Analysis of Differences in Financial and Market Performances That Do or Do Not Practice Income Smoothing

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ABSTRACT

This study aims to examine differences in profitability, liquidity, leverage, stock returns, and share risk in real estate companies that do and do not practice income smoothing. The population of this study is companies publicly traded on the Indonesian Stock Exchange in the period 2015 to 2017, from which sample of 32 companies was acquired for each of the three years of the study, giving 96 items in total. The indicators used in the study are return on assets (ROA) to measure profitability, current ratio (CR) to measure liquidity, debt-to-equity ratio (DER) to measure leverage, capital gains from stock prices to measure stock returns, and standard deviation of stock returns to measure stock risk. Because the data is not normally distributed, both independent samples t-testing and Mann-Whitney t-testing are used to discover if there are differences in liquidity, profitability, leverage, average stock prices, and stock returns between companies that carry out income smoothing and those that do not. The results of the study show that there is no difference in ROA, CR, DER, stock returns, and share risk between income-smoothing and non-income-smoothing companies.

Keywords: Return on Assets; Current Ratio; Debt-to-Equity Ratio; Stock Return; Stock Risk; Income Smoothing

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ABSTRAK

Penelitian ini bertujuan untuk menguji perbedaan profitabilitas, likuiditas, leverage, return saham, dan risiko saham pada perusahaan real estate yang melakukan dan tidak melakukan praktik perataan laba. Populasi penelitian ini adalah perusahaan publik yang diperdagangkan di Bursa Efek Indonesia pada periode 2015 hingga 2017, dimana sampel sebanyak 32 perusahaan diperoleh untuk masing-masing tiga tahun penelitian, dengan total 96 item. Indikator yang digunakan dalam penelitian adalah return on assets (ROA) untuk mengukur profitabilitas, current ratio (CR) untuk mengukur likuiditas, debt to equity ratio (DER) untuk mengukur leverage, capital gain dari harga saham untuk mengukur return saham, dan standar deviasi pengembalian saham untuk mengukur risiko saham. Karena data tidak berdistribusi normal, maka uji-t sampel independen dan uji-t Mann-Whitney digunakan untuk mengetahui apakah terdapat perbedaan likuiditas, profitabilitas, leverage, harga saham rata-rata, dan return saham antara perusahaan yang melakukan perataan laba. dan mereka yang tidak. Hasil penelitian menunjukkan bahwa tidak ada perbedaan ROA, CR, DER, return saham, dan share risk antara perusahaan income-smoothing dan non-income-smoothing.

Kata Kunci: Return on Assets; Current Ratio; Debt to Equity Ratio; Return Saham; Resiko Saham; Perataan Laba

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INTRODUCTION

Income smoothing is a form of "engineering" of profits performed by company management to reduce the reported differences in company profits across reporting periods, so that the amount of profit for one period is similar to that of a previous period. Income smoothing is carried out to indicate that the performance of a company is good and to help investors to predict its prospects for the future. To smooth profits, managers take actions that increase reported profits when profits are low and reduce profits when profits are relatively high. Company managers carry out income smoothing to manage shareholders' perceptions of profit variability because such actions can have a positive impact on the market value of the company. Some income-smoothing activities are ethically acceptable, for example, realizing sales and expenditures for research and development, advertising, and social responsibility in stages over several reporting periods, while others are unethical, such as not recording expenditure or reporting spending in stages.

Investors are very concerned and often focus on profit information without regard to the procedures used to obtain this information. This is realized by management, so that management tends to do behavior that should not be done, namely by doing earnings management (Jin & Machfoedz, 1998). Scott (2000) states that earnings management actions can be divided into four, namely taking a bath, income minimization, income maximization, and income smoothing or income smoothing.

Income smoothing is a form of profit engineering carried out by management to reduce differences in company profits so that the total profit of a period is not too different from the profit of the previous period. This income smoothing practice is carried out so that the company's performance is good and investors can predict the company's prospects in the future. To smooth earnings, managers take actions that increase reported earnings when they are low and take actions that decrease earnings when they are relatively high. Company managers perform income smoothing to provide shareholder perceptions of earnings variability because actions like this can have a positive impact on the company's market value. Ethical actions taken, for example, realize sales and expenses for R&D, advertising, and social responsibility in stages for several periods, while the unethical way is by not recording these expenses in stages.

