CHAPTER I

INTRODUCTION

1.1 Background of Study

In assessing the performance of a company, one of the sources of information used is financial statements. PSAK No. 1 (2013) explains the financial statement is a structured presentation of the financial position, financial performance, and cash flow of an entity that is beneficial to a large number of users in making economic decisions. One important element in the financial report used to measure the performance of management is profit. Earnings information is a major concern for external parties (investors) to estimate management performance. In addition, earnings information is used by external parties (investors) as an indicator of the efficient use of funds embedded in the company which is manifested in the rate of return and an indicator for increased prosperity (Ghozali and Chariri, 2007: 350). With the tendency of external parties (investors) paying more attention to earnings information will encourage management to perform an action to improve the financial report by managing and manipulating the profit of a company, which is known as earnings management.

Earnings management is the choice by a manager of accounting policy to achieve some specific reported earnings objective (Scott, 2012). Earning management occurs when management uses certain decisions in financial reporting and the preparation of transactions that alter financial statements, aimed to create doubt among investors about the conditions of the firm's economic performance. Earning management is used to smooth out earnings fluctuations and present consistent profits for each month, quarter, or year. It is a normal for company's operations that have large fluctuations in income and expenses, but these changes may alarm investors who prefer to see growth and stability. The stock price of the company will increase or decrease is determined by whether the earnings meet the expectations or not. According to Scoot (2011: 426), there are several motivations that encourage management to influence accounting practices such as bonuses purposes, debt covenant hypothesis, meet investors' earnings expectations, and IPO (share price go up). Excessive earnings management can lead the company to not fully disclose the information on financial statements, which in result not only investors will be affected but also the other stakeholders such as shareholders and creditors will be affected.

There are several factors that can influence earnings management practices in a company, one of them is the free cash flow policy. Rosdini (2009) defines free cash flow as cash available for the company that can be distributed to creditors or shareholders after a company pays for its operating expenses and capital expenditure. The company's operation value depends on the amount of free cash flow expected in the future. Free cash flow will be relevant when it is used to determine the company value. Therefore, managers often increase the amount of their free cash flow to make their company has a higher value. In allocating free cash flow, the principal and agent will have different interests. If free cash flow in a company is not used to maximize or balance shareholder income in the form of profitable investments, the company is indicated to face greater agency problems. Managers tend to act opportunistically to benefit themselves by investing in less profitable projects, then to cover managers' actions and show principal a good company performance, the manager will try to increase company profits. White et al. (2003: 68) revealed that the greater the level of free cash flow, the healthier the company as it has cash available to run the business and reinvest for the business growth. Meanwhile, the smaller the amount of free cash flow, the more it can be categorized that the company is unhealthy. A company with consistently low free cash flow might need to restructure because there is a little money remaining after covering the bills. Company with rapidly rising free cash flow is more attractive for investors as such companies tend to have excellent prospects, therefore companies with low free cash flow tend to perform earnings management to make it an attractive choice for investors to invest. Research conducted by Vivi Adeyani Tandean (2019) and Tri Jatmiko Wahyu Prabowo (2018) found that free cash flow has a significant influence on earnings management.

The company's financial leverage can also be trigger for earning management activities, as a higher financial leverage ratio indicates that a company is using debt to finance its assets and operations. Leverage is illustrated to see the extent to which a company's assets are financed by debt compared to their capital (Kasmir, 2013: 41). Leverage can be understood as an estimator of the inherent risk to a company. The more debt that the company uses will endanger the company as the company being threatened with failure to pay its obligations. Companies that are trapped in a high level of debt will tend to perform earnings management in order to maintain good reputation in the eye of shareholders and public. According to Agustia (2013), a company with a high leverage ratio means that the proportion of its debt is higher than its asset, thus will tend to manipulate in the form of earnings management. Meanwhile according to (Kosasih and Widayati, 2013) states that higher leverage means the company has a total debt that is greater than its total asset, so there are other external parties, namely creditors who will help to oversee the financial reporting. Having external parties who contribute to oversee the financial reporting, will make supervision become tighter so the flexibility of management to manage earnings will decreases. Research conducted by Widyaningdyah (2001) found that financial leverage has positive significant effect on earnings management. Similarly research, conducted by Sosiawan (2012) proves that leverage does influence earnings management, while research conducted by Nejad et al. (2012) has a different result which stated there is negative results between leverage and earnings management. However, research conducted by Nasser and Parulian (2006) found that leverage does not significantly influence the practice of earnings management.

