

# The effect of good corporate governance on earnings management in companies that perform IPO

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## ABSTRACT

Initial Public Offering (IPO) is one of the motivations of the occurrence of earnings management practices. Earnings management is done by a company to obtain a positive response from the market in order to increase the amount of funds. Good corporate governance (GCG) is considered capable of minimizing the measures of earnings management because it has a goal to achieve a better and healthier company under the principles owned. This study aims to determine the effect of GCG on earnings management in companies that perform IPO. Samples are taken using purposive sampling method and are acquired as many as 31 companies, which are analyzed using multiple linear regressions. The result of this study indicates that management ownership, independent commissioners, and audit committee have negative and significant relationship with earnings management, in which this result is consistent with the research hypothesis. Meanwhile, institutional ownership has positive and significant relationship with earnings management, in which this result is not consistent with the research hypothesis.

## ABSTRAK

Initial Public Offering (IPO) adalah salah satu motivasi terjadinya praktik manajemen laba. Manajemen laba dilakukan oleh perusahaan untuk memperoleh respon positif dari pasar dalam rangka meningkatkan jumlah dana. Good corporate governance (GCG) dianggap mampu meminimalkan tindakan manajemen laba karena ini bertujuan untuk mencapai perusahaan yang lebih baik dan sehat di bawah prinsip-prinsip yang dimiliki. Penelitian ini bertujuan untuk mengetahui pengaruh GCG terhadap manajemen laba pada perusahaan yang melakukan IPO. Sampel diambil dengan metode purposive sampling dan diperoleh sebanyak 31 perusahaan, yang dianalisis dengan menggunakan regresi linier berganda. Hasil penelitian ini menunjukkan bahwa kepemilikan manajemen, komisaris independen, dan komite audit memiliki hubungan negatif dan signifikan dengan manajemen laba, dan temuan tersebut konsisten dengan hipotesis penelitian. Sementara itu, institutional ownership memiliki hubungan yang positif dan signifikan dengan manajemen laba, di mana hasil ini tidak konsisten dengan hipotesis penelitian.

## 1. INTRODUCTION

Initial Public Offering (IPO) is a mechanism that should be conducted by a company when making stocks offering to public for the first time in primary market. The company's goal to conduct the IPO is to meet the needs of additional funds for business expansion or for its operational funding. The company conducting IPO still has not had established market price, so accounting information becomes useful signal to investors (Yasa 2007). When the company reports higher earnings, the investors are expected to

give a positive response. Most of the previous literatures show that one of the main incentives for managers to inflate accruals in the company's IPO is to increase the IPO issuance price (Armstrong et al. 2009). If the managers systematically inflate revenues for increasing the stock price that may be expected with high discretionary accruals, the company will have a high stock price.

In order to be able to sell and make the company's shares demanded by the market, the management presents the company's financial information

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with maximum earnings (Luhglatno 2008). Many companies use the earnings information in their financial statements as a benchmark to evaluate the performance of the companies. The company's earnings information is so important that the manager always displays good earnings information by doing earnings management. Earnings management is defined as an opportunistic act in the sense that a manager has the opportunity to choose one of the accounting policies or actions that affect the earnings in order to achieve certain goals in reporting the earnings (Scott 2009: 403). One of the motives that lead the manager to conduct earnings management is Initial Public Offering (Scott 2009: 411). A new go public company still does not have definite market value. It makes the company's managers tend to perform earnings management in their prospectus. For investors, it is more difficult to obtain information of non-go public companies than that of go public ones (Indra 2012). The information mastery gap between companies and potential investors is commonly called information asymmetry. Information asymmetry encourages the companies to perform earnings management in order to get a positive market reaction that will increase the amount of funds raised. Earnings management is done to make as if the income had good and stable earnings quality (Kusindratno and Sumarta 2005).

