THE EFFECT OF CORPORATE GOVERNANCE AND INCOME TAX ON INCOME SMOOTHING

Agustin Palupi*
agustin@dosen.stietrisakti.ac.id
Trisakti School of Management, Indonesia
*Penulis Korespondensi

Abstract
The purpose of this research is to obtain empirical evidence about the factors that influence income smoothing. This research used non-financial companies listed on the Indonesia Stock Exchange from 2015-2017. There are 50 companies that meet the criteria using purposive sampling method. The research model used was regression binary logistic. The results of the research show that leverage, firm value, profitability, firm size, income tax, and dividend payout ratio have an influence on income smoothing. However, managerial ownership and quality audit have no influence on income smoothing. Implication of the research indicate that investors assess income smoothing by income tax and accounting numbers in their annual reports for their investment decision.

Keywords: Income Smoothing; Managerial Ownership; Income Tax; Quality Audit; Firm Value; Leverage; Profitability; Firm Size; Dividend Payout Ratio

INTRODUCTION
Financial statements must describe the actual financial condition. Its intended for user to determine policies for making decisions to achieve company's goals, both long-term and short-term corporate goals. The most important information in determining a company's decision is profit
Information about earnings is a component of a company's financial statements that aims to assess management's performance, help estimate the ability of earnings in the long term, and estimate investment risks or lend funds (Keirschenter and Melumad, 2002).

Dysfunctional behavior is a deviant action by management with the aim of increasing profits and avoiding fluctuations in earnings by utilizing the flexibility of the accounting standards used (Wulandari et al., 2013). It makes management have to do earnings management. One form of earnings management is income smoothing.

The case that occurred in Indonesia, Sunprima Nusantara Financing (SNP Finance), financing company (multi-finance) that harmed 14 banks in Indonesia. One of the banks that was heavily affected was Bank Mandiri. SNP Finance is proven manipulated financial statements with adding, duplicating, and filling of accounts receivable (fictitious), in the form of a data list from PT CMP. According to Anwar and Chandra (2017), there are several reasons companies did income smoothing, like to reduce taxes, increase manager's confidence because stable income will support a stable policy and also avoid pressure from employees for salary or wage increases.

The purpose of this research is to obtain empirical evidence about the factors that influence income smoothing. This research wants to analyze the effect of corporate governance measured with managerial ownership, income tax, quality audit, firm value, leverage, profitability, company size, and dividend payout ratio on the practice of income smoothing.

LITERATURE REVIEW

Agency Theory

Agent defined as company management while the principal is a shareholder (Ratih and Damayantri, 2016). According to Scott (2015), Agency theory is a branch of game theory that studies the design of contracts to motivate a rational agree to act on behalf of a principal when the agent's interest would otherwise conflict with those of the principal.

Agency theory according to Jensen and Meckling (1976) states that the agency relationship is an agreement between two parties, namely the principal (owner) and agent (management). Management is given the trust by the principal to manage and run the company so that the company's goals increase and the company's value achieved (Octalianna and Rahayuningsih, 2013).

Jensen and Meckling (1976) define the agency relationship as a contract under which one party (the principal) engages another party (the agent) to perform some service on their behalf. As part of this, the principal will delegate some decision-making authority to the agent. These agency problems arise because of the impossibility of perfectly contracting for every possible action of an agent whose decisions affect both his own welfare and the welfare of the principal, Brennan (1995). Arising from this problem is how to induce the agent to act in the best interests of the principal.

Management gets more information than owner who is rarely in the
company, so that the owner has difficulty controlling management actions when managing company (Jamaluddin and Amanah, 2015). Because management knows more information than principals, information that is known by management and shareholders is not balanced. This is called asymmetric information.

**Signalling Theory**

Steven and Lina (2011) define signaling theory is the management’s steps of a company that actually provides instructions implicitly to investors about how management views the company's prospects. The manager's impetus to give a signal is to make a profit, because if investors believe in the signal, stock prices will increase and shareholders will get benefit (Godfrey, 2010).

According to Lokollo and Syafruddin (2013) states to reduce information asymmetry between companies (internal parties) and external parties, a company must provide information to external parties in the form of reliable financial statements. And to give a positive signal to other parties, companies must provide information about working capital and financial ratios that are true and clear.

**Income Smoothing**

Income smoothing is a method used by company managers to reduce changes in the amount of tax reported whether it is the distribution of real profits or the distribution of artificial profits in order to achieve the desired profits of the company (Vakilifard and Allame Naeri 2001 in Peranasari and Dharmadiaksa 2014). According to Subramanyam (2014, 95), income smoothing is a form of earnings management by reducing or increasing earnings to reduce earnings fluctuations by not reporting a portion of income in high-income years. According to Fatmawati and Djajanti (2015) the concept of income smoothing is related to earnings management whose discussion uses the agency theory approach. Dysfunctional behavior is a deviant action by management (Noviana and Yuyetta, 2011).

