The Role of Free Cash Flow in Improving Earning Management

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Abstract

The objectives of this study revolve around examining the influence of free cash flow, financial distress, employee differentiation, and corporate social responsibility on profit management within transport companies that are publicly listed on the Indonesian Stock Exchange during the period spanning from 2019 to 2021. To select samples, specialized sampling techniques were employed in this research. A total of 32 companies were chosen as representatives for the study. Duplicate regression analysis, facilitated by SPSS version 23.0, served as the primary analytical tool. The findings of this study indicate that free cash flows have a significant impact on income control. However, it was observed that income management remains unaffected by financial issues, employee turnover, or corporate social responsibility.

Keywords: *Earning Management, Free Cash Flow, Financial Distress, Employee Diff, CSR.*

A. INTRODUCTION

Every business is expected to improve the performance of its financial statements. According to Nazalia & Dedik (2018), earning management is carried out by estimating accounting in accordance with the Generallly, Accepted Accounting Principle (GAAP) which means that the company that performs the practice of earnings management will manage the profits it holds in line with the limits of applicable accounting procedures. The two concepts of accrual transactions in income management are discretionary and non-discretional accumulation. Due to the difficulty of tracking accounting policies, discresionary accumulations become common proxy for management practices (Yanthi, Pratomo & Kurnia, 2021).

The issue of earning management issues can be seen at PT Garuda Indonesia Tbk. From the previous period, the company suffered a loss of $216.58 million, with a net profit of $809.85 thousand. On RUPST, two commissioners namely Chairal Tanjung and Dony Oskaria refused to sign the company's annual report because they believed the profits recorded in the report did not reveal the facts. They oppose the recognition of revenue from the cooperation agreement for the provision of connectivity services signed by PT Mahata Aero Technology (Mahata) and PT Citilink Indonesia (Citilink) on October 31, 2018. According to Financial Accounting Standards Report (FAS) No. 23, such recognition does not meet the requirements (finance.detik.com, April 2019).

Furthermore, PT Garuda Indonesia Tbk is also suspected of abusing the Garuda Indonesian Partnership and Environmental Development Programme (PKBL) funds which are an attempt of the company in implementing Corporate

Social Responsibility (CSR). The allegation is obtained from the evidence of the transfer of PT Garuda Indonesia Tbk to Garuda Kabin Cabin Indonesia (IKAGI) for Rs.50 million for the purpose of sending funds for the 2019 IKAGI general election, while the funds above are named as the form of Garuda Indonesian PKBL. (cnnindonesia.com, Des 2019).

Based on the above issues, it can be seen that earning management practices still tend to be conducted by corporate management given the high level of competition between companies to show good profits. In addition to earning management, CSR is also a major concern that requires a company's commitment to be responsible towards the environment and the community around it. It is a challenge for the parties concerned with the company to evaluate information in the company's financial statements before making a decision.

The discrepancies between previous researchers Nazalia and Dedik (2018) stated of available cash on earnings management was found to be negligible in this study. However, financial challenges and disparities in employee roles were identified as factors significantly affecting earnings management. Moreover, Setiawati et al. (2019) found the manipulation of earnings is influenced by the existence of free cash flow. Nurdiansyah (2015) stated financial distresses had no impact on profits management, and Susanti and Kevin (2021) showed that employee if had no effect on profit Management. Lastly, Wardani & Desifa (2018) found that CSR had a different influence over profit management than Kalbuana et al. (2020)

A previous study by Nazalia & Triyanto (2018) explored the impact of free cash flows, financial issues, and employee turnover on earnings management, while incorporating the independent variable Corporate Social Responsibility.

B. METHOD

This study used is the method of documentation, which is to study the relevant documents both from the library and searching through the Internet to obtain the necessary information and data. This study relies on secondary data sources, specifically the annual reports of transport companies listed on the Indonesian Stock Exchange for the period 2019-2021. This annual report can be accessed directly at www.idx.co.id

Transportation companies listed on the Indonesian Stock Exchange from 2019 to 2021 are the population of this study. In this study, sampling methods are used to select samples., i.e. the sample is drawn from a certain number of populations using certain considerations or criteria. The selection criteria to be examined are: (1) Transport companies registered in the EIB in 2019-2021. (2) Transport companies not delisting in the 2019-2021 period.

