

Income Smoothing Determinants in Indonesia Banking Industry

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Abstract—The research aims to determine the effect of profitability, corporate value, company size and financial risk to income smoothing. Researchers would like to review the factors affecting income smoothing, at the banking companies listed on the IDX during the period of 2014-2016. The sampling method use author is purposive sampling there are 21 company of research sample or 66 sample. The analysis technique used is logistic regression with enter method and quartile analysis. The results showed profitability, corporate value and financial risk have a positive and significant effect on income smoothing, but size of the company doesn't effect on income smoothing. Quartile analysis showed that most of companies that conduct income smoothing have PBV 0.82- 1.66 and DAR > 0.8.

Keywords: Company value, Debt, Income smoothing, Profitability, size

I. INTRODUCTION

Income smoothing is a common phenomenon as management efforts to reduce reported income fluctuations. Income smoothing conducted by the manager, based on various reasons such as reducing tax payment issues Guenther in [1]; [2] debt covenants Watts and Zimmerman in [3] to keep their positions safe within the company [4].

Income is one of the considerations for the investors. Attention from investors and stakeholders on income information, raises the problem to management activities to manage the income. The tendency of management to result in the practice of income smoothing at companies listed on the Indonesia Stock Exchange, especially the risky industries, one of which is banking. Recently Bukopin Bank, one of private bank in Indonesia, restated income for 2015, 2016 and 2017. Duru and Tsinidis in [5] stated that insurance and banking are industries that usually engage in income smoothing.

Income smoothing practice can be explained with agency theory and signalling theory. The practice of earnings management based on the agency theory approach explains the conflict of interest between the management (agent) and the owner (principal) arising from the employment contract and consensual agreement. The agency conflict arises because each party seeks to achieve and maintain the desired level of prosperity. The approach of signal theory to income smoothing is a company management steps to provide guidance or signs about the conditions that describe the state

of the company from the information and record information produced, according to Pratiwi and Mahastanti in [6].

The definition of income smoothing according to Barnea in [7] is income smoothing as a deliberate reduction of profit fluctuations at some level of profit to be considered normal for the company. Meanwhile, according to Beidleman in [8] income smoothing is an attempt conducted by management to suppress the variation in profit as far as possible by accounting principles Pratama in [9] Because banks are a service industry, the sales variables in convention with income.

Some previous studies show inconsistent results even on the same object. Research on income smoothing conducted on firms registered on Indonesia Stock Exchange (IDX) has been conducted but found inconsistent result. The research results show that company size Anwar and Chandra in [10]; Nurliyasaki and Saifudin in [11] profitability Sherlita and Kurniawan in [12] financial leverage Boudiche in [13] and company value Aji and Mita in [14] have a positive significant effect on income smoothing. The other results found in Aji and Mita in [14] profitability and firm size have no effect on income smoothing. Table I presents determinant factors of income smoothing.

TABLE I. DETERMINANT FACTORS OF INCOME SMOOTHING

Determinant Factor	Sign	Company Sector	Income smoothing measurement	Researchers
Profitability	-	Basic industry and chemical sector in Indonesia	Correlation between changes in discretionary accruals and change in pre-discretionary income	Ratnaningrum (2016)
Debt (financial risk)	+ -	All sector in Tunisia	Variability of operating cash flow	Boudiche (2013)
Audit quality				
Profitability	+	All sector in Indonesia	Eckel Index	Sherlita and Kurniawan (2013)
Net profit margin	+			
Company size	+	Miscellaneous industry in Indonesia	Eckel Index	Anwar, Chandra (2017)
Dividend ratio	-			
Ownership structure	+	Pharmaceutical companies in Indonesia	Eckel Index	Nurliyasaki and Saifudin (2017)
Company size	+			
Leverage	+			
Financial Risk	+	Manufacturing companies in Indonesia	Eckel Index	Aji and Mita (2010)
Firm Value	+			

The rest of this paper is organized as follow: Section II describes the hypothesis development. Section III describes the proposed method. Section IV presents the obtained results and following by discussion. Finally, Section V concludes this work.

II. HYPOTHESES DEVELOPMENT

This section presents the hypothesis development.

