International Journal of Economic Literature (INJOLE) e-ISSN: 3026-0221
Vol. 3 No. 3 December 2025, page., 723-739

THE RELATIONSHIP BETWEEN LEVERAGE, FREE CASH FLOW, AND INVESTMENT CASH FLOW ON ACCOUNTING CONSERVATISM OF MANUFACTURING COMPANIES LISTED ON THE INDONESIA STOCK EXCHANGE

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Abstract

Accounting conservatism is a prudence principle applied by corporate management in preparing financial statements. This study aims to empirically examine the relationship between leverage, free cash flow, and investment cash flow and accounting conservatism in manufacturing companies listed on the Indonesia Stock Exchange (IDX) during the 2021–2023 period. The research population consists of manufacturing companies continuously listed on the IDX from 2021 to 2023. A saturated sampling method was employed, whereby the entire population was used as the research sample, resulting in a total of 188 companies. Data were analyzed using multiple linear regression analysis. The results indicate that leverage, free cash flow, and investment cash flow are associated with accounting conservatism. Leverage and free cash flow show a positive relationship, meaning that higher leverage and free cash flow are associated with more conservative financial reporting by management. In contrast, investment cash flow exhibits a negative relationship, indicating that an increase in investment cash flow is associated with a decrease in the level of accounting conservatism.
Keywords: Accounting Conservatism, Leverage, Free Cash Flow, Investment Cash Flow

INTRODUCTION

Increasingly intense business competition in the era of modern business development encourages companies to seek ways to maintain operational sustainability. One of the main elements reflecting a company's performance is its financial statements, which serve as an essential tool for both internal and external parties to obtain information regarding the company's financial position (Margaretha & Ramadhan, 2010).

Management has flexibility in selecting accounting methods for financial reporting, one of which is the application of the accounting conservatism principle. Watts (2003) defines conservatism as managerial behavior that tends to recognize profits or revenues more slowly. When this principle is applied, reported earnings and revenues tend to be lower, while expenses tend to be higher. Basu (1997) defines conservatism as the tendency of accountants to recognize bad news as losses more quickly than good news as gains.

The principle of accounting conservatism has generated debate due to widespread criticism of its application. On one hand, it is criticized for potentially causing biased financial statements that do not fully reflect the company's actual financial condition (Kiryanto & Supriyanto, 2006). On the other hand, conservatism is supported because it is considered capable of preventing opportunistic managerial behavior in manipulating corporate earnings

(Fala, 2007). Despite the controversy, accounting conservatism continues to be applied in practice because it helps reduce the potential for financial statement manipulation, particularly the tendency to overstate earnings, by adopting a more pessimistic approach to counterbalance managerial optimism. Moreover, overstated earnings are perceived to pose greater risks than understated earnings, as they may lead to more serious legal consequences if financial statements fail to reflect actual conditions (Dyahayu, 2012).

At the firm level, conservative financial reporting is particularly important for manufacturing companies. As one of the main sectors on the Indonesia Stock Exchange (IDX), manufacturing companies possess unique characteristics in financial reporting. This sector is capital-intensive, characterized by long operating cycles, and vulnerable to global economic fluctuations. These challenges are exacerbated by pressures to maintain cost efficiency and market competitiveness. Under such conditions, conservative financial reporting becomes essential to ensure the stability and accountability of financial information, especially for investors and creditors who rely on these reports for decision-making.

Factors suspected to influence the level of accounting conservatism include corporate cash flows originating from operating, investing, and financing activities—as well as leverage. Manufacturing companies listed on the IDX exhibit variations in operating cash flow, investment cash flow, and leverage, which may affect the application of accounting conservatism.

