

## The Role of Institutional Ownership and Audit Quality in Moderating the Effect of Free Cash Flow on Earnings Management

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### ABSTRACT

*Purpose: The aim of this research is to examine how audit quality and institutional ownership affect the way free cash flow affects earnings management in Indonesian non-financial firms. Methodology/approach: "In this study, 179 observations are collected using proportionate stratified random sampling, and multiple linear regression analysis and moderated regression analysis (MRA) are used to analyze non-financial companies that were listed on the IDX for at least a year prior to the observation period (2019) and had not been delisted until the end of 2023." Findings: The study's findings suggest that earnings management benefits from free cash flow. It has been demonstrated that audit quality reduces the beneficial impact of free cash flow on earnings management, even though institutional ownership cannot mitigate this effect. Businesses audited by top-notch KAP will restrict opportunistic managers' ability to manipulate earnings. Practical implications: Unless audited by a reputable KAP, investors and prospective investors should exercise caution when funding businesses with significant free cash flow since it may encourage managers to engage in earnings management. If managers are audited by a top-notch KAP, their incentive to engage in earnings management will decline. Originality/value: In order to explain how free cash flow affects earnings management, this study adopts a novel strategy by combining audit quality and institutional ownership characteristics as moderating variables.*

**Keywords:** Free cash flow, institutional ownership, audit quality, earnings management

### INTRODUCTION

Accounting profit is the most important aspect of financial statements. According to Jiang et al. (2023), stock earnings will fall when reported earnings are lower than investors' expectations, and their decline will be slower than when earnings are higher than analysts' analysis. In addition to increasing expectations among investors, accounting profit serves as a performance measure for CEO compensation (Ghazali et al., 2015).

Healy and Wahlen (1998) found that when managers are compensated based on profitability, they may be motivated to maximize the value of their bonuses by controlling accounting policy choices and processes. As a result, managers have a strong incentive to limit profits, a practice known as profit management, to the benefit of the company and the managers themselves (Callao et al.). In order to keep the company's image attractive to stakeholders and shareholders, especially investors, this action is often used to improve the company's performance.

Profit management is not new in companies. One of the most famous scandals that is still remembered by the global community is the accounting fraud case involving the United States energy company, namely Enron. This company was revealed to have committed massive accounting fraud in 2001. The firm, along with accounting firm Arthur Andersen, manipulated financial statements to hide \$30 billion in debt through creative accounting practices and the use of special purpose entities to move financial obligations off the balance sheet. The main goal of this tactic is to cover the huge losses resulting from high-risk energy businesses, giving the illusion of stable financial performance and increasing profits, thereby giving the impression of financial performance that is much better than the actual condition (Sukarya et al., 2024).

In addition to Enron, there have been several other financial scandals that show how manipulation of financial statements can have a major impact on investor confidence and market stability. One fairly well-known case is Xerox, which in the early 2000s was known to have engaged in misleading accounting practices by admitting earnings earlier than it should. This strategy makes the company's financial statements look better and attractive to investors, even though the reported revenue has not been actually realized. Xerox inflated its revenue

by about \$3 billion during the period 1997-2000 to meet market expectations and increase its stock price. As a result, the U.S. Securities and Exchange Commission (SEC) imposed sanctions on Xerox, which eventually had to pay a fine of \$10 million and restate its financial statements (Wiyogo et al., 2021). Cases such as Enron and Xerox show that manipulation of financial statements, whether by concealing debt or inflating revenues, has serious consequences. Lack of transparency and compliance with accounting standards not only harms investors, but can also lead to the collapse of companies and a loss of public trust in financial markets.

