

# GOOD CORPORATE GOVERNANCE AND EARNINGS MANAGEMENT IN INDONESIAN INITIAL PUBLIC OFFERINGS

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## Abstract

This study investigates the relationship between corporate governance mechanisms and earnings management (as measured by discretionary current accruals) for Indonesian IPO firms. Previous studies have mainly focused on an examination of the effect of corporate governance on the earnings management of publicly traded firms, whilst this study examines newly listed firms. It employs a modified Jones model to measure earnings management as developed by Tykvova (2006). The hypothesis predicts that Indonesian IPO firms with good corporate governance will engage in less earnings management in the periods prior to the IPO year. The sample consists of 75 IPOs and the results show that the proportion of board of commissioners, public ownership, institutional ownership and managerial ownership constrain the extent of earnings management of IPO firms. This study contributes to the literature in showing that corporate governance mechanism is an important determinant in earnings management practices for Indonesian IPO firms.

**Keywords:** Corporate Governance, Earnings Management, Initial Public Offering, Indonesia

## 1. INTRODUCTION

Pricing newly issued shares in an initial public offering (IPO) is difficult because, prior to becoming a public firm, limited or no publicly available information is available about the firm. One relevant source of information used by potential investors in assessing the firm is the financial statement contained in the prospectus (Friedlan, 1994). The potential relationship between accounting information and the offering price of an IPO implies that issuers may have an incentive to choose certain accounting methods. Such selected methods can increase revenues from selling the new shares by managing the firm's profit through so-called earnings management. An information gap or information asymmetry between firms and potential investors during the IPO stimulates the incentive for the firm owners to increase profits that are not detected by the market (Healy and Wahlen, 1999). Rahmawati and Nurul (2006) have revealed that the higher the information asymmetry, the greater the possibility of earnings management practices.

Earnings management studies for IPOs have been widely performed. For example, Friedlan (1994) and Teoh et al. (1998) find evidence of earnings management practices of firms that conduct IPOs in the United States. Tykvova (2006) also documents the earnings management practices of IPOs in Germany. However, Aharony et al. (1993) report the absence of any strong indication of the occurrence of earnings management at the time of IPO.

In Indonesia, the findings are mixed. Gumanti (2001) examines Indonesian IPOs that went public

from 1995 to 1997 and finds earnings management in a two-year period before the IPO. A similar finding is reported in Irawan et al.'s research (2013). Amin (2007) also provides evidence of earnings management during IPO. Joni and Hartono (2009) find that the value of earnings management profit fell in the two-year period prior to the IPO and increase in the period of five years after the IPO. However, Warganegara and Indriastari (2009) report no evidence of 28 IPOs that went public during 2001-2006 inflating their reported earnings.

One effort that can be done to avoid the practice of earnings management is the implementation of good corporate governance (Siregar and Utama, 2005; Ujijantho and Pramuka, 2007; Gumanti and Prasetyawati 2011; Lande et al., 2014). According to Boediono (2005), corporate governance is one of the most efficient ways to reduce conflicts of interest and ensure the achievement of corporate objectives. Darmawati et al. (2004) state that good corporate governance can help to provide a structure that facilitates the determination of goals and the means to determine the performance monitoring techniques that can be a key element of improving the economic efficiency of an enterprise. Some corporate governance mechanisms, amongst others, include the presence of an independent board of commissioners, audit committees and the structure of ownership in a firm.

The existence of the external independent board is expected to carry out the supervisory function more effectively in a firm, so as to minimize managers' opportunistic actions. The

effective role of independent board in that matter has been evidenced (Peasnell et al., 2005; Xie et al., 2003; Wilopo, 2004; Cornett et al., 2008). In addition to independent directors, the establishment of an audit committee is also expected to help monitor the performance of directors and management. The existence of an audit committee will ensure the quality of financial reporting, thereby minimizing the occurrence of earnings management (Raja et al., 2014).

