FACTORS THAT DRIVE PRACTICE OF INCOME SMOOTHING

TIMOTHY CAROLUS ALVIANDY
IRWANTO HANDOJO

Trisakti School of Management, Jl. Kyai Tapa No. 20 Jakarta 11440, Indonesia
timothyalviandy@gmail.com, irwanto@tsm.ac.id

Abstract: Practice of income smoothing is one of four earnings management patterns. Income smoothing itself could be defined as a method used by management to reduce profit fluctuations that are deemed abnormal through various accounting methods or through transactions. This research is done to acquire empirical evidence about the effect of company size, financial leverage, profitability, public ownership, tax avoidance and cash holding towards the practice of income smoothing. The method used in sample selection is purposive sampling method. This research uses companies from consumer cyclical and consumer non-cyclical sector that is listed on the Indonesia Stock Exchange (IDX) from the year 2020 to 2022. The number of companies that fit criteria and can be used as research samples is 49 companies with 147 data samples. The result of the research shows that variables company size, profitability, public ownership, tax avoidance, and cash holding does not have any effect on income smoothing and the variable financial leverage has an effect on income smoothing.

Keyword: Cash Holding, Company Size, Financial Leverage, Income Smoothing, Profitability, Public Ownership, Tax Avoidance

INTRODUCTION

Financial reports are reports that contain business transactions related to incomes and expenses. Many parties use financial reports as factor to determine how a company performs. Therefore, financial reports are a key factor to determine the financial position of a business and is used to assess how the company works (Fraser & Ormiston, 2010).

The management of company usually knows how important financial reports are to investors, but, financial reports don't look good or all the time. This factor is what drives management to do earnings management. One of the forms earnings management is income smoothing. According to (Fudenberg & Tirole, 1995), income smoothing is a process of manipulating the time profile of income or income reports to lessen the variation of income flow. There are many reasons to why management decided to do income smoothing. One of them is to give a sense of security towards investors looking to invest in the company.

There are a few examples of companies that are suspected of doing income smoothing. PT. Garuda Indonesia had an unusual increase of profit through their net income of Rp 11,56 trillion at the end of 2018. This is unusual as PT. Garuda

Indonesia was at a loss of Rp 1,63 trillion on the third quarter of 2018. Another example came from PT. Pertamina that declared a net profit of Rp 35,99 trillion. This announcement is staggering when compared to their net profit in the third quarter of 2018, which is %p 5 trillion (Arieza, 2019).

This research is a development from the research done by Ernayani et al. (2020), Megarani et al. (2019) and Alexander (2019). The purpose of this research is to retrieve empirical evidence of whether company size, financial leverage, profitability, public ownership, tax avoidance and cash holding has an influence on income smoothing.

Agency Theory

Agency theory is a contract relationship where an owner (principal) will hire an agent (agent) to perform a number of services according to the principal's wishes, which includes delegating power to make decisions to the agent (Jensen et al. 1976). Both principal and agent will maximize each other's utilities which leads to an agent not always acting according to the interests of a principal. In this study, income smoothing is carried out by management that results in information asymmetry with the owners of the company.

Income Smoothing

Income smoothing is an activity related to measurement or reporting of a certain pattern which results in less variation than it truly is (Saputra and Agustin, 2022). The result of income smoothing is a financial report that is both inaccurate and unreliable.

According to Alexander (2019), income smoothing is an act that will be detrimental to investors. This is because investors will not know the company's real financial position and financial fluctuations. However, income smoothing can also

impact the company positively as it can strengthen a management's relationship between external parties. This effect is because income smoothing makes the company's financial position seem stable. This intrigues external parties which will propose cooperation with the company.

Company Size

Company size refers to total assets, human resource, capital and other things that correlate (Anwar & Gunawan, 2020). This factor affects the funding structure of a company where big companies require more funding while smaller companies require less funding. According to Sari & Amanah (2017), the bigger the company is, the bigger it tends to perform income smoothing. This is because big companies tend to attract investors because investors have a chance to develop their funds through that company.

