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Financial Distress, Free Cash Flow, Employee Diff, and Earnings Management

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Abstract

This study examines the effects of financial distress, free cash flow and employee diff on earnings management. Companies that experience financial difficulties and have little free cash flow are predicted to carry out earnings management to hide poor financial performance. Companies that experience an increase in the number of workers which is not followed by an increase in profits are also predicted to carry out earnings management. To test the hypothesis, samples were taken from transportation, infrastructure, hotel, restaurant and tourism sector companies listed on the Indonesia Stock Exchange in 2019-2022. A total of 137 observations were available to test the hypothesis. Testing was carried out using regression analysis with the help of Eviews 12. The results showed that free cash flow has positive effect on earnings management but financial distress and employee diff had no effect on earnings management. The practical implication of the research results is that investors must pay attention to cash flow conditions before using profits as a basis for making investment decisions.

Keywords: *earning management, pandemic, service sector*

Abstrak

Penelitian ini menguji pengaruh *financial distress, free cash flow dan employee differences* terhadap manajemen laba. Perusahaan yang mengalami kesulitan keuangan dan memiliki *free cash flow* yang sedikit diprediksi akan melakukan manajemen laba untuk menyembunyikan kinerja keuangan yang buruk. Perusahaan yang mengalami peningkatan tenaga kerja yang tidak diikuti peningkatan laba juga diprediksi akan melakukan manajemen laba. Untuk menguji hipotesis, sampel diambil dari perusahaan-perusahaan sektor transportasi, infrastruktur, hotel, restoran, and turisme yang terdaftar di Bursa Efek Indonesia Tahun 2019-2022. Sebanyak 137 observasi yang tersedia untuk menguji hipotesis. Pengujian dilakukan dengan analisis regresi dengan bantuan *Eviews* 12. Hasil menunjukkan bahwa *free cash flow* berpengaruh positif terhadap manajemen laba tetapi *financial distress*, dan *employee differences* tidak berpengaruh terhadap manajemen laba. Implikasi praktis dari hasil penelitian adalah bahwa investor harus memperhatikan kondisi arus kas sebelum menggunakan laba sebagai dasar pengambilan keputusan investasi.

Kata Kunci: *Earnings management, financial distress, free cash flow,* employee differences.

1. INTRODUCTION

According to the Central Bureau of Statistics in 2020, the transportation sector experienced a significant decline in revenue of 90.34% due to the impact of the Covid-19 pandemic. This sector also experienced a decline in demand down to 85% as a result of consumers being affected by Covid-19 (Central Bureau of Statistics, 2020). During pandemic there were local, national, and international travel restrictions which greatly affected the national economy (Gössling et al., 2020). The implementation of PSBB or Large-Scale Social Restrictions during the pandemic also caused many companies in the transportation sector to suffer (Anwar, 2020). Based on their financial reports, several transportation sector companies experienced losses in 2020, including PT Blue Bird Tbk, PT Garuda Indonesia (Persero) Tbk, PT Kereta Api Indonesia (Persero) Tbk, and PT Express Transindo Utama Tbk.

Apart from the transportation sector, the hotel, restaurant and tourism sub-sectors have also been affected by the Covid-19 pandemic, making this sector unstable. Some of the risks that these companies will face include a decrease in total revenue and operating profit which will have an impact on financial performance (Esomar & Christianty, 2021). The implementation of Large-Scale Social Restrictions is part of the impact of Covid-19 so that many companies in various sectors experienced a decline in turnover (Rahmawati & Prihastiwi, 2021), which resulted in the transportation and hotel sectors experiencing losses up to IDR 85.7 trillion (Wahyudi, 2020). As of June 2020, the Indonesian hotel sector has recorded the layoffs of as many as 430 thousand employees, the closure of more than 2,000 inns and the stoppage of operations of more than 5,000 restaurants (PHRI, 2020). In addition, in 2020 there was also a decrease in the number of foreign tourists up to 74.84% (Data Kementerian Pariwisata dan Ekonomi Kreatif, 2020). Several companies in the hotel, restaurant, and tourism sub-sector that experienced losses included PT Red Planet Indonesia Tbk, PT Hotel Mandarine Regency Tbk, PT Saraswati Griya Lestari Tbk, and PT Pudjiadi & Sons Tbk.