A. Effect of profitability on Income Smoothing

A high level of profitability will affect income smoothing action, since profits that appear to be highly positive fluctuate give a bad impression according to management. This is because management is afraid of not being able to meet investor expectations of the expected rate of return. Closely related to signalling theory and agency theory, management will perform income smoothing and provide good figures processing information, in order to be used to address the old investors and bring in new prospective investors, as they are more dominantly interested in stable profit information and keep them away from risks that would harm them and expect good returns Noviana and Yuyeta in [15]; Salim in [16]. In Tax perspective, high profit will increase tax expense, so manager tend to smoothing income [14].

H1: Profitability affects income smoothing.

B. The Effect of Company Value on Income Smoothing

The value of stocks that are fluctuating and high, is an inconsistent signal on investor valuation. Management actions that are related to the information asymmetry from investors' point of view in the capital market, they are more dominantly interested in the signal processing of management figures in stable profit information, as investors will respond to it as a signal of capital market conditions from the investor's perspective Suranta and Merdistuti in [17] Evidence that income smoothing is driven by high stock prices, if the value of shares will signal and the market responds to such information as information in decision making and on the other side the company uses income smoothing to attract resource flows.

H2: Company value affects income smoothing

C. The Effect of Company Size on Income Smoothing

Companies on a large scale tend to make income smoothing and respond to information circulating in the market. This is conducted by management to give a positive signal that the condition of the company is good. Because it gets more attention from external parties (investors, creditors, analysts) then management will act to maintain its existence by way of profit-sharing. This result is supported research Moses in [18], Nurliyarsari and Saifudin in [11].

H3: Company size affects income smoothing

D. The Influence of Financial Risk on Income Smoothing

Financial risk is the ratio of debt held in the company as a source of funding and assets owned to be guaranteed. High financial risk adversely affects investors' judgment, in decisions affecting their investment, the risk is a consideration that investors will use to predict the profitability that will be obtained and potential investors will avoid companies that have a high financial risk because it does not have promising future prospects. This result is supported by research conducted by Agung and Bagus in [19], Aji and Mita in [14].

H4: Financial Risk affects income smoothing.

III. PROPOSED METHOD

The location of this research was conducted in the Laboratory of Indonesian Stock Exchange Investment Gallery

(BEI) Faculty of Economics and Business Universitas Musamus Merauke. Population in this research is Banking company registered and active in Indonesia Stock Exchange period year 2013-2016. Determination of the sample is conducted by purposive sampling method with criteria: 1. Companies whose financial statements are published in the Indonesia Stock Exchange in each period during the period 2013-2016, 2. The Company during the observation period has never experienced a loss, 3. The company presents the financial statements in rupiah. Based on these criteria, then obtained 21 companies into the sample. Furthermore, seckel index is calculated in order to know the company of grader and not grader and generalize with 2014-2016 object of research counted 63 years.

E. Research Variables and Operational Definition

Dependent variable in this research is income smoothing and independent variables are profitability, company value, company size and financial risk. Operational variables are presented in Table II.

TABLE II. OPERATIONAL DEFINITIONS

Variable	Definition	Measurement
Dependent		
Income Smoothing	effort by management to reduce the profit fluctuations in the company.	Eckel Index = $\frac{CV\Delta S}{CV\Delta I}$ CVAS = dispersion coefficient of sales variations CVΔI = dispersion coefficient of profit variations The researcher uses Eckel index to measure the company doing income smoothing where if, the value is less than 1 or equal to 0 (zero) and the company that does not do income smoothing is given more than 1 (one) value.
Independent		
Profitability	Profitability is a ratio that measures the ability of the company with the overall funds invested in the asset in obtaining profit	$ROA = \frac{Net\ Profit}{Total\ Assets} \times 100\%$ ROA = Return on asset
Company Value	The company value is a reflection of the value of the company's shares circulating within the company and sold in the capital market	$PBV = \frac{MPS}{BVS}$ PBV = Price Book Value MPS = Market Per Share BVS = Book Value Per Share
Company Size	The company size is measured from the book value of the assets owned by the company that is calculated by using the natural logarithm of asset value.	Natural logarithm of total assets = Ln (total assets).
Financial Risk	Financial risk is how the company relies on external financing (Bank) to support ongoing operations and reduce financial flexibility.	$DAR = \frac{total\ liabilities}{total\ asset} \times 100\%$ Debt asset Ratio