This study employs a descriptive quantitative analysis method to examine the acquired data through dual regression analysis. The analysis will be conducted utilizing the SPSS program. The tests performed are statistical tests, normality tests, classical assumptions tests, double regressive analysis and hypothesis tests. To test this research hypothesis, a double regression model is used. Dual linear regression analysis examines the linear correlation among two or more independent and dependent variables (Ghozali, 2013:96).

C. RESULTS AND DISCUSSION

Descriptive statistics include the transformation of raw data into forms that can provide information to explain various factors of the situation (Now, 2011:285). They show a picture or description of data through the use of metrics such as averages, standard deviations, variances, maximum, minimum, quantity, range, curtosis, and perfection (Ghozali, 2018:19). The research variables have been tested statistically descriptively as seen in table 1 below:

Table 1. Results of Descriptive Statistical Tests

Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
FCF	96	-3251440000000000000.00	613491000000000000.00	-5192558178850206.0000	391150088531388840.00000
FD	96	-9137543367.00	9712485968.00	915428694.1354	4065899086.08517
ED	96	-2711171798.00	9303575666.00	63233829.5417	1084605800.81818
CSR	96	10989011.00	472527473.00	174450549.6250	132486021.19491
EM	96	-439807044.00	1292600659.00	-93548635.8125	182914066.74918
Valid N (listwise)	96				

Source: Process Data, 2022

The Kolmogorov-Smirnov test is employed to assess the normal distribution of either the dependent or independent variable in the regression model under consideration. The obtained significance value for the result is 0.000, which exceeds the threshold of 0.05. Consequently, outlier data was eliminated, and the significance value was derived from the Kolmogorov-Smirnov section, as presented in Table 2 below:

Table 2. Findings from the normality test conducted through the One-Sample Kolmogorov-Smirnov Test

One-Sample Kolmogorov-Smirnov Test

		Unstandardized Residual
N		66
Normal Parameters[a,b]	Mean	.0000000
	Std. Deviation	100229717.25756055
Most Extreme Differences	Absolute	.108
	Positive	.049
	Negative	-.108
Test Statistic		.108
Asymp. Sig. (2-tailed)		.053[c]

a. Test distribution is Normal.
b. Calculated from data.
c. Lilliefors Significance Correction.

Source: Process Data, 2022

According to the information provided in the aforementioned Table 2, the Kolmogorov-Smirnov value is noteworthy at 0.053, surpassing the significance level of 0.05. This indicates that the residual data is distributed normally.

Multicollinearity Test Results

Multicollinearity refers to a condition in which there exists a genuinely or nearly perfect linear relationship among independent variables within a regression model. The objective of the multicollinearity test is to determine if the regression model indicates a correlation among independent variables (tidak terpisah). Tolerance values and variation inflation factor (VIF) can be used to Evaluate whether multicollinearity is present in the regression model. Both coefficients indicate the extent to which an independent variable is influenced by the other independent variables. A common cuttof value to indicate multicollinearity is identified when the tolerance value is less than 0.10 or when the Variance Inflation Factor (VIF) is equal to or greater than 10 (Ghozali, 2018:107). The results of the multicollinearity test are presented in the following Table 3.

Table 3. Results of the Multicollinearity Test

Coefficients[a]

Model		Collinearity Statistics	
		Tolerance	VIF
1	FCF	.990	1.011
	FD	.882	1.134
	ED	.801	1.248
	CSR	.906	1.104

Dependent Variable: EM

Source: Process Data, 2022

In table 3 above, the VIF values for all independent variables are found to be < 10, and the tolerance values are > 0.10. Consequently, it can be inferred that the regression model is devoid of multicollinearity.

Autocorrelation Test Results

An autocorrelation test was performed to determine whether a double linear regression model showed a strong relationship between positive and negative data on the research variable. Autocorrelation-free regression is considered a good regression model. Durbin Watson values can be used to determine whether there is an automatic correlation. The following table 4 shows the autocorrelation test results.

Table 4. Results of the Autocorrelation Test

Model Summary[b]

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.357[a]	.127	.070	103463762.12048	2.121

a. Predictors: (Constant), CSR, FD, FCF, ED

b. Dependent Variable: EM

Source: Process Data, 2022

The findings from Table 4 reveal a Durbin-Watson value of 2.121. Considering a data sum of 66 and 4 independent variables, the calculated dL value is 1.4758, and the dU value is 1.7319. Consequently, it is observed that dU < DW < 4-dU = 1.7319 < 2.121 < 2.261 (4–1.7319). This indicates the absence of autocorrelation in the regression model.

