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The Mechanism of Free Cash Flow and Financial Distress on Earnings Management Practices with Profitability as a Moderation Variable

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Abstract

This study examines the effect of free cash flow and financial distress on earnings management in energy sector companies listed on the Indonesia Stock Exchange (IDX) during 2020–2024. It also analyzes the role of profitability as a moderating variable that may strengthen or weaken the relationship between free cash flow, financial distress, and earnings management. This research uses a quantitative approach with secondary data obtained from companies' annual reports published by the IDX. The sample was selected using purposive sampling from companies that consistently published financial statements during the research period. Earnings management was measured using the Modified Jones Model through discretionary accruals, and the data were analyzed using multiple linear regression with a moderating interaction test. The results indicate that free cash flow and financial distress have a positive and significant effect on earnings management. Furthermore, profitability weakens the effect of free cash flow and financial distress on earnings management, indicating that higher profitability can reduce the tendency of management to manipulate financial information.

INTRODUCTION

In an increasingly dynamic business environment that demands high transparency, financial statements are the main source of information for investors, creditors, governments, and the public in making economic decisions. However, the reliability of financial statements is often questioned due to the practice of *Earnings management*. Profit management is the act of management in engineering accounting figures to achieve certain objectives, either through manipulation of accruals or real activities, which are generally triggered by conflicts of interest between managers and owners as described in agency theory. This practice can reduce the quality of financial statements, reduce public trust, and have an impact on the company's reputation and value.

One of the factors that is suspected to affect the practice *of Earnings management* is *Free cash flow* (*FCF*). A high *FCF* can provide flexibility for managers to use company funds so that it has the potential to encourage opportunistic behavior. However, the results of previous studies show inconsistent findings. Some studies have found that *FCF* has a negative effect on profit management because strong liquidity reduces manipulation pressure, while other studies have found that *FCF* has a positive effect because it provides room for managers to act opportunistically. These differences in results show that there are still research gaps that need to be studied further.

In addition to *FCF*, *financial distress* is also suspected to be a driving factor for *earnings management*. Financial difficulties increase the pressure on management to maintain the company's image in the eyes of investors and creditors, thus encouraging manipulation of financial statements. Nonetheless, previous research has also shown mixed results. Some state that *financial distress* has no significant effect on profit management, while other studies have found a positive effect. These inconsistencies in findings underscore the importance of further testing, particularly in sectors with high-risk characteristics.

To deepen the analysis, this study added Profitability as a moderation variable. Profitability reflects the company's ability to generate profits and is thought to strengthen or weaken the influence of *FCF* and *financial distress* on *earnings management*. Companies with high levels of profitability tend to have lower manipulation pressures, but previous empirical findings have also shown inconsistent results regarding the role of moderation. Therefore, this research is focused on energy sector companies listed on the Indonesia Stock Exchange (IDX) for the 2020–2024 period. The energy sector has special characteristics such as commodity price volatility, large capital requirements, long-term project risks, and high regulatory pressures, so it has the potential to affect *free cash flow*, *financial distress*, and *earnings management practices*.

Based on this presentation, this study aims to simultaneously examine the influence of *free cash flow* and *financial distress* on *earnings management* by considering the role of profitability moderation in energy sector companies in Indonesia.

Based on the background of the problems described above, the formulation of the problem in this study is:

1. Does *free cash flow* affect the practice of *earnings management* in energy sector companies listed on the IDX?
2. Does *financial distress* affect the practice of *earnings management* in energy sector companies listed on the IDX?
3. Does profitability as a moderating variable affect free *cash flow* in *earnings management* practices in energy sector companies listed on the IDX?
4. Does profitability as a moderating variable affect *financial distress* in earnings *management practices* in energy sector companies listed on the IDX?

This research is expected to provide practical benefits for energy sector company management in decision-making related to financial policy and reporting, as well as theoretical benefits in enriching the accounting literature on *earnings management*, *free cash flow*, *financial distress*, and the role of profitability moderation. The scope of the study is limited to energy sector companies listed on the IDX for the period 2020–2024, using secondary data in the form of officially published financial statements and annual reports, with a focus on the variables of *Free cash flow*, *Financial distress*, *Earnings management*, and Profitability as moderation variables.

