

The impact of profitability, leverage, managerial ownership, and dividend payout ratio on income smoothing

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ABSTRACT

This paper examined the impact of profitability, leverage, management ownership, and dividend payout ratio on income smoothing of companies listed in IDX in the range of 2015-2020 based on Eckel Index. The lower the Eckel Index the higher the intensity of income smoothing and vice versa. The hypothesis proposed were tested by a multiple regression analysis. This research concluded that return on asset, debt to capital ratio, and dividend payout ratio have significant and positive impacts on the Eckel Index. It is interpreted that the higher these variables, the lower the intensity of income smoothing. However, this research revealed that management ownership has a negative and significant impact on the Eckel Index, thus proving that managers ownership will drive them to conduct the income smoothing.

Introduction

Financial statements are written records as the end result of an accounting process, which contains information about the financial position of the company during a certain period for the benefit of internal parties or management as well as external parties, such as investors, creditors, government, and the public. The company profits serve as the most important information in the financial statements required by external parties, especially investors and creditors.

Profit/loss statement summarizes the gap between the revenue of the company and its expenses. Profit is the financial gain when the total amount of revenue of the company exceeds the expenses to produce goods and services. In other words, profit is the excess of income over costs (total costs in the production process and delivery of goods/services) (Suwardjono, 2005). Large or stable profits are more preferable for investors and creditors, than fluctuating profits. Given the preference of investors and creditors on large and stable profits, the management that play an important role in preparing the financial statements generally perform dysfunctional behaviour to manipulate earnings in order to improve company performance (Garel et al., 2021). Commonly, managers manipulate the company earnings through the practice of income smoothing.

Yunengsih et al. (2018) and Monjed and Ibrahim (2020) defined income smoothing as a method that managers generally use to reduce reported fluctuations in earnings to match the desired target, either through accounting methods or through transactions. Income Smoothing is very likely to occur in companies with long business processes, such as manufacturing companies. Manufacturing companies normally have many gaps in management that trigger the practice of dysfunctional behaviour. Given the numerous business processes in this type of company, the management can easily practice income smoothing by reducing or adding some components to these processes.

Research conducted by Barus (2021) revealed that profitability and dividends have a positive and significant impact on income smoothing. Meanwhile, income smoothing is also impacted by profitability and company size (Ashari et al., 1994). However, research conducted by Tseng and Lai (2007) shows that profitability has a negative impact on income smoothing. In addition, debt/leverage and profitability were proven to have a positive impact on income smoothing (Savitri, 2019; Yusuf & Soraya, 2004). This study is motivated to fill the gap among of those research findings. This research also adds managerial ownership as the variable that is expected to have impact on income smoothing.

Literature Review

In this case, agency theory is an appropriate approach to analyse conflict of interest differences between managers as agents and shareholders as principals (Jensen & Meckling, 1976). The conflict of interests makes the agent and

principal try to find loopholes for their own interests to reap benefits, because both parties want to maximize their respective utility (Mahesa, 2018).

The agency theory demonstrates a separated relationship between the control (manager or agent) and ownership (shareholder or principal) when the manager and shareholders are bound by a contract. In this theory, managers have more information and knowledge about the company, because they manage and control the money invested by shareholders. Therefore, managers must be held accountable for their obligations to shareholders, who constantly hope that managers will generate returns on the money they invested. Managerial ownership is best defined as the role of managers as agent and principle. In this case, they serve as the manager but on also function as the shareholder, which thus makes them less motivated to conduct income smoothing.

In this line, Mendoza et al. (2021) held that earnings management is the manager's actions to increase or decrease the company profit of the current period that they manage without causing an increase or decrease in the company's long-term economic profit. Sulistyanto (2008) also reinforced that earnings management refers to a method used by company managers in influencing information in company financial statements as a way to deceive stakeholders who require the information on the performance and condition of the company. Earnings management is done by changing the parts of the accruals in the company's financial statements, because these accruals are the easiest part to be altered by people who record transactions and prepare financial statements according to their wishes.

Income smoothing is the management's effort to reduce the fluctuating reported company profits as a way to achieve the desired target. Income smoothing is the process of manipulating the period of earnings or reporting of earnings to make the reported earnings or profits of the company appear stable (Fudenberg & Tirole, 1995). According to Barnea (1976), income smoothing for companies is a way of reducing several levels of profit to make it look normal. On this basis, this research is intended to reconfirm the factors that have an impact on the intensity of income smoothing conducted by the managers. It is also aimed at serving as reference to examine the double roles of managers as the agent and the principle.