One of the techniques that is common in the corporate world, especially in Indonesia, is profit management. Of the 31 countries that often do profit management, Indonesia is ranked 15th (Zulaikha & Fuad, 2022). In Indonesia, PT Garuda Indonesia (Persero) Tbk is a well-known example. Despite a third-quarter loss of \$114.08 million (Rp1.66 trillion), the company was accused of inflating its 2018 net profit to \$809.85 thousand or Rp11.33 billion at an exchange rate of Rp14,000. In violation of the Financial Accounting Standards Statement (PSAK) 23, the company's management acknowledged receivables as income at the General Meeting of Shareholders (GMS) on January 24, 2019, ending the situation. PT Mahata reported sales of US\$239.94 million, including US\$28 million from profit sharing with PT Sriwijaya Air (CNN Indonesia, 2019).

This behavior shows an attempt to manipulate using the phenomenon of window dressing, which is a tactic used to embellish financial data to attract investors. The same thing also happened to PT Tiga Pilar Sejahtera Food Tbk. The 2017 financial statements contained allegations of embezzlement of funds amounting to 4 trillion rupiah. An audit conducted by PT Ernst & Young Indonesia and the company's new management found manipulation of fixed assets, accounts receivable, and inventories as well as significant discrepancies between internal financial records and external auditor data. The data shows that the company performs profit management, which is inflating profits or reducing losses unfairly to improve financial statements, according to Arief (2019). PT Akasha Wira Internasional Tbk's net profit increased by 38.48% from IDR 38.24 billion in 2017 to IDR 52.96 billion in 2018. Sales decreased by 1.25 percent in 2018 from Rp814.49 billion to Rp804.3 billion (Ayuningtyas, 2019).

This inequality shows the existence of profit management strategies used to maintain business attractiveness for investors (Jannah et al., 2024). Decision-making can be influenced by the profit margin shown in the financial statements (Al-Absy et al., 2017). In order to show strong performance to investors, management will strive to report large profits. In the face of fierce competition, businesses will strive to maximize profits to increase their overall value. According to the facts, financial statements are only used to present profit information; the method of generating such profits is not taken into account. The amount of profit indicates the company's efforts to increase its value. Companies can use profit management to boost or show high profit levels (Hernawati et al., 2021). Profit management is defined by Saraswati and Atiningsih (2021) as "management actions to influence the occurrence of profits according to the desired through internal factors controlled by the organization" through the selection of accounting standards using certain methodologies. Jensen and Meckling (2019) stated that profit management in agency theory is driven by the competition of interests between managers and shareholders.

When the interests of management and the interests of owners or investors conflict, a situation known as agency conflict will arise. A manager can breach his agency's duties if he acts against the interests of his principal, who is often the owner, shareholder, or investor. When owners and managers put themselves first, it can lead managers to take advantage of the situation to advance their own interests, even if it means endangering others (such as owners or investors). Managers can take advantage of the situation by manipulating their profits (Dewi & Priyadi, 2016). Another way managers can influence profits is to change the time of recognition of expenses and revenue (Xu et al., 2024).

Profit management strategies do not violate GAAP, but their popularity from a procedural point of view can undermine investors' confidence in external financial statements. According to Agustia & Suryani (2023), because the figures provided do not accurately describe the business situation, profit management techniques can damage the credibility of financial statements. To influence reported profits, management can use profit management techniques. These actions can reveal financial benefits that the business doesn't actually enjoy and can even be detrimental to the business. Given the aforementioned incidents, it is interesting and important to investigate the elements that motivate managers to engage in profit management as well as the elements that can prevent it. One explanation for why managers are involved in profit management is free cash flow (Clara & Susanto, 2022).

The presence of free cash flow can cause agency problems. This is because management and shareholders have different interests. While management wants current funds to be used to grow the company beyond its ideal

size so that they can continue to invest even when the investment has a negative net present value, shareholders want the rest of the money to be distributed to improve their well-being. The option is seen by shareholders as an option that is not in their favor (Hastuti et al., 2018). Free cash flow refers to the amount of money a business has after paying all of its operating and investment costs (Oh & Penman, 2020).

