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The Influence of Dividend Policy and Income Tax on Income Smoothing

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ABSTRACT

Objective – This research aims to obtain the empirical evidence on the influence of dividend policy, income tax, firm size, profitability, and leverage on income smoothing.
Methodology/Technique – In this research, income smoothing is proxied with the Eckel index and logistic regression is used to test the hypothesis. The research population consists of non-financial companies listed on the Indonesian Stock Exchange from 2013 to 2016. The sampling method used in this research is purposive sampling. The number of companies selected is 79 with 316 data.
Findings – The results show that dividend policy, income tax, profitability, and leverage all have an influence on income smoothing. Meanwhile, firm size has no significant influence on income smoothing.
Novelty – These findings are consistent with a firm's dividend policy and income tax having an incremental impact on income smoothing behavior.
Type of Paper: Empirical.

JEL Classification: M40, M41, M49.

Keywords: Income Smoothing; Dividend Policy; Income Tax; Firm Size; Profitability; Leverage.

1. Introduction

With rapid economic development, the need for accurate financial information has become more important. Income smoothing is one of the approaches in creative accounting whereby companies make adjustments and manipulate company revenue (Saeidi, 2012). Income smoothing is carried out to smooth the income stream of a company (Eckel, 1981). Income smoothing has effect on the company's financial statements. Income smoothing is done for various reasons, for example, to reduce taxes and ensure the company obtains a stable income (Anwar & Chandra, 2017). Income smoothing is a technique of earnings management which involves smoothing reported fluctuations in earnings that are considered normal for the company (Doraini & Wibowo, 2017). Various methods can be carried out by managers as income smoothing actions. Income smoothing can influence investor decisions and have consequences for the capital market (Salehi & Gholami, 2015).

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Dividend policy is the decision to share parts of the profits obtained by the company to shareholders in the form of dividends to be used as capital enhancers to finance future investments (Widhyawan & Dharmadiaksa, 2015).

The burden of income tax is very important for the company. In order to move profits and tax burdens to the next period, management will usually manage and manipulate profits (Bahadori et. al., 2013). Increased profits mean companies will be required to pay large taxes. However, a decline in profits shows poor performance. Thus, managers will conduct income smoothing to minimize their tax burden, whilst still demonstrating good performance (Ratnaningrum, 2016). The research problem is whether dividend policy, income tax, firm size, profitability and leverage affect income smoothing.

2. Literature Review

2.1 Agency Theory

Agency theory refers to the situation whereby one person appoints other people, known as agents, to perform services on their behalf (Jensen & Meckling, 1976). Sometimes, the contract between principals and agents result in conflict because of differences in the interests of each party. An agent may produce financial statements for their own benefit, and not in the interest of the principal, particularly where the data in the financial statements is used to assess their performance (Jensen & Meckling, 1976).

There is a view on income smoothing that management can lie to shareholders and potential shareholders by conducting smoothing practices. By leveling the company's profit pattern, it can be seen that management has a high value for its services (Lambert, 1984). Income smoothing refers to the situation whereby management reports artificial income. The desire to have outstanding performance in each organization is reasonable. However, the motivation for income smoothing may be due to the gaining of some personal benefit (Shiyanbola et. al., 2018).

Contrary to this, the process of income smoothing needs to include the manager's knowledge about the company's performance in the future. When managers can smooth the reported earnings of the company, this reflects the accuracy of the manager's knowledge of the company's potential achievements which is very valuable for the potential investors. Investors are expected to have a positive response to more informative income, which will benefit their wealth. Thus, income smoothing may also be advantageous for both existing shareholders and potential investors (Wang & William, 1994).

2.2 Dividend Policy and Income Smoothing

The Dividend Payout Ratio is a percentage of company income that is distributed to shareholders (Anwar & Chandra, 2017). If there is a fluctuation in profit, companies with a high dividend payout ratio have a greater risk than companies that implement a low dividend payout ratio policy. Thus they are more likely to do income smoothing (Widhyawan & Dharmadiaksa, 2015). The same findings were obtained by Anwar and Chandra (2017), Budiasih (2014), and Ebrahimpour et. al. (2013). Hence, the following hypothesis will be tested:

H1: Dividend policy has an effect on income smoothing.

2.3 Income Tax and Income Smoothing

The taxation system and tax regulations play an important role in determining the accounting policies and methods that the company will use. Companies tend to do income smoothing to minimize taxes, particularly in cases where the company has a large tax debt (Saeidi, 2012). The same findings were obtained by Luqman and Shahzad (2012) and Bahadori et. al. (2013). Hence, the following hypothesis will be tested:

H2: Income tax has an effect on income smoothing.

2.4 Firm Size and Income Smoothing

Large entities are more likely to be noticed by the public compared to smaller entities because decisions made by large entities can have a greater impact on the public. The size of the firm is a scale, which can be classified according to various consideration, including total assets, the market value of stock, etc. Bigger companies have a greater motivation to do income smoothing compared to smaller companies due to tighter supervision by the government and the general public (Budiasih, 2009). The same findings were obtained by Anwar and Chandra (2017), Doraini and Wibowo (2017), and Indrawan et. al. (2018). Hence, the following hypothesis will be tested:

H3: Firm size has an effect on income smoothing.

2.5 Profitability and Income Smoothing

Shareholder confidence will increase when a company has a stable profit, which will have a further impact on share value and capital costs. Hence, companies with lower profitability have more incentive to do income smoothing in order to increase investor confidence (Tseng & Lai, 2007). Income smoothing is also done to increase management confidence because stable profitability will support a stable policy (Anwar & Chandra, 2017). The same findings were obtained by Budiasih (2014), Saeidi (2012), and Indrawan et. al. (2018). Hence, the following hypothesis will be tested:

H4: Profitability has an effect on income smoothing.

