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The Effect of Profitability, Company Size, and Financial Leverage of Income Smoothing

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ABSTRACT : *The current financial statement is an investor's consideration to make a decision. One way of management to show good financial report, that is with income smoothing.The purpose of this study was to determine the effect of profitability,company size, and financial leverage through income smoothing. This research was conducted at company which listed in BEI and LQ45 index year 2014-2018. The number of samples taken are 24 companies with purposive sampling method. Data collected through non-partisipan observation. Data analysis technique used is logistic analysis.Based on the results of the analysis found that profitability has not direct effect on income smoothing while firm size has a negative effect on income smoothing. Financial leverage has a positive effect on income smoothing.*

Keywords: *income smoothing, profitability, firm size and financial leverage*

I. INTRODUCTION

Financial statements are a description of a company that has an important role. Financial statements are a structured presentation of the financial position and financial performance of an entity (PSAK No. 1.2017: 1). The report displayed contains the history of the entity that is quantified in currency values. Financial statements are also part of the financial accountability process. Basically, managers do various ways so that the financial statements produced have attractive value for investors. Whereas to make a good financial report, what investors see is profit. A good profit is a profit that has a relatively stable level of fluctuation. The focus of investor attention on earnings information without regard to how the procedure in obtaining data and in investing tends to only focus on the final results of earnings reports that are presented without looking or finding out about the earnings making opportunities for managers to carry out strategies that will increase company profits (Beattie et al., 1994). Inequality of information is used by managers to do real and artificial alignment (Koh, 2003). To get good profits one way is to practice income smoothing (Income smoothing). The practice of income smoothing is an action that is intentionally carried out by managers using accounting policies.

Management practices income smoothing to reduce reported earnings fluctuations and improve investors' ability to predict future cash flows (Barnea et al, 1994). Companies that do income smoothing have a significantly lower average annual return and risk than companies that do not do income smoothing (Michelson, Jordan-Wagner, and Wootton, 1995). The impact arising from the practice of income smoothing (Income smoothing) causes the information obtained to be inaccurate information for investors. This inaccurate information will also result in losses due to mistakes on the part of investors in making decisions.

Based on the political cost hypothesis in positive accounting theory that large companies tend to manage earnings including making income decreasing when they get high profits to avoid the emergence of new regulations from the government (Watts and Zimmerman, 1986), for example raising corporate income tax. When viewed from profitability, companies that have high profitability (seen from ROA and high Net Profit Margin) will be more free to do income smoothing because management knows the company's ability to earn profits in the future (Budiasih, 2009). Research conducted by Tseng and Lai (2007) found evidence that companies with low profitability have a great motivation to do income smoothing. Business managers will benefit from stable profitability such as maintaining position if the performance is measured by the level of profit that can be generated. Furthermore, when viewed from financial leverage, based on the debt covenant hypothesis in positive accounting theory it is stated that companies with high debt levels tend to manage earnings to avoid violating debt agreements (Watts and Zimmerman, 1986).

Profit has to do with the size of the company. Company size is a scale that is classified according to various ways, including total assets, log size, stock market value, and others. The size of the company is divided into categories namely large, small and medium. Changes in company size will attract the attention and interest of analysts, governments and investors in assessing the company going forward. The size of the company can be measured by looking at the total assets of the company (Budiasih, 2009), the greater the number of assets owned by the company, the company's performance in generating funds to pay off the company's debt will be assessed better. Large companies avoid profit fluctuations. This is caused by a decrease in profits that are not directly from the decline in assets can cause adverse effects for the company.

II. LITERATURE REVIEW AND RESEARCH HYPOTHESIS

Income smoothing is the process of manipulating the time profile of income or income statements to make earnings reports less variable, while not increasing the reported income during the period (Belkaoui, 2007). When the company produces low profits, the profitability of the company also becomes low so that management will do income smoothing to increase the profits obtained means that profitability has a significant effect on income smoothing (Dewi and Sujana 2014). Profitability is the level of the company's ability to make a profit in relation to sales, total assets, and own capital (Lia and Wirawati, 2018).Research by Pratiwi and Damayanthi (2017) states that profitability is partially positive and significant effect on income smoothing. Profitability has a positive effect on income smoothing conducted by companies listed on the IDX in 2010-2013 (Surya Dewi and Latrini, 2016). Tsuroyya and Astika (2017) research which took a sample from the Kompas 100 index in the 2013-2015 period found that profitability has a positive effect on income smoothing.