Profitability refers to a ratio of the company's ability to seek profits and to measure the level of management effectiveness in a company. Investors and creditors normally use profitability to assess a company, which will determine their decisions in investment and in credit provision. Companies with a low profit margin are more inclined to practice income smoothing as compared to companies with a high profit margin (Abiprayu, 2011). Profitability is the company's ability to earn profits related to sales, total assets and own capital (Budhijono, 2006). Therefore, the company with a large profit margin will attract investment in the company. This is in line with research conducted by Yovi et al. (2022), Budhijono (2006), and Budiasih (2009) highlighting that the more stable the company's earnings, the higher the investor's interest in investment, and the greater the possibility of income smoothing practice. On this basis, this research proposes hypothesis 1 as follow:
H₁: Profitability has a significant positive impact on income smoothing practices.

Generally, the company's financial statement reports two capital structures or funding structures to finance its business, namely equity (shares) and debt. Equity and debt are different in terms of their characteristics. Equity is the residual interest in assets after deducting all debts of the company, while, debt is an obligation that the company must repay to creditors, both for the short-term debt and long-term debt. The use of debt greatly affects the company's financial leverage.

Leverage is the proportion of debt in the company's capital structure, which makes the company bear a fixed burden. The use of a higher amount of debt than the capital will make the company pay higher costs because it has to pay interest and instalments. The bigger the company's debt, the greater the risk faced by investors so that investors will ask for a higher level of profit. This allows managers to carry out income smoothing practices to create a good presentation of the company's value in the eyes of creditors and investors alike. This fact is in line with the research outputs of Lee (2022) and Yusuf and Soraya (2004) indicating that leverage has a positive effect on income smoothing. Hence, based on the abovementioned, hypothesis 2 is formulated as in the followings:
H₂: Leverage has a significant positive impact on income smoothing practices.

Managerial ownership is share ownership by the company's management as measured by the percentage of the total share ownership by the management. Ownership of shares by a manager will affect the manager's performance in running the company's operations.

Managerial ownership is the percentage of shares held by the management of the company. The higher the managerial ownership in the company, the more it will encourage management to improve its performance for the benefit of shareholders and for its own interests (Wati et al., 2022; Rosa et al., 2020; Amanza, 2012). Therefore, the higher the managerial ownership in a company, the less the likelihood for the practice of income smoothing. This fact is in accordance with the research finding of Harumnida (2016), which revealed that managerial ownership had a negative effect on income smoothing. Therefore hypothesis 3 is proposed as follow:
H₃: Managerial ownership has a significant negative impact on income smoothing practices.

Dividend payout ratio is the amount of profit or return divided in the form of cash dividends from retained earnings. In other words, it measures net income per share paid in the form of cash dividends to investors. Distributing retained earnings as dividends will improve the welfare of investors, so that investors are expected to continue their investment in the company.

Li and Chen (2020) and Purwanto (2004) noted a significant correlation between the dividend payout ratio and the practice of income smoothing. Therefore, it is justified to say that the dividend payout ratio is very influential on income smoothing behaviour, because dividend policy will have a significant effect on shareholder decision making in buying company shares. This point is consistent with the finding revealed by Martins et al. (2022) and Li and Chen (2020), which stated that the dividend payout ratio had a positive effect on smoothing practice. On this basis, the hypothesis 4 is proposed as follows:

H₄: Dividend Payout Ratio has a significant positive impact on income smoothing.

Research Method

This study used secondary data taken from the financial statements of manufacturing companies listed on the Indonesia Stock Exchange in the range of 2015 to 2020. The manufacturing companies were selected given their significant contribution in total trading volume of IDX. The research samples were determined using the purposive sampling method based on the following criteria: manufacturing companies that are actively listed on the IDX in the range of 2015 – 2020; the company that published audited financial statements annually; the financial statements that contained data in accordance with the variables studied; the company that used the rupiah currency in its financial statements; and the that company did not experience consecutive losses during the 2015-2020 period.

The use of purposive sampling method resulted in 24 sample companies that meet to the criteria, and thus obtained 120 observational data in the course of 2015 to 2020.

