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Employee Diff, Free Cash Flow, Corporate Governance and Earnings Management

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Abstract

This study aims to test if employee diff and free cash flow can lead the desire of managers to manipulate the earnings in two different conditions: intensive monitoring and less intensive monitoring. Sample of manufacturing companies is taken from the list of Indonesia Stock Exchange during the period 2011 to 2013. Using multiple regression analysis, discloses that: in less intensive monitoring, managers tend to manipulate earnings when company has excess cash and the existence of employee diff. Monitoring system needs to be intensified especially for companies with the above characteristics.

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Keywords: Earnings Management; Employee Diff; Free Cash Flow; Institutional Ownership; Board Independent; Audit Committee

1. Introduction

Earnings manipulation has been a negative trending topic in accounting literature, which is regarded as a tool for managers to fulfill their personal interest. In this case, the managers change and manipulate profit, with the purpose of deceiving and misleading the view of the reader of financial statements, about the firms' real condition (Healy & Wahlen, 1999). Manipulation in earnings incident that shocked the business world, such as Enron and Worldcom cases, has caused huge losses for businesses and the accounting profession. Public accounting profession has also received public attention and provokes public confidence, with respect to the failure of Arthur Andersen accounting firm in carrying out the functions of independent attestation. Not only abroad, earnings management cases also

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occurred in Indonesia such as PT Ades Alfindo case, the case of PT Indofarma, Tbk, PT Perusahaan Gas Negara case, the case of PT Bank Lippo and Case of PT Kimia Farma Tbk (Sulistiawan, Januarsi, & Alvia , 2011, p . 53-64). Earnings management practice often creates agency problems, information asymmetry, losses, and the crisis of investor confidence (Healy & Wahlen, 1999).

Past studies suggest the need to investigate the earnings management practices from two points of view, such as incentive view and monitoring view. From the incentive view, past study suggest that employee diff, that is the difference between employee growth and revenue growth, may influence a firm revenue fraud with a high risk. For example, Brazel, Jones, and Zimbelman (2009) find that the inconsistency patterns between non-financial measure, such as employee growth, and the financial measure, such as revenue growth, was higher for fraud firms than for non-fraud firms. The company's financial performance which is not parallel with non financial figures may be a clue to accounting fraud. This is still rarely investigated.

Another incentive view, free cash flow can provoke earnings manipulation practices. Although theoretically there is no relationship between free internal operational funds with investment, but empirically there is correlation between excess cash and investment. Firm managers tend to use free cash flow as for investment rather than for dividends (Agrawal & Zong, 2006).

Investments that have good prospects will benefit shareholders, and vice versa. But, for bad investment decision, there is a tendency the manager wants to cover up the firm poor performance from the view of the investors. To mislead the shareholders about the company's prospects, the managers may report the firms' performance with earnings management practices (Chung, Firth, & Kim, 2005). However, the influence of free cash flow on earnings management is rarely tested.

Given the impact of losses incurred in an accounting manipulation case, the effective monitoring system is very important. Effective preventive measures will be able to reduce the cost of investigation and detection. Past studies show that good corporate governance may improve the monitoring system of the company. However, as accounting manipulation cases still remain a lot, many parties re-question the effectiveness of firm monitoring mechanisms. This study examines whether employee diff and free cash flow motivate managers to practice earnings management depend on the firm monitoring system.

2. Background and hypotheses

2.1. Earnings management

Earnings management occurs because a manager uses the opportunity of his/ her actions to satisfy his/ her own interests (Healy & Wahlen, 1999). The manager is responsible for the provision of the financial statements to show the performance of the company to the shareholders. In preparing these financial statements, the manager may use discretion in selecting accounting principles (Healy & Wahlen, 1999). Managers select accounting principles to demonstrate the achievement of profit targets that reflect the prospects of the company in the future (Chung, Firth, & Kim, 2005). The manager may alter and manipulate the earnings numbers to obscure the view of investors about the real firm' performance (Healy & Wahlen, 1999).

