CHAPTER I

INTRODUCTION

1.1 Background of Study

The rapid development of business in the globalization era causes many businesses to desire to advance by generating earnings in order to attract additional investors. Companies in the consumer goods business is one of the most rapidly expanding companies. Companies in the consumer goods companies will always be dealing with general public since they supply goods that are truly necessary for everyday life. Consumer goods companies are one of the corporate sectors with bright prospects and resilience in the face of adversity. On the other hand, although a company has good prospect, it is also practicing income smoothing in order to produce financial results as expected by investors.

A company's success has a significant influence on its long-term viability and also determines how well it can compete with other businesses. As a result, in order to survive the market, the organization must execute the appropriate strategy. In the face of rivalry, a company's management would be driven to produce successful results in order to compete with other businesses. Financial statements are one way to demonstrate results (P. Andriani, 2017).

These days, the behavioral aspects of the assessment process and financial statements are becoming more widely recognized. This is primarily due to the enormous influence that such behavioral aspects imply on various interested parties with financial statement details. Investors, financial analysts, lenders, auditors, and others are among the interested parties. This phenomenon necessitates a particular concern about how to rationalize financial reports consumers so that they can realistically determine the quality and reliability of accounting numbers when making decisions.

Financial statements are summaries of financial reports from a company at a certain point of time that can be used to illustrate a company's success or used as one of the media to show management's accountability for the resources entrusted to them (Triani, 2019). Profit produced is one of the variables that has become increasingly important in evaluating a company's results. It has been noted that the income statement is one of the financial reporting statements that must be presented. As a result, the reports of a corporation are considered critical information because they can be used to assess the company's result, while earnings reporting, in general, is often tainted by accounting fraud.

The practice of income smoothing is still a point of contention. Some argue that income smoothing in financial statements is not a problem because companies can enhance their profitability while still reflecting their economic value. As long as there is no fraud involved, income smoothing is not an issue. However, there are some argue that the practice of income smoothing leads to deceptive profit disclosure and decision-making errors. Income smoothing is, in reality, one of the accounting manipulation techniques. Income smoothing is actually legal, but the definition of “Income smoothing” encompasses a wide variety of good and poor practices that cannot be classified as legal or illegal as a whole. While one business company may use strategic means and proper accounting methods to smooth out its profits, another may use questionable or unscrupulous methods. Income smoothing that is done by violating accounting standards' leeway is immoral and does a disservice to financial statement users. Accountants should adhere to their general rules, which include accuracy, comparability, neutrality, complete disclosure, and conservatism. There are some purposes of why income smoothing is done in an organization as mentioned by R. Andriani (2017), in below:

a) Reducing tax burden

   This is the fabrication to lower income and increase prices in the short term will help to minimize tax debt.

b) Business management strategic

   Profit growth that is consistent is preferred by company. Have a psychological effect on the economy, in which growth and decline are opposed to optimism and pessimism.

c) Attract investors

   Income smoothing also have the intention to boost investor trust by ensuring profit consistency and a dividend strategy that is consistent with the company's goals.

Income smoothing is a kind of the type of income manipulation used to make a company's results to appear better. Income smoothing is linked to the profit management principle which is called as earnings management.

According to Triani (2019), the practice of income smoothing is linked to agency theory. Based on agency theory, income smoothing is motivated by a conflict of interest between management (agent) and the owner (principal) that occurs as each party attempts to achieve or sustain the company's level of prosperity. Management has more information about the company than shareholders, according to agency theory, resulting in information asymmetry. Due to the asymmetry of knowledge, management is encouraged to take steps that will benefit its own interests and engage in dysfunctional conduct, such as withholding information from shareholders and altering financial statement statistics.

Based on the theory of agency, the potential for a change in the information circulating will be extremely high from the information circulating that will be absorbed by investors to make decisions to acquire shares or investments. Because the motive is based on management's desire to always show something positive about the company, such as profit information on financial statements. Investors may suffer the impact of income smoothing because they are unaware of the company's true financial condition and fluctuations. In the Indonesian economy, income smoothing is nothing new. Given the value of knowledge relevant to financial statements and benefit explanations, analysis on the effects of income smoothing is a must-do study with considering that companies listed on Indonesia stock exchange must be accountable to the general public for their results.