In the infrastructure sector, the impact of the Covid-19 pandemic has delayed most construction activities, resulting in a reduction in imports of capital goods, non-absorption of domestic raw materials and loss of jobs (Aprillia, 2021). Not a few infrastructure sector companies have experienced losses as a result of this pandemic. During the 2018 to 2021 period, several infrastructure sector companies experienced losses, such as PT First Media Tbk, PT Bakrie Telecom Tbk, PT Leyand International Tbk, and PT Smartfren Telecom Tbk. The company's negative net profit and operating profit for the current year (loss) were caused by the company's operational activities not running as they should (Tannaya & Lasdi, 2021). This can be a trigger for earnings management actions, namely by manipulating financial data, especially profit levels reported by companies with the aim of deceiving users of financial reports (Astari & Suryanawa, 2017).

There are several factors that cause and indicate companies are involved in earnings management. Financial distress is thought to cause earnings management. Financial distress refers to a situation of financial difficulty that the company felt before the company went bankrupt (Mahaningrum & Merkusiwati, 2020). Financial distress is the company's inability to fulfill all of its obligations (Shilpa & Amulya, 2017), so that it becomes the cause of the liquidation of the company (Susilowati & Fadlillah, 2019). Earnings management tends to be carried out by companies that are facing financial distress by trying to close their debts so that the financial statements present show good company performance even though the actual condition of the company is experiencing consecutive losses (Panjaitan & Muslih, 2019). According to agency theory, more information about the company's financial condition is known by agents than principals (Santosa et al., 2022). Earnings management actions will be carried out by companies to cover up their financial problems in order to retain investors (Chaq

& Wahyudin, 2020).

Previous research conducted by Salim & Davianti (2022) shows that public companies facing financial distress, especially the transportation sector, were involved in earnings management actions. The findings from this study are inconsistent with the research of Irawan & Apriwenni (2021) which shows that earnings management activities carried out by managers are not affected by financial distress. The inconsistency of these findings is one of the motivations for the author to conduct further studies.

Free cash flow is also suspected to be the cause of earnings management. According to Handayani (2017) free cash flow is cash flow that can be allocated to investors after investing in the company's fixed assets and working capital needed to maintain business continuity. According to Lidya & Efendi (2019), free cash flow is cash flow available to investors (creditors) and equity (owners) who provide loans after the company meets all its operational needs and pays for it to invest in clean and available fixed assets. According to Setyawan (2019), free cash flow is the company's excess cash that can be allocated to shareholders (creditors) when the company no longer needs its investment in working capital or fixed assets. Free cash flow is thought to encourage earnings management actions. if the availability of free cash flow is only used for investments that provide personal benefits and is not used to fulfill the interests of investors, conflict will arise between management (agents) and investors (principals). Company managers often engage in earnings management efforts to hide their poor performance from shareholders as a result of poor investment decisions (P. S. Utami & Meiranto, 2017). Managers expect incentives and bonuses through this increase in profits (Irawan & Apriwenni, 2021). Setiawati et al. (2019) stated that there is a positive and significant influence of free cash flow on earnings management actions. Managers are more likely to engage in earnings management actions when the company's free cash flow level is large (Ramadhani et al., 2017).

Research findings Setiawati et al. (2019) in companies engaged in the manufacturing sector proved that significantly free cash flow can affect earnings management activities. The amount of the company's free cash flow indicates that the company is able to survive in difficult conditions because the company has the opportunity to invest and capital expenditure in order to maintain ongoing operational activities. However, if the company has a small cash flow, the tendency to engage in earnings management increases because the company tries to cover the lack of capital in its operating activities.

