

The Influence of Good Corporate Governance Mechanisms and Free Cash Flow on Earnings Management in the Infrastructure Sector Listed on the Indonesia Stock Exchange (IDX) for the Period 2018-2022

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DOI: <https://doi.org/10.56293/IJMSSSR.2025.5412>

IJMSSSR 2025

VOLUME 7

ISSUE 1 JANUARY – FEBRUARY

ISSN: 2582 - 0265

Abstract: This research explores the influence of corporate governance mechanisms and free cash flow on earnings management within infrastructure companies listed on the IDX from 2018 to 2022. The committee overseeing audits, independent commissioners, and board of directors are the proxies that are used to assess excellent corporate governance. This study makes use of a quantitative approach to descriptive research. This information is derived from secondary sources, including the firms' annual reports and financial statements, with the sample selection utilizing purposive sampling based on specific criteria. Before excluding outlier data, the sample consisted of 40 companies over a 5-year observation period, resulting in 200 sample data points. After excluding outlier data, the number of qualified samples is 150 data points from 30 companies. Descriptive statistics, hypothesis testing, model feasibility, and classical assumption testing are some of the analytical methodologies used. This study's findings show that independent commissioners and audit committees do not significantly impact earnings management, although free cash flow and the board of directors do positively.

Keywords: good corporate governance mechanisms, free cash flow, earnings management, board of directors, independent commissioners, audit committee

1. Introduction

1.1 Background

One of the best ways to gauge a business's health and success is to look at its financial statements. However, this opens up opportunities for managers to manipulate the reports to appear favorable and meet investors' expectations. Profit information is often the only thing that users of financial statements think about, ignoring the procedures and techniques employed to get it. This condition encourages management to engage in earnings management by manipulating financial statements to present a better performance impression (Adetea, 2020). As stated by Jensen & Meckling (1976), agency conflicts arise when the interests of the owners and the management are at odds with one another, leading to earnings management. This conflict can trigger investors' distrust in the company, as investors expect transparent and unmanipulated financial statements, with profit increases that appear reasonable across all aspects of the reports.

In recent years, several large companies have been embroiled in earnings management cases, which involve manipulating financial statements to improve company performance. For example, Garuda Indonesia in its 2018 financial report recognized revenue prematurely from a 15-year contract, violating PSAK No. 23 as no economic benefits had yet materialized. The Financial Services Authority (OJK) subsequently ordered a revision of the report and imposed a fine (Junestine & Christian, 2021). Also in 2017, PT Tiga Pilar Sejahtera Food was found to have recognized fraudulent revenues as business revenue (Wulandari, 2022). As an added bonus, two state-owned companies, PT Waskita Karya and PT Wijaya Karya, have recently been accused of financial statement manipulation, due to their financial reports not reflecting actual conditions, as both issuers were experiencing cash flow difficulties, thin profits, and loss-making projects. However, the financial statements suggested that the companies were continuously generating profits (Ramadhani, 2023).

In light of these phenomena of earnings management, Good Corporate Governance (GCG) procedures are required to guarantee that investors' invested money are being utilized responsibly. Many parties stand to gain from the implementation of robust GCG processes, which should promote economic development by making corporate management more open and honest. Good GCG processes are important, but Free Cash Flow (FCF) is another component that could affect profits management strategies. High availability of FCF can prompt managers to utilize the company's available cash.

Various studies have shown mixed results regarding the relationship between GCG mechanisms and earnings management. Putri (2020) found that audit committees and independent commissioners exert a negative effect on earnings management. Sari & Hasnawati (2020), suggests that the presence of audit committees and independent commissioners negatively impacts earnings management. Attia et al. (2022) showed that board size is significantly negatively correlated with earnings management. For the FCF variable, Aburishah et al. (2022) concluded that FCF affects earnings management, while Nasuki (2023), found a statistically significant positive relationship of FCF on earnings management action.

This study is unique in its focus on the infrastructure sector, which involves significant investments and long-term projects with a substantial impact on the economy. The research covers the period 2018-2022 to capture changes in economic and regulatory dynamics. Additionally, this study combines the Good Corporate Governance (GCG) mechanism variables, to examine their impact on profits management using the Free Cash Flow (FCF) variable, as proxied by the board of directors, independent commissioners, and audit committees. The integration of these four variables within the infrastructure sector distinguishes this study from previous research, which generally discusses these variables separately.

