

# The Positive Accounting Theory, Corporate Governance, and Income Smoothing

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# The Positive Accounting Theory, Corporate Governance, and Income Smoothing

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This research aims to determine factors affecting income smoothing from the positive accounting theory hypothesis viewpoint. Using a logistic regression analysis, it analysed how such variables as a firm size, a bonus, a debt covenant, reputation of Big Four Audit Firms, institutional ownership, managerial ownership, independent commissioners, and the audit committees, affect the firms' income smoothing practices. The data of this research was sourced from the financial statements of listed non-financing companies in Indonesia Stock Exchange (IDX) of 762 samples from the period of 2011-2013. The dependent variable in this research was income smoothing firm status. With a 5% significance level, the results of this research show that the firm size, the bonus, and the audit committee significantly influence income smoothing, while the other variables have no significant effect. The study concludes that the firm size, the bonus, and the audit committee can influence income smoothing practices.

**Key words:** *Corporate Governance, Income Smoothing, Positive Accounting Theory, Reputation of Big Four Audit Firms.*

## Introduction

Corporate financial performance can be viewed from a company's financial report. According to the (Board 1978) Financial Accounting Standard Board No.1 (2009), the purpose of financial report is to provide information of a firm's financial position, performance and changes in financial position that is useful for a great number of interest groups as a basis for economic decision making. Thus, a financial report is an important means of firm's information.

One aspect of interest about financial information in a financial report as a basis for decision making is information on income. According to the Financial Accounting Standard Board



(1992) (Board 1978), income information is useful to evaluate management performance, to assist long-term representative income capacity/ability estimation, and to predict income and investment or credit risk estimation. Thus, income information in a financial report is important information for external parties as a basis for economic decision making.

The positive accounting theory whose purpose is to predict and to explain accounting practices describes the most appropriate accounting policy for certain upcoming condition. (Watts and Zimmerman 1986) mention three hypotheses of managers' opportunistic behaviour to be tested with the positive accounting theory the *Bonus Plan Hypothesis*, the *Debt-Covenant Hypothesis*, and the *Political Cost Hypothesis*.

Non-financing and opportunistic income smoothing practices will give misleading information to interest groups and false information to the economic decision makers and may result in potential mistakes in decision making by economic actors. Such problems and indications lead to the need to investigate the factors influencing income smoothing practices by opportunistic firm management. This study is intended to be a contribution and reference for economic actors and income smoothing literature developers. Previous studies are the basis and reference for analysing the variables that influence income smoothing practices.

This study applies hypotheses from the positive accounting theory and the corporate governance mechanism. This article comprises of a discussion on literature review, research methods, results and discussion, and conclusion of the whole study.

## Literature Review

### *Positive Accounting Theory*

Accounting standard provides flexibility to managers to choose implementable accounting policy for the firm. (Watts and Zimmerman 1986) explain the positive accounting theory as follows: "*Positive Accounting Theory is concerned with predicting such actions as the choice of accounting policies by firm managers and how managers will respond to propose new accounting standards*".

Based on Watts and Zimmerman's concepts of positive accounting theory, managers have certain reasons for choosing accounting policies to be implemented in the firm. The selected policies should have legitimation for standard established by professional boards such as Indonesian Accountant Association (Ikatan Akuntan Indonesia, IAI) or FASB (*Financial Accounting Standard Board*) (Ghofar 2003). Accounting standard becomes an important guide for managers to select firm accounting policies. The selection can be used for efficiency and opportunistic purposes. Efficiency means that the managers can choose the most suitable



accounting policies for their firm business scope with the purpose to maximize the firm value or to minimize the firm contract cost. Managers' opportunistic behaviour aims to maximize their personal interests, such as a default risk, a bonus and a promotion, so that the opportunistic purpose can potentially lead to the practice of management's income smoothing.

The positive accounting theory explains the current accounting phenomenon based on certain present or future condition. (Watts and Zimmerman 1986) postulate three hypotheses in the positive accounting theory: the *Bonus Plan Hypothesis* explaining that the income level-based bonus will encourage the management to choose an accounting method which increases income in the current period; the *Debt-Covenant Hypothesis* stating that a debt covenant will encourage the management to choose an accounting procedure that shifts income from the future period to the present period in order to avoid the potential risks from the debt covenant; and the *Political Cost Hypothesis* which occurs due to the fact that big firms have great resources, business scope and capacity to gain more public attention.

