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An Examination of Firm Size, Profitability, Leverage, and Audit Committee on Income Smoothing in Manufacturing Companies Listed in Indonesia Stock Exchange

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Abstract

The purpose of this study is to provide empirical evidence on the effects of firm size, profitability, leverage and audit committee on income smoothing among manufacturing companies listed in Indonesia stock exchange for the period of 2013-2015. Regression statistics are employed to analyze the collected data. Measurement of income smoothing is based on discretionary accruals. The result of this research shows that profitability and leverage have a significant impact on income smoothing, while firm size and audit committee have no impact on income smoothing.

Keywords: income smoothing, firm size, profitability, leverage, audit committee

1. INTRODUCTION

Financial statements are objected to extending financial information of the reporting entity to be used by investors, loaners and creditors in making decisions on resource provisions for the entity (Kieso et al., 2014). A prepared and reported financial statement consists of the statement of financial position, comprehensive income statement, changes in equity statement, cash flow statement, notes to the financial statements (Kartikahadi et al., 2012). Income is one of the indicators considered by investors in determining investment decisions. The income statement is a summary of a company’s business activities that arise from business activities and other activities (Fraser, & Ormiston, 2007). An entity makes efforts to increase the quality of earnings in preparing financial statements. The total earnings can be manipulated easily; therefore, the quality of profit should be analyzed thoroughly. Focusing on the quality of earnings is also essential. Thus the investors can be specific on the sustainability of business operations and accounting assumptions (Larrabee and Voss, 2012).

The quality of earnings stimulates management to manipulate profit to influence the outlook of external parties. Prior literature has shown that companies with stable profits show lower risks, they, therefore, attract more investors (Akhoondnejad et al., 2013). Income smoothing practices are one of the general approaches to creative accounting (Saeidi, 2012). There are two forms of income smoothing: (1). The efforts to increase company's report of earnings, with aiming to make company's performance and management to look better, (2). The efforts to decrease company's report of earnings, with aiming to reduce company's tax obligation (Rezazadeh et al., 2014).

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Income smoothing is closely related to earnings management since both use the agency theory approach. The theory states that profit management is influenced by the conflicts of interest between management as an agent and the owner, occurring when both attempt to attain prosperity (Masodah, 2007). Indonesia, among Asian countries with high level of income smoothing practice, is positioned after Thailand and Korea (Shen & Chih, 2007). The practice of income smoothing can be influenced by several factors, such as firm size, profitability, leverage, and non-financial factors namely good corporate governance mechanism in a proxy audit committee.

Firm size is a measurement of the size of the company that is usually determined by the total asset within the company. There is a higher tendency for large companies to avoid earning fluctuations because it will reduce the investment risks to investors and creditors. It can be said that large companies have a massive impact on the practice of income smoothing (Akhoondnejad et al., 2013). Profitability is an important measurement to assess the company’s strength. Companies with low-level profitability will be motivated to perform income smoothing to influence the investors’ outlook. Research conducted by Alexandri and Anjani (2014) shows that profitability has a significant influence towards income smoothing.

Leverage demonstrates the efficiency in utilizing equity to anticipate debt; in other words the company's ability to meet all its obligations (Subramanyam, 2014). The higher the leverage means, the higher the debt compared to capital; this will increase the risk to investors and motivate the management to perform income smoothing. Alexandri and Anjani (2014) showed that the leverage has a positive and significant impact on income smoothing. The audit committee has an important role to ensure the quality of the financial reports. In this study, the audit committee is part of non-financial factors. The audit committee, with its task to oversee the financial reporting process and to observe the internal control, will increase the quality of the financial report and influence the practice of income smoothing (Uwuigbe et al., 2012). The presence of an audit committee gives a negative influence towards the practice of income smoothing (Handayani et al., 2016).

Based on the description above, it is essential to examine the influence of firm size, profitability, leverage and the audit committee towards income smoothing, especially practices that occur in manufacturing companies listed in the IDX. This study aims to find: (1) Whether there is influence of firm size towards income smoothing; (2) Whether there is influence of profitability towards income smoothing; (3) Whether there is influence of leverage towards income smoothing; and (4) Whether there is influence of audit committee towards income smoothing. The results of this study are expected to provide practical advantages to investors and company management in making decisions related to the practice of income smoothing.

2. LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

An agency relationship between shareholders and managers exists because the owners do not possess adequate expertise to manage the firm by themselves; thus the stockholders employ an agent as their representative to manage the operation of the firm (Schroeder et al., 2013). The extreme varieties of accounting practices have made the development of comprehensive accounting description is a difficult situation. In order to become a theory, a description must have definite values. The theory of positive accounting arose because the existing theory could not thoroughly explain the accounting practices (Schroeder et al., 2013). The positive accounting theory uses a viewpoint that a company will organize itself most efficiently to attain its objective to keep operating (Scott, 2009).

Financial reports are the main medium for companies to communicate the financial information to their stakeholders (Kartikahadi et al., 2012), this is the final product of series on summarizing business transaction data (Subramanyam, 2014). Financial reports are fair and structured presentations of a company’s financial positions and financial performances (Ikatan Akuntan Indonesia-PSAK, 2014). Profit occurs when income is higher than current expenses; on the other hand, loss occurs when expenses are greater income. Earnings management has a negative impact on the quality of earnings because it can distort the information contained in the financial statements. Distortion happens when the manager arranges a transaction to amend the financial statements to make a good impression (Subramanyam, 2014). Income smoothing is only one aspect of earnings management (Subramanyam, 2014). The practice of carefully timing the recognition of revenue and expenses to balance the number of reported earnings from one period to the next is called income smoothing (Belkaoui, 2004).

2.1 The Influence of Firm Size towards Income Smoothing

Company size is a scale to classify the size of a company through a variety of ways, including total assets, log size, the value of the stock market and so forth (Alexandri & Anjani, 2014). This study uses the total asset as a proxy for company size. Akhoondnejad et al., (2013) states that income smoothing is influenced by the size of the firm. Firm size has a significant and positive influence towards income smoothing (Lassaad, 2013; Shen & Chih, 2007), yet in a bright situation, it is found that firm size does not have a significant influence towards income smoothing (Supriyanto et al., 2016). Another research states that firm size has a negative significance towards income smoothing (Alexandri and Anjani, 2014). Therefore, large companies are highly motivated to perform income smoothing.

Ha1: Firm size significantly influences income smoothing.

2.2 The Influence of Profitability towards Income Smoothing

Profitability ratio is a ratio that shows the company's ability to generate earnings (Subramanyam, 2014). Profitability portrays the effectiveness of a company to obtain earnings from the company's operations. It is used to measure the effectiveness of management as a whole, which is generated by the return of sales and investment received. Several ratios are used as a measurement of profitability, including the return on stockholders' equity (ROE). Alexandri and Anjani, (2014) found that profitability has a significant negative influence towards income smoothing. Other research has discovered that profitability does not have a significant influence towards the practice of income smoothing (Parijan, 2013).

Ha2: Profitability significantly influences income smoothing.

2.3 The Influence of Leverage towards Income Smoothing

Total leverage or combined leverage is the combination of operating leverage and financial leverage (Ross et al., 2016). The leverage ratio is a ratio that shows the company's ability to meet all its obligations (Subramanyam, 2014), measures the extent of the financial needs of companies to be financed by borrowed funds (Copeland et al., 2004). Thus, leverage is an analysis of the use of funds to the composition of debt and equity or assets and the ability to meet all its obligations. Leverage is used to measure how much debt funds a company. Leverage can be measured by several ratios; debt to total assets ratio, debt to equity ratio, long-term debt to equity ratio and times interest earned ratio (David, 2013). Alexandri and Anjani (2014) found that leverage has a significant positive influence towards the practice of income smoothing. In contradiction to the previous the findings, Parijan (2013) states that financial leverage does not influence toward income smoothing.

Ha3: Leverage significantly influences income smoothing.

2.4 The Influence of the Audit Committee towards Income Smoothing

The audit committee is responsible for assisting the board and encouraging the establishment of an adequate internal control structure to improve the transparency and quality of financial reports. Another responsibility of audit committee is reviewing the scope and accuracy of external audits (Agoes & Ardana 2011). The audit committee consists of at least one independent board commissioner and at least two members other than the issuer or public company (Forum for Corporate Governance in Indonesia- FCGI, 2001). The audit committee becomes the monitoring committee with objectives including securing the needs of shareholders and other interested parties and working effectively; the committee is dominated by non-executive directors (Ghillyer, 2014). The existence of an audit committee negatively influences the practice of income smoothing (Handayani et al., 2016). However, the findings are not by the findings of Marpaung and Latrini, (2014) which indicated that the audit committee does not significantly affect income smoothing.