Non-financial factors can also trigger earnings management actions, employee diff is one of them. Incompatible data between financial data (such as revenue/earnings growth) and non-financial data (such as employee growth), called employee diff, can provoke suspicion that the company does not provide real financial information (Ames et al, 2012). Employee diff is non-financial issues that can impact practice earnings management. According to Nazalia & Triyanto (2018) employee diff is a gap between employee growth and growth income. The company is trying to cover up the decline in financial performance by reducing the number of employees with the aim of increasing company income. Therefore, labor costs must be charged, so that this burden is made to appear very small for increased company revenue. Research conducted by Bukit & Nasution (2015); Saputri & Achmad (2017) showed that employee diff is associated with earnings management.

When a large increase in the number of workers is not followed by an increase in income, due to increased expenditure on labor costs will raise suspicion because the large number of employees is not in line with the company's total income so that the company's performance looks good, the company will take earnings management actions (Nazalia & Triyanto, 2018). This indicates that the number of existing employees does not contribute to increasing income giving rise to the idea of carrying out earnings management. Findings from research conducted by Saputri & Achmad (2017) in manufacturing companies prove that there is a positive and significant effect of employee diff with earnings management. The employee diff can raise suspicions that the financial information provided by the company is invalid so that it can provide opportunities for managers to engage in earnings management. This is done so that the company's performance appears good. Nazalia & Triyanto (2018) support the finding and prove that there is a positive effect of employee diff on earnings management. However, Kurniasih (2017) showed that employee diff is not associated with earnings management.

2. LITERATURE REVIEW AND HYPOTHESIS FORMULATION

Earnings management actions can be explained using agency theory. Santosa et al., (2022) stated that this happened because agents (company managers) and principals (shareholders) have conflicts of interest. Furthermore, Santosa et al., (2022) stated that agents as parties who have direct involvement in the daily activities of the company receive more information about the company than the principal, resulting in asymmetry or information imbalance between the two. Information asymmetry opens opportunities for agents to close some information from principals (Adryanti, 2019). The lack of information that the principal has allows (agents) to carry out earnings management by reporting company performance that is not in accordance with actual reality (Tannaya & Lasdi, 2021).

Earnings management is defined by Chairunesia et al. (2018) as accounting policies chosen by managers to achieve certain goals, namely influencing or intervening in financial statements. As long as it is within the limits of generally accepted accounting principles, several accounting estimates and procedures can be used to carry out earnings management actions (Ghazali et al., 2015), so as to increase the amount of company profits. According to Chairunesia et al. (2018), the reasons for companies to take earnings management when the company is experiencing financial distress include: Reducing company profits or increasing profits. Research related to this has been carried out by Gupta & Suartana (2018) which revealed that there is a positive and significant effect of financial distress on earnings management actions. Prior to bankruptcy, the company will face financial distress (Mahaningrum & Merkusiwati, 2020). Shilpa & Amulya (2017) interpret financial distress as a company's inability to meet its current financial obligations. When a company faces financial distress, managers will tend to take earnings management actions by hiding their poor performance (Chaq & Wahyudin, 2020) to attract investors to invest. Therefore, the hypothesis in this study is:

H1: There is a positive and significant effect of financial distress on earnings management.

Free cash flow is thought to encourage earnings management actions. Company managers are often involved in earnings management efforts to hide their poor performance from shareholders as a result of bad investment decisions (Utami & Meiranto, 2017). When faced with difficult conditions, a company will be better able to survive if it has sufficiently large and well-managed free cash flow. A small free cash flow is an indication that the company's internal funding sources are insufficient to meet its investment needs, therefore capital injections from third parties are needed in the form of issuing more shares. This also causes managers to carry out earnings management activities to hide the company's weakening financial condition (Utami & Handayani, 2019). Research related to this matter has been carried out by Setiawati et al. (2019) stated that there is a positive and significant effect of free cash flow on earnings management actions, therefore the hypothesis in this study is:

H2: There is a negative and significant effect of free cash flow on earnings management.

