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Income Smoothing in Indonesia: Could Reputable Auditors Suppress it?

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ABSTRACT: *Managers can manage reported earnings through income smoothing.Therefore, it affects information about earnings becomes misleading and may inflict financial loss for investors or other users of financial statements. Previous studies related to the effect of the company size on income smoothing giving inconsistent results have encouraged the researcher to conduct a study using moderating variables. Auditor reputation is considered as a mechanism that can suppress income smoothing practices. This study aims to empirically test the ability of the auditor reputation in moderating the effect of the company size on income smoothing. The study was conducted from 2015 to 2019, by applying a purposive sampling method on all companies listed on the Indonesia Stock Exchange, obtained 449 sample companies. This study strengthens the results of previous studies which state that the company size has a negative effect on income smoothing in listed companies on the Indonesia Stock Exchange. This indicates that public attention to large companies has limited their managers in doing income smoothing. The major result is that auditor reputation moderation weakens the relationship between the company size and income smoothing. A reputable auditor in a small company, based on the results of this study, was able to suppress the practice of income smoothing.*

KEY WORD*: Income Smoothing, Company Size, Auditor Reputation*

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I. INTRODUCTION

The information asymmetry between managers (agents) and company owners (principals) gives managers the flexibility to manage their financial statements so that they can be reported properly(Azizah, 2017a),(Damayanti et al., 2021), (Natanael et al., 2021),(Cahyo et al., 2022). One item in financial information that investors focus on is profit figures, and managers in Indonesia are aware of this(Amyulianthy et al., 2020). Managers always strive so that the reported profit figures can attract investors and satisfy shareholders as well(Muhyidin et al., 2021).

Management as the manager of the company can intervene so that the profit generated looks good by carrying out earnings management(Azizah et al., 2021), (Azizah et al., 2019), (Majid et al., 2020), (Azizah, 2021), (Azizah, Bantasyam, et al., 2020), (Romantis et al., 2020), (Prasetyo et al., 2021). One form of earnings management practice is income smoothing. Income smoothing may be carried out by companies, as long as the implementation does not contain fraud. But unfortunately, researches by (Azizah, 2017a)proves that the perspective underlying managers in Indonesia to do earnings management is an opportunist perspective.

Researches conducted by Aemanah and Isynuwardhana (2019), Oktoriza (2018), Andiani and Astika (2019), Dewi and Suryanawa (2019), Oktaviasari, et al. (2018), Marhamah (2016), Fadlli and Khairunnisa (2020), Azizah et al. (2020) show inconsistent results regarding the effect of the company size on income smoothing. In addition, very few studies have examined income smoothing practices in all companies listed on the Indonesia Stock Exchange. The novelty of this research is to examine all public companies listed on the Indonesia Stock Exchange.

The inconsistency results of the previous studies regarding the effect of the company size on income smoothing allow other variables to moderate the causal relationship. Auditor reputation is considered as a mechanism that can suppress the practice of income smoothing, like a study that has been successfully proven by Sellah and Herawaty (2019) and Marhamah (2016). Therefore, the researcher conducted a study entitled "Income Smoothing in Indonesia: Could Reputable Auditors Suppress it?".

II. LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

Belkaoui (2012) explains that income smoothing is a reduction in profit fluctuations from year to year by moving income from high-income years to less profitable ones. It can be concluded that income smoothing is an act of deliberate manipulation, carried out by management on reported earnings fluctuations so that the company's reported profits look stable.

The reason behind the practice of income smoothing, among others, is to maximize the managers' functions and welfare, like job security, ranks, and salary growth rates as well as company ratings and growth rates, as shareholder satisfaction on company performance that can increase the status and rewards of the company managers themselves, and as a level of growth and stability of company earnings.

The cooperation contract contains agreements explaining that companies' management should do the jobs optimally to provide maximum satisfaction such as high profits to owners. The implication is that it allows opportunistic attitudes (Azizah, 2017a). Managers are encouraged to maximize their interests by beautifying the financial statements to match the owners' expectations even though the financial statements do not represent the actual condition of the company(Azizah, 2017b).

In large companies, income smoothing by managers as a form of earnings manipulation is considered not to provide real information related to company performance so that it can result in large companies getting more attention. Meanwhile, if the company reports a drastic decline in profits, this indicates that the company is experiencing financial difficulties or a crisis. Thus, public attention to large companies will limit managers in performing income smoothing (Azizah, Zoebaedi, et al., 2020).

The quality of external auditors is expected to be one of the management controllers in conducting income smoothing. Auditors from Big Four accounting firms are reputable auditors who have superior resources, professionalism, quality, specialization, and more ability to innovate through technology to increase the possibility of Big Four accounting firms to find violations in companies financial reporting. Thus, a reputable auditor is expected to suppress the practice of income smoothing. The hypothesis is formulated as follows:

Ha: Auditor reputation moderates the relationship between company size and income smoothing.

