

Analysis of the Impact of Free Cash Flow, Agency Cost, and Earning Management against Share Return

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Abstract

The purpose of this research is to analyze free cash flow, agency cost, and earning management influence against share return. The research object is firm that listing in Indonesia stock exchange in period 2015 to 2019, by using purposive sampling method. The results of this study, free cash flow and agency cost generated insignificant effect result on share return, and earning management is the independent variable that generated significant positive effect result on share return. This research will provide empirical data that good corporate governance doesn't have significant effect toward share return.

Keywords:

Agency Cost, Free Cash Flow, Earning Management, Share Return

Introduction

Investment is defined as a present postponement consumption so it can be included to the productive assets. In this field, investors are needed because in order for a company or corporation to operate itself they need fund. Extra fund will also be needed for company scope expansion. Therefore, investors play an important role in this field. Generally, the first thing an investor going to do before they investing is observing and rate the financial statement of the company's that catch their attention. Especially, Public Listed Company in Indonesia Stock Exchange (IDX). We can tell the company performance is it operating effectively and efficiently, also other factors beside the economy, politic, financial of the company using the financial statement that posted on the website (Adisetiawan, 2017). Compared with other investment instrument risk, investing in share indeed has a bigger risk. Even though the risk is higher, that doesn't stop investor to keep investing because higher risk will also give them higher return in a short period (Nurhidayah et al., 2019).

Profit gain from the fund they have invested is their purpose of investing. The profit mentioned come from shares. Share Return is a measurement that used to calculate how much profit that generated by shares. Share Return is a profit rate that's enjoyed by investors for their share investment. A high share return rate indicates that the shares is actively traded (Aryaningsih et al., 2018). Therefore, the fund in the form of cash is an important for a company. Free cash flow is an available cash flow to be distribute to the investors or shareholders after the company place all the investment on fixed assets, new products, and working capital needed to maintain the operation.

According to Wang (2010) free cash flow was defined as a value after discounted from operating cash flows available of the positive NPV projects needed. Also, for additional to the concept of accounting, idle cash flows at the management preferences also represent the definition of free cash flow. When the company made an investment that expected to make a profit in future, paid off debts, and distributed dividends, but there is still remaining cash left. Then it called as free cash flow (Sari Bujana & Yaniartha, 2015). Too much idle cash flow or free cash flow will cost the company problems, because the management might allocate the fund to unnecessary and inefficient resources, for example such as purchasing new cars to facilitate higher-up management. The debt policy is one of the mechanisms to reduce free cash flow problem in firms. Too many idle cash will increase the agency cost.

In the recent study of Effects of Growth Companies and Agency Costs against Return of Shares (Nurkharomi et al., 2017) stated that agency cost is a cost or risk that happened when the shareholder pay manager to run a task where the manager's interest against the or not aligned with the shareholder's interest. Shareholders want manager to act as they wish on running the company based on principles that could maximize the share value on market, while the manager has an interest on expanding the business through a shortcut which actually may lower the company's share value. Agency cost is proxied by SG&A which is a ratio between operational expense with total sales. This ratio could measure the exceeded payment and consumption by the management.

Earning also play a crucial part when it comes to share return, because if the earning is low then the share returns to be distributed will also become lesser. Earning or profit is an economic benefits increment in a certain period in the form of income, change in assets or a degression in liability also can be said as a reward of the company effort on operating that resulted in earning that cover the expenses (Endang Masitoh W., 2017). The measurement of earning management is a crucial issue for shareholders also for investors alike. Proper selection of earning management measurement is a way for efficient evaluation to investors (Sayari et al., 2014).

According to efficiency theory, correlation between information and stock markets is noticeable. Indeed, it is declared information which is supposed to be reflected in stocks (Sayari et al., 2014). Earning management is a management act in order to increase the value of the firm and to increase company's earnings (Handoyo & Putri, 2015). Earning management is the process of converting financial accounting values from the real image to desired image, so new values created will give a definite advantage for the company (Omush et al., 2019).

Investors is needed because a company or corporation need to operate, thence fund is a necessity. Extra fund will also be needed for company scope expansion. Therefore, investors play an important role in this field as mentioned above, either the investors are within Asia or not. Share return could increase and also decrease, because the influence of free cash flow and agency cost.