One of the ways used to monitor the accounting practices issue and to limit the opportunistic behavior of the management is corporate governance (Sriwedari, 2012). Corporate governance is a tool to reduce managerial opportunism and the guidelines that drive the organization toward its goals. According to the Forum for Corporate Governance in Indonesia (2006) corporate governance is a set of rules governing relationships between shareholders, managers of companies, creditors, governments, employees, and other internal and external rights holders, or in other words a system that regulates and controls the company. According to Surjadi and Tobing (2016), the proportion of independent commissioners has a fundamental responsibility to encourage the implementation of good corporate governance principles in order to produce good quality of financial reporting and give more value-added for the company.

Based on the explanation above, the writer is interested in conducting further research and explore whether free cash flow and leverage give effect to the earning management of a company or not, with the role of corporate governance practices as moderating variable. Below is the data on earnings management, free cash flow, financial leverage, and corporate governance in three consumer goods companies listed on Indonesia Stock Exchange for the year 2018 to 2020.

Table 1.1 Earnings Management, Free Cash Flow, Financial Leverage, and Proportion of Independent Commissioners in Three Consumer Goods Industries Listed on Indonesia Stock Exchange for the year 2018-2020

Company	Year	Earnings Management	Free Cash Flow	Financial Leverage
PT. Ultra Jaya Milk Tbk. (ULTJ)	2018	0.0005	(0.3452)	0.1405
	2019	0.0020	(0.3066)	0.1443
	2020	0.0001	(0.2799)	0.4537
PT. Chitose International Tbk. (CINT)	2018	0.0016	(0.3362)	0.2090
	2019	0.0019	(0.2889)	0.2528
	2020	(0.0036)	(0.2699)	0.2262
PT. Kalbe Farma Tbk. (KLBF)	2018	0.0281	(0.3801)	0.1571
	2019	0.0205	(0.3886)	0.1756
	2020	(0.0058)	(0.2926)	0.1901

Source: Prepared by the writer (2021)

Table 1.1 points out the difference in the application of earnings management by different companies. The companies whose data are showcased above are under the consumer goods companies listed in Indonesia Stock Exchange from the year 2018 to 2020, which are PT. Ultra Jaya Milk Tbk. (ULTJ), PT. Chitose International Tbk. (CINT), and PT. Kalbe Farma Tbk. (KLBF). The writer will briefly present the results of the observation and will only focus on the period of 2018 to 2020 as to narrow down the observation scope. As seen in the table above from 2018 to 2019, ULTJ and CINT have proved the proposed effect in a proportional way, in which with the increase of financial leverage and free cash flow, the earnings management is also experiencing an increase. However, KLBF showed a different effect where there is decreasing in earnings management percentage followed by free cash flow ratio, the financial leverage ratio has increased. On the other hand, in 2020 compared to the prior year, ULTJ and KLBF have shown different effect where its drastic fell in earnings management, the free cash flow and financial leverage ratio have increased. This shows the discrepancy of the prevailing theory, as when the financial leverage ratio has increased, the earnings management should also increase, as well as free cash flow when free cash flow has increased, the earnings management should increase. This shows that the two variables of free cash flow and financial leverage experience a mismatch with changes in earnings management. Contrarily, CINT showed a different effect where there is decreasing in earnings management percentage followed by financial leverage ratio, the free cash flow has increased. Meanwhile, the moderating variable of corporate governance uses only proportion of independent commissioners, it has shown an insignificant moderating effect on the relationship between free cash flow and financial leverage towards earnings management.