If the number of employees in a company is large, the production and sales will increase. But if higher labor costs reduce the level of income, then there is a discrepancy between financial data and non-financial data (Nazalia & Triyanto, 2018). The situation is called employee diff which is the difference between changes in the number of employees and changes in income. The employee diff may lead to agency problems that forces managers to intervene in financial reporting to increase reported earnings (Saputri & Achmad, 2017). Before the Covid-19 pandemic, an increase in the number of employees in the company was expected to increase the company's income. However, this was different from the conditions when the company was faced with the Covid-19 pandemic. Companies are faced with conditions where costs for employees continue but are not balanced by increases in income. This is what causes companies to carry out earnings management to make the firm's performance look good. This condition occurs in several sectors; such as the transportation and tourism sectors where companies continue to incur costs for their employees but this is not accompanied by an increase in income. Thus, during Covid-19 pandemic companies were compelled to engage in earnings management to display the company's good performance (Nazalia & Triyanto, 2018).

Saputri & Achmad (2017) provide evidence that earnings management is significantly affected by employee diff. The mismatch between changes in the number of employees and changes in income has led management to engage in earnings management because the company continually incur costs for its employees but income has not increased and instead tends to decrease as a result of Covid-19. In pandemic conditions, management was under pressure by stockholders to perform well, giving rise to agency conflicts which triggered management to carry out earnings management. Therefore, the hypothesis in this study is:

H3: There is a positive and significant effect of employee diff on earnings management.

3. RESEARCH METHODS

Sample

The sample was selected from the transportation, infrastructure, hotel, restaurant, and tourism sectors listed on the IDX for the period of 2019 to 2022 with a purposive sampling method. These sectors were severely impacted by the Covid-19 pandemic. The impact is due to the implementation of work-from-home policies and regular social restriction policies so that many people do not travel in crowds, which results in this sector experiencing a decline in income. As many as 137 firm-observations are available for further analysis.

Variable Measurement

Earnings Management

Discretionary accruals are the proxy for earning management which is estimated using modified Jones model.

Financial Distress

Financial distress is measured using the Altman Z-Score model modified in 1995. This model can be applied to all companies, both in the manufacturing sector and the non-manufacturing sector (Rosi & Hasanuh, 2020). The Altman Z-Score model calculation formula is as follows:

Bankruptcy Index = 6,56 Working Capital/Total Assets + 3,26 Retained Earnings/Total Assets + 6,72 Earnings Before Interest and Taxes/Total Assets + 1,05 Book Value of Equity / Book Value of Debt.

Free Cash Flow

A high level of free cash flow can provide an illustration of how much the company is growing, paying debts to third parties and paying dividends to investors or investing in new projects (Padmini et al., 2020). The calculation is as follows:

FCF= AKO-PM-NWC/AS

Where: FCF = free cash flow; AKO = Operating Cash Flow= Total cash receipts - Cash disbursements for operational costs; PM = Capital Expenditure= expenditures made for capital formation; such as purchasing, procuring or constructing tangible fixed assets or inventory items with a useful value of more than one accounting period (1 year), including adding routine expenditures such as maintenance costs that maintain or increase the useful life, increase the capacity and quality of assets; NWC = Net Working Capital= the difference between current assets (cash, accounts receivable, inventory, and finished goods) and current liabilities (accounts payable/payable); AS= Total assets.

Employee Diff

Employee diff is the difference between income growth and employee growth where Income growth = $(\text{Income}_t - \text{Income}_{t-1})$/ Incomet-1 and Employee Growth= $(\text{Number of Employees}_t - \text{Number of Employees}_{t-1})/\text{Number of Employees}_{t-1}$.

Research Model

The data analysis method in this research is by using panel data (pool data). To estimate the regression model using panel data, three approaches can be used, namely the Common Effect Model (CEM), Fixed Effect Model (FEM), and Random Effect Model (REM). The estimation model selection is carried out to determine the most appropriate regression model to use. This model selection can be done using the Chow test, Hausman test and Lagrange multiplier test.