Another form of corporate governance mechanism that is believed to control the earnings management is the structure of ownership. According to Jensen (1993), public ownership can create governance systems in order to function properly; that is, it is able to increase monitoring of the management measures so as to enable the limiting of the occurrence of earnings management. A high level of institutional ownership will also encourage institutional investors to oversee and monitor the performance of management with the aim of ensuring the integrity of financial statements (Raja et al., 2014). Managerial ownership is believed to reduce the potential of conflict between principal and agent. Share ownership by managers will encourage the pooling of interest between principal and agent so as to improve firm performance (Jensen, 1986).

This study aims to examine the effect of corporate governance mechanisms in terms of the composition of the board of directors, audit committee and corporate ownership structure on the earnings management of Indonesia IPO firms. Previous studies have examined the effect of corporate governance on the earnings management of firms that have already gone public, while this study tests the newly listed firms, which certainly have different motivations for earnings management. Using a sample of 75 IPO firms, this study finds evidence that the proportion of independent board of commissioner and ownership structure are able to limit earnings management at the time of IPOs. The study also finds that the cash flow from operating activities is negatively related to earnings management.

The paper is organized as follows. Section Two provides a literature review and hypotheses development. Section Three presents the research methods. Section Four presents the findings and discussion and the final section provides a conclusion and outlines directions for future study.

## 2. LITERATURE REVIEW

Corporate governance is a concept based on agency theory, which contains a set of rules governing the relationship between shareholders, the managers of firms, creditors, government, employees and other stakeholders related to rights and obligations in order to achieve the firm's goals. Corporate governance mechanisms are expected to minimize agency conflicts within the firm. If the mechanism of corporate governance can work effectively and efficiently, then the whole process of the firm's activities will run well and hence it will be able to improve the firm's performance, both in financial and non-financial terms (Brown and Caylor, 2004). The application of good corporate governance is also expected to reduce the unprofessional actions of the management firm that can hurt many parties.

Earnings management is an act when managers use their judgment in financial reporting process

and in arranging transactions to affect the financial statements on the basis of the economic performance of the organization or to influence the results in accordance with the contract that depends on the reported accounting numbers (Healy and Wahlen, 1999). Healy and Wahlen (1999) and Scott (2011) confirm that the IPO setting provides an opportunity for the emergence of earnings management. Ball and Shivakumar (2008) give two reasons for the existence of earnings management in the IPO; namely, market demand and the firm's response to all sorts of rules as a public firm. IPO could be one of the driving factors for management to perform management actions by increasing the firm's profits with the goal of creating a positive image to potential investors (Friedlan, 1994; Teoh et al., 1998). Previous studies - amongst others Friedlan (1994), Teoh et al. (1998), Gumanti (2001) and Tykova (2006) - document the existence of earnings management conducted by the management prior to the IPO year.

Various studies have been carried out in relation to corporate governance mechanisms serving to minimize earnings management practices. Some of these studies show the components of corporate governance, such as composition of the independent board of commissioner, the existence of audit committee, the duality of roles, ownership structure, reduce earnings management (Saleh et al., 2005; Rahman and Ali, 2006; Bradbury et al., 2006; Gumanti and Prasetyawati, 2011).

### 2.1. Independent board of commissioner and earnings management in IPO

According to Fama and Jensen (1983), a non-executive director (independent director) has a supervisory in regard to management policies and can act as a mediator when dispute occurs among internal managers. The presence of an independent director strongly influences the effectiveness of the role of the board of directors in balancing the power of the CEO (Zahra and Pearce, 1989). Independent boards of directors will hence be more effective in monitoring the firm's financial reporting process (Klein, 2002).

The existence of an external board member may not only improve control measures, but also impact on the low utilization of discretionary accruals (Cornett et al., 2008). Several studies have shown that the role of independent board is to limit earnings management. For example, Peasnell et al. (2005) examine the effectiveness of the board of directors and independent directors in the UK and show that the presence of independent directors is able to limit earnings management action. Xie et al. (2003) also conclude that the expertise of independent directors and audit committees has been an important factor in preventing the tendency of managers to manage earnings. In Indonesia, Wilopo (2004) concludes that the presence of independent board and audit committee reduce earnings management practices. The term 'independent board of directors' in Western countries is synonymous to the independent board of commissioners in Indonesia.

Based on those arguments, we propose the following hypothesis:

H<sub>1</sub> The presence of independent board has a negative effect on the earnings management of IPOs.