Due to the fact that there is a gap between theory and the phenomena of data which are shown and described above, thus it becomes an encouragement for the writer to conduct a research with the title **"THE EFFECT OF FREE CASH FLOW AND FINANCIAL LEVERAGE TOWARD EARNINGS MANAGEMENT WITH CORPORATE GOVERNANCE AS THE MODERATING VARIABLE IN CONSUMER GOODS INDUSTRIES LISTED IN INDONESIA STOCK EXCHANGE".**

1.2 Problem Limitation

With the recent corporate accounting scandal over earning management practices in Indonesia, the writer decided to conduct research on factors that can influence management to perform earnings management practices in order to strengthen earning management detection in Indonesia. Due to time and resource constraints, this research will focus only on consumer goods companies listed on Indonesia Stock Exchange as one of the industries that will keep changing and make innovations. The period of this study is limited from 2018 to 2020. This research does not discuss every factor that gives effect on earnings management. This research focuses only on the effect of free cash flow and financial leverage (Debt-to-Assets) to earning management, with the moderating variable of corporate governance uses only proportion of independent commissioners.

1.3 Problem Formulation

Based on the background that has been described, then the problems can be discussed are:

1. Does Free Cash Flow partially have a significant effect on earnings management of consumer goods companies listed in Indonesia Stock Exchange for the year 2018-2020?
2. Does Financial Leverage partially have a significant effect on earnings management of consumer goods companies listed in Indonesia Stock Exchange for the year 2018-2020?

3. Do Free Cash Flow and Financial Leverage simultaneously have a significant effect on earnings management of consumer goods companies listed in Indonesia Stock Exchange for the year 2018-2020?
4. Does Corporate Governance as the moderating variable have a significant effect on the relationship between free cash flow and earnings management of consumer goods companies listed in Indonesia Stock Exchange for the year 2018-2020?
5. Does Corporate Governance as the moderating variable have a significant effect on the relationship between financial leverage and earnings management of consumer goods companies listed in Indonesia Stock Exchange for the year 2018-2020?

1.4 Objective of Research

The objective of the research to answer the above problem formulations, which are:

1. To identify whether Free Cash Flow partially has a significant effect on earnings management of consumer goods companies listed in Indonesia Stock Exchange for the year 2018-2020.
2. To identify whether Financial Leverage partially has a significant effect on earnings management of consumer goods companies listed in Indonesia Stock Exchange for the year 2018-2020.

3. To identify whether Free Cash Flow and Financial Leverage simultaneously have significant effect on earnings management of consumer goods companies listed in Indonesia Stock Exchange for the year 2018-2020.
4. To identify whether Corporate Governance as moderating variable has a significant effect on the relationship between free cash flow and earnings management of consumer goods companies listed in Indonesia Stock Exchange for the year 2018-2020.
5. To identify whether Corporate Governance as moderating variable have a significant effect on the relationship between financial leverage and earnings management of consumer goods companies listed in Indonesia Stock Exchange for the year 2018-2020.

1.5 Benefit of Research

1.5.1 Theoretical Benefit

Theoretically, the research is expected to generates benefit as follows:

1. This research paper is expected to benefit the development of accounting theory and the academies by providing valuable information and extending the existing knowledge regarding the earnings management practices and how free cash flow and leverage relate to the practice.

2. This research paper is expected to benefit the next researchers who are interested in conducting similar research by providing information that could be used as a basic reference and improving the knowledge regarding the earnings management.

1.5.2 Practical Benefit

Practically, the research is expected to generates benefits as follows:

1. This research paper is expected to provide information to current and potential investors regarding the factors that can trigger management to conduct earnings management., hence investors must be aware that there are possibilities that the financial reports contain earnings management practices. Moreover, it is also expected to help creditor in weighing their consideration while making decisions to extend loans to companies.
2. This research paper is expected to be used as a reference for the company in assessing the possibility of earning management. Moreover, it is also expected to help management in maximizing the quality of their performance and create a better competitive edge strategy in order to achieve the objectives of the company.