

# Free Cash Flow, Financial Distress, and Earnings Management: The Moderating Role of Independent Commissioner

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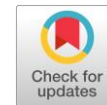
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## ABSTRACT

This study examines the effect of free cash flow and financial distress on earnings management. In addition, this study also examines the role of the independent commissioner as a moderator in the relationship between the independent and dependent variables. The research data is obtained from the financial statements of transportation sub-sector companies in Indonesia listed on the Indonesia Stock Exchange (IDX) for 2018-2020. Based on the purposive sampling method, the final samples used in this study amounted to 87 observations. This study concludes that free cash flow is negatively associated with earnings management, while financial distress is positively associated with earnings management. This study also finds that independent commissioners strengthen the negative effect of free cash flow on earnings management, and independent commissioners weaken the positive effect of financial distress on earnings management. This study indicates that the Financial Services Authority (OJK) needs to carry out supervision and improvement related to the provisions on the recruitment of independent commissioners to improve corporate governance and investor protection.



## KEYWORDS

Earnings Quality  
Free Cash Flow  
Financial Distress  
Independent Commissioner



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## Introduction

Operating profit is one of the important elements in the company's financial statements that function as a measurement of management performance in the company's operations (Agustia, 2013). A company certainly has several objectives in its operation. One of the goals is to obtain the maximum possible profit and maintain the company's viability for as long as possible (Kieso et al., 2018). Companies must efficiently and maximally empower their resources (Setia & Nopiana, 2017). Within a certain period, the profits earned by the company every period need to be reported by the company's management to company owners and other parties who have interests, such as shareholders, through financial reports (Setiawati et al., 2019).

Financial statements are important for external company parties such as investors and creditors because they have the least information regarding the contents of financial statements (Kieso et al., 2018). Profit reporting in financial statements must be reported under the amount of profit obtained by the company. However, there are still many activities carried out by the company's management to make it appear as if the company did not appear to have suffered losses during the corresponding period (Astari & Suryanawa, 2017). Intervention in preparing financial statements is one of the actions that can be taken by company management to make the company look attractive to investors and creditors. Activities, where company management intervenes in the preparation of financial statements that will be used by external parties so that profits can be changed according to the will of management, are called earnings management (Schipper, 1989).

In the United States, there was a case of earnings management in Waste Management Inc (WMI). In November 2017, the Securities and Exchange Commission (SEC) examined WMI's financial statements. It was found that the company announced a change in accounting method that resulted in a loss of \$1.2 billion and a decrease in reported retained earnings of \$1 billion. In 1998, Waste Management Inc. restated the previous period's financial statements. Waste Management Inc. admits it had increased its profit before tax by \$1.7 billion and decreased certain aspects of its tax burden by \$190 million. Waste Management Inc. has increased its net profit after tax by more than \$1 billion. The Securities and Exchange Commission (SEC) asked Waste Management Inc's auditors. to pay a fine of USD 7 million. The Securities and Exchange Commission (SEC) asked partner companies to be fined and prohibited from practicing (Rahma & Muzdalifah, 2014).

In Indonesia, the earnings management case also occurred to PT Kimia Farma. In 2001, PT Kimia Farma reported a net profit of Rp132 billion. The Ministry of SOEs and Bapepam considered that the reported amount was too large, and it was suspected that there was interference in preparing financial statements. In 2002, the 2001 financial statements of PT Kimia Farma were restated, and the total profit presented was Rp32.6 billion, lower than the profit reported in the previous financial report. According to Bapepam, the PT Kimia Farma case violates Bapepam Regulation No. VII G.7 concerning Guidelines for the Presentation of Financial Statements (Stephanus, 2021).

Earnings management actions can affect a financial statement's credibility and accounting information bias. Accounting information in financial statements is used by investors and other parties interested in the company to assess a company and assist in making investment decisions. As a result of earnings management actions, many users of financial statements, especially owners and investors, do not know the essential information about the company's financial condition, so that these parties can experience investment losses (Surahman & Firmansyah, 2017). The occurrence of earnings management is often caused by the existence of asymmetric information between the management (agent) and the owner of the company (principal). The relationship between the management and the company owner can be referred to as an agency relationship (Lisa, 2012). According to Jensen & Meckling (1976), agency relationships arise when an owner employs another party (manager) to run the company and gives that party decision-making authority. The existence of decision-making authority in managing the company can cause managers to know more about company operational information than company owners (Luayyi, 2012). It allows managers to gain personal gain by conducting earnings management to provide inaccurate information regarding the company's performance to owners, investors, and creditors, as well as other parties who use the company's financial statements (Widyaningrum et al., 2018). Thus, earnings management discussions need to be investigated further.