1.2 Literature Review

Agency Theory

In a principal-agent relationship, one or more parties (principals) choose another party (agent) to carry out the principal's instructions and make decisions on the principal's behalf. This connection is described by Jensen & Meckling (1976). This idea sheds light on the potential for management and shareholder conflicts of interest, known as agency conflicts. These conflicts can lead to earnings management practices, and the implementation of GCG mechanisms is expected to mitigate such issues.

Signaling Theory

According to signaling theory, which is based on Ross (1997) thesis, managers of companies try to boost stock prices by telling prospective investors how the firm is doing. This theory can also explain why company managers engage in earnings management practices, where they attempt to present financial statements as a medium of communication that reflects a healthier company condition than reality.

Earnings Management

According to (Sulistyanto, 2018, p. 6), states that earnings management occurs when a firm's management tries to manipulate financial statement information in order to deceive stakeholders who are trying to figure out how well the company is doing. Company management can engage in three patterns of earnings management. First, earnings increase, where the company manipulates current period profits to exceed actual profits by increasing revenue or decreasing costs. Second, earnings decrease, where current period profits are lowered to be below actual profits by reducing revenue or increasing costs. Third, earnings smoothing, which aims to maintain profits at a relatively constant level without significant fluctuations by adjusting revenues and costs.

Good Corporate Governance Mechanisms

GCG mechanisms are a set of rules that assist companies in enforcing laws and regulations and clarifying the relationships among the parties involved in the company (Suroso, 2022, p. 2). It can be said that GCG mechanisms are the implementation of existing GCG principles. GCG mechanisms are designed to address issues

arising from agency relationships, thereby enhancing the efficiency of company management and building trust among stakeholders.

The theoretical foundations of the GCG mechanism proxies used in this research are as follows:

- a. The board of directors is defined as individuals who are legally responsible for controlling employees and the activities of the company (Syofyan, 2021, p. 53).
- b. Independent commissioners are defined as individuals who are not personally tied to other companies or engaged in management roles other than their position as commissioners (Syofyan, 2021, p. 111).
- c. The audit committee was formed by the board of commissioners to aid in fulfilling their duties and obligations. (Syofyan, 2021, p. 24).

Free Cash Flow

How much money a company has on hand that isn't going toward paying bills or investing is called its "free cash flow" (FCF). With more capital available for investment, a high free cash flow (FCF) indicates that a firm is doing well financially, pay down debt, and distribute to shareholders (Puspitasari et al., 2019). Companies with significant FCF have stronger financial flexibility, allowing them to invest and seize new opportunities, even in challenging economic conditions.

1.3 Hypothesis Development

Board of Directors and Earnings Management

The number of directors in a company can control managerial actions that do not align with the company's goals, as a larger board of directors has more independent professional parties experienced in managing companies (Saona et al., 2020). Attia et al. (2022) found a substantial negative association between earnings management and the size of the board of directors. This detrimental effect is predicated on the idea that closer inspection of financial statements by a larger board will reduce the likelihood of earnings management.

H₁: *The Board of Directors has a Negative Effect on Earnings Management.*

Independent Commissioners and Earnings Management

The 2006 General Guidelines for GCG in Indonesia state that the board of commissioners' supervisory function should better safeguard minority shareholders' interests. This is mainly achieved through rules governing the board's composition that require independent members. Results from studies conducted by independent commissioners have been shown to have a detrimental impact on earnings management Wahyuwidi & Lusmeida (2020) and Putri (2020). The idea that having more independent commissioners would have a detrimental impact is, the less likely earnings management will occur due to more effective oversight.

H₂: *Independent Commissioners have a Negative Effect on Earnings Management.*

Audit Committee and Earnings Management

According to Kep. 29/PM/2004, as cited in Bhayangkari et al. (2019), In order to oversee the company's management, the board of commissioners formed the audit committee. There should be less profits management thanks to the audit committee's scrutiny. According to studies conducted by NGO & LE (2021), increasing the size of the audit committee has a significant negative impact on earnings management. More people on the audit committee, the theory goes, the greater this detrimental effect, the less likely earnings management will occur due to increased effectiveness in supervision.

