The Influence of Financial Performance towards Income Smoothing in Property, Real Estate, and Building Construction Industry

by Anthony Milikan Aloysius Harry Mukti

The Influence of Financial Performance towards Income Smoothing in Property, Real Estate, and Building Construction Industry Listed in Indonesia Stock Exchange.

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ABSTRACT

Background: Many factors can affect Income smoothing; one of them is financial performance. Performance relates to function of the ability of an organization to gain manage the resources in several different ways to develop competitive advantage. There are two kinds of performance, financial performance and non-financial performance (Hansen and Mowen, 2005). Financial statements provides information for the board of directors for decision making, investors, bank, and also government. So, the financial statement should provide information which are reliable, relevant, can be compared with other companies, and also could give the snapshot of the firm's condition in the past and projecting the future. **Objective:** The main issue in this research is, whether ROA, EPS and leverage as control variable influence the practice of income smoothing. **Results:** ROA, EPS, and Leverage have a significant influence on Income Smoothing on all companies in property, real estate, and building construction industry listed on IDX. By analyzing these ratios, investors or related party will know whether the company conduct income smoothing or not **Conclusion:** financial performance ratio analysis could be used an alternative to predict Income Smoothing practices in the stock market and can be used as an early warning system of setback of company's financial condition and transparency which affects the going concern of companies especially for the listed ones

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INTRODUCTION

1.1 Research Background:

Competition in the business world of free market economy is getting stricter. This is due to increasing number of companies that stand up and develop in accordance with the increasing number of business units or increasing economic activity marked by increasing market demand. The government has provided various facilities to further enhance economic activities, as well as provided capital assistance and given permission for the business. Capital is needed for the survival of a business, it is also an obstacle often faced by the company.

All manufacturing companies, especially property, real estate, and building construction industry, in Indonesia during the era of globalization should strive to produce high quality goods at low cost in order to increase competitiveness in both domestic and global markets. The rapid developments of construction and property companies are not clamped down. This issue causes many problems in the construction and property world, such as lending abuses that eventually become bad debts, so that such construction and property company suffer a severe liquidity shortage and finally goes bankrupt.

Corporate reported earnings have been major focus of interest from both academics and practitioners [38]. According to PSAK No. 1 [37] financial statements are part of financial reporting process. The complete financial statements usually consist of statement of financial position, comprehensive income statement, stockholders equity report (can be reported in various way, for example cash flow statement). Financial statements provides information for the board of directors for decision making, investors, bank, and also government. So, the financial statement should provide information which are reliable, relevant, can be compared with other companies, and also could give the snapshot of the firm's condition in the past and

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projecting the future. The most important information for decision making is net profit. Usually, profit will be the main attention in assessing the firm's performance or management's responsibility. Therefore, there is tendency to make the financial statement better, one of the methods that could be used to make better financial statement is by doing the earning management. Because earning management are opportunistic if the management try to maximize the profit for the firm itself.

Schipper (1989) in Subramanyam and Wild (2009) defined earning management as the "purposeful intervention by management in the earnings determination process, usually to satisfy selfish objectives". It often involves window-dressing financial statements, especially the bottom line earning number. Earning management can be cosmetic, where managers can manipulate accruals without any cash flow consequences. It also can be real, where managers take action with cash flow consequences for purposes of managing earnings. While, according to Scott (2009), earning management is the selection of accounting policy by the management to achieve some goals. The selection of that accounting policy is motivated from the efficiency and opportunistic purposes. Earning management is efficient if the firm's management manage to increase profit's transparency in communicating things that are classified as firm's internal information.

According to Scott (2009), there are three earning management patterns which are income maximization, income minimization, taking a bath and also income smoothing. Recent studies shows that earnings management practices are carried out for the main purpose of Income Smoothing [9] that enhances earnings information. Income smoothing is a common form of earning management, under this strategy, managers decrease or increase reported income so as to reduce its volatility. Income smoothing involves not reporting a portion of earnings in good years through creating reserves or earning "banks", and then reporting these earnings in bad years. Smooth income from a period to the next period are favored both by the management and also investors, because the smooth income indicate that the firm is solid and firm.