The concept centers on the money a business makes from its operations after paying all the operating costs and investments for its development. It is the duty of business management to make the best use of free cash flow to maximize profitability. Effective management will wisely use free cash flow for high-yield investments that increase business revenue (Hastuti et al., 2018).

If cash flow is high, organizations can benefit from free cash flow. This explains why businesses have strong capital recovery capabilities for both loans and equity capital (Erawati & Jedaru, 2022). "A company with high free cash flow means that the company is financially healthy. High free cash flow means that companies can invest more freely, pay off debt, buy back shares, or increase liquidity. Companies that have solid financial conditions increase shareholder value through dividends, strong stock price returns, or retained earnings for future investments".

Although on the one hand free cash flow is one of the measurements of the company's financial performance, on the other hand, free cash flow can cause agency problems if used for opportunistic purposes by managers, for example not distributed as dividends, but instead invested in projects that do not bring profits to the company (*NPV* is negative). To cover up their exploitative actions, the managers engage in profit management operations, which include an increase in reported profits. This is the driving force behind managers involved in profit management. Managers exert more control over profits when free cash flow is high. According to a number of studies, free cash flow can improve profit management (Dewi & Priyadi, 2016; Ghazali et al., 2015; Irawan & Apriwenni, 2021; Shadmehri et al., 2017; Tavakolnia, 2017).

If there are effective control variables, then the profit management tactics carried out by managers can be reduced. Institutional ownership is one of the elements that influences the opportunistic behavior of managers. Institutional ownership is expected to reduce the positive impact of free cash flows on profit management. Therefore, the opportunistic behavior of managers in profit management methods is partly limited by institutional ownership (Saraswati & Atiningsih, 2021). According to the point of view of agency theory, managers often run businesses for their own benefit rather than considering the interests of shareholders.

According to Ramadhani et al. (2023), institutional ownership is considered more efficient than managerial ownership in carrying out supervisory functions in this situation. Furthermore, other studies, such as those conducted by Puspaningrum & Indriyani (2022) and Saraswati & Atiningsih (2021), show that institutional ownership can also reduce the beneficial impact of free cash flows on profit management. Audit quality and institutional ownership moderate the influence of free cash flow on profit management.

A credible Public Accounting Firm (*KAP*) must build an effective corporate control system with its audit quality (Alexander, 2021). In order for businesses to provide high-quality financial statements, particularly profit statements, these controls seek to limit managers' opportunistic behavior when creating financial statements. Thus, the company will be more trusted by investors. Audit quality is an essential element because it reflects the auditor's ability to collect adequate audit evidence, identify unnatural activities, reduce the possibility of manipulation of accounting information, and provide an accurate opinion on the material aspects of financial statements (Soliman et al., 2014).

High-quality audits also increase the trust of financial information users in the integrity and independence of auditors as well as the reliability of financial reporting (Hasan et al., 2020). Therefore, audit quality moderates the impact of free cash flow on profit management, making it an efficient monitoring tool. The quality of the audit is expected to help identify profit management strategies and reduce the opportunistic activities of managers in financial statements (Siala & Jarbou, 2019). For the purpose of profit management, free cash flow, it is expected that businesses audited by a reputable (qualified) *KAP* will be able to reduce or eliminate the beneficial effects of free cash flow on profit management. The three main factors that affect audit quality are input, process, and output. As part of the audit output, audited financial statements are often used to assess the quality of audits in research. The quality of subsequent audits improves along with the quality of the profit data shown in the financial statements. This shows how a good audit improves the accuracy and openness of business financial reporting, which in turn strengthens stakeholders' trust in the company.

While Achyani and Lestari (2019) have shown that free cash flows improve profit management, this study fills the gap by examining the relationship between free cash flow and profit management, Dewi & Priyadi (2016), Ghazali et al. (2015), Irawan & Apriwenni (2021), and Shadmehri (2017). Savannah & Jenny (2023) and Nazalia &

Triyanto (2018) found that free cash flow has no effect on profit management and even has a negative relationship. The differences in previous studies were reflected in these variations in results. Nonetheless, two variables of audit quality moderation and institutional ownership have not been included in this investigation.