Previous studies which examined earnings management include managerial ownership (Ali et al., 2008; Kouki et al., 2011; Mahariana & Ramantha, 2014), institutional ownership (Jao & Pagalung, 2011; Tehranian et al., 2006; Widyastuti, 2009), firm size (Apriadi et al., 2022; Halim et al., 2005; Llukani, 2013), leverage (Apriadi et al., 2022; Fatmala & Riharjo, 2020; Indriyani, 2010; Puspitasari et al., 2019), profitability (Apriadi et al., 2022; Guna & Herawaty, 2010; Lestari & Wulandari, 2019), audit quality (Boedhi & Ratnaningsih, 2017; Christiani & Nugrahanti, 2014; Indriyani, 2010; Lidiawati & Asyik, 2016), corporate governance (Kouki et al., 2011; Kusumawati et al., 2015; Nasution & Setiawan, 2007), tax avoidance (Prabawa et al., 2020), corporate social responsibility (Prabawa et al., 2020), financial distress (Chairunesia et al., 2018; Effendi, 2019; Handayani & Hariyani, 2019; Riadiani & Wahyudin, 2015), free cash flow (Herlambang et al., 2017; Kosasih & Paramitha, 2021; Nugroho & Agustia, 2017; Puspitasari et al., 2019), audit committee (Sari et al., 2021), independent commissioner (Sari et al., 2021).

The company's financial condition is also related to earnings management activities carried out by managers. Managers will be more aggressive in carrying out earnings management related to certain financial conditions (Muflihah, 2017). The worse the company's financial condition, the more aggressive the manager will be in managing the company's earnings because when the company experiences financial difficulties.

Managers will be responsible for restoring the company's financial condition so that investors remain interested in investing (Farhansyah, 2021). The company has high free cash flow when the company can earn high earnings as well. With the high free cash flow owned by the company, the company can operate the company smoothly and avoid financial distress (Muflihah, 2017). According to Farhansyah (2021), the more free cash flow the company generates, the company will be better able to finance the company's operational costs.

Bankruptcy is one of the conditions that can occur when a company experiences financial difficulties. According to Rahayu et al. (2016), there are two main factors causing bankruptcy: internal and external. Internal factors can be seen in the company's financial performance, such as the lack of revenue receipts from the company's operational business. If the availability of free cash flow in small companies, the company will find it difficult to finance all of its debts. Meryana & Setiany (2021) concluded that a good company could be judged by its free cash flow to measure its ability to finance its debts. One example of an external bankruptcy factor is the covid-19 pandemic, which caused many financial difficulties experienced by various companies, especially in Indonesia (Rahayu et al., 2016). Many companies have experienced financial difficulties and have gone bankrupt since the emergence of the pandemic due to the difficulty of obtaining income due to the many social restrictions in Indonesia (Tannaya & Lasdi, 2021).

Signs of financial distress in a company can be seen through negative net income and book equity value (Tannaya & Lasdi, 2021). Chairunesia et al. (2018) and Handayani & Hariyani (2019) concluded that financial distress is positively associated with earnings management. Thus, managers are more aggressive in performing earnings management if the higher the level of financial distress experienced by the company. In contrast to the research of Effendi (2019) and Riadiani & Wahyudin (2015), financial distress is negatively associated with earnings management. The inconsistency of the previous test results resulted in the testing of financial difficulties on earnings management needs to be reinvestigated.

According to Brigham & Houston (2019), free cash flow is cash available in a certain period and will be paid to all investors for all their investments in the company. High free cash flow can reduce the possibility of earnings management because it shows owners and investors that the company is in good condition. Herlambang et al. (2017), Nugroho & Agustia (2017) found that free cash flow has a negative effect on earnings management. The more availability of free cash flow in the company, the less likely it is that earnings management actions will occur because, without earnings management, the company will still look to be running well (Agustia, 2013). Meanwhile, Kosasih & Paramitha (2021) and Puspitasari et al. (2019) concluded that free cash flow positively affects earnings management. The greater the availability of free cash flow, the greater the possibility that managers are interested in taking earnings management actions. The inconsistency of the previous test results resulted in free cash flow testing on earnings management needs to be reexamined.

This study aims to analyze the effect of free cash flow and financial distress conditions on earnings management. This study also includes an independent commissioner in testing free cash flow and financial difficulties on earnings management which are still rarely used in previous studies. Putri & Rachmawati (2018) have used independent commissioners in testing free cash flow and financial distress on earnings management. Still, there are differences in the use of proxies for variable testing. Putri & Rachmawati (2018) used the Springate Model (1978), while this study employs the Altman (1968) was modified by Graham et al. (1998) as a proxy for financial distress. The model has been adapted to developing countries, so it is more relevant to be used in Indonesia as one of the developing countries in the world (S. A. Nugroho & Firmansyah, 2017; Richardson et al., 2014). In the research of Putri & Rachmawati (2018), earnings management employs the conditional revenue model, while in this study, Kothari et al. (2005) as a proxy for earnings management. The model can detect management actions related to discretionary accruals in financial statements, making it more effective in testing earnings management (Mahari & Purwanto, 2016; Pamungkas et al., 2021).

Independent commissioners are one of the mechanisms for controlling corporate governance. An independent commissioner is a board of commissioners with no business or other relationship with the company so that the independent commissioner can meet the company's expectations in the company's control and supervision process (Tannaya & Lasdi, 2021). The existence of the recruitment of independent commissioners causes company owners (shareholders) to incur agency costs to hire independent commissioners in terms of monitoring the performance of managers so that they act based on the interests of the company. Agency costs are costs that need to be incurred by the company to control and supervise the actions of managers so that they act based on the interests of the company (Sintyawati & Made, 2018).