Suwito and Herawaty (2005) proved that some indication of earning management that shows the Income Smoothing technique is usually aimed at the income as a main target. This happens because it is substantial information in a company.

The probability of selecting an accounting procedures provides an opportunity to managers to decide the recognition and on estimating the earnings and expenses. Therefore, managers are motivated to conduct a non conservative accounting procedure to make the company's income growth stable. This research tries to investigate whether the financial leverage and financial performance of companies listed on IDX can influence the of practice income smoothing.

Many factors can affect Income smoothing; one of them is financial performance. Performance relates to function of the ability of an organization to gain and manage the resources in several different ways to develop competitive advantage. There are two kinds of performance, financial performance and non-financial performance [24]. Financial performance focuses on variables related directly to financial report and consists of various kinds, but the indicators which are beneficial for investors in order to invest in the capital market and avoid high tax payment are financial leverage and profitability ratio, such as return on assets (ROA) and earnings per share (EPS).

This research is also driven by previous researches such as research conducted by Noviana and Yuyetta [36] found out that Return on Assets and Financial Leverage have no significant influence on Income Smoothing as well as research done by Juniarti and Carolina (2004). They proved that profitability ratio (ROA) does not affect income smoothing because investors tends to ignore information from ROA and management is not motivated to smooth the income by profitability variable. Unlike Noviana and Yuyetta (2011), research from Kustono and Sari (2012) proves that profitability have significant influence on income smoothing. The stable profitability ratio will give benefit to the management to secure their position and also gives assurance to their investors regarding their investment. This research is supported by previous research conducted by Yudho and Farah (2010), they were successful to proved that companies which have low profitability ratio are related to existence of income smoothing practice.

1.2 Problem statement:

Based on the descriptions above, the problems in this research are as follows:

1.   How does return on assets (ROA) influence the income smoothing of all companies in property, real estate, and building construction industry listed on IDX?

2.   How does earning per share (EPS) influence the income smoothing of all companies in property, real estate, and building construction industry listed on IDX?

2. Literature review:
2.1 Income Smoothing:

Income smoothing is a technique used by a manager to reduce the change or movement in the reported amount of net income by artificial or real earnings management, so that it can reach a desired income level [27]. In general, it includes the exertion of a company manager in the transposition of recording the earnings and

expenses or transferring them to next year, thus enabling a profit without major changes within the continuous years.

According to Hejazi et al [27], there have been some motivations for the companies as for as income smoothing are concerned, including the following:

1. Evaluation of a manager's performance: The manager will increase performance by income smoothing.
2. A stability of share market value: companies that are interested in satisfying their financial needs by selling shares will engage in smoothing, because the income fluctuation leading to fluctuation in share prices will discourage investors to buy shares.
3. Tax motivations: by income smoothing, a company might pay less taxes.
4. Increasing shareholders welfare
5. Facilitating the capability of predicting income
6. Enhancing the manager's welfare

2.2 Financial Performance:

One of the most fundamental facts about businesses is that the operating performance of the firm shapes its financial structure. Performance measurement is the determination of the company performances periodically especially for operational activities, organizational structure and employees based on the objectives, standards and criteria established previously in research conducted by Veron (2010). According to Horhgen (1993) in Veron (2010), performance measurement has the objective to measure business performance and management compared with the goal or the target of company. It is also true that the financial situation of the firm can also determine its operating performance. Financial statements are therefore important diagnostic tools for the informed manager. The financial statement is a statement that describes the financial condition and result of operations of a company at a given period of time [23].

2.3 Hypotheses Development:

Budiasih (2007) concluded that profitability variables (Return on Assets) influence income smoothing. The high profitability or increasing profitability is a motivation to do income smoothing because management knows the companies capability in generating profit in the future in order to manage the earnings. Based on that research, the first hypotheses is going o be tested is:

- H_a: ROA has a significant influence on income smoothing of the companies in property, real estate, and building construction industry listed on IDX.

