

CORPORATE GOVERNANCE MECHANISM AND EARNING MANAGEMENT WITH INTEGRATED MODEL

Rina Trisnawati and Suleksi Ekawati
Faculty of Economics and Business, Magister management programs
Muhammadiyah University of Surakarta
Jl A. Yani tromol pos 1 Pabelan, Surakarta, Indonesia
Phone: 062-271-717417; Faks: 062-271715448;
E-Mail: rinaums@yahoo.com. Mobile phone: 06285647248202

Abstract

Previous studies examining earnings management from accruals perspective even though this model can't describe the earning management practices completely. It ignored the relationship between accrual and cash transaction. In contrast, this study measuring integrated earnings management proxies i.e. real and accruals earnings management. Real earnings management proxies are measured by abnormal cash flow of operation, abnormal production cost, and abnormal discretionary expenses. While accruals earnings management proxies are measured by short and long term discretionary accruals. The purpose of this study examines the relationship between Corporate Governance mechanism i.e institutional ownership, managerial ownership, the independence of board committee, audit committee, and the size of board committee. The sample are 123 companies listed in JII and 158 companies listed in LQ 45 during 2004-2010 periods. Descriptive qualitative used to measure the mean value of these proxies, then aggregate earning management measured by ranking of them. The regression analysis used to examine the relationship between EM (integrated model) and CG. The results showed that proportional independence board committee, the size of board committee and audit committee have significant effect on EM (prob. vale 0.044;0.046;0.000) but the institutional ownership and managerial ownership have not significant effect on EM. In the future, researcher will continue this model by looking for the relationship EM with other variables such as relevance of accounting information and the explanation power of this model. The mechanism CG should be used CG index.

Key words: Corporate governance mechanism, Integrated earning management, Indonesian Stock Exchange

I. INTRODUCTION

Managers as corporate managers have more aware of internal information and prospects of the company in the future than the owners (shareholders). The gap of information will trigger a condition called as asymmetric information It can provide an opportunity for managers to manage the earnings in order to mislead the owner (shareholder) of the company's economic performance.

Corporate governance is a concept based on agency theory, is expected to serve as a tool to provide confidence to investors that they would receive a *return* on the funds they have invested. Corporate governance is concerned with how the investors believe that

managers will benefit them, sure that the manager will not steal or embezzle or invest in projects that do not benefit associated with funds or capital that has been invested by the investor, and the investor is concerned with how to control the managers. In other words, corporate governance is expected to reduce earnings management practices by management.

Earnings management practices by management can be minimized through monitoring mechanism to align differences in the interests between owners and management, It used by (1) increase the company's share ownership by management (managerial ownership) (Jensen and Meckling, 1976), (2) increase the stock ownership by institutional because they are considered a sophisticated investor (Midiastuti and Machfoedz, 2003), (3) the larger proportion of independent board (Peasnell, Pope and Young, 1998), (4) the size of board of commissioners, where the more number of commissioners that is to reduce earnings management (Midiastuty and Machfoedz, 2003) and (5) the existence of an audit committee also can reduce earnings management (Wilopo, 2004).

Research on earnings management with various earnings management models in the Indonesian capital market both in the Islamic and conventional indexes has been done by (Wiyadi et al.2011, 2012). Generally, previous studies (Boediono (2005); Kusumawati (2005); Veronica and Bakhtiar (2005); Rahmawati, Suparno and Qomariyah (2006); Nasution and Setiawan (2007); Ujijantho and Pramuko (2007); Herawaty (2008) , Sasongko and Fauziah (2011), Wiyadi and Prasnowo (2011), Trisnawati and Nugroho (2011), are measuring earnings management used accruals aggregate approach. This approach separated total accruals into non-discretionary component and discretionary accruals (accruals components are in management or policy managers to intervene in the financial reporting process). This models frequently used is the modified Jones

Further models were developed to perform separation of components of discretionary accruals into short-term discretionary accruals component and long-term discretionary accruals. The separation is expected to clarify the role of each of the components of discretionary accruals to measure earnings management (Sasongko and Purbasari, 2012; Wiyadi and Safitri, 2012; Romi, 2011; Zayene and Jilani, 2010; Subekti, Wijayanti and Ahmad, 2010 ;).

The accrual earnings management measurement model is considered by some researchers still have not been able to reveal the full of the earnings management practices because the model ignores the relationship between cash flow transactions and accruals (Dechow et al. 1995, Kothari et al., 2005, Subekti, et al. 2010). Accounting research drawing conclusions about the earnings management only based on accrual adjustment alone may be invalid (Roychowdhury, 2006). Furthermore, Trisnawati and Suhestiningsih (2012) measured earnings management based on real activity. Survey Graham, Harvey and Rajgopal (2005)

found the evidence that top management as respondents are much more willing to engage in real earnings management) rather than accruals management to achieve earnings targets

The integrated management model introduced by Leuz, Nanda and Wysocki (2003). This model is a combination of the values of smoothing earnings and reported earnings discretion (discretionary accruals) and real earnings management. Later, this model adopted by Habib (2004). Subekti, Kee and Ahmad (2008) also conduct an integrated approach to earnings management by performing factor analysis to determine the value of earnings management. Trisnawati et al (2012) conducted a study of earnings management by integrated approach with an average approach. They refer Baharudin and Satyanugraha (2008). Real earnings management is measured by abnormal operating cash flow, abnormal production costs, and abnormal discretionary expenses (Suhastiningsih and Trisnawati, 2012). While accrual earnings management is measured by *short-term discretionary accruals* and *discretionary long term accruals* (Wiyadi and Safitri, 2012; Sasongko and Purbasari, 2012). Integrated measurements provide a more accurate model to measure earnings management in the Indonesian capital market (Trisnawati et al, 2012).