H₃: *The Audit Committee has a Negative Effect on Earnings Management.*

Free Cash Flow and Earnings Management

For evaluating a company's financial performance and future potential, investors must have insight into its FCF.

But in reality, FCF is often used by businesses as part of earnings management strategies to boost the worth of the organization. Results from the study by Irawan & Apriwenni (2021), earnings management is significantly and positively influenced by FCF. The rationale for this beneficial effect is that management has more leeway to make changes to financial reporting when there is more cash on hand, which in turn increases the chance of earnings management activities.

H4: *Free Cash Flow has a Positive Effect on Earnings Management.*

2. Method

2.1 Type, Data, and Sample of Research

A quantitative approach to descriptive research is used. In order to learn about and find the links between the dependent and independent variables, this study uses a causal research strategy. The audit committee, independent commissioners, and board of directors serve as independent variables in this study, while earnings management is used as the dependent variable. Participants in the study include infrastructure companies that were listed on the IDX in Indonesia between 2018 and 2022. The firms' financial statements and annual reports, which could be found on their separate websites as well as the IDX website, were used to compile the data. We utilize a technique called purposive sampling, which is based on certain criteria. Data analysis was performed using multiple linear regression.

Table 1. "Selection Criteria and Sample Size for the Research

No	Criteria	Population
1	Infrastructure sector firms traded on the IDX	69
2	Companies in the infrastructure sector that were recently listed on the IDX after 2018	(21)
3	Companies in the infrastructure sector that failed to publish their financial statements and annual reports in their entirety from 2018 to 2022	(5)
4	Companies in the infrastructure sector that lack comprehensive data for all four variables for a minimum of one year during the 2018-2022 period	(3)
Total companies used as research samples		40
Total companies with outlier data		(10)
Total companies after removing outlier data		30
Research period (years)		5
Total research data		150

Source: Author Processed Results (2024)

2.2 Operationalization of Variables

Earnings Management (Y)

According to Scott (2015), as cited in Wahyuwidi & Lusmeida (2020), earnings management is the act of smoothing, reducing, and inflating earnings by management for personal or corporate interests. A modified version of the Jones model (1991) created by Dechow et al. (1995). The following are the steps involved:

a. Calculate Total Accruals (TA) using the following formula:

$$TA_t = (\Delta CA_t - \Delta CL_t - \Delta Cash_t + \Delta STD_t - Dep_t) / (A_{t-1})$$

- b. Perform linear regression to obtain the coefficients (α) needed to calculate the Non-Discretionary Accruals (NDA). The dependent variable (Y) is computed using the following formula:

$$Y = TA / A_{t-1}$$

While the formulas for calculating the independent variables (X) are as follows:

$$X1 = 1 / A_{t-1}$$

$$X2 = (\Delta REV_t - \Delta REC_t) / A_{t-1}$$

$$X3 = PPE_t / A_{t-1}$$

- c. Calculate Non-Discretionary Accruals (NDA) using the formula:

$$NDA_t = \alpha_1 (1 / A_{t-1}) + \alpha_2 ((\Delta REV_t - \Delta REC_t) / A_{t-1}) + \alpha_3 (PPE_t / A_{t-1})$$

- d. Calculate Discretionary Accruals (DA) using the formula:

$$DA = TA - NDA$$

Notes:

TA = Total Accrual

ΔCA = Change in Current Assets

ΔCL = Change in Current Liabilities

$\Delta Cash$ = Change in Cash and Cash Equivalents

ΔSTD = Change in Debt Included in Current Liabilities

Dep = Depreciation and Amortization Expense

A = Total Assets

t = Years in The Estimation Period

t₋₁ = Previous Year in The Estimation Period

ΔREV = Change in Revenues

ΔREC = Change in Receivables

PPE = Property, Plant, and Equipment

α = Coefficients

NDA = Non-Discretionary Accrual

DA = Discretionary Accrual

Board of Directors (X₁)

