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Identifying Income Smoothing Factors Drive on Indonesian Manufactured Companies

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Abstract

This study aims to analyze whether Profitability, Financial Risk, Company's Value, Managerial and Public Ownership Structure; and the company size influence the practices of Income Smoothing or not. In this study, income smoothing is measured by Eckel index which is different from previous studies. The population of the study is companies listed on the Indonesian Stock Exchange from 2007 to 2011. The sample selection uses purposive sampling method. There are 285 data meet the criteria and free from outlier data. Moreover, data analysis technique uses multiple linear regression. The finding of the study shows that partially profitability, managerial ownership structure and company size significantly influence the income smoothing. Meanwhile, financial risk, the company's value and ownership structure of public have no significant influence toward income smoothing. Simultaneously, profitability, financial risk, the company's value, managerial and public ownership structure; and the company size have a significant influence on income smoothing.

Keywords: Income Smoothing, Profitability, Financial Risk, Managerial Ownership Structure, Public Ownership Structure.

I. INTRODUCTION

Background

To promote a company, it takes no small amount of resources. It can not rely solely on the results of the company's operation. It is also required additional resources, especially in the form of large amounts of funds. Sources of a company funding can be derived from the internal and external sources. The Internal source of a company can be in the form of additional capital from the owner, while the external funding can come from the bank or from investors.

The main focus of the external funding source is in the form of information about profits. Realizing the importance of the profits information, the management is trying to reduce fluctuations in earnings by income smoothing. Income smoothing performed by management is a deliberate effort in order to minimize fluctuations in the rate of profit which the company is considered as normal (Beidelmen, 1973 in Belkaoui, 2000). According to the study by Purwaningsih and Sucipto, 2007 (in Ratnasari, 2012), income smoothing is a rational behavior, it is based on the assumption of the positive accounting theory that the Management is rational individuals who pay attention to their interests. However, if seen from the side of investors and shareholders, this income smoothing practices is certainly not expected. Due to the existence of this practice, they do not know the true state of the company, so that the decisions taken for the future could be detrimental.

Some of the factors triggering the occurrence of income smoothing are: profitability, financial risk, corporate values, managerial and public ownership structure. Some previous studies on the factors triggering the occurrence of income smoothing show different results, as study by Suranta and Merdistuti (2004) which shows that ROA does not have a positive influence on the practice of smoothing earnings, so do *net profit margin* and *operating profit margin*. While financial risk, firm size, managerial and public ownership have a positive influence toward income smoothing practices. Moreover, Budiasih (2009) states that profitability, *dividend payout ratio,* and firm size have significant positive influence toward the practice of income smoothing. However, *Financial leverage* is proven to give no significant infleuence toward income smoothing practices.

Furthemore, Aji and Mita (2010) concludes that there is no positive influence of profitability toward income smoothing practices. The scale of public and management ownership does not have positive influence on the income smoothing practices by the company as well. Yet, the corporate risk and the value of the company prove a positive influence on the practice of income smoothing. The study by Noviana and Yuyetta (2012), suggests that profitability, financial risk, the value and the ownership structure of the companyb do not give a positive influence toward the practice of income smoothing. However, *Dividend payout ratio* has a positive influence toward the income smoothing practices.

From the definition above, this study intends to re-examine the occurrence of the trigger factor of the income smoothing on manufacturing companies in Indonesia by the reference to the study by Aji and Mita (2010). Nevertheless, there are differences between this study and the previous ones, in this study, the researchers: 1). Use a model of *Eckel index* to measure the value of income smoothing. 2). add the number of the company as the independent variable. The addition of variable is supported by Budiasih (2009) which states that the scale of the company significantly influence the income smoothing, the larger the company the higher the indication of income smoothing practices will be, because the larger companies have a higher *political cost, so* that the large companies tend to perform Income Smoothing to avoid taxes that are too high at the time the company obtains a high-profit, and maintain the company *image* when income generated is too low. 3). In addition, the sample used in this study is manufacturing companies listed in the Indonesian Stock Exchange in the range of 2007-2011. This period is used to obtain the value that has a higher ability to describe the practice of income smoothing within a company.

II. LITERATURE REVIEW AND HYPOTHESES FORMULATION

The Influence of of profitability toward Income Smoothing

According Sartono, 2001 (in Abiprayu, 2011) profitability is the ability of the company makes a profit in relation to sales, total assets, and equity. Profitability can be used as a benchmark for investors and creditors in assessing whether the company is healthy or not. To measure the profitability,this study uses ratio *return on assets* (ROA). ROA indicates management's ability to generate profits by exploiting assets used in operations. The higher the change of ROA shows the larger fluctuations in the management's ability to generate profits.