This research is to analyze the role of corporate governance mechanisms in reducing earnings management. Corporate governance mechanism is measured by the managerial ownership, institutional ownership, the proportion of independent board, the number of independent board and audit committee existence. While the measurement of earnings management using integrated earnings management refers Leuz, Nanda and Wysocki (2003). Habib (2004) Subekti, Kee and Ahmad (2008) and Trisnawati et al (2012).

LITERATURE REVIEW AND HYPOTHESES

Earnings Management

Scott (2006: 344) defines earnings management as follows “*Given that managers can choose accounting policies from a set (for example, GAAP), it is natural to expect that they will choose policies so as to maximize their own utility and/on the market value of the firm*”. From this definition, the earnings management is an accounting policy chosen by the manager from accounting standards that can maximize their utility or the enterprise market value.

Schipper (1989) defines earnings management as an intervention with the specific purpose of external financial reporting process deliberately to gain some personal advantage. Fischer and Rosenzweig (1995) defines earnings management as an act of a manager by presenting a report that raise (lower) profit for the period of the business unit that became his responsibility, without causing an increase (decrease) the economic profitability of such units

in the long run. Meanwhile, Healy and Wahlen (1999), earnings management occurs when managers use considerations (judgment) in financial reporting and the preparation of transactions to alter financial reports, in order to manipulate the size (magnitude) of income to some stakeholders about the economic performance of the company or to influence the outcome agreement (contract) which depends on the accounting figures reported.

Healy and Wahlen (1999), states that the definition of earnings management contains several aspects. The first, intervention of earnings management from financial reporting can be done with the use of judgment, for example judgment needed in estimating the number of economic events in the future to show in the financial statements, such as the estimated economic life and residual value of fixed assets, the responsibility for pensions, deferred taxes, losses receivables and a decrease in asset values. Besides, the manager has the option of accounting methods, such as the depreciation method and cost method. Secondly, the purpose of earnings management to mislead stakeholders about the economic performance of companies. This is occurs when management has access to information that it is not accessible by outsiders. Earnings management is intervening process of external financial reporting in order to make benefit themselves. Earnings management is one factor to reduce the credibility of financial reporting, it increases the bias in the financial statements and can interfere the trust of financial statements users because the profit rate was engineered as a number of profit without engineering (Setiawati and Na'im, 2000).

Corporate Governance mechanism

Effendi (2009) defines corporate governance as a system of internal control that has the main purpose to manage risk to achieve its business objectives through enterprise asset security and enhance the value of shareholders' investment in the long run. Roodposhti and Chashimi (2011) describes the good corporate governance is to decrease difference interest between shareholder and managers. The role is more useful when manager have the opportunity to deviate from the shareholders' interests or conduct earnings management. *Principles of Good Corporate Governance* is based on the principles of transparency, accountability, responsibility, independence, and fairness (corporate governance principles in accordance with Keputusan Menteri BUMN No 117/M-MBU/2002 dated July 31, 2002 about the implementation of GCG the in BUMN).

Managerial Ownership

Managerial ownership is a situation where the manager as well as the company's shareholders. In the financial statements, the circumstances shown by the percentage of ownership in company stock by the board of commissioners, the board of directors is

disclosed in the notes to the financial statements. Firms with managerial ownership as well as its shareholders would be aligning its interests. If a company has a high managerial ownership, managers are much more concerned about the interests of shareholders. Thus, capital structure with high managerial ownership reduce agency costs and increase voluntary disclosure (Saputri, 2010).

The results Morck et al. (1988), Warfield *et al.* (1995); Gabrielsen, *et al.* (2002), and Midastry and Mahfoedz (2003) gives the conclusion that the company is managed by a manager and have a certain percentage of the company's stock can affect the earnings management practice. In addition, pressure from capital markets cause firms with low managerial ownership will choose accounting methods that increase reported earnings, which in fact does not reflect the economic circumstances of the company concerned. According to Jensen and Meckling (1976) the interests of managers and shareholders can be aligned when managers have a larger company shares. Based on the reasoning and findings of previous research, this study will examine the effect of managerial ownership with measures of earnings management. In other words, the greater the ownership of the manager, the earnings management can be reduced. Then the hypothesis can be formulated as follows:

H₁: Managerial ownership affects negatively on earnings management

Institutional Ownership

Institutional ownership is the shares owned by institutions, such as insurance companies, banks, investment companies, and other institutional ownership. Institutional ownership is important to monitor because of the presence of management by institutional ownership leads to a more optimal control (Permanasari, 2010). Institutional ownership has the ability to control the management through monitoring process effectively so the management reduce earnings management. This reasoning supported by Rajgopal *et al.* (1999), Bushee (1998), Rajgopal and Venkatachalam (1998), and Midastry and Mahfoedz (2003). Conclusions of these results are institutional ownership has the ability to affect earnings management practice that can be pressing *discretionary* management in the financial statements for providing the quality of reported earnings. Indicators used to measure institutional ownership is the percentage of shares owned by institutions from the total shares of the company