Peasnell et al. (2005) argue that the composition of the board of commissioners affects earnings management practices. Increased supervision by independent commissioners can be associated with a smaller use of discretionary accruals (Cornett et al., 2008). Dechow et al. (1996), as well as Nasution and Setiawan (2007), conclude that there is a significant negative effect on the proportion of independent board members on earnings management practices. Accordingly, we propose the following hypothesis:

H<sub>2</sub> A proportion of board independence has a negative effect on the earnings management of IPOs.

## 2.2. Audit committee and earnings management in IPO

The audit committee is a committee established in order to implement the principles of good corporate governance, with the aim of helping to oversee the performance of directors and management team. The audit committee is obliged to maintain a professional level of independence in assessing performance and management responsibilities. An audit committee is acknowledged to be capable of affecting the behavior of management and should so be more cautious in carrying out their duties (Tiswiyanti et al., 2012).

Raja et al. (2014) state that the existence of independent audit committee will ensure the quality of financial reporting, thereby minimizing the occurrence of earnings management. This finding is in line with Wilopo (2004), Bradbury et al. (2006), and Nasution and Setiawan (2007) who find evidence that the existence of audit committee has a negative effect on earnings management. Accordingly, we propose the following hypothesis:

H<sub>3</sub> The audit committee has a negative effect on the earnings management of IPOs.

## 2.3. Ownership structure and earnings management in IPOs

The proportion of public ownership is the percentage of the firm's shares offered to the public during the IPO, compared to the total number of shares issued and fully paid. The financial interests of public investors can create a corporate governance system that can improve the function of the supervision of the management and create measures to enable the limiting of the occurrence of earnings management (Jensen, 1993).

Raja et al. (2014) have examined firms listed at the Indonesia Stock Exchange to show that the greater the percentage of shares offered to the public during the IPO, the lower the level of earnings management activity. This happens as a result of increased public scrutiny of the information presented by management firms. Based on this argument, the proposed hypothesis is:

H<sub>4</sub> Public ownership has a negative effect on the earnings management of IPOs.

Institutional ownership is one form of the implementation of corporate governance mechanisms, which shows the percentage of shares owned by the institution; namely banks, insurance firms, investment firms or private firms. Jensen and Meckling (1976) state that institutional ownership has an important role in minimizing the agency conflict that occurred between owners and managers. A high level of institutional ownership

will encourage institutional investors to a greater scrutiny so that it can deter managers' opportunistic behavior. Institutional investors are often referred to as sophisticated investors because they have a better ability to use the current period information to predict future earnings compared to non-institutional investors (Siregar and Utama, 2005).

Institutional ownership is expected to increase managerial accountability because the manager will act more cautiously in making decisions that can affect the integrity of the financial statements. Jiambalvo (1996) finds that the absolute value of discretionary accruals is negatively related to institutional ownership. Raja et al. (2014) conclude that the greater the level of institutional ownership, the greater is the power of the voice and the encouragement of financial institutions to oversee the management so as to restrict the actions of earnings management. Based on this argument, the proposed hypothesis is:

H<sub>5</sub> Institutional ownership has a negative effect on the earnings management of IPOs.

One way of reducing the conflicts between principals and agents is by improving the managerial ownership of a firm (Wiranata and Nugrahanti, 2013). When associated with the agency theory, share ownership by managers will encourage the pooling of interest between principal and agent so as to improve firm performance (Jensen, 1986). Managers will also be more cautious in making decisions because every decision will have a direct impact on the welfare of the manager who is also the shareholder of the firm. Accordingly, managerial ownership is expected to reduce the motivation of managers to manage earnings that will adversely affect the firm. Ujiyantho and Pramuka (2007) show that managerial ownership can become corporate governance mechanisms that can limit earnings management action. Based on this argument, the proposed hypothesis is:

H<sub>6</sub> Managerial ownership has a negative effect on the earnings management of IPOs.