F. Data Analysis Method

Data analysis methods and techniques used to determine the effect of independent variables on dependent variable in accordance with the objectives of the research is logistic regression analysis with the help of application analysis tools SPSS 22 software For Windows statistical. The regression model is formulated as follows:

$$LN = \frac{IS}{1-IS} = \alpha + \beta 1ROA + \beta 2PBV + \beta 3Total\ Assets + \beta 4DAR + e \quad (1)$$

To test the feasibility of the logistic regression model, then the test conducted is the test to evaluate the fit model, assess the feasibility of the regression model, test the coefficient of determination, and parameter estimation test. The next test is partial hypothesis testing (Wald Test) and simultaneous (Omnibus Test) to know the significance of the influence of

independent variables. The degree of confidence used to test the research hypothesis is $\alpha = 5\%$ (0.05).

IV. RESULT AND DISCUSSION

This section presents the results obtained and following by discussion.

a. Descriptive statistic

Descriptive statistics are presented in Table III.

TABLE III. DESCRIPTIVE STATISTICS OF THE VARIABLES

Variable	N	Minimum	Maximum	Mean	Std. Deviation
ROA	63	0.0017	1.05	0.029	0.131
PBV	63	0.22	3.04	1.323	0.745
Size	63	28.26	34.52	31.20	1.678
DAR	63	0.74	0.91	0.845	0.384
IS	63	0	1	0.56	0.501

b. Fit Model

The test results of overall model fit after the data is transformed by before and after on the research model.

TABLE IV. FIT MODEL

Iteration		-2 Log likelihood	Coefficients
			Constant
Step 0	2	86.557	.223
Step 1	9	57.895	-19.156

Early -2LL value of 86.557 and Final -2 LL of 57.895 as shown in Table IV above means a decline in value so it is concluded that the regression model used is fit.

c. Assess the feasibility of the regression model

The test result of feasibility assessment of regression model on logistic regression in Hosmer and Lemeshow Test which is described in Table V.

TABLE V. HOSMER AND LEMESHOW TEST

Step	Chi-square	Df	Sig.
1	12.049	8	.149

The result of the assessment of the logistic regression model in Table V Hosmer and Lemeshow test, found that Chi-Square statistic value is (12.049) with significance probability value (0.149). In Hosmer and Lemeshow test at probability significance level 0.149 bigger than level (sig) 0.05 or 5% and chi Square value bigger than significance level meaning no difference of estimation data with logistic regression model. It can be concluded that the regression model used is feasible and fit enough to be used as an analytical tool. After conducting the feasibility test of the regression model then, the next step is to see the accuracy of classification of the model as for the results of the classification of the regression model can be seen in Table VI presented as follows:

TABLE VI. CLASSIFICATION TABLE

			Predicted		Percentage Correct
			IS		
Observed	IS	Not Smoothing	21	7	75.0
		Smoothing	6	29	82.9
Overall Percentage					79.4

The results of classification accuracy calculation after the explanatory variables included in the regression model show a value of 79.4 percent. Based on the value of the classification number, it can be explained that the number 79.4 has been very good because it has exceeded 50 percent (cut off figure) meaning that it can be concluded that the model is very good and can classify the data with income smoothing of 79.4 percent.

d. Testing the Coefficient of Determination

Nagelkerke, s R Square is a modification of Cox and Snell coefficients, s to ensure that values vary from 0 (zero) to 1 (one). The Nagelkerke statistical model is used to measure the ability of the logistic regression model in matching the data.

