

FREE CASH FLOW AND EARNINGS MANAGEMENT: BOARD OF COMMISSIONER, BOARD INDEPENDENCE AND AUDIT QUALITY

Yulius Kurnia Susanto*, Arya Pradipta*, Indra Arifin Djashan*

* Trisakti School of Management, Jakarta, Indonesia



Abstract

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The purpose of the research is to provide empirical evidence about the effect of board of commissioner, board independence and audit quality on relationship between free cash flow and earnings management. This research used 290 data from manufacturing companies listed in Indonesia Stock Exchange, selected using purposive sampling method, during 2012 until 2014. Earnings management calculated using Modified Jones (1991) Model include ROA from Kothari et al. (2005). Data for the research were analyzed using multiple regression analysis. The results of the research showed that the effect of board of commissioner, board independence and audit quality on relationship between free cash flow and earnings management is negative and significant. Board of commissioners, board independence and audit quality can reduce earnings management problems arising from free cash flow. Board of commissioners, board independence and audit quality oversee the opportunistic behavior of managers that arises from free cash flow problem.

Keywords: Earnings Management, Free Cash Flow, Board of Commissioner, Board Independence, Audit Quality.

1. INTRODUCTION

Earnings information is used by investors or other interested parties as an indicator of the efficient use of funds that are embedded in the company are realized in the rate of return and an indicator for the increase in prosperity (Ghozali and Chariri, 2007). Earnings information is sometimes used as a basis for measuring the success or failure of the business in achieving operational goals. This will encourage management to manipulate earnings information to make financial statements look good. These actions are called earnings management.

Earnings management is the activity of manipulating reported earnings, so the company did not indicate accurately the economic income in certain periods (Goel and Thakor, 2003). Earnings management is the selection of accounting policies specified by the management company to achieve certain goals. Earnings management is a manager intervention against the financial reporting process in order to gain advantage, both for managers and companies (Scott, 2012). If the free cash flow is not used to maximize shareholder earnings in the form of a profitable investment, then investors will find that the management is not able to provide

benefits to the owner of the company. In the end, the company will be in a position of low growth (Jensen, 1986).

Agustia (2013), Amertha et al. (2014), Yogi and Damayanthi (2016) showed that the effect of free cash flow on earnings management is negative and significant. Kangarluei et al. (2011) and Cardoso et al. (2014) showed that free cash flow does not have a significant effect on earnings management. Rusmin et al. (2014), Bukit and Iskandar (2009), Chalak and Mohammadnezhad (2012) showed that the effect of free cash flow on earnings management is positive and significant. The existence of differences in results inconsistencies relationship between free cash flow and earnings management indicates contingency factor. The contingency factors, namely the board of commissioner, board independence and audit quality. The research is the first paper to systematically test the effect of board of commissioner, board independence and audit quality on relationship between free cash flow and earnings management practices in the Indonesia context. The research objective was to obtain empirical evidence that board of commissioner, board independence and audit quality can reduce

the positive effect of free cash flow on earnings management.

The remainder of this paper is organised as follows. First: literature review including hypothesis development. Second: the research method is discussed. Third: the research result and discussion, and final, the research conclusions.

2. LITERATURE REVIEW

2.1. Agency theory

Agency theory is one of the theories underlying the company's business practices that have been used for this. This theory began to evolve through the writings of Jensen and Meckling (1976) Theory of the firm: managerial behavior, agency costs and ownership structure. Agency theory is a theory that emerged through the development of accounting research. This theory is a modified form of the development of financial accounting model by adding aspects of human behavior into economic models. Jensen and Meckling (1976) describes an agency relationship in agency theory is that the company is a collection of a contract between the owner of the resource costs (principal) and the manager (agent) who took care of the use and control of these resources.

According to the agency theory, the relationship between owners and managers difficult to create due to their conflicting interests. The existence of a conflict of interest between principal and agent can cause problems known as asymmetric information is condition imbalance information for the agent in a position to have more information about the company than the principal. The presence of asymmetric information has led to the possibility of conflict between the principal and agent.