Eckel (1981) distinguishes two different type of smoothing income stream. Those that are naturally smooth and intentionally smoothed by management. Natural smoothing is the alignments resulting from transactions that inherently produce a smoothed earning. It means, the company’s operations to generate income by collecting revenues and expenses are inherently to eliminate fluctuations flow of income. An intentionally smoothed income stream can be the result of real smoothing or artificial smoothing techniques. Real income smoothing indicates management action that seeks to control economic conditions that affect corporate future earnings. Artificial income smoothing occurs when management manipulate the timing of accounting entries to produce smooth income streams.

**Corporate Governance and Income Smoothing**

In this research, corporate governance’ proxy is managerial ownership. According to Pratama (2012), Mahmud (2012), and Gantino (2015) showed the influence of managerial ownership on income smoothing actions. Whereas the research conducted by Pratiwi and Handayani (2014) shows that there is no influence between managerial ownership on income smoothing actions.

Managers who have control and access to company information will
manipulate company information if they feel the information is detrimental to their interests (Febrianto and Erna, 2005 in Mambraku and Hadiprajito, 2014). It shows that managerial ownership has a positive influence on income smoothing. On the basis of the explanation above, the first hypothesis is:

**H1: Managerial ownership significantly increase the opportunity for companies to practice income smoothing.**

**Income Tax and Income Smoothing**

According to Saedi (2012) and Luqman and Shahzad (2012), concluded that there was a significant positive effect between income tax on income smoothing. Large income tax will increase practice of income smoothing. In addition, according to Rifai and Widyatmini (2012) states that income tax has a significant negative effect on income smoothing. A large income tax will reduce the practice of income smoothing. Ratnaningrum (2016) and Linandi (2013) who stated income tax had no effect on income smoothing actions. They concluded low or high income tax, the company will continue to practice income smoothing. On the basis of the explanation above, the second hypothesis is:

**H2: Income Tax significantly increase the opportunity for companies to practice income smoothing.**

**Quality Audit and Income Smoothing**

Dewi and Latrini (2016) and Marpaung and Latrini (2014) concluded that quality audit has a significant negative effect on income smoothing. Other studies by Linandi (2013), Wahyunia et al., (2013), Arif (2014) and Supriyanto (2016) stated that quality audit has no significant effect on income smoothing practices. The type of Public Accounting Firm (KAP) which is classified as The Big Four or Non Big Four does not affect the management's choice to make income smoothing. On the basis of the explanation above, the third hypothesis is:

**H3: Quality audit significantly reduce the opportunity for companies to practice income smoothing.**

**Firm Value and Income Smoothing**

Peranasari and Dharmadiaksa (2014), Husaini and Sayunita (2016), Rahmawanti (2016), Arum et al (2017), Pratiwi and Damayanth (2017), Saputri et al (2017), and Pratama et al (2018) and Budhi et al., (2018) concluded that there is a significant influence between firm value on income smoothing. According to Pratama (2012), Oktyawati and Agustia (2014), Gantino (2015) and Daud and Fauzan (2017) who said firm value does not affect on income smoothing. Which is if the number of firm values increases or not, it does not lead to income smoothing practices. On the basis of the explanation above, the fourth hypothesis is:

**H4: Firm Value significantly increase the opportunity for companies to practice income smoothing.**
RESEARCH METHODS

This research used non-financial companies listed on the Indonesia Stock Exchange from 2015-2017. Sample selection is presented in Table 1.

Table 1. Sample Selection Procedures

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Companies</th>
<th>Sample</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non financial companies consistently listed during 2015-2017</td>
<td>367</td>
<td>1101</td>
</tr>
<tr>
<td>Companies with no Rupiah currency</td>
<td>(75)</td>
<td>(225)</td>
</tr>
<tr>
<td>Companies with no periods ending 31 December</td>
<td>(8)</td>
<td>(24)</td>
</tr>
<tr>
<td>Companies with no positive profit during 2015-2017</td>
<td>(126)</td>
<td>(378)</td>
</tr>
<tr>
<td>Companies with consistently do not have managerial ownership during 2015-2017</td>
<td>(81)</td>
<td>(243)</td>
</tr>
<tr>
<td>Companies with no dividend during 2015-2017</td>
<td>(27)</td>
<td>(81)</td>
</tr>
<tr>
<td>Companies selected at last sample</td>
<td>50</td>
<td>150</td>
</tr>
</tbody>
</table>

