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The Effect of Free Cash Flow, Dividend Policy, and Financial Leverage on Earnings Management

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ABSTRACT: This research was conducted to empirically examine the effect of free cash flow, dividend policy, and financial leverage on earnings management of manufacturing companies. The research population was 157 manufacturing companies in 2017 to 2018. Samples were obtained using the nonprobability sampling method with a purposive sampling technique. The number of research samples were 34 companies in 2 years of observation, so that 68 observations were obtained. The data analysis technique is multiple linear regression. The analysis shows that free cash flow has a negative effect on earnings management. Dividend policy has a negative effect on earnings management. While financial leverage has no effect on earnings management.

KEYWORDS: *earnings management, free cash flow, dividends, financial leverage*

I. INTRODUCTION

Financial statements have an important role for internal and external parties of the company for decision making related to the company. Users of financial statements often only pay attention to the value of a company's profits without seeing how profits are generated. This resulted in management being able to take opportunistic actions towards profits. Earnings management actions taken by management aim to maximize the welfare of the management or increase the value of the company. Some parties consider earnings management practice is not an act of fraud, but a legal action to do, because earnings management activities are the impact of generally accepted accounting principles. Accounting principles provide freedom for management to choose the accounting methods the company wants to use in accordance with company goals.

One case of profit management in manufacturing companies is the case of PT Tiga Pilar Sejahtera (AISA), which is suspected to have manipulated its financial statements. Starting from the company's shareholders refusing to approve the 2017 financial statements on the grounds of one of the shareholders namely KKR & Co. L.P. still question the existence of an unclear flow of funds to third parties. Another conflict also occurred because AISA's shareholders and commissioners asked for a change of company management, which in the end of October 2018 management was taken over by Hengky Koestanto who was previously a company commissioner and approved at the Extraordinary General Meeting of Shareholders (EGMS).

At this EGMS shareholders also requested that an 2017 financial statement be investigated. The results of an investigation conducted by PT Ernst & Young Indonesia (EY) found allegations of markups in the accounting post of Rp.4 trillion, suspected Rp662 billion in revenue swelling, and alleged swelling of Rp.662 billion in revenue. others valued at Rp.329 Billion in the profit before interest, tax, depreciation and amortization (EBITDA) account, as well as the alleged flow of funds of Rp.1.78 Trillion from the AISA group to parties suspected of being affiliated with the old management. Another thing that was found was the difference in the presentation of financial records between internal data and notes used by 2017 financial auditors. Another problem arose within the company, namely the issue of default on bonds due to 4 bankrupt subsidiaries. This problem in AISA has resulted in the cessation of AISA stock trading by the IDX since July 5, 2018.

The cases that occur indicate that management has the opportunity to take earnings management actions. Earnings management actions taken by company management can be based on various factors. Earnings management is influenced by one factor, the availability of free cash in the company. Free cash flow is free company cash that can be used for various activities and not used as working capital. Jensen (1976) states that if free cash flow in a company is not used or invested to maximize or balance shareholder income in the form of profitable investments, it will increase agency problems.

Managers will tend to act opportunistically to benefit themselves by investing in projects that are less profitable. Then to hide the negative effects of these less profitable investments, then managers will try to increase company profits. When control in the company is weak, the manager will manipulate profits when the company

has excess cash. Research on the effect of free cash flow on earnings management conducted by Barkhordar and Tehrani (2015) found that free cash flow had a significant effect on earnings management, while Nazalia and Triyanto (2018) found that free cash flow had no effect on earnings management.

The information asymmetry that occurs between managers and shareholders as a result of the separation of ownership and management of a company is one of the reasons management performs earnings management because it can cause agency problems. One of the information asymmetries is related to a company's dividend policy. Dividend policy can be used as a reason for managers to process profits because it is determined by the AGM and not a management decision (Putri, 2012). This can lead to a conflict of interest between the shareholders and the manager. Conflict between management and shareholders through dividend policy can cause managers to manage earnings to maximize the manager's personal profit. Research on the effect of dividend policy on earnings management conducted by Barkhordar and Tehrani (2015) found that dividends had a significant effect on earnings management, different results were obtained by Wirawati et al., (2018) who found empirical dividends had no effect on earnings management.