To gain the amount of profit that they want, investors need to be careful on making decision. This research will help investors to make decision on investment. Investors need to know how much the profit they have gain. This research will become helpful for investors. Indonesia's stock market is currently the weakest among the world's major indexes, one of the main reasons is because of the trading war crisis between United States of America and People's Republic of China.

On the 2nd and 5th paragraph of 2019, 20th July from Indonesia's CNBC news article, it's written that PT. Bliss Properti (POSA) underwent a correction in their shares. Starting from Rp 570, - per share at the beginning of the week and ended at Rp 204, - per shares at the closing of the week. This 64.21% correction has caused them to be the top loser for the week. It happened because one of the investors presume POSA has committed a misleading act or manipulated the investors, the investors presume that there's a deal between POSA and PT. NH Korindo Sekuritas Indonesia where they are the Initial Public Offering underwriter and also the party that has POSA under an absolute control during IPO so POSA share price will jacked up and the trimmed off warrant price, with Rp 314.26 billion total warrant transaction value at 15th May, this is 33 times higher than the usual daily transaction which is only Rp 9.37 billion. Also, the others presumptions that cause negative impact on POSA reputation at the share market.

Whereas stock market is a reflection of investors optimism stock market and future prospects. And the other reason is, (1) 2019 was the year of Indonesia's Presidential election, that made investors still unsure to invest in Indonesia before the winner is announced, (2) new government, after the stock market movements turned out did not as expected it will be, investors is still waiting to see the formation of government cabinet, and also (3) based on the 14th paragraph of 2019, 31st October Indonesia's CNBC news article, it is written that expensive valuation, the present stock price per earnings ratio of historical *Indeks Harga Saham Gabungan* at 19.93 times in the world's highest valuation row, which means it is overvalued or too expensive.

Literature Review

There is a lot of research about earning management, free cash flow, agency cost, and share return. The first complete study of agency theory was done by Jensen and Meckling, and the idea of free cash flow was proposed by Jensen. Because free cash flow is management's discretion financial resources it is also can be called an idle cash flow. While, the agency problem was originally raised by Berle and Means who argued that agency cost might be incurred in the separation of ownership and control due to inconsistent interests of management and shareholders. Generally, the agency problem is shareholder's wealth loss that caused by the management. From agency's point of view, argues that managers firm with excess cash flow might invest excessively for their

personal interest. It is likely that the severity of agency cost may affect the relative strength of investment sensitivity to cash flow. Managers or the agent collects internal information faster than the investor or the principal so that caused information asymmetry (Fitrianingsih, 2018).

The management favored their self-interest motive, that would increase perquisite consumption and shirking behavior, which led into the increased agency costs, and they will choose the projects that maximized their own self-interest or the negative result of NPV investment project rather than choosing the highest NPV investment projects (Khidmat & Rehman, 2014). Based on the research done by Evendy & Isynuwardhana (2015), showed that free cash flow has an insignificant positive effect on share return, with size as it controls variable. It was because size variable is dominantly defining share return more than free cash flow itself, because of the size variable reflect more of the political cost rather than free cash flow.

Managers are left with control over the use of future free cash flows, but they can promise to pay out future cash flows by announcing "permanent" increase in the dividend. It's a weak promise because dividends can be reduced in the future. Debt can be an effective substitute for dividends, it's something that not generally recognized in the corporate finance literature. By issuing debt in exchange for share, managers are bonding their promise to pay out future cash flows in a way that cannot be accomplished by simple dividend increases. If the interest and principal payments is failed to realized, then it will lead the firm into the bankruptcy court. Free cash flow is a company cash flow that can be distribute to creditor or shareholders that is not used for working capital or invested to fixed asset, in conclusion free cash flow is a cash to be given to shareholders (Evendy & Isynuwardhana, 2015). Idle cash flows at the management preferences also represent the definition of free cash flow (Wang, 2010). Free cash flow will become as an agency problem if the firm has excess cash and the managers don't know what to do with the cash (Khidmat & Rehman, 2014) . A healthy company would have a free cash flow prepared or available to be used for investing, paying dividend or debts (Montoliang & Tjun, 2018). If they have an excessive free cash flow, then it will lead into a waste of agency cost. The wasted free cash flow because of agency cost, will make the return received by shareholders become lesser than it supposed to be (Galogah et al., 2013).

