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PROFITABILITY, FIRM VALUE, INCOME SMOOTHING: THE MODERATING ROLE OF FIRM GROWTH

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ABSTRACT

This study examines the effect of profitability and firm value on income smoothing. In addition, this study examines the moderate effect of firm growth on the relationship between these variables. This study employs a sample of companies in the banking sector listed on the Indonesia Stock Exchange/IDX. The number of samples in this study is 31 observations based on purposive sampling. Moreover, the hypothesis in this study was examined with multiple regression analysis for cross-section data. The results of this study suggest that profitability and firm value are not associated with income smoothing. Furthermore, firm growth cannot strengthen the negative relationship between profitability and income smoothing. Also, firm growth cannot strengthen the negative relationship between firm value and income smoothing.

Keywords: Earnings Quality, Firm Growth, Market Response, Operating Performance.

INTRODUCTION

Currently, the world economic order leads to a free market economic system and has experienced many developments. The development of the business world in Indonesia in this globalization era also shows very tight competition between similar companies in the market. It is a challenge for companies to run their business. External conditions that threaten the survival of employees can be a risk for the company. On the other hand, companies need external funding to develop their business from equity and debt sources.

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The source of stock income is obtained from investor investment. During COVID-19, the number of investors experienced a massive growth of 92.99% (Dirgantara, 2022). Investors select companies to invest in by assessing the performance of a company. Company performance can be assessed by information that can be seen through financial reports and data that can be seen on the Indonesia Stock Exchange/IDX. However, companies that carry out income smoothing can make investment decisions from investors that can be bad (Natalie & Astika, 2016).

In investing, investors expect the risk of their investment to be low. Under these conditions, managers attempt to reduce risk by stabilizing earnings (Novianti & Firmansyah, 2020). In practice, managers stabilize earnings in natural or artificial ways (Novianti & Firmansyah, 2020). However, not all of the manager's efforts to stabilize earnings are carried out naturally, so there are attempts by managers to stabilize earnings artificially. The act of artificially stabilizing profits is usually called income smoothing. From the investor side, stable earnings indicate managers are trying to reduce risks due to earnings volatility. High earnings volatility indicates a higher potential for future uncertainty about the company's condition (Firmansyah, Utami, & Umar, 2020).

According to (Artawan et al., 2020), income smoothing is a voluntary action taken by management to reduce the variation in profits owned by a company by using specific accounting tools for logical and rational reasons. The income smoothing action taken by this company is an action that can harm investors by hiding income that it is not good to move the company's income from a good year to a bad year so that investors cannot make good decisions. The banking company is a line of business that often performs income smoothing to increase trust and corporate image. Indonesian banking companies carry out income smoothing to reduce fluctuations in earnings, so visible profits are expected for these banks. This action is unethical because income smoothing can lead investors to make wrong decisions. Thus, companies should refrain from smoothing income and providing sober information.

Income smoothing carried out by managers can obscure actual profit information. Agency theory states that agency relations are a contract with one or more persons acting as principals and appointing other people as agents to perform services for the interests of principals, including delegating powers in making agent's decisions (Lahaya, 2017). Agency theory explains differences in interests between agents and principals, so it is possible if management only sometimes takes the best actions for the owners' interests (Sellah & Herawaty, 2019). As executors of the company, management tries to show good company performance to achieve specific goals. In several other cases, the intended interest is between management and company owners or shareholders and with other users of accounting information, such as the government, creditors, and potential investors. Managers can use asymmetric information between managers and shareholders to take action to influence the figures in the financial statements, including profit information (Scott, 2015). Stable earnings indicate that managers can reduce firm risk (Firmansyah, Utami, & Umar, 2020). However, income smoothing can be detrimental to investors in making decisions based on fundamental analysis. Therefore, the review of income smoothing needs further investigation.