Another factor that can also influence the management of earnings management is the level of corporate leverage. This is because companies are motivated to show a good reputation not only for investors, but also for creditors as lenders. Financial leverage is the use of a source of funds that has a fixed burden, with the expectation that it will provide additional benefits that are greater than the fixed expense, so that shareholder profits increase. Companies with a high degree of leverage are usually motivated to do earnings management when the company is getting closer to violating the debt agreement. This is consistent with the debt covenant hypothesis which states that the closer a company is to a violation of accounting based on a debt agreement, the tendency is the more likely the company manager chooses the accounting procedure by changing reported earnings. Research Barkhordar and Tehrani (2015) examine the effect of financial leverage on earnings management to get the results that free cash flow, leverage has a significant effect on earnings management, while Ardiyansyah (2015) research found leverage does not significantly influence earnings management.

This study is a replication of the study of Barkhordar and Tehrani (2015) which examines the effect of free cash flow, dividends, and leverage on earnings management on the Tehran Stock Exchange. This research was conducted to re-examine the factors that influence earnings management. Based on the background that has been described, this study was conducted to re-examine the effect of free cash flow, dividend policy, and financial leverage on earnings management in manufacturing companies listed on the Stock Exchange for the 2017-2018 period.

Agency theory states that management and company owners have different interests. Three basic human assumptions used in agency theory according to Eisenhardt (1989), namely: (1) selfishness, (2) having limited thinking about future perceptions, and (3) always avoiding risk. Such assumptions can cause managers as human beings to act opportunistically or prioritize their personal interests.

Positive accounting theory seeks to explain a process of using knowledge understanding and accounting policies that are most suitable for dealing with conditions in the future. The principle of positive accounting theory holds that the purpose of accounting theory is to explain and predict accounting practices. Watts and Zimmerman (1986) formulated three hypotheses based on predictions made by positive accounting theory (PAT), namely 1) Hypothesis of bonus plans. 2) The debt contract hypothesis. 3) The political cost hypothesis

Signal Theory explains how to give company signals to parties who are interested in the information. The provision of information is expected to be able to convince external parties related to the profit presented by the company, especially for external parties who lack understanding of financial statements can utilize management information and financial ratios in measuring the company's prospects. The positive signal given by the company will influence the decisions of shareholders which in turn will affect the increase in share ownership. Providing information to outsiders will be able to reduce information asymmetry by providing true and trustworthy information.

Free Cash Flow is cash flow available within a company that can be used for payments to investors after the company has invested to maintain ongoing operations. Companies that have a large free cash flow indicated a large agency problem so that they are more likely to act opportunistically with earnings management. In such conditions managers will act opportunistically by taking actions that are less favorable for the company, but can benefit himself. Activities undertaken can be in the form of investing in unprofitable projects, excessive investments, and misuse of funds that can harm shareholders. Managers will carry out earnings management with the aim to hide the negative impacts of these projects. Barkhordar and Tehrani's research (2015) states that free cash flow has a direct effect on earnings management. Research by Kono and Yuyetta (2013), Dewi and Priyadi (2016), and Kodriyah and Fitri (2017) also obtained the results of free cash flow which had a positive effect on earnings management. Based on the theory presented and the results of previous studies, this study proposes the first hypothesis as follows.

H1: Free cash flow has a positive effect on earnings management

Dividend policy is the company's decision to distribute profits to shareholders as dividends or hold it in the form of retained earnings to finance future investments. Managers tend to want a low dividend distribution that will

provide benefits for managers, while shareholders want their profits divided in the form of dividends with a high amount. Bird in the hand theory explains that shareholders prefer cash dividends today rather than waiting for capital gains in the future, because the distribution of cash dividends signifies certainty which means reducing risk for shareholders.

The higher the level of dividend distribution, it can reduce earnings management actions. This is in accordance with the theory of signals that explain how the giving of signals in the form of information to interested parties, so as to convince external parties related to the profits generated. Dividend distribution is a good signal for investors that indicates the company is in good condition and has good prospects in the future, so that it can increase stock prices. High stock prices indicate the company has a greater responsibility to maintain investor confidence, so that to maintain the company's good reputation, managers will avoid earnings management actions that can reduce the company's reputation. Research conducted by Fajri (2018), and Dahayani et al., (2017) states that dividend policy has a negative and significant effect on earnings management. Based on the description of the theory and the results of previous studies, the second hypothesis put forward in this study is.