Therefore, in order to pursuit the analysis of income smoothing in the company, this research will be conducted by determining the rationality of the relationship between income smoothing and the variables of firm size, profitability, and firm value.

Profitability is a metric used to evaluate a company's ability to make a profit as well as the efficacy of its management. Profitability is one of the factors that influence income smoothing practice, with the assumption that an increased in profit periods will boost the company's profitability, but if the profit produced falls short of expectations or fluctuate, it will allow management to take opportunistic measures. This might be due to management's desire to avoid being labeled not prospective, resulting in income smoothing by management. Furthermore, the value of assets is critical for the organization since asset is worth has multiple benefits, namely, the value of asset has possible future benefits, which can be in the form of productive things that generate cash or cash equivalents.

Liquidity which also known as the liquidity ratio, represents an operation ability to fulfill in short-term bonds for uncompensated debt repayment. Operating income of a firm may show operating profit (before taxes) on net income (after taxes) without operating the business has the ability to cover current liabilities while leaving long-term liabilities to still be.

The current ratio, acid ratio, and cash ratio are all indicators used in liquidity ratios. Many inside views are usually acquired from this ratio, including the competence of existing financial capacities for firms and their ability to remain competent in the face of crises. But in this research liquidity will be measure using current ratio. The current ratio measures a company's capacity to pay or satisfy short-term obligations that must be paid right away.

A high liquidity value is desirable, but too much liquidity gives the appearance that managers are unable to effectively control liquidity sources. Excess in current assets should be used for investments that can generate more return. On the other hand, if the liquidity generated by a current ratio has a low value, this might appear to the investor as if the company may not have enough cash to pay its short-term debt. Therefore, a stable liquidity value suggests that management performance is good, this is what might trigger managers to perform income smoothing practice.

Firm size is the third variables in this research. The firm size can be categorized into three categories as below:

1. Big firms,
2. Medium firms,
3. Small firms.

Larger company size is thought to have a stronger tendency to operate on income relations like income smoothing since the bigger an organization is, the more financial risks it must face. This is because business with a large size is more likely to attract interest from the government and the general public. Companies with a large scale might conduct benefit income smoothing by lowering profits gained in order to pay less tax and satisfy people demands. The scale of the company's calculation can be seen as the total assets kept by the company at the end of the year is the size of the company.

There are firms of various sizes in a sector. Hence, the larger the organization, the more likely it is to conduct income smoothing practices. The size of a corporation can be determined in a variety of ways, including total assets, log size, stock market value, and so on. The size of the company was estimated using Ln total assets in this study. Research with total assets presented is historically considered more stable and can reflect the size of the company. The usage of total assets is justified by the fact that total assets reflect the company's size and have an influence on income smoothing methods.

Table 1. 1 The Return on Asset (ROA), Current Ratio (CR), Firm Size, and Income smoothing of Consumer goods companies that listed in Indonesia Stock Exchange for the period of 2017 – 2020

Kode Saham		2017	2018	2019	2020
ADES	Return on Asset (ROA)	0.0455	0.0601	0.102	0.1416
	Current Ratio (CR)	1.2015	1.3877	2.0042	2.9704
	Firm size	27.4569	27.5046	27.4355	27.5889
	Eckel Index (Income smoothing)	3.7571	0.9415	0.5499	0.0064
HMSP	Return on Asset (ROA)	0.2937	0.2905	0.2696	0.1728
	Current Ratio (CR)	5.2723	4.302	3.2761	2.4541
	Firm size	31.3955	31.4727	31.5609	31.5365
	Eckel Index (Income smoothing)	3.9021	3.3941	1.5269	-0.6219
KLBF	Return on Asset (ROA)	0.1476	0.1376	0.1252	0.1241
	Current Ratio (CR)	4.5089	4.6577	4.3547	4.116
	Firm size	30.4414	30.5295	30.6399	30.7474
	Eckel Index (Income smoothing)	1.6306	2.5535	3.0066	1.8387
SIDO	Return on Asset (ROA)	0.169	0.1989	0.2288	0.2426
	Current Ratio (CR)	7.8122	4.2013	4.1975	3.6641
	Firm size	28.7810	28.8363	28.8922	28.9790
	Eckel Index (Income smoothing)	0.1138	0.6903	0.7984	0.8115
UNVR	Return on Asset (ROA)	0.3528	0.4468	0.358	0.3489
	Current Ratio (CR)	0.6203	0.7325	0.6529	0.6609
	Firm size	30.6193	30.6430	30.6587	30.6531
	Eckel Index (Income smoothing)	0.127	0.9032	4.8747	5.0397