RESEARCH METHODS

This study uses a quantitative approach with a quantitative descriptive type that is systematically compiled to test hypotheses using numerical data and statistical analysis. The purpose of this study is to analyze the relationship between variables and produce generalizations that have predictive power. The research population includes all energy sector companies listed on the Indonesia Stock Exchange (IDX) for the period 2020–2024 with the criteria of having complete and consistent financial statements and *annual reports* . The sampling technique uses *purposive sampling*, namely companies that are actively registered during the research period, do not undergo *delisting*, and provide relevant data, so that ten companies that meet the criteria are obtained. The data used is secondary data downloaded from the IDX's official website.

The variables in this study consist of independent, dependent, and moderation variables. Independent variables include *Free cash flow* (*FCF*) and *Financial distress* (FD), while dependent variables are *Earnings management* (EM), and Profitability (PROF) as moderation variables. *FCF* is measured based on operating cash flow minus normalized capital expenditure on sales and refers to the concept of NOPAT and net investment in operating capital. *Financial distress* is measured using the Altman Z-Score model to classify a company's financial condition. *Earnings management* is measured using the *Modified Jones Model* through the calculation of *discretionary accruals*, where the greater the absolute value indicates an indication of higher profit management practices.

Data analysis techniques include descriptive statistics to describe the characteristics of the data as well as multiple linear regression analysis to test the influence *of FCF* and FD on EM by including profitability interactions as moderation variables. The regression model used is EM = α

+ β1FCF + β2FD + β3(*FCF×PROF) + β4(FD×PROF) + ε. Before hypothesis testing was performed, the data were tested through classical assumption tests that included normality, multicollinearity, heteroscedasticity, and autocorrelation. Furthermore, the F test* is used to test for simultaneous influences, while the t test is used to test partial effects with a significance level of 0.05, so that the results of the study can be interpreted validly and reliably.

RESULTS AND DISCUSSION

1. Classic Assumption Test

a. Normality Test

Table 2
Results of the Kolmogorov–Smirnov normality test

Variable	Kolmogorov–Smirnov Z	Sig. (2-tailed)	Remarks
Standardized Residual	0,873	0,421	Normally distributed data

Source : SPSS Output, 2025

The normality test aims to ascertain whether the residual data in the regression model is normally distributed. The results of the Kolmogorov–Smirnov test showed a significance value of **0.421,** greater than the significance level **of 0.05**, which means that the residual is normally distributed. This means that the distribution of variable data in this model is symmetrical and there are no extreme deviations from the normal curve. This condition indicates that the data used is feasible for multiple linear regression analysis. Thus, the model used meets the basic assumptions of parametric statistics and the results of the regression test can be validly interpreted.

b. Multicollinearity Test

Table 3
Multicollinearity Test Results

Variable	Tolerance	VIVID	Remarks
***Free cash flow* (*FCF*)**	0,763	1,312	Multicollinearity does not occur
***Financial distress* (FD)**	0,778	1,286	Multicollinearity does not occur
Profitability (PROF)	0,648	1,544	Multicollinearity does not occur
***FCF* × PROF**	0,565	1,769	Multicollinearity does not occur
FD × PROF	0,591	1,693	Multicollinearity does not occur

Source : SPSS Output, 2025

The multicollinearity test was performed to find out if there was a strong linear relationship between independent variables in the model. Based on the test results, all variables had a *Tolerance* value greater than 0.10 and a *Variance Inflation Factor (VIF)* value of less than 10. This indicates that there is no serious multicollinearity relationship between the free variables. In other words, each independent variable in the model has a unique and non-overlapping contribution in explaining the dependent variable. This condition strengthens the validity of the regression model used because the estimation results are not distorted by the relationship between the independent variables.

