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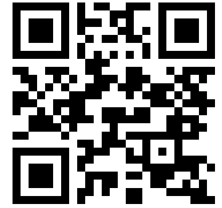
Effect of Leverage and Free Cash Flow on Earnings Management with an Independent Audit Committee as a Moderation



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ABSTRACT: This study aims to examine the Effect of Leverage and Free Cash Flow on Earnings Management with the Independent Audit Committee as a Moderating Variable. The samples used were manufacturing companies in the basic and chemical industry sectors that were listed on the Indonesia Stock Exchange (IDX) and published annual reports and sustainability reports for the 2018-2020 period.
Sampling was carried out using the purposive sampling method. Data analysis used in this study used Panel Data Regression Analysis with the Eviews 9 application tool. The results of this study indicate that the free cash flow variable as measured by DAC has a negative effect on earnings management. However, the leverage variable as measured by DAR has a positive effect on earnings management. The moderating variable, namely the independent audit committee as measured by the independent audit committee ratio, is unable to moderate the relationship between leverage and free cash flow on earnings management.

KEYWORDS: Leverage, Free Cash Flow, Earnings Management and Independent Audit Committee

I. INTRODUCTION

Financial statements are information presented by the company to convey the company's financial performance in a certain period. The preparation of financial reports is carried out by applicable standards to produce complete and accurate information. According to Handayani (2014) quality financial reports are reports that are relevant and reflect the condition of the company, besides that financial reports, must be comparable and timely. These financial statements are the basis for decision-making by users, for example, investors and creditors. Financial reports are used by investors and creditors to measure the company's prospects. Therefore, quality financial reports are needed to avoid mistakes when measuring company prospects. The prospect that is the center of attention of investors and creditors is the company's ability to earn profits. This is related to the main goal of a competitive economic company which is to obtain maximum profits with long-term company growth to maintain the survival of the company itself (Choiriah, 2019). Profit is also used by the company to measure the performance of managers who are responsible for that period. Seeing the importance of profit for investors and creditors as a reference for measuring company prospects, many managers practice earnings management to gain the trust of investors and creditors.

The 2019 earnings management case in Virginia that befell Comscore. The Securities and Exchange Commission (SEC) sued Comscore and former CEO Serge Matta for a fraudulent scheme that involved overstating revenue by $50 million and making false statements about Comscore's financial performance. From February 2014 to February 2016, Comscore under the leadership of CEO Serge Matta reported revenue from engineered transactions. the earnings management case in Virginia in 2019 that befell Comscore. The Securities and Exchange Commission (SEC) sued Comscore and former CEO Serge Matta for a fraudulent scheme that involved overstating revenue by $50 million and making false statements about Comscore's financial performance. From February 2014 to February 2016, Comscore under the leadership of CEO Serge Matta reported revenue from engineered transactions. . This scheme makes it appear as if Comscore is exceeding its revenue targets and creates the illusion of smooth and steady growth. Comscore and CEO Serge Matta agreed to pay a fine of $5,000,000 and $700,000, respectively (CNBC 2019).

Schipper (1989) explains that earnings management is intentional management intervention in the profit determination process, usually to fulfill personal goals. According to Sulistyanto (2008) earning management is an attempt to manipulate the numbers in the financial statements by playing with the accounting methods and procedures used by the company. Earnings management carried out by managers reduces the credibility of financial reports and harms users of financial statements in

making decisions because the information presented is not under facts. Earnings management is a complex phenomenon and has a broad meaning.

Debt is one source of company funds from creditors. The company will try to fulfill the debt agreement so that creditors obtain adequate assurance. This motivates managers to practice earnings management to fulfill the debt agreement. Because companies that do not fulfill debt agreements have the potential to face possibilities such as accelerated maturity, increased interest rates, and renegotiation of debt terms (Herlambang 2017). Free cash flow is company cash that can be distributed to creditors or shareholders that is not used for working capital or investment in fixed assets (Ross et al. 2000). Companies that have high free cash flow will have a greater possibility of carrying out earnings management practices to cover manager performance that is not optimal in utilizing company wealth (Bukit & Iskandar, 2009). To minimize earnings management practices, an independent party within a company is needed, and that party is the Independent Audit Committee. The audit committee is very important to assist the board of commissioners in overseeing the internal control system and the implementation of the duties of external auditors and internal auditors (POJK.04, 2016). The audit committee holds regular meetings to ensure audit quality is always maintained. Regularly scheduled audit committee meetings will assist the audit committee in monitoring accounting records and internal control systems. Similar to the auditor, the audit committee is also required to be independent in carrying out its duties, this demand is in line with the reasons for the stock exchange to make regulations concerning the independence of the audit committee.