## 2.4. Firm size, cash flows from operating activities, and the earnings management of IPOs

Here, two variables are used as control variables; namely, the size of the firm and the operating cash flow. Under the political cost hypothesis of the positive accounting theory, large firms will have less incentive in managing earnings compared to small firms (Watts and Zimmerman, 1986). Chen et al. (2005) and Nuryaman (2008) conclude that the size of a firm has a significant negative effect on earnings management because large firms have little incentive to undertake earnings management as they generally receive close supervision of financial analysts and investors. Although Nastiti and Gumanti (2011) and Pambudi and Sumantri (2014) report that the size of the firm has a positive effect on earnings management, this study predicts that firm size is negatively related to earnings management in the IPO.

The quantity of cash flows arising from operating activities is an indicator of whether the firm's operational activities can generate sufficient cash flows to repay loans, maintain the operating capability, pay dividends and make new investments without relying on external sources of financing. Meythi (2006) states that cash flow information is a financial indicator that is superior to accounting

income due to the fact that the cash flow statement is relatively easier to interpret and relatively difficult to manipulate. One way to determine the indication of earnings management is to compare the distribution of net cash flow from operating activities standardized by total assets in the previous year (Irawan et al., 2013). Dechow et al. (1995), Chen et al. (2005) and Nastiti and Gumanti (2011) show that operating cash flow has a significant negative relationship with earnings management. Thus, this study predicts that operating cash flow is negatively related to earnings management in the IPO.

### 3. METHODOLOGY

#### 3.1. Population and sample

The subjects of this study are the firms making IPOs at the Indonesian Stock Exchange from 2003 to 2012. The sample is determined using a purposive sampling method, with the following criteria:

- firms operating in the financial sector (banking, insurance, financial institutions and property, real estate and construction) are not included in the sample selection, as it has specific accounting rules that might affect the measurement of current discretionary accruals (DCA);
- firms must have three years of audited financial statements in the prospectus in order to calculate the components of the DCA;
- firms should be in the industrial sub-sectors where there are at least four firms in the same sub-sector. This is related to the industry sub-sector approach used to estimate the current value of non-discretionary accruals (NDCA).

Table 1 presents the process of sample determination. As can be seen in Table 1, from the 163 firms that went public from 2003 to 2012, 75 of them met the selection criteria.

**Table 1.** Sample determination process

No.	Description	Number of firms
1	Firms went public from 2003 to 2012	163
2	Firms in banking, insurance, financial institutions and property, and real estate and construction.	(58)
3	Firms with less than three years of financial statement available in the prospectuses	(5)
4	Firms with extreme DCA value	(3)
5	Prospectuses are not available in the database	(22)
Final sample		75

#### 3.2. Calculation of DCA

This study uses an approach that focuses on accruals to indicate the current earnings management, as in Nastiti and Gumanti (2011). It is based on the assumption that the manager has the flexibility and better control to the current accruals than the long-term accruals (Dechow et al., 1995; Teoh et al., 1998). Current accruals can be classified as non-discretionary and discretionary component, in which the determination of non-discretionary component of accruals (NDCA) is restricted by regulations, firms' policies and industry conditions, whilst the components of current discretionary accruals (DCA) can be controlled by the manager.

In the IPO context, the time series approach to estimating discretionary accruals developed by

Jones (1991) is difficult to apply because to be able to use the Jones model, we need longer time series data. Generally, the financial statements contained in the firm's IPO prospectuses in Indonesia consist on average of three periods only. Therefore, this study follows the approach used by Tykvoa (2006), which is a cross-sectional modification of the Jones model (1991).

To estimate the value of NDCA of firms making IPOs (firms  $i$ ), we use the NDCA components from other firms (firm  $k$ ) which are in the same sub-sector as the IPO firm (sub-sector  $j$ ) of the same year as the IPO firm (year  $t$ ). The NDCA component of the firms in the sub-sector  $j$  is then regressed and the results are used as the regression coefficient for calculating the NDCA component of the IPO firm.