A higher presence of independent commissioners in a company can reduce the possibility of financial distress the company (Triwahyuningtias & Muharam, 2012). In line with the research of Putri & Merkusiwati (2014), independent commissioners negatively affect financial distress. Independent commissioners can also lead to weaker earnings management practices carried out by managers (Sari et al., 2021). Tannaya & Lasdi (2021) stated that the higher the number of independent commissioners, the higher the level of supervision within the company. Independent commissioners can work more fairly in their supervision so that the company's performance will increase further and maintain the sustainability of the company's life. Therefore, the role of independent commissioners in the company is very important in controlling and supervising the company's operational performance so that the possibility of earnings management in the company can be avoided. Thus, the independent commissioner can be used as a moderating variable in testing the relationship between free cash flow and financial distress with earnings management.

To support the research, this study also employs control variables of profitability, firm size, and leverage. Profitability is a company's management's level of ability/effectiveness in seeking profit. The higher the level of profitability of a company, the company's ability to generate profits (Kasmir, 2014). Fatmala & Riharjo (2020) concluded that the level of profitability has a negative effect on earnings management. It differs from Lestari & Wulandari (2019), which concluded that profitability positively affects earnings management.

Firm size is a scale that can describe the company's size. The size is calculated based on several aspects, such as total assets, shares, sales, income, and others (Riadi, 2020). Large companies will be more supervised by the company's external parties. Therefore, large companies will be more careful in preparing financial statements, making the contents of the financial statements being reported more accurate. Small companies are usually interested in showing the company's condition that always looks good so that investors are interested in investing in the company. Therefore, small companies are more likely to practice earnings management than large companies (Nasution & Setiawan, 2007). In contrast to the research of Watts & Zimmerman (1990), the larger the size of a company, the higher the probability of earnings management due to ownership of higher political costs compared to small companies.

Leverage shows how much the company in its operational activities is financed by debt (Fatmala & Riharjo, 2020). According to Fatmala & Riharjo (2020), companies with a high level of leverage tend to be late in paying debts, resulting in a decrease in the confidence of investors and creditors. Prastiti et al. (2013) and Purwanti et al. (2012) concluded that if a company's leverage is high, the company will tend to carry out earnings management to avoid violating debt agreements by reporting higher profits than it should maintain the company's credibility in the eyes of investors/creditors.

In Indonesia, the transportation sub-sector company is one of the sector companies experiencing financial difficulties; some are even going bankrupt. PT Garuda Indonesia is an example of a transportation sub-sector company experiencing financial difficulties (Ramalan, 2021). PT Garuda Indonesia Tbk until the end of September 2021, it is known that the company is in debt of up to USD 9.78 billion. If it is equated with the rupiah currency, the value reaches Rp. 140 trillion (Putra, 2021). There are several reasons why the company is experiencing financial difficulties, including the Covid-19 pandemic, the imbalance in the amount of debt and the availability of the company's free cash flow, and others. PT Garuda Indonesia continues to increase the types of aircraft owned without considering the company's finances, coupled with

the Covid-19 pandemic. It is increasingly difficult for the company to obtain sufficient operating income due to transportation restrictions in Indonesia (Ramalan, 2021). It shows that it is important for management to pay attention to making decisions in operating the company to be able to control the availability of the amount of free cash flow to avoid the condition of financial difficulties (Rahayu et al., 2016). Seeing these problems, this research is interested in making transportation sub-sector companies the object of research.

This research is expected to contribute to the literature on financial accounting, especially earnings management/earnings quality, by using Indonesian data regarding the effect of free cash flow and financial distress on earnings management. In addition, the results of this study are also expected to provide additional information for the Financial Services Authority (OJK) to improve or improve policies with investor protection in the Indonesian capital market and for the Indonesian Accounting Association (IAI) to improve regulations related to earnings disclosure in the Indonesian capital market financial statements.

### Literature Review and Hypothesis Development

Based on agency theory, conflicts of interest between managers and stakeholders can occur due to asymmetric information. This conflict occurs when managers who are part of the companies internally have more information than stakeholders. This situation opens up opportunities for managers to take policies that can maximize their benefits or cover up the company's financial condition that is not good (Jensen & Meckling, 1976). With discretion over accrual policies, managers can influence accounting numbers in financial statements, such as increasing profits and the value of free cash flows (Putri & Rachmawati, 2018). This action will certainly harm outside parties such as investors, creditors, and stakeholders because the company's profits and free cash flow are aspects that outsiders consider.

Management responsible for preparing financial statements is faced with disclosing the amount of free cash flow available and the company's profits. Still, it does not obtain any reward or manipulate the value to be worth higher. Management obtains a bonus and then maximizes its profits (Jensen & Meckling, 1976).