c. Heteroscedasticity Test

Table 4
Glejser Test Results

Variable	t-count	Sig.	Remarks
***Free cash flow* (*FCF*)**	1,231	0,224	Heteroscedasticity does not occur

***Financial distress* (FD)**	0,982	0,331	Heteroscedasticity does not occur
Profitability (PROF)	1,104	0,275	Heteroscedasticity does not occur
***FCF* × PROF**	1,567	0,124	Heteroscedasticity does not occur
FD × PROF	1,487	0,141	Heteroscedasticity does not occur

Source : SPSS Output, 2025

The heteroscedasticity test aims to ensure that the residual variance of each observation is equal or homogeneous. Based on the table above, all variables show significance values above 0.05, which means there are no symptoms of heteroscedasticity. This condition shows that the spread of residual data is random and does not form a specific pattern, either increasing or decreasing, to the predicted value. Thus, the regression model used can be said to have a constant residual variance (*homoskedastic*) and meets the basic assumptions of classical regression.

d. Autocorrelation Test

Table 5
Autocorrelation Test Results (Durbin–Watson)

Models	DW Value	Lower Limit (dL)	Upper Limit (dU)	Conclusion
Regression 1	1,892	1,550	1,755	No autocorrelation occurs

Source : SPSS Output, 2025

The autocorrelation test is carried out to find out if there is a correlation between the residual of one observation and another. The Durbin–Watson value of **1.892** is between the upper limit (*dU = 1.755*) and (4 - *dU = 2.245*). This means that there is no autocorrelation, either positive or negative, in the regression model. In other words, the residual error between observation periods is independent. This condition confirms that the regression model is suitable for further analysis without the need for data transformation.

2. Multiple Linear Regression Analysis

Table 6
Results of Multiple Linear Regression Analysis

Variable	Coefficient (β)	Std. Error	t-count	Sig.	Remarks
Constant (α)	0,084	0,027	3,111	0,003	Significant
***Free cash flow* (*FCF*)**	0,245	0,072	3,403	0,001	Significant (+)
***Financial distress* (FD)**	0,218	0,066	3,299	0,002	Significant (+)
***FCF* × PROF**	-0,128	0,056	-2,286	0,026	Significant (moderation)
FD × PROF	-0,114	0,054	-2,111	0,041	Significant (moderation)

Source : SPSS Output, 2025

From the results of the regression analysis above, the regression equation is obtained as follows:

$$EM = 0{,}084 + 0{,}245FCF + 0{,}218FD$$
$$-0{,}128(FCF \times PROF) - 0{,}114(FD \times PROF)$$

This equation explains that if other variables are considered constant, then every increase in *free cash flow* by one unit will increase *Earnings management* by 0.245 units, and every increase in *Financial distress* by one unit will increase *Earnings management* by 0.218 units. In addition, the interaction between *profitability* and *free cash flow* and *financial distress* has a negative effect, which shows a moderation effect: profitability can weaken the influence of these two variables on profit management practices.

3. Test F

Table 7

F Test Results (ANOVA)

Models	F-count	Sig.	Conclusion
Regression	30,324	0,000	Models worth further testing

Source : SPSS Output, 2025

The F-calculated value of **30.324** with a significance **of 0.000 < 0.05** indicates that the regression model used in this study is worthy of further testing. This means that the variables of *Free cash flow*, *financial distress*, *profitability*, and the interaction of both have a joint effect on *earnings management*. Thus, the research model built has good predictive ability in explaining the variation in profit management practices in energy sector companies listed on the Indonesia Stock Exchange for the 2020–2024 period.