Previous studies has examine income smoothing using profitability (Artawan et al., 2020; Arum & Aminah, 2017; Fitri et al., 2018; Fitriani, 2018; Gunawan & Hardjunanto, 2020; Haniftian & Dillak, 2020; Herdjiono et al., 2019; Indrawan & Damayanthi, 2020; Oktaviasari et al., 2018; Oktoriza, 2018; Oktyawati & Agustia, 2014; Peranasari &

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Dharmadiaksa, 2014; Sellah & Herawaty, 2019; Setyaningtyas & Hadiprajitno, 2014; Yanti & Dwirandra, 2019), firm size (Arum & Aminah, 2017; Benandri & Andayani, 2018; Fitri et al., 2018; Fitriani, 2018; Gunawan & Hardjunanto, 2020; Indiraswari & Rahmayanti, 2022; Indrawan & Damayanthi, 2020; Lahaya, 2017; Lim, 2022; Nathania & Nugroho, 2023; Nugraha & Dillak, Julianti, 2018; Oktaviasari et al., 2018; Oktoriza, 2018; Peranasari & Dharmadiaksa, 2014; Setyaningtyas & Hadiprajitno, 2014; Sunetri et al., 2022), firm risks (Benandri & Andayani, 2018; Lahaya, 2017; Leviany et al., 2019; Masning et al., 2022; Peranasari & Dharmadiaksa, 2014), dividend policy (Bobby et al., 2022; Gunawan & Hardjunanto, 2020; Lahaya, 2017; Yanti & Dwirandra, 2019), firm growth (Artawan et al., 2020; Indawati & Anggraini, 2019; Saputri et al., 2017), financial leverage (Artawan et al., 2020; Bobby et al., 2022; Fitriani, 2018; Gunawan & Hardjunanto, 2020; Indawati & Anggraini, 2019; Indrawan & Damayanthi, 2020; Lim, 2022; Nathania & Nugroho, 2023; Oktaviasari et al., 2018; Oktoriza, 2018; Oktyawati & Agustia, 2014; Ramanel & Susuilo, 2018; Saleh et al., 2022; Sellah & Herawaty, 2019; Setyaningtyas & Hadiprajitno, 2014; Sunetri et al., 2022), firm value (Arum & Aminah, 2017; Benandri & Andayani, 2018; Gunawan & Hardjunanto, 2020; Haniftian & Dillak, 2020; Lahaya, 2017; Leviany et al., 2019; Oktoriza, 2018; Oktyawati & Agustia, 2014; Peranasari & Dharmadiaksa, 2014; Ramanel & Susuilo, 2018; Saputri et al., 2017; Sellah & Herawaty, 2019), firm age (Sellah & Herawaty, 2019), ownership structure (Gunawan & Hardjunanto, 2020; Oktoriza, 2018; Peranasari & Dharmadiaksa, 2014; Susmitha & Zulaikha, 2021), cash holdings (Haniftian & Dillak, 2020; Natalie & Astika, 2016), bonus plans (Natalie & Astika, 2016), auditor reputation (Natalie & Astika, 2016; Saputri et al., 2017; Sellah & Herawaty, 2019), institutional ownership (Florentina & Hastuti, 2022; Safitri & Mulatsih, 2019), audit quality (Sunetri et al., 2022), investment opportunity set (Masning et al., 2022), cash holding (Safitri & Mulatsih, 2019), bonus plan (Edwita & Kusumawati, 2022), debt covenant (Edwita & Kusumawati, 2022), political cost (Edwita & Kusumawati, 2022), managerial ownership (Yunitasari & Agustiningsih, 2022) and audit committee (Nathania & Nugroho, 2023; Oktoriza, 2018).