Ha4: Audit committee significantly influences income smoothing.

3. RESEARCH METHOD

This study analyzes the research objects which consist of firm size, profitability, leverage, the audit committee and income smoothing. The quantitative data feature is data that can do mathematical operations; quantitative data can be divided into interval-scaled data and ratio-scaled data (Hallebone & Priest, 2009). The data of firm size, profitability and leverage data are obtained from the company's financial statements. Audit committee data is obtained from the company's annual report while the income smoothing data obtained by calculating the company's annual discretionary accruals Jones modification (Akhoondnejad et al., 2013) based on existing records on the company's financial statements.

3.1 Population and Sample

The population used in this study is all the companies listed on IDX within the 2013-2015 as an observation period. A selected number of samples were chosen from the population to be processed in this study. The sampling technique used was purposive sampling, the samples that conform to some criteria set by the researcher (Sekaran and Bougie, 2013) as follows:

a. Companies listed on the IDX, which are not delisting and relisting during the period 2013-2015.
b. Companies that present financial statements data ended on December 31 and did not suffer from losses during the observation period, as well as presenting the financial statements in Indonesian Rupiah.

3.2 Operationalization of Variables

This study uses the ratio scale for all variables with a description of the operationalization of the variables described in the following table.

Table 1. Operational variables

Variables	Dimensions	Measurement	Scales
Dependent Variable			
Income smoothing	Discretionary accruals (Modified Jones)	a. $TA_t = (\Delta CA_t - \Delta Cash_t) - (\Delta CL_t - \Delta CPL_t) - DEP_t$ b. $TA_t/A_{t-1} = \beta_1(1/A_{t-1}) + \beta_2(\Delta REV_t/A_{t-1}) + \beta_3(PPE_t/A_{t-1}) + \varepsilon$ c. $NDA_t = \beta_1(1/A_{t-1}) + \beta_2(\Delta REV_t - \Delta REC_t)/A_{t-1}) + \beta_3(PPE_t/A_{t-1})$ d. $DA_t = TA_t - NDA_t$ Where : DA_t : Discretionary accruals at t period TA_t : Total of accruals at t period NDA_t : Non discretionary accruals at t period ΔCA_t : Delta current assets at t period $\Delta Cash_t$: Delta cash and cash equivalent at t period ΔCL_t : Delta current liabilities at t period ΔCPL_t : Delta long term liability at t period DEP_t : Depreciation expense of fixed assets at t period A_{t-1} : Total asset at period of t – 1 ΔREV_t : Delta revenue at t period ΔREC_t : Delta accounts receivable at t period PPE_t : Gross property, plant and equipment at t period $\beta_1, \beta_2, \beta_3$: regression coefficients (Akhoondnejad et al., 2013)	Ratio
Independent Variables			
Firm size	Total assets	Ln total assets (Akhoondnejad et al., 2013)	Ratio
Profitability	Return on equity	$\frac{\text{Net income}}{\text{Total equity}}$ (Subramanyam, 2014)	Ratio
Leverage	Debt to total equity	$\frac{\text{Total debt}}{\text{Total equity}}$ (Subramanyam, 2014)	Ratio
Audit committee	Audit committee member	$\frac{\text{Audit committee member out of board Independent}}{\text{Total of audit committee}}$ (Uwuigbe et al., 2012)	Ratio

Income smoothing is a practice used to stabilize fluctuations in earnings by transferring profit from one period to another to raise or lower the profit (Subramanyam, 2014; Belkaoui, 2004). Income smoothing in this study uses the modified model of Jones discretionary accruals measurement. Firm size is a measurement that shows the characteristics of the size of a company to perceive several categories. In this study, firm size is measured by the logarithm of the total assets of the company (Alexandri & Anjani, 2014). Profitability is a portrayal of the effectiveness of the company to obtain a return on the company's operations by efficiently utilizing the resources of the company (Subramanyam, 2014; Subramanyam, 2014). Profitability in this study uses return on equity as a measurement.

Leverage is an analysis of the use of funds by the composition of liabilities and equity or assets and the ability to pay off its obligations (Ross et al., 2016; Subramanyam, 2014). Leverage in this study uses debt to equity ratio measurement. The audit committee is a committee in charge to oversee financial reporting process to provide security to shareholders and other interested parties (Agoes & Ardana, 2011; Ghillyer, 2014). The audit committee is measured based on the number of independent non-board member of the audit committee.