The emergence of earnings management can be explained by agency theory (Ujjiyantho and Pramuka 2007). A manager, in practice, acts as an agent who is morally responsible for optimizing the benefit of the owner (principal), and in return the manager (agent) will be compensated according to the contract. Under these conditions, there are two different interests in the company, where each party is trying to acquire or maintain a desired level of prosperity. As a manager (agent) of the company, he knows the internal information and the company's prospects in the future better than the owner (principal). So, the manager has an obligation to provide a signal about the state of the company to the owner through the disclosure of accounting information.

The detection of the possibility of earnings management in the financial statements can be investigated through the use of estimates of total accruals. Total accruals consist of nondiscretionary accrual (normal accrual) and discretionary accrual (abnormal accruals). The accrual used to perform earnings management is discretionary accrual (abnormal accruals). Earnings management using accrual discretionary responds drastically to the incentive of management (Cornett et al. 2008).

Earnings management is a phenomenon that is

difficult to avoid, but the practice can still be minimized. Earnings management will be lower when there is a better monitoring on the management policy from institutional shareholders, board of directors and independent directors (Guna and Herawaty 2010). The behavior of a manager who performs earnings management can be minimized by applying the mechanism of Good Corporate Governance (GCG). The GCG proxied by independent directors has a significant influence on earnings management, where it is shown by the increasing control by independent directors that will reduce the likelihood of earnings management action by the company (Afifa 2013; Prabaningrat 2015). Management ownership has a significant influence on earnings management (Mahariana 2014). GCG proxied by institutional ownership has an influence on earnings management, where it is shown from the number of shares held by institutional parties that will affect the decision of the management to manage earnings (Wahyono et al. 2013). GCG proxied by audit committee has an effect of minimizing earnings management in a company (Wiralestari et al. 2012).

One of the ways used to monitor the contract issue and to limit the opportunistic behavior of the management is corporate governance (Xie et al. 2003; Cornett et al. 2006; Sriwedari 2012). The mechanism of corporate governance is a tool to reduce managerial opportunism (Tangjitprom 2013). The companies with poor corporate governance are more susceptible to managerial opportunism, and earnings management would be harmful to the company's value. Meanwhile, the companies with good corporate governance can reduce managerial opportunism and will be profitable for the company's value. Good corporate governance is shown by the presence of management ownership, institutional ownership, independent directors, and independent audit committee in the company.

Managerial ownership is the shares held by the management personally and the shares held by a subsidiary of the company concerned and its affiliates (Sudibyo 2013). Shleifer and Vishny (1986) stated that large shares ownership, in terms of economic value, has incentives to monitor (Sudibyo 2013). Institutional ownership is the share ownership by the government, financial institutions, legal entities institution, foreign institutions, trust funds and other institutions (Alves 2012). Institutional ownership has significant importance in monitoring the management because the existence of institutional ownership will encourage a more optimal supervision. Independent commissioner is one of the core of good corporate governance who is in charge of and

responsible for ensuring the implementation of corporate strategy, overseeing the management in managing the company, giving advice to the directors, and requiring the implementation of accountability. Independent commissioner usually consists of independent board of commissioners who come from outside the company (NCCG 2001). The existence of audit committee is accepted as a part of Corporate Governance. Even in assessing the implementation of good corporate governance in the company, the presence of an effective audit committee is one of the aspects of assessment criteria (Purwandari 2011).

## **2. THEORETICAL FRAMEWORK AND HYPOTHESIS**

Agency theory argues that entity is the lifeblood of agency relationship and tries to understand organizational behavior by examining how the parties in the agency relationship maximize the utility through cooperation. One of the most important agency relationships is the cooperation between the management group and the entity owners. The manager is paid by the owner to manage the entity he leads, and cooperation indicates the creation of agency relationship (Astika 2011: 76). Manager, in practice, acts as an agent and is morally responsible for optimizing the benefit of the owner (principal) and, in return, the manager (agent) will be compensated according to the contract. Under these conditions, there are two different interests in the company, in which each party is trying to acquire or maintain a desired level of prosperity.