The phenomena observed in Indonesian manufacturing companies reflect complex economic dynamics. In the post–COVID-19 period, manufacturing firms faced slow economic recovery, global supply chain disruptions, and volatility in raw material prices. Data show that national manufacturing performance declined significantly beginning in March 2020, with the Purchasing Managers' Index (PMI) falling from 51.9 in February 2020 to 45.3 in March 2020, and reaching a low of 27.5 in April 2020. These conditions required companies to exercise greater caution in preparing financial statements, aligning closely with accounting conservatism practices to reduce the risk of earnings overstatement that could trigger unrealistic stakeholder expectations.

These issues are further illustrated by several cases involving Indonesian manufacturing companies. In October 2024, PT Sri Rejeki Isman Tbk (Sritex) faced bankruptcy threats after a court accepted a petition from a trading partner regarding unpaid debt. The company reported total liabilities of USD 1.6 billion as of June 2024. Similarly, in 2022, PT Indofarma Tbk part of the state-owned pharmaceutical holding experienced increased leverage to finance new product development projects and suffered a significant decline in operating cash flow due to reduced pharmaceutical sales during the COVID-19 pandemic. These conditions pressured the company to improve profitability to meet rising debt obligations and created difficulties in meeting short-term liabilities, necessitating debt restructuring to maintain business continuity. This case illustrates the relationship between leverage, operating cash flow, and the need for conservatism in financial reporting.

Another case involves PT Garudafood Putra Putri Jaya, which in 2023 undertook significant expansion through major investments in new manufacturing facilities and brand acquisitions, resulting in increased investment cash flow. Despite the rise in investment cash flow, the company faced challenges in maintaining stable operating cash flow, which may influence its level of accounting conservatism.

Additional supporting evidence comes from PT Tiga Pilar Sejahtera Food Tbk (AISA), which experienced a financial crisis due to financial statement manipulation and improper management of free cash flow. In 2020, the company reported substantial losses, largely attributable to the use of free cash flow for unproductive expenditures, such as acquiring assets that did not generate added value. During this period, the company failed to manage excess cash effectively and did not apply accounting conservatism, resulting in difficulties in maintaining liquidity and investor credibility.

These cases indicate that several Indonesian manufacturing companies have faced challenges related to free cash flow, investment cash flow, and leverage in the post–COVID-19 period. Therefore, this study focuses on the 2021–2023 period to examine the condition of manufacturing companies listed on the IDX following the pandemic.

Factors such as declining sales, rising production costs, and unfavorable market conditions contribute to cash flow and leverage problems, which in turn affect accounting conservatism policies. Leverage and cash flow—both free cash flow and investment cash flow—play important roles in accounting conservatism. Companies with high leverage tend to encourage managers to adopt more conservative financial reporting in response to creditor pressure, with conservatism serving as a mechanism to reduce the risk of debt covenant violations (Ahmed & Duellman, 2007).

Regarding free cash flow, managers may be inclined to overinvest or engage in inefficient spending when firms possess excess cash, creating agency conflicts between managers and shareholders. Accounting conservatism can therefore function as a control mechanism to limit opportunistic managerial behavior (Jensen, 1986). Conversely, firms with high levels of investment are more susceptible to overinvestment risk. In this context, cautious managers may apply accounting conservatism as a reporting strategy to project prudence to investors and reduce the risk of negative valuation (Richardson, 2006).

Previous studies examining the influence of leverage, free cash flow, and investment cash flow on accounting conservatism have produced inconsistent results. Moreover, there is a lack of research specifically investigating the effect of free cash flow on accounting conservatism, which constitutes a key novelty of this study. Riyadi (2022) found that leverage significantly affects accounting conservatism, consistent with Husna et al. (2023). Dewi and Heliawan (2021) also found that managerial ownership, public ownership, leverage, firm size, and operating cash flow simultaneously influence accounting conservatism.