Since income manipulation is an ill-favored practice, it reduces transparency and increases fraudulent information. Earnings management which is done intentionally by managers could be considered as irregularities or fraud (Rezaee, 2005). SEC in the United States revealed some large companies that go bankrupt caused by the manipulation practice of financial statements through earnings management (Rezaee, 2005).

Managers manipulate earnings at the instigation of two motives. First, opportunist motives that managers change firm' earnings figures to mislead investors to meet the manager's personal interests (Healy & Wahlen, 1999). For example, the manager changed the profit figures, in order to look better, by inclusion of expected revenues or defer losses (Healy & Wahlen, 1999). The managers wish to get personal benefits, such as greater compensation, better reputation and higher stock prices. Higher profit figure is expected to obscure the view of investors, especially in making investment decisions. Second, the information motive, namely managers implements earnings management to convey their personal information and expectations about the future prospects of the company (Christie & Zimmerman, 1994). For example, when a manager has personal information about the company's future prospects, the manager felt the need to change the profit figures in order to reflect better conditions. Whatever the motives of the manager, whether

opportunistic motives or information motives, cause the users of financial statements feel difficult to distinguish them (Healy & Wahlen, 1999). Based on the previous discussion that the motive of the manager using earnings management is difficult to know, and then this study will describe the drives and the limitations for company's manager to manipulate the accounting numbers.

2.2. Incentives and monitoring of earnings management

Earnings management practices can be seen from two factors: the incentive factor and monitoring factor (Bauwhede, Willekens, & Gaeremynck, 2003). An incentive is an encouragement or motivation, either financial or non-financial figure, which causes a person to involve an action. Some examples of incentive factor, which encourages the practice of earnings management, is asset utilization (Ang, Cole, & Lin, 2000), free cash flow (Chung, et al., 2005), the investment decisions (Richardson, 2005) and employee diff (Brazel et al., 2009).

Monitoring is the control or limitation of managerial opportunistic behavior. Examples of monitoring factors, which may limit the managerial opportunistic behavior, are monitoring mechanism of corporate governance ((Wang & Campbell, 2012), ownership monitoring (Jensen & Meckling, 1976; Koh, 2003) and supervision of the capital market (Chung et al. 2005). The presence of shareholders, who have interest and desire to oversee the management of the company, is expected to control the managerial behavior in choosing the accounting methods that benefit themselves.

2.3. Employee diff and earnings management

Several factors which drive the manager to change the profit to the level they wanted could be: huge losses, business failures, strong competition, and high growth. The manager wants to satisfy interested parties, the capital market and fulfill debt covenants. If a manager can convert the data on sales, revenues or profits, then he or she will also able to adjust non financial data, so that the action does not appear doubtful. But some non financial data can't be set easily in a short time, for example: consumer satisfaction levels, number of employees, and number of facilities. The non compatible between financial data (such as revenue growth) and non-financial records (such as employee growth), which is called employee diff, could provoke suspicion that the company does not provide real financial information (Brazel, et al., 2009; Ames, Brazel, & Jones, 2012). Based on the above arguments, this study promotes hypotheses 1 as below:

H1: Employee diff is positively related with earnings management.

2.4. Employee diff and earnings management

Managers who use free cash flow for their own benefits rather than for the benefit of the shareholders tend to report higher earnings (Gul & Tsui, 1998). They change the earning figure and conceal their opportunistic action. Although managers are authorized by the shareholders, to manage and control the company with an aim of maximizing the shareholders' interests but some managers also promote his/hers own interests (Jensen and Meckling, 1976). This authorization gives managers the absolute power to act on behalf of shareholders. When a firm possesses free cash flow, the firm manager is expected to decide on investing the free cash flow in profitable investment activities which generate high returns.

The free cash flow theory anticipates, however, that managers often use free cash flow on investments with negative present values (Jensen, 1986). This behavior may have a negative impact on the welfare of the shareholders because it may lead to earnings management practices that mislead shareholders believe that their manager always seeking high profit with their excess cash (Christie & Zimmerman, 1994). There is a possibility that excess cash opens an opportunity to managers to practice earnings management (Chung et al., 2005; Gul & Tsui, 1998). Thus, managers practice earnings management to hide the real picture of company poor performance. To confirm the possibility, hypothesis 2 is constructed as follows:

H2: Free cash flow is positively related to earnings management.