Earnings management is the action of a manager to select accounting policies or the action that affects earnings in order to achieve certain goals in reporting earnings (Scott 2009: 403). Subramanyam and Wild (2010: 130) stated that earnings management occurs for several reasons, such as to avoid debt requirements, to meet analyst forecasts and to affect stock prices (Rizky 2011). Earnings management can be done in two ways: (1) changing the accounting method, which is the most obvious form of earnings management, and (2) changing the estimation and accounting policies that determine the accounting numbers, which is a more vague form of earnings management. Some of the motivation that lead the manager to perform earning management are Bonus Scheme, Debt Covenant, Political Motivation, Taxation Motivation, CEO turnover, and the Initial Public Offering (IPO) (Scott 2009: 411).

Good Corporate Governance is one of the strategies to limit the activities of earnings management by empowering the corporation both state and private owned companies (Purwandari 2011). Accord-

ing to the National Committee on Corporate Governance Policy (KNKCG), corporate governance is a process and structure used by the organs of the company to provide added value to the company continuously in a long period for shareholders, with regard to the interests of other stakeholders, under the laws and norms applied. Corporate governance includes the relationship between the stakeholders involved and the objectives of company management. The main parties in corporate governance are the shareholders, management and board of directors. Other stakeholders include employees, suppliers, customers, banks and other creditors, regulators, environment, and the community. In this study, the mechanism of corporate governance is proxied by the mechanism of institutional ownership, independent commissioner, managerial ownership and audit committee.

According to Herawaty (2008), managerial ownership is the shares held by the management personally and the shares held by a subsidiary of the company concerned and its affiliates (Sudibyso 2013). In general, it can be said that a certain percentage of share ownership by management (managerial ownership) tends to affect earnings management action (Boediono 2005).

Institutional ownership is the ownership by government, financial institutions, legal entity institutions, foreign institutions, trust funds and other institutions (Alves 2012). Institutional ownership has significant importance in monitoring the management because the existence of institutional ownership will encourage a more optimal supervision. The monitoring, of course, will ensure the prosperity of the shareholders, in which the effect of institutional ownership as a supervisory agent is pressed through their sizeable investments in the capital market (Irawan 2013).

The board of commissioners is the party in charge of supervising over the policies on the structure and general structure, both related to the company and the company's business, and giving advice to the board of directors (Afifa 2013). The presence of independent commissioners in a company can balance the decision-making, especially in the context of the protection of minority shareholders and other parties concerned. This indicates that the presence of independent commissioners in a company can influence the integrity of a financial report generated by the management.

In the National Committee on Corporate Governance (NCCG 2011), the commissioners establish an audit committee consisting of the members of the board of commissioners. The audit committee con-

sists of independent directors and external auditors and should present any reports to the board of commissioners. The existence of audit committee at this time is accepted as a part of a Corporate Governance. Even in assessing the implementation of good corporate governance in the company, the presence of an effective audit committee is one aspect of the assessment criteria (Purwandari 2011).

Based on the above explanation, the problem that can be put forward in this study is whether good corporate governance has an effect on earnings management in companies that perform initial public offering (IPO). The purpose of this study is to find out whether good corporate governance represented by management ownership, institutional ownership, independent commissioners and independent audit committee has an effect on earnings management in companies that perform IPO. The hypotheses that can be put forward are as follows:

H1: Management ownership has negative effect on earnings management in companies that perform initial public offering (IPO)

H2: Institutional ownership has negative effect on earnings management in companies that perform initial public offering (IPO)

H3: Independent commissioner has negative effect on earnings management in companies that perform initial public offering (IPO)

H4: Independent audit committee has negative effect on earnings management in companies that perform initial public offering (IPO).

### 3. RESEARCH METHOD

This research is a quantitative research. The object of this research is companies performing an initial public offering (IPO) and listed on the Indonesia Stock Exchange (IDX) in 2008-2012. Sources of data in this study are derived from the company's annual financial statements from 2004 to 2012 and www.sahamok.com to collect companies performing IPO in 2008-2012. The data used in this research are secondary data obtained through the publication of the annual financial statements of the entire companies performing initial public offering (IPO) listed on the Indonesia Stock Exchange (IDX) from 2008 to 2012.