The steps to calculating DCA are as follows:

a. Calculate Current Accruals (CA) of IPO in year  $t$  using the following equation:

$$CA = \Delta (\text{current assets} - \text{cash}) - \Delta (\text{current liabilities} - \text{long term liabilities due in less than 1 year}) \quad (1)$$

b. Calculate the NDCA components of firm  $k$  in the sub-sector  $j$  using the following equation:

$$\frac{CA_{jk,t}}{TA_{jk,t-1}} = \alpha_{j,t,0} \frac{1}{TA_{jk,t-1}} + \alpha_{j,t,1} \frac{\Delta REV_{jk,t}}{TA_{jk,t-1}} + \varepsilon_{jk,t} \quad (2)$$

Where  $CA_{jk,t}$  = Current accruals of firm  $k$  in the sub-sector of  $j$  at year  $t$ ;  $TA_{jk,t}$  = Total assets of firm  $k$  in the sub-sector  $j$  at year  $t$ ;  $\Delta REV_{jk,t}$  = the change of revenues (year  $t$  minus year  $t-1$ ) of firm  $k$  in the sub-sector  $j$ ;  $\alpha_{j,t,0}$ ,  $\alpha_{j,t,1}$  = regression coefficients of NDCA components of firm  $k$  in the sub-sector  $j$ .

c. Calculate NDCA of IPO firm at year  $t$  from regression coefficients of equation (2) using the following equation:

$$NDCA_{ji,t} = \alpha_{j,t,0} \frac{1}{TA_{ji,t-1}} + \alpha_{j,t,1} \frac{\Delta REV_{ji,t} - \Delta TR_{ji,t}}{TA_{ji,t-1}} \quad (3)$$

Where  $NDCA_{ji,t}$  = non discretionary current accruals (NDCA) of IPO firm in sub-sector  $j$  at year  $t$ ;  $TA_{ji,t}$  = Total assets of IPO in sub-sector  $j$  at year  $t$ ;  $\Delta REV_{ji,t}$  = the change of revenues (year  $t$  - year  $t-1$ ) of IPO firm in sub-sector  $j$ ;  $\Delta TR_{ji,t}$  = the change of account receivable (year  $t$  - year  $t-1$ ) of IPO firm in sub-sector  $j$ ;  $\alpha_{j,t,0}$ ,  $\alpha_{j,t,1}$  = regression coefficients of NDCA components of firm  $k$  in the sub-sector  $j$  from equation (2).

The change of account receivables is used as a component in calculating the IPO firm's NDCA because there is a possibility that the issuers would manipulate the value of credit sales in an effort to play down a high level of sales in the financial statements at the time of IPO (Dechow et al., 1995)

d. Calculate DCA of IPO firm in sub-sector  $j$  at year  $t$  using the following equation:

$$DCA_{ji,t} = \frac{CA_{ji,t}}{TA_{ji,t-1}} - NDCA_{ji,t} \quad (4)$$

Where  $DCA_{ji,t}$  = discretionary current accruals of IPO firm in sub-sector  $j$  at year  $t$ ;  $CA_{ji,t}$  = Current accruals IPO firm in sub-sector  $j$  at year  $t$ .

Table 2 presents the summary of variables measurement used in the study.

**Table 2.** Summary of variables measurement

No	Variable	Notation
1	<i>Independent board of commissioner:</i> The existence of an independent board is measured using dummy variable. A value of 1 is given to company that has independent board, and 0 for otherwise.	IBOD
2	<i>Proportion of independent board of commissioner:</i> The proportion of independent board is calculated by dividing the number of independent board members over the total of all board members.	PBOD
3	<i>Audit committee:</i> The audit committee is measured using dummy variable. A value of 1 is given if the firm has an audit committee, and 0 for otherwise.	AC
4	<i>Public ownership:</i> Public ownership is the percentage of shares offered to the public during the IPO expressed in terms of percentage.	PO
5	<i>Institutional ownership:</i> Institutional ownership is the percentage of shares owned by the institution of the entire outstanding shares at the time of IPO.	IO
6	<i>Managerial ownership:</i> Managerial ownership is the percentage of shares owned by the management of all the firm's outstanding shares at the time of IPO.	MO
7	<i>Firm size:</i> Firm size is the natural logarithm of total sales value at the end of the year <i>t</i> . Year <i>t</i> is the year of the last complete financial statements included in the prospectus.	FS
8	<i>Operating cash flows:</i> Operating cash flow is the operating cash flows in year <i>t</i> standardized by total assets of the previous year ( <i>t-1</i> ). Year <i>t</i> is the year of the last complete financial statements included in the prospectus	CFO