H2: Dividend policy has a negative effect on earnings management

Financial leverage is the financing of a portion of a company's assets with securities that have a fixed (limited) interest rate with the expectation of an increase in funding for shareholders. Companies with high levels of leverage are more likely to experience bankruptcy if the company concerned cannot pay off its debts in the face of external financing. Leverage can be a motivation for earnings management to fulfill debt agreements arising from long-term debt contracts. This is consistent with the hypothesis contained in the positive accounting theory that is the debt contract hypothesis which states that the closer a company is to a violation of a debt agreement, the more likely the company manager to change reported earnings. Research conducted by Barkhordar and Tehrani (2015) states that financial leverage has a significant effect on earnings management. These results are in line with the research of Prastiti and Meiranto, (2013), Amertha et al. (2014), and Agustia and Suryani (2018) who found that leverage had a positive and significant effect on earnings management. Based on the theory and results of previous studies, the third hypothesis in this study is.

H3: Financial leverage has a positive effect on earnings management

II. METHODS

This research uses a quantitative approach in the form of an associative causality relationship to empirically examine the effect of free cash flow, dividend policy, and financial leverage on earnings management. The company studied was a manufacturing company listed on the IDX. Data was obtained from the IDX's official website, the Indonesia Stock Exchange (IDX) website. The object of this study is the earnings management of manufacturing companies from 2017 to 2018. Used as the dependent variable in this study is earnings management, while free cash flow, dividend policy, and financial leverage are used as independent variables.

The free cash flow variable is calculated using the formula (Agustia, 2013):

$$\textit{Free Cash Flow} = \frac{(AKO - PM - NWC)}{\text{total asset}} \quad \ldots\ldots (1)$$

Information:
AKO: Operating cash flow
PM: Capital expenditure
NWC: Net Working Capital

Kebijakan dividen dalam penelitiam ini menggunakan proksi *Dividen Payout Ratio* (DPR)dengan formulasi berikut (Martono dan Harjito, 2010: 4):

$$DPR = \frac{\text{Dividends per share}}{\text{Earnings per share}} \times 100\% \quad \ldots\ldots (2)$$

This study uses the ratio of debt to equity to measure the level of financial leverage. (Sonadi, 2018)

$$\textit{Financial leverage} = \frac{\text{total debt}}{\text{total equity}} \quad \ldots\ldots (3)$$

This study uses discretionary accruals with the Modified Jones Model as a proxy for measuring earnings management. The calculation formula using the Modified Jones Model is as follows:

$$TACit = NIit - CFOit \quad \ldots\ldots (4)$$

Calculates the total accrual value (TAC) estimated with the following regression equation:

$$TACit/TAit\text{-}1 = \beta 1i(1/TAit\text{-}1) + \beta 2i(\Delta REVit/TAit\text{-}1) + \beta 3i(PPEit/TAit\text{-}1 \quad \ldots\ldots (5)$$

By using the regression coefficient, the Nondiscretionary Accrual (NDTA) value can be calculated using the formula:

$$NDTACit = \alpha i\ (1/TAit\text{-}1) + \beta 1i\ ((\Delta REVit - \Delta RECit)/\ TAit\text{-}1) + \beta 2i\ (PPEit/TAit\text{-}1\ ) + \varepsilon \quad \ldots\ldots (6)$$

Discretionary Accrual (DTA) is the residual obtained from the estimated total accruals calculated as follows:

$$DTAC = (\ TACit/TAit\text{-}1) - NDTACit \quad \ldots\ldots (7)$$

(Muliati, 2011)

Information:

DTACit = Discretionary accrual of company i in period t

NDTACit = Non Discretionary accrual of company i in period t

NIit = Net income of company i in period t

TACit = Total company accrual i in period t

CFOit = Flow of operating cash flow of company i in period t

TAit-1 = Total assets of company i in period t-1

ΔREVit = Difference in company income i in period t withcompany revenue in period t-1