Moreover, this matter affects investors in predicting profits and risk in an investment, so that it will impact on investor belief toward the company. Accordingly, the management is motivated to perform income smoothing practices in order to make reported earnings do not fluctuate so as to increase investor belief. So, it is in line with the study conducted by Budiasih (2009) which states that the profitability proxied by the variable of ROA significantly influences income smoothing.

H_1 = *Profitability has a significant positive influence toward income smoothing.*

The Influence of Financial Risk toward Income Smoothing

Financial risk is the additional risk borne to common shareholders as a result of the decision to obtain financing through debt. This study uses the *leverage* ratio in the measurement. The *leverage* ratio describes the sources of operating funds used by the company and also indicates the proportion of debt to finance investments. The higher the the company's debt, the higher the risk faced by investors will be. As a result, investors will ask for higher rates of return and because of these conditions, the company tends to practice income smoothing (Sartono, 2001 in Abiprayu, 2011).

Suranta and Merdistuti (2004) concludes that the Election of accounting policies (income smoothing) is performed to avoid the violation of debt covenants, so that companies with a high financial risk will tend to perform income smoothing in order to avoid breach of contract over its debt agreements. From the definition above, the hypothesis can be formulated as follows:

H_2 = *Financial risks have significant positive influence toward income smoothing.*

The Influence of the Value of the Company toward Income Smoothing Practices.

Corporate value is the price paid by the prospective buyer, if the company is willing to be sold (Husnan, 2005). The value of the company is reflected in its stock price. Companies that have a high market value will tend to perform income smoothing. This happens because companies will tend to maintain the consistency of the returns in orderto make the market value of the company remains high, so that it can be more attractive to obtain resources for the company (Suranta and Merdistuti, 2004).

Aji and Mita (2010) also concludes that, the higher the value of the company, the more the company implements the practice of income smoothing. By implementing income smoothing, the income with minimum variability will be defended in order to attract the interest of investors, because the stable value of the company is one of the factors considered by investors to make investment decisions. From the definition above, here is the hypothesis that can be formulated:

H_3 = *the value of the company significantly influences income smoothing practiced by the company.*

The Influence of Managerial Ownership Structure toward Income Smoothing.

Managerial ownership is the ownership of shares held by the company’s parties management, such as the manager and the board of directors. The managerial ownership is associated with *agency theory* because within the framework of *agency theory*, it explains the correlation of *agent* and *principal.* Managers who is also as the shareholder will increase the value of the company. With the increase of the value of the company, the value of the manager’s wealth as individual shareholders will increase as well (Pujiningsih 2011 in Amanza, 2012). The larger the proportion of managerial ownership within a company, the more the management seek efforts to meet the interests of shareholders (who in this case is himself). By implementing income smoothing, it will boost the belief of investors to stay invested in the company.

Smith, 1976 (in Noviana and Yuyetta, 2012) found that *income smoothing* is significantly more often implemented by companies controlled by managers than by companies controlled by their owners. From the definition above, the hypothesis formulated is as follows:

H $_4$ = *The presence of managerial ownership structure provides significant positive influence toward income smoothing practiced by the company.*

The influence of the Public Ownership Structure toward Income Smoothing.

Public ownership structure reflects the number of shares outstanding in the community. A large proportion of public ownership suggests that the level of investor confidence toward the company tends to be high because the management tends to implement income smoothing to demonstrate the level of good earnings and performance of the company (Nur'aeni, 2010 in Noviana and Yuyetta, 2012).

Michelson, et al., 2000 (in Noviana and Yuyetta, 2012) concludes that the higher the public ownership structure within the company, the more the company performs income smoothing in order to produce a low profit variability which indicates a low risk. This low risk will be responded positively by investors. From the definition above, the hypothesis proposed is as follows:

H $_5$ = *The existence public ownership structure significantly influences income smoothing practiced by companies.*

The Influence of Company Size toward Income Smoothing

The company size is one of scales to classify the company. According to its size, the company can be classified into three types: large, medium, and small. In this study, to measure the size of company, it uses total assets of the company. The large companies usually receive more attention from analysts and investors than the small ones (Budiasih, 2009). One of the companies having a large total assets will get more attention from outside parties, including the government. The government tends to impose a variety of costs that are considered in accordance with the company's capabilities. In this case, the large companies will bear the high cost anyway, e.g., taxes (Watts & Zimmerman, 1986 in Chariri and Ghozali, 2011).