According to Ernayani et al. (2020), Surya and Arnan (2022), and Anwar and Chandra (2017), company size has a significant effect on income smoothing. This contradicts the research done by Anwar and Gunawan (2020), Sari and Amanah (2017), and Stefannandra et al. (2022) that states that company size has no significant effect on income smoothing.

H₁: **Company size has influence towards income smoothing**

Financial Leverage

Financial leverage could be defined as using debts to fund a company's investment activities (Indrawan & Damayanthi, 2020). When a company has a high level of debt, that translates to investors having a higher level of risk. The higher the level of risk, investors would also ask for a higher level of profit. These factors are what make companies tend to perform income smoothing.

According to Indrawan and Damayanthi (2020) and Musyafa and Kholilah (2023), financial

leverage has a significant effect on income smoothing. This contradicts the research done by Ernayani et al. (2020), Wijaya et al. (2020), and Wijoyo (2014) that states that financial leverage has no significant effect on income smoothing.

H₂: Financial leverage has an effect on income smoothing

Profitability

According to Anwar and Gunawan (2020). Profitability is the company's ability to produce profit according to its income, total asset and own capacity. Profitability tends to be used by investors and creditors to determine whether a company is healthy or not (Surya and Arnan 2022). A company tends to do income smoothing because it has a low profitability.

According to Alexander (2019), Sari and Amanah (2017), and Pratiwi and Handayani (2014), profitability has a significant effect on income smoothing. This contradicts the research done by Inayah and Izzaty (2021), Holinata and Yanti (2020), and Anwar and Chandra (2017) that states profitability has no significant effect on income smoothing.

H₃: Profitability has an effect on income smoothing

Public Ownership

Public ownership is a proportion of shares owned by the public (Ernayani et al. 2020). The bigger portion of shares owned by the public, the more information about the company is known publicly (Wijoyo, 2014). This factor hinders companies from income smoothing so that the public trust on company is not stained.

According to (Stefannandra et al., 2022), public ownership has an effect on income smoothing. This contradicts the research done by (Nurani & Dillak, 2019), (Ernayani et al., 2020), and (Wijoyo, 2014) which states that public ownership has no significant effect on income smoothing.

H₄: Public ownership has an effect on income smoothing

Tax Avoidance

Tax avoidance are methods that a company uses to lessen its tax expenses (Mardiani et al., 2023). The purpose of tax avoidance is to make the company's profit seem bigger than it's supposed to. Investors are usually interested in investing their funds to companies with big profits.

According to Saputra and Agustin (2022), tax avoidance has a significant effect on income smoothing. This contradicts the research done by Alexander (2019), and Mardiani et al. (2023) which states that tax avoidance has no significant effect on income smoothing.

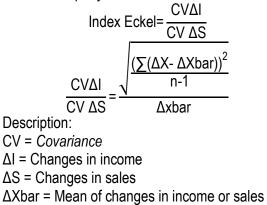**H₅: Tax avoidance has an effect on income smoothing**

Cash Holding

According to Inayah and Izzaty (2021), Cash holding is the free cash flow that is used to fulfill manager's interests above shareholders needs. Cash is a liquid asset which is easy to turn into other assets. This factor is what drives manager to do income smoothing because of the characteristic of cash available in a company.

According to Natalie and Astika (2016), Mambraku and Hadiprajitno (2014), Anwar and Gunawan (2020), and Inayah and Izzaty (2021), cash holding has a significant effect on income smoothing. This contradicts the research done by (Alexander, 2019) which states that cash holding has no significant effect on income smoothing.

