

THE EFFECT OF SURPLUS FREE CASH FLOW AND AUDIT QUALITY ON EARNINGS MANAGEMENT

**(Empirical Study on Manufacturing Companies Listed on The
Indonesia Stock Exchange from 2013-2016)**



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DECLARATION OF ORIGINALITY

I, Abdurachman, hereby declare that this thesis titled: The Effect of Surplus Free Cash Flow and Audit Quality on Earnings Management (Empirical Study on Manufacturing Companies Listed on The Indonesia Stock Exchange), is real and is my own work, specially written as a partial requirement to complete the Bachelor's Degree of Accounting, and has never been previously presented before. I am fully responsible for this undergraduate thesis.

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MOTTO AND DEDICATION

“Man Jadda Wajada”

“When the snow falls and the white wind blows, the lone wolf dies, but the pack survives.”

“Everything happens for a reason.”

“You have to look within yourself to save yourself from your other self, only then, will your true self reveal itself.”

I dedicate this thesis to:

Ferial Abdullah

Hendra Altessy Vivryanov

Siham Adila

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The writer is aware of his weakness and limitations in writing this thesis, so that any kind of advice and critique is expected to help the writer improve in

the days to come. Last but not least, the writer expects this thesis to be useful to the academic world and all the parties involved.

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ABSTRACT

This study aims to investigate the influence of surplus free cash flow on earnings management, as well as the interaction between audit quality and surplus free cash flow. The dependent variable of this study is earnings management, with surplus free cash flow and audit quality as the independent variables. Audit quality is measured using two measurements, audit firm size and auditor's industry specialization. This study also uses a control variable which is cash flows from operations.

The data used in this study is secondary data obtained from financial statements of 500 manufacturing companies listed on the Indonesia Stock Exchange from 2013-2016 as the sample. This study uses purposive sampling as the sampling method. The method used in this study to examine the interactions between the variables is multiple regression analysis.

The findings in this study indicate that surplus free cash flow has positive significant influence on earnings management. Audit firm size is found to have positive significant effect on earnings management, while auditor's industry specialization do not have a significant effect on earnings management. However, the interactions between both audit quality measurements and surplus free cash flow have significant effect on earnings management.

Keywords: earnings management, surplus free cash flow, audit quality, audit firm size, auditor's industry specialization

ABSTRAK

Penelitian ini bertujuan untuk menginvestigasi pengaruh dari surplus arus kas bebas terhadap manajemen laba, begitu juga dengan interaksi antara kualitas audit dan surplus arus kas bebas. Variabel terikat dalam penelitian ini adalah manajemen laba, dengan surplus arus kas bebas dan kualitas audit sebagai variabel bebas. Kualitas audit diukur menggunakan dua ukuran, ukuran kantor audit dan spesialisasi industri auditor. Penelitian ini juga menggunakan variabel kontrol yaitu arus kas operasi.

Data yang digunakan dalam penelitian ini merupakan data sekunder yang diperoleh dari laporan keuangan 500 perusahaan manufaktur yang terdaftar di Bursa Efek Indonesia dari tahun 2013-2016 sebagai sampelnya. Penelitian ini menggunakan *purposive sampling* sebagai metode pemilihan sampel. Metode analisis yang digunakan penelitian ini untuk memeriksa interaksi antara variabel-variabelnya adalah metode analisis regresi berganda.

Temuan dalam penelitian ini mengindikasikan bahwa surplus arus kas bebas memiliki pengaruh positif yang signifikan terhadap manajemen laba. Ukuran KAP memiliki pengaruh positif yang signifikan terhadap manajemen laba, sedangkan spesialisasi industri auditor tidak memiliki pengaruh yang signifikan terhadap manajemen laba. Tetapi, interaksi antara kedua pengukuran kualitas audit tersebut dan surplus arus kas bebas memiliki pengaruh yang signifikan terhadap manajemen laba.

Kata Kunci: manajemen laba, surplus arus kas bebas, kualitas audit, ukuran KAP, spesialisasi industri auditor

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CHAPTER I

INTRODUCTION

1.1 Research Background

Accounting, as defined by American Institute of Certified Public Accounting (AICPA), is the art of recording, classifying, and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least of financial character, including interpreting the results.

The main function of accounting is to present periodic reports called financial statements for management, lenders, investors and external parties. The financial statements are the result of normal operating activities of the organization. The definition of financial statements in IAS 1 (2009) as follows:

"The financial statements are a structured representation of the financial position and performance of an entity. The purpose of financial statements is to provide information regarding the financial position, financial performance, and cash flows of an entity that is useful for the majority of reports among users in making economic decisions. The financial statements also show the results of management responsibility for the use of resources entrusted to them. "

The financial statements are a tool used by external parties to assess the performance of a company that aims to provide information about the financial position, financial performance, and cash flow of corporate entities (Ikatan Akuntan Indonesia, 2009). The purpose of financial statements is to provide information for users of financial statements to predict, compare and evaluate the ability of companies in generating future earnings or cash flow.