The population of this research is the companies performing initial public offering (IPO) listed on the Stock Exchange from 2008 - 2012. The sampling technique used in this study is purposive sampling method and is acquired 31 companies. Data analysis technique used in this research is multiple linear regression analysis. The hypothesis in this study is tested using the feasibility test of the model (F-test)

and individual parameter test (t-test) to determine the influence between variables. The classic assumption test used in this study is the normality test, heteroscedasticity, multicollinearity test and autocorrelation test.

#### Classification of Variables

The dependent variable is earnings management (DAC). The discretionary accruals (DAC) which becomes a proxy of earnings management is measured using a model developed by Kothari et al. (2005). The model of Kothari et al. (2005) is considered as the most appropriate model in measuring discretionary accruals because it has a better explanatory power. The stages of the determination of discretionary accruals are as follows:

1. Calculating total accruals.

$$TA_{it} = NI_{it} - CFO_{it} \quad (1)$$

Description:

$TA_{it}$  = Total accruals of company  $i$  in year  $t$

$NI_{it}$  = Net income of cash from the operating activities of company  $i$  in the period of  $t$ .

$CFO_{it}$  = Cash flow from operating activities of company  $i$  in period of  $t$ .

2. Determining the regression coefficient of total accruals.

$$TA_{it}/A_{it-1} = a + \beta_1(1/A_{it-1}) + \beta_2((\Delta REV_{it}-\Delta REC_{it})/A_{it-1}) + \beta_3(PPE_{it}/A_{it-1}) + \beta_4(ROA_{it-1}/A_{it-1}) + e \quad (2)$$

Description:

$TA_{it}$  = Total accrual of company  $i$  in the year  $t$  (resulting from the calculation of the number 1 above)

$A_{it-1}$  = Total assets of company  $i$  at the end of the year  $t-1$

$\Delta REV_{it}$  = Changes in the earnings of company  $i$  in the year  $t$

$\Delta REC_{it}$  = Changes in net receivable of company  $i$  in the year  $t$

$PPE_{it}$  = Property, plant and equipment of company  $i$  in the year  $t$

$ROA_{it-1}$  = Return on assets of company  $i$  at the end of the year  $t-1$ .

3. Determining Non-discretionary Accrual.

$$NDACC_{it} = a + \beta_1(1/A_{it-1}) + \beta_2((\Delta REV_{it}-\Delta REC_{it})/A_{it-1}) + \beta_3(PPE_{it}/A_{it-1}) + \beta_4(ROA_{it-1}/A_{it-1}) + e \quad (3)$$

Description:

$NDACC_{it}$  = Non-discretionary accrual of company  $i$  in year  $t$

$E$  = Error.

4. Determining Discretionary Accrual

$$DACC_{it} = (TA_{it}/A_{it-1}) - NDACC_{it} \quad (4)$$

Description:

$DACC_{it}$  = Discretionary accrual of company  $i$  in year  $t$

The independent variables in this study are:

1. Managerial ownership (KpMj)

**Table 1**  
**Description of Data**

	N	Minimum	Maximum	Mean	Std Deviation
DAC	31	-0.218225	4.910879	0.238242	0.880453
KpMj	31	0.000006	0.736871	0.092660	0.168767
KpInst	31	0.100025	0.989029	0.667407	0.234644
KI	31	0.250000	0.500000	0.342253	0.045460
KMA	31	0.250000	0.666667	0.645698	0.080042
Valid N (listwise)					

Source: Processed data, 2014.