Managements perform income smoothing to give a positive impression of their performance to both owners and creditors, to reduce fluctuations in earnings reporting, and to reduce risk, with the intention of maintaining a perception of good management within their companies (Suryandari, 2012). In addition to considerations of management performance, income-smoothing actions can also ensure that profits to be announced are in line with expectations and that the market price of the company's stock will be stable (Putra & Rahmanti, 2013)

Leveling of income is expected to provide a signal that increases the accuracy of profit predictions for investors, to support the view of investors that companies with stable earnings are low risk. Stable profit can also reflect a stable income and this in turn can ensure a stable return on investment. It is this combination of low risk and stable return on investment that determines investors' preferences and is calculated by investors in their investment analysis. Research

conducted by Salno & Baridwan (2000) in the period before the 1997 monetary crisis found that there were no differences in risk and return between companies that practiced income smoothing and those that did not.

Funderberg & Tirole (1995) state that income smoothing is the process of manipulating earnings by shifting earnings time or earnings reporting so that reported earnings changes are lower. This activity can then create changes in the financial ratios used to measure the performance of companies. For example, companies that have a higher ROA tend to be more likely to perform income smoothing than companies with lower returns because management know the ability to earn profits in the future and this can facilitate their delaying or accelerating of profit reporting (Assih, 2000). In companies that have a large amount of debt, the greater risk faced by investors will lead those investors to ask for higher rates of profit. As a result of these conditions, such companies tend to practice income smoothing (Budiasih, 2009: 07). High levels of liquidity indicate that a company's ability to pay off short-term debt is also high, and this provides opportunity for managers to practice income smoothing.

The currently developing phenomenon illustrates that the property and real estate sector is a business industry sector that is growing rapidly in Indonesia. The role of the property and real estate sector operating in Indonesia has a positive impact on economic progress in Indonesia.The property and real estate sector in Indonesia is growing rapidly, marked by increases in land and building prices, and this is having a positive impact on the country's economic progress. However, throughout 2015, the sector suffered a severe downturn. In research by Indonesia Property Watch, sales in the middle and upper segments of the market fell by 36.9% and 41.8%, respectively. The property survey issued by Bank Indonesia also predicted that price growth in these two segments would not exceed 4% at the end of 2015. This had an impact on companies' financial statements and triggered their managements to take actions in the form of earnings management, including income smoothing.

Agency theory is closely related to earnings management or income smoothing by companies. Agency theory states that management practices are influenced by conflicts of interest between management (agent) and owners (principals) that arise when each party seeks to achieve and maintain the desired level of prosperity (Noviana & Yuyyeta, 2011). As the owner of capital, the principal has access to the company's internal information while the agent as an actor in the company's operational activities has information about the company's operations and performance. Thus the agent knows more about the condition of the company than the principal so that the agent has more opportunities to make the information contained in the financial statements better by utilizing the information he knows which is often compelled to take actions that can maximize the benefits of himself and his company.

One way of management to overcome the problem of conflicts of interest between internal and external parties of the company is to carry out earnings management. Earnings management that is often carried out by management is income smoothing. In this case, income smoothing is done because profit information is the main target of published financial report information for

external parties. The practice of income smoothing is a common phenomenon in many countries.

Many previous studies have mentioned the benefits of using financial ratios to detect financial efficiency in assessing a company. Investors, as one of the users of financial statements, in determining which company's shares are worth buying, of course, will choose stocks that can provide the maximum possible profit level at a certain level of risk. Stocks that provide profits that tend to be stable attract more investors than stocks of companies whose profits have a high level of fluctuation.

According to Ronen & Sadan (1975), income smoothing is carried out because earnings information is the main purpose of financial statement information published for external parties. Jin & Machfoedz (1998: 175) state that there is a tendency for external parties to pay more attention to the profits contained in the income statement than to other indicators. The same opinion was also expressed by Beattie et al. (1994), who found that investors' attention is most often focused on profits without regard to the procedures used in generating earnings information. As a result, this tendency encourages management to manipulate earnings (Assih & Gudono, 2000: 36) because financial statements reveal management performance and are thus an important tool for evaluating such performance. Michelson et al.'s (1995) research proved that non-income-smoothing firms have higher average annual earnings than income-smoothing firms and argues that investors are not provided with a choice of smoother income stream and that income smoothing does not increase the market value of a company. Ashari (1994) reports that there are indications of income smoothing and operating profit is a common target used for income smoothing, and income smoothing tends to be carried out by companies with low profitability. The results of the study by Murni & Santoso (2007) state that there is no difference in profitability between companies that perform income smoothing or those that do not. The formulation of the first hypothesis in this study is.