II. BASIC THEORY AND HYPOTHESIS DEVELOPMENT

Agency Theory

Agency theory is a contract under one or more which involves the agent carrying out several services for the principal by delegating to the agent in the form of authority in decision-making (Jensen & Meckling, 1976). Because managers as agents are given authority by the principal to manage the company and provide rewards for good performance by managers. For this reason, managers have the opportunity and motivation to carry out earnings management practices to get rewards for their performance. Managers and shareholders have different goals and each wants their goals to be fulfilled, the result is a conflict of interest. Managers will want to provide incentives or maximum compensation for the performance that has been carried out in the company, while shareholders prefer large returns as soon as possible from the investment that has been invested (Zakia et al., 2019). Companies that face high monitoring and contracting costs tend to choose accounting methods that can increase reported profits, and companies that face high political visibility tend to choose accounting methods and techniques that can report lower profits.

Earning Management

According to Scott (2003) Earnings management can be seen from the point of view of contracts and financial reporting. From the point of view of earnings management contracts are considered a way to protect themselves and the company in anticipating unexpected events for the benefit of all parties involved in the contract. Profit is the main element in financial statements and is very important for those who use it because it has predictive value. However, in practice, companies often carry out earnings management so that the predictive value of these earnings becomes imprecise. According to Scott (2003), there are four patterns of earnings management carried out by companies, namely taking a bath, and income minimization to avoid a high tax burden, because the higher the profit, the higher the tax burden. The income maximization that is carried out will stop when it reaches the stamp in the bonus and income smoothing scheme which gives a stable impression on published financial reports to attract the attention of investors.

Leverage

Leverage or solvency is a ratio to determine a company's ability to pay its obligations (Rice, 2016). Creditors see leverage as a level of security in returning loan funds if the company is liquidated (Sari & Khafid, 2020). Leverage plays an important role in companies obtaining funds from creditors. Leverage is a company's performance in using assets or fixed costs (debt or special shares) to realize its goals to increase the wealth of company owners.

Free cash flow

Free cash flow is company cash that can be distributed to creditors or shareholders that are not used for working capital or investment in fixed assets (Ross et al., 2000). Free cash flow is one of the factors that attract investors, because the greater the free cash flow, the company's ability to pay dividends increases. However, free cash flow that is too high is also not good, because companies must manage this money to generate greater profits. Free cash flow is the remaining cash flow that is

distributed to shareholders after the company pays all operating, investment, and financing expenses to maintain current product capacity (Tualeka et al., 2020).

Independent Audit Committee

The audit committee is one of the committees formed by the board of commissioners and is responsible to the board of commissioners with the main duties and responsibilities of ensuring that the principles of Good Corporate Governance are applied consistently and adequately by executives. The audit committee has an important role in maintaining the credibility of financial reports by maintaining the company's oversight system so that the process of preparing financial reports can run according to applicable standards and rules. The duties of the audit committee include reviewing accounting policies adopted by the company, assessing internal controls, reviewing external reporting systems, and compliance with regulations.

Effect of Leverage on Earnings Management

Companies that have high leverage ratios due to a large amount of debt compared to the assets owned by the company are threatened with failing to fulfill obligations under debt contracts. Accelerating maturity, increasing interest rates, and renegotiating debt terms are the consequences that can occur if the company violates the debt contract (Herlambang, 2017). To avoid violating the debt contract, managers practice earnings management. The higher the leverage, the higher the motivation of managers to carry out earnings management. This indicates that Leverage affects Earnings Management.

Effect of Free Cash Flow on Earnings Management

A high level of free cash flow is considered ineffective because the funds should be used to increase the value of the company. Companies that have high free cash flow tend to practice earnings management because managers try to hide their poor performance in managing company assets which fail to generate high ROA. The failure of managers to produce high ROA motivates managers to carry out Earnings Management. On this basis, the Free Cash Flow affects Earnings Management. Research conducted by Astami et al. (2017); Irawan & Apriwenni (2021) concluded that Free Cash Flow affects Profit Management.