Institutional ownership is often referred to as institutional investors are sophisticated investors and should be able to use the information in the current period compared to predict future earnings with non-institutional investors. Balsam *et.al* (2002) found a negative association between discretionary accruals are not expected to stock returns around the

announcement date, which is a negative relationship varies depending on the level of sophistication of investors, where the reaction of the market is more sophisticated investors who preceded unsophisticated investors. Jiambalvo *et. al* (1996) found that the absolute value of discretionary accruals is negatively related to institutional investor ownership. Madiastuty and Mahfoedz(2003) found that the presence of high institutional ownership restricts managers do earnings management. This study will test the effect institutional ownership to earning management, so the hypothesis can be formulated as follows:

H₂: Institutional ownership affects negatively on earnings management

The size of the Board Commissioners

Number of board members that are owned by the company, consisting of the main commissioner, an independent commissioner, and the commissioner. Commissioners have a duty and responsibility to supervise and advise the board of directors and also ensure that the company has conducted to *good corporate governance* rules No. 40/2007 Section 108 subsection (5) explains that for companies is required to have at least two (2) members of the Board of Commissioners. Therefore, the number of members of the Board of Commissioners in Indonesia vary depend on the complexity of the company with regard to its effectiveness in decision-making. In Indonesia, the number of Commissioners at most three and five people (Ratnasari, 2011). Number of commissioners is an important factor in the effectiveness of the commissioners. Through the role of the board in exercising oversight of the company's operations by management, the board can make an effective contribution to the outcome of the process of preparation of the financial statements of quality or avoid the possibility of fraudulent financial statements. However, the literature has not provided a consensus regarding the relationship between the number of commissioners and effectiveness (Chtourou et al. 2001). A large number of commissioners will reduce the effectiveness of the functions but it is easier to control the board of directors (Jensen and Meckling, 1976)). On the other hand, a large number of commissioners created a better environment relationships and more expert. The research hypothesis can be formulated;

H₃: The size of the board of commissioners affect on earnings management

Proportion of Independent Commissioner

Independent Commissioner is a commissioner who is not a member of management, shareholders, or other party related directly or indirectly to the majority shareholder of a company(Surya and Yustivandana, 2006). Independent directors are expected to put justice (*fairness*) as a core principle in the interests of other parties, such as minority shareholders and other *stakeholders*, because the independent directors should be free of interest and any

business that may be considered as interference to act in the interests profitable companies (Linoputri, 2010). The commissioners composition consisting of members from outside the company have a tendency affect earnings management. This reasoning supported research Dechow et al. (1996), Chtourou et al. (2001), Midiastuty and Mahfoedz (2003, and Xie et al. (2003). The results provide conclusion that companies with compositions by commissioners who come from outside the company may affect the action of earnings management. Through its role in oversight, board composition may influence the management in preparing the financial statements in order to obtain a qualified profit (Anderson *et al.*, 2003). Dechow *et al.* (1995) in his research shows that companies that earnings manipulation is more likely to have a board that is dominated by management and are more likely to have a major directors who concurrently as chief commissioner. Chtourou et al. (2001) and Wedari (2004) found that independent commissioners will restrict earnings management activities. Based on the above arguments and empirical findings, the research hypothesis can be formulated:

H4: The proportion of independent board effect on earnings management

Existence of audit committee

Research by Veronica and Bakhtiar (2004) found that audit committees have a significant relationship with discretionary accruals in manufacturing company in Indonesia, especially for the period 2001 to 2002, The presence of an audit committee to effectively reduce the amount of earnings management in the company. Wilopo (2004) analyzes the relationship of independent board, audit committee, corporate performance and discretionary accruals. These studies reported that the presence of audit committees and independent board affecting earnings management practices in the company. It indicates that the mechanism of corporate governance is important to ensure the implementation of company practices will be fair (fair) and transparent. The research hypothesis can be formulated:

H5: the existence of an audit committee negatively affect earnings management practices

RESEARCH METHODS

The population was all companies listed in the index JII and Conventional Index (LQ 45) during the period 2004-2010. The sample selected by purposive sampling. The data is the annual financial statements published consecutively and have complete information for analysis. The following table describes the sample used in this study

Table 1. The sample

| Companies listed in LQ-45 | |
|---|------------|
| Companies listed on the LQ-45 during the 2004-2010 periods (45x7) | 315 |
| Number of banking industries, insurance and other financial industries | (49) |
| The number of companies that do not publish financial statements in order | (79) |
| Number of companies which data is incomplete | (24) |
| Outlier | (7) |
| The number of companies as the sample in LQ 45 | 158 |
| Companies listed in JII | |
| The companies listed in the JII during the 2004-2010 periods (30 x 7) | 210 |
| The number of companies have incomplete data | (80) |
| Outlier | <u>(7)</u> |
| Number of companies as the sample in JII | 123 |