H_1: There is a difference in profitability between income-smoothing and non-income-smoothing companies.

The act of income smoothing is very detrimental to external parties, especially investors in making investment decisions. The practice of income smoothing is an action in which informed profit is more stable so that it looks good and attractive to users of financial statements, so that it will also influence behavior in making decisions later. Reported income smoothing can be defined as a deliberate effort to level or fluctuate profit levels, so that at present it will be considered normal for a company (Ghozali & Chariri, 2007: 370). Liquidity is the ratio that shows the relationship between current assets owned by the company and current liabilities owned by the company. Usually this ratio is used by companies to measure the extent to which the company's ability to meet all of its short-term obligations. This research will prove whether there are differences in the liquidity of companies that carry out income smoothing and companies that do not carry out income smoothing. The second hypothesis is formulated as follows.

H_2: There is a difference in liquidity between income-smoothing and non-income-smoothing companies.

Investors attention is focused on earnings information in making investment decisions, attracting managers to manipulate data by leveling profits. As a result of manipulating profits, changes in the financial ratios which reflect company performance are likely to occur. The existence of this managerial tendency leads to the possibility of incorrect accounting and economic decisions being taken or policies put in place by users of financial statements. Investors, as the main users of financial statements, will be affected by bias in earnings information resulting from earnings management or income smoothing. The results of the study by Murni & Santoso (2007) state that there is no difference operating leverage between companies that perform income smoothing or those that do not. The third hypothesis is formulated as follows:.

H_3: There is a difference in leverage between income-smoothing and non-income-smoothing companies.

Research Michelson et al. (1995) tested the relationship between income smoothing and stock market performance. In his research, Michelson obtained empirical evidence that public companies in the United States that carry out income smoothing have an average return and risk that are lower than companies that do not carry out income smoothing. Michelson et al. (1995) argue that income smoothing reduces the risk attaching to a company which in turn will reduce profits for those who invest in such lower-risk companies. Michelson et al. (1995) conclude that companies that carry out income smoothing have lower average returns than companies that do not. Similar results were also obtained by Samlawi & Sudibyo (2000), who found that there was a significant difference in the average annualized return between income-smoothing and non-income-smoothing companies. Assih & Gudono (2000) and Khafid et al. (2002) obtained results that indicated that market reaction measured using cumulative abnormal return compared between income-smoothing companies and non-income-smoothing firms was significantly different. These results are contrary to the results of research by Salno & Baridwan (2000) and Murtanto (2004), which found that there were no differences in returns between these types of companies. Subekti (2005) also found that market reactions proxied by abnormal returns and stock trading volumes show no different between such firms. The fourth hypothesis is formulated as follows.

H_4: There is a difference in returns between income-smoothing and non-income-smoothing companies.

In his research, Michelson obtained empirical evidence that public companies in the United States that carry out income smoothing have an average return and risk that are lower than companies that do not carry out income smoothing. Michelson et al. (1995) argue that income smoothing reduces the risk attaching to a company which in turn will reduce profits for those who invest in such lower-risk companies. Ronen & Sadan (1975) suspected that income smoothing produces a better evaluation in the eyes of investors, from whose point of view stable earnings show good management, thus suggesting that the company is not risky. Kristianto's research (2009) indicates that the stock risk applying to income-smoothing and non-income-smoothing companies is no different. Khafid, et al (2002) also found that the investment risk of income

smoothing companies is smaller than non income smoothing companies. The fifth hypothesis is formulated as follows.

H_5: There are differences in stock risk between income-smoothing and non-income-smoothing companies.

