CHAPTER I

INTRODUCTION

1.1 Background

For many years, study of income smoothing practices had been carried out. One of the reasons for the practice of income smoothing is to present the company's financial statements with good value. Financial statements are important data for companies, especially for shareholders, to see the performance and benefits to be gained from the company's performance. Financial statements presented to the public show how well the company performs and is the basis of information for investors to invest. Sholikhah and Worokinasih (2018) said that income smoothing is one form / pattern of earnings management conducted to reduce earnings fluctuations so that reported earnings are relatively stable from one period to the next and are considered normal for the company.

In the other side financial statement presentation based on *Pernyataan Standar Akuntansi Keuangan (PSAK)* state that reasonable presentation requires an honest presentation of the impact of transactions, events and other conditions in accordance with the definition and criteria for the recognition of assets, liabilities, income and expenses as stipulated in the Basic Framework for Preparation and Presentation of Financial Statements. The adoption of SAK, with additional disclosures if needed, is deemed to result in a fair presentation of financial statements. SAK also provide flexibility for management to choose accounting policies that better represent the situation of company. Flexibility in

choosing policy used sometimes lead management to carry out income smoothing practices.

Statement of Financial Accounting Concepts (SFAC) No. 1 state that earnings information is the main concern in assessing performance or management accountability and earnings information helps owners or other parties to assess the company's earnings power in the future. The tendency of outside parties to pay attention to profits encourages management to conduct improper behaviour such as making financial statements better. One of the actions that can be taken by management is to do income smoothing.

One pattern of earnings management is income smoothing. Income smoothing actions are known as logical and rational actions by management used to obtain stable profits, the company will avoid drastic fluctuations in profits by taking income smoothing actions, because the company will be burdened with large taxes and minimize risks that are likely to occur. The concept of income smoothing is motivated by agency theory which is assumed by owners and management to have an interest in maximizing each utility's information, resulting in a conflict of interest called information asymmetry.

The topic is about the interest of the writer regarding potential factors that affect income smoothing practices. The writer will redo study based on the previous research to prove if the factors chosen really affect the income smoothing practices done by management. Previous research has tested that the factors that influence income smoothing include profitability, managerial ownership, financial leverage, cash holding and auditor reputation.

Data used for this study will include manufacturing companies listed on Indonesia Stock Exchange during the period of 2015 - 2017. Writer chose only Indonesian firm due to writer interest for the disclosure income smoothing practices in Indonesia. Only manufacturing companies are being observed to reduce effect of unique characteristics of each respective sector. Period observed limited to 2015 – 2017 because writer believes that period chosen is relevant with the period the study is conducted since it represents latest company profile.

Based on listed facts above, writer wishes to further examine whether profitability, manager ownership, financial leverage, cash holding and auditor reputations significantly impacts income smoothing practices. In conclusion, writer takes the title of "**FACTORS THAT DETERMINE INCOME SMOOTHING PRACTICES**".

1.2 Research Problem

Based on background presented above, it is known that income smoothing practices might be done by management because of several reasons. The information will be obtained through return on asset, managerial ownership, financial leverage, cash holding and auditor reputations. To achieve expected target, writer define research problems as follow:

1. Does profitability significantly positive affect income smoothing practices?

2. Does managerial ownership significantly positive affect income smoothing practices?

3. Does financial leverage significantly positive affect income smoothing practices?

4. Does cash holding significantly positive affect income smoothing practices?

5. Do auditor reputations significantly negative affect income smoothing practices?

1.3 Research Objective

In composing the objective of the study, writer holds on to the problem statement. The following are the objective of the study:

1. Prove empirically that profitability significantly positive affect income smoothing practices.

2. Prove empirically that managerial ownership significantly positive affect income smoothing practices.

3. Prove empirically that financial leverage significantly positive affect income smoothing practices.

4. Prove empirically that cash holding significantly positive affect income smoothing practices.

5. Prove empirically that auditor reputation significantly negative affect income smoothing practices.

1.4 Significance of the Study

1. Writer

   Hopefully, the study could provide deeper knowledge regarding issue being discussed, experience, and the application of knowledge gained during the process of learning in university.

2. Universitas Pelita Harapan

   The result of this study hopefully may give additional information about application of theories taught during process of learning, as well as additional consideration of depth of material to be taught in the process of learning at class. Additionally, hopefully the study conducted may be proper addition to literature collection of Johannes Oentoro Library.

3. Next researchers

   The result of this study hopefully is able to give additional knowledge for future studies related to factors that determine income smoothing practices.

4. Literature reference

   The result of this study hopefully is able to contribute to literature or research regarding the topic of income smoothing in Indonesia.

5. Investor

   Hopefully, this study could be useful as additional information regarding several factors that influence income smoothing practice in making decisions, especially in terms of assessing quality profit stated in the company's financial statements.

1.5 Scope of the Study

For the purpose of this study, it will only examine 1 dependent variable, which is income smoothing (measured based on ROA, managerial ownership, DAR, cash holding and auditor reputation). The study will also only focus on the manufacture industry. The financial information gathered will come from public companies that have been listed on the Indonesia Stock Exchange. This study will also limit the observation years to only 3 working company years; 2015, 2016, 2017.

1.6 Systematic Discussion

The study paper systematically divided into five chapters as follows.

CHAPTER I INTRODUCTION

This chapter will discuss subchapters including background, research problem, research objective, significance of the study, limitation as well as systematic discussion.

CHAPTER II THEORETICAL FRAMEWORK AND HYPOTHESES

DEVELOPMENT

This chapter will first discuss in detail its basic concept definition, related literature review, conceptual framework, and the hypothesis development.

CHAPTER III METHODOLOGY

This chapter will state in detail what method of study is being used. This includes the population and sample, the empirical model, operational variable, and method of data analysis.

CHAPTER IV RESULT AND DISCUSSION

This chapter will discuss the result and empirical findings in the study in relation to profitability (ROA), managerial ownership, financial leverage (DAR), cash holdings and auditor reputations towards income smoothing practices.

CHAPTER V CONCLUSION

This chapter consists of conclusion and suggestion from the result and discussion preceding this chapter, along with recommendation for future researches.