The Moderation of Corporate Governance in the Effect of Surplus Free-Cash-Flow on Earnings Predictability

Henny Wirianata[1*] Elsa Imelda[1] Yetty Yetty[1]

[1]*Faculty of Economics and Business, Universitas Tarumanagara, West Jakarta - 11470, Indonesia*
**Corresponding author. E-mail: hennyw@fe.untar.ac.id*

ABSTRACT
This research aimed to reveal the effect of surplus free-cash-flow on earnings predictability as well as the moderation effect of board independence, board size, dan independent chairman in that relationship. The subject of this research is manufacturing firms that were listed on Indonesia Stock Exchange (IDX) during the period of 2016 - 2018. This research design is descriptive research with purposive sampling method to test the effect of independent variables on the dependent variables, and also the effect of moderation variables in that relationship. The hypothesis testing was done by using panel data regression and moderation regression model using EViews 11. The results indicate that firms' earnings from using the assets has a significant effect on earnings predictability, and there's no significant effect of institutional ownership dan managerial ownership in the relationship between surplus free-cash-flow and earnings predictability. The implication of this study is the need to pay attention to firm performance to improve the predictive value of earnings.

Keywords*: Surplus Free-Cash-Flow, Earnings Predictability, Corporate Governance*

1. INTRODUCTION

In Indonesia's growing economic growth and tend to be stable, investors still rely on the information from financial statements prior to make investment decisions. The information in financial statements such as earnings will help investors assess company performance, if the profits reported have good quality. Bellovary, et. al. defined profit strength as the ability of reported earnings to reflect actual earnings, as well as the usefulness of reported earnings to predict future earnings [1].
Some companies will not make profit predictions. Only companies that will conduct an IPO (Initial Public Offering) will make profit predictions listed in the Prospectus Report. The information about profit forecasting on the Prospectus Report will greatly assist investors in making decisions. By predicting future earnings, investors can find out the company's ability to make future profits and estimate the distribution of dividends to its investors.
Not many companies make profit predictions, perhaps because the predictability of profits in companies in Indonesia is still not good, and there is still a lack of research on profit predictability in Indonesia. To predict future profits, companies need certain information. So, with the low predictability of profit in Indonesia, the information needed to predict profits becomes less precise.
Surplus Free-Cash-Flow (SFCF) can affect profit predictability. SFCF is a state when a company's cash is used to pay dividends, pay-off debt, buy back shares, make investments, and still have the rest of the cash, but the company is still in low growth, because the investments made by management do not turn a profit. In the Agency Theory, management as an agent prefers to invest excess cash to enlarge the business entity in order to get profits in the future, while investors expect excess cash to be distributed as a return on their investments. According to Hashim & Devi, corporate governance can help align the interests of managers with shareholders, improve the correctness of financial information, and the quality of the company's reported earnings [2]. Corporate governance is believed to reduce SFCF issues associated with high free-cash-flow but with low corporate growth. Shadmehri, et al. [3] research shows that corporate governance mechanisms are able to moderate the relationship between SFCF and profit predictability.
AL-Dhamari & Ismail [4] argued that companies with high SFCF have smaller levels of profit predictions. However, if the company has good governance mechanisms, it tends to reduce the agency conflicts with respect to SFCF and improve profit-predictability capabilities. Al-Dhamari & Ismail [4] found that the moderation of board size and independent chairman significantly provides a positive relationship between SFCF and profit predictability. However, board-independence moderation had no significant effect.
This research is expected to be beneficial for companies that pay attention to their profit reporting in order to improve the profit predictability, and for investors to reveal the factors that can affect the profit predictability.

2. THEORETICAL REVIEWS

2.1. Value Relevance Theory

Relevance is a concept showing that information from the results of the accounting process can be used to influence the decisions in investing. The term 'value relevance' first appeared in the Ball & Brown study [5], but the topic of value relevance is well known. since the research by Feltham & Ohlson that used the term relevance of value from the net-surplus theory and stated that accounting data on financial statements can reflect the value of the company [6]. Francis & Schipper's research used four interpretations to determine the relevance of values [7]. One of them is that financial information has a value relevance, if there are variables being used in a valuation model that can predict other variables.