3.3 Technical Data Collection and Processing

The data in this research are secondary data, which are provided to be processed (Sekaran & Bougie, 2013). The research data were taken from the manufacturing company's annual report published on its website http://www.idx.co.id. The data used are from the period of 2013-2015. This study uses a significance level of 5%. The software used to process variable data in this study is SPSS version 23.0 for Windows. The regression analysis was used to measure the effect of independent variables towards dependent variables, also shows the relationship between dependent variables and independent variables. Hypothesis testing is used, which includes to find out: (1) Correlation r, to find out the strength of relationship among variables. (2) t-test, to find out significance influence among variables. (3) The coefficient of determination test or R^2 test is to measure the ability of the model to explain variations on the dependent variable (Bartholomew et al., 2008).

4. RESULTS AND DISCUSSION

4.1 Statistics Analysis

Based on the sampling criteria, the numbers of samples obtained are 65 manufacturing companies during the periods of 2013-2015 with 195 data. After the outlier test was done, 64 companies were obtained with 192 data used as samples for the study.

Table 2. Descriptive statistics

	N	Minimum	Maximum	Mean	Std. Deviation
Size (million IDR)	192	133,782.751	245,435,000.000	10,322,226.980	31,441,409.076
Profitability	192	.000626711	.764285359	.1443457954	.11251209780
Leverage	192	.074316047	5.972176022	.8587640470	.80137136980
Aud_Comm.	192	.000000000	.750000000	.6130208335	.13382768592
Inc_Smooth.	192	-.131747398	.618775402	.1557953410	.10545832490
Valid N (listwise)	192				

Table 2 shows the descriptive statistics of the variables of this study. The average value of firm size (in a million IDR) is 10,322,226.98 with the size of the companies studied vary considerably indicated by the standard deviation of 31,441,409.07. The average value of profitability (ROE) is 14.43%, with a minimum of 0.06% and maximum at 76.43% standard deviation for profitability is 0.1125. The average value of leverage (debt to equity) is 85.88%; indicating that nearly half of the company's capital comes from debt and standard deviation value of 0.8014. The average value of audit committee is 61.30% indicating 61.30% of audit committee members are independent with a range from minimum to maximum value are 0% to 75% respectively.

Income smoothing practice has a mean value of 0.15579. The negative value on income smoothing shows that the income smoothing practice performed by management reduces the reported profit for the political cost (including minimizing the tax cost), the reversal practices undertaken by management to generate better rewards and bonuses. From the processing results data in Table 3, a regression equation model is obtained as follows:

$$IS = 0.123 + 0.004\ SIZE - 0.143\ PROFIT - 0.028\ LEV - 0.034\ AC + \varepsilon$$

The regression model gives the interpretation that the larger companies tend to do more income smoothing practice in an attempt to maintain their corporate image. Companies experiencing downward profit tend to do more income smoothing practice to minimize bad prejudices upon managerial and company's performance. Companies experiencing lower leverage (lower debt to equity ratio) are motivated to do more income smoothing practice due to the smaller risks. Companies experiencing a decline in audit committee members tend to improved income smoothing practice due to lower supervision in the financial reporting process.

Table 3. Multiple linear regression test results

	Unstandardized Coefficients		Standardized Coefficients		
Model	B	Std. Error	Beta	T	Sig.
(Constanta)	.123	.154		.799	.425
Size	.004	.005	.055	.722	.471
Profit	-.143	.067	-.152	-2.120	.035
Lev	-.028	.008	-.257	-3.642	.000
Ac	-.034	.060	-.044	-.576	.565

a. Dependent variable: income smoothing (IS)

4.2 Hypotheses Testing Results

Hypothesis testing aims to show the influence of firm size, profitability, leverage and audit committee towards income smoothing with a significance level of 5% ($\alpha = 0.05$). The result showed that the firm size has a significant value of 0.471, greater than 0.05; therefore, it can be concluded that Ha1 is rejected, which means that firm size has no significant influence towards income smoothing. The company size is not a significant consideration for investors in making their investment decisions; that is the reason why that it does not influence the management's decision to apply income smoothing. The company that is indicated doing income smoothing practice, especially for the large ones, might lose their good reputation. These research findings are by the research done by Supriyanto et al., (2016), stating that the size of the company does not have a significant influence towards income smoothing. However this research is not on the research done by Akhoondnejad et al., (2013), Lassaad (2013), Alexandri and Anjani (2014), Fiscal and Steviany (2015), also Parijan (2013).