VARIABLE

Dependent variable in this study is earning management as measured by **earnings management integrated** (the average value of each proxy is *Short term discretionary accruals and discretionary long term accruals, abnormal cash flow operations (CFO), abnormal production costs (PROD)* , and *abnormal discretionary expenses (DISCR)*. Measurement of real earnings management refers to Roychowdhury (2006). Measurement accrual earnings management refers to Kothari et al (2005) and the idea of an integrated measurement of earnings management refers Baharudin and Satyanugraha (2008). Measurement of each proxy is:

a. Abnormal Cash Flow Operation (*Abnormal CFO*)

$$CFO_t / A_{t-1} = \alpha_0 + \alpha_1(1/\log.A_{t-1}) + \beta_1(S_t/A_{t-1}) + \beta_2 (\Delta S_t/A_{t-1}) + \varepsilon_t$$

b. Abnormal Production Costs

$$PRODt / A_{t-1} = \alpha_0 + \alpha_1(1/\log. A_{t-1}) + \beta_1(S_t/A_{t-1}) + \beta_2 (\Delta S_t/A_{t-1}) + \beta_3 (\Delta S_{t-1}/ A_{t-1}) + \varepsilon_t$$

c. Abnormal Discretionary Expenses

$$DISC_t / A_{t-1} = \alpha_0 + \alpha_1 (1 / \text{Log} \cdot A_{t-1}) + \beta (\Delta S_{t-1} / A_{t-1}) + \varepsilon_t$$

d. Short Term Discretionary Accrual

$$STDA = \frac{STACCI_t}{TA_{i,t-1}} \left\{ \beta_1 \left(\frac{1}{\text{Log} TA_{i,t-1}} \right) + \beta_2 \left(\frac{\Delta REVI_t - \Delta RECI_t}{TA_{i,t-1}} \right) + \beta_3 \left(\frac{INCI_t}{TA_{i,t-1}} \right) \right\}$$

e. Long Term Discretionary Accrual

$$LTDA = \frac{LTACCI_t}{TA_{i,t-1}} \left\{ \beta_1 \left(\frac{1}{\text{Log} TA_{i,t-1}} \right) + \beta_2 \left(\frac{PPE_{i,t}}{TA_{i,t-1}} \right) + \beta_3 \left(\frac{INT_{i,t}}{TA_{i,t-1}} \right) + \beta_4 \left(\frac{INCI_t}{TA_{i,t-1}} \right) \right\}$$

Qualitative descriptive analysis performed to calculate the amount of abnormal CFO, abnormal PROD, abnormal DISCR, STDA and LTDA and to express the degree of *earnings* management in each proxy for each sub-group sample (JII and LQ45) during the period 2004-2010. Ranking made to the value AGGREGATE EARNINGS MANAGEMENT by calculating the average value of the four proxies of aggregate earnings management (AGGR).

Independent variables in this study include:

1. Managerial Ownership

Managerial ownership is the percentage of shares owned by management who actively participate in corporate decision-making (commissioners and directors). Its measurement is (the number of shares owned by management divided by total number of shares outstanding) x 100%

2. Institutional Ownership

Institutional ownership is the percentage of shares owned by institutional investors. Institutional ownership = (the number of shares owned by institutional investors divided by the total number of shares outstanding) x 100%

3. Commissioners Size

Board of commissioners is the supervisor in charge of the company and responsible for overseeing and providing advice to directors and to ensure that companies implement GCG. Board size was measured by using the number of commissioners from both internal and external.

4. Proportion of Independent Board of Commissioners

It measured by the percentage of independent board members from companies commissioner outsiders (not management and owner). So, the formula is (Number of independent commissioners commissioners coming from outsiders divided by the total number of commissioners).

5. Existence of the Audit Committee

The audit committee is a dummy variable, if the company's Audit Committee established committee audit consisting of three people, led by an independent commissioner was given the score 1. If there is no audit committee was given the zero score.

Qualitative descriptive analysis performed to calculate the amount of abnormal CFO, abnormal PROD, abnormal DISCR, STDA and LTDA and to express the degree of *earnings management* in each proxy for each sub-group sample (JII and LQ45) during the period 2004-2010. Ranking made to the value AGGREGATE EARNINGS MANAGEMENT by calculating the average value of the four proxies of earnings management integrated form (AGGR). Multiple regression analysis was used to test the hypothesis by using the following equation:

$$ITG = + {}_1MGROWN + {}_2INSTOWN + {}_3BOARSIZE_L + {}_4BOARDINP + {}_5AUDCOM + e$$

Description:

ITG_{LQ-45} : Earnings management with an integrated approach

A : intercept,

_{1,2,3,4,5} : coefficient

MGROWN : managerial ownership

INSTOWN : institutional ownership

BOARSIZE : board size

BOARDINP: the proportion of independent board

AUDCOM : the existence of an audit committee

i : error term.

RESULTS AND DISCUSSION

The purpose of this study was to analyze the effect of *corporate governance* mechanisms as measured by managerial ownership, institutional ownership, board size, and the presence of independent board audit committees on earnings management which measured by integrated (AGGR) model in the company is incorporated in the Islamic Indices (JII) and conventional index (LQ45). The description of the variables studied can be seen in Table 2 below.