Income smoothing aims to stabilize the manager's performance in one period (Firmansyah & Herawaty, 2019). Company performance includes operating and market performance (Damayanti & Firmansyah, 2021). Stable earnings show that the company has a low risk (Firmansyah, Utami, Umar, et al., 2020). The income smoothing action is expected to attract investors and potential company investors because the earnings generated by the company are stable (Firmansyah & Herawaty, 2019; Novianti & Firmansyah, 2020). Thus, testing profitability as a measure of the company's operating performance and firm value as a measure of market performance or investor response to the company's conditions in the capital market is necessary to investigate further income smoothing. Profitability is a comparison used to determine the size of a company's ability to generate profits from income related to equity, assets, and sales based on specific measurements (Yanti & Dwirandra, 2019). Profitability is essential in influencing income smoothing. The company will attempt to maintain good financial performance by conducting income smoothing so that the profitability of the company looks stable (Haniftian & Dillak, 2020). Low or declining profitability fluctuations tend for these companies to do income smoothing. It is triggered if the company determines bonus compensation based on the profit generated (Natalie & Astika, 2016). Stable profitability will increase market confidence so the company maintains a consistent profit. According to agency theory, the manager can perform income smoothing with the asymmetric information factor (Jensen & Meckling, 1976). Managers will carry out income

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smoothing when obtaining faster information regarding fluctuations in profitability through asymmetric information, even though this action is against the interests of investors to fulfill management's interests. Fitri et al (2018); Herdjiono et al (2019); Nugraha & Dillak, Julianti (2018); Oktaviasari et al (2018); Oktoriza (2018); Oktyawati & Agustia (2014); Peranasari & Dharmadiaksa (2014); Yanti & Dwirandra (2019)suggested that profitability is positively associated with income smoothing. Arum & Aminah (2017); Natalie & Astika (2016); Nurani & Dillak (2019) found that profitability is negatively associated with income smoothing. While, Artawan et al (2020); Fitriani (2018); Gunawan & Hardjunanto (2020); Haniftian & Dillak (2020); Indrawan & Damayanthi (2020); Sellah & Herawaty (2019); Setyaningtyas & Hadiprajitno (2014), concluded that profitability is not associated with income smoothing. The inconsistency of these results leads to reexamining profitability on income smoothing.

Firm value can be used to assess company performance. Companies with high stock prices usually have large firm sizes and receive much attention from many parties (Saputri et al., 2017). According to Haniftian & Dillak (2020), firm value is an essential factor affecting income smoothing because it reflects the stability of the company's performance. Companies that have stable performance will increase their firm value. One of the company's goals is to increase its value of the company (Sellah & Herawaty, 2019). Companies that have high firm value will tend to be closely monitored by investors so that they will be more careful in their actions (Sellah & Herawaty, 2019). Meanwhile, companies with low corporate value will try to increase their value. One of the ways they do this is to do income smoothing so that investors can see the stability of their business. According to the agency theory, the manager can perform income smoothing due to asymmetric information regarding fluctuations in the firm value. A manager is motivated to carry out income smoothing because of management's desire to increase sales of shares. Sales of shares can be increased with the stability of the firm value. Arum & Aminah (2017); Benandri & Andayani (2018); Oktoriza (2018); Peranasari & Dharmadiaksa (2014); Saputri et al (2017) suggested that firm value is positively associated with income smoothing. Sellah & Herawaty (2019) concluded that firm value is negatively associated with income smoothing (Gunawan & Hardjunanto, 2020; Haniftian & Dillak, 2020; Lahaya, 2017; Leviany et al., 2019; Oktyawati & Agustia, 2014) concluded that firm value is not associated with income smoothing. The inconsistency of these results is a factor that encourages this study to examine the firm value on income smoothing.