**Dependent Variable**

Income smoothing was measured by Eckel index (1981) by using earnings after tax (net profit) and net sales (CV). The group of companies that practice income smoothing is given a value of 1, while the group of companies that do not practice income smoothing is given a value of 0. Companies that have income smoothing index less than 1, then identified doing income smoothing, while companies with more than one income smoothing index are not identified do income smoothing. The income smoothing index is calculated as follows according to (Eckel, 1981):

\[
\text{Income smoothing} = \frac{\text{CV} \Delta I}{\text{CV} \Delta S} \quad \ldots \quad \ldots \quad \ldots \quad (1)
\]

**Independent Variables**

There are four main independent variables in this research, which are Managerial Ownership, Income Tax, Quality Audit, and Firm Value. Managerial Ownership is measured by number of shares owned by management divided by outstanding share (Gantino, 2015). Income tax is tax that is imposed on individuals income, companies or other legal entities. The calculation of income tax used a ratio scale based on Linandi’s research (2013) with net income before tax minus net income after tax. Quality audit is measured using a dummy variable, which will be assigned a value of “1” if audited by “The Big Four” and a value of “0” other-wise (Linandi, 2013). Firm Value measured by price earning ratio (Gantino, 2015)

**Control Variables**

In addition to the variables described above, this research also includes four control variables, namely financial leverage, profitability, firm size, and dividend payout ratio. Financial leverage is measured using Debt-to-Asset Ratio (DAR). The
profitability variable measured by Return on Asset (ROA). Company size is calculated by using the natural logarithm formula for total assets and proxy of dividend is dividend payout ratio.

**EMPIRICAL RESULTS**

This paper’s research examined 150 non financial firms years listed in Indonesia Stock Exchange. The descriptive statistics are shown in Table.2.

<table>
<thead>
<tr>
<th></th>
<th>N</th>
<th>Minimum</th>
<th>Maximum</th>
<th>Mean</th>
<th>Std. Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>IS</td>
<td>150</td>
<td>0</td>
<td>1</td>
<td>0.59</td>
<td>0.493</td>
</tr>
<tr>
<td>KM</td>
<td>150</td>
<td>0,0000</td>
<td>5,020</td>
<td>0,0345</td>
<td>0,0822</td>
</tr>
<tr>
<td>TAX</td>
<td>150</td>
<td>-98,863.</td>
<td>9,958,000</td>
<td>602,098,023</td>
<td>1,493,924.</td>
</tr>
<tr>
<td>QA</td>
<td>150</td>
<td>753,278.</td>
<td>000,000</td>
<td>302,57</td>
<td>661,436,042</td>
</tr>
<tr>
<td>FV</td>
<td>150</td>
<td>4,2230</td>
<td>1224,2268</td>
<td>30,5531</td>
<td>102,0509</td>
</tr>
<tr>
<td>LEV</td>
<td>150</td>
<td>0,0750</td>
<td>0,8108</td>
<td>0,4406</td>
<td>0,1853</td>
</tr>
<tr>
<td>PROF</td>
<td>150</td>
<td>0,0075</td>
<td>0,4579</td>
<td>0,0891</td>
<td>0,0865</td>
</tr>
<tr>
<td>SIZE</td>
<td>150</td>
<td>25,6195</td>
<td>33,3202</td>
<td>29,4973</td>
<td>1,6534</td>
</tr>
<tr>
<td>DPR</td>
<td>150</td>
<td>0,0353</td>
<td>6,7568</td>
<td>0,4946</td>
<td>0,7998</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Variabel</th>
<th>B</th>
<th>Significant</th>
</tr>
</thead>
<tbody>
<tr>
<td>KM</td>
<td>2,494</td>
<td>rejected</td>
</tr>
<tr>
<td>TAX</td>
<td>0,000</td>
<td>accepted</td>
</tr>
<tr>
<td>QA</td>
<td>-0,714</td>
<td>rejected</td>
</tr>
<tr>
<td>FV</td>
<td>0,039</td>
<td>accepted</td>
</tr>
<tr>
<td>LEV</td>
<td>-2,781</td>
<td>accepted</td>
</tr>
<tr>
<td>PROF</td>
<td>-9,233</td>
<td>accepted</td>
</tr>
<tr>
<td>SIZE</td>
<td>0,365</td>
<td>accepted</td>
</tr>
<tr>
<td>DPR</td>
<td>1,537</td>
<td>accepted</td>
</tr>
<tr>
<td>Constant</td>
<td>-9,030</td>
<td>0,109</td>
</tr>
</tbody>
</table>

Note:
* = significan 10%
** = significan 5%
*** = significan 1%

During the observation period of the years 2015-2017, in calculating the index from the years 2015-2017 Eckel required data from the years 2012-2017 to calculate the Eckels’ Index each year. Furthermore, the entire sample further classified into income smoothers (0) and non income smoothers (1). Based on the
analysis of the 150 financial statements, there were 89 financial statements (59.3%), which indicate income smoothers and 61 financial statements (40.7%) were non-income smoothers companies.

