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THE EFFECT OF PROFITABILITY, FIRM SIZE AND FINANCIAL LEVERAGE ON INCOME SMOOTHING PRACTICES IN NON-CYCLICALS CONSUMER SECTOR LISTED IDX 2021-2023

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ABSTRACT

The objective of this research is to ascertain how profitability, firm size, financial leverage affect income smoothing. This research utilized a quantitative approach. Purposive sampling was the method chosen and used, then this method produced 73 samples of companies listed on the Indonesia Stock Exchange for 3 periods from 2021-2023. The SPSS application was used to process data and test the hypothesis of logistic regression analysis. Accordings to the findings, income smoothing is significantly positively affected by profitability and financial leverage. On the other hand, income smoothing is unaffected by firm size.

Keywords: *Profitability, Firm Size, Financial Leverage, Income Smoothing.*

1. INTRODUCTION

In our modern globalized world, all companies whether engaged in the trade, service or industrial sectors, must have the same goal. This goal is to obtain profit or profit as much as possible and maintain the sustainability of the company (going concern). The financial statements in a company become one of the most important information because the report can measure the firm's continuing success. Evaluation of whether a business performance is good or bad can be observed in the financial accounts of the business (Abdurrahman & Ermawati, 2018). It can be concluded that performance assessment through good financial reports of a company can be an important indicator to prove the company's ability to stakeholders or interested parties both to internal and external parties. Good and consistent financial reports aim to maintain the trust of investors and also attract the attention of potential new investors. Indirectly, a company is required to account for a profit for shareholders who invest in the company. Therefore, the company should give maximum effort in maintaining the performance of its financial statements.

One technique for minimizing earnings fluctuates in financial reports by covering information that should be disclosed is income smoothing (Suhartono and Hendraswari, 2020). Income smoothing is done as long as it is permitted by good accounting and management practices. The process carried out in income smoothing does not mean equating the same high amount of profit in each year but adding less favourable income in that period with income from a period that is considered high. This shows that a company is not transparent in disclosing actual events and will ultimately mislead investors in making decisions.

The consumer non-cyclicals sector are one of the numerous business categories mentioned on the Indonesia Stock Exchange (IDX), faces inconsistent profit fluctuations over several years,

so these companies have the possibility of using income smoothing practices to keep financial statements consistent.

This research sought to determine the extent to which profitability, firm size, and financial leverage affected income smoothing during the period of 2021-2023 in non-cyclical consumer companies listed on the Indonesia Stock Exchange.

Agency Theory
This theoretical relationship addresses the contractual relationship between principals and agents in Jensen & Meckling's (1976) agency theory. The relationship related to this research is the difference in interests between the company owners and management. A conflict of interest between owner companies and management is likely to arise, such as the principal focusing on helping to build a sustainable company and seeking maximum profit. Meanwhile, the agent is more concerned with personal interests to get the promised benefits.

Agency theory has a relationship with the treatment of income smoothing practices. This is evidenced by the potential conflict due to divergent interests of management and owner. Management use income smoothing techniques for their own benefit, where these interests are not in line with the interests of the company owners (principals).

Positive Accounting Theory
The positive accounting theory describes how accounting policies and practices that can be applied by a company to deal with certain conditions (Watts & Zimmerman, 1986). In the face of various uncertain future situations, this theory is considered capable of predicting what actions managers should take.

Positive accounting theory is closely related to income smoothing practices. This is due to the fact that one tactic managers might employ when facing unstable earnings conditions is the practice of income smoothing. This decision is taken not only solely for the company, but also for personal interests. Therefore, managers will be encouraged to choose accounting policies to maintain earnings stability by carrying out these practices.

Earning Management
In the theory of earnings management, the manager's actual activity to control profits in order to generate profit outcomes in line with set objectives is known as earnings management (Scott, 2015). Income smoothing is one of the earnings management practices that will be analyzed.

Earnings management theory is two interconnected concepts in the accounting world. Managers will certainly choose techniques that will benefit them from the many earnings management strategies. Income smoothing practices represents a few of the strategies in earnings management. The practice focuses on controlling consistent profits from year to year so that it is achieved in accordance with predetermined targets.