Agency cost is proxied by SG&A which is a ratio between operational expense with total sales. A corporate manager are the agents of shareholders, it's a relationship that's full of conflicting interests. In agency theory, analysis of such conflicts has become part of economics literature. The pay-out cash to shareholders creates major conflicts that received little attention. Internal financing projects avoids being monitored by shareholders and the possibility of available funds is none or it is available but at an explicitly high price. On one hand, shareholders as principal hire managers to manage the company so they could maximize the profit value so shareholders divide the free cash flow as dividend. But on the other hand, managers as the agent also have their own interests to gain, so it will led to agency cost sooner or later because conflict of interest between principal and agent are bound to happen. Agency cost is a solution to

mitigate or resolve the generated conflict of interest by principal and agent (Herliana, 2016).

Managers with substantial free cash flow can increase dividends or repurchase share and thereby pay out current cash that would otherwise be invested in low return projects or get wasted. Shareholders will give the authority of decision making to the managers in order to fulfil shareholder's interest, but managers will not always comply with the shareholders. Because nowadays most of companies have a separated controls from ownership, so it become possible for managers to act as they want to satisfy their personal interests, such as their own income, power, their pride, and others (Wicaksono, 2017).

Shareholders will monitor and appreciate managers by giving the managers with a proper incentive that includes bonus, additional income and others to make sure that managers will act as shareholder's will. Monitoring will be done by financial statement audit report, monitoring management's additional income, and also limiting the management decision making (Wicaksono, 2017). With the existence of agency conflict will develop the cost to control the conflicts. Therefore, that cost is called as the agency cost (Nurkharomi et al., 2017). Agency cost might be incurred in the separation of ownership and control due to inconsistent interests of management and shareholders. Agency problem is caused by management would cause a loss in shareholder's wealth (Wang, 2010). The agency problems nature nowadays is unlikely for the management to act as they expected to be in an ideal way. Conflicts between the self-interested managers and shareholders, of which earnings management behavior under compensation contracts is the most obvious (Xue & Hong, 2016).

Earning or profit is an economic benefits increment in a certain period in the form of income, change in assets or a degression in liability also can be said as a reward of the company effort on operating that resulted in earning that cover the expenses (Endang Masitoh W., 2017). The measurement of earning management is a crucial issue for shareholders also for investors alike. Proper selection of earning management measurement is a way for efficient evaluation to investors (Sayari et al., 2014). Earning management is management's measurement to select the policies set by accounting standard available to maximize their benefit and company's value. Therefore, a manager can influence the company's market share value through the earning management (Yusrianti & Satria, 2014).

According to research done by Nuryaman (2013), by measuring the discretionary accruals using the modified Jones model that represented earning management, share returns are adversely affected by earning management. Inverse relationship between share return and earning management is more significant for companies audited by Big 4 auditing firms compared to other firms. Also, earning management allows the increase in of positive share return of large Tunisian companies. Earning management is an intervention done by management in the process of external financial reporting to reach a certain level of earning to benefit individual's or company's interest. Rather than describing the real situation or performance of a company, the practice of earning management reflect the manager or management desired image. Shareholder or investor takes the information contained in financial statement as consideration on their

investment decision making in order to get a high return from the high investment on share (Halim & Atmadja, 2015).

The opportunity to achieve the earning itself arises from provides opportunities for the management to record a particular fact in a different ways that come from an accounting method (Handoyo & Putri, 2015). Firm or company's management will seize the leeway allowed by accounting standard in processing the financial statement to alter or modify the earnings information, if the management reached the condition where they failed to meet the expected target at the beginning period (Adiwibowo, 2018). Investors will certainly expect a return from the investments they made such as share return, but on the other hand manager would always want a bonus as their reward. Hence, manager will do anything to create a worth investing financial statement for the investors to see such as doing an earning management (Surya & Januarti, 2012).

It's necessary for company to delve the method used by managers, because they could increase the earning of the company with various of method. Earning management help in the avoiding of decreased income and losses report (Xue & Hong, 2016). For shareholders, earning management indeed is a crucial issue. In order to maximize their self-interests, managers will do exploitation the existed loopholes of accounting standard and create the information into the most successful view that later will be presented to public (Sayari et al., 2014).

Research Methods

To explain the relationship between the variables is the objective of this research. Research and testing have been defined by the available taken data. The research method is basically a way to get data for certain purposes and value. Quantitative research is the type of this research that aim to obtain result, because of the collected data and it can be used as a cornerstone to obtain a measurable information. Quantitative research does not concern the relationship between the author with the research subject because the result of the research depends more on the measured variable and instrument used (Firman, 2018). The purpose of quantitative research method is for the researches done by the researcher so they can project and bring it into wider population through an objective process, data collected through the research process will always get through surveys or part of a population so the researcher could generalize or conclude the result that will become an interpretation to determine the probability of the concluded research sample can be replicated (Borrego et al., 2009).