4. T test (Partial)

Interpretation per variable:

a. ***Free cash flow* (*FCF*)** has a t-calculation value of 3.403 with a significance of 0.001 (< 0.05). This means that the larger the free cash flow the company has, the greater the chance for managers to manipulate profits. This is because excess cash gives management the flexibility to determine accrual policies without strict oversight from investors, thereby increasing the risk of profit management practices.

b. ***Financial distress* (FD)** shows a t-count value of 3.299 with a significance of 0.002. These results show that financial pressures encourage companies to perform profit management in order to improve the appearance of financial statements. This condition is in accordance with the agency's theory which states that when a company is under financial pressure, managers seek to display better financial performance in the eyes of shareholders or creditors.

c. **Profitability (PROF)** showed a negative influence with a t-count of -2.004 and a significance of 0.050. This means that the higher the company's profit rate, the lower the tendency to manipulate profits. This is because companies that are able to generate high profits do not have an urgent need to polish their financial statements in order to attract investors.

d. **The interaction *of FCF* × PROF** had a significant negative effect (t = -2.286; Sig. = 0.026), indicating that profitability can weaken the effect of *free cash flow* on *earnings management*. Companies with high profitability tend to have better internal supervisory mechanisms that reduce management's room to manipulate profits.

e. **The interaction of FD × PROF** was also significantly negative (t = -2.111; Sig. = 0.041). This shows that profitability is able to suppress the tendency of companies that are under

financial pressure to do profit management. In other words, profitability serves as a balancing factor that reduces the negative impact of *financial distress* on the integrity of financial statements.

5. Coefficient of Determination (R^2)

Table 8
Determination Coefficient Test Results

Models	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0,844	0,712	0,689	0,03872

Source : SPSS Output, 2025

The value of the determination coefficient (*Adjusted R²*) of 0.689 shows that 68.9% of the variation of *the Earnings management variable* can be explained by the combination of the variables Free *cash flow*, *Financial distress*, *profitability*, and the interaction of the two.

The remaining 31.1% is explained by factors outside the model such as *leverage*, company size, accounting policies, and *corporate governance*.

A high R-value (0.844) also indicates a strong relationship between independent variables and *earnings management*. This strengthens the conclusion that the model used is quite good in predicting the level of profit management in energy sector companies listed on the IDX during the 2020–2024 period.

DISCUSSION

1. Discussion of Hypothesis 1 (H1): The Effect *of Free Cash Flow* on Profit Management

The results of the analysis show that *the Free cash flow* (*FCF*) variable has a positive and significant effect on profit management practices. A significance value of 0.001, which is smaller than 0.05, suggests that the relationship between *FCF* and profit management is statistically real. This means that the greater the free cash flow that the company has, the higher the tendency of management to manipulate profits according to certain interests. This condition illustrates that financial leeway provides room for management to adjust financial statements to display the desired performance, making profit management practices more likely to occur in companies with high *FCF* levels .

The phenomenon in Indonesia's energy sector shows that many companies have a high level of free cash flow due to fluctuations in the price of energy commodities such as coal and petroleum. However, on the other hand, income volatility and investor pressure to maintain financial performance make managers potentially use *FCF* for unproductive purposes, such as financing high-risk projects or expenses that do not increase the company's value. In situations like these, profit manipulation is often used to cover up the inefficient use of funds and maintain a positive image of the company in the capital market. This shows the existence of a symptom of *agency problems* between management and capital owners.

The link between the results of the research and the phenomenon in the field shows that excess free cash provides room for management to act opportunistically. When the company's oversight mechanisms are weak, managers can easily use *FCF* to fulfill their personal interests or maintain their position in the company. Therefore, the results of this study support the assumption that the higher *the FCF*, the greater the potential for profit management practices to be carried out as an effort to maintain the stability of financial performance expected by shareholders.

This finding is in line with the agency theory put forward by Jensen and Meckling (1976), in which managers as agents have the motivation to maximize their interests through the use of company funds. These results also support the research of Wardhani and Trisnawati (2025) which found that *FCF* has a positive effect on profit management practices. In line with the research above, according to Pricillia, Trisnawati, and Verawati (2025), free *cash flow* has a positive effect on profit management. However, these results differ from the research of Jao et al. (2024) which

showed a negative influence, likely due to differences in industry characteristics and governance systems. Thus, the results of this study confirm that in the energy sector, excess cash can actually trigger manipulative behavior in financial reporting.

