The Affecting Factors Of Earnings Management In Mining Companies Listed On Indonesia Stock Exchange

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Abstract

This research purpose is to analyze the effect of leverage, free cash flow, and firm size on earnings management of mining companies listed on Indonesia Stock Exchange 2010-2014. Earnings management is managerial activity to intervene in financial statements to generate the desired profit level in income statement. This study uses discretionary accruals as a proxy for earnings management, and Jones Model was used for calculation of discretionary accruals.

The population in this study is all mining companies registered in Indonesia Stock Exchange period of 2010-2014. The samples used are selected using purposive sampling method. Data were analyzed using panel data regression analysis.

The results of study showed that leverage, free cash flow, and firm size have a significant effect on earnings management simultaneously. In partial variable firm size have a significant effect on earnings management with a positive direction. While variable leverage and free cash flow have no significant effect on earnings management.

Keywords: Earnings Management, Leverage, Free Cash Flow, Firm Size.

1. Introduction

The rapid development of business and economic and the increase of a fiercer competition have forced the companies to survive and create excellence in their business field. To be able to compete and grow, the companies need extra capital to support the operational activity, therefore many companies are taking alternative by borrowing funds from the bank or doing stock offering to the public. However, in order to get the funds, the company must gain the trust of the creditor as well as the investor in advance.

The financial statement is one of the information sources about the company condition and performance as well as a communication tool regarding the management work result and the management responsibility to the stakeholder of the resources entrusted to them. Information contained in the financial statement can become the foundation for the stakeholder in measuring the company's ability based on the management's ability to manage the resources and generate profits which presented in the income statement.

Profit is one of the main indicators to measure the management performance and responsibility. The profit information can be used as a guide for investing which helps the investors or other parties in assessing the company's earning power (ability to generate profits) in the future. The tendency of profit observing is realized by the management especially the manager whose performance is measured based on that profit statement, thus encouraging the emergence of earnings management actions.

Earning management is a management intervesion against the financial reporting process in order to gain advantage, both for management and company. Earning management practice has shown the accounting fraud with the findings of manipulation indication of financial statements made by the companies especially in Indonesia mining sector including PT. Bumi Resources, and their two subsidiaries PT. Kaltim Prima Coal (KPC) and PT. Arumtim Indonesia, also PT. Ancora Mining Service (AMS). PT Ancora Mining Service (AMS) which was reported by Forum Masyarakat Peduli Keadilan (FMPK) to the Tax General Directorate (Direktorat Jenderal Pajak - DJP) of Ministry of Finance on 2011 for alleged manipulation of financial statement that was seen in the revenue of 34.9 billion rupiahs but there was no investment activity and the discovery of the evidence of 18 billion rupiahs interest payment whereas the AMS claims to have no debt. FPMK also found the evidence of 5.3 billion rupiahs amounts of receivable but there is no clarity in that transaction (www.republika.co.id, 2011).

Earning management practices conducted PT. Bumi Resource, Tbk can be indicated affected by the leverage. Leverage arises due to the emergence of financing activities of the company to add cash used in operating companies through loans to other creditors.

Free cash flow is another factor indicated that has effects on earnings management, if the company has high *free cash flow* will potentially tend to do earnings management with increasing profit scheme.

Earning management can be seen from firm size. The firm size is the scale to classify big or small the firm is. According to Upayarto (2013) big firm at certain condition will decrease the profit report due to the reported profit is minor that can save the paid tax and employees wage raise demand. Whereas Nariastiti and Ratnadi (2014) state that small firm tend to apply Earnings Management practice to show good company performance in order to gain investors to invest their capital in the companies.

2. Literature Review

2.1. Leverage and Earnings Management

Leverage is the ratio of the total liability with the total asset. The higher the leverage ratio, it means the higher the company debt. Leverage arises because of the funding activity by the company to add cash used in the company operation by loan propose to the bank, other parties, or creditor. The company that has a high leverage caused by the number of loan than the company's asset is alleged to do earnings management practices because that company is threatened to default which unable to meet the obligation to pay the loan on time. The company will try to avoid it by creating a policy which can levitate the incomes and profits (Widyaningdyah 2001). High leverage can also make the company having difficulties on gaining extra funds by loan because the creditor refused to give the loan since they need assurance for that loaned fund.

2.1.2. Free Cash Flow and Earnings Management

Free Cash Flow is an actual cash flow which is distributed to the investor after the company completed all the required investments and work capitals to keep the operation sustainability (Agustina, 2013). Free cash flow is one of the causes of the agency conflict that will cause agency cost. Where free cash flow which meant to be used as the loan payment, and the payment to the stakeholder in dividend form, used by the managers for their personal needs. The management prefers to invest their free cash flow to the new project rather than sharing it to the stakeholder (by dividend or buying back stock). The manager can chose to invest in a non-profitable project or in an over risky project for their own benefits so it can harm the company. The manager can hide the information about the activities with manipulating the account number by the act of opportunistically earnings management by the management to increase the reported profits so it can cover the company's terrible performance.

2.1.3 Firm Size and Earnings Management

According to Marachi (2001); the firm size is a scale to classify big or small a firm is, in Setyaningrum and Sari (2011) big size firms have bigger investor basis, thus they get stronger pressure to deliver a more credible financial statement. Therefore, big firmswill be more careful to deliver the financial statement where the management's pressure to do earnings management practice will be decreased. Where the bigger firm size, then the bigger the firm profit and also the bigger tax (political cost) that the firm must pay. So the firms will prefer a method which can decrease the profit to decrease the tax that the firm must pay.