Data used in this research is secondary data, means data is obtained or collected indirectly. Population on this research is listed company on IDX website from 2015 until 2019 period. Research collected data is audited and published financial statements starting from 2015 until 2019 period. Collected sample then will be process using Version 25.00 SPSS Program and Version 10.00 EViews Program.

The presentation of data is an important phase in analyzing data. Data presentation provide information of data description and data characteristics. Statistics descriptive is a part of statistic regarding data collection, presentation, determination of

statistical value and charting design to simplify the data form. Therefore, the data will be easier to be read by user (Nasution, 2017). The statistics descriptive present the description and characteristics of data through the number of samples (sum), the minimum value, the maximum value, the average value, and the standard deviation of each research variable.

Outlier test is conducted by eliminating data that is categorized as outlier. The procedure is carried out to ensure the research data is free from the influence of the deviated observation. Outlier data in regression analyze is interpreted as residual values of particular data that deviate from other data residual values, which believed might cause conflict between research model and data (Hair et al., 2010). The outlier test of this research was conducted under multivariate analyze by employing Studentized Deleted Residual (SDR). Data that is categorized as outlier are data which the computed SDR value is ≥ 1.96 or ≤ -1.96 (Santoso, 2012).

The F test is intended to carry out the regression coefficient (slope) regression test simultaneously. Thus, the F test is employed to determine whether the model chosen is feasible or not to interpret the effect of the predictor variables on the attributed variable. If the significance of p-value is above 0.05, the predictor variables are said to simultaneously do not significantly influence the dependent variable. Conversely, if the significance of p-value is below 0.05, the predictor variables are said to simultaneously have significant influence the attributed (Santoso, 2012).

In contrast to the F test, the t test is carried out to test the regression coefficients individually. The predictor variables with the significance of p-value above 0.05 do not significantly influence the attributed variable. In contrast, the predictor variables with the significance of p-value below 0.05 are said to have significant effect on the attributed variable (Santoso, 2012).

Results and Discussion

Table 1

	N	Minimum	Maximum	Mean	Std. Deviation
Share Return	861	-3350.000000	4489840258.00 0000	190696110.879619 90	473075557.5027331 00
Total Asset Turnover	861	.000027	4.463489	.77262037	.666201505
Operating Expense Ratio	861	.013094	1362.583655	1.81467403	46.429646682
SGA Expense Ratio	861	.013094	1362.583655	1.78434258	46.430534033
NOI Volatility	861	.002119	886.112132	4.89990239	56.779004263
NI Volatility	861	.001218	611.048452	3.49557494	39.342903915
FCF	861	-53.381235	395.377628	.91861311	15.342499547
EM	861	-6543.683636	5622.822665	23.98669592	413.374441920
Size	861	10.813603	15.151296	12.84413072	.774984025

Age	861	6.00	1820.00	41.0918	66.64344
Growth	861	.282544	22.232837	1.72874580	2.049970068
Leverage	861	.074971	6.911292	.49984129	.332418835
Profitability	861	-3.950938	2258.448579	5.87504216	102.331720825
Valid N (listwise)	861				

Source: Tested data (2019)

On Table 1, estimated tested average value for share return alongside with free cash flow, agency cost and earning management also the control variables 190696110,879. As the data has shown we can conclude that average listed company doesn't have a good performance on their share return. The standard deviation is 473075557,502. The average value of asset turnover is 0,7726 and the standard deviation is 0,666201505. The average value of operating expense ratio is 1,81467403, and the standard deviation is 46,429646682. The average value of SG&A expense ratio is 1,78434258 and the standard deviation is 46,430534033. The average value of net operating income volatility is 4,89990239 and the standard deviation is 56,779004263. The average value of net income volatility is 3,49557494 and the standard deviation is 39,342903915. Free cash flow average value is 0,91861311 and the standard deviation 15,342499547. The average value of earning management is 23,98669592 and the standard deviation 413,374441920. The average value of size is 12,84413072 and the average value of age is 41,0918 and the standard deviation is 66,64344. The average value of growth is 1,72874580 and the standard deviation is 2,049970068. The average value of leverage is 0,49984129 and the standard deviation is 0,332418835. The average value of profitability is 5,87504216 and the standard deviation is 102,331720825.