In financial statement information, free cash flow is one of the important aspects that investors pay attention to. The value of free cash flow in a company describes its ability to finance all of its operations and its ability to pay dividends to investors under the investment value. When a company has a high free cash flow value, investors will be more interested in investing because they consider its ability to pay dividends (Agustia, 2013). Companies with a lot of free cash flow have good financial conditions because many investors are interested in investing, so managers do not need to manage earnings to beautify their financial condition. In line with the results of research by Agustia (2013) and Herlambang et al. (2017), high free cash flow can avoid the possibility of earnings management actions.

One of the main values that investors pay attention to before investing is the free cash flow information. High free cash flow provides information that the company can pay dividends on investments to investors. The company does not need to do earnings management to beautify the company's financial condition. Therefore, the first hypothesis in this study is as follows:

*H1. Free cash flow is negatively associated with earnings management*

Based on agency theory, parties within the company, especially managers, generally have more complete information regarding the company's actual condition than outside parties, namely investors, creditors, and stakeholders (Pramesti & Budiasih, 2017). In asymmetry information conditions, it is difficult for investors to objectively know which companies are of good quality (high-quality firms) and which are of poor quality (low-quality firms). Managers of companies with good or bad quality will claim that the companies they manage have good quality. Companies with poor quality or financial conditions can profit by making fictitious claims that induce investors to believe those claims. To the results of research by (Chairunesia et al., 2018; Handayani & Hariyani, 2019), financial difficulties in a company will trigger managers to take earnings management actions by increasing company earnings. The company's bad financial condition



causes outside parties, such as investors, to be disinterested in investing because of the possibility of earning a small profit. To cover up bad financial conditions and still attract investors, company managers need to carry out earnings management to change bad conditions to be good from the investor's perspective. Thus, the second hypothesis in this study is as follows:

*H2. Financial distress is positively associated with earnings management.*

Based on agency theory, asymmetric information can harm outside parties such as investors, creditors, and stakeholders. Information asymmetry results in company management taking advantage of opportunities to maximize individual profits because management has more company information than outside parties (Pramesti & Budiasih, 2017). The existence of free cash flow has the potential to cause agency conflicts between stakeholders and managers. On the one hand, stakeholders intend the remaining funds to be distributed as dividends. At the same time, managers prefer to invest the available funds in profitable projects to increase future incentives for managers.

To resolve the agency conflict, stakeholders are willing to incur higher agency costs to fulfill their interests (Sartono, 2010). Agency costs are costs incurred by stakeholders to monitor the actions of company managers so that managers can act based on the company's interests (Sintyawati & Made, 2018). One type of agency cost is monitoring costs. Monitoring needs to be carried out by every company to ensure the company can meet the principles of good corporate governance. Stakeholders need to recruit independent parties to monitor company managers and ensure the company is managed in the stakeholders' interests. Independent commissioners are independent parties who can carry out company monitoring activities as one of the mechanisms for controlling corporate governance (Tannaya & Lasdi, 2021).

According to Putri & Rachmawati (2018), the higher the presence of independent commissioners in a company, the stronger the relationship between free cash flow and earnings management. The existence of an independent commissioner in a company causes managers to be more supervised and controlled in making decisions regarding the allocation of free cash flow so that free cash flow can be allocated optimally to finance company operations and pay dividends to investors. Therefore, the third hypothesis in this study is as follows:

*H3. Independent commissioner strengthens the negative effect of free cash flow on earnings management.*

Based on agency theory, the condition of asymmetric information between parties within the company, especially managers and outside parties, namely investors, creditors, and stakeholders, can cause parties outside the company to find it difficult to know the actual condition of a company (Gumanti, 2009). Under these conditions, it is difficult for investors to objectively determine which companies are of good quality (high-quality firms) and which are of poor quality (low-quality firms). Companies with poor financial conditions will try to profit by making fictitious claims that are influencing investors' investment decisions.

Asymmetric information impacts agency conflicts between managers and external parties such as investors, creditors, and stakeholders (Pramesti & Budiasih, 2017). It is difficult for parties outside the company to know the actions and decisions made by company managers in managing the company. One way parties can do this, especially stakeholders, are to issue agency costs. Agency costs are a way to monitor all actions taken by company managers so that managers can act in the company's interests (Jensen & Meckling, 1976). Monitoring costs are one type of agency cost that need to be incurred by stakeholders to be able to provide better supervision (Uzaimi, 2017).

An independent commissioner is a party needed in a company to fulfill the monitoring or supervisory duties required by the company. The monitoring or supervisory function can only be carried out properly by independent parties prioritizing the company's interests over personal ones. Independent commissioners have an independent nature and can carry out the function of monitoring or supervising the actions of the company's management so that no party is harmed as a result of the earnings management actions.

According to Putri & Rachmawati (2018), the higher the level of the independent board of commissioners in a company, the more violations, such as earnings management due to financial difficulties in a company, can be avoided. The existence of independent commissioners in a company can provide

tighter monitoring of all actions of company managers so as not to manipulate financial statements that should be bad when conditions are in financial difficulty so that no party is harmed. Therefore, the fourth hypothesis in this study is as follows:

*H4. Independent commissioner weakens the positive effect of financial distress on earnings management.*

## Research Method

This research is a quantitative method using panel data. Secondary data in this study is from the financial statements of transportation sub-sector companies listed on the Indonesia Stock Exchange from 2018 to 2020. The company's financial statements are obtained from the official website of the Indonesia Stock Exchange ([www.idx.co.id](http://www.idx.co.id)) and the official website of the Indonesia Stock Exchange ([www.idx.co.id](http://www.idx.co.id)). The summary of the research sample based on the purposive sampling procedure is presented in Table 1.