According to (Wahyuwidi & Lusmeida, 2020), The total number of board members is proportional to the size of the company's board of directors. The following formula is used by the board of directors:

$$\text{Board of Directors} = \sum \text{Members of the Board of Directors}$$

Independent Commissioners (X₂)

The following formula (Pramithasari & Yasa, 2017) is used to calculate the proportion of independent commissioners is independent commissioners as a percentage of the total number of commissioners in the firm:

$$IC = \frac{\text{Number of Independent Commissioners}}{\text{Total Number of Commissioners}} \times 100\%$$

Audit Committee (X₃)

With the following formula, the number of members in the company's audit committee may be measured (Putri, 2020):

$$\text{Audit Committee} = \sum \text{Members of the Audit Committee}$$

Free Cash FLOW (X₄)

According to (Yogi & Damayanthi, 2016), a company's free cash flow is the amount of money that remains after paying for all investments and operating expenses related to business growth. Here, we use a ratio scale to calculate free cash flow, and the calculation is as follows:

$$FCF = \frac{\text{Operating Cash Flow} - \text{Investment Cash Flow}}{\text{Total Assets}} \times 100\%$$

3. Results

3.1 Descriptive Statistics Analysis

Table 2. Descriptive Statistics Analysis Results

	N	Minimum	Maximum	Mean	Std. Deviation
Board of Directors	150	2.00	8.00	4.8867	1.37834
Independent Commissioners	150	0.17	0.75	0.4099	0.10296
Audit Committee	150	3.00	6.00	3.2133	0.52567
Free Cash Flow	150	-11373.61	0.53	-77.4825	928.77142
Earnings Management	150	-2.21	0.48	-0.0289	0.22851
Valid N (listwise)	150				

Source: Data Processed SPSS 29 (2024)

Based on the table above, it can be explained that the board of directors has a minimum value of 2, found at PT Jasa Armada Indonesia Tbk, and a maximum value of 8 at PT Nusantara Infrastructure Tbk. On average, infrastructure sector companies have a board of directors with five members, indicating compliance with the minimum requirement of two members set by OJK Regulation Number 33/POJK.04/2014. The standard deviation of 1.37834 shows relatively small variation in the number of board members across companies.

The independent commissioners have a minimum value of 17%, seen in PT Adhi Karya and PT Cardig Aero Services, and a maximum value of 75% at PT Smartfren Telecom Tbk and PT PP (Persero) Tbk. On average, infrastructure sector companies have an independent commissioner proportion of 40.99%, meaning they comply with the minimum 30% requirement set by OJK Regulation Number 57/POJK.04/2017. The standard deviation of 0.10296 indicates relatively small variation in the proportion of independent commissioners among companies.

The audit committee has a minimum value of 3 members, seen in several companies in this study, and a maximum value of 6 members at PT Wijaya Karya (Persero) Tbk. The average number of audit committee members in infrastructure sector companies is 3, complying with the minimum requirement of 3 members as stipulated in OJK Regulation Number 55/POJK.04/2015. The standard deviation of 0.52567 shows a relatively even data distribution, with limited variation in the number of audit committee members across companies.

Free cash flow (FCF) has a minimum value of -11,373.61 at PT Leyand International and a maximum value of 0.53 at PT Link Net. The average FCF value among infrastructure sector companies is -77.4825, indicating that companies allocate more funds for investment than they generate from operations. The standard deviation of 928.77142 reveals significant variation in FCF data.

Earnings management has a minimum value of -2.21 at PT Leyand International Tbk and a maximum value of 0.48 at PT Nusantara Infrastructure Tbk. The average earnings management value for infrastructure sector companies is -0.0289, suggesting a tendency toward income decreasing due to the negative value, though relatively minor as it is close to zero. The high standard deviation of 0.22851 indicates considerable variation in earnings management data.

3.2 Classical Assumption Test

Normality Test

Table 3. Normality Test Results

One-Sample Kolmogorov-Smirnov Test	
	Unstandardized Residual
N	150
Asymp. Sig. (2-tailed) ^c	0.200 ^d

Source: Data Processed SPSS 29 (2024)

A significance level of 0.200, which is higher than 0.05 or 5%, indicates that the One Sample Kolmogorov-Smirnov test was successful in testing for normalcy. The data appears to follow a normal distribution, thereby satisfying the assumption of normality.