TABLE VII. TEST RESULT OF SUMMARY MODEL (NAGELKERKE SQUARE)

Step	-2 Log likelihood	Cox & Snell R Square	Nagelkerke R Square
1	57.895a	.366	.489

The output data of SPSS in Table VII above shows that the independent variables in this model are able to explain profit gains of 48.9 percent and the remaining 51.1 percent are explained by other variables outside in this research model.

e. Parameter Estimation (Testing Regression Coefficients)

The final stage in this test is to test the logistic regression coefficient, where the result of the calculation is as follows:

$$LN = \frac{IS}{1-IS} = \frac{-19.156+X1 \ 201.134+X21.597 -X3 \ 0.443+X4 \ 34.196+e}{-19.15+X1 \ 201.134 +X21.597-X3 \ 0.443+X4 \ 34.196+e} \tag{2}$$

$$LN = \frac{IS}{1-IS} = 1,00 \tag{3}$$

As previously defined in the logistic regression model, score 1 is a "smoothing" category or a chance of success and a score of 0 is a "not smoothing" category or chance of failure. The predicted result of the parameter estimation above can be categorized that the data included in the model can be explained in the regression equation as a company really performing income smoothing practice. This is because the result of the logit value of 1 above is worth greater than the cut-off value of 0.5 percent. However, if the logit value is less than the cut-off value of 0.5, then the predicted result can be categorized as "not smoothing". From result of equation test

of logistic regression analysis, it is seen that the constant value produced is negative 19.156 with Exp (B) 0.00. Regression coefficient value of profitability variable (X1) generated positive equal to 201.134. It means that if change of profitability by 1 percent then affecting the practice of income smoothing amounted to 22.4587. Company value variable (X2) has a positive regression coefficient of 1.597. It means, if the variable value of the company increases it will affect the practice of income smoothing (Y) will increase by 4,938.

The value of regression coefficient of Company Size variable (X3) which produced negative equal to -0.443. This means that if the company size variable increased by 1 unit then the practice of income smoothing tend to be more decreased 0.642 units assuming that other independent variables remain. The financial risk variable has a positive regression coefficient of 34,196. This means that if the financial Risk variable increases then the practice of income smoothing (Y) will increase by 709714 with the assumption of free variable remain.

f. Hypothesis Test Results

1) Partial Test (Wald Test)

Table VIII below presents the partial test output results:

TABLE VIII. PARTIAL REGRESSION CALCULATION RESULT

		B	S.E.	Wald	Df	Sig.	Exp(B)
Step 1a	ROA	201.134	82.266	5.978	1	.014*	2.245E+87
	PBV	1.597	.607	6.932	1	.008*	4.938
	LnTA	-.443	.269	2.715	1	.099	.642
	DAR	34.196	10.866	9.904	1	.002*	7.097E+14
	Constant	-19.156	11.276	2.886	1	.089	.000

a. Variable (s) entered on step 1: ROA, PBV, LnTA, DAR.

*) Significant in 0.05

The significance test of partial influence in Table VIII describes the effect of independent variables on the dependent variable partially, that is, among others:

- Effect of Profitability on income smoothing, Based on Table VII, it is shown that the probability (Sig) value of profitability (ROA) is 0.014 smaller than (sig) 0.05. Then the hypothesis H0 rejected and Ha accepted, which can be explained that the profitability (ROA) has a positive and significant effect on the income smoothing of banking companies at a level of significance less than (α) 0.05 or 5 percent.
- The effect of company value on income smoothing, based on Table VIII, it is shown that the probability value (sig) of company value (PBV) is 0.008 which is smaller than 0.05 (α). Then the hypothesis H0 rejected and Ha accepted, which can be explained and concluded that the Company Value (PBV) have a significant positive effect on the income smoothing of banking companies at a significance level less than 0.05 or 5%.
- The effect of company size on income smoothing, Based on Table VIII, it is shown that the probability value (sig) of company size (LnTA) is 0.099 larger and above 0.05. Then the hypothesis H0 is accepted and Ha is rejected, which can be explained and concluded that the Company Size (LnTA) has a negative and insignificant effect on the

income smoothing of the banking company on the significance level over the 0.05 or 5% level (sig).

- The effect of financial risk on income smoothing, Based on Table VIII, it is shown that the probability (sig) value of Financial Risk (DAR) is 0.002 smaller than 0.05 (α). Then the hypothesis H0 rejected and Ha accepted, which can be explained and concluded that the profitability (DAR) has positive and significant effect on income smoothing of banking companies at the level of significance less than 0.05 or 5%.

g. Simultaneous Test (Omnibus Test of model Coefficients)

Profitability, Corporate Value, Company size and financial risk simultaneously have a positive effect on income smoothing present Table IX.