**Table 1.** Research Sampling

Criteria	Number
Transportation sub-sector companies are listed on the IDX until 1 May 2022	49
Companies listed on the IPO on the IDX before 2018	(20)
Companies with incomplete financial statements	-
Number of sample companies	29
Number of years of research	3
Final sample total	87

Source: Secondary data processed

In this study, the dependent variable used is earnings management, while the independent variables used are free cash flow and financial distress. In addition, this study also uses control variables, profitability, firm size, and leverage, as well as moderating variables, namely independent commissioner. Earnings management in this study is proxied by discretionary accruals obtained from the model equation of Kothari et al. (2005), with the following formula:

$$\frac{TACC_{it}}{TA_{it-1}} = \beta_1 \left( \frac{1}{TA_{it-1}} \right) + \beta_2 \left( \frac{\Delta REV_{it}}{TA_{it-1}} \right) + \beta_3 \left( \frac{PPE_{it}}{TA_{it-1}} \right) + \beta_4 (ROA_{it-1}) + \varepsilon$$

The value of discretionary accruals is obtained from the residuals from the regression equation above every year. The residual is then absolute to capture management actions that do not differentiate between increasing and decreasing earnings (Mahari & Purwanto, 2016; Pamungkas et al., 2021). The value of discretionary accruals is absolute, so discretionary accruals caused by earnings management will increase profits and decrease profits.

This study's free cash flow proxy follows Bahrin et al. (2020) and N. L. R. Handayani (2016).

$$FCF = \frac{\text{Net Profit After Tax} - \text{Dividend} + \text{Depreciation}}{\text{Total assets}}$$

In this study, financial distress refers to the model of E. I. Altman (1968), modified by Graham et al. (1998). The model has been adapted to developing countries, so it is more relevant to be used in Indonesia as one of the developing countries (S. A. Nugroho & Firmansyah, 2017; Richardson et al., 2014). The following formula measures the level of financial distress:

$$Z = 1.2 \left( \frac{\text{Working Capital}}{\text{Total Assets}} \right) + 1.4 \left( \frac{\text{Retained Earning}}{\text{Total Assets}} \right) + 3.3 \left( \frac{\text{Profit Before Tax} + \text{Interest Expense}}{\text{Total Assets}} \right) + 0.999 \left( \frac{\text{Sales}}{\text{Total Assets}} \right)$$

The larger Z, the lower the level of financial distress experienced by the company. Therefore, in this study, financial distress will be transformed by multiplying the Z value by -1 so that the resulting Z value of the transformation will show an increase in the value of financial difficulties. The level of independent commissioners is measured using the percentage of independent commissioners compared to the total number of commissioners (Richardson et al., 2014). The proxy in this study was also used in previous studies such as the study by Kusumawati et al. (2015), Nugroho & Firmansyah (2018), and Putri & Merkusiwati (2014), namely:

$$INDCOM = \frac{\text{Number of Independent Commissioners}}{\text{Member of the Board of Commissioners}}$$

Profitability in this study is measured using return on assets (ROA) following the proxy used by Lestari & Wulandari (2019), Muflihah (2017), and Widyaningrum et al. (2018)

$$ROA = \frac{\text{Net income}}{\text{Total Assets}}$$

Firm size is measured using the natural logarithm (Ln) of total assets (S. A. Nugroho & Firmansyah, 2017). The proxies in this study were also used in previous studies, such as research by Astari & Suryanawa (2017), Lidiawati & Asyik (2016), and Pradipta (2019).

$$SIZE = \text{Ln (Total Assets)}$$

The debt measures leverage in this study to equity ratio (DER) by comparing the total debt with the company's total equity. The proxy in this study was also used in previous studies, such as research by Hermuningsih (2012), Novari & Lestari (2016), and Sintyawati & Made (2018).

$$DER = \frac{\text{Total Debt}}{\text{Total Equity}}$$

Hypothesis testing in this study employs multiple linear regression analysis for panel data. There are two models in this study. The equation of model 1 used to test the first and second hypotheses is as follows:

$$AEM_{it} = \beta_0 + \beta_1 FCF_{it} + \beta_2 FINDIS_{it} + \beta_3 ROA_{it} + \beta_4 SIZE_{it} + \beta_5 DER_{it}$$

In addition, the equation of model 2 used to test the third and fourth hypotheses is as follows:

$$AEM_{it} = \beta_0 + \beta_1 FCF_{it} + \beta_2 FINDIS_{it} + \beta_3 ROA_{it} + \beta_4 SIZE_{it} + \beta_5 DER_{it} + \beta_6 INDCOM_{it} + \beta_7 FCF_{it} * KMI_{it} + \beta_8 Z_{it} * KMI_{it}$$

Where:  $AEM_{it}$  is Accrual earnings management in year  $t$ ;  $FCF_{it}$  is Free cash flow in year  $t$ ;  $FINDIS_{it}$  is Financial difficulties in year  $t$ ;  $ROA_{it}$  is Profitability level in year  $t$ ;  $SIZE_{it}$  is Company size in year  $t$ ;  $DER_{it}$  is Leverage rate in year  $t$ ; and  $INDCOM_{it}$  is Independent commissioners level company  $i$  in year  $t$ .