Profitability ratios measure a corporation's ability to generate net income. That ratio is an important indicator in assessing management capability to manage company assets for producing profits in long term. Investors are paying close attention to this ratio since thier top concern is the company's capacity to turn a profit. A company with good management will generate large profits. According to the findings of Musyafa and Kholilah (2023) study,

income smoothing is significantly positively influenced by profitability. But the difference result were presented by Nathalia & Sufiyati (2022) and Indrawan et al. (2018).
According to Musyafa and Kholilah (2023) profitability and income smoothing have a positive relationship. Higher profit means a higher chance of the company doing the practice. Since companies with high profitability must maintain their profits to be stable every year so that their investors remain. Therefore, the company will use legal means such as income smoothing practices.
H1: Profitability significantly and positively affect on income smoothing. (See **Figure 1**)

The size of a firm, measured to describe the company as large or small. Firm size can be used to demonstrate the ability to use their resources to generate revenue. The calculation of the total assets will be utilized for measuring this (Chireka and Fakoya, 2017). Larger companies tend to possess greater resource capabilities. Wijaya et al. (2020) revealed income smoothing is significantly positively influenced by firm size. This finding is contrary to the results of Susanto & Pradipta (2019) and Helmi & Kurniadi (2024).

According to Wijaya et al. (2020) company size and income smoothing are positively correlated. As a company grows larger, it garners increased attention from investors and the government. Because attention is more dominant to large companies, management must be able to balance its profits from year to year in order that investors would keep investing the business. With the pressure conditions faced, the tendency of large company management to practice income smoothing becomes even greater.
H2: *Firm size* significantly and positively affect on income smoothing. (See **Figure 1**)

Financial leverage is a ratio that assesses a company's ability to settle its debt. This ratio will be indicate the proportion of the company's assets funded by debt. The greater the use of debt, the higher risk that must be borne (Sari and Darmawati, 2021). The result of the risk of large debt is that investors will consider the company unable to manage its finances properly, because profits earned are prioritized to pay the debts. According to Sari & Darmawati (2021), income smoothing is significantly positively influenced by financial leverage. These result are inversely proportional to Musyafa & Kholilah (2023) and Suhartono & Hendraswari (2020).

According to Sari & Darmawati (2021) financial leverage and income smoothing have a positive relationship. The higher the debt, the greater the profit that must be generated to pay off the liability. If a large amount of debt cannot be paid off by the firm, investors will indirectly reduce their trust in the company. Investors assume that profits will be prioritized to pay debt. This results in management being pressured to practice income smoothing.
H3: *Financial leverage* significantly and positively affect on income smoothing. (See **Figure 1**)

This theoretical framework will illustrate how profitability, firm size, and financial leverage affect income smoothing as seen below:

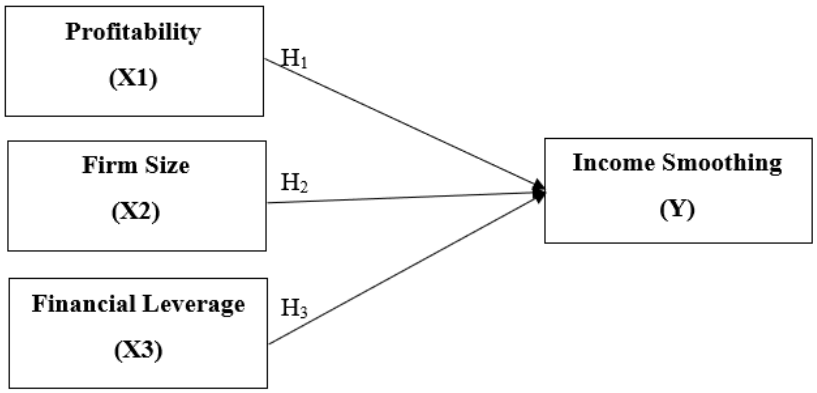

Figure 1. Research Model

2. RESEARCH METHOD

This research employs a quantitative methodology. The study population consisted of 73 companies. This research utilizes financial statements from 2021-2023 of non-cyclicals consumer sector companies listed on the IDX which were subsequently processed using SPSS program. This study employed purposive sampling and focusing the following criteria: 1) Companies in non-cyclical consumer sector listed on the IDX between 2020 and 2023. 2) Companies issue audited year-end financial statements on December 31. 3) Non-cyclicals consumer sector companies that were consistently from 2020-2023 listed on the IDX. 4) Companies whose reporting uses Indonesian currency or Rupiah (IDR).