### **Income Information**

According to *Financial Accounting Standards Boards* (Silviana 2011), income information can be utilized as a measuring standard for management performance, for estimating future corporate income capacity, and for estimating the investment risk in an entity. Income information in the corporate financial report comprises projection for selection and implementation of accounting policy by the firm management. The *Financial Accounting Standards Boards* Statement No.25 (revised 2009) mentions the criteria for selection and changes in accounting policy, in line with accounting treatment and accounting policy changes expression, accounting estimation change, and error correction.

### **Income Smoothing**

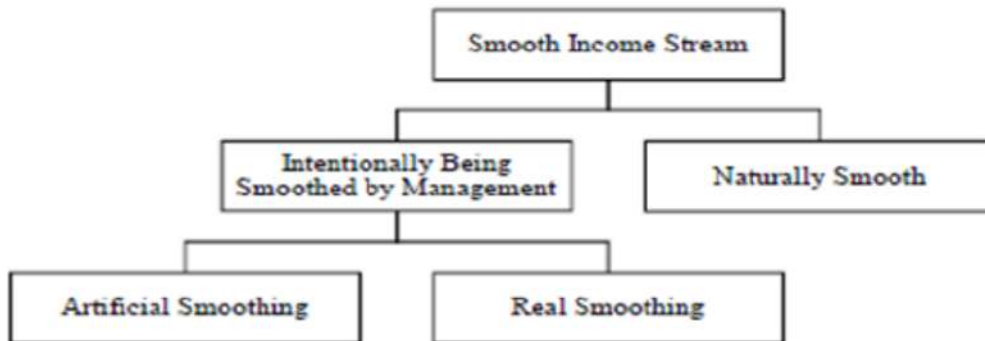
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Income smoothing is one of the methods of income management. According to Scott (2012), income smoothing involves managers deliberate and systematic actions to influence the income rate by selecting a particular accounting policy and accounting procedure to maximize management utility and the firm value. Income smoothing is defined by (Beidleman 1973) as management efforts to reduce income variation fluctuation within allowable accounting and management principles.

(Eckel 1981) distinguishes two types of income smoothing, *naturally smooth* as an impact of firm income cycle based on the real condition and events and *intentionally being smoothed by corporate management* which means that income smoothing is deliberately conducted by the corporate management to build an equal income stream. The latter type of income smoothing is caused by two situations, real smoothing which means that income smoothing is obtained by

controlling economic events through operational and time policies based on real financial transaction resulting a final equal income stream and artificial smoothing which is defined as income smoothing obtained by implementing an accounting method to move income and cost from one period to another.

**Gambar 2.1**

**Tipe Perataan Laba**



Sumber : Norm Eckel, 1981, *The Income Smoothing Hypothesis Revisited*, Abacus Vol 17, No 1

The present study adopts selection criteria of firms with income smooth and non-income smooth status based on Eckel Index. Eckel Index is an income smoothing index developed by (Eckel 1981) that is useful to identify the existence of income smoothing practices in a firm based on income variation coefficient on sales. (Eckel 1981) distinguishes two types of income smooth are *naturally smooth* and *intentionally being smoothed by management*.

The Eckel Index method focuses on *intentionally being smoothed by management*. (Eckel 1981) states that income is a linear function of sales; the variable cost ratio in a currency unit on sales which is assumed to be constant from time to time; the cost which is assumed to have constant value, increase from one period to another, but never reduce; and gross sales which can only be influenced by natural smoothing, not by artificial smoothing. Shareholders have control over management to produce an accurate financial report. Having an equal role as the board of commissioners in monitoring its function, the board composition can also influence management in financial report composition to achieve a qualified income report (Boediono 2005)



**Method**

The present study adopted the quantitative method. The assumptions in the study were measurable variables which were useful to explain mutual relation that began with a hypothesis and theories. The dependent variable (Y) in the study was income smoothing practices calculated based on the Eckel Index. Eckel Index is an income smoothing index developed by (Eckel 1981) that is used to identify income smoothing status or non-income smoothing status of a firm based on the model of income variation coefficient on sales. The Eckel Index is formulated as follows.