III. METHOD

The population of this study is all companies in Indonesian Stock Exchange. The purposive sampling method is used to select the sample with criteria:

a. Companies are listed consecutively on the Indonesia Stock Exchange from 2015 to 2019 and publish audited financial statements.
b. Companies present financial statements in rupiah.
c. Companies have complete data.

The moderating variable in this study is the auditor reputation. Auditor reputation is a condition where the auditor is responsible for maintaining public trust and good name of the auditor himself and the accounting firm where the auditor works by issuing an opinion accordance actual client condition. The auditor reputation measured using accounting firms that are affiliated with the Big Four accounting firms. It can be measured using a dummy:

1 = auditors working for Big Fouraccounting firms
0 = auditors working for Non-Big Fouraccounting firms

The independent variable in this study is the company size. It is measured by the natural logarithm (Ln) of the company total assets. Meanwhile, the dependent variable in this study is income smoothing. It is measured using the Eckel index. Based on the Eckel index, a company carries out income smoothing practices if the Eckel index value is less than 1. According to Eckel (1981), income smoothing can be calculated by the formula:

$$\boxed{\text{Eckel Index} = \frac{\text{CV } \Delta \text{I}}{\text{CV } \Delta \text{S}}}$$

Note:

CV ΔI = changing in net profit between year n and year n-1
CV ΔS = changing in sales between year n and year n-1
CV = variable Variation Coefficient, namely the standard deviation divided by the average change in profit (I) or sales (S)

By using SPSS version 26 for Windows, the regression equation model for hypothesis testing is as follows:

$$Y = \alpha + \beta 1X1 + \beta 2X2 + \beta 3X1.X2 + \varepsilon$$

Note:

Y	: Income smoothing
α	: Constant
β1 β2 β3	: Regression Coefficient
X1	: Company size
X2	: Auditor reputation (moderation)
X1.X2	: Interaction between the company size and auditor reputation
ε	: Error

IV. RESULTS

Table 1 shows that the mean value of income smoothing is 1.277 of 449 companies using technique of purposive sampling. Based on the Eckel index, it shows that, on average, income smoothing is not done by the sample companies. It also can be seen that the mean of the company size by the natural logarithm is 7.873, meaning that, on average, the companies during the observation period are large-sized. Meanwhile, the mean value of auditor reputation is 0.40, approaching the number 0 (zero) as a dummy variable, meaning that on average the auditor samples in this study are those from non reputable auditor.

Table 1. Variable Descriptive Statistics

Variable	Minimum	Maximum	Mean	Standard Deviation
Company Size	0.693	13.853	7.87279	1.891557
Income Smoothing	0.0130	31.0310	1.277212	2.4673176
Auditor Reputation	0	1	0,40	0.490

Table 2 below shows the results of the hypothesis testing. The company size regression coefficient is -0.076 with a significance level of 0.006 which is smaller than the 5% significance level. It can be concluded that the company size variable has a significant negative effect on income smoothing for all companies listed on the Indonesia Stock Exchange. Meanwhile, the auditor reputation variable has no significant effect on income smoothing.

Table 2. Hypothesis Testing Results

Variable	Coefficient	Significance	Conclusion
(Constant)	1.453	0.000	-
Company Size	-0.076	0.006	Significant
Auditor Reputation	0.446	0.383	Not Significant
Moderate (Company Size*Auditor Reputation)	-0.048	0.436	Not Significant

The moderating variable, which is the interaction between the company size and auditor reputation, is not statistically significant. The interaction between the company size and auditor reputation with criteria if significant is > 5%, then Ha is rejected and if significant is < 5%, then Ha is accepted.

- Ho: Moderation of auditor reputation weakens the relationship between the company size and income smoothing.
- Ha: Moderation of auditor reputation can strengthen the relationship between the company size and income smoothing.

The testing results of the hypothesis in table 2 show that the interaction value is 0.436 which is greater than 0.05. Based on this value, Ha is rejected, showing that the moderation of the auditor reputation weakens the relationship between the company size and income smoothing. The testing results of the hypothesis give quite interesting results. It can be seen that in small companies where income smoothing practices are high, the relationship between the two variables can be weakened by the presence of reputable auditors. The presence of reputable auditors in small companies, based on the results of this study, turned out to be able to suppress the practice of income smoothing.

V. CONCLUSION

This study was conducted from 2015 to 2019 and the sample was all companies listed on the Indonesia Stock Exchange.There were 449 companies as samples of this study. The test results using the auditor reputation as a moderating variable prove that it weakens the relationship between the company size and income smoothing. In small companies, the presence of a reputable auditor can suppress the practice of income smoothing.

The results of this study can be used by users of financial statements as a basis for consideration to analyze financial statements because management efforts of income smoothing will make the information presented in the financial statements irrelevant.

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