TABLE IX. SIMULTANEOUS REGRESSION CALCULATION RESULT

	Chi-square	Df	Sig.
Step	28.663	4	.000
Step 1 Block	28.663	4	.000
Model	28.663	4	.000

Table IX shows that the simultaneous model in Chi-Square (step, block and model) has no difference between the chi-square value where degree of freedom amounted to 4 is able to explain the four independent variables. Omnibus Test's Model Coefficient test results are obtained by probability value (Sig) 0.000 because the probability value (0.000) is smaller than (0.05). It can be concluded that the independent variables (profitability, company value, company size and financial risk) used statistically together (enter method) have a significantly positive effect on income smoothing of banking companies.

B. Discussion

a. Effect of Profitability on Income Smoothing

These findings prove empirically that the higher the profitability of banking companies registered on the IDX period 2014-2016. The results of this hypothesis are supported in Wijaya in [20], Agung dan Bagus in [19] who state the higher level of profitability of banking companies will maintain the information, if high reported earnings bring the company in a favourable condition, because with a signal (high profit) will give full confidence to external parties (investors, debtors, and government) and draw resources into the company and give the impression that the company's performance is very good. These result opposite direction by Saeidi in [21] and Ratnaningrum [22].

The amount of net profit that can be earned on the created sales will be determined by the success in controlling costs. The accuracy and appropriateness in choosing the equipment, production methods, and capacity used are among the factors that affect the efficiency level in the cost will affect the management to level out the profit.

b. The Effect of Company Value on Income Smoothing.

The findings of this research prove that the company value has a relationship that can affect the profit gains. The results of this hypothesis is aligned in the research of Prayudi and Daud in [23] where the results of logistic regression testing with enter method found that the company value firms high

positive fluctuations have a significant effect on income smoothing. This raises the appraisal of investors who consider this signal to be a bad signal. The investor's reason to take a "yes" step to invest or to choose "no" to invests because the company value is a signal in the capital market, as well as investors' respect are less sensitive to the information, whether the result of natural processes of company operations or the result of manipulation / management engineering to attract resources.

To gain better understanding about company size and income smoothing, we divided bank into 3 category using quartile analysis. Company size and income smoothing divide in three groups of banks are presented in Table X.

TABLE X. PRICE BOOK VALUE AND INCOME SMOOTHING

No.	PBV	Income Smoothing		Not Income Smoothing		Total	
		N	%	N	%	N	%
2014							
1	< 0,79	2	9,52	3	14,29	5	23,81
2	0,82 – 1,66	5	23,81	6	28,57	11	52,38
3	> 1,69	4	19,05	1	4,76	5	23,81
Total		11	52,38	10	47,62	21	100
2015							
1	< 0,79	1	4,76	3	14,29	4	19,05
2	0,82 – 1,66	6	28,57	7	33,33	13	61,90
3	> 1,69	3	14,28	1	4,76	4	19,05
Total		10	47,62	11	52,38	21	100
2016							
1	< 0,79	-	-	5	23,81	5	23,81
2	0,82 – 1,66	9	42,86	2	9,52	11	52,38
3	> 1,69	5	23,81	-	-	5	23,81
Total		14	66,67	7	33,33	21	100

In 2014, 2 income smoothing companies with PBV < 0.79, 5 companies with PBV 0.82-1,66 and 4 companies with PBV >1.69 . In 2015, 1 income smoothing companies with PBV < 0.79, 6 companies with PBV 0.82-1,66 and 3 companies with PBV >1.69. In 2016, no one income smoothing companies with PBV < 0.79, 9 companies with PBV 0.82-1,66 and 5 companies with PBV >1.69. According quartile analysis most of companies with PBV 0.82-1.66 conduct income smoothing.

c. Effect of Company Size on Income Smoothing.

The result of hypothesis test of company size variable with log total natural asset proxy (LnTA) shows negative regression coefficient value equal to 0.443 with significant level (sig) variable equal to 0.099 which is bigger than significant level of 0.05. It means that it can be concluded that company value with Natural log total assets proxy has negative insignificant effect to income smoothing. So in this case, Hypothesis 3 is rejected because the size of a large company is not proven to affect income smoothing (income smoothing) at a significant value level greater than the significant level of 0.05 or 5% with a negative regression value of 0.443 where each decrease of 1 unit of company size then the action of income smoothing will decrease.