2.2. Board of commissioner on relationship between free cash flow and earnings management

Free cash flow likely will make managers to behave opportunistically if it does not take maximum advantage when the company was growing. It can make earnings management. The existence of commissioners oversees the behavior of the manager who did the earnings management. The Board of commissioners has the responsibility for overseeing the management tasks carried out by the board of directors. The number of board of commissioners is believed to minimize earnings management (Susanto and Pradipta, 2016; Susanto, 2016). Commissioners can play an important role in the control agency problems (Meca and Ballesta, 2009). Abed et al. (2012), Prastiti and Meiranto (2013) and Sumanto et al. (2014) showed that the commissioners a significant negative effect on earnings management. Commissioners can reduce earnings management problems arising from free cash flow. Board of commissioners reduces the effect of free cash flow on earnings management. The hypothesis is:

H1: Board of commissioners negatively effects on the relationship between free cash flow and earnings management.

2.3. Board independence on relationship between free cash flow and earnings management

The Board of Commissioners has the responsibility for overseeing the management tasks, but the commissioners should not be involved in management duties and may not represent the company in dealings with third parties. The existence of board independence is effective in monitoring management. However, it will be effective only if the board independence as independent within one company. Commissioners who come from outside the company or outside director can influence the actions of earnings management (Klein et al., 2005). The more the number of board independence, the supervisory increased so as to reduce earnings management. Company has a lot of independent commissioners, the likelihood of earnings management will decrease because they are capable of detecting earnings management (Susanto and Pradipta, 2016; Susanto, 2016).

Susanto (2013), Nabila and Daljono (2013) and Adigüzel (2013) found a negative and significant effect of board independence on earnings management. The more commissioners who come from outside or independent diminishing earnings management arising from free cash flow problem. Board independence reduces the effect of free cash flow on earnings management. The hypothesis is:

H2: Board independence negatively effects the relationship between free cash flow and earnings management.

2.4. Audit quality on relationship between free cash flow and earnings management

Auditors working in KAP big four are considered higher quality because the auditor is supplied by a series of training and procedures and have the audit program is considered more accurate and effective than the auditor of KAP non big four. Earnings management practices is increasing, while the examination of financial statements conducted by the auditor have the qualities vary therefore the auditor must have a very good audit quality in detecting earnings management practices in order to prevent the occurrence of earnings management. The rate of occurrence of earnings management in companies audited by the big four accounting firm lower than companies audited by KAP non big four (Nini and Trisnawati, 2009). Gerayli et al. (2011) and Swastika (2013) states the audit quality has a significant negative effect on earnings management. Audit quality can reduce earnings management arises from a problem of free cash flow (Nekhili et al., 2016). KAP big four limits the use of earnings management when high free cash flow (Rusmin et al., 2014). Audit quality reduces the effect of free cash flow on earnings management. The hypothesis is:

H3: Audit quality negatively effects the relationship between free cash flow and earnings management

3. RESEARCH METHOD

The sample used in the study is listed manufacturing companies in Indonesia Stock Exchange. The sample selection in the study using

purposive sampling method (Sekaran and Bougie, 2013). The data used in hypothesis testing as many as 294 data drawn from public manufacturing company from 2012 to 2014. The sample selection procedure can be seen in Table 1.

Table 1. Sample selection procedure

<i>Sample Criteria</i>	<i>Company</i>	<i>Data</i>
Manufacturing companies in Indonesia Stock Exchange during the period 2012-2014	127	381
Companies that do not report any financial statements as of December 31	(2)	(6)
Companies that do not use Rupiah	(27)	(81)
The number of companies and data used	98	294
Outlier		(4)
The number of companies and data used in the study		290

Earnings management is the activity of manipulating reported earnings, so the company did not indicate accurately the economic income in certain periods (Goel and Thakor, 2003). Earnings

management in this study using the scale ratio is measured by discretionary accrual Modified Jones (1991) Model include ROA from Kothari et al. (2005) Discretionary accruals were calculated using the following formula:

$$\frac{TA_{i,t}}{A_{i,t-1}} = \alpha_1 \left(\frac{1}{A_{i,t-1}} \right) + \alpha_2 \left(\frac{\Delta REV_{i,t} - \Delta REC_{i,t}}{A_{i,t-1}} \right) + \alpha_3 \left(\frac{PPE_{i,t}}{A_{i,t-1}} \right) + \alpha_4 ROA_{i,t-1} + \epsilon_{i,t} \quad (1)$$

where, $TA_{i,t}$ total *accruals* (Net income - cash flow from operating), $A_{i,t-1}$ prior total asset, $\Delta REV_{i,t}$ change of revenue, $\Delta REC_{i,t}$ change of receivable, $PPE_{i,t}$ property plant and equipment,

$ROA_{i,t-1}$ *return on assets*, $\epsilon_{i,t}$ *discretionary accruals*. The measurement of variables is summarized in Table 2.