In logistic regression analysis there is no assumption test. Instead, there are four tests that will be carried out to evaluate the efficacy of the logistic regression model. These tests include: evaluating the regression model's viability (goodness of fit test), assessing the overall model fit, the coefficient of determination (Nagelkerke R square), and the classification matrix. Income smoothing is the dependent variable in this study. The independent variables used include profitability, firm size, and financial leverage. A detailed explication of these variables is presented in Table 1 below:

Table 1. Operationalization of Research Variables

Variable	Scale	Proxy
Income smoothing	Nominal	Indeks Eckel : $\frac{\text{CV }\Delta\text{I}}{\text{CV}\Delta\text{S}}$
Profitability	Ratio	$Return\ on\ Equity = \frac{\text{Net Income}}{\text{Total Equity}}$
Firm size	Ratio	$Fsize = Ln(Total\ Asset)$
Financial leverage	Ratio	$DAR = \frac{Total\ Debt}{Total\ Asset}$

3. RESULTS AND DISCUSSIONS

Table 2. Descriptive Statistics

Variables	Min	Max	Mean	Std. Deviation
ROE	-2.549	2.170	0.04854	0.419004
FSize	24.655	32.860	28.88279	1.680396
DAR	0.093	2.312	0.52307	0.299659
IE	0	1	0.47	0.500

Based on the descriptive statistical above, the income smoothing variable (Y) value range from minimum 0 and a maximum value 1. Then the average is 0.47 with a standard deviation value of 0.500. Return On Equity (ROE) value ranging from minimum value -2.549 and maximum value 2.170. The Average ROE value is calculated to be 0.04854 with a standard deviation of 0.419004. Firm size (FSize) value ranging from minimum value 24.655 and maximum value 32.860 which leads to an average value 28.88279 and FSize standard deviation value is 1.680396. The Debt Asset Ratio (DAR) value ranges from minimum value 0.093 and maximum value 2.312, considering 0.52307 as the average, the obtained DAR standard deviation value is 0.299659.

Table 3. The Result of Goodness of Fit Test

Hosmer and Lemeshow Test

Step	Chi-Square	df	Sig.
1	9.644	8	0.291

The significant value as determined by the test from above is 0.291. Since this value exceeds the significance level (0.291>0.05). Hence, the model is fit and applicable to the observed data, so this logistic regression model is suitable for further use.

Table 4. The Result of The Overall Model Fit Test

Overall Model Fit (-2LogL)

-2LogL Block Number = 0	Nilai 295.994
-2Log L Block Number = 1	Nilai 276.323

The test results from the Overall Model Fit show that the -2log likelihood value has decreased from step 0 (295.994) to step 1 (276.323). This value is stated to have decreased by 19.671. Thus, it can be concluded that each reduction in the log-likelihood value indicates a better-fitting logistic regression model.

Table 5. The Result of The Coefficient of Determination Test

Nagelkerke R Square

-2Log Likelihood	Cox & Snell R Square	Nagelkerke R Square
276.323	0.088	0.117

The test results from the table above show the value is 0.117, indicating the independent factors have an 11.7% effect on the dependent variable. It means that just 0.117 or 11.7% of the dependent variable (income smoothing), can be accounted for by the independent variables (profitability, firm size, and financial leverage). These findings suggest that additional factors not included in this study have an impact on and explain 88.3%.

Table 6. The Result of Classification Matrix Test

Classification Table

			Predicted		
			Income smoothing		
	Observed		Does not Practice Income smoothing	Does Practice Income smoothing	Percentage Correct
Step 1	Income smoothing	Does not Practice Income smoothing	82	31	72.6
		Does Practice Income smoothing	47	54	53.5
	Overall Percentage				63.6

The test results from the classification matrix table show the regression model ability to estimate the chance of not using income smoothing is 72.6%. This indicates out of 214 samples the model predicted 82 samples not to engage in income smoothing, while 31 were predicted to engage in it. In contrast, the predictive accuracy for the likelihood of engaging in income smoothing is 53.5%. Out of 214 samples, 54 examples were correctly predicted by the model to use income smoothing techniques, leaving 47 cases wrongly predicted as not engaging in income smoothing. The Result from the test above, show this model produces a regression model accuracy of 63.6%.

Table 7. The Result of Omnibus Tests
Omnibus Tests of Model Coefficients

		Chi-Square	df	Sig.
Step 1	Step	19.670	3	0.000
	Block	19.670	3	0.000
	Model	19.670	3	0.000

Omnibus tests analyze whether a group of independent variables, considered together, signiciantly affect the dependent variable. The findings showed a significance level of 0.000 that is less than 0.05 threshold for statistical significance (0.000<0.05). Therefore, it may be said that the test simultaneously demonstrates that the independet variable significantly influences the dependent variable.

