CHAPTER I

INTRODUCTION

1.1 Background of the Study

One of the most desired things in operating a business is earning large profits. As the economy and technology in the world have developed fast in this era, every business is trying to adapt and compete with each other to achieve the goals. This tough competition has caused the company attempt to present a good performance to attract investors from both inside and outside the country. However, good performance will not always base on reality because the management can manipulate the company's financial statement. One of the possibilities that the management can do is practicing income smoothing (Fiscal and Steviany, 2015).

Even though these undesirable actions prone to appear, investors who have a significant role for the company will not feel troubled all the time since several countries have formed rules to guard the investors (Purwanti and Nugrahanti, 2016). Nevertheless, based on Yusuf and Soraya in Purwanti and Nugrahanti (2016), one of the ways to draw investors' attention which is done by lots of companies in Indonesia is by practicing income smoothing and hiding their undesirable action in any manner.

Those improper actions such as manipulating financial statements have been arisen long time ago and still happened until now because of several advantages. One of the scandals that boomed recently is Garuda Indonesia.

As reported by (thejakartapost.com.access, 2019), the management of Garuda Indonesia took the opportunity from the agreement with the startup, which is Mahata Aero Technology that cost US$239 million and recorded as other income. From the agreement, Mahata will set up the Wi-Fi networks and entertainment in the subsidiaries of Garuda Indonesia and the payment will be done after 15 years.

However, according to (nasional.kontan.co.id.access, 2019), this action led to issue as the net income stated approximately US$809 thousand in the financial statement for the year 2018 which showed the income fluctuation from the year before that suffering loss amounted to US$216.5 million. This issue caused the rejection from both Chairul Tanjung and Dony Oskaria who are the commissioners of Garuda by stating that the cost from the agreement with Mahata might not be realized.

In the end, Garuda was penalized with an amount of US$7,080 and had been told to restate the financial statement. The directors that had signed the financial statement were penalized US$7,080 while altogether for the directors and commissioners less the ones who had not signed the financial statement were collectively penalized US$7,080. After the restatement, the company revealed having a loss of US$175.02 million for that year.

The issue above shows there is an application of the earning management by the airline company which is Garuda Indonesia. This action also has the same effect on the practice of income smoothing as one of the earning management techniques.

According to Kustono in Fatmawati and Djajanti (2015), income smoothing is one of the earning management techniques where the management tries to adjust the amount of the income to avoid the fluctuation and also can draw investors' attention to invest in the company as the financial statement shows quite promising returns. Furthermore, this practice might give advantages like increase the price of the share and value of the company toward the owners including the management's benefit in getting the reward in the form of money (Juniarti and Corolina in Purwanti and Nugrahanti, 2008). On the other hand, income smoothing can cause the financial statement users to make a wrong decision as the information stated in the financial statement has been manipulated.

Based on the previous research, some determinants impact the practice of income smoothing. In this research, the writer is going to choose corporate governance which proxy by institutional ownership and managerial ownership together with dividend policy and company size as the independent variable. These four variables have ever been used by previous researchers.

Good corporate governance can be defined as a company's system that regulates and controls the mechanism of relations among several parties to achieve the goals ethically. The practical example of corporate governance can be seen from the popular scandals which include WorldCom, Enron and Xerox that suspected non-implementation of good corporate governance principles which happened in the United States. Moreover, the issue of the Indonesian political-economic crisis that began in 1997 is also being caused by poor corporate governance which can be felt until now (BPKP, 2020).

The other case that appeared and built the long argumentation is about the dividend which is related to the wealth of shareholders and regulated under the dividend policy. Dividend can be defined as the distribution portion of a company's earnings to the shareholders, commonly in the form of cash. The decision of the payment is related to a higher level of management and board of directors together with analysts and investors. The amount that must be distributed can be calculated by using the dividend payout ratio (CFA Institute, 2016).

Company size is also considered essential under the company relationship with the operations, external and the growing impacts of the multinational worldwide companies (Abiodun, 2013 in Dahmash, 2015). The size of one company can be measured by examining the value of sales, total assets, or equity of the company. Company size is usually used as an indicator in predicting the company's level of bankruptcy as it correlated with the level of crisis (Linasmi, 2017).

Table 1.1 Income Smoothing, Institutional Ownership, Managerial Ownership, Dividend Policy and Company Size of Several LQ45 Companies Listed in Indonesia Stock Exchange during 2018–2019

Code	Income Smoothing (Eckel Index)	Institutional Ownership (%)		Managerial Ownership (%)		Dividend Policy (%)		Company Size	
		2018	2019	2018	2019	2018	2019	2018	2019
ASII	2.64	50.11	50.11	0.0497	0.0606	40.00	39.93	33.47	33.49
BBCA	0.75	54.94	54.94	1.9548	1.9466	32.41	47.89	34.35	34.45
INDF	7.56	50.07	50.07	0.0157	0.0157	49.74	49.73	32.20	32.20
LPPF	-3.14	17.48	18.85	0.0003	0.0003	85.08	0.000	29.25	29.21

Source: Prepared by the writer (2021)

The company that being selected randomly by the writer which stated on the table above consists of Astra International (ASII), Bank Central Asia (BBCA), Indofood Sukses Makmur (INDF) and Matahari Department Store (LPPF). From the table above can be seen that ASII and INDF from the year 2018 to 2019 do not practice income smoothing, while BBCA and LPPF from the year 2018 to 2019 practice income smoothing. The conclusion of income smoothing can be taken from the value of the Eckel Index. When the value is higher than 1, then the company is not practicing income smoothing. In contrast, the company is practicing income smoothing when the value is lower than 1. The other determinants such as institutional ownership, managerial ownership, dividend policy and company size also have been stated in the table above. The institutional ownership of LPPF is increasing, while others are seen to be constant. The managerial ownership is increasing for ASII, decreasing for BBCA, while the remaining companies are constant. The result of the dividend policy is increasing for BBCA and decreasing for the other three companies. For the company size, LPPF is decreasing, ASII and BBCA are increasing and INDF is constant.