High leverage motivates managers to practice earnings management by manipulating the company's financial reports which result in a decrease in the credibility and quality of financial reports. High free cash flow indicates poor management performance in managing assets. To cover up their poor performance, managers practice earnings management. Lack of supervision and internal control of the company is an opportunity for managers to manage earnings. The Audit Committee plays an important role in minimizing the occurrence of earnings management practices in a company. Plays an important role in ensuring that the company's financial statements are presented appropriately according to applicable standards, so the credibility and quality of the company's financial reports can increase and prevent managers from manipulating these financial reports (Rahmah & Soekotjo, 2017).

Variable operational definitions

Research variables are determined, but based on theory and confirmed by hypotheses. The variables used in this research are the dependent variable and the independent variable.

The dependent variable in this study is earnings management using the Modified Jones Discretionary accruals model from Dechow et al. (1996). Leverage is measured using total debt divided by total assets. Free cash flow is measured using NOPAT minus net investment in operating capital (Brigham and Houston, 2010). While the audit committee is based on the number of independent audit committees divided by the number of audit committees in the company.

III. RESEARCH METHODOLOGY

This form of research is causality. Causality studies are designed to test hypotheses about the effect of one or more variables (independent variables) on another variable (dependent variable). Namely by analyzing and explaining the effect of the independent variables on the dependent variable. This study examines the impact of leverage and free cash flow on earnings management. The independent variables in this study are leverage, free cash flow, independent audit committee, and earnings management which influence each other. The population of this study is manufacturing companies listed on the Indonesia Stock Exchange (IDX) from 2018 to 2020. Sampling in this study used a purposive sampling method, which is a sampling method that meets research standards and objectives. The criteria for this research sample include Basic and chemical industries listed on the Indonesia Stock Exchange (IDX) from 2018 to 2020. The data used is data prepared by companies including annual financial reports, and annual reports, as well as data obtained from other parties, include company websites and other sites related to research. The following is the research model:

$$EM = \alpha + \beta 1LE + \beta 2FC + \beta 3LE*IAC + \beta 4FC*IAC + \varepsilon$$

IV. RESULTS AND DISCUSSION

Based on the results of data processing it can be seen that

Table 1. Statistik Deskriptif

	N	Min	Max	Mean	Std. Deviation
LE	96	.0188	2,58	.4892	.2765
FC	96	-5,86	8,83	1,15	1,5600
EM	96	-0,9416	0,3419	0,0453	0,2025
IAC	96	0,166	0,667	.03628	0.09488
Valid N (listwise)	96				

Individual Significance Test Results

Based on the descriptive statistical test table 1, it shows that Profit Management (EM) has the lowest (minimum) value of -0.941616 and the largest (maximum) value is 0.349129 while the average value (mean) is 0.045373 with a standard deviation value of 0.202549. Leverage (LE) has the lowest (minimum) value of 0.018856 and the largest (maximum) value of 1.988846. While the average value (mean) is 0.489269 with a standard deviation value of 0.276581.

Free cash flow (FC) has the lowest value of -5.86E+12, namely for companies, and the largest value of 8.83E+12. While the average value (mean) is 2.58E+11 with a standard deviation value of 1.56E+12. The independent audit committee (IAC) has the lowest (minimum) value of 0.166667 and the largest (maximum) value of 0.666667, namely. Meanwhile, the average value (mean) is 0.362847 with a standard deviation value of 0.094883.

Before proceeding with the regression test, this study was preceded by classical assumptions. the classic assumption results show that this study has passed the normality, heteroscedasticity, multicollinearity, and autocorrelation tests.