**Table 2**  
**Results of Classical Assumption Test**

Normality	Variable	Multicollinearity		Heteroscedasticity	Auto-correlation
		Tolerance	VIF		
0.260	KpMj	0.490	2.039	0.158	2,160
	KpInst	0.491	2.035	0.124	
	KI	0.911	1.098	0.239	
	KMA	0.949	1.054	0.116	

Sourcer: Processed data, 2014.

$$KpMj = \frac{\text{Number of managerial shares}}{\text{Total capital shares}} \times 100\% \quad (5)$$

2. Institutional ownership (KpInst)

$$KpInst = \frac{\text{Number of institutional shares}}{\text{Total capital shares}} \times 100\% \quad (6)$$

3. Independent Commissioner (KI)

$$KI = \frac{\text{Number of independent commissioners}}{\text{Total board of commissioners}} \times 100\% \quad (7)$$

4. Independent audit committee (KMA)

$$KMA = \frac{\text{Number of exterenal audit committe}}{\text{Total members of audit committee}} \times 100\% \quad (8)$$

#### 4. DATA ANALYSIS AND DISCUSSION

##### Descriptive Analysis

Table 1 describes the minimum value, maximum value, mean value, and standard deviation of management ownership, institutional ownership, independent commissioner, and independent audit committee.

From Table 1, it can be seen that the minimum value of DAC is -0.218225 and the maximum value is 4.910879. The mean value of 0.238242 indicates that the mean value of earnings management is in fairly low figure. This means that the mean value of earnings management in the sample companies is relatively low. Standard deviation of 0.880453 shows that the data variation of earnings management in the study samples is high.

The minimum value of managerial ownership is 0.000006, the maximum value is 0.736871, and the mean value is 0.092660. Share ownership by management as indicated by the relatively low mean value means that in the company samples, the average of the shares owned by the management is relatively low. The standard deviation of 0.168767 is greater than the mean value, which means that the

data variation of managerial ownership in the study sample is relatively high.

The minimum value of institutional ownership is 0.100025, the maximum value of institutional ownership is 0.989209, and the mean value is 0.667407. The high mean value of institutional ownership shows that the average share owned by institutional parties in the sample companies is quite high. The standard deviation of 0.234644 is greater than the mean value, which means that data variation of institutional ownership in the study sample is relatively high.

The results of descriptive statistical analysis show that the minimum value of independent commissioners is 0.250000, the maximum value is 0.500000, and the mean value is 0.342553. Judging from the low value of the independent commissioners, it can be said that the average number of independent commissioners in the company sample is proportional with the number of commissioners from outside companies that are required by National Committee on Governance Policies (KNKG). The standard deviation of 0.045460 is smaller than the average, which means that the data variation of independent commissioners in the study sample is quite low.

The minimum value of the audit committee shown in Table 1 is 0.250000, the maximum value of the audit committee is 0.666667, and the mean value is 0.645698. The mean value of the audit committee in the company sample is relatively high. This shows the tendency that the number of audit committee from outside the company is relatively big. The standard deviation of 0.080042 is smaller than the

**Table 3**  
**Results of Multiple Linear Regression Analysis**

Variable	Regression Coefficient	t	Sig
Konstant	7.949	11.032	0.000
KpMj	-1.127	-2.344	0.028
KpInst	0.852	2.458	0.021
KI	-10.864	-14.548	0.000
KMA	-4.000	-3.105	0.005
Adj R2 = 0.874		F = 53.038	
df = n-k = 31-5= 26		Sig. = 0.000	

Source: Processed data, 2014.

mean value, which means that the data variation of audit committee in the study sample is very low.

### Results of Classical Assumption Test

Table 2 shows that the testing model has been free from the problem of normality, multicollinearity, heteroscedasticity and autocorrelation.

### Multiple Linear Regression Analysis

Multiple linear regression analysis is used to determine the influence of managerial ownership, institutional ownership, independent commissioners, and independent audit committees on earnings management in companies performing initial public offering (IPO). The results of multiple linear regression analysis are shown in Table 3.

The regression equation used in this study is:

$$DAC = 7.949 - 1.127KpMj + 0.852KpInst - 10.864KI - 4.000KMA$$

Description:

DAC = earnings management,

KpMj = managerial ownership,

KpInst = institutional ownership,

KI = independent commissioners,

KMA = independent audit committee.