This study examines the effect of profitability and firm value on income smoothing. Most of the previous research used proxies for income smoothing using the Eckel index. Meanwhile, this study used a proxy developed by Tucker & Zarowin (2006) is more able to capture actual income smoothing activities because they involve data from the previous five years to calculate income smoothing in the current year. In addition, this study includes firm growth to moderate the relationship between profitability and firm value on income smoothing, which still needs to be employed in previous studies. Firm growth affects profitability through assets owned so that it affects the productivity and efficiency of the company, which in turn affects profitability. Firm growth is a factor that increases profitability. According to agency theory, management can know that there will be an increase in profitability due to information asymmetry, which makes management receive information more quickly about the company's growth. With high company growth, the company can increase its productivity to increase sales, ultimately increasing profitability. Companies that continue to grow will generally have good prospects, which

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will undoubtedly be responded to positively by investors. It will affect the increase in stock prices (Suastini et al., 2016). Companies that experience good growth will experience an increase in company value because, with higher company growth, the development and prospects of the company will also be higher. It increases investor interest, making the company's price rise, so its value rises.

According to Aeni & Asyik (2020), firm growth is a comparison between the company's total assets and assets in the previous year, which shows a company's excellent or imperfect condition. As agents of investors, companies are interested in making the company grow to increase the profitability and value of the company. Ramdhonah et al (2019) and Suastini et al (2016) concluded that firm growth is positively associated with firm value. Companies with high company growth will increase company prospects. Furthermore, Brastibian & Rinofah (2020) firm growth is positively associated with profitability. The firm growth increases the productivity and efficiency of the company's operations, thereby increasing the company's assets and increasing profitability. Saputri et al (2017) and Indawati & Anggraini (2019) found that firm growth is negatively associated with income smoothing. Companies with high growth tend to have low risk. In addition, high sales growth can encourage increased investment. Therefore, high sales growth is unlikely to be used by managers in practicing income smoothing.

RESEARCH METHODS

This study employed secondary data and quantitative cross-sections from the company's annual financial statements. The data was derived from www.idx.co.id. The basis year is 2020, but the data started from 2015 because the income smoothing calculation in this study needs the data from 2015. The samples using a purposive sampling technique are as follows:

Table 1. Research Sample Criteria

Criteria	Amount
The total companies in the banking sector in June 2022	47
Companies in the banking sector that have not been registered in 2015	8
Companies in the banking sector that do not have the necessary data	8
Total Research Sample	31

Source: Data processed

The dependent variable in this study is income smoothing. This proxy follows Firmansyah & Herawaty (2019); Firmansyah & Irwanto (2020); Novianti & Firmansyah (2020) There are several steps to obtain income smoothing. The first step is measuring discretionary accruals using a cross-sectional model from Kothari et al. (2005).

$$\frac{\text{Accruals}_{it}}{\text{Assets}_{it-1}} = \beta_0 \frac{1}{\text{Assets}_{it-1}} + \beta_1 \frac{1}{\text{Assets}_{it-1}} + \beta_2 \frac{\text{PPE}_{it}}{\text{Assets}_{it-1}} + \beta_3 \frac{\text{ROA}_{it}}{\text{Assets}_{it-1}} + \varepsilon_{it} \qquad (1)$$

Discretionary accrual is derived from the residual of the equation. The second step is obtaining pre-discretionary income from net income minus discretionary accrual.

PDI = NI– DA..(2)

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The third step is obtaining income smoothing value, derived from correlating the changes in discretionary accruals with five pre-discretionary income observations multiplied by minus 1.

- Corr (ΔDA, PDI) .... (3)

Independent variables in this study are profitability and firm value. The profitability proxy in this study is the return on equity following Artawan et al (2020).

$$\text{ROE} = \frac{\text{net income}}{\text{equity}}$$

Firm value is calculated using Tobin's Q, following Firmansyah, Setiawan, & Fathurahman (2020); Putri et al (2020); Riswandi & Yuniarti (2020).

$$\text{Tobin's Q} = \frac{\text{market value of equity} + \text{total liabilities}}{\text{total assets}}$$

The moderating variable in this study is firm growth. Firm growth is calculated by dividing the total assets of a year and the total assets of the previous year by the total assets of the previous year, following Artawan et al (2020).