However, shareholders or investors and other external financial report users do not simply believe in the content of the financial statements presented by

the management. The internals of the company needs financial report to assess management's performance in company management, assess the productivity and efficiency of each company, while the external parties, especially investor and creditor, need financial report to assess the company's performance.

Schipper (1989) defines earnings management as management's intervention in the external financial reporting process for the purpose of personal gain. Similarly, Belkaoui (2006) explains that earnings management is management's capability in manipulating financial statements' content on the accrual component to increase the company's profit with the aim to earn personal gains. Earnings management can occur in any part of the financial statement disclosure process or in some parts only by changing the reported earnings figures by utilizing the accounting policy gaps that firms apply in order to look better. Scott (2000) stated that the actions taken by management in the selection of accounting policies for a particular purpose can be considered as a form of earnings management.

There are several personal reasons as to why managers engage in earnings management activity, these reasons include salaries, bonuses, and promotions by relying on performance during the mandatory period. According to Sulistyanto (2008), earnings management activities can still be accepted when the activity still complies with generally accepted accounting principles (GAAP) and current accounting standards. Conversely, if earnings management activities are not in accordance with GAAP and the current accounting standards, it can be categorized as a form of fraud.

The agency problem of earnings management gets worse when companies have surplus free cash flow. According to Jensen (1986), the agency problem between management and external parties is due to the large amount of free cash flow. Free cash flow is net cash flow derived from the remaining funding of all projects with a positive Net Present Value (NPV) when discounted at the relevant cost of capital. According to Ross, Westerfield, and Jordan (2009), free cash flow

is a company's cash that can be distributed to creditors or shareholders that was not used as working capital or investment in fixed assets.

Chung, Firth, and Kim (2005) stated that companies that have free cash flow but low growth opportunities are companies experiencing agency problems. Under such circumstances, managers make ineffective spending and can reduce shareholder wealth. To disguise this unfavorable investment, managers can use accounting policies to increase reported earnings. In addition, the research conducted by Bukit and Iskandar (2009) found that the relationship between surplus free cash flow to earnings management shows that earnings management occurs in companies that have a high surplus free cash flow.

To increase the users of financial statements' confidence on the information presented by the management, the financial statements need to be audited. Agoes (2004), defines audit as an examination conducted critically and systematically by an independent party, the financial statements are presented by management along with the copy of records and supporting evidence, in order to be able to give an opinion on the fairness of the financial statements. While Arens et al (2012) defines auditing as the accumulation and examination of evidence about information to determine and report on the degree of correspondence between the information and established criteria. The auditing activity should be done by a competent, independent person.

To have their financial statements audited, companies usually go to public accounting firms for their audit services. The public accounting profession is a profession of public trust, where people expect independent assessment and impartiality of the information presented by the company management in the financial statements (Mulyadi, 2002). One of the benefits of a public accounting firm is providing accurate and reliable information for decision-making purposes. The fairness of the financial statements that have been audited by a public accountant is more trustworthy than the financial statements that have not been audited.

The users of audit reports are hoping that the financial statements that have been audited by public accountants are free from material misstatement, are credible to serve as a basis for decision-making process and in accordance with accounting principles that are applicable in Indonesia. Therefore, we need a professional service that is independent and objective (i.e. public accountant) to assess the fairness of the financial statements presented by management.

With auditors present, managers are expected to retain their intention to manipulate the information in the financial statements. Since it is auditor's job to prevent any form of intervention to exist in the financial reporting process. Thus, auditor's role is important in the effort to mitigate the agency problems between managers as agents and shareholders as principals.

Carrying out the audit is not merely for the benefit of the client, but also for other parties concerned on the audited financial statements, such as potential investors, investors, creditors, government entities, communities and other relevant parties to assess and take strategic decisions related to the company. In this case, the public accountant is responsible for providing reasonable assurance and opinions on the fairness of the financial statements.

The number of cases of companies that "fall" due to business failure is associated with the failure of auditors, this threatens the credibility of the financial statements. This threat then influences public perception, especially the users of financial reports. Audit quality is essential because high quality audits will produce reliable financial reports as a basis for decision-making. In this regard, the auditor should be able to maintain and improve the quality of the audit resulting from their work.

De Angelo (1981) in Rusmin et al (2014) defines audit quality as the possibility that the auditor will find and report violations within the client's accounting system. The findings of these violations measure the quality of audits related to the knowledge and expertise of auditors. While reporting the violation

depends on the impulse on the auditor to disclose such violations. This impulse will depend on the independence possessed by the auditors.