RESEARCH METHODS

The object population of this research is all companies in the real estate industry in Indonesia. The property and real estate sector operating in Indonesia has had a positive impact on economic progress in Indonesia, but throughout 2015, the property industry staggered to its lowest point. This has an impact on the company's financial statements and triggers the company to take management actions in the form of earnings management, one of which is income smoothing.

The sample is determined by purposive sampling of data from the web sites of the Indonesian Stock Exchange (BEI) and Yahoo Finance, chosen according to the following criteria: real estate companies listed on the BEI from 2014 to 2017, companies that issued financial reports to the BE1 during the observation period, companies for which there is stock price data available during the observation period, companies that did not suffer losses.

Operational definitions of variables in this study are as follows: The variable "company profitability" is measured using the ratio between profit after tax and total assets (Brigham & Houston, 2017). The variable "company liquidity" is measured using the ratio between current assets and current liabilities ((Brigham & Houston, 2017)). The variable "financial leverage" is measured using the debt ratio divided by the equity of the company ((Brigham & Houston, 2017)). The variable "stock return in a period" is calculated as return = capital gain (loss) using the following formula (Jogiyanto, 2003).

$$Rit = \frac{\text{P it} - \text{P it}-1}{\text{P it}-1} \quad \text{..... (1)}$$

Explanation:

R_t = stock return

P_t = share price at the end of the period

P_{t-1} = stock price *i* at the beginning of the period

If the current investment price (P*t*) is higher than the investment price of the previous period (P*t*-1) there is a capital gain and if the opposite there is a capital loss.

The variable "share risk" is measured by the deviation between realized return and expected return ((Brigham & Houston, 2017)). The calculation of the standard deviation is formulated as follows:

$$SD = | Xi - E(Xi) | \quad \text{..... (2)}$$

Explanation:

SD = standard deviation (σ)

X*i* = period return *i*

E (X*i*) = value of expected return or average return

To discover whether a company performs income-smoothing practices, the Eckel index (1981) is used.

$$\text{Income-smoothing index} = (CV\Delta I / CV\Delta S) \quad \text{..... (3)}$$

Explanation:
ΔI = changes in earnings in one period
ΔS = changes in sales in one period
CV = coefficient of variation of variables, namely standard deviation divided by expected value.
CVΔI = coefficient of variation for changes in earnings
CVΔS = coefficient of variation for changes in sales.
Information on CVΔI and CVΔS can be calculated as follows:

$$CV = \sum_{i=1}^{n} \frac{(xi-\ddot{x})^2}{n-1} : \Delta\ddot{x} \quad \text{..... (4)}$$

Explanation:
Δẍ = average change in earnings (I) or sales (S) between years *n* and *n*-1
n = number of years observed.

A company is deemed to carry out income-smoothing actions if the Eckel index is < 1 and is deemed not to carry out income-smoothing actions if the Eckel index is ≥ 1. The steps of the analysis technique are as follows: After the sample is selected based on the predetermined sample criteria, then determine real estate companies income-smoothing and non-income-smoothing companies using Eckel's index. A company is not classified into the leveling group if CVΔI > CVΔS, Calculating financial performance with ratios of profitability, liquidity, and leverage, Calculating market performance using stock returns and stock risk, Do a data normality test first, if the data is not normally distributed then for the statistical test use the non-parametric independent sample t-test with the Mann Whitney test.

RESULTS AND DISCUSSION

The five hypotheses were tested on the population of all listed real estate companies in the Indonesian Stock Exchange from 2015 to 2017. Through purposive sampling, a sample of 32 companies was obtained for each of the three observation years, providing 96 observations in total. After selection, the sample was classified using the Eckel index (1981) into groups of companies that carried out income smoothing and those that did not. Eckel uses the variation coefficient (CV) reflecting variable profit and net sales. A company is not classified as income smoothing if CVΔI > CVΔS. Table 1 presents the results of the classification.

Table 1. Sample classification based on the Eckel index

Status	CVΔI > CVΔS
Income smoothing	50
Non-income smoothing	46
Total sample	96

Source: Research Data, 2022

From Table 1 it can be seen within the total sample of 96 company years there are 50 in the income-smoothing group and 46 in the non-income-smoothing group.

Descriptive statistical tests were carried out on data on profitability, liquidity, leverage, stock returns and stock risk. The results of the descriptive statistical test are presented in Table 2.