Swasti and Meidiyustiani (2024) found that operating cash flow has a positive and significant effect on accounting conservatism, consistent with Martani and Dini (2010). Halim (2021) found that operating cash flow positively affects accounting conservatism, while leverage does not. Noviantari and Ratnadi (2015), as well as Aryani and Mulyati (2020), found a negative relationship between leverage and accounting conservatism. Research on investment cash flow remains limited; Martani and Dini (2010) found that investment cash flow does not significantly affect accounting conservatism. Meanwhile, no prior studies have specifically examined the effect of free cash flow on accounting conservatism, as free cash flow has primarily been studied in relation to firm value and earnings management.

This study employs behavioral theory as its grand theory. In accounting, behavioral theory is used to explain how individuals make decisions based on motivations, incentives, and external pressures, including psychological influences on auditors or managers during accounting

decision-making processes (Bruns & De Coster, 1969). This theory is relevant to accounting conservatism, as its application is closely tied to managerial behavior influenced by a firm's internal financial conditions.

Based on the above discussion, this study differs from previous research in three key aspects. First, it focuses on manufacturing companies listed on the IDX during the 2021–2023 period, reflecting the novelty of the research timeframe. Second, it incorporates free cash flow as an independent variable. Third, it includes firm age and firm size as control variables.

METHOD

This study employs a quantitative approach with an associative research design to analyze the effect of leverage, free cash flow, and investment cash flow on accounting conservatism, with firm age and firm size as control variables. The approach is grounded in positivist philosophy, emphasizing hypothesis testing through statistical analysis. The research gap lies in its focus on all manufacturing companies listed on the IDX during the 2021–2023 period and the inclusion of free cash flow, firm age, and firm size as control variables. Research data were obtained from financial statements published by the Indonesia Stock Exchange (Sugiyono, 2019).

The research variables consist of accounting conservatism as the dependent variable, measured using the Givoly and Hayn model, and leverage, free cash flow, and investment cash flow as independent variables. Leverage is measured using the Debt to Assets Ratio (DAR), free cash flow is calculated based on the Ross et al. model, and investment cash flow is measured by changes in investment cash flow across periods. Control variables include firm age and firm size, proxied by total assets. All manufacturing companies for the 2021–2023 period were included as samples using a saturated sampling technique, and data were collected through non-participant observation of publicly available financial statements (Ratnadi et al., 2013; Ross et al., 2000; Ghozali, 2021).

Data analysis was conducted using multiple linear regression with SPSS, beginning with descriptive statistical analysis followed by classical assumption tests, including multicollinearity and correlation tests, to ensure an unbiased model. Hypothesis testing included the F-test to assess model feasibility, the coefficient of determination (R^2) to measure the model's explanatory power, and the t-test to evaluate the effect of each independent variable. A significance level of 5% was applied for all tests (Ghozali, 2021).

RESULTS AND DISCUSSION

Overview of Manufacturing Companies

This study was conducted on manufacturing companies listed on the Indonesia Stock Exchange (IDX), the official institution responsible for organizing the capital market and providing an orderly, fair, efficient, and transparent securities trading system. In addition to facilitating transactions, the IDX provides comprehensive public information and classifies listed companies into eleven main sectors to facilitate performance analysis based on business activities.

The research population includes all manufacturing companies continuously listed on the IDX during the 2021–2023 period, totaling 188 companies engaged in processing raw materials into finished goods through structured production processes. Within the IDX,

manufacturing companies are classified into the basic and chemical industries sector, miscellaneous industries sector, and consumer goods industry sector, each consisting of various subsectors according to their business characteristics.

Table 1. Sample Selection Criteria

Criteria	2021	2022	2023	Total
Manufacturing companies listed on the IDX (2021–2023)	214	226	230	670
Manufacturing companies not continuously listed (2021–2023)	26	38	42	106
Companies continuously listed (2021–2023)	188	188	188	564
Total observations (2021–2023)				564

Source: Processed data, 2025

This study employed a saturated sampling technique; therefore, the entire population constituted the research sample. After examination, 188 manufacturing companies were found to be continuously listed over the three-year observation period (2021–2023), resulting in a total of 564 observations.