3. Methodology

The population in this research is all mining companies registered in the Indonesia Stock Exchange in the period of 2010-2014. The mining companies registered in the Indonesia Stock Exchange during the research period are 39 companies. The sample selection method used in this research is non probability sampling, with purposive sampling technique.

The data analysis used in this research is panel data regression analysis. According to Yamin et al (2012:2) there are several models which can be used to estimate the panel data regression model, such as common effect, fixed effect, and random effect. Where to determine which model is the most appropriate to estimate the panel data regression, is the chow test, and the hausman test.

4.ANALYSIS AND DISCUSSION

4.1. The Panel Data Regression Equation

Based on the method testing that has been conducted then the method used in the panel data regression is the fixed effect method. The following is the test result with using fixed effect model

Table 1
Fixed Effect Model

Variabel	Coefficient	Std. Error	t-Statistic	Prob.
C	-4.121781	1.057738	-3.896787	0.0005
LEV	0.197631	0.158396	1.247704	0.2209
FCF	-0.010336	0.110165	-0.093820	0.9258
UKP	0.327129	0.086300	3.790589	0.0006
	Effects Specification			
Cross-section fixed (dummy variabels)				
R-squared	0.649848	Mean dependent var		-0.078038
Adjusted R-squared	0.533131	S.D. dependent var		0.146279
S.E. of regression	0.099949	Akaike info criterion		-1.545131
Sum squared resid	0.329665	Schwarz criterion		-1.063355
Log likelihood	46.76545	Hannan-Quinn criter.		-1.365530
F-statistic	5.567718	Durbin-Watson stat		2.167405
Prob(F-statistic)	0.000057			

Source: the output result of the Eviews 7

According to table 1, it is found that the probability value (F-statistic) is 0.000057. The probability value (F-statistic) amount of 0.000057 < 0.05 so H_{01} is rejected which means leverage, free cash flow, and the company size are simultaneously or altogether having a significant effect to the earnings management of the mining companies registered in the Indonesia Stock Exchange on the period of 2010-2014.

Based on the table 1, it is found that the value of R^2 (Coefficient determination) amount of 0.649848 or 64.9848 %. It shows that the independent variable which consists of leverage, free cash flow and the company size are able to explain the dependent variable which is the earnings management amount of 64.9848 % whereas the rest of 35.0152% is explained by the other variable outside this research.

4.2. The Effect of Leverage to Earnings Management

Based on the test on table , the leverage variable regression coefficient value is 0.197631 with positive direction. Based on descriptive from 55 total observation data, the majority of leverage worth below average is 36 samples or equivalent with 65%, whereas 10 samples or equivalent with 28% are doing income increasing and 26 samples or equivalent with 72% are doing income decreasing. Whereas 19 samples have above average leverage value or equivalent with 35%. Where 5 samples are doing income increasing and 14 samples are doing income decreasing.

The majority of the samples that have below average leverage value is 65% which can describe that the majority of the mining companies in this research sample have the ability to pay their obligations, which shown by the low leverage majority which means that the mining company on the sample reduce the usage of debt on funding the asset. Where theoretically delivered on the state of mind that the company which has a high leverage ratio level tend to do earnings management practice by increasing its profits. So in this research, leverage does not significantly affect the earnings management.

4.3. The Effects of Free Cash Flow on the Earnings Management

According to the test result on table 1, the free cash flow variable has a negative direction. Based on the description, from the total of 55 observation data, the majority of the free cash flow has above average value for 37 samples or equivalent with 67%, where 8 samples or equivalent with 22% are doing income increasing and 29 samples or equivalent with 78% are doing income decreasing, whereas 18 samples have below average leverage value or equivalent with 33%. And where 7 samples are doing income increasing and 11 samples are doing income decreasing.

The free cash flow value in this research is mostly above average, namely 37 samples or equivalent with 67%. The high free cash flow shows that the companies have big actual cash for debt payment and dividend. Therefore the companies do not need to manipulate the profit. This shows that the free cash flow value of a company does not significantly affect the value of discretionary accruals if the free cash flow faces escalation. This does not mean it is followed by the earnings management increasing, and vice versa. White *et al* (2003:68) in Agustia (2013) states that the bigger the free cash flow available in a company, the healthier the company is. Kangarluei et al (2011) in Agustia (2013) finds that the smaller the free cash flow value of a company does not have any significant effect on the earnings management probability.

4.4. The Effects of the Firm Size to the Earnings Management

Based on the testing on table 1, the firm siza does not have any significant effect on the Earnings Management. The net profit variable regression coefficient value is 0.327129 with positive direction. This research result rejects the research of Wuryani (2012), Nariastiti and Ratnadi (2014) which states that the firm size have negative effect on the Earnings Management, which means the bigger the firm size is, then the smaller the Earnings Management practice is. Whereas the result of this research shows that the firm size has positive direction with Earnings Management indication done by the company.

This means that the bigger the firm size, the bigger the probability of Earnings Management indication. This is because big companies are forced to fulfill the demands of the stakeholders, particularly the investors and creditors, because the big company will keep the trust from the stakeholders to keep investing their funds. And this result accepts the positive accountancy theory stated by Watts and Zimmerman (1986) in Shita (2011) which states that the size of the used in the political budget guide and political budget will keep increasing along with the increasing of the company size and risks.

5. Conclusion

The results of this study indicate that only the size of the companies that show the effect on earnings management. While the leverage that describes the level of debt and free cash flow do not affect earnings management.

APPENDIX

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