2.2. Agency Theory

Jensen & Meckling research described the relationship in agency theory as a contract between shareholders (principal) and company management (agent) to conduct operational activities involving the delegation of authority in decision making by the company management (agent) [8]. Agency conflicts will not arise, if management and shareholders share the same goal. But in practice, management, that has the authority to control the company's finances, prefers to develop the company to increase its power, while shareholders are more hopeful of getting rewarded from the results of their investments. So, the insanity of objectives between management and shareholders causes problems and conflicts of the agency.

2.3. Surplus Free-Cash-Flow (SFCF)

Chung, et al. used the term SFCF for low-growth free-cash-flow conditions of companies [9]. Companies that have FCF, have the opportunity to invest in high-risk projects that cause their growth to be not good, so management will think of various ways to cover up the mistakes so that the loss is covered. In order to cover up the error, management may report higher than actual profits in the financial statements, that will cause positive perceptions so that when using the information to predict the company's future cash flow, its profit predictability will decrease.

The results of the AL-Dhamari & Ismail [4] and Shadmehri, et al. [3] study found that there is a negative relationship between SFCF and profit predictability, which means that companies with high free-cash-flow tend to make investments with low returns so that the profits listed in financial statements have the possibility of being elevated by management. Hence, the ability of profit predictability will be low.

H_1: Surplus free-cash-flow negatively affects earnings predictability (see **Figure 1**).

2.4. Board Independence

Fuzi, et al. defined board independence as the board with no relationship with management entrusted by shareholders to represent them within the company, to monitor the company's operations and performance, and to help reduce the agency problems [10]. The role of board of commissioners in a company is to supervise and control the management activities. But in conducting the supervision of management, board of directors is inseparable from the possibility of bias, especially if the board has interests or affiliations to management or other interested parties. Therefore, it takes an independent board of commissioners who have absolutely no interest or affiliation to management and other interested parties to be more rational in decision making.

The relationship between surplus free-cash-flow and earnings predictability will depend on the role of an independent board of commissioners. However, the results of the AL-Dhamari & Ismail study found that board independence moderation had no significant effect on the relationship between SFCF and profit predictability [4]. This could happen, as board members of the board of commissioners are more numerous and less independence, and then such board of commissioners will be less effective in preventing financial reporting errors by the management aimed at concealing losses from such investments.

H_2: Board Independence weakens the effect of surplus free-cash-flow on earnings predictability (see **Figure 1**).

2.5. Board Size

Board size is the total number of board of directors in a company. In carrying out its obligations, each member of the board of commissioners must comply with the laws and regulations and be responsible for conducting supervision and giving opinions to the board of directors for the benefit of the company. The company's board of commissioners acts as a monitor against management actions within the company. A large board of commissioners is not necessarily good for a company, because there may be some members who do not perform their obligations because their duties have been carried out by other members yet still benefit even though they do not carry out their responsibilities that finally will cause inefficiencies. With the composition of the smaller board of commissioners in the company, the supervision and control of management becomes more effective, so that the relationship between surplus free-cash-flow and earnings predictability will depend on the composition of the board of commissioners.

Al-Dhamari & Ismail found that board-size moderation significantly provides a positive association between SFCF and profit predictability [4]. Companies with a small composition of board of commissioners are less likely to mitigate the agency conflicts, hence increasing the profit predictability.

H_3: Board Size weakens the surplus free-cash-flow effect on earnings predictability (see **Figure 1**).

2.6. Independent Chairman

Amran, et al. defined the chairman or chair of board (COB) as the chairman of the board of commissioners responsible for ensuring the effectiveness of the company's board of commissioners, communicating and establishing good relations between shareholders and management [11]. So, it can be said that independent chairman is the chairman or president of the independent board of commissioners who holds the highest power in the board of commissioners, while leading and monitoring the other members of the commissioners.