Source : Prepared by the writer (2021)

Several research have been undertaken to establish the variables that can influence the company's income smoothing practice. Based on the table of phenomena above, we can observe the statistics from several companies in the period 2017 to 2020. The Eckel Index above if less than 1, then will assigned status

1, where presence of number 1 in the Eckel index row, suggests that the company has taken place on income smoothing. While if the Eckel Index more than 1, then it will be assigned status of 0. A score of 0 shows that the corporation does not smooth its earnings. As can be seen, there are some of the companies in the table that utilize income smoothing between 2017 and 2020.

From the table above, we can see that return on assets, current ratio and firm size in PT Akasha Wira International Tbk (ADES) from the year 2017 until 2020 are increasing. The Eckel index result in 2017 shows that the company does not do income smoothing, while the other year 2018 until 2020, as return on assets, current ratio and firm size value increased, the result of Eckel index shows that the company has done income smoothing.

As for PT Hanjaya Mandala Sampoerna (HMSP), the return on assets, current ratio value is decreasing, but the firm size value is increasing from year to year. The Eckel index result from the year 2017 – 2019 shows that the company does not do income smoothing, while for the last year the Eckel index indicate the company has taken place on income smoothing. In PT Kalbe Farma Tbk (KLBF), the case is similar with PT Hanjaya Mandala Sampoerna (HMSP), but the result between them is different. Based on the Eckel index, the company from the year 2017 until 2020 the company has not detected income smoothing action.

While for PT Industri Jamu dan Farmasi Sidomuncul Tbk (SIDO), the return on assets and firm size is increasing from year to year, but on the other hand, the current ratio value is decreasing. The result of the Eckel index, indicate that the company has done income smoothing action from the year 2017 – 2020. Different situation for the PT Unilever Indonesia Tbk (UNVR), the return on assets, current ratio and firm size is up and down from year to year. Based on the result of Eckel index, the company for the first two year does not do income smoothing, while for the next two year detected to have done income smoothing action.

The table of phenomenon above shows that there is inconsistency in every variable from return on assets, current ratio and firm size. Therefore, below are the previous research regarding income smoothing.

In research study, according to Rasinih and Musnandar (2016), they discovered that profitability had a substantial effect on income smoothing in partial testing tests. This is inversely proportional to Nurliyasari and Saifudin (2017) study's findings. According to their research profitability has no significant influence towards income smoothing.

In the previous research, according to Siregar and Vivian (2017), their research shows that liquidity has an effect towards income smoothing. While on the other hand, there's an opposite research that shows liquidity has no effect on income smoothing practices. MansorehBanam and Mehrazeen (2016) mentioned that, because investors tend to focus solely on profit statements, ignoring high or low liquidity.

According to Lahaya (2017), the size of a company has a favorable and considerable influence on income smoothing. However, Laila Yuliani and Susanto (2017) research showed that the size of the company had no effect on income smoothing practices because income smoothing is affected by variations in the wishes of each company manager, such as a preference for a greater investment, which means that the practice of income smoothing is dependent on the managers themselves rather than the company's size.

Although there has been a lot of research on income smoothing, all of the findings have not revealed any major consistency in the elements that can determine a company's income smoothing doings. Despite measuring the same thing, earlier researchers came up with different results. As what already stated in previous research, there are a wide range of variables that influence income smoothing management in a corporation. So, it is necessary to do the research again. However, this study will only focus on three variables as follows: profitability, liquidity, and the size of the firms towards income smoothing.