PPEit = Fixed assets of company i in period t

ΔRECit = Difference in company receivables i in period t with company receivables in period t-1

ß = Regression coefficient

Ɛ = Error term

The analysis technique used is multiple linear regression. The results of the analysis are expressed in the form of linear regression equations as follows.

$$\hat{Y} = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \mathcal{E} \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots (8)$$

Information:

Ŷ = earnings management

α = constant value

X1 = Free cash flow

X2 = dividend policy

X3 = Financial leverage

ß1 = Regression coefficient of free cash flow (X1)

ß2 = Regression coefficient of dividend policy (X2)

ß3 = Regression coefficient of financial leverage (X3)

Ɛ = Standard error

III. RESULT AND DISCUSSION

Descriptive statistics is an analysis to see the minimum, maximum, mean, and standard deviation of each research variable. Descriptive statistical test results are presented in Table 1.

Table 1: Descriptive Statistics of Research Variables

	N	Minimum	Maximum	*Mean*	Std. Deviation
Free Cash Flow	68	-0,5577	0,5690	-0,2235	0,1949
DPR	68	0,0741	0,9849	0,4237	0,2101
Financial leverage	68	0,0906	3,6093	0,7204	0,6855
Profit Management	68	-0,1942	0,1732	-0,0465	0,0565
Valid N (listwise)	68				

Secondary Data, 2019

The minimum value of earnings management is -1,949 which is owned by PT Hanjaya Mandala Sampoerna Tbk. (HMSP) and the maximum value is 0.1732 owned by PT KMI Wire and Cable Tbk. (KBLI). The mean value for the earnings management variable is -0.0465. The standard deviation of earnings management variables is 0.0565.

The minimum value of free cash flow is -0,5577 owned by PT Delta Djakarta Tbk. (DLTA) and the maximum value is 0.5690 owned by PT Unilever Indonesia Tbk. (UNVR). The mean value for the free cash flow variable is -0.2235. The standard deviation of free cash flow is 0.1949.

The minimum value of the dividend policy is 0.0741 owned by PT Lionmesh Prima Tbk. (LMSH) and the maximum value is 0.9849 which is owned by PT Hanjaya Mandala Sampoerna Tbk. (HMSP). The mean value for the divient policy variable is 0.4237. The standard deviation of dividend policy is 0.2101.

The minimum financial leverage value is 0.0906 owned by PT Industri Jamu and Pharmacy Sido Muncul Tbk. (SIDO) and the maximum value is 3.6093 owned by PT Indal Aluminum Industry Tbk. (HENNA). The mean value for the financial leverage variable is 0.7204. The standard deviation of financial leverage is 0.6855.

Multiple Linear Regression

Table 2.
Multiple Linear Regression Analysis

Keterangan	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
constant	-0,052	0,025		-2,140	0,036
Free Cash Flow	-0,099	0,043	-0,340	-2,279	0,026
DPR	-0,067	0,032	-0,250	-2,127	0,037

Financial leverage	0,017	0,012	0,208	1,419	0,161
Adjusted R^2			0,129		
F_{hitung}			4,294		
Sig. F			0,008		

