CHAPTER I

INTRODUCTION

1.1 Background

PSAK No. 1 (2018) explains the financial statements are a structured presentation of the financial position and financial performance of an entity. This information concerns the financial position, performance and changes in the financial position of a company and is useful for large number of users in making economic decisions. One important element in the financial report used to measure management performance is profit. Earnings information is a major concern for estimating management performance. As external parties (investors) tend to pay more attention to earnings information as a parameter of company performance, management will be encouraged to manipulate earnings information, which is referred to as earnings management.

Earnings Management is the accounting policy chosen by the manager to achieve their reported earnings objective (Scott, 2009). Management have tendency to use earnings management to meet the forecast earnings to avoid reputation damage and negative emphasis towards their company. Management doesn't want to let down the investor especially if it's related to the share price, therefore they tend to perform excessive write-off and do earnings construct to achieve their company earnings objective. Excessive earnings management may lead the company to not fully disclose the information and it might not be helpful to the investor itself to make the right decision (Scott, 2009). If the company ends up not fully disclose the information, not only the investor will be affected by it but the other stakeholders such as shareholders and creditors will be affected too by this action. As defined by Cornett et al (2008) he argues that earning management is a preventive step to avoid in-default (failure) circumstances during a loan agreement, to reduce regulatory costs, and increase regulatory benefits. It is an intentional structuring that incorporates smoothing company income behavior and also any try to change reported income.

There are several factors that can influence earnings management practices in a company, one of them is the free cash flow policy. According to Brigham and Houston (2014), free cash flow is defined as the amount of cash that could be withdrawn without harming a firm’s ability to operate and to produce future cash flows. A positive level of FCF indicates that the firm is generating more than enough cash to finance current investments in fixed assets and working capital. By contrast, negative free cash flow means that the company does not have sufficient internal funds to finance investments in fixed assets and working capital, and that it will have to raise new money in the capital markets in order to pay for these investments (Brigham and Houston, 2014). Companies with high free cash flow will have a greater opportunity to manage earnings, because the company is indicated to face greater agency problems (Chung et al., 2005). Companies with high free cash flow, without adequate supervision, can create opportunistic moment because management does not make optimal use of available cash appropriately, or use it for investments that benefit the company. This has an impact on increasing earnings management practices to improve reporting earnings, so that the inefficiency in the use of cash flow could be hidden. Previous research shows that companies with high free cash flow also tend to practice earnings management by increasing reported earnings to cover the manager's actions that are not optimal in utilizing the company's wealth (Bukit and Iskandar 2009). According to (Bukit and Iskandar, 2009) on the relationship between surplus free cash flow and discretionary accounting accruals, the result shows surplus free cash flow is positively and significantly related to discretionary accounting accruals. The results of this study differ from (Agustia, 2013) that show free cash flow has a negative and significant effect on earnings management.

According to Amertha (2014), leverage is a measure of how much of the operation of company is financed by debt. The use of debt that is too high will endanger the company because it will be included in the category of extreme leverage (i.e. extreme debt). Companies that are trapped in a high level of debt high and difficult to release the debt burden. So it can be expected to conduct earnings management because the company is threatened with default (cannot fulfill debt obligations on time). High leverage means a higher proportion compared to the proportion owned by their assets will require manipulation in the form of earnings management (Agustia, 2013), meanwhile according to (Kosasih and Widayati, 2013) states that higher leverage means the company has a debt that is greater than its assets, so there are other external parties, namely creditors who help improve corporate financial reporting. By accepting external parties who contribute to oversee, making supervision increasingly stringent so that the flexibility of management to manage earnings decreases. Previous research regarding the effect of leverage on earnings management showed inconsistent results. As research by

Gunawan, et al., (2015) and Wiyadi, et al., (2016) which shows that capital structure as measured by leverage has no influence towards earnings management. However, the results of research from Sosiawan (2012) proves that leverage does influence earnings management and the research of Roodposhti and Chashmi (2011) revealed that leverage has positive impacts towards earnings management, while a study by Nejad et al (2012) found negative impact between leverage and earnings management.