Moses, 1987 (in Noviana and Yuyetta, 2012) finds empirical evidence that the large companies have a greater incentive to perform income smoothing than the small ones, because the big companies become a more rigorous subject to be examined by the government and society in general. So that, the big companies have a higher tendency to perform income smoothing by the reasons for tax evasion. Based on the description above, this study formulates the following hypotheses:

H $_6$ = *the company size has a significant positive influence on income smoothing.*

III. RESEARCH METHODS

Population and Sample

The population of this study is a manufacturing company in the Indonesian Stock Exchange in the range of 2007-2011. The sampling used is purposive sampling with the following criteria: (1). The company that publishes a complete financial statement and income experienced during the observation period of 2007-2011. (2). The Samples Company have variable data required. Based on these criteria,it is acquired 285 companies as samples and free from outliers.

Definition of Operational Variables

Technique of Analysis

The analysis technique used is multiple regression model as follows:

$$STATUSit = \alpha 0 + \beta 1ROAit\text{-}1 + \beta 2LEVit\text{-}1 + \beta 3PBVit\text{-}1 + \beta 4POWNit\text{-}1 + \beta 5MOWNit\text{-}1 + \beta 6SIZEit\text{-}1 + \varepsilon it$$

In which;

STATUSit = Status of companies which are considered performing income smoothing practice, if income smoothing index is <1 and if not, the income smoothing index will be ≥ 1. ROAit-1 = ratio of *return on assets* in firm i in year t-1

Levit-1 = *leverage* ratio of firm i in year t-1

PBVit-1 = *price-book value* ratio of firm i in year t-1

POWNit-1 = Percentage of total public ownership of firm i in year t-1

MOWNit-1 = Percentage of total ownership of the company's management i in year t-1

SIZEit-1 = logarithm of total assets of the firm i in year t-1

εit = *error term*

IV. FINDINGS AND DISCUSSION

Table 1
Findings Analysis of Descriptive Statistics of Research Variables

Descriptive Statistics					
	N	Minimum	Maximum	Mean	Std. Deviation
Gain Flattening	285	-2.7679	3.3682	.455798	.8220124
ROA	285	.0013	3.8779	.117719	.2416910
Leverage	285	.0551	4.8108	.441187	.3160063
PBV	285	.09	38.97	2.6373	4.58220
Mown	285	.00	35.14	3.1815	7.40988
Pown	285	1:00	78.72	24.4624	16.11121
Size	285	10.75	18.85	14.1513	1.52175
Valid N (listwise)	285				

Sources: Secondary data processed in 2013

All variables are non-classical assumption test. From the descriptive statistical analysis, it is obtained that leverage, POWN and size variables have standard deviation value which is smaller than the average value. It means that these variables have average data dissemination. This suggests that each company of the samples has almost the same magnitude among each sample company.

Whereas, the Income smoothing variable, ROA, PBV and MOWN have a higher standard deviation a value than the average ones. It means that the variables have an uneven spread of data. This suggests that each of the sample companies have different magnitudes among each sample company. The results of the descriptive statistics are presented in Table 2 below.

Table 2. Summary of Hypothesis Results

Hypothesis	Significant Value	Result
H_{1}: *Profitability has a significant positive influence toward income smoothing.*	0.000 <0.05	H_1 accepted
H_{2}: *Financial risks have a significant positive influence toward income smoothing.*	0.000 <0.05	H_2 accepted
H_{3}: The *value* of *the company has a significant positive influence toward income smoothing.*	0.488> 0.05	H_3 rejected
H_{4}: *The existence of managerial ownership structure has a significant positive influence toward income smoothing.*	0.016 <0.05	H_4 accepted
H_{5}: *The existence public ownership structure has a significant positive influence toward income smoothing.*	0.993> 0.05	H_5 rejected
H_{6}: *The company size has a significant positive influence toward income smoothing.*	0.008 <0.05	H_6 accepted

The Influence of Profitability toward Income Smoothing

the profitability variable influence income smoothing, this finding is demonstrated by the profitability regression coefficient of 1.329 and with significance value of 0.000 <0.05. This indicates that profitability is a measure of performance, the higher the profitability, the better the company's performance will be. The management is trying to perform income smoothing through profitability to gain a *reward.*

In addition, the profitability also influences investment and lending decisions. For investors, using the information published is very important to make an investment decision. The higher the profitability, the better the company's performance will be, because the rate of return *(return)* to be received is even greater. Consequently, the increased profitability will improve market confidence, so that companies will have a tendency to keep their consistency level of profit. Briefly, This occurence will lead to the income smoothing consistently as expected. However, this finding is contrary to study by Suwito and Herawaty (2005), Santoso (2010), Dewi and Zulaikha (2011), Noviana and Yuyetta (2012), Dewi and Prasetiono (2012), and Ramdani (2012). Yet, it supports the study by Merdistuti and Suranta (2004), Budiasih (2009), Aji and Mita (2010) who prove that the profitability influences income smoothing.