Results of the Heteroscedasticity Test

The heteroskedasticity test is conducted to determine whether the residual variation between observations in the regression model is uniform. If the residual variation is consistent across observations, it is referred to as homoskedasticity; if not, it is termed heteroskedasticity. The identification of heteroskedasticity can be accomplished through a Breusch-Pagan test. The outcomes of the heteroscedasticity test are presented in Table 5.

Table 5. Findings from the Heteroscedasticity Test

Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients		
		B	Std. Error	Beta	t	Sig.
1	(Constant)	80007838.445	12409120.507		6.448	.000
	FCF	-2.702E-9	.000	-.202	-1.630	.108
	FD	.002	.002	.135	1.032	.306
	ED	-.062	.041	-.210	-1.528	.132
	CSR	-.004	.059	-.009	-.071	.944

Dependent Variable: ABRESID

Source: Process Data, 2022

From the information presented in Table 5, it is evident that there are no indications of heteroscedasticity in the Sig column because the independent variable indicates a Sig value greater than the degree of significance (α = 0,05).

Hypothesis Test Results

Partial tests (statistical t tests) and determination coefficient tests employed in this study serve to examine the hypotheses. Statistical t-tests, in particular, reveal the extent to which a single independent variable impacts the variability of the dependent variables (Ghozali, 2018:97). H1 is accepted and the null hypothesis (H0) is rejected if the t-value for profitability is below 0.05. Instead, H1 has been refused and the H0 has been accepted occurs if the value of profitability of t was less than 0.05. Table 6 presents the outcomes of the t-statistical test.

Table 6. Results of Hypothesis Test

Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients		
		B	Std. Error	Beta	t	Sig.
1	(Constant)	-112835559.573	21808976.689		-5.174	.000
	FCF	-6.529E-9	.000	-.269	-2.241	.029
	FD	-.007	.004	-.245	-1.922	.059
	ED	.054	.071	.102	.763	.449
	CSR	.073	.103	.089	.711	.480

Dependent Variable: EM

Source: Process Data, 2022

The regression model derived from the information in Table 5 is as follows:
Y= α + β1 X1 + β2 X2 + β3 X3 + β4 X4 + ε
EM = -112835559,573 -6,529 FCF -0,007 FD + 0,054 ED + 0,073 CSR + e

Description:

EM	: Earning Management
FCF	: Free Cash Flow
FD	: Financial Distress
ED	: Employee Diff
CSR	: Corporate Social Responsibility

Determination Coefficient Test Results (R^2)

Determination coefficient (R^2) measures how far a model is capable of describing independent variable variations. The determination coefficient value falls within the range of zero (0) to one (1) (Ghozali, 2018:97). The outcomes of the determination coefficient test are displayed in the following Table 7.

Table 7. Results of the Determination Coefficient Test (R^2)

Model Summary[b]

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.357[a]	.127	.070	103463762.12048	2.121

a. Predictors: (Constant), CSR, FD, FCF, ED
Dependent Variable: EM

Source: Process Data, 2022

Table 7 the preceding information presents the outcomes of the determination coefficient test, indicating an adjusted R-square value of 0.070. It shows Ninety-three percent of income management is influenced by variables not incorporated in this regression model. These variables include free cash flows, financial difficulties, wage differences, and corporate social responsibility variables.

First, the test outcomes indicate that Free Cash Flow significantly impacts Revenue Management, with a significance level of 0.029, which is less than 5%. This implies the acceptance of the first hypothesis (H1). As they are shown to face larger agency problems, companies with high free cash flows will have a greater opportunity to do profit management. It relates to the Jensen and Meckling (1976) theory agency posits a conflict of interest between the principal (director) and the agent. While the manager wants a free cash flow for reinvestment, the principal wants a dividend. If the company's profit target does not meet expectations because the investment result does not yield a profit to the company, the manager is asked to use profit management to cover losses arising from the use (Watriani & Serly, 2022).

This research aligns with a study carried out by Watriani & Vanica (2021) as well as Kodruyah and Anisah (2018) which stated that Earning management is significantly positively influenced by free cash flow. While Nazalia and Dedik (2018) and Susanti and Kevin (2017) gave the opposite research results that the high or low value of free cash flow companies will not affect the management of corporate profits.

Second, the test results showed that financial distress did not exert a significant influence on earning management, as indicated by a significance level of 0.059 or above 5% which meant that the second hypothesis (H2) was rejected.