As a response to this, writer engage to conduct this research to do further research with the aim of this study to determine how these independent variables (profitability, liquidity and firm size) influence the potential to perform income smoothing. The study investigates consumer goods companies listed on Indonesia Stock Exchange for the year 2017 – 2020. Therefore, this research is given title "**THE INFLUENCE OF PROFITABILITY, LIQUIDITY AND FIRM SIZE TOWARDS INCOME SMOOTHING IN CONSUMER GOODS COMPANIES LISTED ON INDONESIA STOCK EXCHANGE".**

1.2 Problem Limitation

Due to the impossibility of conducting comprehensive research, therefore this report will undoubtedly be limited. Since, in reality, there is a very large forum to research on. In this regard, the writer will limit the research as follows:

1. The data(s) that the writer will be using are only from the years 2017 to 2020. As a result, no research will be specified for the years prior to 2017 and the most recent after 2020. Since the four (4) - year time period used in this analysis is so short, the testing could be unreliable.
2. The writer will only use data from the consumer goods sector from the Indonesia Stock Exchange's annual years of 2017 to 2020. As a result, this analysis will not be applicable to other market sectors.
3. In this study, the writer will only limit to three independent variables to be analyzed, that are the profitability, liquidity and firm size. As a result, other factors that may influence income smoothing aggressiveness will not be considered.

1.3 Problem Formulation

In this analysis, the formulation of the research problems is a product of the identified problems, which are expressed as questions. Based on the background of the study mentioned above, the formulation of the research will be as follows:

1. Does profitability have a significant influence towards income smoothing in consumer goods companies that listed on Indonesia Stock Exchange in year 2017-2020?
2. Does liquidity have a significant influence towards income smoothing in consumer goods companies that listed on Indonesia Stock Exchange in year 2017-2020

3. Does firm size have a significant influence towards income smoothing in consumer goods companies that listed on Indonesia Stock Exchange in year 2017-2020?
4. Do profitability, liquidity and firm size simultaneously have a significant influence towards income smoothing in consumer goods companies that listed on Indonesia Stock Exchange in year 2017-2020?

1.4 Objectives of the Research

Based on the problem formulation that has been done on above, therefore, the research's final reach, depth, and course will be determined to as follows as the objectives of this study:

1. To find out the influence of profitability towards income smoothing in consumer goods companies that listed on Indonesia Stock Exchange in year 2017-2020,
2. To find out the influence of liquidity towards income smoothing in consumer goods companies that listed on Indonesia Stock Exchange in year 2017-2020,
3. To find out the influence of firm size towards income smoothing in consumer goods companies that listed on Indonesia Stock Exchange in year 2017-2020,
4. To find out whether profitability, liquidity and firm size have simultaneously influence towards income smoothing in consumer goods companies that listed on Indonesia Stock Exchange in year 2017-2020.

1.5 Benefits of the Research

The writer hopes that this paper will benefit from the study and can be used wisely as a result of the findings. As a result, there are two types of benefits in this study, as follows:

1.5.1 Theoretical benefits

This study is intended to serve as a reference for financial concepts. This research may possibly be used as a source of inspiration and new ideas for future research on profitability, liquidity and firm size in relation to income smoothing aggressiveness. Furthermore, may the readers gain additional insight from any theory presented in this paper.

1.5.2 Practical benefits

1. For academics

   Provides a broader perspective on income smoothing, using the profitability, liquidity and firm size as influence or variables in studies and as a reference for future study.

2. For consumer goods companies

   The consumer goods companies on Indonesia stock exchange can allude to factors that are either highly influential or have no bearing on income smoothing.

3. For investors

   Investors can check the results if any of the variables: profitability, liquidity, or firm size have an influence towards income smoothing. Hence, this also can assist investors in deciding whether or not to in consumer goods companies by understanding the income smoothing risks.

1.6 Writing systematics

In this study, writing systematics is offered to provide an overall perspective of the research's substance. The aim of writing systematics is to make the writing discussion easier. This analysis was written in a systematic manner as follows:

1. CHAPTER I (INTRODUCTION)

   This chapter will cover background of the study, problem limitation with the formulation, giving the objectives of the research, benefits of this research, and also the writing systematics.
2. CHAPTER II (LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT)

   This chapter will include the theoretical background of this study and also the hypothesis development. In this chapter, it will also provide the previous research that similar with the conducted research.
3. CHAPTER III (RESEARCH METHODOLOGY)

   This chapter will cover research variables and organizational concepts, populations and samples, data types and sources, data collection methods, and data analysis methods.
4. CHAPTER IV (RESULT OF THE RESEARCH AND DISCCUSION)

   The definition of research items, data analysis, and discussion of the research findings will all be covered in this chapter.
5. CHAPTER V (CONCLUSION)

This chapter will cover the conclusions drawn from the previous discussion, as well as the research's weaknesses and recommendations to those who are interested in the findings.