This study measured the income smoothing using the Eckel Index, based on the Coefficient of Variation (CV) variable of sales (income) and the variable of net income using the following formula (Eckel, 1981):

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

CV ΔI and CV ΔS were calculated by the following formula:

$$CV\Delta I = \sqrt{\frac{\sum(\Delta I - \bar{\Delta I})^2}{n - 1}} \div \bar{\Delta I}$$

$$CV\Delta S = \sqrt{\frac{\sum(\Delta S - \bar{\Delta S})^2}{n - 1}} \div \bar{\Delta S}$$

CV ΔI : the coefficient of variation in earnings changes

CV ΔS : the coefficient of variation in sales/income changes

ΔI : profit changes

ΔS : changes in sales/income

$\bar{\Delta I}$: average changes in earnings

$\bar{\Delta S}$: average changes in sales/revenue

$\bar{\Delta S}$: average changes in sales/revenue

n : the number of periods observed

Companies are considered practicing income smoothing if $CV \Delta I \leq CV \Delta S$, but if it is the opposite of this formula, the company is considered not to practice income smoothing. Companies indicated to practice income smoothing have an index of <1 , while companies that do not practice income smoothing have an index of ≥ 1 .

This study measured profitability using Return on Assets (ROA), a comparison of profitability calculated and used to measure the company's ability to use its total assets for company operations to generate profits (Scherer, 2021; Pesci et al., 2022; Lubis, 2016).

Leverage was measured with the debt to capital ratio; managerial ownership was measured as percentage of shares held by the management of the company; and dividend payout ratio was defined as a ratio that measures net income per share paid in the form of cash dividends to investors.

The classical assumption test was conducted as a preliminary test to examine the proposed multiple linear regression model. The test was aimed to determine the feasibility of regression model for the next testing stage. The classical assumption tests carried out in this study were: normality test, multicollinearity test, heteroscedasticity test, and autocorrelation test.

To test the hypothesis, this study used multiple linear regression analysis as the data analysis technique. The regression models proposed in this study were:

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + e$$

Y : Eckel Index
 α : constant
 X1 : return on assets
 X2 : debt to equity ratio
 X3 : managerial ownership
 X4 : dividend payout ratio
 β_1 - β_4 : regression coefficient

This study used the T test to determine the effect of the independent variable on the dependent variable by looking at the significance level (sig.) in the coefficient table (Ghozali, 2012). The decision was made by looking at the regression coefficient and the sig value. The positive regression coefficient with the p-value of <0.05 indicates that the independent variable has a significant positive effect on the dependent variable. In contrast, the negative regression coefficient with the p-value of <0.05 indicates that the independent variable has a significant negative effect on the dependent variable. However, the p-value of > 0.05 generates that the independent variable does not have a significant effect on the dependent variable.

Results and Discussion

Descriptive Statistics

This study examined manufacturing companies listed on the IDX in the range of 2015-2020 as the research population, which was further selected using purposive sampling to determine the test sample. After selecting the sample according to the predetermined criteria, 24 companies were found to meet the sample criteria and generated 120 observational data. The descriptive statistics the data is presented in the Table 1.

Table 1. Descriptive Statistics

	N	Min.	Max.
Eckel Index (Y)	120	-18.851	409
RoA (X ₁)	120	-0.044	0.421
DER (X ₂)	120	0.111	0.733
MO (X ₃)	120	0.000	0.256
DPR (X ₄)	120	-0.120	1.141
Valid N (listwise)	120		

Source: data processed

Normality Test

The Kolmogorov-Smirnov test (as presented in Table 2) resulted in the significance level of 0.061 > 0.05, and thus indicating that the data for all variables are normally distributed.

Table 2. Normality Test

One-Sample Kolmogorov-Smirnov Test		
	Unstandardized Residual	
N		120
Normal Parameters ^{a,b}	0,0000000	0,0000000
	1,23952094	1,07088534
	0,030	0,121
Most Extreme Differences	0,030	0,072
	-0,030	-0,121
Kolmogorov-Smirnov Z		1,332
Asymp. Sig. (2-tailed)		0,061
a. Test distribution is Normal.		
b. Calculated from data.		

Source: data processed

Multicollinearity Test

The tolerance and VIF test results in Table 3 show that all variables had a tolerance value greater than 0.10 and a VIF value less than 10.00. Thus, it is conclusive that there is no multicollinearity in the tested variables.