4. RESULTS AND DISCUSSION

Descriptive statistics

Based on the output of descriptive statistics presented in Table 1, the minimum value of the financial distress (FD) variable of -1.06792 from PT Tower Bersama Infrastructure Tbk in 2020 indicates that this company is experiencing financial difficulties because it has a Z-score < 1.10. The maximum value of 13.90109 from PT Andalan Perkasa Abadi Tbk in 2018 indicates that this company is categorized as a healthy company with a Z-score > 2.60.

Table 1. Descriptive Statistics

	EM	FD	FCF	ED
Mean	7.94E-05	3.001927	0.200013	0.057655
Median	4.85E-05	2.958318	0.185353	0.055465
Maximum	0.002868	13.90109	0.797088	0.804270
Minimum	-0.001274	-1.067192	-0.322134	-0.416547
Std. Dev.	0.000535	2.548417	0.198613	0.196240
Observations	137	137	137	137

The mean for financial distress value is 3.001927, meaning that on average the company is not facing financial difficulties. The minimum free cash flow (FCF) value of -0.322134 from PT Jasa Marga (Persero) Tbk in 2019 indicates that this company lacks internal resources so that to meet its investment needs the company requires external funding either through debt or by issuing new shares. The maximum free cash flow value of 0.797088 from PT Satria Antaran Prima Tbk in 2021 indicates that the company is able to survive in bad situations. The mean for free cash flow is 0.200013. The minimum value of the employee diff (ED) variable of -0.416547 from PT Wijaya Karya (Persero) Tbk in 2020 indicates that this company is experiencing an employee diff condition where there is a gap between negative income growth or a decrease in income and increasing employee growth. The maximum employee diff value of 0.804270 from PT Totalindo Eka Persada Tbk in 2021 indicates that this company does not experience employee diff conditions because its revenue growth is in line with employee growth. The mean for diff is 0.057655. The minimum value of the earnings management (EM) variable is -0.001274 in 2021 from PT Wijaya Karya (Persero) Tbk, indicating that this company is trying to reduce its profits. The maximum value of 0.002868 in 2021 from PT Satria Antaran Prima indicates that this company is trying to increase its profits. With an average of 0.0000794, it indicates that the companies included in the sample on average carry out earnings management actions through income.

Results

After conducting several tests, the researcher determined that the model chosen and very suitable for use in this research is the Random Effect Model. Table 2 presents the regression results using a random effect model.

Table 2. Regression Results

Variable	*Coefficient*	*Std. Error*	*t-Statistic*	*Prob.*
C	-3.19E-05	8.20E-05	-0.389425	0.6976
FD	7.04E-06	2.15E-05	0.327182	0.7440
FCF	0.000462	0.000262	1.762589	0.0803
ED	3.52E-05	0.000229	0.153586	0.8782

The probability value of the financial distress (FD) variable is 0.7440. Thus, H1 is not supported. No significant effect of financial distress on earnings management. The probability value of the free cash flow variable (FCF) is 0.0803 suggesting that free cash flow and earnings management are significantly correlated at a 10% level of significance. In other words, there is a weak correlation between these two variables. But the coefficient of FD is contrary to the prediction. Thus, H2 is not supported. The positive direction of the coefficient suggests that earnings management increases as free cash flow increases. The probability value of the employee diff (ED) is 0.8782. Thus, H3 is not supported. No significant effect of employee diff on earnings management. Overall, out of the three hypotheses, only H2 is statistically supported.