Table 8. The Result of Wald Test
Variables in the Equation

Variables	B	S.E.	Wald	df	Sig.
ROE	0. 859	0.410	4.394	1	0.036
FSize	0.107	0.088	1.473	1	0.225
DAR	2.227	0.676	10.847	1	0.001
Constant	-4.374	2.543	2.958	1	0.085

Table 9. The Result of Hypothesis Test

	Hypothesis	Coefficient	Wald	Sig.	Result
	Constant	-4.374	2.958	0.085	
H1	Profitability significantly positively affected income smoothing.	0. 859	4.394	0.036	Accepted
H2	Firm size significantly positively affected income smoothing.	0.107	1.473	0.225	Rejected
H3	Financial leverage significantly positively affected income smoothing.	2.227	10.847	0.001	Accepted

The following is the formulation of the logistic regression equation:

$$\text{Ln}\left[\frac{\text{Pi}}{1-\text{Pi}}\right] = -4.374 + 0.859\ \text{ROE} + 0.107\ \text{FSize} + 2.227\ \text{DAR}$$

Effect of Profitability on Income smoothing

According to the data above, the significance level is 0.036, which is stated to be less than 0.05 and a regression coefficient (B) is 0.859. Results concluded that income smoothing (Y) is significantly positively impacted by the profitability variable (X1). Therefore, H1 accepted in this research because profitability significantly positively affected income smoothing.

The findings of this research corroborate the findings of Musyafa and Kholilah (2023) which state that profitability significantly and positively affects income smoothing. The greater the

profit, the more likely companies do income smoothing. Companies with high profitability must maintain their profits to be stable every year so that their investors remain. Therefore, the company will use legal means such as practicing income smoothing.

The Effect of Firm size on Income smoothing

The research result from above show the level of significance is 0.225, which is stated to be higher than 0.05 and a regression coefficient (B) of 0.107. The findings indicate a lack of significant link between firm size (X2) and income Smoothing practices (Y). Hence, H2 is rejected in this research since firm size insignificance with income smoothing.

The findings of this research corroborate the findings of Helmi and Kurniadi (2024), income smoothing is not signicantly influenced by firm size. These findings indicate that company size does not influence its propensity to engage in income smoothing practices. Large companies will be reluctant to carry out this practice, because of the amount of attention that shines on the company. Therefore, the management may not necessarily dare to practice income smoothing. Then, small companies will not have sufficient resources or capabilities to practice income smoothing. Generally, small companies will focus on long-term development and growth rather than practicing income smoothing.

Effect of Financial leverage on Income smoothing

The findings above indicate that the significance level is 0.001 which is stated to be smaller than 0.05 and a regression coefficient (B) of 2.227. Results concluded that income smoothing (Y) is significantly positively impacted by the financial leverage variable (X3). Therefore, H3 accepted in this research because financial leverage significantly positively affected income smoothing.

The findings of this research corroborate the findings of Sari & Darmawati (2021) which state that financial leverage significantly and positively affects income smoothing. Increased debt necessitates increased profits for repayment. If a large amount of debt cannot be paid off by the companies, investors will indirectly reduce their trust in the company. Investors assume that profits will be prioritized to pay debt. This results in management being pressured to practice income smoothing.

4. CONCLUSIONS AND SUGGESTIONS

The conclusions from previous analysis and discussion above, can be seen as follows: 1) Profitability significantly positively affected income smoothing. 2) Firm size doesn't affect the income smoothing. 3) Financial leverage significantly positively affected income smoothing. However, when tested together at the same time the data indicate that profitability, firm size, and financial leverage affect income smoothing.

The following are some limitations of this research: 1) The research is only limited to three independent variables, namely profitability, firm size, and financial leverage; 2) The amount of time used in the research is only three years, from 2021 to 2023; 3) Only consumer non-cyclical sector that are listed on the Indonesia Stock Exchange are included in the sample.

Suggestions to further research include adding other variables that have stronger potential to influence income smoothing, extending the duration time in order to produce data that can be analysed in the long term, conducting comparative studies by expanding the use of sectors such as comparing two sectors at once or adding samples from companies in other countries.

Companies are advised to be more transparent in reporting and income smoothing practices must be carried out in accordance with applicable accounting standards. Management should focus on achieving targeted profits to ensure the sustainability of the company, as well as maintaining stable profits to meet the expectations of stakeholders. Before making decisions, investors and potential investors are encouraged to analyse financial performance from various aspects before making judgements and decisions.

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