Free Cash Flow, Firm Characteristic, Corporate Governance on Earnings Management

Yulius Kurnia Susanto and Elizabeth Bosta
Trisakti School of Management, Jl. Kyai Tapa No. 20, Jakarta, Indonesia

Keywords: Earnings Management, Free Cash Flow, Profitability, Board Independence.

Abstract: The purpose of this research is to obtain empirical evidence about the influence of free cash flow, audit quality, profitability, board of directors, board independence, growth opportunities, and managerial ownership on earnings management. The population in this research is all manufacturing companies listed in Indonesia Stock Exchange during 2014 to 2016. Samples are obtained through purposive sampling method, in which 60 manufacturing companies listed in Indonesia Stock Exchange meet the sampling criteria, which resulted in 240 data as samples. Multiple linear regressions and hypothesis testing are used as the data analysis methods in this research. The result of this research shows that free cash flow, profitability and board independence statistically have an influence on earnings management. On the other hand, audit quality, board of directors, growth opportunities, and managerial ownership statistically do not have any influence on earnings management. This research is expected to enhance the knowledge of management regarding the impacts of misinterpretation of earnings information.

1 INTRODUCTION

The agents which are the managers have the responsibility to report the firm performance in the form of financial statements to the owners. The financial information such as the earnings is often used by stakeholders to make decisions (Nurdiniah and Herlina, 2015). The existing investors and potential investors will usually make investing decisions based on the return that will be earned from the firm. Thus, they will be more attracted to the firm with higher return. This is why managers tend to manipulate earnings to make the financial statements look good for the investors (Nurdiniah and Herlina, 2015). The actions or strategies of adjusting the earnings are known as earnings management. Bad earnings management will reduce the investors' trust. The cash withdrawal will be done collectively, which will lead to rush.

This research is the development of the research conducted by Bassiouny (2016), and supported by several researches conducted by some researchers. The differences from previous researches include several independent variables from other prior researches. The study samples are all manufacturing companies listed in Indonesia Stock Exchange (IDX) for the period of 2013 to 2016.

The purpose of this research is to obtain empirical evidence about the influence of free cash flow, audit quality, profitability, board of directors, board independence, growth opportunities, and managerial ownership on earnings management.

1.1 Free Cash Flow and Earnings Management

Free cash flow is the excess of cash that a firm owns after financing positive net present value projects for the operating activites aiming for firm expansion. In allocating free cash flow, the principal and management will have different interests. The principal wants to maximize its wealth thus will prefer the free cash flow to be distributed as dividend. On the other hand, the manager will tend to use the free cash flow to fund the investment to expand the firm, even if the investment will generate negative net present value. The choice for making poor investments may reduce future earnings. When management makes poor decision to invest in negative net present value projects, the management will tend to commit earnings management to show the principal a good company performance. Thus, it will reduce the likeliness of the principal for replacing the directors and/or senior executives (Bukit and

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Iskandar, 2009). Agustia (2013), Selahudin (2014), Cardoso (2014), and Susanto et al., (2017) showed that free cash flow had a relationship towards earnings management. On the other hand, Yogi and Damayanthi (2016), Bukit and Iskandar (2009), and Bhundia (2012) had contradictory results. The hypothesis is as follows:
H_1: Free cash flow has an influence on earnings management.

1.2 Audit Quality and Earnings Management

The agency problems and information asymmetry, which resulted from the separation of ownership and control, create the demand for external audit (Lin and Hwang, 2010). A firm audit quality is the audit performance quality performed by public accounting firms. Audit quality may ensure the accuracy and reliability of financial information (Yasar, 2013). Financial statements audited by outsiders may reduce asymmetries between principles and agents. High quality audit may detect and report errors and regularities, thus becomes an effective barrier to earnings management (Bassiouny, 2016). Big four auditing firms will usually perform a high quality audit because they have a large number of clients, have better technology resources, have good training programs and experience, and have good reputation that might be lost if they do not report a misstatement or a manipulation (Bassiouny, 2016). Researches conducted by Bassiouny (2016), Yasar (2013), and Susanto (2013) showed no relationship between audit quality and earnings management. On the other hand, Swastika (2013), Lin and Hwang (2010), and Bakht et al., (2014) showed contradictory result. The hypothesis is as follows:
H_2: Audit quality has an influence on earnings management.

1.3 Profitability and Earnings Management

The financial statements that become a linking media between management and the owners of the company will not be able to fully reflect the real condition of the company if the management 'manipulates' accounting numbers presented (Amertha, 2013). If a firm performed badly or well, it will encourage the manager to increase or decrease the income based on the performance condition of the firm. If a firm performed badly, the management will tend to increase the income because investors will not invest or lend some money to poor performance firm. In addition, managers want to receive a bonus that is often given based on the firms' profit. On the other hand, if the firm performed well, the management will tend to decrease the income (Amertha, 2013). Susanto (2013) showed that profitability has no effect on earnings management, while Nurdiniah and Herlina (2015), Aygun et al., (2014), and Amertha (2013) showed that profitability has an effect on earnings management. The hypothesis is as follows:
H_3: Profitability has an influence on earnings management.