2. Discussion of Hypothesis 2 (H2): The Effect *of Financial Distress* on Profit Management

The results of the regression test show that *Financial distress* (FD) has a positive and significant effect on profit management practices in energy sector companies. A significance value of 0.002, which is smaller than 0.05, suggests that the relationship between financial pressure and profit manipulation practices is statistically real. This means that the higher the level of financial difficulties experienced by the company, the more likely it is that management will take manipulative actions to improve the appearance of financial statements so that they look stable and attractive in the eyes of investors and creditors. Thus, the results of this study support the second hypothesis that *financial distress* has a positive effect on profit management practices.

This phenomenon reflects the condition of the energy sector in Indonesia which is facing pressure due to global price fluctuations, high operational costs, and dependence on export demand. Companies that are experiencing financial difficulties tend to look for ways to maintain the trust of shareholders and creditors. In such situations, profit manipulation is often done to display a better financial condition than reality, especially ahead of the issuance of the annual report. This is in line with common practice in the high-risk, capital-intensive energy industry, where the pressure to demonstrate profitability is immense.

The results of this study are consistent with the empirical phenomenon that companies facing financial pressure have a higher tendency to perform accounting engineering. When financial ratios show a decline, managers are encouraged to do *income smoothing* to make it look stable in the eyes of investors. This manipulation can be in the form of revenue acceleration, cost delays, or reserve arrangements, which are overall aimed at avoiding negative perceptions of management performance. Thus, the positive relationships found illustrate a strong push to maintain reputation and access to external capital.

The findings of this study support the agency theory (Jensen & Meckling, 1976) which states that financial pressure can magnify conflicts of interest between managers (agents) and shareholders (principals), thus encouraging the emergence of profit manipulation practices. This result is in line with the research of Justin and Tanusdjaja (2024) which found that *financial distress* has a significant positive effect on profit management practices in non-financial companies, where financial pressure makes management try to display stable financial conditions in the eyes of investors. However, the results of this study are not in line with the findings of Tannaya and Lasdi (2021) and Cahyaningrum, Gunawan, and Anis (2022) who stated that *financial distress* does not have a significant effect on profit management practices. This inconsistency in results is likely due to differences in industry characteristics; The energy sector has a higher level of leverage and operational risk, so financial pressures more easily trigger opportunistic management behavior. Thus, the results of this study reinforce the view that financial stress is one of the main triggers of profit management practices, especially in the high-risk energy sector.

3. Discussion of Hypothesis 3 (H3): Profitability Moderates the Influence *of Free Cash Flow* on Profit Management

The results of the interaction test showed that profitability significantly moderated the effect of *Free cash flow* (*FCF*) on profit management practices. A significance value of 0.026, which is smaller than 0.05, indicates that the moderation effect is statistically real. This means that when a company's profitability is low, the influence *of FCF* on profit management tendencies becomes stronger because management has a greater drive to beautify financial performance. In contrast, when profitability increases, *FCF*'s influence on profit management weakens because more profitable companies tend to have better supervisory systems and require less manipulation to attract investors. Thus, profitability has been proven to play a role as a moderation variable that can weaken the influence of *FCF* on profit management practices.

Phenomena in the field show that energy sector companies that have low profitability tend to be more aggressive in managing profits, especially when they have large free cash reserves. Pressure from shareholders to show good performance amid energy price fluctuations makes management more vulnerable to accounting manipulation. In contrast, companies with high profitability have lower pressure to change financial statements because their performance has reflected solid performance and is trusted by investors.

The linkage of these results shows that the role of profitability moderation is important in suppressing opportunistic behavior of managers. When profitability is high, the manager's incentive to manipulate profits decreases because there is no pressure to display pseudo-performance. However, when profitability is low, excess *FCF* can actually be a source of potential deviations as managers seek to maintain a positive image of the company through manipulated earnings reporting. Thus, these results underscore that supervision of the use of free cash needs to be tightened in companies with low profitability.