## Result and Discussion

The results of the descriptive statistical analysis of this study are presented in Table 2.

**Table 2.** Descriptive Statistics of Research Data

Va	Mean	Median	Max	Minimum	Std.Dev.	Obs.
AEM	0,0503	0,0361	0,2193	0,0004	0,0457	87
FCF	0,2622	0,1850	0,8357	-0,3345	0,2634	87
FINDIS	-0,9431	-1,0165	3,2101	-6,3080	1,3864	87
ROA	-0,0317	-0,0127	0,3320	-0,4530	0,1148	87
SIZE	28,0416	27,9734	32,6561	25,9004	1,3363	87
DER	1,0683	0,8763	27,3560	-8,6636	3,9652	87
INDCOM	0,3958	0,3333	0,7500	0,2500	0,1156	87

Source: Secondary Data Processed

Table 2 shows that the mean of discretionary accruals is 0.0503, and the median is 0.0369. The maximum value is 0.2193, the value of BIRD in 2020, while the minimum value of all observations is 0.0004, which is the value of PSSI in 2020. The mean of the free cash flow variable is 0.2622, and the median is 0.1850. The maximum value of all observations is 0.835733, which is the value of RIGS in 2020, while the minimum value of all observations is -0.334560, which is the value of CMPP in 2020. On average, the transportation sub-sector companies have a level of financial difficulty. It is low because the mean value is -0.9432, which is greater than the median of -1.0165; the maximum value of all observations is 3.2101, which is the value of CANI in 2020, while the minimum value of all observations is -6, 3080 which is the value of HITS in 2019. The mean ROA value of -0.0317 is smaller than the median of -0.0128; the maximum ROA is owned by HITS in 2019 with a value of 0.3320, while the minimum value of the probability level is in CMPP in 2020 with a value of -0.4530. The firm size has an average of 28,0416, which is greater than the



median of 27,9734; the maximum firm size is at GIAA in 2020 with a value of 32.6561, while the minimum value of firm size is in SDMU in 2020 with a value of 25, 9004. The mean leverage value is 1.0683, which is greater than the median of 0.876321; the maximum leverage value is HRU in 2020 with a value of 27.3560, while the minimum leverage value is CANI in 2018 with a value of -8.6636. The mean value of independent commissioners is 0.3958, which is greater than the median of 0.3333; the maximum value for independent commissioners is IPCM in 2020 with a value of 0.75, while the minimum leverage value is found in several companies, namely AKSI (2020), IPCM (2018, 2019), LRNA (2018, 2019, 2020), and PSSI (2019, 2020) with a value of 0.25.

After performing the Chow Test, Hausman Test, and Lagrange Multiplier Test, the best model chosen for models 1 and 2 is the common effect model (CEM). The summary of the results of hypothesis testing is presented in Table 3.

**Table 3.** Summary of Hypothesis Test Results

Var.	Model 1				Model 2			
	Coeff.	t- Stat.	Prob.		Coeff.	T-Stat.	Prob.	
C	0.222	-3.009	0.003	**	-0.225	-2.977	0.004	***
FCF	0.017	-1.743	0.085	*	0.038	1.077	0.284	
FINDIS	0.008	3.136	0.002	***	0.019	1.901	0.061	*
ROA	0.179	-4.153	0.000	**	-0.228	-5.809	0.000	***
SIZE	0.009	3.571	0.000	***	0.009	3.237	0.002	***
DER	0.001	-2.152	0.034	**	-0.002	-2.927	0.005	***
INDCOM					-0.009	-0.148	0.883	
FCF*INDCOM					0.151	1.938	0.056	*
FINDIS*INDCOM					-0.081	-3.127	0.003	***
R <sup>2</sup>		0.314				0,567		
Adj.R <sup>2</sup>		0.27				0,523		
F-stat		7.444				12,787		
Prob(F-stat.)		0.000				0,000		

Description: \*\*\*) affects the significant rate of 1%; \*\*) affects the significant rate of 5%; \*) affects the significant rate of 10%

Source: Secondary Data Processed

### ***The Association Between Free Cash Flow and Earnings Management***

The hypothesis testing results suggest that free cash flow is negatively associated with earnings management. The result is in line with Agustia (2013) and Herlambang et al. (2017). However, this study's result differs from Kosasih & Paramitha (2021) and Puspitasari et al. (2019). The difference in this study can occur because the sample used is also different from previous research. This study used research samples of transportation sub-sector companies listed on the IDX, while Puspitasari et al. (2019) used research samples of coal companies listed on the IDX.