H₆: Cash holding has an effect on income smoothing

Research Method

The samples are sorted out using purposive sampling method and the criterias are displayed in the table below. According to Alexander (2019), **Income Smoothing** is measured using index eckel, where this variable uses a dummy scale and categorizes the result by 0 and 1. When the index show ≤ 1, this indicates that company performs income smoothing on the contrary, when the index shows > 1, this indicates that the company does not do income smoothing.

$$\text{Index Eckel} = \frac{CV\Delta I}{CV\ \Delta S}$$

$$\frac{CV\Delta I}{CV\ \Delta S} = \frac{\sqrt{\frac{(\sum(\Delta X - \Delta Xbar))^2}{n-1}}}{\Delta xbar}$$

Description:
CV = *Covariance*
ΔI = Changes in income
ΔS = Changes in sales
$\Delta Xbar$ = Mean of changes in income or sales

$\dfrac{\sqrt{\dfrac{(\sum(\Delta X - \Delta Xbar))^2}{n-1}}}{\Delta xbar}$ = The standard deviation of the change in revenue or sales

Company Size is the measure of a company according to the total assets that it has (Sari and Kristanti 2015). This variable uses the ordinal scale which counts company size using the natural logarithm of total asset using the following formula:

$$CMPY = \text{Ln } Total\ Asset$$

Description:
CMPY = *Company Size*
Ln = Natural logarithm

Financial Leverage can be defined as investing activities which the company funds using debt (Indrawan & Damayanthi, 2020). Financial leverage is counted using DER ratio (Debt-to-Equity) using the following formula:

$$DER = \frac{Total\ Debt}{Total\ Equity}$$

Description:
DER = Financial Leverage

Table 1. Sample Selection Procedure

No	Kriteria Pemilihan Sampel	Jumlah Perusahaan	Jumlah Data
1	Consumer cyclical, and consumer non-cyclical companies that are consistently listed on the Indonesia Stock Exchange (IDX)) from 2017-2022	151	453
2	Consumer cyclical, and consumer non-cyclical companies that don't have financial reports available on the Indonesia Stock Exchange (IDX) from 2017-2022	(6)	(18)
3	Consumer cyclical, and consumer non-cyclical companies that don't use Rupiah as the currency in financial reports from 2017-2022	(14)	(42)
4	Consumer cyclical, and consumer non-cyclical companies that don't have an ETR value 0< and <1	(82)	(246)
	Total Perusahaan yang dijadikan sampel	49	147

Source: Result of Data Collection

Profitability is defined as the company's ability to produce profit according to income, total asset and its own capital. Profitability is counted using the ROA ratio (Return on Asset) using the following formula:

$$ROA = \frac{\text{Net Profit}}{\text{Total Asset}}$$

Description:
ROA = Profitability

According to Ernayani et al. (2020), **Public Ownership** is the proportion of shares owned by the public. The measurement of public ownership is done using a ratio scale with the following formula:

$$POS = \frac{\text{Shares Owned by Public}}{\text{Total Outstanding Shares}}$$

Description:
POS = Public Ownership

Tax Avoidance is a method used by management to reduce the tax expense that it has to pay when compared to its income expenses (Mardiani et al. 2023). According to Alexander (2019), Tax avoidance is measured using Effective Tax Rate (ETR) using the following formula:

$$TAV = \frac{\text{Current Tax Expense}}{\text{Income Before Tax}}$$

Description:
TAV = Tax Avoidance

Cash Holding is the flow of free cash that the manager can use to fulfill its needs above the interests of shareholders. According to Alexander (2019), cash holding is measured using a ratio scale using the following method:

$$CSH = \frac{\text{Total Cash and Cash Equivalent}}{\text{Total Asset}}$$

Description:
CSH = Cash Holding

Data Analysis

Binary logistic regression analysis is used in this study to ensure that the testing and the result of analysis provides accurate information regarding the effect of company size, financial leverage, profitability, public ownership, tax avoidance and cash holding towards income smoothing. The model is as shown below:

$$\text{Ln}\left[\frac{Pi}{1-Pi}\right] = \beta_0 + \beta_1 CMPY + \beta_2 DER + \beta_3 ROA + \beta_4 POS + \beta_5 TAV + \beta_6 CSH + e$$

Description:

