Free Cash Flow, Size, and Earning Management

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Free Cash Flow, Size, and Earning Management

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ABSTRACT
The purpose of this study is to determine the effect of free cash flow and firm size on earnings management in banking companies on the IDX. Research period 2016-2017, secondary data in the form of annual financial reports, with a sample of 30 banking companies. The results of the FCF study have a positive influence on earnings management, Size has a negative influence on earnings management, Size cannot mediate free cash flow on Earnings Management, and free cash flow cannot moderate Size on earnings management.
Keywords: *free cash flow, size, earning management*

1. INTRODUCTION

Increasing economic growth in Indonesia, especially banking companies, is very good. How to measure the growth of a company by looking at profits derived from financial statements. Information regarding the failure or success of a business can be seen from the earnings information, therefore the management of the company taking action to compile financial statements looks good one of them with earnings management practices [1]. Earnings management is an action or activity of management in manipulating financial statements with the aim of presenting the profit looks good
The problem is the misalignment between the shareholders and agents. According to Jasen and Mecking [2], there are differences in interests between the principal and the agent, where both parties try to maximize their own well-being, so that an agency conflict arises and most likely the agent does not always act in the best interests of the principal. The manager also wants to seek profit so that it sacrifices the interests of others [3], [4].
Therefore, to minimize earnings management actions, it is necessary to look at the free cash flow, and the size of the company. According to Shen and Chih [5] and Chung, Firth, and Kim [6] companies with high free cash flow tend to practice earnings management, because the company indicated a very large agency problem. Company size is the size of the company, where large-scale companies tend to involve more parties related to decision making [7].

2. HYPOTHESIS AND FRAMEWORK

2.1. Free cash flow towards earning management

According to Fitriyah [8], the emergence of agency conflicts, one of which is caused by high FCF. Rosdini [9] states that FCF is used for investment, paying off debt, repurchasing company shares and the manager is using FCF for personal gain. Retno and Yuyetta [10], Yogi and Damayanthi [11] stated that FCF had a positive effect on earnings management.
H_1: FCF has a positive effect on earnings management

2.2. SIZE to Earning Management

The large size of the company causes the company to manage earnings because the company is the target of the government to reduce the large tax payments so that managers tend to do earnings management. The results of the research of Pramono [12], Arfan and Wahyuni [13] and Azlina [14] stated that size has a positive effect on earnings management
H_2: Size has a positive effect on earnings management

2.3. FCF to SIZE

Free cash flow is residual cash flow from funding activities and the company's operating activities. If there is remaining cash the company management will use the cash to enlarge the company, logically FCF can affect the size of the company.
H_3: FCF has a positive effect on SIZE

2.4. FCF to earning Management with SIZE as Mediation Variable

High free cash flow tends to make corporate managers manage earnings, because the rest of the funding can be used for personal gain. The size of the company cannot mediate FCF to earnings management because the high FCF is not used to increase the scale of the company but cash is used for other purposes such as personal interests of the management.
H_4: SIZE cannot mediate FCF to Earning Management

2.5. Framework

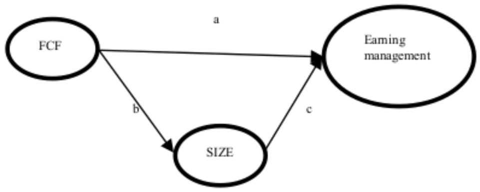

Figure 1 Model 1 Mediation

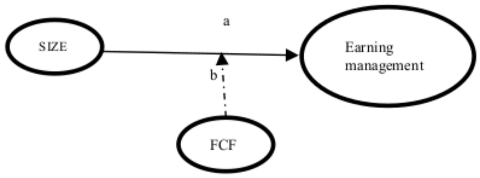

Figure 2 Model 2 Mediation

3. RESEARCH METHODS

Research on earnings management is one type of empirical survey research, the object of research of banking companies listed on the Indonesia Stock Exchange in 2016-2017. The type of data is secondary data in the form of annual financial statements, and other reports related to this research. Data sources were taken from www.idx.co.id and www.bi.go.id which are the official sites of the Capital Market Reference center (PRPM) and the Indonesia Capital Market Directory (ICMD). Sample in this study uses purposive sampling, the number of research samples of 30 banking companies listed on the Stock Exchange in 2016-2017.

The dependent variable is earnings management Determination of earnings management calculations using the eckel index [15].

$$Index\ Eckel = \frac{CV\ \Delta I}{CV\ \Delta S}$$

Information:

ΔI = Change in earnings in one period

ΔS = Changes in sales in one period

CV = coefficient of variation, which is the standard deviation divided by the expected value

The Eckel index for non-earnings management companies is ≥ 1, while for earnings management companies <1.