Based on the results of the descriptive statistics of this study, the mean free cash flow is 0.2622. The result of this study illustrates that, on average, the transportation sub-sector companies in Indonesia have good free cash flow. Proper corporate management with good free cash flow can give a company the ability to pay dividends or obligations to stakeholders so that, according to stakeholders, the company's financial condition looks good and earnings management actions can be avoided. Principals want free cash flow to be distributed to improve their welfare, while managers want free cash flow to enlarge the company beyond its actual size to obtain more profits (Kono & Yuyetta, 2013).

According to agency theory, a good free cash flow can lead to a greater opportunity to take earnings management actions because the company is indicated by a bigger agency problem (Chung et al., 2005).

Companies with a higher free cash flow tend to take earnings management actions by increasing reported company profits to cover optimal manager actions in utilizing company wealth (Agustia, 2013). Therefore, these problems can also provide an opportunity for company managers to take earnings management actions to get more profits. However, the results of this study did not confirm the agency theory. Companies with high free cash flow should be better able to avoid the possibility of earnings management actions so that most transient investors (temporary owners of the company) are more focused on the company's free cash flow information that describes the company's ability to pay dividends.

On average, transportation sub-sector companies in Indonesia have good corporate management, especially in allocating cash flows so that the available cash is allocated to the right things (Ramalan, 2021). High free cash flow and proper allocation of companies in the transportation sub-sector can make the company look good and profitable for investors. This condition causes companies in the transportation sub-sector not to take earnings management actions to attract investors' attention. Therefore, the high free cash flow in the transportation sub-sector companies can reduce the occurrence of earnings management actions.

#### ***The Association Between Financial Distress and Earnings Management***

The hypothesis testing results suggest that financial distress is positively associated with earnings management. The result of this study is in line with Chairunesia et al. (2018) and Handayani & Hariyani (2019). However, this study's result differs from Effendi (2019) and Riadiani & Wahyudin (2015). The difference in the result of this study occurred due to differences in the samples used. The sample in this study is the transportation sub-sector companies listed on the IDX. At the same time, the research by Riadiani & Wahyudin (2015) uses a sample of manufacturing companies listed on the IDX.

Based on the results of the descriptive statistics of this study, the mean financial distress variable ( $Z$ ) is -0.9531. The results of this study illustrate that, on average, the transportation sub-sector companies in Indonesia have a low level of financial difficulty. The level of financial difficulty indicates the existence of financial problems in a company. These problems tend to result in company managers needing to take actions that aim to beautify the contents of financial statements so that the company's condition looks good from the investor's perspective (Putri & Rachmawati, 2018).

Under agency theory, the company generally has more information related to the company's financial condition compared to outside parties such as investors, creditors, or stakeholders. Thus, the company has the advantage of mastering information more than outsiders who are interested in the company. In financial theory, the condition where one party has an excess of information while the other party does not is called information asymmetry. Managers can use this information asymmetry to beautify the contents of financial statements or seek more profits without being noticed by external parties (Gumanti, 2009).

The transportation sub-sector company is one of the corporate sectors in Indonesia that has been affected by the COVID-19 pandemic; trips in Indonesia have been limited for a long time, so profits from buying tickets or using transportation services to travel are getting smaller. As a result, the average transportation sub-sector company experienced financial difficulties, making it difficult to find investors to cover the existing losses. So that these companies can still attract the attention of investors, company managers carry out earnings management to cover the actual condition of the company. One example of a transportation sub-sector company significantly affected by the COVID-19 pandemic is PT Garuda Indonesia (Persero). Tbk, where the company had experienced severe financial difficulties, carried out earnings management to improve the company's condition and still attract attention. Investors (Ramalan, 2021).

Bankruptcy is a condition that all companies fear, so the company will make every effort to maintain the company image in the eyes of investors. Several companies in the transportation sub-sector companies choose earnings management when facing financial difficulties due to the COVID-19 pandemic to maintain a good image in the eyes of investors, so investors will still be interested in investing in profits. Thus, financial difficulties in transportation sub-sector companies can increase the occurrence of earnings management actions.

### ***The Moderating Role of Independent Commissioners in The Association Between Free Cash Flow and Earnings Management***

The hypothesis testing result indicates that independent commissioners strengthen the negative effect of free cash flow on earnings management. The existence of an independent commissioner in a company can strengthen the supervision of the allocation of free cash flow so that earnings management actions can be minimized. An Independent commissioner is one of the mechanisms for applying the principles of good corporate governance to make movements within the company more supervised so that deviant actions in the company can be avoided. The results of this study confirm the research of (Putri & Rachmawati, 2018).

Based on the result of the descriptive statistics of this study, the mean independent commissioner variable (KMI) was 0.3958. It illustrates that Indonesia's average transportation sub-sector company has a sufficient number of commissioners above 30%. With a sufficient number of independent commissioners, the allocation of free cash flow can be more closely monitored so that it can be allocated properly and appropriately (Putri & Rachmawati, 2018).