The lack of previous research in this area has emerged as an attractive catalyst for additional investigations. The study adopted a new technique to fill a gap in previous research by combining audit quality variables and institutional ownership as moderation factors to explain how free cash flow affects profit management. Taking into account external variables that can influence manager behavior, this method seeks to provide a more thorough explanation of how free cash flow can affect profit management procedures. The high quality of audits can act as a monitoring tool to reduce the likelihood of manipulation of financial statements, while the institutional ownership factor is anticipated to reduce the tendency of managers to manipulate profits.

**METHOD**

The population of non-financial companies listed on the *IDX* in the period 2019–2023 is the subject of causality in this study. Before the observation period, these companies were listed on the *IDX* for at least one year and remained listed until the end of 2023. Table 1 shows the size of the population. Sampling was carried out by proportional stratified random sampling technique. Based on calculations using the *Slovin* formula, a total of 81 companies were selected as sample subjects, resulting in a total of 405 observations (5 years of observation). Only 179 observations could be used in the analysis of this study, as 226 data were found as outliers after the identification process. Multiple linear regression analysis (*MRA*) is the analytical approach used.

**Table 1 Research Population**

Yes	Criterion	Sum
1	Non-financial companies that have been listed on the Indonesia Stock Exchange before 2019 and until 2023 have not been <i>delisted</i>	563
2	Companies with financial years not closed on December 31, 2023	(46)
3	Companies whose financial statements are not declared in rupiah	(82)
	<b>Number of companies</b>	<b>435</b>

In this study, there are 4 variables studied, namely free cash flow (AKB) which acts as an independent variable, institutional ownership (KI) and audit quality (KA) as moderation, and profit management (ML) which acts as a dependent variable. The measurement of the variables used has been adopted from the previous literature, and a summary of the variables and their measurements is listed in Table 2.

**Table 2 Variables and Their Measurements**

Research Variables	Operational Definition	Measurement	Scale
<b>Variable Dependency</b>			
Profit Management (ML)	The difference between the total accrual and the non-discretionary accrual	$DACit = (TACit / Ait-1) - NDAit$ Information: DACit=Discretionary accruals of the company i in the year t TACit=Total accruals of the company i in year t Ait-1 =Total assets of the company i in year t-1 NDAit=Nondiscretionary accruals of the company i in year t (Wawo et al., 2023)	Ratio
<b>Moderation Variables</b>			
Possession Institutional (KI)	The proportion of share ownership by an institution, which is calculated by dividing the number of shares owned by the institution by the total number of shares outstanding in the company. (Githaiga, 2023)	$\frac{\text{Jumlah saham yang dimiliki institusi}}{\text{Jumlah saham yang beredar}}$	Ratio

Audit quality (KA)	A measure that shows how well the audit can keep financial statements within a reasonable range	Dummy 1 if using Big 4 KAP and 0 if not using Big 4 KAP  (Wawo et al., 2023)	Nominal
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Independent Variables	
Arus kas bebas (AKB)	Deduction of various expenses, including interest costs, tax expenses, ordinary and preferred dividends, from operating income before depreciation then divided by total assets  $FCF_{mt} = (INC_{mt} - TAX_{mt} - ITEXP_{mt} - PSDIV_{mt} - CSDIV_{mt}) / TAm_{t-1}$  Information: FCF <sub>mt</sub> = Free Cash Flow of the company m in period t INC <sub>mt</sub> = Net profit of operations before company depreciation m in period t TAX <sub>mt</sub> = The amount of corporate income tax m in period t ITEXP <sub>mt</sub> = Company interest expense m in period t PSDIV <sub>mt</sub> = Dividend of the preferred stock of the company m in the period t CSDIV <sub>mt</sub> = Dividend of ordinary shares of company m in period t TAm <sub>t-1</sub> = The total book value of the company's assets m in the year t - 1 (Wawo et al., 2023)
	Ratio