Table 2. Descriptive Statistics

| Variables | JII (average value) | LQ45 (average value) |
|------------------|----------------------------|-----------------------------|
| INTEGRATION JII | 0.09398 | 0.04090 |
| MGROWN | 0.08565 | 0.10493 |
| INSTOWN | 0.54272 | 0.50874 |
| BOARDSIZE | 6:33 | 6:18 |
| BOARDINDP | 0.35103 | 0.3579 |
| AUDCOM | 00:46 | 0.39 |

Descriptive statistical results showed that the average profit management integration approach for companies listed in the index and the LQ-45 index JII is 0.04090 and 0.09398 for. Earnings management by numbers approach to enterprise integration in the LQ-45 index and JII is positive, it shows that in the period 2004 to 2010 the company made with the pattern of earnings management practices increase profit figures. These results support the study by Jiambalvo et al (1996), Sweeney (1994); Rosner (2003); Djakman (2003); Andriyani (2004), and Kusumawati and Sasongko (2005) who provide empirical evidence of the pattern of earnings management in the form of raising the earning reported..

Institutional ownership for companies in the LQ-45 index greater than the index of JII is equal to 0.50874 and 0.54272, while the average lower managerial ownership is equal to 0.08565 versus 0.10493 companies listed in the LQ-45 index and JII has the proportion of the board of commissioners that is a percentage of the number of independent directors in the board of commissioners whole company amounted to 35 percent. This means that according to one of the Decree grain Directors. No.Kep-315/BEJ/06-2000 Jakarta Stock Exchange, that the issuer must have at least 30 percent of the total number of independent board of commissioners (www.bapepam.com). Average corporate existence of audit committees in both the JII and LQ45 index is less than 50%. The average number of commissioners who

represent the number of commissioners from both internal and external company amounted to 6 members.

To answer hypothesis 1 to hypothesis 5, it will be investigated the level of significance of independent variables on the dependent both on JII and LQ45 index. The table below is the result of regression to the research model.

Table 3. Regression Analysis

| Variables | Koef. LQ 45 | Sig. | Koef.JII | Si.g |
|---------------------|--------------------|-------------|-----------------|-------------|
| Constants | 0262 | .002 | - .281 | .138 |
| INSTOWN | - .080 | .346 | .203 | .232 |
| MGROWN | - .044 | .712 | .363 | .256 |
| BOARDINP | - .002 | .017 | - .415 | .044 |
| BOARDSIZE | - .007 | .280 | .030 | .046 |
| AUDCOM | - .112 | .000 | .004 | .953 |
| R | .355 | | .303 | |
| R ² | .126 | | .092 | |
| Adj. R ² | .098 | | .053 | |
| F | 4,583 (0,001 *) | | 2,364 (0,044 *) | |

Testing Hypothesis 1 (managerial Ownership)

The results demonstrate the coefficient value is -0.044 (sig.0.712) and 0.0363 (sig.0.256). This suggests that managerial ownership (MGRWON) had no effect on earnings management practices with an integrated approach in the LQ-45 index and the index of JII.

The result is in contrast with some studies that high managerial ownership will reduce earnings management practices Gabrielsen, *et al.* (2002); Midiastuty and Mas'ud Mahfoedz (2003). The reason for this is in the study, the percentage of managerial ownership is very low (10%). Thus, these results have not addressed that managerial ownership reduce the misalignment of interests between management by the owners or shareholders.

Testing Hypothesis 2 (Institutional Ownership)

The analysis showed that for INSTOWN variables, coefficients (beta) is (-0080; sig.0.346) and (0203; sig.0.232). These results suggest that hypothesis 2 is not supported, it means that institutional ownership does not negatively affect earnings management practices with an integrated approach in both the Islamic indexes and conventional index). The results of this study do not support the research conducted by Jensen and Meckling (1976), Warfield *et al.*, (1995), Dhaliwal *et al.*, (1982), Morck *et al.*, (1988). The results are consistent with the view or concept that institutional owners are more focused on current earnings (Midiastuty and

Mahfoedz, 2003). As a result, managers are forced to take action that can improve short-term profits, for example, with earnings manipulation. The same view was also expressed by Cornett *et al.*, (2006) which states that institutional ownership would make the manager feel bound to meet profit targets of the investors, so that they will still tend to engage in earnings manipulation.

Midiastuti and Machfoedz (2003) stated that the presence of institutional investors may reduce earnings management measures, as institutional investors are considered more experienced. However, the assumption of this condition is the possession of a *sophisticated institution*. In fact not all investors are institutional investors who *sophisticated*. This is especially true in terms of the percentage of institutional investor ownership low.

Testing Hypothesis 3 (Size Board of Commissioners)

Based on descriptive statistics, board number is 6 both in JII and LQ45 indexes. Number of commissioners give effect to the earnings management differently. In LQ 45, many commissioners does not affect earnings management (beta -0.07; sig.0.280). This study gives the opposite result with Xie, et al. (2003), Yu (2006), and Chtourou, et al.(2001) which shows that board size larger to reduce management profits in the company, as indicated by the significant negative coefficient.