2.5. Interaction role of Institutional ownership (IO)

Institutional shareholders, especially those that have a significant stake, have the power and incentive to oversee the company's operations as they are concerned with the performance and survival of the company (Koh, 2003). Institutional shareholders have the ability to express their views with regard to the prosperity of the company through the general meeting of shareholders, as a policy to distribute excess cash in the form of dividends. They also have the ability to acquire and process information to evaluate the firm performance and make investment decisions. Hence, institutional shareholders are believed to be able to limit earnings management practices, especially in companies that have excess cash or employee diff.

2.6. Interaction role of Independent board (IB)

The increasing the number of independent directors of board looks likes to be a good practice to limit the income manipulation (Wang & Campbell, 2012). Musteen, Datta, and Kemmerer (2010) found that independent board exhibited better reputations than that non independent board. The present of outsider director in board of directors, who have interest and desire to oversee the management of the company, is expected to control the managerial behavior in choosing the accounting methods that benefit themselves.

2.7. Interaction role of Independent audit committee (IAC)

Audit committee has a significant role in overseeing the financial reporting process. When there is a dispute between auditors and management, audit committee acts as the intermediary. To achieve the effectiveness of the audit committee responsibility, the SEC set rules on independence of audit committee members in order to carry out the task and to properly monitor the firm without pressure from the management. Independence is viewed as the important factor for encouraging the effective governance (Wang & Campbell, 2012). Thus, independent audit committee are expected to conscientiously monitor and control the earnings management practices, particularly in the condition where firms have high free cash flow or high employee diff.

It may be stated that free cash flow (FCF) drives earnings management practices more among firms with low IO/ low IB/ low IAC compared to firms with high IO/ high IB/ high IAC. Thus, it is hypothesized as follows.

H3A: The interaction between FCF and IO affects earnings management

H3B: The interaction between FCF and IB affects earnings management

H3C: The interaction between FCF and IAC affects earnings management

This study argues that employee diff is related with earnings management practices more among firms with low IO/ low IB/ low IAC compared to firms with high IO/ high IB/ high IAC. Thus, it is hypothesized in the following manner.

H4A: The interaction between employee diff and IO affects earnings management

H4B: The interaction between employee diff and IB affects earnings management

H4C: The interaction between employee diff and IAC affects earnings management

3. Methodology

3.1. Sample description

The sample of this study is chosen from all manufacturing firms listed on Indonesia Stock Exchange, from 2011-2013. The sample only includes firms with complete data for all selected variables for each year from the website www.idx.com which contains annual report information. Table 1 describes the sample selection procedure which produces the test sample of 243 firm-year observations.

Table 1 Sample selection criteria

	Number of firm-year
Manufacturing firms (2011-1013)	420
Firm listed on JSE inconsistently	(27)
Firm with insufficient data	(42)
Firm reporting losses	(108)
Test sample	243

3.2. Operationalization of variables

The study uses the Chen, Lee, and Li, (2008) and Chung et al. (2005) discretionary accruals to measure earnings management. The model for discretionary accruals (DAC) is as follows.

$$TAC_{it}/TA_{i,t-1} = DAC_{it}/TA_{i,t-1} + NDAC_{it}/TA_{i,t-1} \quad \text{.....(1)}$$

Non-discretionary accruals (NDAC) are determined by the economic environment of the firms, i.e., the change in earnings after being adjusted by accounts receivables and property, plant and equipments (Jones 1991; Dechow, Sloan, & Sweeney, 1995). The difference between the expected and actual total accruals represents discretionary accruals (εit).

$$TAC_{it}/TA_{i,t-1} = \alpha_0\,(1/TA_{ji,t-1}) + \alpha_1[(\Delta REV_{ji,t-1} - \Delta AR_{ji,t})/TA_{ji,t-1}] + \alpha_2(PPE_{ji,t}/TA_{ji,t-1}) + \varepsilon_{ji,t} \quad \text{.....(2)}$$

Table 2 summarizes the operationalization of variables under study.

