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Procedia - Social and Behavioral Sciences 211 (2015) 585 – 594

Procedia
Social and Behavioral Sciences

2nd Global Conference on Business and Social Science-2015, GCBSS-2015, 17-18 September 2015, Bali, Indonesia

# 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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Peer-review under responsibility of the Organizing Committee of the 2nd GCBSS-2015

*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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Peer-review under responsibility of the Organizing Committee of the 2nd GCBSS-2015
doi:10.1016/j.sbspro.2015.11.077

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

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