Table 3. Multicollinearity Test

	Tolerance	VIF
RoA (X ₁)	0.874	1.144
DER (X ₂)	0.980	1.021
MO (X ₃)	0.915	1.093
DPR (X ₄)	0.796	1.257

Source: data processed

Heteroscedasticity Test

The results of the heteroscedasticity test (as presented in Table 4) in this research resulted in the significance level of the profitability variable of 0.871, the leverage variable of 0.431, the managerial ownership variable of 0.079 and the dividend payout ratio variable of 0.408. From these data, it is clear that there is no heteroscedasticity in all tested variables, because the significance level of all variables is greater than 0.05.

Table 4. Heteroscedasticity Test

Coefficients ^a					
Model	Unstandardized Coefficients		Standardized Coefficients	T	Sig.
	B	Std. Error	Beta		
Const.	0,871	0,153		5,699	0,000
1 RoA (X ₁)	-0,080	0,487	-0,016	-0,163	0,871
DER (X ₂)	-0,075	0,095	-0,073	-0,791	0,431
MO (X ₃)	1,289	0,728	0,168	1,770	0,079
DPR (X ₄)	-0,183	0,220	-0,084	-0,830	0,408

a. Dependent Variable: Abs_res

Source: data processed

Autocorrelation Test

In this study, the autocorrelation test (as shown in Table 5) was carried out using the Durbin-Watson test. Based on the analysis on the total 120 sample size, the 4 number of independent variables ($k = 4$) revealed the du value of 1.7715, and the $4-du$ value of 2.2285. Thus, it can be concluded that there is no autocorrelation because the Durbin-Watson value is between du and $4-du$ values ($1.7715 \leq 1.903 \leq 2.2285$).

Table 5. Autocorrelation Test

Model Summary ^b					
Model	R	R ²	Adjusted R ²	Std. Error of the Estimate	Durbin-Watson
1	0,4733 ^a	0,224	0,197	1,08935	1,903

a. Predictors : (Constant) RoA, DER, Head Manager, DPR

b. Dependent Variable: Y (Eckel Index)

Source: data processed

Regression Analysis

Multiple linear regression analysis was used to determine the effect of profitability, leverage, managerial ownership, and dividend payout ratio on the Eckel Index. The results of multiple linear regression tests are presented in Table 6 as follows:

Table 6. Regression Analysis

Model	B	t	Sig.	Information
Const.	0.43	1.51	0.14	
RoA (X ₁)	1.79	1.99	0.04	H1 supported
DER (X ₂)	0.37	2.08	0.04	H2 supported
MO (X ₃)	-3.80	-2.83	0.01	H3 supported
DPR (X ₄)	0.82	2.02	0.04	H4 supported

Source: data processed

The linear regression test in Table 6 resulted in the following regression equation:

$$Y = 0,43 + 1,79X_1 + 0,37X_2 - 3,80X_3 + 0,82X_4$$

The regression analysis test in Table 6 resulted in the significance level or p-value of the profitability variable (RoA) of $0.04 < 0.05$ and the regression coefficient of 1.79. These results indicate that profitability has a positive and significant effect on the Eckel Index. The higher the company's profitability, the higher the Eckel index; which implies the lower the intensity of income smoothing practice. On this basis, this study reveals that the increasing level of profitability will further reduce the intensity of earnings management practices and thus enhances that the quality of financial statements. These findings are in line with the output of previous researches conducted by Yovi et al. (2022), Budhijono (2006), and Budiasih (2009) demonstrating that profitability had a significant effect on income smoothing practices. In other words, the more stable or the higher the company earnings, the better the condition of the company's financial statements due to the decreasing intensity of income smoothing practice. However, these results contradict the findings of previous research by Abiprayu (2011), and Yusuf and Soraya (2004), which stated that profitability did not affect the practice of income smoothing.

The test results in Table 6 above show that the leverage significance level (DER) of $0.04 < 0.05$ and the regression coefficient of 0.37, insinuating that leverage has a positive and significant effect on the Eckel index. The increasing level of leverage will be followed by an increase in the Eckel index, which also means a decrease in the intensity of income smoothing practices. The results of this study highlight that the increase in corporate leverage will further reduce the intensity of earnings management, and thus increasing the quality of financial statements. This finding is in line with the finding of the previous research conducted by Lee (2022) and Yusuf and Soraya (2004), which stated that leverage had a significant effect on income smoothing practices. However, this finding contradicts the previous research by Swastika (2017), Abiprayu (2011), and Budhijono (2006) which stated that leverage had no significant effect on income smoothing practices.