Table. 2 Variable Definition and Operationalization

Variable	Definition	Operationalization
Dependent Variable		
EM	Earnings Management	Discretionary accrual based on Modified Jones Model (Chen et al., 2008; Chung et al., 2005).
Independent Variable		
FCF	Free Cash Flow	EBIT minus depreciation and amortization / Total asset beginning of the year (Chi, 2005).
E_DIFF	Employee Diff	The absolute value of the difference between revenue growth and employee growth (Brazel et al., 2009)
Variabel Moderating		
	Monitoring System	
IO	Intuitional Ownership	The percentage of shares held by institutional shareholders (Chung et al., 2005).
IB	Independent Board	The ratio of independent board and the total number of board (Koh, 2003)
IAC	Independent Audit Committee	The ratio of independent audit committee and the total number of audit committee (Bukit & Iskandar, 2009).
Control Variable		
DEBT	Debt	Debt to Total Asset Ratio (Chung et al., 2005).
AUD	Audit Quality	Auditor Dummy, Big 4=1; Non Big 4 = 0 (Chung et al., 2005).

GROWTH	Firm Growth	Price Earnings Ratio (Chung et al., 2005).

The following equation (3) represents the model of this study.

$$EM = \alpha_0 + \alpha_1 FCF + \alpha_2 EDIFF + \alpha_3 IO + \alpha_4 IB + \alpha_5 IAC + \alpha_6 DEBT + \alpha_7 GROWTH + \alpha_8 AUD + \varepsilon \quad \text{.....(3)}$$

4. Results

4.1. Descriptive statistic

Table 3 shows firm characteristics for the sample. The mean of discretionary accruals is 0.0877. The mean of free cash flow is 0.0433. The mean of employee diff is 0.2011. The average of institutional ownership is 28.86% of firms' equity. The average of board independent is 38.68%. The variable PER has the highest mean with the highest standard deviation, it means that its variation is the largest.

Table 3 Summary Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
Free Cash Flow	271	-,77	1,34	,0433	,20116
Employee Diff	267	,00	2,03	,2011	,24161
Intuitional Ownership	250	,00	,94	,2886	,27044
Board Independent	272	,14	1,00	,3868	,11339
Audit Committee	272	,00	,75	,6273	,13867
Leverage	272	,00	2,17	,4396	,25320
Kualitas Audit	272	,00	1,00	,4338	,49651
Price Earnings Ratio	270	-50,80	181,38	16,2575	19,60860
Earnings Management	272	,00	1,28	,0877	,12074
Valid N (listwise)	243				

4.2. Correlation analyses

Summary of correlations test between the independent variables are shown in Table 4. A small number of independent variables are significantly correlated with each other. The magnitude of correlation coefficients is less than 0.183 (i.e., correlation between FCF and AQ), therefore, the correlations between independent variables should not affect the results of this study (Gujarati, 2003).

Table 4. Correlation test

	FCF	E_Diff	IO	IB	IAC	LEV	AQ	PER	EM
FCF	1								
E_Diff	,021	1							
IO	-,041	-,049	1						
IB	,043	-,089	,0535	1					
IAC	,021	-,068	,0156	-,017	1				
LEV	-,114	,122	-,137**	-,055	,103	1			
AQ	,182***	-,079	-,0485	,067	-,149**	-,054	1		

PER	-,029	-,010	-,0030	,103	-,065	-,028	,077	1	
EM	,150***	,216***	-,0844	-,022	,011	,109	,008	,109	1

4.3. Regressions results

Table 5 summarizes results of testing the regression models (Model 1-4). Results on Model 1 show that free cash flow (FCF) has a significant positive relationship with earnings management (EM) at $p < 0.01$ (β=0.123; t=3.040). The result demonstrates the association between FCF and EM is in the same direction which is in accordance with past studies such as Gul (2001), Chung et al (2005), and Bukit and Takiah (2009). The result supports hypothesis 1. As Brazel et al. (2009) suggested, this study also prove that employee diff (E_Diff) is positively associated with EM at p<.01 (β=0.098; t=3.066), consistent with hypothesis 2.