De Angelo (1981) in Rusmin et al. (2014) argues that the quality of the auditor depends on the relevant auditor's report in contractual relationships and reporting of violations. Violations found by the auditor are influenced by the competence of the auditor's knowledge and ability to disclose the violation. Audit quality is often measured by using the size of the Public Accounting Firm, in which Big 4 accounting firms become a benchmark and a guarantee. Public Accounting Firms such as Pricewaterhouse Coopers, Deloitte Touche Tohmatsu, Ernst and Young, and KPMG are included in the Big 4 Group.

The case of earnings management that shocked the business world, and caused substantial harm to business and accounting profession is Enron and Worldcom scandals. The profession of public accountants received attention and it influenced the public's confidence, in connection with the failure of the firm Arthur Andersen in performing an independent attestation.

The existence of factors affecting earnings management and the inconsistency of results in previous studies make it interesting to investigate this topic deeper. This research examines the effect of surplus free cash flow and audit quality, as well as the interaction between surplus free cash flow and audit quality to earnings management. This study combines three independent variables, i.e. free surplus cash flow and audit quality that is proxied by firm size and auditor's industry specialization, and also operating cash flow as a control variable, in influencing the dependent variable that is earnings management. This study aims to determine the effect of surplus free cash flow and audit quality in earnings management. The difference of this research to previous research is the research sample and audit quality measurements. The previous study used a sample of non-financial companies in 2005-2010, while this study uses manufacturing companies listed in the Indonesia Stock Exchange in 2013-2016, this study also adds auditor's industry specialization to measure audit quality since prior researches

mostly used firm size to measure audit quality. Based on the description above, this research is titled "THE EFFECT OF SURPLUS FREE CASH FLOWS AND AUDIT QUALITY ON EARNINGS MANAGEMENT" (Empirical Study on Manufacturing Companies Listed in The Indonesia Stock Exchange).

1.2 Problems Formulation

The agency theory is a theory that explains the behavior of agents. Agents do moral hazard action to the principal that causes conflict between the two. The presence of information that is not symmetrical makes things worse, where agents know more information than the principals. The principal feels the existence of information asymmetry in which management does not provide information to the principal. Therefore, external audit is needed to prove financial statements that reflect the performance of the company. The audit function reduces the agency costs created by information asymmetry and reduces the control problems caused by the separation of ownership and management (Watts and Zimmerman, 1983).

Chung et al. (2005) in Rusmin (2014) stated that companies with surplus free cash flow face greater agency problems. The agency problem arises when the principal wants free cash flow to be distributed to shareholders. In the absence of effective oversight from shareholders, management prefers to use free cash flow for investment to develop firm size beyond the optimal size or on projects that have negative NPV.

Based on above description, we can formulate the following research questions:

1. Does free surplus cash flow affect earnings management?
2. Does audit firm size affect earnings management?
3. Does auditor's industry specialization affect earnings management?

4. Does audit firm size moderate the relationship between surplus free cash flow and earnings management?
5. Does auditor's industry specialization moderate the relationship between surplus free cash flow and earnings management?

1.3 Research Objectives

This study is undertaken to meet the following objectives:

1. Analyze the influence of surplus free cash flow on earnings management.
2. Analyze the influence of audit firm size on earnings management.
3. Analyze the influence of auditor's industry specialization on earnings management.
4. Analyze whether or not audit firm size moderate the relationship between surplus free cash flow and earnings management
5. Analyze whether or not auditor's industry specialization moderate the relationship between surplus free cash flow and earnings management.

1.4 Research Contributions

This study is expected to deliver the following benefits:

1. For academics, this study is expected to be an addition to the existing knowledge and can be used as a reference for future research to determine the factors influencing earnings management such as surplus free cash flow and audit quality.

2. For investors, this study is expected to be a reference for investment decision-making in the future to assess the quality of the company's financial statements and help investor avoid investing in companies that practice earnings management.
3. For companies, this study is expected to be a source of information so that companies can be more careful in presenting financial statements and avoid earnings management practices that reduce stakeholders' confidence.

1.5 Writing Systematics

CHAPTER I: INTRODUCTION

This chapter describes the background of this study, formulates the problems, elaborates the objectives and contributions, and explains the writing systematic.

CHAPTER II: LITERATURE REVIEW

This chapter contains underlying theories, prior studies, research frameworks, and hypotheses development.

CHAPTER III: RESEARCH METHODOLOGY

This chapter contains the methods that are used to analyze the variables, explains the operational variables, population and samples, data type and source, data collecting method, and data analysis method.

CHAPTER IV: RESULTS AND ANALYSIS

This chapter describes the research object, analyzes the data, and interprets the results of this research.

CHAPTER V: CONCLUSION

This chapter concludes the result of the research, explains the research constraints, and gives advices to help future researches.