Discussion

The results show that there is no significant effect of financial distress on earnings management. The finding is not consistent with Gupta & Suartana (2018) and Davianti & Salim (2022) where financial difficulties are reported to be associated with earnings management. However, the finding is consistent with Irawan & Apriwenni (2021). When companies are experiencing financial difficulties, they do not have to engage in earnings management because this will result in a loss of trust from shareholders to invest in the company. Even though the company is experiencing financial distress, shareholders will still continue to invest in the company if the company is deemed to be able to overcome its problems. The financial distress faced by companies during the pandemic can certainly encourage managers to take earnings management actions, but if the company is proven to have taken earnings management actions, it will lose the trust of shareholders so that the company is even more likely to lose its investors. This will result in a lack of capital, making it even more difficult for companies to resolve their financial problems (Irawan & Apriwenni, 2021). Further observation on the sample shows that only a small number of companies experienced financial distress. These companies were able to maintain their financial condition during the pandemic, so that earnings management was not needed. The Covid-19 pandemic has created economic uncertainty in many sectors. Instead of taking earnings management actions, sample companies that experienced financial distress during this pandemic were more focused on recovering their financial condition, restructuring, and maintaining business continuity because the companies considered that this pandemic condition was only temporary.

Referring to the test results, it was found that there is a positive weak correlation between free cash flow and earnings management. The finding is not consistent with Setiawati et al. (2019) where they found that earnings management is significantly influenced by free cash flow. The positive correlation found in this study indicates that firms with higher free cash flow will also engage in earnings management. From the perspective of signaling theory, the result indicates that companies with higher free cash flow will try to give signal to the market about the company's good prospects. The purpose is to reduce the negative impact of asymmetric information on the company share price. Outsiders' understanding of the company is very limited because they only rely on information circulating in the market and financial information released by the company. Confidential information is not disclosed to the public because it could harm the company's ability to compete with competitors. In fact, some of this confidential information is very relevant for investors in assessing the company's prospects. The asymmetry information between inside and outside parties will result in differences in the belief of firm’s prospect. To anticipate the negative impact of information asymmetry on company stock prices, managers use earnings management tools to signal the market about the company's true prospects.

As previously stated, there is no significant effect of employee diff on earnings management. This finding is not consistent with Saputri & Achmad (2017). One important factor in the continuity of a company's operational activities is employees. Under certain conditions, increasing the number of employees in a company will increase the amount of revenue. On the other hand, the company's expenditure on labor costs will also increase, thereby reducing the company's income. This results in a mismatch between financial data and non-financial data, because the increasing number of employees actually results in a decrease in company income (Nazalia & Triyanto, 2018). During the Covid-19 pandemic, the transportation, infrastructure and hospitality, restaurant and tourism sub-sectors were also affected, causing these companies to experience a decline in income and financial pressure, resulting in mass layoffs. Although layoffs can provide benefits in cost savings, they can have a negative effect on a company's revenue in the long term. Based on the data that has been collected, during the pandemic several companies experienced a gap between revenue growth and employee growth, but this was not significant enough to influence earnings management actions or in other words employee diff was not the main factor in carrying out earnings management actions.

5. CONCLUSIONS AND SUGGESTIONS

This study examines the effect of financial distress, free cash flow, and employee diff on earnings management. Financial distress is thought to cause earnings management. Financial distress refers to a situation of financial difficulty that the company felt before the company went bankrupt. Earnings management tends to be carried out by companies that are facing financial distress by trying to close their debts so that the financial statements present good financial performance even though the actual condition is far from good. Previous research shows that public companies facing financial distress, especially the transportation sector, were involved in earnings management actions. Free cash flow is also suspected to be the cause of earnings management. Free cash flow is the company's excess cash that can be allocated to shareholders (creditors) when the company no longer needs its investment in working capital or fixed assets. Free cash flow is thought to encourage earnings management actions.

A sample of 137 firms from transportation, infrastructure, hotel, restaurant, and tourism sectors listed on the IDX in 2019-2022 were selected. The test of hypotheses shows that: 1) Financial distress has no effect on earnings Management 2) Free cash flow has a positive significant effect on earnings management but only at 10% level of significance. 3) Employee diff has no effect on earnings management. Future research can explore the effect of corporate strategy on earnings management and is also expected to use other methods in measuring financial distress and earning management.

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