Descriptive Statistics

Table 2. Descriptive Statistics

Variable	N	Minimum	Maximum	Mean	Standard Deviation
Leverage (X1)	564	0.7086	2.4540	0.9931	0.1910
Free Cash Flow (X2)	564	26,152.4801	7,033,474.9290	949,247.7788	1,077,263.9930
Investment Cash Flow (X3)	564	0.7071	4,673,435.5670	393,251.5904	531,111.4702
Firm Age (X4)	564	0	46	18.4400	13.0450
Firm Size (X5)	564	24.6549	33.7306	28.4499	1.6877
Accounting Conservatism (Y)	564	0.7071	1.4628	0.7496	0.0545

Source: Processed data, 2025

Based on the descriptive statistical results presented in Table 2, the total number of observations (N) is 564. This indicates that the study analyzes 564 firm-year observations derived from 188 companies over a three-year period from 2021 to 2023. The descriptive results are explained as follows.

1) **Accounting Conservatism (Y)**

The accounting conservatism variable has a minimum value of 0.7071 and a maximum value of 1.4628, with a mean of 0.7496. As this value appears to be relatively constant in the regression model, its variation is very limited, as indicated by the low standard deviation of 0.0545. The standard deviation, which is smaller than the mean, suggests that accounting conservatism data are relatively homogeneous, indicating low dispersion across firms and a generally consistent level of conservatism among the sampled companies.

2) **Leverage (X1)**

The leverage variable has a minimum value of 0.7086, indicating that the firm with the lowest leverage in the sample holds a relatively low level of debt relative to its total assets. The maximum value of 2.4540 indicates the presence of firms whose debt exceeds twice the value of their total assets. The mean leverage of 0.9931 suggests that, on average, firms in the sample have a capital structure in which debt is nearly equivalent to total assets. The standard deviation of 0.1910, which is smaller than the mean, indicates that leverage data are relatively homogeneous, with limited variation across firms.

3) **Free Cash Flow (X2)**

The free cash flow variable has a minimum value of 262,152.4801, indicating that firms with the lowest free cash flow in the sample exhibit relatively limited financial activity or economic value. The maximum value of 7,033,474.9290 reflects firms with the highest level of economic activity. The mean free cash flow of 949,247.7788 suggests that, in general, firms in the sample operate at a relatively large economic scale. The standard deviation of 1,077,263.6930, which exceeds the mean, indicates that free cash flow data are heterogeneous, reflecting substantial variation in financial and economic activity across firms.

4) **Investment Cash Flow (X3)**

The investment cash flow variable has a minimum value of 0.7071 and a maximum value of 4,673,435.5670, indicating a wide range between firms with the lowest and highest investment activity. The mean value of 393,251.5904 suggests that most firms exhibit relatively low investment activity compared to the maximum observed value. The standard deviation of 531,111.4702, which is significantly higher than the mean, indicates considerable differences in investment intensity across firms in the sample.

5) **Firm Age (X4)**

The firm age variable ranges from 0 to 46 years, indicating substantial variation in firm maturity, from newly established firms to those that have operated for up to 46 years. The mean firm age of 18.4400 years suggests that most firms in the sample are relatively established. The standard deviation of 13.0450 reflects a wide dispersion in firm age, indicating that firms are at different stages of development.

6) **Firm Size (X5)**

Firm size, measured by total assets, has a minimum value of 24.6549 and a maximum value of 33.7306, indicating variation in firm scale from smaller to very large asset holdings. The mean value of 28.4499 suggests that most firms in the sample are classified as relatively large. The standard deviation of 1.6877, which is relatively small compared to the mean, indicates that firm size is relatively homogeneous, with limited dispersion in asset size across firms.