According to Nikoomaram (2010), one of financial based variables which is used as performance measurement is Earning per Share (EPS). This ratio has been applied to measure the performance and efficiency of companies belonging to the metal industries and accepted in Tehran Stock Exchange Corporation. Such variable can be considered as appropriate criteria and introduced as substitute variables to measure the performance and efficiency of enterprises. Based on that research the second hypotheses in this research is:

- H_b: EPS has a significant influence on income smoothing of the companies in property, real estate, and building construction industry listed on IDX.

Research Design:
3.1 Population and Sample:

The population of this study is all companies in the property, real estate, and building construction industry listed on IDX during period 2010 to 2012.

The average population data consists of 58 companies in property, real estate, and building construction industry that are listed on IDX for the period 2010-2012. Based on the above criteria, 43 companies are eligible and 15 companies are eliminated. The samples of companies selected in this research based on their founding date are as follows:

3.2 Empirical Research Method:

In this study, the estimated regression equation is defined as:

$$IS = b_0 + b_1 ROA + b_2 EPS + b_3 LEV$$

whereas,

b_0	=	a constant
b_1, b_2, and b_3	=	regression coefficient, these estimate values are used in measuring how

effectively the predictor variable influences the criterion variable.

IS	=	income smoothing
ROA	=	return on asset
EPS	=	earning per share
LEV	=	financial leverage

3.43 Operation Variables:

A variable is any measured characteristic or attribute that differs for different subjects. Some variables are manipulated by the researcher and others are measured from the subjects. The former variables are called as independent variables while the latter are called as dependent variables.

Research variables in this study are:

1. *Dependent variable (Y):*

Dependent variable is the variable simply measured by the researcher. In this study, the dependent variable is income smoothing.

According to Kothari et al (2005), income smoothing could be measured by using discretionary accrual model. The steps of discretionary accrual calculation are as follows:

    a. Calculating total accrual by using cash flow approach.

$$TAC_{it} = NI_{it} - CFO_{it} \ldots\ldots(1)$$

whereas:

TAC_{it}	= Total Accrual of company i in period t
NI_{it}	= Operating Net Income of company i in period t
CFO_{it}	= Net cash flow from operating activities of company in period t

    b. Determine coefficient of total accrual regression. Discretionary accrual is a difference between total accrual (TAC) and non discretionary accrual (NDAC). The first step to determine NDAC is regressing:

$$TAC_{it}/Asset_{it-1} = \beta_1 (1/Asset_{it-1}) + \beta_2 (\Delta Rev_{it}/Asset_{it-1}) + \beta_3 (PPE_{it}/Asset_{it-1}) \ldots (2)$$

Whereas:

TAC_{it}	= Total accrual of company i in period t
$Asset_{it-1}$	= Total assets of company i in period t-1
ΔRev_{it}	= The change of revenue of company i between period t and t-1
PPE_{it}	= Acquisition cost of fixed asset of company i in period t

    c. Determine nondiscretionary accrual by using the coefficient from the second step beta result (beta 1, beta 2, beta 3). The beta coefficients are used to predict NDAC through the following equation:

$$NDAC_{it}/Asset_{it-1} = \beta_1(1/Asset_{it-1}) + \beta_2 [(\Delta Rev_{it} - \Delta Rec_{it})/Asset_{it-1}] + \beta_3 (PPE_{it}/Asset_{it-1}) \ldots (3)$$

Whereas:

$NDAC_{it}$	= Nondiscretionary accrual of company i in period t
ΔRec_{it}	= Change of account receivable of company i between period t and t-1

    d. Determine discretionary accrual (DAC) is a difference between total accrual with NDAC. The calculation is as follows:

$$DAC_{it} = TAC_{it} - NDAC_{it} \ldots (4)$$

    e. Determine smoother or non smoother. The companies will be grouped as smoother companies if there is a negative correlation between the change of discretionary accrual with the change of pre-discretionary income. PDI is a difference between net income with discretionary accrual which will be calculated as follows:

$$PDI_{it} = NI_{it} - DAC_{it} \ldots (5)$$

2. *Independent variable (X):*

Independent variable is something that is hypothesized to influence the dependent variable. In this study, three variables are used which are:

a. *ROA (X₁):*

ROA is tool to measure the company's ability to generate profit by managing total asset

$$ROA = \frac{\text{Net Income after Tax}}{\text{Total Assets}}$$

b. *EPS (X₂):*

EPS generally considered to be single most important variable in determining a share's price.

$$EPS = \frac{\text{Net Income after Tax}}{\text{Outstanding Shares of Common Stock}}$$

c.   21 *(X₃):*

Financial leverage reflects the debt amount used in the capital structure of the firm.