The results of this test indicate the Managerial Ownership variable (KM) has a significance value of 0.570, greater than the significant value of alpha 0.1 with a coefficient value of 2.494. Thus, it can be stated that $H_1$ is rejected or the managerial ownership variable has not been proven significantly increase opportunity for the company to practice income smoothing. This result is likely to occur because the average non-financial companies sampled in this study have low number of managerial ownership. This result is consistent with the research of Pratiwi and Handayani (2014). However, this result inconsistent with Pratama (2012), Mahmud (2012), and Gantino (2015).

The value of Income Tax (TAX) has a significance value of 0.085, less than the significant value of alpha 0.05 with a coefficient value of 0.000. Thus, it can be stated that $H_2$ is accepted or the Income Tax variable has been proven significantly increase opportunity for the company to practice income smoothing. The bigger income tax, the bigger opportunity for the company to practice income smoothing. This result is consistent with the research of Saedi (2012) and Luqman and Shahzad (2012). However, this result inconsistent with Ratnaningrum (2016) and Linandi (2013).

The results of this test indicate the Quality Audit (QA) has a significance value of 0.139, greater than the significant value of alpha 0.1 with a coefficient value of -0.714. Thus, it can be stated that $H_3$ is rejected or the Quality Audit variable has not been proven significantly reduce opportunity for the company to practice income smoothing. This result is likely to occur because the type of Public Accounting Firm (KAP) which is classified as The Big Four or Non Big Four does not affect the management’s choice to make income smoothing. The purpose of the audit is to increase the credibility of the company’s financial statements not to detect practice of income smoothing. This result is consistent with the research of Linandi (2013), Wahyuni et al., (2013), Arif (2014) and Supriyanto (2016). However, this result inconsistent with Dewi and Latrini (2016) and Marpaung and Latrini (2014).

The value of Firm Value (FV) has a significance value of 0.045, less than the significant value of alpha 0.05 with a coefficient value of 0.039. Thus, it can be stated that $H_4$ is accepted or the Firm Value has been proven significantly increase opportunity for the company to practice income smoothing. The higher value of the firm, the bigger opportunity for the company to practice income smoothing. This result is consistent with the research of Peranasari and Dharmadiaksa (2014), Husaini and Sayunita (2016), Rahmawanti (2016), Arum et al (2017), Pratiwi and Damayanti (2017), Saputri et al (2017), and Pratama et al (2018) and Budhi et al., (2018). However, this result inconsistent with Pratama (2012), Oktyawati and Agustia (2014), Gantino (2015) and Daud and Fauzan (2017).

The value of Leverage (LEV) has a significance value of 0.020, less than the significant value of alpha 0.05 with a coefficient value of -2.781. The lower financial leverage, the bigger opportunity for the company to practice income smoothing. Profitability (PROF) has a significance value of 0.003, less than the significant value
of alpha 0.05 with a coefficient value of -9.233. Its means, the lower company profiability, the bigger opportunity for the company to practice income smoothing. The value of Size (SIZE) has a significance value of 0.066, less than the significant value of alpha 0.05 with a coefficient value of 0.365. The bigger size of the company, the bigger opportunity for the company to practice income smoothing. Dividend Payout Ratio (DPR) has a significance value of 0.081, less than the significant value of alpha 0.05 with a coefficient value of 1.537. Its means, the more dividends distributed, the bigger opportunity for the company to practice income smoothing.

CONCLUSIONS

Based on the results of hypothesis testing, it can be concluded that Income Tax, Firm Value, Firm Size and Dividend Payout Ratio are proven significantly increase the opportunity for companies to practice income smoothing. Leverage and profitability have been proven significantly reduce the opportunity for companies to practice income smoothing. While managerial ownership and Quality Audit have not proven significantly increase the opportunities for companies to practice income smoothing.

There are limitations in this study. This research only examines a three-year period and variables used are limited to eight. The recommendation from this research is to increase the research time and conduct it over long period, and to include additional variables that may have an effect on income smoothing, such as other proxy of corporate governance like independent commissioners, other comprehensive income, bonus plan, industry sector and cash holdings.

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