Companies in financial distress will not always do profit management in attracting or retaining investors. This is because profitability is not the only factor that is considered by investors when investing such as the application of CSR, GCG or corporate profitability (Tanaya & Lodovicus, 2021). Profit-management measures can be detrimental to the bigger companies ahead of them. The management would prefer to report the profit as a good sign to the outside who would be able to reduce the information asymmetric rather than doing profit management (Moratis, 2018). When a company is in financial distress, investors may think twice about putting it in or continuing to put it in the company. However, there is a possibility that investors can continue to put them in considering other factors of the company such as the good image that the company has can restore the company's financial condition in the future. However, if a company has already experienced financial distress and is indicated to engage in fraudulent actions such as profit management, it is more likely that investors will not invest their funds in the company and this makes it increasingly difficult for the company to solve the difficulties of its financial conditions due to the low capital it owns (Irawan & Apriwenni, 2021). This is supported by a study by Tannaya & Lasdi (2021) that proves that companies in financial distress will not always do profit management to cope with it. In contrast, Nazalia and Dedik (2018) asserted that financial distress has a notable impact on profit management.

Third, test results showed that employee Diff had no significant impact on Earning Management with a significance rate of 0.449 or above 5% which means the third hypothesis (H3) was rejected. Whether or not an employee is different in a company does not affect the management's action to do profit management. (Susanti & Kevin, 2021). The findings of this study refute the agency theory positing information asymmetry between management, which possesses more information regarding financial data disparities (income growth) and non-financial data (employee growth) than other parties in a company. Such a situation can be exploited by management to maximize its own profits (Saputri & Tarmizi, 2017). Companies should pay attention to the effectiveness of the number of employees, whether with a few or many employees can significantly increase the company's profits (Kurniasih, 2017). It shows that the gap between income growth and employee growth does not mean that managers are manipulating financial reports and earning management actions. So, employee diff is not a factor that affects earning management. The outcomes of this study align with the findings of the research conducted by Susanti and Kevin (2017) and Kurniasih (2017) with the results of the employee diff study have no influence on earning management. Instead, the research with different results carried out by Nazalia and Dedik (2018) and Tatar & Sujana (2021) which stated that employee differential influences on earnings management.

Fourth, the test results showed that Earning management was not significantly influenced by Corporate Social Responsibility, as indicated by the study's results with significance rate of 0.480 or above 5% which meant that the fourth hypothesis (H4) was rejected. Referring to the theory of legitimacy, companies need the support of the public so that the company can operate well and continue to carry out responsibility activities towards the environment and social. This awareness of the legitimacy of the society is what drives the company to reveal CSR and further limit the existence of profit management actions. The wider the CSR disclosure then will not affect the management of a company to carry out a profit management action. This is because the main purpose of disclosure of Corporate Social Responsibility (CSR) activities by the company serves to enhance the company's profile and reputation positively, so that the company will limit the profit management actions that are not in line with the purpose of the company. Business fraud practices conducted by management can be said to be conducting irresponsible practices (Solikhah, 2022). Companies responsible for the environment will report the true information about the company. The fraud practice can also affect CSR disclosure information, so that when indications of profit management are found, then the public and investors do not believe in the truth of such disclosures CSR, investors will not be sure investing in the company can be influenced by the company's reputation, and the findings of this study are corroborated by Solikhah (2022) who stated that CSR does not affect profit management, while Santi & Wardani (2018) stated CSR has an influence on profit management. The legitimacy gained by a company through the disclosure of Corporate Social Responsibility (CSR) is utilized by the company to mask its profit management activities.

D. CONCLUSIONS

The conclusion drawn is that (1) free cash flow influences income management, as companies with higher free cash flows are more likely to engage in profit management, indicating increased principal-agent problems. (2) financial difficulties do not affect income management, which suggests that facing financial problems will not always do profit management. (3) employee diff has no impact on earning Management because large or no employee different within an enterprise does not affect the management actions to carry out profit management (4).

The limitation faced by researchers when collecting and processing data is that the data required by that researchers on the website www.idx.co.id is incomplete. The study uses only four independent variables and a three-year observation period, so it has not been able to describe earning management as a whole.

The study's ramifications contribute to a comprehension of the practices that companies can use to conduct profit management. Implications are that regulators and supervisors need to improve their understanding of profit management strategies and develop better rules and guidelines to prevent profit management in companies. Furthermore, this study can help investors and analysts to identify and understand profit management practices which can affect the performance of companies. The implications are important for investors to analyze financial statements and look for indications of potential profit management practice before making investment decisions.

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