Chapter 5
Free Cash Flow and Earnings Management:
The Moderating Role of Leverage

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ABSTRACT

This study draws on Jensen's free cash flow hypothesis to evaluate the relationship between free cash flow and earnings management. This study also examines whether the level of leverage moderate the relationship between free cash flow and earnings management. This study uses a fixed effects regression model to examine the effect of free cash flow on earnings management and to test whether leverage levels moderate that relationship for an unbalanced panel of 13,850 firms' year observations from 2011 to 2018 across five European countries. Consistent with the free cash flow hypothesis of Jensen, this study suggests that firms with high free cash flow are more likely to manage earnings. Further, the results also suggest that the positive impact of free cash flow on earnings management is attenuated in firms with high leverage levels. This study contributes to the literature by examining how free cash flow affects the extent of earnings management and by shedding light on the mediating effect of leverage on the relationship between free cash flow and earnings management.

INTRODUCTION

Free cash flow (FCF) is important because it shows how much actual cash a company has at its disposal. This FCF allows company to search for opportunities going up shareholder's value. Ideally, managers of firms with free cash flow are expected to invest excessive cash in profitable investment in order to generate high returns to shareholders. However, firms with a large amount of free cash flow are normally affected with major agency problems. Jensen (1986) suggests that the existence of free cash flow increases the potential conflicts of interests between managers and shareholders as managers have discretion over the use of free cash flow. There is an increased risk that managers may spend this money on unprofitable projects rather than returning the money to shareholders, for example, in the form of dividends.

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Managers do not have any obligation to disclose to their investors the rationale behind investment decisions or the investment's feasibility. Therefore, investors may not be able to know the prospect and the advantages or disadvantages of the project for their wealth (Chung, Firth, & Kim, 2005). Likewise, managers may not provide adequate discloses to investors on investment's cash flow projections and underlying assumptions, which increases the opportunity for managers to divert corporate resources to gain personal advantage. Wang (2010) finds that free cash flow increases agency costs due to managerial perquisite consumption.

Excessive free cash flow in the hands of managers leads to overinvestment due to investment in projects with negative net present value (Jensen, 1986, Jensen & Meckling, 1976). Cai (2013) and Chen et al. (2016) find that firms with higher free cash flow show more pronounced overinvestment.

Non-value-maximising investments eventually reduce earnings and will result in lower stock prices. This could lead shareholders to remove directors and senior executives (Habib, 2011). However, to camouflage the effects of the non-wealth-maximizing investments, managers may use accounting techniques that increase (decrease) reported income. Earnings management allows managers to finance sub-optimal investments that maximize their own utilities at the expense of some informationally disadvantaged stakeholders (An, Li, & Yu, 2016). In this vein, Chung et al. (2005) and Astami et al. (2017) find that management use accounting discretion to obscure the earnings impact of investments in negative net present value projects and other self-serving activities.

According to Jensen (1986), leverage is helpful for reducing free cash flow in the hands of company managers as well as reducing agency cost. The interest and principal payments reduce the cash available to management for non-optimal spending. When a firm employs debt financing, it undergoes the scrutiny of lenders and is often subject to lender-induced spending restriction (Jensen, 1986). Hence, leverage reduces the agency costs of free cash flow by reducing the cash flow available for spending at the discretion of managers. Park & Jang (2013) find that the reduction of free cash flow in managers' control reduce agency cost and raise company worth. This suggests that higher level of debt reduces the free cash flows available to managers and therefore limits their discretionary behaviour, and thus reduce earnings management. However, some studies also show that leverage intensifies earnings management (Defond & Jiambalvo, 1994, Iatridis & Kadorinis, 2009, Chamberlain, Butt, & Sarkar, 2014).

Using a sample of non-financial listed European firms-year from 2011 to 2018, this study aims to test whether earnings management is higher for firms with more free cash flow. Additionally, this study examines how leverage influence the impact of free cash flow on earnings management.

The study makes some contributions to the existing literature. First, although many studies have examined the incentives for earnings management, the relationship between free cash flow and earnings management in the Europe region has received little attention. Second, to our knowledge, this study is the first to investigate the role of leverage on the association between free cash flow and earnings management in the European context. Third, the findings of this study can provide useful information mainly for shareholders and auditors whether free cash flow affect earnings management, and especially whether leverage moderate the relationship between free cash flow and earnings management. Finally, findings based on European data also help build a more expansive international understanding of the relation between free cash flow, leverage and earnings management debate.

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