Table 5. Regression results Model 1-4

	Expected Sign	Model 1	Model 2	Model 3	Model 4
		DV: Earnings Management			
(Constant)	?	,014	,014	-,001	,015
		(,283)	(,282)	(-,018)	(,288)
Free Cash Flow	+	,123	,124	,261	,104
		(3,040)***	(1,931)*	(2,289)**	(,311)
Employee Diff	+	,098	,098	,100	,098
		(3,066)***	(3,060)***	(3,123)***	(3,017)***
Intuitional Ownership	_	-,026	-,026	-,030	-,026
		(-,875)	(-,859)	(-1,017)	(-,875)
Board Independent	_	-,004	-,004	,034	-,004
		(-,054)	(-,056)	(,466)	(-,052)
Audit Committee	_	,044	,044	,046	,043
		(,733)	(,731)	(,757)	(,701)
Leverage	+	,046	,046	,045	,046
		(1,473)	(1,469)	(1,454)	(1,471)
Audit Quality	_	-,003	-,003	-,001	-,003
		(-,184)	(-,182)	(-,043)	(-,178)
Price Earnings Ratio	+	,001	,001	,001	,001
		(1,688)*	(1,683)*	(1,707)*	(1,685)*
FCF*IO			-,003		
			(-,017)		
FCF*IB				-,349	
				(-1,294)	
FCF*IAC					,029
					(,057)
R^2		0.105	0.105	0.111	0.105
Adj. R^2		0.074	0.070	0.077	0.070

Notes: */ **/ *** is statistically significant at the 10% level/ 5% level/ 1% level

Results on Model 2, 3 and 4 in Table 5 incorporate the interaction effects of monitoring variables (i.e. institutional ownership, independent board, and independent audit committee) on the association between FCF and EM such as FCF*IO, FCF*IB, and FCF*IAC. When the variable FCF*IO is included in the Model 2, the direct relationship between FCF and EM is significant at $p<0.10$ ($\beta=0.124$; $t=1.931$). The coefficient of the relationship is still positive but its significant level is lower (from $p < 0.01$ to $p < 0.10$). It means that institutional ownership has the important role in monitoring the earnings management practices, especially in firms with high FCF. However, the coefficient of FCF*IO is not significant ($\beta= -0.003$; $t=-0.017$). The result does not support hypothesis 3A.

Model 3 in Table 5 present the result of the coefficient of FCF*IB which is negative and not significant ($\beta= -0.349$; $t=-1.294$). When the variable FCF*IB is included in the Model 3, the direct relationship between FCF and EM is positive and significant at $p < 0.05$ ($\beta=0.261$; $t=2.289$). But the significance level of the coefficient FCF in the Model 3 is lower than that in the Model 1. This result suggests that the independent board carry out the supervisory functions in controlling opportunistic behavior of managers when the company has surplus cash. However the coefficient of FCF*IB is still not significant. The result does not support hypothesis 3B. Similarly, after the variable FCF*IAC is included in the Model 4, the sign of FCF is positive and not significant ($\beta=0.104$; $t=0.311$). This result suggests that presence of independent audit committee could reduce the practice of earnings manipulation, especially when excess cash is available. However, its effect is still not significant which is inconsistent with hypothesis 3C.