H1: Profitability has a positive effect on income smoothing practices

Company size is a scale or value in which companies can be classified large or small based on total assets, log size, share value and so on (Wati, 2016). The size of the company is considered to affect the practice of Income Smoothing. The large size of the company assumes that investors will have high and stable profits. This manager as an agent will take actions that strive for high and stable profits so that the principal or investor continues to invest.

The size of the company will affect the practice of income smoothing. (Alexandri and Anjani 2014) in their research stated that company size simultaneously influences income smoothing. Research (Yulia, 2013) shows that company size has a significant influence on income smoothing practices in manufacturing, financial, and mining companies listed on the Indonesia Stock Exchange in the period 2007-2011. Research using company type as moderating variable gets similar results where company size influences income smoothing practices where the population used is companies listed on the Indonesia Stock Exchange in 2010-2012 (Dewi and Sujana, 2014). Fadhli's research (2015) found that company size variables had a significant influence on the practice of Income smoothing in Wholesale and Retail Trade. Research conducted in 2017 results that company size has a positive effect on income smoothing where the companies studied include manufacturing companies in the 2013-2015 period (Pratiwi and Damayanthi, 2017).

H2: Company size has a positive effect on income smoothing practices

Financial leverage indicates the use of debt to finance the investment. Financial leverage is closely related to agency theory. The greater the company's debt, the greater the risk faced by investors so that investors will ask for higher profit levels. Theseconditions will make companies tend to practice income smoothing to meet the wishes of the parties.

Research entitled Income smoothing: Impact Factors, Evidence In Indonesia shows the results where banking companies that entered the Indonesia Stock Exchange in the 2009-2013 period showed that financial leverage has a significant positive effect on Income smoothing (Alexandri and Anjani, 2014). Financial leverage has a significant positive effect on income smoothing practices in manufacturing companies on the Indonesia Stock Exchange 2015-2017. This means that having high leverage or greater corporate debt, the greater the risk faced by investors, therefore investors practice income smoothing so that investors are interested in investing in companies (Nanda Ayunika and Yadnyana, 2018). Research conducted by Putri and Budiasih (2018) is in line with previous research where financial leverage has a positive effect on income smoothing. Companies that have a high level of financial leverage show the greater risk faced by investors so that investors will ask for a higher level of profits.

H3: Financial leveragehas a positive effect on income smoothing practices

III. METHODS

The object of this research is Income smoothing for companies in the LQ45 Index for the 2014-2018 period. In this study sample selection is done by purposive sampling technique. Purposive sampling is a sampling technique with certain considerations (Sugiyono, 2017; 144). Data collection methods or sampling techniques in this study use non-participant observation methods. Non-participant observation method is an observation that is conducted without involving oneself or becoming part of the social or company environment and only as data collectors (Sugiyono, 2013). This study uses logistic analysis techniquesto obtain a comprehensive picture of the effect of profitability, company size and financial leverage on income smoothing using the SPSS for windows program.

IV. RESULT AND DISCUSSION

This study uses a sample of 24 companies obtained samples for five years with a total of 120 observational observations at LQ45 companies. Table 1 shows the process and results of sample selection based on criteria using a purposive sampling technique.

Tabel1.The Results of Sample Selection Based on Criteria

No.	Explanation	Total	Accumulation
1.	Companies included in the LQ45 index during 2014-2018	70	225
2.	Companies that are not included in the LQ45 index in a row during 2014-2018	-45	-100
3.	Companies that not publish financial statements in a row during 2014-2018.	0	0
4.	Companies that not publish financial statements in rupiah.	0	0
5.	The company did not make a profit in a row during 2014-2018.	-1	-5
Number of observations that met the criteria for the period 2014 - 2018		24	120

Sumber: Research Data, 2019

Tabel2.Descriptive StatisticalResults

		N	Minimum	Maximum	Mean	Std. Deviation
Income smoothing	(Y)	120	0,000	1,000	0,833	0,374
Profitability	(X_1)	120	1,410	46,660	8,725	8,271
Total assets	(X_2)	120	29,980	34,800	31,899	1,339
Financial leverage	(X_3)	120	13,000	88,000	53,583	21,191