1.4 Board of Directors and Earnings Management

The role of board of directors is to supervise chief executive management, who has the power of controlling board of director minutes and meetings. The board can be viewed as one of the important internal monitoring mechanisms that may affect a company's earnings management (Aygun et al., 2014). Jensen and Meckling (1976) showed that only if the agents are monitored and only if they are given appropriate incentives and rewards, the principals, who are the company owners, can comfort themselves that the agents will make the most favorable decisions. A high monitoring by directors in their duty will result in a lower manipulation of earnings thus resulting in negative relationship between board of directors and earnings management (Iraya et al., 2015). Susanto (2013) showed that there was no relationship between board of directors and earnings management. While Abbadi et al., (2016), Patrick et al., (2015), Aygun (2014), and Swastika (2013) showed that board of directors affected earnings management. The hypothesis is as follows:
H_4: Board of directors has an influence on earnings management.

1.5 Board Independence and Earnings Management

The effect of board independence on earnings management will be referring to non-executive directors (Swastika, 2013). The primary role of the non-executive director is to oversee the management of a company and to protect the interests of its shareholders. In order to fulfill its monitoring role, directors and supervisors must be independent from the firm's management (Chen et al., 2008). The more non-executive directors on the board, it is more possible to improve the way that the firm discloses its financial information. Therefore, they will show a greater transparency in their reports because the

outside directors do not have any interest regarding the shareholding of the firm and they are expected to act in a manner that maximizes the value of the firm in order to protect their reputation. A better supervision on the executive managers will improve their reputation (Hassan and Ahmed, 2012), and thus will decrease the chances of earnings management. Indriastuti (2012) showed that earnings management had no relationship with board independence, while Uwuigbe et al., (2014), Shah and Butt (2009), Jatiningrum et al., (2016), and Hashim and Devi (2008) showed contradictory results. The hypothesis is as follows:
H_5: Board independence has an influence on earnings management.

1.6 Growth Opportunity and Earnings Management

The firms with high level of growth opportunities are expected to achieve higher profitability. The increase in profitability increases both their political visibility and political costs. The political cost hyphotesis predicts that the probability of wealth transfer will affect managers' managerial behavior. Managers will also try to decrease the reported income number compared to the low growth opportunity and low income number of firms in order to reduce the likelihood and size of the wealth transfer (Watts and Zimmerman, 1978). Besides that, firms with visible profitability and high growth opportunities will face political risk such as potential economic losses arising as a result of governmental measures or special situations that may limit the operational and profitable activities of a firm. One way to limit the potential of political risk is to reduce the reported earnings number. Wibiksono and Rudiawarni (2015) showed that growth opportunity does not affect the practices of earnings management. On the other hand Ngamchom (2015), Bakth et al., (2014) and AlNajjar (2001) showed that growth opportunity affected the practices of earnings management. The hypothesis is as follows:
H_6: Growth opportunity has an influence on earnings management.

1.7 Managerial Ownership and Earnings Management

One way to reduce the agency problem is by giving incentives to managers in a form of share. As a result, it will reduce the conflict between managers and shareholders (Warfield et al., 1995). Managers' accounting choices are systematically related to the level of managerial ownership. The increase in the accounting-based-constraints for firms with low managerial ownership will impair the faithfulness of determining accounting number. Then, the informativeness of accounting number is predictably positively related to the level of managerial ownership (Warfield et al., 1995). When managerial ownership is low, the magnitude of accrual discretionary accounting adjustments is significantly higher. Susanto (2013) showed that managerial ownership did not affect earnings management. While Aygun et al., (2014), Yang et al., (2008), and Teshima and Shuto (2008) showed that managerial ownership affected earnings management. The hypothesis is as follows:
H_7: Managerial ownership has an influence on earnings management.

2 RESEARCH METHOD

This research examines 240 data from 60 manufacturing firms listed in Indonesia Stock Exchange from the year of 2013 to 2016. The samples are selected using purposive sampling with criteria summarised in the following table.

Table 1: Sample selection procedure.

Criteria Description	Total Firms	Total Data
Manufacturing firms consistently listed in Indonesia Stock Exchange from the year of 2013 to 2016	129	516
Manufacturing firms which do not consistently use IDR currency in the financial statements from 2013 to 2016	(29)	(116)
Manufacturing firms which do not consistently publish financial statements as of 31 December from 2013 to 2016	(1)	(4)
Manufacturing firms which do not consistently earn profit from 2013 to 2016	(39)	(156)
Number of sample of firms used	60	240

The measurement of discretionary accruals is calculated using modified Jones (1991) model defined formally as:

$$\frac{TACt}{A_{t-1}} = \beta 1\text{j}\ [\frac{1}{A_{t-1}}] + \beta 2\text{j}[\frac{\Delta REVt - \Delta \text{ARt}}{A_{t-1}}] + \beta 3\text{j}[\frac{PPEt}{A_{t-1}}] + \varepsilon t$$

TACt shows total accruals in year t (net income − cash flows from operating activities), At-1 is the total asset at the end of year (t-1), ΔREVt is the change in revenue between year (t-1) and year t, ΔARt is the change in receivables between year (t-1) and year t, PPEt is gross property, plant, and equipment in year t, β1 - β3 are regression parameters, and εt is the error term as discretionary accruals. The independent variable measurements in this research are as follows:

Table 2: Variable measurement.