Table 6. Regression results Model 5-6

	Expected Sign	Model 5	Model 6	Model 7
		DV: Earnings Management		
(Constant)	?	,021	,117	,019
		(,392)	(1,978)**	(,345)
Free Cash Flow	+	,122	,118	,123
		(3,013)***	(2,966)***	(3,018)***
Employee Diff	+	,083	-,541	,084
		(1,950)*	(-2,748)***	(1,252)
Intuitional Ownership	_	-,040	-,037	-,026
		(-,986)	(-1,273)	(-,881)
Board Independent	_	-,005	-,237**	-,004
		(-,074)	(-2,442)	(-,052)
Audit Committee	_	,039	,018	,036
		(,642)	(,310)	(,519)
Leverage	+	,047	,064	,046
		(1,486)	(2,044)**	(1,474)
Audit Quality	_	-,003	-,007	-,003
		(-,213)	(-,456)	(-,200)
Price Earnings Ratio	+	,001	,001	,001
		(1,685)*	(1,727)*	(1,696)*
EDIFF*IO		,079		
		(,508)		
EDIFF*IB			1,734	
			(3,286)***	
EDIFF*IAC				,026
				(,230)
R^2		0.106	0.144	0.105

Adj. R^2	0.071	0.111	0.070

Notes: */ **/ *** is statistically significant at the 10% level/ 5% level/ 1% level

Table 6 summarizes results of testing the regression models (Model 5-7). Results on Model 5, 6 and 7 in Table 6 present the interaction effects of employee diff and institutional ownership (EDIFF*IO), of employee diff and independent board (EDIFF*IB), and of employee diff and independent audit committee (EDIFF*IAC); to their relationships with earnings management. The results of this study show that the coefficient of EDIFF*IO (β=0.079; t=0.508) and EDIFF*IAC (β=0.026; t=0.230) are both insignificant in the Model 5 and 7. The direct relationship between employee diff and earnings management is still positive in both Model 5 (β=0.083; t=1.950) and model 7 (β=0.084; t=0.230). The results suggest that the institutional ownership and independent audit committee weaken the positive FCF and EM associations. However, since the interaction effects are not significant in both model 5 and 7, thus these findings do not support the hypothesis 4A and hypothesis 4C. Subsequently, in the Model 6, independent board strengthens the positive relationship of employee diff and earnings management. This finding is inconsistent with the hypothesis 4B.

5. Conclusion, limitations and recommendations

The results of this study show that high free cash flow and high employee diff are important factors for manager to conduct earnings management. Therefore, it is needed to ensure that firms achieve better performance must use their free cash flow in profitable project that could avoid the tendency for them to misbehave themselves and get involved in managing earnings. Furthermore, the reduced earnings management practices would bring the high correlation between the financial measures and non-financial measures. Thus, the present of institutional investors, independent director in board of directors and independent director in audit committee member have important monitoring role in controlling the earnings manipulation, especially in surplus cash firms and high employee diff firms. Still, this study does not present strong evidence of the effective monitoring role of institutional investor, independent board and independent audit committee in explaining the effect of excess cash flow and employee diff on earnings management.

The results offer some practical implications on policy making. The regulatory bodies need to be aware of the possibility of certain misbehavior among firms' managers when excess cash is available and or employee diff is high. The use of excess cash on an unprofitable project could cause the company suffered losses, so that the manager may obscure it by practice the income manipulation that may affect the financial reporting quality. Also, the inconsistent pattern between financial measures and nonfinancial measures may also indicate that the practice of earnings manipulation occurs. Thus, a precautionary monitoring measure needs to be put in place to protect shareholders' interests and to improve the quality of reporting.

Measurements for some variables under study which were adopted from other previous studies may be improved. For instance, the measurement of earnings management used in this study as what is widely used previously may be able to differentiate between the practice of managing earnings resulting from opportunistic behavior of the managers or from the discretionary action of the management to provide internal information. Using firms of manufacturing industry listed on the Indonesia Stock Exchange may limit the generalizability of the results to other firms. Thus, results may be used with caution.

Finally, this study explains the suggestion for future research to search for a better measure of monitoring system. Future research may address the issue of earnings management practices which is motivated by the availability of surplus cash and the existence of employee diff when there is good monitoring system by testing their relationships simultaneously using the structural equation model which is expected to produce a better result as a result of higher testing power and lower testing errors. For instance, the influence of excess cash and employee diff on the earnings management may need to be investigated in more than one situation in order to evaluate whether any monitoring mechanism would be able to reduce such behavior of the management.

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