The Influence of of Financial Risk toward Income Smoothing

Financial risk variables influence income smoothing, it is evidenced by the results of the regression coefficient value *leverage* of -0.829 and with significance value of 0.000 <0.05. However, the direction of the regression coefficients for the variables of financial risk is negative. The findings of this study indicate that although the company has a low financial risk, they keep implementing income smoothing practice. This is done to keep the company *image* to make it look to have a good and stable performance. However, this study contradicts with the *debt covenant hypothesis* that explains if the company is in a position to do a threatened debt deal, it will likely perform earnings management by *income increasing.*

The different findings of this study occur because the average sample of firms having not so high a debt level, or in other words, the company does not rely on debt to finance assets in the company. This is evidenced by the average value of *the leverage* ratio of 44.11%. This finding is not in accordance with the studies by Santoso (2010), Aji and Mita (2010), and Ramdhani (2012), but consistent with the findings by Suranta and Merdistuti (2004), Budiasih (2009), Dewi and Zulaikha (2011), Ernawati (2011), Noviana and Yuyetta (2012), which suggest that the financial risk does not have significantt positive influence towars income smoothing.

The Influence of Corporate Values toward Income Smoothing

The company’s value variable does not significantly influence income smoothing. It is evidenced by the results of the regression coefficient value of 0.008 and with significant level of 0.488> 0.05. Investment decisions are not only influenced by the company's stock price. The high stock price is not an issue that can attract the attention of investors, investors tend to be more careful in analyzing the performance achieved by looking at the company's financial performance. In addition, investors also need information that is beneficial to them, e.g. dividend sharing.

Therefore, it can be concluded that the stock price is not an important benchmark in investment, so that the management is not motivated to do income smoothing. This finding is in contrast to study by Aji and Mita (2010), but it supports the study by Noviana and Yuyetta (2012) which states that the value of the company does not influence income smoothing.

The Influence of Managerial Ownership Structure toward Income Smoothing

Managerial ownership structure variable significantly influences income smoothing, it is proven by the results of the regression coefficient of 0.017 with significant value of 0.016 <0.05. This condition indicates that managers which are also the shareholders will increase or make a leveling profit for its own sake as a bonus from the company and also increase the shareholder confidence that the management is able to generate profits. This finding is in contrast to studies by Aji and Mita (2010) and Noviana and Yuyetta (2012) but supports the study by Suranta and Merdistuti (2004) which states that the managerial ownership provides influence toward income smoothing by the company.

The Influence of Public Ownership Structure toward Income Smoothing

Public ownership structure variable doe not influence the income smoothing, it is evidenced by the results of the regression coefficient value of public ownership of 2.766>0.05 with the significance value of 0.993> 0.05. This indicates that public ownership does not play a role in income smoothing. This happens because the public shareholding in the companies taken as sample tends to have small average value of 24.64 percent. Thus, it can not give influence to the managers' discipline to act in accordance with shareholders' interests. This finding in contrast to studies by Aji and Mita (2010) Suranta and Merdistuti (2004) but supports the study by Noviana and Yuyetta (2012) which states that public ownership does not significantly influence income smoothing.

The Influence of the Company Size toward Income Smoothing

The company size variable has significant influence toward income smoothing, it is evidenced by the results of the regression coefficient of 0.097 with significance value of 0.008 <0.05. This indicates that the size of the company's gives influence on the quest for income smoothing. Larger companies tend to perform income smoothing to keep the *image* of the company because they are highlighted by the public and the government. If the company is able to produce a constant or a fixed income, it will demonstrate their management ability to manage the company well. This result is in contrast to the studies by Suwito and Herawaty (2005), Santoso (2010) And Ernawati

(2011) but supports the study by Suranta and Merdistuti (2004), Budiasih (2009), Dewi and Zulaikha (2011), Aji and Mita (2010), Ramdhani (2012), Prasetiono and Dewi(2012), which state the larger companies have an incentive to do income smoothing than the smaller oness because the large companies are deemed to be researched and more critical.

V. CONCLUSIONS AND IMPLICATIONS OF RESEARCH

Based on the study done, it can be concluded that the triggering factor of income smoothing is profitability, managerial ownership structure and the company size. This happens due to several limitations in the study, such as: 1) The object of the study only on companies that have positive earnings, so that research findings can not be generalized, 2). The ability of the independent variables in explaining the dependent variable is relatively low, that is less than 50%. By paying attention to some limitations of the study explained, the recommendations for further research is as follows:

1. Researchers are recommended to include all categories of companies listed on the Indonesian Stock Exchange as an object of the study and
2. To add other variables such as; Dividend payout ratio, net profit margin.

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