Data Analysis Results

This section explains the analytical methods employed in the study, namely classical assumption tests and multiple linear regression analysis. The classical assumption tests consist of multicollinearity and correlation tests, which are conducted to ensure the validity

and reliability of the regression model. Multiple linear regression analysis is then applied to examine the relationship between leverage, free cash flow, and investment cash flow and accounting conservatism.

Classical Assumption Tests

Regression analysis requires the fulfillment of several underlying assumptions to ensure that the model can be used as a reliable predictive tool. The purpose of conducting classical assumption tests is to confirm that the estimated regression model does not violate these assumptions. In this study, the classical assumption tests include multicollinearity and correlation tests. Each of these tests is explained in the following sections.

a) Multicollinearity Test

Table 3. Multicollinearity Test Results

Variable	Tolerance	VIF
Leverage (X1)	0.933	1.072
Free Cash Flow (X2)	0.301	3.323
Investment Cash Flow (X3)	0.297	3.362
Firm Age (X4)	0.910	1.099
Firm Size (X5)	0.389	2.568

Source: Processed data, 2025

All tolerance values exceed 0.10 and all VIF values are below 10, indicating the absence of multicollinearity.

b) Correlation Test

Table 4. Correlation Test Results

Variable	Sig. (2-tailed)	Correlation with Y
Leverage (X1)	0.000	0.415
Free Cash Flow (X2)	0.000	−0.147
Investment Cash Flow (X3)	0.000	−0.369
Firm Age (X4)	0.133	−0.063
Firm Size (X5)	0.000	−0.412

Source: Processed data, 2025

Leverage exhibits a significant positive correlation with accounting conservatism. Free cash flow and investment cash flow show significant negative correlations, while firm age is not significantly correlated. Firm size has a significant negative correlation with accounting conservatism.

Multiple Linear Regression Analysis

Table 5. Multiple Linear Regression Results

Variable	Unstandardized B	Std. Error	Standardized Beta	t	Sig.
Constant	0.882	0.018	–	49.677	0.000
Leverage (X1)	0.039	0.004	0.356	10.701	0.000

Variable	Unstandardized B	Std. Error	Standardized Beta	t	Sig.
Free Cash Flow (X2)	8.526	0.000	0.440	7.513	0.000
Investment Cash Flow (X3)	−1.390	0.000	−0.354	−6.002	0.000
Firm Age (X4)	3.327	0.000	0.021	0.617	0.537
Firm Size (X5)	−0.006	0.001	−0.494	−9.596	0.000

Model Statistics:
Adjusted R^2 = 0.418
F = 81.986
Sig. = 0.000

Based on the results of the multiple linear regression analysis presented in Table 5, the regression equation can be formulated as follows:

$$Y = 0.882 + 0.039X_1 + 8.526X_2 - 1.390X_3 + 3.327X_4 - 0.006X_5 + \varepsilon \quad (6)$$

Where:
Y= Accounting Conservatism
X_1= Leverage
X_2= Free Cash Flow
X_3= Investment Cash Flow
X_4= Firm Age
X_5= Firm Size
The interpretation of the multiple linear regression equation is as follows.

1. **Constant Term**

   The constant value of 0.882 indicates that when all independent variables (leverage, free cash flow, and investment cash flow) are equal to zero, the level of accounting conservatism is 0.882, assuming other factors remain constant.

2. **Leverage (X_1)**

   The regression coefficient for leverage (X_1) is 0.039, which is positive, indicating that higher leverage is associated with increased accounting conservatism in corporate financial reporting, ceteris paribus. This implies that a one-unit increase in leverage leads to an increase of 0.039 units in accounting conservatism. The t-test results show that the leverage coefficient is statistically significant (p = 0.000 < 0.05). Therefore, leverage has a significant positive relationship with accounting conservatism, supporting and accepting the first hypothesis (H1).