2.6 Leverage and Income Smoothing

Financial leverage is the level of a company's financial obligations to other parties that have not been met. The indication that the company is conducting income smoothing to avoid violating existing debt agreements can be seen through the company's ability to pay its debt using its assets. Companies that have a high degree of leverage are thought to practice income smoothing because the company has a high risk, so management makes policies can increase revenue (Widhyawan & Dharmadiaksa, 2015). The same findings were obtained by Doraini and Wibowo (2017), Fanani and Pracistia (2014), and Indrawan et. al. (2018). Hence, the following hypothesis will be tested:

H5: Leverage has an effect on income smoothing.

3. Research Methodology

The research population consists of non-financial companies listed on the Indonesian Stock Exchange. The sampling method used is purposive sampling with a research period from 2013 to 2016. The research sample includes non-financial companies listed on the Indonesia Stock Exchange in 2010-2016, with financial statements ending on December 31 reported in Rupiah, and profits and distributed dividends. The data used in this research includes secondary data obtained from the companies' annual financial statements. The number of companies sampled is 79, with 316 data results. Logistic regression is used to test the hypotheses in this research.

3.1 Operational Definition

The goal of income smoothing is to generate a steady stream of earnings growth. Income smoothing is basically a decrement in profit variance (Stolowy, 2004). This research is based on Eckel's (1981) method of determining income smoothing. This research uses the coefficient of variation to measure the variability of sales and income. The formula for measuring income smoothing is as follows (Saeidi, 2012):

$$IS = CV\ \Delta I / CV\ \Delta S \qquad (1)$$

$$CV\Delta I = \frac{\sqrt{\sum(\Delta I_i - \Delta\bar{I})^2 / n-1}}{\Delta\bar{I}} \qquad (2)$$

$$CV\Delta S = \frac{\sqrt{\sum(\Delta S_i - \Delta\bar{S})^2 / n-1}}{\Delta\bar{S}} \qquad (3)$$

A company is considered to do income smoothing if the Eckel index is smaller than 1 and is considered not to do income smoothing if the Eckel index is more than 1. This variable uses a dummy variable, income smoothing, which is given a value of 1, while no income smoothing is given the value of 0 (Budiasih, 2009).

Dividend policy is measured using the dividend payout ratio (Budiasih, 2009). The dividend payout ratio (DPR) is the amount of dividends paid per share against earnings per share. Dividend policy in this research sets the percentage of profit that will be paid to shareholders as cash dividends. Income tax is tax that must be paid by the company based on its' net operating profit. The amount of income tax due is calculated by the income tax expenses paid by the company (Ratnaningrum, 2016).

Firm size is calculated by the natural logarithm of total assets. Return on Assets (ROA) is an important measure to assess the health of a company, which affects the decision by investors to invest in the company. Profitability is measured by the ratio between net profit before tax and total assets. Financial leverage shows the proportion of debt used to finance its investments. Leverage is measured as the ratio between total debt and total assets (Budiasih, 2009).

4. Results

The results of the statistical test can be seen in Table 1 below.

Table 1. Hypotheses Results

Variable	B	Sig.
(Constant)	-1.002	0.731
Dividend Policy	1.676	0.003
Income Tax	0.001	0.035
Firm Size	0.064	0.523
Profitability	-7.956	0.000
Leverage	0.312	0.027

5. Discussion

Table 1 shows that dividend policy, income tax, profitability, and leverage all have an influence on income smoothing, while firm size has no significant effect on income smoothing. The result show that the size of the dividend depends on the size of the profits obtained so that the company tends to practice income smoothing.

When a company wants to share a stable dividend for it's' shareholders, the company must also have a stable income stream. The lower the profitability of the company, the more likely the management will flatten profits so that fluctuations do not occur from period to period whilst still providing good performance.

Conversely, the higher the profitability of the company, the less likely the manager will conduct income smoothing, because the company demonstrates good potential for investors. High debt levels indicate high risk, hence, management will tend to do income smoothing to reduce risk. This aims to show good information to shareholders and potential investors. Investors will prefer companies with lower risk levels and good performance. Hence, the condition of the company becomes an important basis for the decision to do income smoothing.

Reducing the variance of companies' net profit from one period to the next is achieved by many companies that use income smoothing; from year to year, the level of profit is shown in an organized manner. The aim of this is to reduce the company's tax burden, management rewards, and to increase investor confidence (Al-Taie et. al., 2017). Large income tax expenses will also encourage companies to make policies that flatten profits and minimize taxes. Balanced profit throughout the period also ensures that the company is not burdened with large taxes.

6. Conclusion

The results of this research show that dividend policy, income tax, profitability and leverage all have an influence on income smoothing. Meanwhile, firm size has no significant effect on income smoothing. Dividend policy has a positive effect on income smoothing because of the company's desire to distribute dividends encourage managers to do income smoothing. Stakeholders are attracted to companies with a high degree of certainty. Leveling profits and reducing variations in earnings changes can minimize dividend payout ratio fluctuations and minimize the likelihood that companies will change dividend levels (Liu & Espahbodi, 2014).

A stable profitability level also demonstrates good management performance. High leverage identifies high risk companies meaning that management is more likely to do income smoothing. On the other hand, firm size may not influence income smoothing. The size of the company does not make management carry out income smoothing, but the condition of the company will encourage income smoothing practices. Thus, regulators must set limits in order to protect investors and stakeholders so that income smoothing practices do not harm the other party.

This research has several limitations that can be corrected in future studies. The research objects used are the non-financial company listed on the Indonesian Stock Exchange and the research period used is 2013-2016. It is recommended that future studies widen the population used and study period. Future studies may also compare the factors that affect income smoothing in several countries over a longer period of time.

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