$$Income\ Smoothing\ Index = \frac{CV\ \Delta I}{CV\ \Delta S} \dots\dots\dots(1)$$

Notes:

$\Delta I$ : Income changes within a period

$\Delta S$ : Sales changes within a period

CV: Variation coefficient from standard variable divided by expected value

CV  $\Delta I$ : Variation coefficient for income changes

CV  $\Delta S$ : Variation coefficient for sales changes

CV  $\Delta I$  and CV  $\Delta S$  are formulated as follows:

$$CV\ \Delta I\ or\ CV\ \Delta S = \frac{Variance}{Expected\ value}$$

**Firm Size**

The firm size can be viewed in different ways such as total activa (logarithm of natural total active), log activa, and or share market value. The size is formulated as follows (Nasser n.d.)

$$Firm\ Size = Natural\ Logarithm\ (total\ Assets) \dots\dots\dots (2)$$

**Debt Covenant**

*Financial leverage* in this study was measured with *total debt to total asset ratios*. The ratio was calculated from the debt total value divided by the firm total asset value from the firm's financial position (balance). *Total debt to total asset ratios* is formulated as follows (Prabayanti and Yasa 2010).



**Reputation of the Big Four Accounting Firms**

In this study, reputation of the Big Four Accounting Firms was an independent variable to represent corporate governance symbolized with “rept kap”. Firms employing auditor service from accounting firms affiliating to the Big Four Accounting Firms, namely PricewaterhouseCoopers, Deloitte Touche Tohmatsu, Ernst and Young, and KPMG were given value 1, while those which are not affiliated to the Big Four Firms were given value 0 (Sari and Laksito 2011)

**Institutional Ownership**

According to (Jensen and Meckling 1976), low managerial ownership constitutes a potential for manager’s opportunistic action. This also indicates the need for managerial ownership in the firm ownership structure. In this study, institutional ownership was an independent variable to represent the corporate governance symbolized with “kep ins”. The institutional ownership is formulated as follows (Mahariana and Ramantha 2014).

$$\text{Institutional Ownership} = \frac{\sum \text{Institutional share number}}{\sum \text{share number in circulation}} \dots\dots\dots(5)$$

**Managerial Ownership**

In this study, managerial ownership was an independent variable to represent the implementation of corporate governance symbolized with “kep man”. The managerial ownership is formulated as follows (Mahariana and Ramantha 2014).

$$\text{Managerial Ownership} = \frac{\sum \text{Managerial Share Number}}{\sum \text{share number in circulation}} \dots\dots\dots(6)$$

**Independent Commissioners**

In this study, independent commissioners became an independent variable to represent the implementation of corporate governance symbolized with “komis\_ind”. The proportion of independent commissioners is formulated as follows (Astuti and Sudantoko 2013).

$$\text{Independent Ownership} = \frac{\sum \text{Independent Commissioners}}{\sum \text{Board of Commissioners}} \dots\dots\dots(7)$$



### *Auditing Committee*

In this study, auditing committee was an independent variable to represent the implementation of corporate governance symbolized with “komit aud”. Firms with auditing committee conforming to the Stock Exchange Examination Board (BAPEPAM) regulation were given value 1, while those without auditing committee conforming to the BAPEPAM regulation were given value 0 (Wijoyo 2014).

### *Data Types and Data Source*

The secondary data in this study were annual financial reports audited by non-financing firms listed in the Indonesia Stock Exchange of 2011-2013 periods ([www.idx.co.id](http://www.idx.co.id)) related to data for independent variables. The data for dependent variable were annual financial reports audited by non-financing firms listed in the Indonesia Stock Exchange of 2007-2013 periods.

## **Results**

### *Description of Research Variables*

The independent variables in this study comprise the firm size, debt covenants, the bonus, reputation of the Big Four Accounting Firms, institutional ownership, managerial ownership, independent commissioners, and auditing committee while the dependent variable in this study is the income smooth status. The variables in this study have an interval scale and a binary scale (1 and 0). The variables with interval scales are the firm size, the debt covenants, the bonus, institutional ownership, managerial ownership, and independent commissioner while the variables with binary scales are income smooth status, reputation of the *Big Four* Accounting Firms, and auditing committee. A descriptive statistical analysis of the variables with the interval scales is presented in Table 1.