Table 2. Descriptive Statistical Test Results

No	Variable	Minimum	Maximum	Average	Standard Deviation
1.	Profitability	0.00	0.36	0.520	0.502
2.	Liquidity	0.54	21.41	2.933	3.078
3.	Leverage	0.00	5.20	0.787	0.671
4.	Stock Return	-0.59	8.24	0.077	0.858
5	Share Risk	-2.85	5.57	0.000	0.712

Source: Research Data, 2022

Based on table 2 above, it can be seen that the profitability variable has an average value of 0.5208, a standard deviation value of 0.502, and the highest value is 0.36 with the lowest value 0.00. The liquidity variable has an average value of 2.9330, a standard deviation value of 3.078, and a highest value of 21.41 with a lowest value of 0.54. The leverage variable has an average value of 0.7873, a standard deviation value of 0.671, and the highest value is 5.20 with the lowest value being 0.00. The return variable has an average value of 0.077, a standard deviation value of 0.8584, and the highest value is 8.24 with the lowest value -0.59. And for the stock risk variable, it has an average value of 0.000, a standard deviation value of 0.712, and a highest value of 5.57 with a lowest value of -2.85.

To ascertain the actual data distribution, the one-sample Kolmogorov-Smirnov test was applied with a significance level of 0.05 (5%). Table 3 presents the results of the normality testing for the data.

Table 3. Results of the one-sample Kolmogorov-Smirnov test

No	Variable	2-Tailed P	Description	Distribution
1.	Profitability	0.000	P ≤ 0.05	Not normal
2.	Liquidity	0.000	P ≤ 0.05	Not normal
3.	Leverage	0.002	P ≤ 0.05	Not normal
4.	Stock Returns	0.000	P ≤ 0.05	Not normal
5	Share Risk	0.000	P ≤ 0.05	Not normal

Source: Research Data, 2022

From the data distribution, the results of the descriptive statistical test show that data for all variables are not normally distributed. This is indicated by the 2-tailed Pvalues of 0.000 for profitability, liquidity, leverage, and stock risk and 0.002 for stock return, all of which are smaller than 0.05. Because the data are not normally distributed, hypothesis testing was carried out using non-parametric statistical tests, namely the independent samples (Mann-Whitney t-tests)

The following are the results of the hypotheses tests based on the Eckel index sample classification.

Table 4. Hypothesis testing

Variable	Sig. (2-tailed)	Description	Ha
Profitability	0.391	P ≥ 0.05	Rejected
Liquidity	0.477	P ≥ 0.05	Rejected
Leverage	0.706	P ≥ 0.05	Rejected
Stock returns	0.163	P ≥ 0.05	Rejected
Share risk	0.502	P ≥ 0.05	Rejected

Source: Research Data, 2022

Based on the results of the independent samples (Mann-Whitney t-tests), the Sig (2-tailed) value is obtained, where Ha is accepted if the Sig (2-tailed) value is less than 0.05 and is rejected if itis greater than 0.05. Based on Table 4 it can be

seen that for each of the five variables––profitability, liquidity, leverage, stock returns, and stock risk––a significance value of greater than 0.05 is obtained and so it can be concluded that there are no differences in ROA, CR, DER, stock returns, and share risk between income-smoothing and non-income-smoothing companies.

The purpose of this study is to empirically test whether there are differences in financial performance as measured by return on assets, current ratios, and debt-to-equity ratios of profit-making and non-profit-making firms. For ROA, CR, and DER the results show that there is no difference between the income-smoothing and the non-income-smoothing companies. The absence of differences in financial performance as measured by profitability, liquidity, and leverage ratios between profit-smoothing and non-profit-smoothing groups may be because in the research years used, the companies categorized as income smoothing were quite accurate in their estimation of profits and in reporting related accounts. The greater the change in ROA, the greater the fluctuation in management's ability to generate profits, so that the greater the opportunity for managers to practice income smoothing. This statement cannot be proven because ROA of the income smoothing is smaller than ROA of non income smoothing. Harmono's statement (2009:106) A high level of liquidity indicates the ability to pay off short-term debt is also higher. So there is a great opportunity for managers to practice income smoothing. This ratio is important because failure to pay obligations can lead to bankruptcy of the company. The difference in the average CR values during the years of observation can be explained by the fact that each year there is not much difference between the CR of income smoothing and non income smoothing companies. The greater the capital structure ratio, the greater the risk borne by the company, causing a decrease in investor interest in investing in the company, which can trigger income smoothing actions. This statement cannot be proven because DER of income smoothing is smaller than DER of non income smoothing companies.