It can be explained that the placement or additional commissioners made to comply with the formal, while the majority shareholder (controlling / *founders*) still plays an important role so that the performance of the board is not increased even down (Gideon, 2005). The size of the board size is not a major determinant of the effectiveness of the oversight of the company's management. However, the effectiveness of control mechanisms depends on the values, norms and beliefs are accepted within an organization (Jennings 2004a; 2004b; 2005a; Oliver, 2004) as well as the role of the board of commissioners in control activities (*monitoring*) to management (Cohen, *et al.*, 2004; Jennings 2005b).

But at JII index, variable BOARDSIZE positive effect on earnings management (koef 0.030; sig.0.046). The results support the research conducted Robert Jao (2011). It can be explained that the number of commissioners is not a major determinant of the effectiveness of the oversight of the company's management. However, the effectiveness of control mechanisms depends on the values, norms and beliefs are accepted within an organization (Jennings 2004a; 2004b; 2005a; Oliver, 2004) as well as the role of the board of commissioners in control activities (monitoring) to management (Cohen, *et al.*, 2004; Jennings 2005b).

Testing Hypothesis 4 (The proportion of independent board))

Results of the analysis showed that the variables BOARDINP (hypothesis 4) is supported data in the LQ 45 index and JII index (koef.-0002; sig.0.017) and (-0415; sig. 0.044). Thus, the proportion of independent board (BOARDINP) negatively affect earnings management practices with an integrated approach This study supports research Chashmi and Roodposhti (2011) about the impact of corporate governance mechanisms on earnings management. Research findings showed board independence is negatively related to earnings management. This results also supported by Dechow et al. (1995), Chtourou et al. (2001), Midiastuty and Mahfoedz (2003), and Xie et al. (2003). The results explain that companies with the compositions by commissioners who come from outside the company may affect the action of earnings management. Through its role in oversight, the composition of the board of commissioners from outside the company may affect the management in preparing the financial statements in order to obtain a qualified profit.

Testing Hypothesis 5 (The existence of audit committee)

The hypothesis aims to test whether the presence of an audit committee negatively affect earnings management practices with an integrated approach on the LQ-45 index and JII index. The analysis showed that the variable AUDCOM have beta value (-0122; sig.0.000) in LQ45 index (beta 0.004; sig.0.953) in JII index. These results indicate that hypothesis 5 is supported. So the existence of an audit committee may reduce the company's earnings management practices on the LQ-45 index. In contrast, the JII index, the presence of an audit committee does not affect earnings management. It means that the audit committee as a part of corporate governance mechanism has not been able to reduce earnings management practices by management. From this it can be seen that the audit committee of the company not performing their duties properly in overseeing the company by upholding the principles

of corporate governance, transparency, fairness, responsibility, and accountability. It is possible, because this study measures the presence of an audit committee with dummy variables and not measure the characteristics of the audit committee members. These characteristics are audit committee activity (number of meetings with the function of the Internal Control System (SPI) and the external auditors, audit committee members competency, educational background and experience as a member of the audit committee

CONCLUSIONS

This study aimed to determine the effect of corporate governance mechanisms on earnings management practices with an integrated approach on publicly traded companies incorporated in the LQ-45 index and the JII index. The results showed that: (1) Managerial ownership has not significant effect on earnings management with an integrated approach (2) institutional ownership has not significant effect on earnings management at JII and LQ 45 index, (3) the number of commissioners effect on earnings management at JII index , but in LQ 45 index, it was not significant. (4) the proportion of independent board commissioners board significant negative effect on earnings management, (5) the existence of audit committee has negative effect on earnings management at LQ 45 index, but has not significant effect on the JII index.

There are some limitations of this study, such as (1) the need for the other variables in the corporate governance mechanisms. By looking at the value of R^2 is relatively small, then for subsequent studies have examined the use of Corporate Governance Issued Index by ICGI so the role of the mechanism of CG is able to reduce the amount of earnings management by management. (2) earnings management perspective used in this study is the opportunistic perspective. It means that earnings management as the actions taken by management to deceive stakeholders. For further research of earnings management needs to be reviewed from the others perspective, such as efficiency perspective. Efficiency perspective states that managers perform the accounting policy choice to provide better information about impending cash flow and to minimize the agency cost that occurs due to a conflict of interest between stakeholders and managers (Jiambalvo, 1996). (3) Variable corporate governance mechanism which proxies by institutional ownership, managerial ownership, board composition, board size, and the existence of an audit committee. These five variables can not be a comprehensive measure of corporate governance practices in the company, so the need for an index that reflects the corporate governance mechanism are more appropriate. (4) Develop a measurement model that is more accurate for counted earnings management each

industry. So, the characteristics of different industries can also identify differences in the pattern of earning management each industries.

Acknowledgment:

* This paper is funded by DP2M DIKTI : Surat Koordinator Kopertis VI
Nomor :
292/K6/KL/2013 Tanggal : 20 Februari 2013

* Thanks for all of team post graduate research programs (Dr Noer Sasongko, Drs Wiyadi MM Ph.D, Nanang Prasnowo, Emy Fauziah, Sidiq Permono Nugroho, Suhestiningsih, Lina Ayu Safitri, Happy Purbasari, Mulyaningsih, Sutanta dan Suleksi Ekawati)

REFERENCES

Baharuddin I, Satyanugraha H. 2008. **Praktek Earning management perusahaan Publik Indonesia**. Jurnal manajemen dan Akuntansi ,Volume 10 No.2. Agustus 2008, Hlm 69-80.