The company size does not influence the income smoothing because the conditions on the scale of total assets of large companies are under intense scrutiny from analysts and investors. Hence the tendency of large company is not indicated to do income smoothing. This is because large companies are not always identified with capital intensive, but they can be labour intensive. The category of the company's

asset size will guarantee performance, so that companies with large assets do not have a tendency to level profit.

d. Effect of Financial Risks on Income Smoothing

The result of statistic test using logistic regression shows that the variable of financial risk with debt to asset (DAR) proxy of positive regression coefficient value is 28.116 with significant value 0.022 which is below level (sig) 0.05. This means that financial risks have a significant positive effect on income smoothing. The financial risk variable measured from the debt to asset shows the significant value level (sig) of 0.022 is smaller than the significant level (sig) 0.05 then in this case Hypothesis 4 is accepted.

Large companies often have high levels of debt assets. Management wants to show that it has the ability to complete its obligations using its total assets. It also shows that the leverage position of the average income smoothing company of 0.85 raises the presence of indicators of risky company.

Hypothesis testing results are supported Boudiche in [13], Aji and Mita [14] high debt to asset levels will trigger management to make income smoothing (income smoothing) in order to give full confidence to additional funders. In this case, management chose this method in order to avoid the risk of debt agreement and assessment for the creditor as the analytical tool. Because if the position of high financial risk then the company will be difficult to get additional funds that will support its operational activities and assessment on debt agreements. Watts and Zimmerman in [3] stated that manager avoid violating debt contracts, so firm with high debt equity ratio select accounting activities to avoid violating debt covenants.

To gain better understanding about financial risk and income smoothing, we divided bank into 2 category using quartile analysis. Financial risk and income smoothing divide in two groups of banks are presented in Table XI.

TABLE XI. FINANCIAL RISK AND INCOME SMOOTHING

No	Debt (DAR)	Asset Ratio	Income Smoothing		Not Income Smoothing		Total	
			N	%	N	%	N	%
2014								
1	< 0,80 (%)		1	4,76	1	4,76	2	9,52
2	> 0,80 (%)		10	47,62	9	42,86	19	90,48
Total			11	52,38	10	47,62	21	100
2015								
1	< 80 (%)		1	7,14	-	0,00	1	4,76
2	> 80 (%)		9	64,29	11	52,38	20	95,24
Total			10	71,43	11	52,38	21	100
2016								
1	< 0,80 (%)		2	9,52	1	4,76	3	14,29
2	> 0,80 (%)		12	57,14	6	28,57	18	85,71
Total			14	66,67	7	33,33	21	100

In 2014, 1 income smoothing companies with DAR <0.8 and 10 companies with DAR > 0.8. In 2015, 1 income smoothing companies with DAR < 0.8 and 9 companies with DAR > 0.8. In 2016, 2 income smoothing companies with DAR < 0.8 and 12 companies with DAR > 0.8 According quartile analysis most of companies with DAR >0.8 conduct income smoothing.

While the point of view of the old investor, they will ask for a high rate of return if it is at risk to be faced. Similarly,

new potential investors will be attracted to companies with low financial risk in order to secure a position when they will invest. Banking companies that have high debt asset value, raises the assumption that the company does not have a promising prospect in the future.

V. CONCLUSION

Income smoothing usually engage in bank sector. Bank' position is very central, bank is intermediaries in society. Based on the research that has been conducted, it can be concluded that profitability, company value, financial risk partially has a positive and significant effect on the income smoothing of banking companies and company size doesn't affect income smoothing. This result support signalling theory. This research also show that major banks that practice income smoothing have PBV 0.82-1.66 and DAR > 0.8.

Next research in income smoothing can analyze accounting activities, such loan loss provision, research and development cost and inappropriate write offs in Indonesia's bank, since that activities used by manager to smooth income [24]. Corporate governance mechanism as agency problem also interesting to explore for further income smoothing research.

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