The following regression model is used to test the proposed hypotheses:

$$DCA_i = \beta_0 + \beta_1 IBOD_i + \beta_2 PBOD_i + \beta_3 AC_i + \beta_4 PO_i + \beta_5 IO_i + \beta_6 MO_i + \beta_7 FS_i + \beta_8 CFO_i + e_i \quad (5)$$

Where *DCA* = Discretionary Current Accruals; *IBOD* = Independent board of commissioner; *PBO* = Proportion of independent board of commissioner; *AC* = Audit committee; *PO* = Public ownership; *IO* = Institutional ownership; *MO* = Managerial ownership; *FS* = Firm size; *CFO* = Cash flows from operation.

#### 4. RESULTS

Table 3 presents the descriptive statistics of the variables. The average *DCA* is -0.046 with standard deviation of 0.343 which indicates a large level of variation in *DCA*. Firm with the lowest *DCA* is PT. Trikonsel Oke, Tbk. that went public in 2009 and firm with the highest *DCA* is PT. Aneka Kemasindo Utama, Tbk.

**Table 3.** Descriptive statistics of variables

Variable	Minimum	Maximum	Mean	Std. Deviation
DCA	-1.98	1.09	-0.046	0.343
PBOD	0.00	0.67	0.365	0.098
PO	0.09	0.73	0.264	0.136
IO	0.00	0.90	0.627	0.251
MO	0.00	0.90	0.085	0.209
FS	9.26	13.17	11.839	0.717
CFO	-0.49	1.03	0.099	0.212

Note: *DCA* = Discretionary Current Accruals. *PBOD* = Proportion of board of commissioner, *PO* = public ownership, *IO* = Institutional ownership, *MO* = Managerial ownership, *FS* = Firm size, *CFO* = Cash flows from Operating. The descriptive statistics of the independent board of commissioner and audit committee are not presented as they are dummy variables

The average proportion of independent commissioners is 0.365, meaning that on average each firm has about one-third of independent commissioner. The average public ownership is 26.44%, the average institutional ownership is 62.67% and the average managerial ownership is 8.47%. These findings show that the public owns just above a quarter of total outstanding shares of the firms. Interestingly, almost two-third ownership of the firms is under the institutional ownership.

Although it is not reported in this paper, the regression model has satisfied the assumption of non-heteroscedasticity. Table 4 presents the results of hypothesis testing.

Multiple regression analysis shows that proportion of commissioners has negative significant effect on the earnings management of Indonesian IPO firms ( $t = -2.188$ ;  $p < 5\%$ ). Similarly, public ownership ( $p < 10\%$ ), institutional ownership ( $p < 1\%$ ) and managerial ownership ( $< 5\%$ ) have negative significant effect on earnings management. Of the two control variables, operating cash flows has negative significant effect on earnings management ( $t = -2.651$ ;  $p < 1\%$ ).

The study finds that the existence of independent board of commissioners does not affect the level of earnings management. Proportion of independent board of commissioners affects negatively and significantly the level of earnings management in the IPO. The effectiveness of the board of commissioners in balancing the power of the CEO is strongly influenced by the level of independency of the board of commissioners (Wardhani, 2006). Higher number of members of independent board is perceived to limit earnings management practice. The result supports Dechow et al. (1996) and Nasution and Setiawan (2007) who assert that the proportion of independent board could limit earnings management. As an independent party or external to the firm, she has less conflict of interest so transparency in corporate financial reporting is more warranted (Nasution and Setiawan, 2007).

The existence of an audit committee is not proven capable of limiting the earnings management practice in the IPO. This result is consistent with Siregar and Utama (2005). However, it contradicts the research of Wilopo (2004), Bradbury et al. (2006), Nasution and Setiawan (2007), and Raja et al. (2014) who report that earnings management activity can be controlled effectively through the existence of the audit committee of a firm.

Public ownership has a negative and significant effect on earnings management. This indicates that a high percentage of shares owned by the public could

minimize earnings management practice. We may hence argue that a larger number of public ownership will force the firm to be overseen by more

parties so reducing the management's opportunistic behavior. This study supports those of Jensen (1993) and Raja et al. (2014).