Balsam, S., Krishnan, J. & Yang, J.S. 2003. **Auditor Industry Specialization and Earnings Quality**. *Auditing: A Journal of Practice & Theory*, 22. 2, 71-97.

Boediono, Gideon SB., 2005. **Kualitas Laba: Studi Pengaruh Mekanisme Corporate Governance dan Dampak Manajemen Laba dengan Menggunakan Analisis Jalur**. Artikel yang Dipresentasikan pada Simposium Nasional Akuntansi 8 Solo tanggal 15 - 16 September 2005.

Chtourou, Sonda Marrakchi, Jean Bedard and Lucie Courteau. 2001. **Corporate Governance and Earnings Management**. Available online at www.ssrn.com

Cornett M. M, J. Marcuss, Saunders dan Tehranian H. (2006). **Earnings Management, Corporate Governance, and True Financial Performance**.
<http://papers.ssrn.com/>

Dechow, P.M. (1995). Accounting Earnings and Cash Flows as Measures of Firm Performance: The Role of Accounting Accruals. *Journal of Accounting and Economics* 17, p. 3-42.

Graham, J.R., Harvey, C.R. & Rajgopal, S. (2005). The Economic Implications of Corporate Financial Reporting. *Journal of Accounting and Economics*, 40, 3-73.

Habib, A (2004). **Impact of Earning Management on Value Relevance of Accounting Information ; Empirical Evidence from Japan**, *Managerial Finance*.30(11), 1-15.

Herawaty, Vinola. Peran Praktek **Corporate Governance Sebagai Moderating Variable Dari Pengaruh Earnings Management Terhadap Nilai Perusahaan**. Makalah disampaikan dalam Simposium Nasional Akuntansi XI di Makassar, 26-28 Juli.

Healy, Paul M. and J.M. Wahlen. (1999). **A Review Of The Earnings**

Management Literature And Its Implications For Standard Setting.
Accounting Horizons 13, p. 365-383.

- Jensen, Michael C. dan W.H. Meckling. (1976). *Theory of The Firm: Managerial Behavior, Agency Cost and Ownership Structure.* Journal of Financial Economics 3. hal. 305-360.
- Kusumawati, Astri Arfani Nur dan Noer Sasongko. 2005. **Analisis Perbedaan Pengaturan Laba (*Earnings Management*) pada Kondisi Laba dan Rugi pada Perusahaan Manufaktur di Indonesia.** Jurnal Akuntansi dan Keuangan, Vol. 4, No. 1. hal.1-20.
- Leuz, C., Nanda, D., & Wysocki, P.D. (2003). **Investor Protection and Earnings Management: An International Comparison.** *Journal of Financial Economics*, 69, 505-527.
- Midiastuty, Pranata dan Mas'ud Machfoedz. 2003. **Analisis Hubungan Mekanisme Corporate Governance dan Indikasi Manajemen Laba.** Artikel yang Dipresentasikan pada Simposium Nasional Akuntansi 6 Surabaya tanggal 16-17 Oktober 2003
- Nasution, Marihot dan Doddy Setiawan. 2007. **Pengaruh Corporate Governance Terhadap Manajemen Laba di Industri Perbankan Indonesia.** Makalah disampaikan dalam Simposium Nasional Akuntansi X di Makassar, 26-28 Juli.
- Peasnell, K.V, P.F. Pope. dan S.Young. (2001). *Board Monitoring and Earnings Management: Do Outside Directors Influence Abnormal Accruals.* Accounting and Business Research, Vol. 30. hal.41-63.
- Rahmawati, Yacop Suparno, dan Nurul Qomariyah. 2006. **Pengaruh Asimetri Informasi terhadap Praktik Manajemen Laba pada Perusahaan Perbankan Publik yang Terdaftar di Bursa Efek Jakarta.** Artikel yang Dipresentasikan pada Simposium Nasional Akuntansi 9 Padang tanggal 23-26 Agustus 2006
- Rajgopal, Shivaram. and Mohan Venkatachalam. (1998). *The Role Institutional Investors in Corporate Governance: An Empirical Investigation.* Working Paper. University of Washington. October.
- Ronen, J. & Yaari, V. (2008). *Earnings Management - Emerging Insights in Theory, Practice, and Research.* Springer Series in Accounting Scholarship
- Roychowdhury, Sugata. (2006). **Earnings Management through Real Activities Manipulation.** *Journal of Accounting and Economic*, 42, 335-370.
- Schipper, Katherine. (1989). **Comentary Katherine on Earnings Management.** *Accounting Horizon.*
- Sasongko, Noer dan Fauziah. (2011). *Identification of Earning Management on the Company Listed on The LQ 45 index in Indonesian Stock Exchange.* PROCEEDINGS, Malaysia-Indonesia International Conference in Economics, Management and Accounting (MIICEMA), October 13th-14th, Bengkulu, Indonesia. ISBN 978-979-9431-68-4