According to Tamimi& Obeidat (2013) financial leverage is defined as:

$$FL = \frac{\text{Total Debt}}{\text{Total Assets}}$$

It reflects the degree which debts are used by industrial companies in financing their investments.

4. Analysis and Discussion:

4.1 Data Collection:

The number of population data consist of 54 companies in property, real estate, and building construction industry that are listed on IDX for the period 2010-2012. Based on the above criteria, 42 companies are eligible. There are 12 companies are eliminated.

**Table 4.1:** Sample elimination

Criteria	2010	2011	2012	Number of data
The companies are classified in property, real estate, and building construction	47	50	54	151
The companies are not listed on IDX	(10)	(8)	(4)	(22)
The companies do not have sufficient financial data	(1)	(1)	(1)	(3)
Total number of yearly firm sample				126

4.2 Company's Overview:

In this part, will be presented characteristics of property, real estate, and building construction firms related to income smoothing, return on asset, earning per share, and also financial leverage.

4.2.1 Income Smoothing:

In order to determine whether the company conducts income smoothing or not, Pear 30 correlation method is used. According to Kothari et al (2005) in Noviana and Yuyetta (2011), if the correlation between Δ discretionary accrual and Δ pre-discretionary income is negative, the company is considered as smoother. From the selected sample of 42 companies, there are 24 companies conducted income smoothing from the period 2010-2012.
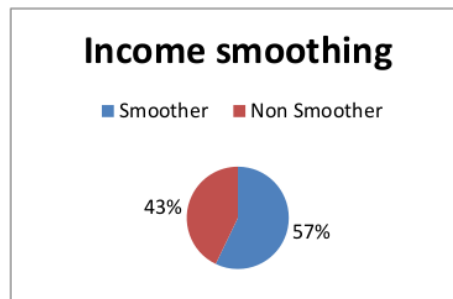
Chart 4.1: Classification of smoother and non-smoother

This chart, represents the percentage of smoother and non-smoother companies. There are 57 % of the chosen sample which are classified as smoother company, while the other 43% are classified as non-smoother. It means, the research samples which are companies in property, real estate, and building construction industry mostly conducted income smoothing periodically, especially during 2010-2012.

4.3 Data Analysis:

After all required data in this research are collected from various sources, we will analyze the data based on the hypotheses that has been determined in previous chapter. The above methodology is used to test whether Return on assets, earnings per share, and Leverage can affect earning management, especially in income smoothing practices.

First of all, the performance of property, real estate, and building construction industry is determined on the basis of the financial ratios. Table 4.2 presents descriptive statistics of research samples. This tool enables us to

identify relationship among the data and to determine directions for further analysis. The descriptive statistic in this research elaborates minimum, maximum, mean, median, and standard deviation value of each year of 42 companies as the research samples for the period 2010-2012.

Table 4.2: Descriptive Statistics

Variable	Mean	Median	Maximum	Minimum	Std. Deviation
IS	0.0474247	0.039370	0.200704	-0.101523	0.047802
ROA	73.59512	28.00000	636.0000	-14.00000	130.1101
EPS	0.441237	0.450000	0.880000	0.070000	0.191500
LEV	4.433565	2.609000	24.86930	0.117000	4.841306
N	126				

Table description: This table represents descriptive statistics of each variable which is used in research model. The aim of this table is to give snapshot about distribution condition and distribution from the data which is used in research model. Dependent variable in research model is IS and independent variables are ROA and EPS independent variable which is used as control variable is LEV. Operational definition are as follow: (i) IS: Income Smoothing (ii) ROA: Return on Assets, is net income divided by total assets for 3 years observation period 2010, 2011, and 2012. (iii) EPS: Earning per Share, is net income divided by outstanding common shares for 3 years observation period 2010, 2011, and 2012. (iv) LEV: Financial Leverage, is total debt divided by total assets for 3 years observation period 2010, 2011, 2012.