Profitability has a significant value of 0.035; this value is less than 0.05. Therefore it can be concluded that Ha2 is accepted, which means that profitability has a significant influence towards income smoothing. Firm's profitability is one of the factors of consideration for an investor in making their investment decisions. In relation to the income-smoothing concept, a company's management stabilizes profit fluctuation by moving the profit from one period to another. A company increases profit when the company experiences a decrease in profit and vice versa. The result of this study is the study done by Alexandri and Anjani (2014), Fiscal and Steviany (2015), also Supriyanto et al., (2016) which states that profitability significantly influences income smoothing. Meanwhile, this research is contrary to the research done by Parijan (2013), Mohebi et al., (2013).

Leverage has a significant value of 0.000; this value is less than 0.05. Therefore it can be concluded that Ha3 is accepted. Leverage has a significant influence towards income smoothing. Leverage is another consideration for management to apply income smoothing because leverage determines the company's ability in paying off its obligations that causes an increase in risks for investors. Thus this may motivate the management to perform income smoothing. This research result is in accordance with the researches of Alexandri and Anjani (2014), Fiscal and Steviany (2015), also Supriyanto et al., (2016) which states that financial leverage has a significant influence towards income smoothing, however, the research results are not in accordance with the research done by Parijan (2013) and Mohebi et al., (2013).

The audit committee has a significant value of 0.565; this value is greater than 0.05. Therefore it can be concluded that Ha4 is rejected; this shows that the audit committee has no significant influence towards income smoothing. The audit committee members report to the board resulting the committee being under the command of the board. When the board loses its independence, it will deter the function of the audit committee in monitoring internal control practice, and it will be difficult to detect when the management performs income smoothing since the financial reports will become less transparent. This research is not by the research done by Handayani et al., (2016) which states that the audit committee has a significant influence towards the practice of income smoothing. However, it is by the research done by Uwuigbe et al., (2012) and research done by Marpaung and Lartini (2014).

4.3 Coefficient of Determination Test (R^2)

The coefficient of determination (R^2) essentially measures the capacity of a model in explaining the variation in the dependent variable. The coefficient of determination test results is shown in the following table:

Table 4. Coefficient of Determination Results (R^2), - Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
	.290[a]	.084	.064	.102005801

The coefficient of determination results above shows the values of the adjusted R^2 is 6.4%. Therefore, it can be concluded that income smoothing can be explained by firm size, profitability, leverage and audit committee by 6.4% and the remaining of 93.6% is explained by other variables out of the models of this research, it could be like effective control over financial reporting process and financial report factors such as return on assets, net profit margin, debt to total assets, the value of the company, liquidity, and others. Other than financial elements, income smoothing may also be explained by non-financial variables such as corporate social responsibility and ownership.

5. CONCLUSIONS AND RECOMMENDATIONS

Hypothesis test result has been found; therefore it may be concluded that firm size is not always taken into consideration by the investor in making investment decisions. The results of firm size shows that it does not motivate the management to apply income smoothing. Profitability is one of the elements that is considered essential to investors in making investment decisions. About the income-smoothing concept, the company's management stabilizes profit fluctuation by moving the profit from one period to another. The company's management will tend to not applying the income smoothing when the company's profit is high, and vice versa.

Leverage is not highly taken into consideration to an investor in making investment decision regardless of the increased risk. Thus it does not motivate the management to apply income smoothing. When the audit committee is not independent, it limits the efficacy of the audit committee. The ineffective monitoring of internal control resulting higher tendency of management to apply income smoothing. Through the Adjusted R^2 test, it can be concluded that income smoothing can be explained by the firm size, profitability, leverage, and audit committee; the remaining can be explained by other variables other than the variables of this research. The research also concludes that income smoothing can be explained by both financial and non-financial variables.

Based on the findings of this research, it is recommended to investors to be aware of the practice of income smoothing performed by companies as considerations in making investment decisions, especially for the companies that experience low profit and leverage. The findings are also an essential input for the company's management to reconsider performing income smoothing. A company that performs income smoothing may reduce the trust of the investors and the company's image.

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