- Sasongko, Noer dan Purbasari, Happy (2012). *Earning Management Practices on Companies in The Shariah Index (The comparative studies between STDAM and LTDAM in Indonesian Stock Exchange during 2004-2010 period)*, PROCEEDINGS Malaysia-Indonesia International Conference in Economics, Management and Accounting (MIICEMA), October 18th - 20th, Palembang Indonesia. ISBN 979-587-424-1
- Scott, William R. (2006). *Financial Accounting theory*. 4th Edition. Canada Inc: Pearson Education.
- Subekti I, Kee PL, dan Ahmad Z. (2010). *The effect of integrated earnings management on the value Relevance of earnings and book value of equity*. . Kumpulan artikel Simposium Nasional Akuntansi (SNA) XIII, Purwokerto.
- Trisnawati, Rina dan Nugroho S.P, (2011), *Accrual Earnings Management Practices: The Comparative Studies Between Shariah Index And Conventional Index In Indonesian Stock Exchange*, PROCEEDINGS, Malaysia-Indonesia International Conference in Economics, Management and Accounting (MIICEMA), October 13th - 14th, Bengkulu, Indonesia. ISBN 978-979-9431-68-4
- Trisnawati, Rina dan Suhestiningsih (2012), *Riil Earnings Management Practices: The Comparative Studies Between Shariah Index And Conventional Index In Indonesian Stock Exchange during 2004-2010 period*, PROCEEDINGS Malaysia- Indonesia International Conference in Economics, Management and Accounting (MIICEMA), October 18th - 20th, Palembang Indonesia. ISBN 979-587-424-1
- Trisnawati, Rina, Wiyadi dan Noer Sasongko. (2012) **Pengukuran manajemen laba: pendekatan terintegrasi**, PROSIDING Simposium Nasional Akuntansi XV. 18-20 September 2012. Banjarmasin Kalimantan Selatan
- Trisnawati, Rina, Wiyadi dan Noer Sasongko. (2012) **Manajemen laba pada perusahaan go public di Indonesia**, Jurnal BPPK Vol 5 tahun 2012 ISSN 2085-3785
- Ujiyantho, Muh. Arief, dan B. A. Pramuka, 2007. **Mekanisme Corporate Governance, Manajemen Laba dan Kinerja Keuangan: Studi Pada Perusahaan Go Publik Sektor Manufaktur**. Kumpulan Makalah, Simposium Nasional Akuntansi (SNA) X, Makassar, 26-27 Juli, h 1-26.
- Veronica, Sylvia, dan Siddharta Utama. 2005. **Pengaruh Struktur Kepemilikan, Ukuran Perusahaan, dan Praktek Corporate Governance terhadap Pengelolaan Laba (Earnings Management)**. Artikel yang Dipresentasikan pada Simposium Nasional Akuntansi 8 Solo tanggal 15 - 16 September 2005.
- Warfield, T., J Wild, and K. Wild. (1995). **Managerial Ownership, Accounting Choices, and Informativeness of Earnings**. Journal of Accounting and Economics, Vol.20. No.1. July, p.61-91.
- Watts, Ross L and Jerold L. Zimmerman. 1978. *Towards a Positive Theory of The Determination of Accounting Standards*. The Accounting Review. Vol LIII. No.1

- Wedari, Linda Kusumaning. 2004. **Analisis Pengaruh Proporsi Dewan Komisaris dan Keberadaan Komite Audit terhadap Aktivitas Manajemen Laba**. Artikel yang Dipresentasikan pada Simposium Nasional Akuntansi 7 Denpasar tanggal 2 - 3 Desember 2004
- Wiyadi, Noer Sasongko dan Rina Trisnawati, (2011).**Pengembangan dan implementasi model manajemen laba melalui mekanisme corporate governance (studi empiris pada perusahaan go-publik di Indonesia**. Laporan Akhir Hibah Pasca Sarjana tahun 1 (pertama)
- Wiyadi, Noer Sasongko dan Rina Trisnawati, (2012).**Pengembangan dan implementasi model manajemen laba melalui mekanisme corporate governance (studi empiris pada perusahaan go-publik di Indonesia**. Laporan Akhir Hibah Pasca Sarjana tahun 2 (kedua).
- Wiyadi dan Prasnowo (2011), *Earning Management Practices in Companies Listed in Jakarta Islamic Index-Indonesian Stock Exchange*. PROCEEDINGS, Malaysia-Indonesia International Conference in Economics, Management and Accounting (MIICEMA), October 13th-14th, Bengkulu, Indonesia ISBN 978-979-9431-68-4
- Wiyadi dan Safitri, Lina (2012), *The Practices of earnings management; Long Term and Short term Discretionary Accrual Models (Empirical Studies on LQ 45 Index during 2004-2010 periods*. PROCEEDINGS Malaysia-Indonesia International Conference in Economics, Management and Accounting (MIICEMA), October 18th - 20th, Palembang Indonesia ISBN 979-587-424-1
- Wilopo. 2004. *The Analysis of Relationship of Independent Board of Directors, Audit Committee, Corporate Performance, and Discretionary Accruals*. Ventura Volume 7 No. 1 April: 73-83
- Yu, M.D. (2009). Big 4 Office Size and Audit Quality. *The Accounting Review*, 84, 5, 1521-1552.