**Table 1:** Descriptive statistical analysis of the variables with interval scales

Variables	Observation	Lowest	Highest	Mean	Deviation Std.
Size	762	22.34878	32.99697	28.09435	1.82871
Debt	762	0.00036	11.84424	0.57885	0.73626
Bonus	762	0.00000	27.84339	19.47810	8.08626
kep_ins	762	0.00000	0.99083	0.66474	0.21800
kep_man	762	0.00000	0.79951	0.03327	0.10196
komis_ind	762	0.14286	1.00000	0.39225	0.10757

Source: Results of Data Analysis





Symbols for the variables in Table 1 are as follows:

size = Firm Size  
debt = Debt Covenant  
bonus = Bonus  
kep\_ins = Institutional Ownership  
kep\_man = Managerial Ownership  
komis\_ind = Independent Commissioner

Descriptive statistics of the variables with binary scales is presented in Table 2.

**Table 2:** Descriptive statistics of the variables with binary scales

Variables	Frequency	Percentage
Income Smooth Status - Non Income Smooth	361	47.4
- Income Smooth	401	52.6
Total	762	100
Reputation of - Non <i>Big Four</i>	461	59.6
- <i>Big Four Firms</i>	301	40.4
Total	762	100
Auditing Committee - Not conforming to BAPEPAM	16	2.1
- Conforming to BAPEPAM*	746	97.9
Total	762	100

**Source:** Results of Data Analysis

Based on the BAPEPAM regulation Number: KEP-643/BL/2012, auditing committee comprises of at least three (3) members from an independent commissioner and an outside emitter or a public enterprise.

#### ***a. Income Smooth Status***

Detailed investigation on firms with income smooth status and those without income smooth status from 2011 to 2013 is presented in Table 3:



**Table 3:** Frequency Distribution of Annual Income Smooth Status

Observation Years	Income Smooth Status		Total
	Non Smooth	Income Smooth	
Years: 2011	121 47.6%	133 52.4%	254 100%
2012	109 42.9%	145 57.1%	254 100%
2013	131 51.6%	123 48.4%	254 100%
<b>Total</b>	361 47.4%	401 52.6%	762 100%

Source: Results of Data Analysis

**b. Reputation of Big Four Audit Firms**

A detailed analysis of firms employing auditing service from the Big Four Audit Firms and those employing auditing service from non-Big Four Audit Firms from 2011 to 2013 is presented in Table 4.

**Table 4:** Frequency Distribution of Annual Big Four Audit Firms

Observation Years	Audit Firms Reputation		Total
	Non-Big Four	Big Four	
Years: 2011	157 61.8%	97 38.2%	254 100%
2012	154 60.6%	100 39.4%	254 100%
2013	150 59.1%	104 40.9%	254 100%
<b>Total</b>	461 59.6%	301 40.4%	762 100%

Source: Results of Data Analysis

**c. Audit Committee**

A detailed analysis of firms with audit committee conforming to the BAPEPAM regulation and those with audit committee not conforming to the BAPEPAM regulation from 2011 to 2013 is presented in Table 5.



### Model Analysis and Hypothesis Testing

A data analysis technique adopted in this study is the logistic regression test due to the dependent variables with the binary scales of 1 and 0. The income smooth status (Y) is the dependent variable, while the independent variables are the firm size, the debt covenants, the bonus, reputation of the Big Four Account Firms (rept\_kap), institutional ownership (kep\_ins), managerial ownership (kep\_man), independent commissioner (komis\_ind), and audit committee (komit\_aud). The logistic regression test in this study adopts factors influencing staged income smoothing practices. Every step (stage) will show the most significant variable. In this study the final step is Step 3 which is used as the reference for statistical calculation results to test the hypothesis.