Under agency theory, a good free cash flow can lead to a greater opportunity to take earnings management actions because the company is indicated by a bigger agency problem (Chung et al., 2005). The agency's problem is that the principal wants to distribute free cash flow to improve his welfare. In contrast, the manager wants free cash flow to enlarge the company beyond its actual size to get more profits (Kono & Yuyetta, 2013). To resolve the agency conflict, the company needs an independent third party to oversee all the actions of company managers so that they remain following the company's interests (Jensen & Meckling, 1976).

Every company needs the role of an independent commissioner to supervise and control the company's performance to create good corporate governance or commonly called good corporate governance. With tighter supervision within the company, company managers cannot arbitrarily carry out earnings management actions to benefit individuals. The existence of an independent commissioner is also able to make the quality of a financial report better because it can include all actual data without any modification by company managers so that external parties such as investors, creditors, and stakeholders can get information related to financial statements accurately (Tannaya & Lasdi, 2021).

To be able to supervise and control the actions of company managers in the context of allocating free cash flow, independent commissioners need to have the right educational background to be able to know the function of free cash flow in a company. The right field of education to understand the function of free cash flow in the company is accounting, economics, management, and business. Several transportation sub-sector companies in Indonesia have recruited independent commissioners with the right backgrounds. Based on searches from notes to financial statements and annual reports of companies in the transportation sub-sector, most companies have placed independent commissioners with the appropriate educational background. This example illustrates that independent commissioners in transportation sub-sector companies can carry out their duties optimally because they have an educational background following their duties.

### ***The Moderating Role of Independent Commissioners in The Association Between Financial Distress and Earnings Management***

The hypothesis testing results indicate that independent commissioners weaken the positive effect of financial distress on earnings management. In conditions of financial difficulty, an independent commissioner is very important to help oversee the decisions made by managers because it follows the second hypothesis that financial difficulties have a positive effect on earnings management. So without an independent commissioner, when the company is experiencing financial difficulties, managers can freely manipulate the contents of financial reports to make the company's condition look good (Tannaya & Lasdi, 2021). The result of this study confirms the research of Putri & Rachmawati (2018).

Based on the results of the descriptive statistics of this study, the mean independent commissioner is 0.3958 %. The result of this study illustrates that the average transportation sub-sector company in Indonesia has a sufficient number of commissioners, above 30%. With a sufficient number of independent commissioners, the supervisory and control tasks within the company can run well (Putri & Rachmawati, 2018).

Based on agency theory, the existence of asymmetric information between the company and outside parties such as investors, creditors, or stakeholders can give company managers the ability to manipulate information to be conveyed to outsiders (Gumanti, 2009). Thus, an independent commissioner is essentially needed to oversee the actions and decisions made by company managers so as not to take actions that harm outsiders utilizing earnings management actions. With good supervision and control of company performance, good corporate governance conditions can be created in a company (Tannaya & Lasdi, 2021).

Financial distress is the worst condition for a company before bankruptcy. Under these conditions, companies are forced to do everything they can to keep attracting investors' attention. Seeing these problems, the supervisory function must be carried out by an independent commissioner with an educational background or the appropriate field to reduce earnings management actions due to financial difficulties. Based on searches from notes to financial statements and annual reports of companies in the transportation sub-sector, most companies have placed independent commissioners with appropriate educational backgrounds.

This appropriate educational background can further maximize the company's supervisory function by an independent commissioner. The maximum level of supervision is that earnings management actions due to the company's bad financial condition can be more easily avoided. If earnings management actions are minimized, the parties outside the company will not be harmed due to the manipulation of financial statement data.

## **Conclusion**

Free cash flow has a negative effect on earnings management. Companies with sufficient profits from the company's operations indicate that the company's financial condition is in good condition, so the manager avoids taking earnings management actions. Financial difficulties have a positive effect on earnings management. Information asymmetry between managers and shareholders allows managers to take earnings management actions to manipulate financial statement data. The manager takes this action because the company's condition is in a phase of financial difficulty. Independent commissioners can strengthen the negative effect of free cash flow on earnings management. With good supervision and control by independent commissioners, companies with good free cash flow can allocate all of their cash to align the interests of shareholders.

Furthermore, independent commissioners weaken the positive effect of financial distress on earnings management. Independent commissioners were successful in preventing earnings management actions due to financial difficulties. Independent commissioners require managers to carry out the best business strategy to avoid the company's financial difficulties.

This study has several limitations, namely the existence of certain criteria, such as a complete financial report as of December 31, 2020, causing a reduced sample to be used. In addition, there is still limited literature that discusses problems similar to this research, so it is necessary to combine several studies to get the right discussion. Future research can use other company sector data with a longer period range to provide a more comprehensive explanation.

This research indicates that the Indonesia Financial Services Authority (OJK) needs to carry out supervision and improvement related to the provisions on the recruitment of independent commissioners aimed at improving corporate governance and protecting investors. One of the arrangements that need to be made by OJK is related to independent commissioners with educational backgrounds in accounting and

finance. In addition, this study also suggests that the Indonesian Accounting Association (IAI) strengthens a more comprehensive disclosure regulation policy on items in the financial statements that impact managers' earnings management actions.

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