Independent variables are Free Cash Flow and Company Size. FCF is an independent variable in this study. FCF is the remaining free cash flow from financing activities used for expansion, acquisition or financial stability in the company. In this study FCF was measured using:

$$\text{FCF} = \frac{\text{Operating Cash Flow} - \text{Capital Expenditures}}{\text{Operating Cash Flow}}$$

Company Size. Size is the size of the company, where the size of the company in this study is used as an independent variable, company size can be measured by:

$$SIZE = log\ aset$$

4. RESULTS AND DISCUSSION

4.1. Analysis Techniques

Data analysis in the study by testing the research hypothesis was carried out by the method of partial least square. This study has 2 models of thinking in which model 1 uses the mediation size variable and the second model uses the FCF moderation variable, therefore the researcher uses the WarpPLS test tool. Hypothesis criteria H0: $\lambda i = 0$ opponents, H1: $\lambda i \neq 0$. The test results are done by t-test, obtained p-value ≤ 0.05 (alpha 5%) with a confidence level of 95%, then concluded significant, and vice versa.

Table 1 Model Fit

Model fit indices	P values
APC=0.165	P=0.084
ARS=0.103	P=0.140
AVIF=1.084	Good if < 5

This model (Table 1) is declared fit because its AVIF is less than <5 and if it is said to be ideal then this model is ideal because it is brought <3, declared free of multicollinearity

Table 2 Path coefficients and P values Path coefficients

	FCF	MLABA	SIZE	FCF*SIZE
FCF				
MLABA	0.389		-0.02	-0.062
SIZE	0.186			
FCF*SIZE				
	FCF	MLABA	SIZE	FCF*SIZE
FCF				
MLABA	0.008		0.449	0.365
SIZE	0.137			
FCF*SIZE				

Table 2 regarding the hypothesis testing part coefficients and p-value where it can be seen that FCF on coef earnings management is 0.389 and p-value 0.008 is significant, the size of earnings management is -0.023 p-value 0.449 is not significant, FCF is on Size coef 0.186 p-value 0137 is not significant. Significant value if the p-value <0.01.

Table 3 Variance Accounted For (VAF)

Indirect effect:	0.14 × 0.49	0.0686
Pathway FCF-SIZE-MLABA		
Direct influence	0.39 + 0.01	0.40
Total effect	0.4686 + 0.49	0.9586
VAF	0.4686/0.9586	0.4888

Table 3 shows the size mediation testing that affects FCF on earnings management with its VAF value of 0.4888 or 48%. If the VAF is in the range of 20% -80% it is said to be a partial mediator [16]. Therefore, hypothesis testing is said to mediate moderately by 48%.

The result of FCF moderation with size on earnings management coefficient -0.006 and the significance of 0.36 can be interpreted that FCF cannot strengthen the effect of size on earnings management. On the contrary, FCF weakens the size of earnings management. The mediation result of this research is FCF mediation size on earnings management

4.2. Discussion

The results showed that FCF can influence earnings management. The results of this study are in line with Boston and Pour [17], Habib [18], Jusni [19], and Wang [20] where free cash flow in companies can be used arbitrarily by management for personal gain or investors who want the cash to be distributed to shareholders in the form of dividends. supported by agency theory where there are differences in interests.

The results showed that size cannot affect earnings management. Companies that have a large scale does not necessarily affect earnings management, because large or small companies do not have the opportunity to do earnings management. The research results are supported by the results of the research of Arifin and Destriana [7] and Suwito and Herawaty [21].

The results showed that FCF had no effect on size. The company's cash flow from remaining funding activities is not only used to enlarge the company. The remaining cash can be used to pay debts, buy equipment or it can also be used to pay dividends.

The results stated that size can be used as a mediating variable between free cash flow and earnings management. Companies that have large free cash flows tend to do earnings management because the remaining cash in funding activities can be turned into profit. If there is a lot of profit from the company it will be subject to greater tax, on the other hand the decline in profits also affects the image / value of the company is not good, therefore earnings management is carried out on a large-scale company. This is in line with Boston and Pour [17], Arfan and Wahyuni [13], dan Wang [20].

The results state that free cash flow cannot moderate the size of earnings management. High cash flow can weaken the size of earnings management, agency theory states that there are differences in the interests of agents and principals in which the amount of the remaining cash flow funding is not only used to enlarge the company, high cash flow can be used to pay debts or distribute dividends, so the manager does not there is a tendency for earnings management.

5. CONCLUSION

Based on the results of the study entitled free cash flow, size of earnings management which in this study uses mediation and moderation variables. The results state that FCF has an effect on earnings management, size has no effect on earnings management, size mediates between FCF on earnings management, and FCF weakens size on earnings management.

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