**Table 5:** Frequency Distribution of Annual Audit Committee Reputation

Observation Years	Audit Committee		Total
	Not conforming to BAPEPAM	Conforming to BAPEPAM	
Years2011	3 1.2%	251 98.8%	254 100%
2012	7 2.8%	247 97.2%	254 100%
2013	6 2.4%	248 97.9%	254 100%
<b>Total</b>	16 2.1%	746 97.9%	762 100%

Source: Results of Data Analysis Result

### Model Fit Test

Regression Model Evaluation (to evaluate fit model) using -2Log Likelihood is seen from the value reduction in the calculation of the first block to the second block. The results of calculation of -2Log Likelihood value is presented in Table 6.

**Table 6:** Results of -2log Likelihood Calculation

Block Numbers	-2log Likelihood
Block Number = 0	1054.256
Block Number = 1*	1036.986

Source: Results of Data Analysis

\*Step 3



### Determination Coefficient

The amount of dependent variable can be explained from the influence of independent variables which is seen from the determination coefficient value of *Nagelkerke R Square*. The determination coefficient value of *Nagelkerke R Square* is presented in Table 7.

**Table 7:** Determination Coefficient Value of *Nagelkerke R Square* from Model Summary

Step	<i>Nagelkerke R Square</i>
3	0.030

Source: Results of Data Analysis

### Model Accuracy Level

The accuracy of logistic regression method in testing the influence of independent variables on dependent variable shows that an increase in percentage shown from calculation means higher accuracy. The calculation is presented in Table 8.

**Table 8:** Results of Calculation of Percentage of Classification Tabel on (Block Number=1)

Observation	Prediction		Percentage Prediction Accuracy
	Status		
	Non-Income Smooth	Income Smooth	
Step 3 Non-smooth Income Status	160	201	44.3
Smooth Income	135	266	66.3
<b>Total Percentage</b>			55.9

Source: Results of Data Analysis

### Logistic Regression Analysis and Hypotheses Testing

The results of logistic regression analysis of independent variables show that the independent variables which insignificantly influence income smoothing practices are the debt covenants, reputation of the Big Four Audit Firm, institutional ownership, managerial ownership, and independent commissioner, whereas the independent variables which considerably influence income smoothing practices are the firm size, the bonus and audit committee. The results of logistic regression analysis are presented in Table 9.



**Table 9: Results of Logistic Regression**

Insignificant variables		Score	Significance
Income Smoothing Status Debt Covenant		2.022	0.155
Reputation of <i>Big Four</i> Audit Firms		3.528	0.060
	Institutional Ownership	0.308	0.579
	Managerial Ownership	0.608	0.436
	Independent Commissioner	0.356	0.551
Significant variables		B	Significance
Step 3	Firm Size	-0.103	0.011
	Bonus*	-0.018	0.047
	Audit Committee**	-1.233	0.057
	Constant	4.580	0.000

Source: Results of Data Analysis

Notes:

\* = Significant at the level 5%

\*\* = Significant at the level 10%

Table 4.9 shows the results of logistic regression equation of the independent variables which have an important influence on income smoothing practices.

$$\text{Income Smooth} = 4.580 - 0.103 (\text{size}) - 0.018 (\text{bonus}) - 1.233 (\text{kom\_aud})$$

The probability value of the firms performing income smoothing practices and those which do not conduct the practices ranges between 0 and 1. The equation value approaching 1 means that the possibility of the firm to perform income smoothing practices is high while the value approaching 0 means that the possibility of the firm to do the practices is low. The odd ratio value (probability) of such variables as the firm size, the bonus, and audit committee that significantly influence income smoothing practices is presented in Table 10.

**Table 10: Odd Ratio Value**

Variables	Exp (B)
Step 3	
Firm Size	0.902
Bonus	0.982
Audit Committee	0.291

Source: Results of Data Analysis



3  
**Discussion**

***The Effect of Firm Size on Income Smoothing Practices***

The present study supports previous studies by (Atarmawan 2011), (Budiasih 2009), (Atarmawan 2011), and (Atarmawan 2011) which show that the firm size influences income smoothing practices. However, the results of the present study do not affirm the *political cost hypothesis* concept of positive accounting theory which states that big firms tend to choose accounting methods that can shift the income of the current period to the future period to reduce the political cost impact. The present study shows, however, that the greater firm size may reduce the potential for income smoothing practices. This may be due to the fact that bigger firms gain more public attention and observation, that they will be more careful in selecting accounting policy and in doing financial reporting. Thus, the greater firm size can reduce income smoothing practices.