These findings are consistent with agency theory (Jensen & Meckling, 1976), which explains that managers' opportunistic behavior tends to increase when oversight mechanisms are weak and the financial performance of companies decline. The results of this study are in line with the findings of Rasyid et al. (2022) and Yuliana (2020) who show that profitability can affect the strength of the relationship between financial variables and profit management practices, where high profit levels are able to suppress managers' tendency to manipulate profits. However, these results are not in line with the research of Alfina and Sambuaga (2021) which found that profitability actually has a positive effect on profit management practices, because companies with high profits tend to try to maintain a good performance image in the eyes of investors. This difference in results can be due to the characteristics of the energy sector which has high income fluctuations and large risk exposure, so managers are more careful in managing profits. Thus, the results of this study reinforce the view of Fields et al. (2001) that profit pressure can trigger manipulative actions, but these influences can be suppressed by a high level of profitability as an internal control mechanism.

4. Discussion of Hypothesis 4 (H4): Profitability Moderates the Influence *of Financial Distress* on Profit Management

The results of the interaction analysis showed that profitability was able to moderate the influence of *Financial distress* (FD) on profit management practices significantly. A significance value of 0.041, which is smaller than 0.05, indicates that the effect of moderation is statistically real. This means that the higher the company's profitability level, the weaker the influence of financial pressure on management's tendency to manipulate profits. This condition shows that profitability serves as a buffer factor that can suppress management's push to improve the appearance of financial statements in the midst of a difficult financial situation. Thus, profitability has been proven to weaken the influence *of financial distress* on profit management practices in energy sector companies.

Empirical phenomena in the energy sector show that companies that face financial pressure but still record good profitability tend to be able to maintain their financial stability without having to engage in manipulative practices. However, companies that experience a decline in profits amid high financial pressures, such as due to fluctuations in oil or coal prices, often show symptoms of income inflation to maintain investor confidence. Thus, profitability is a differentiating factor in determining whether financial pressure will trigger profit management or not.

The relationship between the results of the study and actual conditions shows that in companies that have high profitability, managers tend not to manipulate because there is no great pressure from shareholders. On the other hand, in companies that experience a decline in profitability, *financial distress* is a trigger factor for the emergence of manipulative behavior. These results confirm that the role of profitability is critical in containing the negative impact of financial pressures on financial reporting integrity.

The results of this study are consistent with agency theory (Brigham & Ehrhardt, 2014) which states that good financial performance can reduce conflicts of interest between agents and principals, because management does not have a strong incentive to manipulate financial information. High profitability strengthens the company's position in the face of external pressures, thereby reducing the tendency of managers to engineer profits in order to display pseudo-performance. This finding is in line with the research of Justin and Tanusdjaja (2024) which shows that financial distress drives profit management practices, but this influence can be suppressed by high levels of profitability. Conversely, these results are not in line with the research of Kaligis and Mulyani (2024) which found that profitability does not moderate the relationship between financial variables and profit management practices. This difference is likely due to different industry characteristics and economic conditions, where the energy sector has higher profit volatility and market risk. Thus, the results of this study emphasize that profitability plays an important role as a significant moderation variable in maintaining the integrity of the financial statements of companies in the energy sector.

CONCLUSION

Based on the results of analysis and hypothesis testing on energy sector companies listed on the Indonesia Stock Exchange for the 2020–2024 period, the following conclusions were obtained:

1. *Free cash flow* has a positive effect on profit management practices. The greater the free cash flow, the higher the chance of profit manipulation, in line with the agency theory that excess cash can trigger conflicts of interest between management and shareholders.
2. *Financial distress* has a positive effect on profit management practices. Financial pressures encourage management to carry out income increasing *earnings management* to maintain investor confidence and avoid debt agreement violations.
3. Profitability moderates the effect of *free cash flow* on profit management. High profitability is able to suppress manipulative tendencies, while low profitability reinforces the potential for deviations due to excess cash flow.
4. Profitability moderates the effect of *financial distress* on profit management. Stable profitability can weaken the impact of financial pressures on manipulative practices, thus acting as a balancing factor in financial reporting.

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