Multicollinearity Test

Table 4. Multicollinearity Test Results

Model	Coefficients ^a	
	Tolerance	VIF
1 (Constant)		
Board of Directors	0.881	1.136
Independent Commissioners	0.987	1.013
Audit Committee	0.897	1.115
Free Cash Flow	0.983	1.018

a. Dependent Variable: Earnings Management

Source: Data Processed SPSS 29 (2024)

There is no variable in the regression model with a VIF value higher than 10, and all four of them have tolerance values higher than 0.10. Thus, there is no issue of multicollinearity in the regression model.

Heteroskedasticity Test

Table 5. Heteroskedasticity Test Results

		Coefficients ^a	Sig.
Model			
1	(Constant)		0.602
	Board of Directors		0.564
	Independent Commissioners		0.873
	Audit Committee		0.145
	Free Cash Flow		0.307

a. Dependent Variable: Absolute

Source: Data Processed SPSS 29 (2024)

In the regression model, each variable has a significance level exceeding 0.05. The absence of heteroskedasticity in the regression model confirms its validity and suitability for the investigation.

Autocorrelation Test

Table 6. Autocorrelation Test Results

		Model Summary ^b	Durbin-Watson
Model			
1			1.939

a. Predictors: (Constant), Free Cash Flow, Audit Committee, Independent Commissioners, Board of Directors

b. Dependent Variable: Earnings Management

Source: Data Processed SPSS 29 (2024)

The value of Durbin-Watson is 1.939. The upper limit (du) is 1.7881 and the value of 4 - du is 2.2119 when a 150-person sample (N) and four independent variables (K=4) are used with a 0.05 significance level. It may be inferred that the regression model does not exhibit positive or negative autocorrelation since the Durbin-Watson value (1.939) is between the range of 1.7881 and 2.2119 (1.7881 < 1.939 < 2.2119).

3.3 Model Feasibility Test

Coefficient of Determination (R²) Test

Table 7. Coefficient of Determination (R²) Test Results

		Model Summary ^b	Adjusted R Square
Model			
1			0.640

a. Predictors: (Constant), Free Cash Flow, Audit Committee, Independent Commissioners, Board of Directors

b. Dependent Variable: Earnings Management

Source: Data Processed SPSS 29 (2024)

Based on the Adjusted R Square (R²) value of 0.640, which is 64%, the variables that might explain the profits management variable are the board of directors, independent commissioners, audit committee, and free cash flow. Other variables, which were not included in this research, account for the remaining 36%.

Significance Test Anova (F- Statistic Test)

Table 8. Significance Test Anova (F- Statistic Test) Results

		ANOVA ^a	
Model		F	Sig.
1	Regression	67.135	<0.001 ^b
	Residual		
	Total		

a. Dependent Variable: Earnings Management

b. Predictors: (Constant), Free Cash Flow, Audit Committee, Independent Commissioners, Board of Directors

Source: Data Processed SPSS 29 (2024)

The computed F-value of 67.135 is more than 4, and the likelihood is less than <0.001, which is lower than the 0.05 significance level. It follows that the independent commissioners, audit committee, board of directors, and free cash flow variables are significant, and that the study's regression model is applicable.

3.4 Hypothesis Test

Significance of Individual Parameters (t-Test)

Table 9. Significance of Individual Parameters (t-Test) Result

		Coefficients ^a	
Model		t	Sig.
1	(Constant)	-1.938	0.055
	Board of Directors	3.308	0.001
	Independent Commissioners	-0.042	0.966
	Audit Committee	0.226	0.822
	Free Cash Flow	15.437	<0.001

a. Dependent Variable: Earnings Management

Source: Data Processed SPSS 29 (2024)