$\text{Ln}\left[\frac{Pi}{1-Pi}\right]$ = *Probability ratio*
CMPY = *Company size*
DER = *Financial leverage*
ROA = *Profitability*
POS = *Public ownership*
TAV = *Tax avoidance*
CSH = *Cash holding*
e = *Error*

Research Result

The analysis of descriptive statistics test and hypothesis test are show in the table below:

Table 2 shows the results of the descriptive statistics test using data samples from companies in the consumer cyclical and consumer non-cyclical sectors that meet the criteria determined. In this case, the dependent variable is income smoothing (IS) which is measured using dummy variable, and has a value of 0 and 1. The value of 0 indicates that the company does not perform income smoothing, while the value of 1 indicates that the company does perform income smoothing. The variable has a mean value of 0,61 and a standard deviation of 0,490 which indicates a level of deviation smaller than the average value.

Table 3 shows the results of the frequency distribution test. From 147 data collected from consumer cyclical and consumer non-cyclical companies, there were 89 companies (60,5%) that

Table 2. Descriptive Statistic Result

	N	Minimum	Maksimum	Mean	Std. Deviation
IS	147	0	1	0,61	0,490
CMPY	147	26,46267	32,82638	29,5072244	1,43720142
DER	147	0,02427	3,58267	0,8717422	0,76780206
ROA	147	0,00042	0,34885	0,0861628	0,06355423
POS	147	0,00026	0,70497	0,2698236	0,15306375
TAV	147	0,00379	0,89345	0,2368698	0,11456555
CSH	147	0,00005	0,72553	0,1561399	0,15188112

Source: Output Statistic Data

were indicated of doing income smoothing, while the 58 companies (39,5%) remaining were not indicated of doing income smoothing.

Company size (CMPY) has a minimum value of 26,46267 which was held by Mutli Prima Sejahtera Tbk. (LPIN) during 2021, meanwhile the maximum value of 32,82638 was held by Indofood Sukses Makmur Tbk. (INDF) during 2022. Company size has a mean value of 29,5072244 and a standard deviation of 1,43720142.

Financial leverage (DER) has a minimum value 0,02427 which was held by Wilmar Cahaya Indonesia Tbk. (CEKA) during 2020, meanwhile the maximum value of 3,58267 was held by Unilever Indonesia Tbk. (UNVR) during 2022. Financial leverage has a mean value of 0,8717422 and a standard deviation of 0,76780206.

Profitability (ROA) has a minimum value of 0,00042 which was held by Bayu Buana Tbk.

(BAYU) during 2021, meanwhile the maximum value of 0,34885 was held by MNC Land Tbk. (KPIG) during 2022. Profitability has a mean value of 0,2368698 and a standard deviation of 0,11456555.

Public ownership (POS) has a minimum value of 0,00026 which was held by Tunas Ridean Tbk. (TURI) during 2022, meanwhile the maximum value of 0,70497 was held by Bintang Oto Global Tbk. (BOGA) during 2022. Public ownership has a mean value of 0,2698236 and a standard deviation of 0,15306375.

Tax avoidance (TAV) has a minimum value of 0,00379 which was held by MNC Land Tbk. (KPIG) during 2020, meanwhile the maximum value of 0,89345 was held by Gema Grahasarana Tbk. (GEMA) during 2022. Tax avoidance has a mean value of 0,2368698 and a standard deviation of 0,11456555.

Table 3. Frequency Distribution Result

	Frequency	Percentage	Cumulative Percentage
Does not perform income smoothing (0)	58	39.5	39.5
Performs income smoothing (1)	89	60.5	100.0
Total	**147**	**100.0**	

Source: Output Statistic Data

Cash holding (CSH) has a minimum value of 0,00005 which was held by Erajaya Swasembada Tbk. (ERAA) during 2021, meanwhile the maximum value of 0,72553 was held by Bayu Buana Tbk. (BAYU) during 2020. Cash holding has a mean value of 0,1561399 and a standard deviation of 0,15188112.