The prior researcher's result of Kurniawan et al. (2016) stated that institutional ownership has a negative significant influence on the practice of income smoothing, while the contrast results shown in the research by Marfuah and Murti (2019). Based on the research result of Puspita (2018), managerial ownership does not give a significant influence on the practice of income smoothing, this is in contrast to the research result that was conducted by Suhaeni et al. (2019). The dividend policy does not give significant influence on the practice of income smoothing which can be seen from the research conducted by Fiscal and Steviany (2015), while the result is different from the research conducted by Firnanti (2015) shows that there has a positive influence on the income smoothing as shows the relation to the dividends distribution. According to the research conducted by Andreas and Wijaya (2019), the result stated that company size has a positive impact on income smoothing. In contrast, Mudjiumami and Setiawan (2018) concluded that the company size does not give a significant influence on the practice of income smoothing.

Several factors have been explained above and seem to affect income smoothing. Nevertheless, there have been a variety of results done by the past researchers. This cause the writer wants to conduct the research with the title **"The Effect of Good Corporate Governance, Dividend Policy and Company Size toward Income Smoothing on LQ45 Companies Listed in Indonesia Stock Exchange".**

1.2 Problem Limitation

There are several issues happening in this world, one of the issues that arise in the business is the practice of income smoothing. This issue has generated the writer to do the research. However, the research conducted by the writer does not explain every factor that gives a significant influence on income smoothing as the limitation of time. Hence, the writer only focuses on good corporate governance which is proxy by institutional ownership and managerial ownership, dividend policy and company size which have been stated above. Moreover, the research is centered to the LQ45 companies listed in the Indonesia Stock Exchange and the period will be taken from 2015-2019.

1.3 Problem Formulation

Here are the problem formulations that the writer has found during the research for the writer *skripsi*:

1. Does the institutional ownership have a significant partial effect on income smoothing of companies listed in the LQ45 index?
2. Does the managerial ownership have a significant partial effect on income smoothing of companies listed in the LQ45 index?
3. Does the dividend policy have a significant partial effect on income smoothing of companies listed in the LQ45 index?
4. Does the company size have a significant partial effect on income smoothing of companies listed in the LQ45 index?
5. Do the institutional ownership, managerial ownership, dividend policy and company size have a significant simultaneous effect on income smoothing of companies listed in the LQ45 index?

1.4 Objective of the Research

Here are some objectives of the research that the writer can make to solve the problem that has been found, which are:

1. To identify whether the institutional ownership has a significant partial effect on income smoothing of companies listed in the LQ45 index.
2. To identify whether the managerial ownership has a significant partial effect on income smoothing of companies listed in the LQ45 index.

3. To identify whether the dividend policy has a significant partial effect on income smoothing of companies listed in the LQ45 index.
4. To identify whether the company size has a significant partial effect on income smoothing of companies listed in the LQ45 index.
5. To identify whether the institutional ownership, managerial ownership, dividend policy and company size have a significant simultaneous effect on income smoothing of companies listed in the LQ45 index.

1.5 Benefit of the Research

There are some benefits of the research according to the objectives and problems found during the research for the writer *skripsi*. These can be separated into two kinds of benefit, which are:

1.5.1 Theoretical Benefit

This research theoretically benefits for:

1. Academics

   This research is expected to present useful information and help to develop the current knowledge in the business accounting field particularly about the practices of income smoothing and show how the relationship of institutional ownership, managerial ownership, dividend policy and company size are associated with the practices.

2. Researchers

   This research is expected to give the conceptual framework for the upcoming research and become the source of information for future researchers who will conduct further research about the income smoothing problems.

3. Writer

This research is expected to provide knowledge that is useful and helps to expand the understanding for the writer about income smoothing and the relation with institutional ownership, managerial ownership, dividend policy and company size.

1.5.2 Practical Benefit

This research practically benefits for:

1. Companies

This research is expected to give an illustration about what determinants affect the practice of income smoothing; therefore the companies can have a better understanding and avoid the intolerant practices to happen.

2. Investors

This research is expected to give information about what determinants affect the practice of income smoothing for the investors. Thus, the investors will be more attentive in choosing the companies that can lead to a better investing decision.

3. Creditors

This research is expected to give knowledge about what determinants affect the practice of income smoothing for the creditors to be more careful on giving the loans to the entity so that it will not bring to a wrong decision.

4. Government regulatory agency

This research is expected to give insights about what determinants affect the practice of income smoothing for the government regulatory agency, especially *Otoritas Jasa Keuangan* that supervises the financial activities in Indonesia. After knowing the factors, the agency probably can create better regulations to prevent the issues.