***The Effect of Debt Covenant to Income Smoothing Practices***

The results of present study confirm previous studies by (N.L.P 2011), (Budiasih 2009), (Agusti and Pramesti 2009), (Dewi and Hidayat 2010), (Silviana 2011), and (N.L.P 2011). These studies indicate that financial leverage ratios have no influence on income smoothing practices. However, the results of present study do not affirm the concept of *debt covenant hypothesis* of positive accounting theory which states that firms with great debt covenants tend to select an accounting method that can shift income of the future period to the current period to avoid the impact of debt covenant risk.

2  
***The Effect of Bonus on Income Smoothing Practices***

The results of the present study supports the previous study by (Pujiati and Arfan 2013) which shows that a bonus has a negative influence on income smoothing practices. However, the results do not conform with the concept of bonus plan hypothesis of the positive accounting theory which states that firms with high management compensation tend to choose account methods that can shift income from the future period to the current period. Indeed, the results of the present study show that higher compensation for management can reduce income smoothing practice potential, whereas lower management compensation can lead to potential of income smoothing practices.

***The Effect of Big Four Audit Firm Reputation on Income Smoothing Practices***

The results of the present study reinforce the previous studies by (N.L.P 2011), Rahmawati (2012), (Prabayanti and Yasa 2010), (N.L.P 2011) which mention that the reputation of the Big Four Audit Firms has no influence on income smoothing practices. Indeed the capacity,



independence, and professionalism of the auditors of the Big Four Audit Firms seem less likely to contribute to accounting practices implemented by the firm management. Thus, they cannot reduce the possibility of opportunistic income smoothing practices by firm management.

#### ***The Effect of Institutional Ownership on Income Smoothing Practices***

The results of the present study support the previous study by (N.L.P 2011) which states that institutional ownership does not influence income smoothing practices. Share ownership, by outside parties or by institutions, has monitoring and controlling functions with the authority to demand management liability to the present financial information; this conforms to the established accounting principles so that the financial report can present accurate and efficient information for interest groups and can reduce the potential for income smoothing practices.

#### ***The Effect of Managerial Ownership on Income Smoothing Practices***

The results of the present study do not confirm the previous study by (Atarmawan 2011) which mentions that managerial ownership influences income smoothing practices. However, the present study shows insignificant results. This is due to the fact that of all the observed corporates, those with managerial ownership only show the mean of 3.32%. It can be concluded that the small amount of managerial share ownership does not influence the vote on control over the firms.

#### ***The Effect of Independent Commissioners on Income Smoothing Practices***

The present study reinforces previous studies by (Sari and Laksito 2011) and (Astuti and Sudantoko 2013) which reveal that independent commissioners have no influence on income smoothing practices. Meanwhile in this study, the insignificant results do not have much influence on income smoothing practices. Indeed, the insignificant results are not influenced by the number of independent commissioners because more independent commissioners may not necessarily mean better performance of the main duties of the board of commissioners for the enterprise monitoring and as management advisers.

#### ***The Effect of Audit Committee on Income Smoothing Practices***

The results of present study confirm the previous study by (Herni and Susanto 2008) which states that audit committee influences income smoothing practices. The significant influence is due to the important role of the audit committee in a firm. The audit committee's duty and responsibility include evaluating management performance and accounting for the evaluation to the board of directors and shareholders.



## Conclusion

Based on the results of analysis test conducted on the variables, the conclusion of the present study is as follows. The firm size, the bonus and audit committee have a significant influence on income smoothing practices; while the debt covenant policy, the reputation of Big Four Audit Firms, institutional ownership amount, managerial ownership amount, and independent commissioner have no significant influence. This may show that the reputation of the Big Four Audit Firms and audit committees conforming to BAPEPAM regulation are capable of doing a mechanism for corporate governance to reduce the potential for income smoothing practices in all non-financing firms in Indonesia Stock Exchange.

The limitation of the present study is that the role of institutional ownership in the notes on corporate financial report is not explicitly revealed whether it is directed to corporate control or to interests other than controlling. A suggestion is made for a further study to examine the institutional ownership variable that reflects control over a corporation by searching for information from sources other than those used in the present study.





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