$$\text{Firm Growth} = \frac{(\text{Total Assets}_{t} - \text{Total Assets}_{t-1})}{\text{Total Assets}_{t-1}}$$

This study includes the control variable, the price-to-earnings ratio (PER). The proxy divides the market price per share by the earnings per share, following Sari & Jufrizen (2019).

$$\text{PER} = \frac{\text{Share Price}}{\text{Earning per Share}}$$

Data analysis employs multiple linear regression for cross-section data. Model 1 is employed to examine hypotheses 1 and 2. Model 2 is employed to examine hypotheses 3 and 4.

$$\text{IS}_{i} = \beta 0 + \beta 1\text{ROE}_{i} + \beta 2\text{TOBIN'S Q}_{i} + \beta 3\text{PER}_{i} + \varepsilon_{it} \ldots \quad (7)$$

$$\text{IS}_{i} = \beta 0 + \beta 1\text{ROE}_{i} + \beta 2\text{TOBIN'S Q}_{i} + \beta 3 \mathit{FIRMGROWTH}_{it} + \beta 4\text{ROE} * \text{FIRM GROWTH}_{i} + \beta 5\text{TOBIN'S Q} * \text{FIRM GROWTH}_{i} + \beta 6\text{ROE}_{i} + \varepsilon_{it} \ldots \quad (8)$$

RESULTS AND DISCUSSION

Table 2 summarizes descriptive statistics for all variables used in the study.

Table 2. Descriptive Statistics

Variable	Obs.	Mean	Std. Dev.	Min.	Max.
IS	31	0,0694	0,5108	-0,99	0,75
ROE	31	0,0280	0,1004	-0,34	0,17
Tobin's Q	31	1,0731	0,2015	0,86	1,64
Growth	31	0,8560	0,1533	-0,34	0,60
PER	31	83,5506	179,6410	-34,67	706,64

Source: Data source, year

Furthermore, the summary of the results of hypothesis testing is as follows:

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Table 3. The Summary of Hypothesis Test Results

		Model 1				Model 2			
Variabel	**Prediction**	**Coeff**	**t-Stat**	**Sig.**		**Coeff**	**t-Stat**	**Sig.**	
C		-0,359	-0,717	0,479		-0,745	-1,271	0,216	
ROE	-	0,486	0,593	0,558		0,583	0,572	0,572	
Tobin's Q	-	0,522	1,091	0,285		0,823	1,485	0,151	
PER	-	-0,002	-3,257	0,003	*	-0,002	-3,051	0,006	*
Growth	-					4,748	1,145	0,263	
ROE*Growth	-					4,578	0,684	0,500	
TobinQ*Growth	-					-4,372	-0,991	0,332	
R2		0,300				0,360			
Adj R^2		0,233				0,200			
F-Stat		3,865				2,252			
Probability. (F-Stat)		0,020				0,073			

Source: Data source, year

Based on the hypothesis testing, it suggests that profitability is not associated with income smoothing. The test results in this study are in line with Artawan et al (2020); Fitriani (2018); Gunawan & Hardjunanto (2020); Haniftian & Dillak (2020); Indrawan & Damayanthi (2020); Sellah & Herawaty (2019); Setyaningtyas & Hadiprajitno (2014), but not in line with Arum & Aminah(2017); Fitri et al (2018); Herdjiono et al (2019); Natalie & Astika (2016); Nugraha & Dillak, Julianti (2018); Nurani & Dilla (2019); Oktaviasari et al (2018); Oktoriza (2018); Oktyawati & Agustia (2014); Peranasari & Dharmadiaksa (2014); Yanti & Dwirandra (2019). In agency theory, managers must obtain good company performance to maximize shareholder wealth (Jensen & Meckling, 1976). The company's good operating performance can be seen from the high level of profitability (Damayanti & Firmansyah, 2021). The profit generated by the company is a measure of the company's operating performance. However, profit information cannot always be used as a manager's success in managing the company (Jadi et al., 2021; Saksessia & Firmansyah, 2020). Managers have accrual policies in influencing the information on profits generated by the company. One pattern of earnings management carried out by managers is income smoothing (Scott, 2015).