Table 4.2 shows the result of descriptive statistic of ROA, EPS, and LEV the independent variables as well as income smoothing as dependent variable. It shows that ROA has the minimum value amounting to -14%, the maximum value amounting to 636%, , and the volatility of ROA is 130.1. Furthermore, the mean of ROA for 3 years period 73.59% this number represents the profit quality of property, real estate, and building construction companies which are observed, have the better quality if compared to the median (28%). For EPS, the minimum value amounting to 0.07, the maximum value amounting to 0.88, and the volatility of EPS is 0.191500. On the other hand, the EPS has mean (0.4412) for 3 years observation period, this result shows the earning quality of property, real estate, and building construction industry have worse quality compared to the median (0.45). The lowest value of LEV amounted to 0.117x, the highest is 24.87x, while the volatility is 4.84. According to the mean result of LEV which is 4.433, shows that the leverage quality of those companies is not good compared to the median which is 2.609.

4.4 Regression Analysis:

Analysis of multiple linear regression is used to describe data and to explain the relationship between one dependent variable and two or more independent variables. The first result which can be seen is the testing of the model analyzed from F value and data determination. The probability of F value shows that the model which is used in this research proved the significant level 5%. This result is shown through the probability value of F statistic which is 0.0000. It means simultaneously, the used independent variables (ROA, EPS, LEV) have significant influence on dependent variable (Income Smoothing).

Adjusted R-square is slightly modified version of R-square and design to penalize the excess number of regressors which do not add to the explanatory power of the regression The testing result of data determination shows that the used independent variables obviously have significant influence on dependent variable which is 48.63%. It means 48.63% of the variation in income smoothing can be explained by the regression on variable ROA, EPS, and LEV. On the other hand, the proportion of the unexplained variation is 51.37%.

Table 4.5: Multiple Regression Model

Research Model*			
IS = β_0 + β_1ROA + β_2EPS + β_3LEV			
Dependent Variable : IS (Income Smoothing)			
Independent Variables	Sign Expectation	Coefficient	Probability
C	None	0.017591	0.1262
ROA	+	0.000228	0.0000
EPS	+	0.021757	0.3745
LEV	+	0.000502	0.5293
F Test Sign	0.0000		
Adjusted R-Square	0.486329		
Durbin-Watson	1.962457		
N	126		
Significance Level	5%		

Table Description: This table represents the estimation of research model by using multiple linear regression. Dependent variable in this model is IS while the independent variables are ROA, and EPS. Meanwhile, the independent variable used as control variable is LEV. Operational definition of each variable are as follows: (i) IS: Income Smoothing (ii) ROA: Return on Assets, is net income divided by total assets for 3 years observation period 2010, 2011, and 2012. (iii) EPS: Earning per Share, is net income divided by outstanding common shares for 3 years observation period 2010, 2011, and 2012. (iv) LEV: Financial Leverage, is total debt divided by total assets for 3 years observation period 2010, 2011, 2012.

From the above Table, the model of estimated regression equation will be defined as follows:

IS = 0.0175 + 0.0002 ROA + 0.0217 EPS + 0.0005 LEV   (1)
Whereas,
IS   = estimated income smoothing
ROA   = Return on Asset (%)
EPS= Earning per Share (Indonesian Rupiah per share)
LEV   = Financial Leverage (x)

From equation 1, the constant value of the model is 0.0175 which means when variable ROA, EPS, and LEV have zero value; the value of income smoothing would be 0.0175. The coefficient or multipliers of ROA, EPS, and LEV are 0.0002, 0.0217, and 0.0005 respectively. In overall, the above model tells us that income smoothing is predicted to increase 0.0002 when the ROA variable goes up by one point, increase by 0.0217 when EPS goes up by one point, increase by 0.0005 when LEV goes up by one point, and is predicted to be 0.0175 when ROA, EPS, and LEV are zero.