hypothesis testing with MRA (Moderate Regression Analysis) and multiple linear regression. On the use of multiple linear regression to test hypothesis 1. The following is the formula:

$$ML_{it} = a + b1AKB_{it} + b2KI_{it} + b3KA_{it} + e$$

MRA is used to test hypotheses 2 and hypotheses 3. The formula is as follows:

$$ML_{it} = a + b1AKB_{it} * KI_{it} + b2AKB_{it} * KA_{it} + e$$

Where ML is profit management; a is a constant; b1-3 is the coefficient of variables; AKB is free cash flow; IP is institutional ownership; TRAIN is audit quality; e is an error term, i is a non-financial company; t is the year of observation.

**RESULTS AND DISCUSSION**

Table 3 shows the descriptive statistics of the research data.

**Table 3 Descriptive Statistics**

	ML	AKB	TO	KA
Mean	0.735	-0.085	0.497	0.162
Median	0.350	-0.081	0.501	0.000
Maximum	8.145	1.669	0.961	1.000
Minimum	0.001	-2.800	0.000	0.000
Std. Dev.	1.215	0.426	0.292	0.369
Observations	179	179	179	179

Source: Data processed (2024)

Table 3 presents the descriptive statistics of the observed variables. An average profit management of 0.735 indicates relatively moderate practices, but a maximum value of 8.145 reflects the presence of companies that are aggressively managing profits, while a minimum value of 0.001 indicates almost no such practices. The standard deviation of 1,215 shows considerable variation between companies. Meanwhile, free cash flow has a negative average of -0.085, indicating cash constraints in most companies. A minimum value of -2,800 indicates extreme negative cash flow, while a maximum value of 1,669 indicates the magnitude of free cash flow within the company with a standard deviation of 0.426 which reflects considerable variation. In the institutional ownership variable, an average ownership of 0.497 indicates that almost half of the shares in the sample are controlled by institutions, with a maximum value of 0.961 indicating institutional dominance in some companies, while a minimum value of 0.000 indicates no institutional ownership at all. The standard deviation of 0.292 indicates a fairly high variation

in institutional ownership between companies. Finally, the audit quality variable showed that only 16.2% of companies in the sample used high-quality auditors such as Big Four firms. A maximum value of 1,000 indicates that some companies choose a high-reputation auditor, but a median value of 0.000 indicates that the majority of companies do not use high-reputation auditors. These results reflect considerable variation in financial practices and corporate governance in the study sample.

The researchers in this study used MRA and multiple linear regression to test their hypothesis. After looking at the results of the chow and thirsty tests, it is clear that the Random Effects Model is the best choice, surpassing the General Effects and Fixed Effects models. Conventional assumption tests are not necessary because the Random Effects Model (REM) produces the best model selection results in these investigations. This is due to the characteristics of REM using the Generalized Least Squares (GLS) method, where this method automatically addresses the problems of heteroscedasticity and autocorrelation in the regression of panel data (Setyawan et al., 2019). In contrast to the Ordinary Least Squares (OLS) used in the Common Effect Model (CEM) and the Fixed Effect Model (FEM), the GLS method in REM already takes into account individual and time variations, so it does not rely on classical assumptions such as homogeneity and the absence of autocorrelations. Therefore, in this study, the analysis can directly focus on the interpretation of regression results without having to test classical assumptions.

The hypothesis results using the panel data regression estimation method on the Random Effect Model as presented in Table 4 and the results of the MRA test can be seen in Table 5.