Table 2. Coefficient Overall Test Results

VARIABEL	+ / -	β	t	Sig
LE	+	0.130	3,9086	0.0002
FC	-	-4,72	-0,8319	0.4087
L *IAC	+	0,4426	0,3399	0.4907
FC*IAC	-	-6,82	-1,392	0.1689

Based on statistical testing and the results of the significance test can be seen in the table 2 above. From the t-statistical test between each independent variable on the dependent variable it can be explained as follows:

The results of the hypothesis test show that the Leverage (LE) t value is 3.9086 and the significant value of the Leverage variable is 0.0002 which is less than 0.05, so the test results show that Leverage proxied by debt divided by company assets has a positive effect on profit management which is proxied using Discretionary Accruals with the Modified Jones Model. Companies with high leverage ratios due to the large debt compared to the assets owned by the company, tend to carry out earnings management because the company is threatened with default, that is, it cannot fulfill its debt obligations on time. Companies with high leverage ratios also have weak supervision of management which causes management to make decisions and set inappropriate strategies (Angelina & Atiningsih, 2020). The greater the leverage ratio, the greater the dependence of the company on creditors. To get loans from creditors, management will be motivated to carry out earnings management, because before making loans, creditors will assess the company's performance through the company's financial reports (Angelina & Atiningsih, 2020), (Madbouly 2021; A. R. Sari & Meiranto, 2017).

The results of the hypothesis test show that the free cash flow (FC) t-count is -0.8319 and the variable probability value is 0.4087 or greater than α = 0.05, which means that free cash flow does not affect earnings management. Companies that have high or low free cash flow values will not affect management's motivation to carry out earnings management because the main reason for management to carry out earnings management is to avoid pressure from their superiors, both directors and commissioners. If the company already has large funds that are not used for operational needs, then management already looks good in the eyes of directors and commissioners. In addition, many investors care more about the company's free cash flow, because the higher the free cash flow, the higher the company's ability to pay dividends, therefore management no longer needs to do earnings management. On the other hand, some companies think that high free cash flow is not good for the company, because

unused cash should be used to generate greater income, therefore management's motivation to carry out earnings management is not influenced by increases or decreases in free cash flow. in line with Bhundia's research (2012); Fatmala & Riharjo (2021); Tualeka et al., (2020).

Based on the results of the Moderating Regression Analysis (MRA) test, the interaction variable between the leverage variable and the independent audit committee on earnings management shows a value of 0.4907, this value is greater than 0.05. This means that the independent audit committee does not affect the relationship between leverage and earnings management. This explains that the existence of an independent audit committee in a company cannot prevent management from carrying out earnings management if the company has a high leverage ratio. Companies with high leverage ratios will still motivate management to carry out earnings management because companies are very dependent on creditors and management also gets pressure from stakeholders if the company fails to get funding from creditors. Thus, the independent audit committee is unable to moderate the relationship between leverage and earnings management in line with previous research conducted by Rahmah & Soekotjo (2017).

Based on the results of the Moderating Regression Analysis (MRA) test, the interaction between the free cash flow variable and the independent audit committee on earnings management shows a value of 0.4907 where this value is greater than 0.05. This means that the independent audit committee does not affect the relationship between free cash flow and earnings management.

The existence of an independent audit committee in a company that already has a high free cash flow value will not have much effect on management behavior in managing earnings. High free cash flow has made management lose its purpose in managing earnings. Therefore, the independent audit committee does not affect the relationship between free cash flow and earnings management, in line with research conducted by Setiawati & Rosit (2019) and Fatmala & Riharjo (2021).

V. CONCLUSION

The results showed that Leverage had a positive effect on Earnings Management and after being moderated by the Audit Committee it had no effect. This is because the independent audit committee in the company cannot prevent a high leverage ratio from occurring due to greater pressure from their superiors. Free Cash Flow does not affect Earnings Management. Companies with a high level of free cash flow will eliminate management's goal of managing earnings and after being moderated by an independent audit committee there is also no significant effect so the existence of an independent audit committee does not have much effect on management behavior.

SUGGESTION

Based on the conclusions above, suggestions that can be given regarding this research in the future are expected to be able to present higher quality research results with some input regarding several things including, in future studies can use the same variables with different research samples originating from other sectors such as the real estate sector, housing, trade with a larger sample size to obtain more accurate results so that comparative results can be obtained from each study. Suggestions for companies, it is hoped that company parties, especially company management, can think of more appropriate strategies to prevent Earnings Management from being able to increase the credibility of company financial reports by submitting financial reports that are factual and accountable because the information presented in the company's financial statements become the basis for decision making of users of financial reports both external and internal.

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