Table 4.5, shows the coefficients and t-test result of the regression model which are beneficial for doing further hypotheses testing. The explanation regarding empirical evidence for main variable and control variable in this research model is:

• *Main Variable:*
  1. In 5% significant level, Hypotheses a has been accepted. It means that return on assets has significant influence on income smoothing. This evidence is consistent with the research result of Budiasih (2007) which found out that return on assets has significant influence on income smoothing. This significant result is caused by ROA is an important measurement of healthiness and also an important tool for decision making. Higher or lower ROA will make the management to do the income smoothing
  2. In 5% significant level, Hypotheses b has been rejected. It means that earning per share has no significant influence on income smoothing. This insignificant result proved that the value of earning per share does not motivated the management of property, real estate, and building construction industry to do the income smoothing.

• *Control Variable:*
  In 5% significant level, leverage variable does not have significant influence on income smoothing. This result is consistent with previous result conducted by Noviana and Yuyetta (2011) which found out that leverage has no significant influence on income smoothing. According to them, this insignificant result was due to the strict debt policy, as a result the company was hard to get credit and managers do not tend to conduct income smoothing.

4.5 Discussion:
4.5.1 Return on Assets:
  Return on assets has significant influence towards income smoothing in property, real estate, and building construction industry. This significant result is caused by ROA is an important measurement of healthiness and also an important tool for decision making. Higher or lower ROA will make the management to do the income smoothing.

4.5.2 Earning per Share:
  Earning per share has no significant influence towards income smoothing in property, real estate, and building construction industry. This insignificant result proved that the value of earning per share does not motivate the management of property, real estate, and building construction industry to conduct income smoothing. The insignificance might be due to form of EPS and income smoothing which are still categorized as income. When we regress variables with the same kind so the results tends to be insignificant.

4.5.3 Leverage:
  Leverage has no significant influence towards income smoothing in property, real estate, and building construction industry. this insignificant result was due to the strict debt policy, as a result the company was hard to get credit and managers do not tend to conduct income smoothing.

5. Limitation and Suggestion:
5.2 Limitation:
  1. One of limitation of this research is lack and incomplete information on single business units' financial reports even though Indonesia Stock Exchange has provided a well summary report. This may prevent further analysis in more details of Income Smoothing of property, real estate, and building construction companies in Indonesia.

2. The number of research companies, used to analyze income smoothing might be insufficient and only focused on Indonesia which may be resulting in bias in the statistical results and not dependable. Moreover, the time of this research which is from 2010-2012 is relatively short in analyzing financial performance in order to know income smoothing in particular.

3. There are some variables which are not used in this research explaining the movement of income smoothing.

5.3 Suggestions for Future Research:

1. In the future research, the samples which are used should be more than one single business unit's financial reports. For instance, we can add manufacturing industry to be tested and compared the research results each other.

2. The period of analysis also can be broadened by using longer period of time. For instance analyzing income smoothing in 5 years period or even more than that.

3. In future works, the use of more financial ratios can be used in analyzing the factors that influence the income smoothing. Thus, the performance of each type of company can be evaluated more in detail. For instance not only return on assets, earning per share and leverage but also other financial ratios such as net profit margin, price earnings ratio and return on investment. Financial analyst, securities analyst, and also investment analyst also can be added as independent variables in the next research.

5.4 Practical Implication:

This study has some practical implications for company's management and decision makers especially for investors. One way to meet the funding requirement in order to survive in both domestic and global markets is the sale of company shares by attracting the investors. A good and stable net income surely will attract the investors. The result from this research shows that return on assets has significant positive influence to income smoothing. However, earning per share and leverage has no significant influence to income smoothing practice. It means financial performance ratio analysis could be used an alternative to predict Income Smoothing practices in the stock market and can be used as an early warning system of setback of company's financial condition and transparency which affects the going concern of companies especially for the listed ones.

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