**Table 4 Multiple Linear Regression Test Results**

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.772886	0.249737	3.094792	0.0023
AKB	0.326617	0.081106	4.027057	0.0001
TO	0.060544	0.237107	0.255345	0.7988
KA	-0.377179	0.549935	-0.685861	0.4937
Effects Specification				
			S.D.	Rho
	Cross-section random		1.223756	0.9405
	Idiosyncratic random		0.307740	0.0595
Weighted Statistics				
R-squared	0.089370	Mean dependent var	0.082308	
Adjusted R-squared	0.073759	S.D. dependent var	0.317162	
S.E. of regression	0.305534	Sum squared resid	16.33641	
F-statistic	5.724896	Durbin-Watson stat	0.932862	
Prob(F-statistic)	0.000926			
Unweighted Statistics				
R-squared	0.022399	Mean dependent var	0.735263	
Sum squared resid	257.0358	Durbin-Watson stat	0.059290	

Source: Data processed (2024)

**Table 5 Moderated Regression Analysis (MRA) Test Results**

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.737090	0.204394	3.606222	0.0004
AKB*KI	-0.252650	0.421110	-0.599961	0.5493
AKB*KA	-0.728794	0.293491	-2.483190	0.0140
Effects Specification				
			S.D.	Rho
	Cross-section random		1.235392	0.9466
	Idiosyncratic random		0.293321	0.0534

Weighted Statistics			
R-squared	0.158937	Mean dependent var	0.077766
Adjusted R-squared	0.144519	S.D. dependent var	0.314205
S.E. of regression	0.290869	Sum squared resid	14.80587
F-statistic	11.02335	Durbin-Watson stat	0.983760
Prob(F-statistic)	0.000001		
Unweighted Statistics			
R-squared	-0.006344	Mean dependent var	0.735263
Sum squared resid	264.5929	Durbin-Watson stat	0.055048

Source: Data processed (2024)

According to the study's findings, free cash flow has a positive impact on profit management; businesses with more free cash flow tend to use profit management techniques to improve market perception of financial performance or achieve profit targets (Iqbal & Darsono, 2020); managers often leverage free cash flow for personal projects, even when those projects do not generate the best returns for the business (Clara & Susanto, 2022). This practice can increase reported profits, although it risks lowering the quality of financial statements in the long run.

Managers and shareholders have conflicting interests, according to agency theory (Jensen & Meckling, 2019), which is consistent with our findings. Managers who have a lot of free cash flow are more likely to manipulate their profits. Previous research by Achyani & Lestari (2019), Dewi & Priyadi (2016), Ghazali et al. (2015), Irawan & Apriwenni (2021), and Shadmehri et al. (2017) Free cash flow also drives profit management. The second hypothesis test shows that institutional ownership does not weaken the profit management effect of free cash flow, which is expected given the difference in the amount of institutional ownership and the likelihood of conflicts of interest (Saraswati & Atiningsih, 2021). Large institutional ownership does not necessarily reduce profit management practices (Lavenia et al., 2023). Therefore, additional oversight is needed such as stricter regulation and a more active role of external auditors. Institutional shareholders with large shareholdings do not always act as active supervisors of the company's management, especially when they have a business relationship or other interests with the company that could potentially give rise to a conflict of interest. In these circumstances, institutional shareholders may prefer to be passive in order to avoid disruption to their business relationships or to maintain certain profits derived from their involvement in the company. In this context, institutional shareholders tend to be less active in overseeing managerial decisions, including profit management practices, due to the interests they need to protect.

The study's findings are consistent with a number of other recent studies. The impact of free cash flows on profit management, for example, cannot be mitigated by institutional ownership structures, according to a study by Saraswati & Atiningsih (2021). This implies that even if institutions have a sizable portion of shares, they may not actively supervise management or be incompetent in overseeing profit management techniques. Furthermore, the research of Lavenia et al. (2023) reveals that institutional ownership has not always succeeded in limiting profit management tactics. This may be because institutional shareholders are less likely to examine profit management strategies strictly or because their goals align with management's interests. This research suggests that institutional ownership may not always serve as an effective monitoring mechanism to limit profit management activities related to free cash flow. Therefore, to prevent management from abusing free cash flow through profit management methods, more oversight mechanisms are needed, including stronger legislation, greater transparency of financial statements, and a more active role of external auditors.