**Table 4.** Results of least square regression

Variables	Predicted sign	Unstandardized coefficients	Standardized coefficients	t-talue
Constant		2,076		3,170***
IBOD	-	0,347	0,164	1,035
PBOD	-	-1,097	-0,313	-2,188**
AC	-	0,104	0,125	1,182
PO	-	-0,810	-0,321	-1,744*
IO	-	-1,068	-0,781	-2,756***
MO	-	-0,908	-0,555	-2,184**
FS	-	-0,090	-0,189	-1,633
CFO	-	-0,508	-0,314	-2,651**

Adj R<sup>2</sup> = 0.224, F-Value = 3.667\*\*\*

Note: the dependent variable is DCA = Discretionary Current Accruals. IBOD = independent board of commissioner, PBOD = proportion of independent board of commissioner, AC = audit committee, PO = public ownership, IO = Institutional ownership, MO = managerial ownership, FS = firm size, CFO = cash flows from Operating; \*, \*\*, \*\*\* denote significant at 10%, 5%, and 1%, respectively

Institutional ownership affects negatively and significantly the extent of earnings management in the Indonesian IPOs. These results support the studies of Jiambalvo (1996) and Raja et al. (2014) who assert that the larger the institutional ownership, the greater is the effort of overseeing the performance of the firm's management; in turn, this would minimize the opportunities of management to manipulate earnings.

Managerial ownership has a negative and significant effect on earnings management at the time of the IPO. This finding advocates that managerial ownership is one of the mechanisms of corporate governance that can reduce the conflict between principal and agent as well as to encourage the pooling of interest between principal and agent so as to avoid the opportunistic behavior of managers. This study supports Ujiyantho and Pramuka (2007).

Of the two control variables, the size of the firm does not have a significant effect on earnings management. This result is not consistent with Chen et al. (2005), Siregar and Pramuka (2005), Sanjaya (2008) and Nuryaman (2008), who find that the size of the firm has a significant negative effect on earnings management. In addition, this finding does not support the political cost hypothesis (Watts and Zimmerman, 1986).

Operating cash flow is found to minimize the occurrence of earnings management of firms making IPO in Indonesia. The result supports Chen et al. (2005), Aussenegg et al. (2009), and Nastiti and Gumanti (2011) who conclude that firms with high operating cash flow will avoid using discretionary accruals to increase their reported profits. This is because the cash flow from operating activities reflects the real prosperity of the firm in generating funds (funds flow) so that if the firms' cash flows from operating activities is high, the motivation to perform earnings management will decline because of the firm's capability to generate sufficient funds is also high (Nastiti and Gumanti, 2011).

## 5. CONCLUSION

This study aims to analyse the mechanisms of corporate governance as measured by the composition of the independent board, along with

the audit committee. It has also explored the existence of ownership structure in limiting the practice of earnings management of 75 firms making an IPO in the Indonesia Stock Exchange from 2003 to 2012. This study also includes two control variables, eg. the size of the firm and the operating cash flow. The results show that, as predicted, the proportion of commissioners, public ownership, institutional ownership and managerial ownership have a negative significant effect on earnings management. The study also finds that the operating cash flow has a significant negative effect on earnings management.

There are two things to keep in mind with regard to the findings reported here that can be treated as the limitations of the study. First, this study is limited to investigating the mechanism of corporate governance based on several characteristics; namely, the composition of the independent board, audit committee and ownership structure that still cannot be fully used as a reference to determine the effect of corporate governance on earnings management practices in an IPO setting. Thus, future study may expand by comparing their relation to earnings level prior to and after the offering. Second, the model to estimate discretionary current accruals has been applied without prior testing to determine whether it is appropriate for the condition in Indonesia. Furthermore, it uses regression estimates from other firms that are in the same sub-sector with the IPO firms to estimate the DCA. The value of the IPOs' DCA may not represent the actual value because the condition of each firm is different. Thus, future study may accommodate the scale or magnitude of the firm in considering the model used for regression or sector-based instead of being sub-sector based.

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