Variable	Measurement
Free Cash Flow	$\frac{\text{CFO} - \text{CFI}}{\text{Total Assets}}$
Firm Audit Quality	1 = audited by big-4 firms, 0 = otherwise
Profitability	net Income ÷ total assets
Board of Directors	the number of directors on the boards
Board Independence	the number of independent commissioner
Growth Opportunity	market value: book value
Managerial Ownership	1 = has managerial ownership, 0= does not have managerial ownership
Control variable	
Firm Size	ln(total assets)
Firm Financial Leverage	total liabilities ÷ total assets
Firm Age	the number of years since the firm's foundation

3 RESEARCH RESULT

The statistical results are as follows:

Table 3: Descriptive Statistics.

Variable	Min.	Max.	Mean	Std. Deviation
DAC	-.16523	.35817	-.0000003	.0741725
FCF	-.19742	.55220	.15877	.12480
AUDIT	0	1	.45	.499
ROA	.0004	.4018	.094294	.0858282
BOD	2	16	5.34	2.700
INDEP	0	4	1.68	.839
GROW	.078	62.931	3.276	7.397
MO	0	1	.52	.501
SIZE	25.62	33.20	28.36	1.67
LEV	.0735	.8809	.404879	.1746842
AGE	4	85	37.30	13.727

Table 4: Hypothesis test.

Variable	B	Sig.
FCF	-.551	. 000***
AUDIT	.004	.704
ROA	.485	.000***
BOD	.002	.205
INDEP	-.011	. 090*
GROWTH	.001	. 309
MO	.003	. 680
SIZE	.002	.566
LEVERAGE	-.016	.519
AGE	.000	.503

Adj. R^2 0.485.*10%, **5%, ***1%

The result shows that free cash flow has a significance level of .000 which is under .05, which means that H_1 is accepted. It means that free cash flow has an influence on the earnings management. The coefficient of free cash flow variable is -.551, which can be interpreted as if the free cash flow is higher, the earnings management will be lower and vice versa. Firms with high free cash flow tend to not committing earnings management. This is because investors focus more on free cash flow information that shows firms' ability to share dividend (Agustia, 2013).

The result shows that audit quality has a significance level of .704, which is above .05, which means that H_2 is not accepted. It means that audit quality has no influence on the earnings management. This is because the institutional setting does not motivate auditors to provide high-quality audits due to lack of effective audit and oversight mechanism for auditors. In such an institutional environment, auditors may not constrain the earnings management practices of client firms. Thus, there may be no difference in audit quality between the Big four and non-Big four auditors (Yasar, 2013).

The result shows that profitability has a significance level of .000 which is under 0.05, which means that H_3 is accepted. It means that ROA has an influence on the earnings management. The coefficient of ROA variable is .485 and can be interpreted as if the profitability is higher, the earnings management will be higher and vice versa. This result shows that firms' good or bad performance will motivate manager to increase or decrease the income in order to make firms' performance is as expected by the management (Amertha, 2013).

The result shows that board of directors has asignificance level of .205, which is above .05, which means that H_4 is not accepted. It means that the board of directors has no influence on the earnings management. This is because the size of board has no effect on the ability of board to detect earnings management committed by the management (Susanto, 2013).

The result shows that board independence has a significance level of .090, which is below .10, which means that H_5 is accepted. It means that board independence has an influence on the earnings management. This is because the existence of independent board of commissioners is effective in reducing earnings management.

The result shows that growth opportunity has significance level of .309, which is above .05, means that H_6 is not accepted. It means that growth opportunity has no influence on the earnings management because growth opportunity does not determine the amount of earnings management (Wibiksono and Rudiawarni, 2015).

The result shows that managerial ownership has a significance level of .680, which is above .05, which means that H_7 is not accepted. It means that managerial ownership has no influence on the earnings management. This is because of only a certain number of companies have managerial ownership. In addition, managerial ownership is unable to become one of the corporate governance mechanisms to protect shareholders' interest (Susanto, 2013).

4 CONCLUSION

The result of this research shows that free cash flow, profitability, and board independence statistically have influences on earnings management. While audit quality, board of directors, growth opportunities, and managerial ownership do not have influence on earnings management of listed manufacturing firms in Indonesia. This research is expected to enhance the knowledge of management regarding the impacts of the misinterpretation of earnings information.

There are some limitations that exist during this research, which are: (1) This research period is relatively short, which is only four years; (2) This research population is relatively small focused only on listed manufacturing firms. Based on the limitations above, some recommendations that can be used for further research are: (1) Further research is expected to make longer period of research; (2) Further research is expected to enlarge the research population.

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