Table 4 shows the result of -2 log likelihood test. The table shows the value of -2 log likelihood decrease when compared between iterations block 0 with a value of 197,199 and

iterations block 1 with a value of 186,212. The values indicate that the model used in the study is well used

Table 5 shows the result of Nagelkerke R Square test. The table indicates that the value of Nagelkerke R Square is 0,098. This means that only around 9,8% of the dependent variable variation used in the model could be explained by the independent variables. The remaining 90,2% can be explained by other independent variables that are not found in the model.

Table 4. Result of -2 Log Likelihood Test

Description	-2 Log Likelihood
Blok 0: Beginning Block	197.199
Blok 1: Method = Enter	186.212

Source: Output Statistic Data

Table 5. Result of Nagelkerke R^2 Test

Cox & Snell R Square	Nagelkerke R Square
0,072	0,098

Source: Output Statistic Data

Table 6. Result of Hosmer and Lemeshow's Goodness of Fit Test

Chi-square	Signifikansi
2.942	0.938

Source: Output Statistic Data

Table 7. Result of Model Accuracy Test

Observed		Predicted		
		Income Smoothing		
		Does not perform income smoothing	Performs income smoothing	Percentage Correct
Step 1	Does not perform income smoothing	15	43	25.9
	Performs income smoothing	8	81	91.0
	Overall Percentage			65.3

Source: Output Statistic Data

Table 8. Result of Coefficient Significance Test

Variable	B	Sig.	Kesimpulan
CMPY	-0,068	0,620	H_1 does not have an influence
DER	-0,704	0,007	H_2 has an influence
ROA	5,060	0,100	H_3 does not have an influence
POS	0,523	0,668	H_4 does not have an influence
TAV	2,217	0,199	H_5 does not have an influence
CSH	-1,486	0,259	H_6 does not have an influence

Source: Output Statistic Data

Table 6 show the result of Hosmer and Lemeshow's Goodness of Fit test. The table shows a significance value of 0,938 which is above 0,05. It indicates that the null hypothesis is accepted and there is no significant difference between the model and the observation value, which results in the model fitting the research observation data.

Table 7 explained that there were 89 data that performed income smoothing, but only 81 data (91%) were correctly predicted based on the model and the remaining 8 data (5,44%) were not correctly predicted which is a type II error. There were 58 data that did not perform income smoothing, but only 15 data (25,86%) were correctly predicted based on the model and the remaining 43 data (29,25%) were not correctly predicted which is a type I error. Overall, the accuracy of prediction based on the model is 96 data (65,30%)

Table 8 shows that company size (CMPY), profitability (ROA), public ownership (POS), tax avoidance (TAV), and cash holding (CSH) have no effect on income smoothing. This indicates that H_1, H_3, H_4, H_5 and H_6 are rejected. On the other hand, financial leverage (DER) has an effect on income smoothing which indicates H_2 is accepted.

Financial Leverage (DER) has a significance value of 0,007 and a significancy of -0,704 which means that H_2 is accepted. It indicates that financial leverage has an effect on income smoothing. Companies that have a high rate of debt usually has less opportunities to do income smoothing because these companies are usually watched more strictly by creditors (Musyafa & Kholilah, 2023).

CONCLUSION

Based on the research shown, this research has concluded that company size, profitability, public ownership, tax avoidance and cash holding has no effect on income smoothing. On the contrary, financial leverage has an effect on income smoothing. However, there are limitations on this research, such as (1) the research can only explain 9,8% of the influence of independent variables toward dependent variable, (2) the research population is limited by only using consumer cyclical and consumer non-cyclical companies in Indonesia Stock Exchange (IDX), (3) there was only one variable has an effect on income smoothing, which was financial leverage with a significance value of 0,007 and significancy of -0,074. With that, there are some recommendations for future research such as (1) using other independent variables such as managerial ownership, institutional ownership, dividend policy, firm value and bonus plan, (2) adding more sectors to the population other than consumer cyclical and non-cyclical consumer companies.

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