Table 2. Measurement of variable

<i>Variable</i>	<i>Measurement</i>
DA	Discretionary accruals, calculated using Modified Jones (1991) Model include ROA from Kothari et al. (2005) as presented in equation (1)
FCF	<i>Free Cash Flow</i> = NOPAT - net investment on operating capital
Commissioner	The number of board of commissioner
Independent	Independent commissioners, the proportion of commissioners who come from outside the company in commissioners
Audit Quality	Dummy variable, which value of 1 if company is audited KAP <i>big four</i> and 0 otherwise.

4. RESULTS AND DISCUSSIONS

The results of descriptive statistics and hypothesis testing can be seen in the following Table 3 and 4.

The results of hypothesis testing showed that interaction effect of FCF and Commissioner has a coefficient value of -0.03387 and significant, H1 is accepted, which means that board of commissioners can reduce earnings management problems arising from free cash flow. Board of commissioners oversees the opportunistic behavior of managers that arises from free cash flow problem. Opportunistic behavior in the form of earnings management. Results of hypothesis

testing showed that interaction effect of FCF and Independent has a coefficient value of -0.26557 and significant, H2 is accepted, which means that board independence can reduce earnings management problems arising from free cash flow. The more independent the commissioner is, the tighter supervision of a manager opportunistic behavior arises from free cash flow problem. The results of hypothesis testing showed that interaction effect of FCF and Audit Quality has a coefficient value of -0.07173 and significant, H3 is accepted, which means that Audit quality can reduce earnings management problems arising from free cash flow (Nekhili et al., 2016). KAP big 4 can prevent opportunistic behavior of managers that arises from free cash flow problem.

Table 3. Descriptive statistics

<i>Variable</i>	<i>Minimum</i>	<i>Maximum</i>	<i>Mean</i>	<i>Std. Deviasi</i>
EM	-0,43799	0,58780	-0,0128318	0,15281302
FCF	-0,44384	5,64684	1,0626815	0,69390122
Commissioner	2	11	4,07	1,759
Independent	0,2	1	0,4019906	0,11988561
Audit Quality	0	1	0,37	0,482

Table 4. Hypothesis testing

Hypothesis	Variable	B	T
H ₁	Constant	-0.11210	-2.28616**
	FCF	0.15222	3.11926***
	Commissioner	0.02101	1.75536*
H ₂	FCF* Commissioner	-0.03387	-2.81950***
	Constant	-0.12008	-1.66854*
	FCF	0.14043	2.54983**
H ₃	Independent	0.18769	1.10722
	FCF* Independent	-0.26557	-2.19338**
	Constant	-0.02026	-1.12816
H ₄	FCF	0.04070	2.88615***
	Audit Quality	-0.01725	-0.47910
	FCF* Audit Quality	-0.07173	-2.51681**

5. CONCLUSIONS

The study has several conclusions of the first, board of commissioners can reduce earnings management problems arising from free cash flow; Second, board independence can reduce earnings management problems arising from free cash flow; Third, audit quality can reduce earnings management problems arising from free cash flow. Board of commissioners, board independence and audit quality oversee the opportunistic behavior of managers that arises from free cash flow problem. Opportunistic behavior in the form of earnings management.

This study has several limitations of the first, the study period is relatively short, ie from year 2012 to 2014 so that earnings management is observed less describe actual conditions. For further research to extend the period of study, a minimum of 5 years so that the data obtained can better describe the actual condition of earnings management. Second, the sample of companies used in this study is only limited to the manufacturing companies listed in Indonesia Stock Exchange, so the lack of research results can be generalized. To further expand the study sample into non-financial companies listed on the Indonesia Stock Exchange. Third, the study only uses three moderating variables while there are many other variables that can affect relationship between free cash flow and earnings management, as independent directors, audit committee and corporate governance bonding (Cong, 2013). Fourth, board of commissioner, board independence and audit quality of each country is different because the culture of each country is different. The different of board of commissioner, board independence and audit quality can be used as development of future research for other country.

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