In order to determine which methods to use between pooled least squares and fixed effect model therefore we will do the chow test. The test result could be seen from the probability value on Cross-Section Chi-Square.

Table 2

Effects Test	Statistic	d.f.	Prob.
Cross-section F	9.461750	(172,676)	0.0000
Cross-section Chi-square	1055.549530	172	0.0000

Source: Tested data (2019)

Determining between fixed effect model or random effect model is the function of Hausman Test. Cross-section random value is the result of Hausman Test. The criteria in determining the model are, if the probability value >0.05 , then the model of regression panel used will be random effect model. Vice versa, if the probability value is <0.05 , then the model of regression panel used will be fixed effect model.

Table 3

Test Summary	Chi-Sq.Statistic	Chi-Sq. d.f.	Prob.
Cross-section random	10.824463	12	0.5440

On Table 4, f test result is 0.00000. The significant value is lesser than 0,05. Which means used independent variable in this research is affecting share return simultaneously and the model can be used to predict share return.

Table 4

Dependent Variable	Prob (F-statistic)
Share Return	0,000000

Source: Tested data (2019)

On Table 5, total asset turnover has an insignificant positive impact on share return. Means that if total asset turnover increased, it will increase share return. Therefore, we can conclude that high asset turnover will increase share return. This result is consistent with Hanivah & Wijaya (2018) and Asmi (2014). Operating expense ratio has an insignificant negative impact on share return. It means if operating expense increased, share return will significantly got increased. Because increased expense will increase firm's dividend.

Table 5

Variable	Coefficient	Prob.	Conclusion	Hypothesis
(Constant)	-3.06E+09	0.0000		
Total Asset Turnover	41488876	0.2418	Insignificant	Not Proven
Operating Expense Ratio	-25878456	0.8949	Insignificant	Not Proven
SGA Expense Ratio	25879417	0.8949	Insignificant	Not Proven
NOI Volatility	7333547.	0.5977	Insignificant	Not Proven
NI Volatility	-11307478	0.5723	Insignificant	Not Proven
Free Cash Flow	41575.23	0.9476	Insignificant	Not Proven
Earning Management	139336.2	0.0000	Significant Positive	Proven
Size	2.53E+08	0.0000	Significant Positive	
Age	-37909.33	0.8006	Insignificant	
Growth	-3699509.	0.7067	Insignificant	
Leverage	-33706769	0.3515	Insignificant	
Profitability	-13731.50	0.9139	Insignificant	

Source: Tested data (2019)

This result is consistent with Nugraha & Hapsari (2018). SG&A expense ratio has an insignificant positive impact on share return, means increased SG&A expense will

insignificantly increase share return. Because of the increased sales expense, the higher it cost then share return will decrease significantly. This result consistent with Nurkharomi, Nurdin, & Azib (2017). Net operating income volatility has an insignificant positive impact on share return. Means that if there's a net operating income aberration, then share return will increase insignificantly, inconsistent net operating income will impact dividend distribution which affect share return. This result consistent with Wang (2010). Free cash flow has an insignificant positive impact on share return. Most of the firms has a minus cash flow, but the fund was mostly invested to fixed assets. This result consistent with Widya & Matusin (2015) and Jensen (1986). Earning management has a significant positive impact on share return. Means that if earning management is under a good control then share return will increase. This result consistent with Omush et al. (2019), Hawari & Putri (2020), Ferdiansyah & Purnamasari (2012) and Uswati & Mayangsari (2016).

Conclusion of this research is operating expense ratio and net income volatility has an insignificant negative impact on share return. While total asset turnover, SG&A expense ratio, net operating income volatility, and free cash flow has an insignificant positive impact on share return. While earning management has a significant positive impact on share return. Among tested variables, earning management have significant positive effect to share return. Therefore, earning management would be better measures for share return, since other variables generated insignificant effect against share return.

Conclusions

We can conclude that operating expense ratio and net income volatility has an insignificant negative impact on share return. While total asset turnover, SG&A expense ratio, net operating income volatility, and free cash flow has an insignificant positive impact on share return. While earning management has a significant positive impact on share return. Among all the tested variables, we can see that earning management have significant positive effect to share return. Therefore, earning management would be better measures for share return, since other variables generated insignificant effect against share return.

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