The chairman of the board of commissioners has higher authority than do other members of the board of commissioners, and when the chairman of the company's commissioners has no interest and affiliation to management and others, then the supervisory ability of the independent chairman of the board of commissioners will be more objective. With the existence of an independent chairman of the board of commissioners, the interests of shareholders can be more maintained.

The relationship between surplus free-cash-flow and earnings predictability will depend on the role of the chairman of the independent board of commissioners. Al-Dhamari & Ismail found a positive and significant influence in the effect of moderation between SFCF and profit predictability [4]. Companies with an independent chairman or president of the board of commissioners will be more effective in supervising and monitoring the management so that the quality of reporting becomes good and profit predictability also increases.

H_4: Independent Chairman weakens the effect of surplus free-cash-flow on earnings predictability (see **Figure 1**).

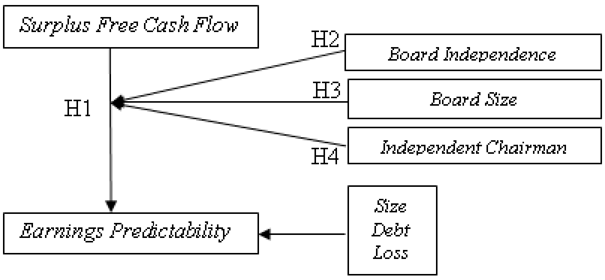

Figure 1 Research Framework

3. METHODOLOGY

This research methodology is quantitative research with secondary data obtained from the Indonesia Stock Exchange (IDX) [12], emiten.kontan.co.id site [13], and the company-owned websites in the period between 2016 - 2018. The sample selection method used is the purposive sampling method in manufacturing companies registered with the criteria as follows: 1) Registered in the IDX during the research period, 2) The presentation of financial statements denominated in Rupiah, 3) Being consistent in presenting financial statements as of December 31st during the research period, and 4) Not in delisting status during the research period. The total number of valid samples consists of 100 companies with a total of 242 sample data. The test consists of descriptive-statistics test, classical-assumption test, hypothesis test [Partial test (t-test) and Simultaneous test (F-test)], and coefficient-of-determination test (R^2).

4. RESULTS

4.1. Descriptive-Statistics Tests

Based on the results of descriptive-statistics tests (see Table 1), it can be found that the average earnings predictability is 0.082696, which shows that the company has a profit predictability of 8.27% of the amount of assets at the beginning of the period. The average value of the variable EARN is 0.060960, which indicates that the average company makes a running profit of 6.096% of the total assets in the company's initial period. The SFCF average of 0.198347 showed that as much as 19.83% of companies experienced SFCF from the study sample. An average of 0.416331 independent boards of commissioners shows that the average company has an independent board of commissioners as much as 41.63% among the company's board of commissioners. The average size of commissioners of 4.190083 shows that the average company has a board of four to five people.

Table 1 Descriptive Statistical Test Results

	Mean	Maximum	Minimum	Standard Deviation
EP	0.082696	0.633800	-0.129100	0.111752
EARN	0.060960	1.239400	-0.192600	0.127332
SFCF	0.198347	1.000000	0.000000	0.399581
BIND	0.416331	1.000000	0.200000	0.123427
BDSIZE	4.190083	12.000000	2.000000	1.953034
CHIND	0.132231	1.000000	0.000000	0.339444
SIZE	6.397634	8.537500	4.951000	0.695594
DEBT	0.180357	3.429100	0.003300	0.331589
LOSS	0.202479	1.000000	0.000000	0.402680

The average independent chief commissioner of 0.132231 shows that the average company whose chairman of the board of commissioners is an independent commissioner is only 13.22%. The average size of the company of 6.397634 shows that the average company has an asset value of Rp2,498,239,000,000. The average corporate debt of 0.180357 shows that the average company has long-term debt of 18.04%. The variable average loss of 0.202479 showed that companies that suffered losses at the end of the period amounted to 20.25% of the studied sample.