3. **Free Cash Flow (X_2)**

   The regression coefficient for free cash flow (X_2) is 8.526, which is positive, indicating that higher free cash flow is associated with a higher level of accounting conservatism, holding other variables constant. This suggests that a one-unit increase in free cash flow increases accounting conservatism by 8.526 units. The t-test results indicate that this coefficient is statistically significant (p = 0.000 < 0.05). Accordingly, free cash flow has a significant positive relationship with accounting conservatism, and the second hypothesis (H2) is supported and accepted.

4. **Investment Cash Flow (X_3)**

   The regression coefficient for investment cash flow (X_3) is –1.390, indicating a negative relationship between investment cash flow and accounting conservatism, assuming other variables remain constant. This means that a one-unit increase in investment cash flow leads to a decrease of 1.390 units in accounting conservatism. The t-test results show that this coefficient is statistically significant ($p = 0.000 < 0.05$). Therefore, investment cash flow has a significant negative relationship with accounting conservatism, and the third hypothesis (H3) is supported and accepted.

Model Feasibility Test (F-test)

The F-test result shows an F-value of 81.986 with a significance level of 0.000 (< 0.05), indicating that leverage, free cash flow, and investment cash flow simultaneously have a significant relationship with accounting conservatism. Therefore, the regression model is deemed appropriate.

Coefficient of Determination (R^2)

The adjusted R^2 value of 0.418 indicates that 41.8% of the variation in accounting conservatism is explained by leverage, free cash flow, and investment cash flow, while the remaining 58.2% is explained by other factors.

Hypothesis Testing (t-test)

The purpose of hypothesis testing using the t-test is to determine the extent to which each independent variable individually explains the variation in the dependent variable (Ghozali, 2021). If the significance value of the t-statistic is less than 0.05, the independent variable is considered to have a significant effect on the dependent variable. Conversely, if the significance value exceeds 0.05, the independent variable does not have a significant effect on the dependent variable.

For the leverage variable, the calculated t-value is 10.677 with a significance level of 0.000, which is lower than 0.05. Therefore, the first hypothesis (H1) is accepted. This result indicates that leverage has a statistically significant relationship with accounting conservatism when examined partially.

For the free cash flow variable, the calculated t-value is 7.513 with a significance level of 0.000, which is also lower than 0.05. Thus, the second hypothesis (H2) is accepted, indicating that free cash flow has a statistically significant relationship with accounting conservatism.

For the investment cash flow variable, the calculated t-value is –6.002 with a significance level of 0.000, which is below 0.05. Accordingly, the third hypothesis (H3) is accepted. This finding indicates that investment cash flow has a statistically significant relationship with accounting conservatism when analyzed individually.

Discussion

The results confirm that leverage, free cash flow, and investment cash flow are significantly related to accounting conservatism. Higher leverage encourages more conservative reporting due to creditor pressure and debt covenant considerations. High free cash flow increases

managerial prudence to mitigate agency problems and maintain investor confidence. Conversely, high investment cash flow is associated with lower conservatism, reflecting more optimistic reporting amid long-term investment uncertainty. These findings align with behavioral theory, which emphasizes the role of pressure, risk, and stakeholder perceptions in managerial accounting decisions.

CONCLUSION

Based on the research findings and discussion presented in the preceding sections, the following conclusions can be drawn:

1. Leverage has a significant and positive partial relationship with accounting conservatism. This indicates that higher corporate leverage is associated with a higher level of accounting conservatism, reflecting increased managerial prudence in financial reporting.
2. Free cash flow has a significant and positive partial relationship with accounting conservatism. This suggests that higher free cash flow leads management to apply greater accounting conservatism. High levels of free cash flow may increase the risk of opportunistic behavior; therefore, management committed to good corporate governance tends to use accounting conservatism as a mechanism to mitigate such risks and reduce investor concerns.
3. Investment cash flow has a significant but negative partial relationship with accounting conservatism. This finding indicates that higher investment cash flow is associated with a lower level of accounting conservatism. Managerial perceptions of risk and uncertainty influence financial reporting behavior, resulting in the inconsistent application of conservatism.

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