It may also be that at a macroeconomic level those years had stable growth and so average company profits generated did not fluctuate too sharply. Thus the agency theory is not sufficiently proven that agents take advantage of the financial information they have to carry out very aggressive income smoothing actions. This research is in line with the research conducted by Murni and Santoso (2007) which states that there is no difference in profitability and operating leverage between companies that perform income smoothing or those that do not.

The purpose of this study is to test empirically whether there are differences in stock performance as seen through stock returns and risk related to company's earnings between income smoothing and non-income-smoothing companies. In terms of stock returns, the results show that there is no difference in stock returns between income-smoothing companies and others. The results of this study are in line with research conducted by Kristianto (2009), Garizi et al. (2011), Salno (2000), and Samlawi (1999), all of which indicate no difference in returns between such companies. Likewise, the research conducted by Subekti (2005) into market reaction as proxied by abnormal returns and the volume of stock trading showed no such differences. However, the results are not in line with research conducted by Michelson et al. (1995) which concluded that companies that

perform income smoothing have lower average returns than companies that do not. Michelson et al.'s (1995) results are confirmed by those obtained by Samlawi and Sudibyo (2000), Assih and Gudono (2000), and Khafid et al. (2002),all of which indicate that there are differences in returns between income-smoothing and non-income-smoothing companies.

The reason for the absence of differences in stock returns between these two groups of companies is that investors may not understand income smoothing and may tend to assume that the practice is not a significant consideration in their decision making. Investors are more likely to consider a company's external factors, such as social conditions and economic conditions, and their own tribal-level interests and these are therefore likely to have more influence on stock prices than a company's own internal factors in terms of income smoothing (Muid, Dul and Nanang Catur, 2005)

The results of stock-risk research provide the same results as research in to stock returns, in that there is no difference in stock risk between income-smoothing and non-income-smoothing companies. The results of this study are in line with those of Salno and Baridwan (2000), Samlawi and Sudibyo (2000), Nasir et.al. (2002), Murtanto (2004), and Kristianto (2009), which all indicate that share risk is no different between income-smoothing and non-income-smoothing companies. The results of this present study are not in line with those obtained in theresearch conducted by Michelson et.al. (1995) which proved that the beta of an income-smoothing company is no different from that of a non-income-smoothing company. Khafid et al. (2002) found that the investment risk of corporate earnings is smaller in income-smoothing than in non-income-smoothing firms. The cause is that there is no difference in stock risk in the two types of firm resulting from flattened profits and uneven profits resulting from the same market and economic conditions and the same government regulations (Nasir et al., 2002).

CONCLUSION

The purpose of this study is to test whether or not there are differences, the financial performance proxied by profitability, liquidity, and leverage between companies that practice income smoothing practices and those that do not practice income smoothing and also whether there are differences or not, the performance of the stocks proxies for stock returns and stock risk between companies that practice income smoothing practices and those that do not practice income smoothing in the real estate sector.

The test results for financial performance as proxied by profitability (ROA), liquidity (CR). and leverage (DER) reject the hypotheses and accept the null hypotheses for these three variables. Thus there is no difference in profitability, liquidity, and leverage between income-smoothing and non-income-smoothing companies. The test results for stock performance as proxied by stock returns and stock risk also reject the hypotheses and accept the null hypotheses for these two variables. Thus there is no difference in stock returns and stock risk between income-smoothing and non-income-smoothing companies.

The limitations in this study are that for calculating the variability of profits and sales the researcher only uses changes in profits and sales of the previous year in the annual financial reports, in this study the researchers only used real estate

companies so the research cannot be generalized broadly to all public companies in Indonesia

Based on these limitations, suggestions that can be submitted for further research are for future researchers to calculate changes in profit and sales each year using quarterly financial reports for the year concerned, for future researchers to use a larger sample and not only in the real estate sector. only but also in other sectors.

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