4.2. Classical-Assumption Test

This research has performed classical-assumption test and found no problem in the classical assumption matters in this study. After ensuring that this research is free from the problem of classical assumptions, then some other tests were carried out to determine the most appropriate model. Based on the results of the model test (Chow-test and

Hausman-test), it was obtained that the most appropriate model of both regression models in this study is the Fixed-Effect Model (FEM).
Based on the test results from Table 2, the regression equation without moderation can be developed as follow:

$$EP = 0.086695 + 1.993417\ EARN - 0.127141\ EARNXSFCF + 0.798712\ EARNXBIND + 0.080322\ EARNXBDSIZE + 0.151928\ EARNXCHIND - 0.419397\ EARNXSIZE - 0.195393\ EARNX\ DEBT + 0.038068\ EARNXLOSS + \varepsilon$$

Based on regression results, the surplus free-cash-flow has an insignificant negative effect (c = 0.127141) (prob = 0.3024, greater than 0.05). This insignificant effect occurs, probably because the companies in Indonesia that have free-cash-flow, tend to make investments with lower risk so that they do not experience a surplus of free-cash-flow. By this way, it will be difficult to have a significant effect on profit predictability.

Table 2 Multiple Regression Analysis Test Results without Moderation

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.086695	0.006452	13.43615	0.0000
EARN	1.993417	0.745975	2.672231	0.0084
EARNXSFCF	-0.127141	0.122822	-1.035163	0.3024
EARNXBIND	0.798712	0.436109	1.831451	0.0692
EARNXBDSIZE	0.080322	0.035660	2.252432	0.0259
EARNXCHIND	0.151928	0.158506	0.958498	0.3395
EARNXSIZE	-0.419397	0.130222	-3.220619	0.0016
EARNXDEBT	-0.195393	0.083900	-2.328875	0.0213
EARNXLOSS	0.038068	0.157560	0.241609	0.8094
R-squared				0.954605
Adjusted R-squared				0.921293
F-statistic				28.65683
Prob(F-statistic)				0.000000

Then, moderation is carried out with board independence, board size, and independent chairman, of which the results can be seen in Table 3.

Table 3 Multiple Regression Analysis Test Results with Moderation

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.086843	0.007013	12.38386	0.0000
EARN	2.012452	0.774872	2.597139	0.0104
EARNXSFCF	-0.298880	0.780142	-0.383110	0.7022
EARNXBIND	0.782979	0.452553	1.730140	0.0859
EARNXBDSIZE	0.079836	0.036388	2.194034	0.0299
EARNXCHIND	0.154507	0.163021	0.947770	0.3449
EARNXBINDXSFCF	0.269943	1.793589	0.150505	0.8806
EARNXBDSIZEXSFCF	0.014930	0.058570	0.254916	0.7992
EARNXCHINDXSFCF	-0.071435	1.124169	-0.063545	0.9494
EARNXSIZE	-0.421057	0.135733	-3.102094	0.0023
EARNXDEBT	-0.195813	0.088102	-2.222566	0.0279
EARNXLOSS	0.037400	0.164382	0.227521	0.8204
R-squared				0.954634
Adjusted R-squared				0.919609
F-statistic				27.25581
Prob(F-statistic)				0.000000

Based on Table 3, the regression equation with moderation can be developed as follow:

$$EP = 0.086843 + 2.012452\ EARN - 0.298880\ EARNXSFCF + 0.782979\ EARNXBIND + 0.079836\ EARNXBDSIZE + 0.154507\ EARNXCHIND + 0.269943\ EARNXBINDXSFCF + 0.014930\ EARNXBDSIZEXSFCF - 0.071435\ EARNXCHINDXSFCF - 0.421057\ EARNXSIZE - 0.195813\ EARNXDEBT + 0.037400\ EARNXLOSS + \varepsilon$$

Based on regression results with moderation variables, board independence has a positive effect with a coefficient of 0.269943 and a significance of 0.8806, which means that board independence is unable to provide a moderating effect in the relationship between surplus free-cash-flow and earnings predictability. Board size moderation variables have a positive effect with a coefficient of 0.014930 and a significance of 0.7992, which means that board size is unable to provide a moderating effect in the relationship between free-cash-flow surplus and earnings predictability. The moderation variable of independent chairman has a negative effect with a coefficient of -0.071435 and a significance of 0.9494, which means that independent chairman is unable to provide a moderation effect in the relationship between surplus free-cash-flow and earnings predictability.
To find out the correlation between independent variables and the dependent variable, a coefficient-of-determination (R^2) test was performed. The Adjusted R-Square value before corporate governance moderation is 0.921293 and after moderation is changed to 0.919609. Based on both probability values in F-Statistics (F-test) which are 0.000000, it can be concluded that surplus free-cash-flow and the moderation of board independence, board size, independent chairman, and control variables have a simultaneous effect on earnings predictability.