The test results as presented in Table 6 revealed the significance or p-value for managerial ownership of $0.01 < 0.05$ and a regression coefficient of -3.80. These results indicate that managerial ownership has a negative and significant effect on the Eckel index. The higher the company's share of ownership by management, the lower the Eckel index, which indicates the increasing intensity of income smoothing practices. Thus, it can be interpreted that the higher percentage of managers in the company's share ownership will further encourage an increase in the intensity of earnings management, which also has the potential to further reduce the quality of financial statements. The results of this study are in line with those of previous research conducted by Wati et al. (2022), Rosa et al. (2020), and Harumnida (2016); denoting that managerial ownership had a significant effect on income smoothing. However, these results contradict that of the previous research conducted by Swastika (2017), which stated that managerial ownership had no effect on income smoothing.

The test results as presented in Table 6 above indicated the p-value of dividend payout ratio of $0.04 < 0.05$ and the regression coefficient of 0.82. These results denote that the dividend payout ratio has a positive and significant effect on the Eckel Index. This research proves that the increasing dividend paid by the company to shareholders will further increase the Eckel index, which implies a decrease in the intensity of income smoothing practices. Therefore, it can be interpreted that an increase in the dividend payout ratio will lead to a decrease in the intensity of earnings management, which also means an increase in the quality of financial statements. The results of this study are in line with the findings of the previous studies by Martins et al. (2022), Li and Chen (2020), Purwanto (2004) and Budiasih (2009) implying that the dividend payout ratio had a significant effect on income smoothing practices. Nonetheless, these results are different from the results of the previous research by Harumnida (2016), which stated that dividends proxied by the DPR had no impact on income smoothing practices.

The F test in this research resulted the significance level of $F 0.000 < 0.05$. Thus, it can be concluded that the regression model in this study is an appropriate model to describe the effect of profitability (RoA), leverage (DER), managerial ownership, and dividend payout ratio on income smoothing practices (Eckel index).

The adjusted r square value (coefficient of determination) was 0.197, which denotes that 19.70% of the practice of income smoothing is resulted from changes in the four variables studied, namely, profitability (RoA), leverage (DER), managerial ownership, and dividend payout ratio. Meanwhile, the remaining of 80.30% is explained by other factors outside the research model.

Conclusion

This study examines the effect of profitability, leverage, managerial ownership, and dividend payout ratio on income smoothing practices. The Eckel Index is a measure of the intensity of income smoothing practice. The higher the Eckel Index, the lower the intensity of the income smoothing practice, and vice versa. From the results of the tests, it is obvious that the higher the profitability of a company, the higher the generated Eckel Index number. The escalating Eckel Index indicates the decreasing intensity of income smoothing practice, which further implies that the increase in profitability will lead to a decrease in the intensity of income smoothing practices, and denotes

an increase in the quality of financial statements.

This research also proves that the higher the leverage of a company, the higher the Eckel Index produced. The increasing Eckel Index pinpoints the decreasing intensity of income smoothing practice, and vice versa. Hence, it can be concluded that the increasing leverage has an effect on the decreasing intensity of income smoothing practices, which implies an increase in the quality of financial statements.

Another finding of this study is that managerial ownership of a company has a significant negative effect on the Eckel Index. The decreasing Eckel Index denotes an increasing intensity of income smoothing practice. In other words, the increase in managerial ownership has an effect on the increasing intensity of income smoothing practices.

In addition, the results of this study prove that the higher the dividend payout ratio of a company, the higher the Eckel Index produced. The increasing Eckel Index indicates the decreasing intensity of income smoothing practice. Therefore, it can be concluded that the increasing dividend payout ratio has an effect on the decreasing intensity of income smoothing practice.

Apart from these findings, the sample of this study is limited to manufacturing companies listed on the IDX in the range of 2015 - 2020. The study may generate different results if the samples are taken from different industrial sectors, such as the financial and banking sectors. Another limitation of this study is the use of the dependent variable in income smoothing practices using the Eckel index. Thus, it is suggested that the subsequent studies use earnings management variables other than Eckel Index variables. This study only used profitability (RoA), leverage (DER), managerial ownership, and dividend payout ratio as the independent variables, without using moderating variables or intermediate variables. Therefore, it is highly recommended that the following studies use the moderating variable of auditor quality, or use intermediate variables.

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