However, a certain level of profitability based on research tests does not indicate managers' income-smoothing activity. The level of profitability achieved by Indonesian banking companies needs to reflect the income-smoothing activities carried out by managers. Although banking companies have high risk, information on operating performance does not indicate managers' actions in stabilizing earnings. Managers of banking companies do not use a certain level of profitability as a basis for conducting income smoothing. Profitability fluctuations do not always show asymmetric information that managers can use to act with specific motives.

Based on the hypothesis testing, it suggests that firm value is not associated with income smoothing. This result is in line with Gunawan & Hardjunanto (2020); Haniftian & Dillak (2020); Lahaya (2017); Leviany et al (2019); Oktyawati & Agustia (2014) but not in line with Arum & Aminah (2017); Benandri & Andayani (2018); Oktoriza (2018); Peranasari & Dharmadiaksa (2014); Saputri et al (2017); Sellah & Herawaty (2019). Firm value shows the market response to assets managed by managers (Firmansyah, Setiawan, & Fathurahman, 2020). In addition, firm value shows the performance of managers who are responded to by investors in the capital market (Firmansyah et al., 2021; Ihsani et al., 2021). Managers are expected to run the company's business following the wishes of

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shareholders (Jensen & Meckling, 1976). However, in practice, managers do not always align their interests with those of shareholders due to certain motives (Scott, 2015).

Income smoothing actions carried out by managers can show opportunistic contracts and efficient contracts (Scott, 2015). However, based on the test results in this study, it has yet to be proven that investors in the capital market can respond to income smoothing. Investors' response in the capital market needs to reflect the income-smoothing activities carried out by managers. Firm value is not an indicator that can detect income smoothing activity. Firm value shows the value of assets that the market responds to; meanwhile, income smoothing aims to stabilize earnings is expected that investors respond to the company's low risk. However, investor confidence in the capital market is unrelated to income-smoothing activities.

Based on the hypothesis testing, the interaction between firm growth and profitability is not associated with income smoothing. Investors look at firm growth in making investment decisions, but this growth cannot encourage the manager to carry out income smoothing. Shareholders expect that the company can grow every year. Based on the results of this study, firm growth is not successful in increasing the negative effect of profitability on income smoothing. Since firm growth and profitability are assumed to be the main factors for investors in making investment decisions for companies in the banking sector. Thus, management needs to be more motivated to perform income smoothing.

Based on the hypothesis testing, the interaction between firm growth and firm value is not associated with income smoothing. In making investment decisions, investors will see and analyze various fundamental information the company owns. Firm growth is one of the factors that investors look at in making decisions. Firm growth is not successful in increasing the negative effect of firm value on income smoothing because firm growth and firm value are not the primary factors investors use to make investment decisions in banking companies. So management does not need to conduct income smoothing.

CONCLUSION

This study concludes that profitability and firm value are unrelated to income smoothing. These two variables are not indicators of the company's income-smoothing activity. At the same time, Indonesian banking companies do not take advantage of operating and market performance as motives for income smoothing. Also, firm growth cannot weaken the positive effect of profitability on income smoothing nor the positive effect of firm value on income smoothing. Although firm growth can be important information for investors in assessing the company's fundamental condition, firm growth does not result in a moderating role for both operational performance and market performance in income-smoothing activities by managers.

This study still has limitations. This study only employs a small number of samples, 31 observations, due to population data limitations, and some samples need to meet the required criteria. Thus, for future research, it is possible to employ companies in sectors with a larger population and the data needed to conduct research. This research can be used to evaluate the policies of the Indonesian financial services authority in detecting income-smoothing behavior aimed at protecting investors in the capital market.

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