5. DISCUSSIONS

H_1: Surplus free-cash-flow negatively affects earnings predictability.
The results of this study contradict the results of research conducted by AL-Dhamari & Ismail [4] and Shadmehri et al. [3], in which their study resulted a significant negative effect of free-cash-flow surplus on earnings predictability. The average value of the surplus free-cash-flow in this study amounted to 19.83%, it can be concluded that companies in Indonesia do not experience a surplus of free-cash-flow, because companies do not dare to invest with great risk, so it is difficult to find a strong negative effect in this relationship. This may be because companies in Indonesia that have free-cash-flow tend to find a safe and sure way to invest. By this way, it will be difficult to find its significant effect on profit predictability.

H_2: Board Independence weakens the effects of surplus free-cash-flow on earnings predictability.
The results of this study contradict the result of research conducted by AL-Dhamari & Ismail [4] whereas board independence has an insignificant negative effect in the relationship between surplus free-cash-flow and earnings predictability. The absence of significant effect from independent commissioners in this study may be because the independent board of commissioners is a supervisory individual who comes from outside company and has no affiliation with other board members, so the independent board of commissioners will not be aware of the latest information about the company, thus the board will be more difficult in conducting its supervision.

H_3: Board Size weakens the surplus free-cash-flow effect on earnings predictability.
The results contradict the result of the research conducted by AL-Dhamari & Ismail [4], whereas board size has a significant and positive moderation effect in the relationship between surplus free-cash-flow and earnings predictability. The absence of significant effect in the study may be due to the board of commissioners at a free-cash-flow surplus company are not participating in decision-making regarding investments. If the board of commissioners do not know whether the company's free-cash-flow will be invested into high-risk or low-risk projects, it is difficult to find a strong effect by the composition of the board of commissioners.

H_4: Independent Chairman weakens the effect of surplus free-cash-flow on earnings predictability.
The results of this study contradict the result of the research conducted by AL-Dhamari & Ismail [4], whereas the independent chairman has a significant and positive moderation effect in the relationship between surplus free-cash-flow and earnings predictability. The absence of significant effect from the independent chief commissioner in this study is probably because the independent chairman commissioner is an external individual who conducts supervision of the company management without having an affiliation to the internal parties. Because the chairman of the independent board of commissioners is not always in the company, it will have less information that causes supervision from this commissioner does not provide strong effect. Other reasons may be because the average company that has an independent chief commissioner in this study is only 13.22%, so it will be difficult to find a strong effect in such relationship.

6. CONCLUSION

As the results of this study, the surplus free-cash-flow along with the moderation variables were able to have a simultaneous effect (together) on earnings predictability. This study was unable to reveal a significant effect of moderation variables partially. Only the earnings variables have significant effects on the company's future cash flow. This explains that the profit predictability is highly dependent on the profit or performance itself. With good profit reporting, the profit information in financial statements will be able to predict the future cash flow and its ability to predict the earnings will increase.
Based on the results of this study, the users of financial statements, especially investors, need to pay more attention to the company's current performance, because it can be used as a basis to predict the company's performance in the future. For the company's internal parties, especially the management, the results of this study are expected to help management realize the importance of the right and proper asset management in the company in order to generate maximum profit. The limitations in this study are: 1) Samples were taken only for three years; 2) Using only one independent variable, namely surplus free-cash-flow, and 3) Research samples were taken only from manufacturing companies. The suggestions for future research include increasing the observation period and number of samples, increasing or replacing the independent variables and corporate governance moderation variables, such as institutional ownership, managerial ownership, audit committees, and etc.

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