and significant impact on firm value.

The estimated value generated for the free cash flow variable (X3) is 0.000 with a P-Value of 0.012. The analysis shows that the P-Value is less than 0.05, indicating significance. Therefore, there is a positive and significant effect of free cash flow on firm value, which means H6 is accepted. This result is consistent with the grand theory of Nurwanto (2022), which states that according to agency theory, free cash flow positively and significantly influences firm value, indicating that free cash flow can be used for discretionary activities such as acquisitions and capital investments to support company growth. This test result contradicts the findings of Putri & Aris (2023), which state that free cash flow does not have a significant effect on firm value.

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