Sumber: Research Data, 2019

Based on the results of the descriptive statistical test in Table 2, the following can be explained, namely Income smoothing (Y) is a dummy variable, where for companies that are suspected of not doing income smoothing value of 0 and value 1 for companies suspected of doing income smoothing. Income smoothing has an average value of 0.833. This shows that from 120 research samples there were 100 samples or 20 companies that did income smoothing (value 1) and the remaining 20 samples or 4 companies did not do income smoothing (value 0). The standard deviation of income smoothing is 0.374. This shows that the difference in the value of income smoothing to an average of 0.374.The average value of profitability (X1) is 8.725. The minimum value owned by BMRI companies in 2016 is 1,410 and the maximum value owned by UNVR companies in 2018 is 46,660. The standard deviation of profitability is 8,271, this means that there is a difference in the value of profitability that has been studied against the average value of 8.277.he average value of company size (X2) is 31.899. The minimum value of the natural logarithm of total assets is ADHI company of 29,980 and the maximum value of natural logarithm of total assets is BBRI company of 34,800. The standard deviation of the size of the company is 1.339, so there is a difference in the value of the size of the company that has been examined against the average value of 1.339. The average value of financial leverage (X3) is 53.583. The minimum value of 13,000 is the INTP company and the maximum value of 88,000 is the BBRI company. The standard deviation of financial leverage is 21,191, this shows that there is a difference in the value of financial leverage that has been studied against the average value of 21,191.

Tabel3.Logistic Regression Test Results and Interaction Test

		B	*Sig.*
$Ln \frac{Pl}{1-Pl} = \alpha + \beta_1 X_1 + \beta_2 X_2 + \varepsilon$	X1	0,148	0,061
	X2	-0,721	0,028
	X3	0,071	0,003
	Constant	20,014	0,042

Sumber: Research Data, 2019

Statistical test results show that the profitability variable (X1) has a positive coefficient of 0.148 with a significance level of 0.061 greater than alpha (0.05). The test results state that profitability has no effect on income smoothing so it can be concluded that the results of this study reject the H1 hypothesis. The results of these studies indicate that low levels of profitability cannot encourage managers to practice income smoothing. The practice of excessive income smoothing will be in the public spotlight because it will jeopardize the company's credibility. Profitability does not affect the practice of income smoothing can also be caused by other considerations from investors before making investment decisions (Anggi Adeliana Dewi and Suryanawa, 2019). The statement means that investors not only see profitability ratios in making investment decisions, but also look at other financial ratios, such as business activity ratios and market valuation ratios and other ratio analyzes. The results of this study are in line with the results of research conducted by Anggi Adeliana Dewi and Suryanawa (2019), Suryani and Damayanti (2015). The results of this study contradict the results of the study, Pratiwi and Damayanthi (2017), Surya Dewi and Latrini (2016), and Tsuroyya and Astika (2017).

The firm size variable (X2) has a negative coefficient of 0.721 with a significance level of 0.028 less than alpha (0.05). The test results state that company size affects income smoothing so it can be concluded that the results of this study reject the H2 hypothesis. The results of this study are in line with the results of research by Lia (2018), Anggi Adeliana Dewi and Suryanawa (2019), and Ratih and Era (2017). Several other studies also found inconsistent results, such as the research of Dewi and Sujana (2014), and Fadhli (2015).

Financial leverage variable (X3) shows a positive coefficient of 0.071 with a significance level of 0.003 smaller than alpha (0.05). The test results state that financial leverage is able to influence income smoothing practices so that it can be concluded that the results of this study accept the H3 hypothesis. The results of this study are in line with the results of Nanda Ayunika and Yadnyana's research (2018), Putri and Budiasih (2018), and Alexandri and Anjani (2014).

V. CONCLUSION

The results of the analysis conducted on the effect of profitability of company size, and financial leverage on income smoothing provide some conclusions, namely the profitability variable does not affect the income smoothing in companies that are included in the LQ45 index during the 2014-2018 period. The company size variable has a negative effect on income smoothing practices in companies that are included in the LQ45 index during the 2014-2018 period. The financial leverage variable has a positive effect on the practice of income smoothing in companies that are included in the LQ45 index during the 2014-2018 period.

The suggestions that can be given in this study are based on the results and discussion as well as the conclusions that have been described, namely investors in analyzing company performance must look at other factors that influence the practice of income smoothing. Other factors such as business activity ratios, market valuation ratios and other ratio analysis. Investors should be more careful about small company financial statements. Small companies do not have an adequate supervision system in addition, small companies tend to want to be seen to have good performance in the interests of the company. In addition, investors should further develop their ability to understand financial statements to understand how much the DAR ratio is to find indications of income smoothing practices in the company. Supervision of large companies also needs to be improved so that the possibility of debt ratio owned by the company remains reasonable with the profit generated by the company. This study in its independent variable can only explain the effect of the dependent variable of 17.8%. then it is expected to be able to use other variables in assessing factors that influence income smoothing, such as dividend policy, market reaction, market activity, and information asymmetry.

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