These earnings management actions can be minimized through a monitoring mechanism that aims to align various interests called corporate governance. The implementation of corporate governance in a company functions as a supervising factor on the entire course of a company's activities that can create various acts of opportunistic behavior in a company. Hence, a good implementation of corporate governance can strengthen or weaken the effect of surplus free cash flow and leverage towards the conduct of earnings management (Amertha, 2014). Jensen and Meckling (1976) found that managerial ownership is one of the determining factors in overcoming agency problems of managers by aligning the interests of managers with shareholders. The board of commissioners is assigned and given responsibility to oversee the quality of information contained in the financial statements. This is important given the interest of management to conduct earnings management which results in a lack of investor confidence (Agustia, 2013). Auditors play a dominant role in reducing the noise in discretionary accruals by constraining opportunistic manipulation of accruals. Therefore, the quality of an audit is likely to affect the pricing of discretionary accruals (Habib, Jiang and Zhou, 2014). Institutional ownership has a negative influence on earnings management practices, the smaller the percentage of institutional ownership, the greater the manager's tendency to take certain accounting policies to manipulate earnings reporting (Widyastuti, 2009).

We have chosen this research topic because of the fact that this concept of earnings management up until the current time has not been thoroughly discussed in Indonesia; research on the topic of earnings management in Indonesia does not appear as frequently as in other countries. With this topic being discussed in many countries, it seems to be a good opportunity to apply and further explore this research topic into Indonesia, especially with regards to the effect of free cash flow and leverage towards earnings management. Another point worth mentioning is how we are using free cash flow risk in our research model, which we have found to be not frequently used in other research. This research paper will explore deeper about the effect of free cash flow and leverage towards earnings management in Indonesia, with corporate governance as moderation. This research is made based on manufacturing companies in Indonesia that is listed on the Indonesia Stock Exchange, with observation years spanning from 2016 to 2018. Based from the facts above, the writers wish to further study and explore whether free cash flow and leverage effects the earnings management of a company, with corporate governance as a moderating variable. To conclude, the writer came up with the title of **"THE EFFECT OF FREE CASH FLOW AND LEVERAGE TOWARDS EARNINGS MANAGEMENT, WITH CORPORATE GOVERNANCE AS A MODERATING VARIABLE."**

1.2 Research Problem

Related to the background, the writers define the research problem as follows:

1. Does Free Cash Flow have effect towards Earnings Management?
2. Does Firm Leverage have effect towards Earnings Management?
3. Does Corporate Governance have effect towards Earnings Management?
4. Does Corporate Governance have a moderating effect on the relationship of Free Cash Flow towards Earnings Management?
5. Does Corporate Governance have a moderating effect on the relationship of Leverage towards Earnings Management?

1.3 Research Objectives

The objectives for this research as follow:

1. To prove empirically that there is an impact of Free Cash Flow towards income increasing Earnings Management.
2. To prove empirically that there is an impact of Firm Leverage towards income increasing Earnings Management.
3. To prove empirically that there is an impact of Corporate Governance on income increasing Earnings Management.
4. To prove empirically that there is a moderating effect of Corporate Governance on the relationship of Free Cash Flow towards income increasing Earnings Management.

5. To prove empirically that there is a moderating effect of Corporate Governance on the relationship of Leverage towards income increasing Earnings Management.

1.4 Significance of Study

a. For Corporation: To understand better about the effect of Free Cash Flow and Leverage towards their Earnings Management.

b. For academician: To give additional knowledge about how to apply theories taught in lectures into the actual world.

c. For next researchers: To give more knowledge for future studies related to earnings management, especially the effect of Free Cash Flow and Leverage towards it with Corporate Governance as moderating variable.

1.5 Scope of Study

For the purpose of this research, writers will examine more than 1 independent variable, which are free cash flow and financial leverage. The financial information gathered will come from public companies in the manufacturing industry that has been listed on the Indonesia Stock Exchange. This research will also limit the observation years to only 3 working company years; 2016, 2017 and 2018.

1.6 Systematic Discussion

This research paper systematically divided into five chapters, explained as follows:

CHAPTER I: INTRODUCTION

This chapter will discuss background, research problem, research objectives, significance of the study, scope of the study, and systematic discussion.

CHAPTER II: LITERATURE REVIEW

This chapter will discuss in detail about its basic concept definition, literature review, conceptual framework, and hypothesis development.

CHAPTER III: METHODOLOGY

This chapter will discuss population and sample, data collection method, empirical model, definition of operational variable, and data analysis method.

CHAPTER IV: RESULTS AND DISCUSSION

This chapter will discuss the results and empirical findings in the research in relation to the effect of Free cash flow and Leverage towards Earnings Management with Corporate Governance as moderating variable.

CHAPTER V: CONCLUSION AND RECOMMENDATIONS

This chapter will conclude the research and will include a short summary to cover again all the main points of the findings as well as suggestions that may arise from the subsequent findings of the research.