- After considering the following, it is clear that the dependent variable is influenced by each independent variable:
- A t-value of 3.308 was computed for the Board of Directors (X1), and the significance threshold was 0.001 < 0.05. Thus, it is clear that the board of directors positive significantly influences profits management for the better.
 - The t-statistic computed for Independent Commissioners (X2) is -0.042, with a significance level of 0.966 > 0.05. The evidence is clear: the independent commissioners had little to no impact on earnings management.
 - The t-value obtained for Audit Committee (X3) is 0.226, assuming a significance criterion of 0.822 > 0.05. Because of this, it is clear that earnings management is unaffected by the audit committee.
 - The computed t-value for Free Cash Flow (X4) is 15.437, and the significance level is less than 0.001 (which is less than 0.05). As a result, free cash flow is a powerful and positively significant factor in improving earnings management.

Multiple Linear Regression Analysis

Table 10. Multiple Linear Regression Analysis Results

Model		Coefficients ^a	
		Unstandardized Coefficients	
		B	
1	(Constant)		-0.169
	Board of Directors		0.029
	Independent Commissioners		-0.005
	Audit Committee		0.005
	Free Cash Flow		0.000

a. Dependent Variable: Earnings Management

Source: Data Processed SPSS 29 (2024)

We get the following equation for the regression:

$$EM = -0,169 + 0,029(BOD) - 0,005(IC) + 0,005(AC) + 0,000FCF + e$$

- Assuming that the values of the board of directors, independent commissioners, audit committee, and free cash flow remain unchanged, earnings management will continue at a constant value of -0.169.
- The Board of Directors (X1) positively correlates with the outcome (regression coefficient: 0.029). Therefore, a one-unit increase in the board of directors will lead to a 0.029 rise in earnings management, assuming that the principles maintained by impartial commissioners, the audit committee, and free cash flow stay stable or constant. When the coefficient is positive, it means that the board of directors and earnings management have a positive relationship.
- A regression coefficient of -0.005 is shown for Independent Commissioners (X2). Board of director, audit committee, and company values and free cash flow remain fixed or constant, a one-unit increase in independent commissioners will result in a decrease in earnings management by 0.005. Negative coefficient indicates a negative relationship between independent commissioners and earnings management.
- A positive regression coefficient of 0.005 is shown by the Audit Committee (X3). If the values of the board of directors, independent commissioners, and free cash flow remain constant, the findings demonstrate that an increase of one unit in the audit committee will lead to a rise of 0.005 units in profits management. A positive coefficient indicates a direct association between the audit committee and earnings management.
- The regression coefficient of 0.000 for Free Cash Flow (X4) indicates that, holding all other variables fixed, an increase of one unit in free cash flow would lead to an increase in earnings management. Better profits management is linked to greater levels of free cash flow, according to a small but positive association between the two.

4. Discussion

The findings show that the board of directors have a positive and significant effect on earnings management. Although significant, this direction of influence contradicts the initial hypothesis, leading to the conclusion that H₁ cannot be accepted. This finding indicates that the presence of the board of directors may facilitate earnings management practices, possibly influenced by internal and external factors. Meanwhile, the independent commissioners and audit committee variables do not show any effect on earnings management, resulting in H₂ and H₃ being rejected. This is further evidence that reining in earnings management methods requires more than just adding independent commissioners and audit committee members. However, H₄ is acknowledged since free cash flow significantly and positively affects earnings management. Earnings management becomes more feasible when free cash flow grows because management has more leeway in how they present financial results.

The study's findings will hopefully be used to improve free cash flow management and Good Corporate Governance (GCG) mechanism, which will help stop unethical profits management. These findings also have the potential to help companies enhance transparency and accountability, provide guidance for investors and stakeholders in decision-making, and support auditors in identifying earnings management risks. Furthermore, this

research can serve as a reference for regulators in formulating policies that encourage more transparent and sustainable financial reporting.

This study has a number of limitations, one of which is that it may not be representative of other industries as it just considers infrastructure companies listed on the IDX from 2018 to 2022. Furthermore, the study's estimation of GCG processes relies entirely on the membership count, while the results indicate that this number does not always significantly affect the reduction of Earnings Management practices. Therefore, future researchers are advised to use other indicators, such as meeting attendance rates, frequency, or types of meetings, to obtain a more comprehensive picture.

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