The result of F count is 53.038 with a probability level of 0.000a (significant). Probability of  $F = 0.000 < 0.05$ , so it can be concluded that this model fits to be used in the research. Table 3 also shows that the independent variables consisting of managerial ownership (KpMj), institutional ownership (KpInst), independent commissioner (KI), and independent audit committee (KMA) have significant influence on the dependent variable consisting of earnings management (DAC).

Based on Table 3, it can be seen that the regression coefficient and significance value of managerial ownership variable are negative. These results mean that the hypothesis, which states that the management ownership has a significant negative effect on earnings management in companies performing IPO, is received. The results of this study show that

the less percentage of share ownership by management is likely to lead to earnings management in a company. This is indicated by the results of statistical analysis where the relatively low average ownership of shares by the management makes the management not flexible in taking decisions to present report as desired, thus allowing the intervention of larger shareholders that causes the management to perform earning management.

Based on Table 3, it can be seen that the regression coefficients and significance value of institutional ownership variable are positive. These results mean that the hypothesis, which states that the institutional ownership has a significant negative effect on earnings management in companies performing IPO, is rejected. Institutional ownership in this study has a significant positive effect on earnings management in companies performing IPO, which means that the increasing institutional ownership will increase earnings management action. The results of this study are in accordance with the views expressed by Potter (1992) in Jao and Pagalung (2011), that an institutional investor is the temporary owner that focuses on current earnings or short-term earnings.

Based on Table 3, it can be seen that the regression coefficient and significance value of independent commissioners variable are negative. These results mean that the hypothesis, which states that independent commissioner has a significant negative effect on earnings management in companies performing IPO, is received. The results are consistent with the results of Rahmawaty (2013), and Cornett (2009) that independent commissioner has negative effect on earnings management. The lower the level of supervision of independent directors, the higher the tendency of managers to manipulate earnings in the financial statements. It shows that as one of the indicators of good corporate governance, independent commissioner has contributed effectively in the process of preparing qualified financial reporting to limit earnings management in the company.

Based on Table 3, it can be seen that the regression coefficients and significance value of independent audit committee variable are negative. These results mean that the hypothesis, which states that independent audit committee has a significant negative effect on earnings management in companies performing IPO, is received. The results of this study are consistent with the results of the researches by Chtourou et al. (2001), Xie et al. (2003), and Wirales-tari (2012), that the presence of audit committee from outside is able to protect shareholders from opportunistic action, such as earnings management done by manager. As one of the variables of good corporate governance, the existence of independent audit committee proves to help companies limit or reduce earnings management action.

## 5. CONCLUSION, IMPLICATION, SUGGESTION, AND LIMITATIONS

Based on the results of discussion, the conclusions that can be put forward are: (1) management ownership has significant negative effect on earnings management in companies performing IPOs. It is in line with the hypothesis that the lack of stock ownership by management makes the management not flexible in making decisions as desired, causing management tend to perform earnings management; (2) institutional ownership has a significant positive effect on earnings management in companies performing IPO. It is in line with the views of Potter (1992) in Jao and Pagalung (2011) that institutional investors are temporary owners who focus on short-term earnings; (3) independent commissioner has a significant negative effect on earnings management in companies performing IPO. It is in line with the results of the researches conducted by Cornett (2009), and Rahmawaty (2013) that the greater the number of independent commissioners, the higher the level of supervision made so as to be able to minimize the actions of earnings management; (4) independent audit committee has significant negative effect on earnings management in companies performing IPO. It is in line with the results of the researches conducted by Xie et al. (2003) and Wirales-tari (2012) that the fewer the audit committees from outside of the company, the lower the supervision on the management which is considered less able to minimize earnings management practices.

Further researchers are recommended to be able to add or extend the period in measuring discretionary accruals in order to get a more accurate value and can use other measurement methods of discretionary accruals in detecting earnings management in a company.

This study is limited to only using accrual-based earnings management, but in fact the company uses various earnings management techniques. Therefore, Roychowdury (2006) stated that the accounting researches that draw conclusions about the earnings management only by basing on the accrual adjustment alone might be less valid (Ratmono 2010). So it is necessary to understand the earnings management conducted by companies through real activities other than through the accrual activities.

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