Secondary Data, 2019

Based on the results contained in Table 2, the following regression equation can be made.
$\hat{Y}$ = -0,052 - 0,099 X_1 - 0,067 X_2 + 0,017 X_3……….…..…………...………….…..(9)
The constant value of -0.052 indicates that if free cash flow, dividend policy, and financial leverage are equal to zero, then earnings management will decrease by 0.052 units. The value of the regression coefficient of free cash flow of -0.099 indicates that if free cash flow increases by one percent, then earnings management will decrease by 0.099 percent assuming other variables are constant. The regression coefficient value of dividend policy of -0.067 indicates that if the dividend policy goes up one percent, then earnings management will experience a decrease of 0.067 percent, assuming other variables are constant. Financial leverage regression coefficient of 0.017 indicates that if financial leverage increases by one percent, then earnings management will increase by 0.017 percent assuming other variables are constant.
The adjusted R square value of 0.129 indicates 12.9 percent of the earnings management variance of manufacturing companies listed on the Indonesia Stock Exchange in 2017-2018 explained by the variable free cash flow, dividend policy, and financial leverage, while the remaining 87.1 percent is influenced by factors other factors not included in the regression model. The model feasibility test (F test) is a test conducted to find out whether all the independent variables simultaneously influence the dependent variable. Regression results show the value of Fcount (4.294)> FT table (3.14), and sig. F = 0.008 <α = 0.05. These results indicate that the equation model in this study is feasible to use, and together (simultaneously) variable cash flow, dividend policy, and financial leverage have a significant effect on earnings management.
The t value of the calculated free cash flow variable was -2.279 while the t value of the Table was 1.66901, and the significance value of the t test (p-value) was 0.026 <α = 0.05, and the value of the regression coefficient was -0.099. These results mean that the free cash flow variable has a significant negative effect on earnings management. These results signify the first hypothesis (H1) in this study was rejected. The results of this study do not support the research of Kono and Yuyetta (2013), Dewi and Priyadi (2016), and Kodriyah and Fitri (2017) which states that free cash flow has a positive effect on earnings management. The results of the descriptive statistical analysis indicate that the average free cash flow in the company used as a sample is relatively low. This causes a statement in the research hypothesis which states that the higher free cash flow can cause increased earnings management, contrary to the results of the analysis obtained. Based on descriptive statistics and regression analysis that has been done, this study found that free cash flow had a negative effect on earnings management. This means that the lower free cash flow available within the company can increase earnings management actions. The results of this study are in line with the studies of Agustia (2013), Febriarti (2013), and Widianingrum and Sunarto (2018) states that free cash flow has a significant negative effect in earnings management in manufacturing companies listed on the Indonesia Stock Exchange.
The t-value of the dividend policy variable is -2,127 while the t-table value is 1.66901, and the t-test significance value is 0.037 <α = 0.05, and the regression coefficient is -0.067. These results mean that the dividend policy variable has a significant negative effect on earnings management. These results signify the second hypothesis (H2) in this study was accepted. The higher dividend payout ratio can reduce earnings management actions. This is consistent with signal theory because the distribution of dividends is a good signal for investors which indicates that the company is in good condition and has good prospects in the future, so as to increase share prices. Companies with high stock prices have a greater responsibility to maintain investor confidence, so managers will avoid earnings management actions that can reduce investor confidence. The results of the study are in line with the research of Fajri (2018), and Dahayani et al., (2017) who in their research show that dividend policy has a negative effect on earnings management.
The t value of the calculated financial leverage variable is 1.419 while the value of t table is 1.66901, and the value of sig. t test (p-value) of 0.161> α = 0.05, and the regression coefficient value of 0.017. These results mean that financial leverage does not have a significant effect on earnings management. These results signify the third hypothesis (H3) in this study was rejected. High or low level of corporate financial leverage does not affect the management's decision to conduct earnings management. The results of this study contradict the results of research Prastiti and Meiranto, (2013), Amertha et al. (2014), Barkhordar and Tehrani (2015), and Agustia and Suryani (2018) which prove that financial leverage has a significant positive effect on earnings management. Financial leverage does not affect management in earnings management due to the results of descriptive statistical analysis which shows that the company used as a sample has a low average financial leverage. This indicates that the average sample company is still able to fulfill the agreement in its debt contract using the company's equity. Therefore, financial leverage in this study does not affect the management's

decision to manage earnings. The results of this study support the research of Sufiantoro (2007) and Upayarto (2013) which found that financial leverage had no significant effect on earnings management actions.

IV. CONCLUSION

Based on the results of the analysis and discussion described, it can be concluded that free cash flow has a negative effect on earnings management. When free cash flow is available in a small company, the company will try to do earnings management so that the company's stock price can increase. Dividend policy has a negative effect on earnings management of manufacturing companies. The higher dividend payout ratio will be able to reduce the possibility of earnings management practices. Financial leverage does not affect the earnings management of manufacturing companies. High and low financial leverage of the company does not affect the management's decision to manage earnings.

For further researchers can add other independent variables or add control variables such as company size, bonus compensation, taxes, and others. Future researchers can also use other sectors listed on the IDX. For investors to be able to pay attention to the company's financial information first before making an investment decision.

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