The third hypothesis results reveal that audit quality can reduce the impact of free cash flow on profit management. High-quality auditors, such as "Big Four" firms, can maintain reputations and improve the transparency of a company's financial statements (Iqbal & Darsono, 2020). In other words, the higher the quality of audits implemented in a company, the less likely management is to use free cash flow to carry out profit management practices. This is consistent with the role of high-quality auditors, such as "Big Four" firms or reputable auditors, who tend to implement stricter auditing standards as well as increase transparency in financial reporting. Auditors with high credibility can safeguard their reputation by ensuring that the company's financial statements have been prepared in accordance with applicable accounting principles and do not contain

excessive manipulation of profits. Credible auditors serve as an effective external oversight mechanism to limit profit management and ensure more efficient free cash flow allocation (Wawo et al., 2023).

Without proper oversight, managers can use financial reporting flexibility to increase profitability, deceive investors, and influence their decisions. This study confirms Iqbal & Darsono (2020), Toumeh et al. (2020), and Wawo et al. (2023) that audit quality can inhibit the opportunistic effects of excessive free cash flow, thereby moderating the relationship between free cash flow and profit management. So, having competent auditors among the staff is one of the strategies to control the opportunistic behavior of managers. Auditors with high reputations, such as Big Four companies, have stricter auditing standards and can improve the transparency of financial statements.

With high-quality auditors, the space for managers to perform profit management becomes narrower, as a rigorous audit process will identify irregularities in profit reporting. In addition, the presence of credible auditors provides a disciplinary effect for management, so they are more careful in presenting financial statements and are more likely to allocate free cash flow efficiently. Therefore, in an effort to mitigate opportunistic earnings management practices, stakeholders, including investors and regulators, need to emphasize the importance of strong oversight through the selection of high-quality auditors, which not only improves financial transparency but also maintains the credibility of the information presented to the market.

## CONCLUSION

According to this study, free cash flow is beneficial for profit management tactics. Companies that have excess free cash flow tend to use the money to increase reported profits, although this strategy usually backfires. The opportunistic actions of managers who seek to meet market expectations or achieve certain profit goals are what motivate this activity. Audit quality has been shown to reduce the negative impact of free cash flow on profit management, although institutional ownership cannot moderate this impact. This is because competent auditors can make financial statements more transparent and limit the opportunities for profit manipulation. There are various limitations to this study. First, the results may not accurately reflect the state of affairs in nonpublic companies because this study only looked at companies listed on the stock exchange. Second, it may be that the metrics used to assess audit quality and profit management are not comprehensive enough to account for all aspects of practice. The agency theory, which states that conflicts of interest between managers and shareholders can lead to profit management methods, is supported by this study. These results also advance our knowledge of how managers' opportunistic behavior is affected by free cash flow and how audit quality can reduce the likelihood of manipulation of financial statements. Further, the study highlights the value of external oversight by qualified auditors to improve the accuracy and openness of financial statements and consequently reduce managers' profit management tactics. The findings of this study shed light on the importance of effective cash flow management and the choice of qualified auditors for practitioners. Investors and potential investors should be cautious when funding businesses with strong free cash flow because, without an audit by a reputable KAP, this can encourage managers to manipulate profits. If a reputable KAP audits the company, managers will be less likely to be involved in profit management. To maintain investor confidence, businesses must make their financial disclosures more transparent. Companies and regulators should think about other oversight mechanisms, such as stricter regulations and a greater role for external auditors in ensuring the accuracy of financial statements, as large institutional ownership is not always effective in reducing profit management practices.

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