Eurasia: Economics & Business, 3(57), March 2022
DOI https://doi.org/10.18551/econeurasia.2022-03

UDC 336

INCOME SMOOTHING PRACTICES IN INDONESIAN BANKING SECTOR BEFORE AND DURING THE COVID-19 PANDEMIC

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ABSTRACT

The Covid-19 pandemic has given rise to the decrease in community activities followed by the decline in economic activities. It also affects the decline of company's performance, including in the banking sector. The impact is related to financial statements that seem not good so that it will precipitate managers to carry out earnings management, one of which is the income smoothing method. This study was intended to examine differences in income smoothing practices in banking companies before the COVID-19 pandemic and during the Covid-19 pandemic. The statistical method applied to test the hypothesis in this study was the Mc Nemar test. The data collection technique used purposive sampling from the quarterly financial report data of both conventional and Islamic banking companies in the 2018 and 2020 periods. Thus, a sample of 31 banking companies is acquired from the purposive sampling result. The results of hypothesis testing using Mc Nemar's test reveals that the significance level of p-value is 0.453 which is greater than (5%) so that Ho is accepted. It indicates that there is no difference in the practice of income smoothing in banking companies before the COVID-19 pandemic and during the Covid-19 pandemic.

KEY WORDS

Income smoothing, Covid-19, banking.

The first case of COVID-19 transmitted infection appeared on March 2, 2020 in Indonesia and so far on November 25, 2021, more than one million people have been infected with this virus. The government uses the PPKM (Enforcement of Community Activity Restrictions/ PPKM) mechanism to break the chain of distribution. This PPKM restrict the activities of the community and also limits the activities of the company. Susilawati, Reinpal, and Agus (2020) stated that the COVID-19 pandemic had a major impact on the transportation, tourism, trade, health and other sectors. The biggest impact has been perceived by the household sector. Sukendri (2021) stated that the COVID-19 pandemic had an impact on the company's liquidity. When trading activities are disrupted, it will have an impact on the decline in company profits. If the company's income and people's income decrease, it is possible that there will be a lot of bad loans and in the end the bank's profit will decrease.

Positive accounting theory states that managers manage reported earnings because of the explicit contracts awarded to them related to accounting numbers Ozili & Outa (2018). In other words, the accounting numbers contained in the financial statements are generated not only from the company's operational activities but also from the selection of accounting methods used to produce the financial information. Watts Zimmerman (1990) and Ozili & Outa (2018) mentioned that explicit contracts given to managers will motivate them to use accounting methods in changing accounting information that will be used to: increase bonuses, avoid debt covenant violations, avoid political costs associated with reported income. Earnings management is a potential use of accrual management in obtaining personal gain (Belkaoui, 2007). Salno and Baridwan said that this earnings management practice could be influenced by the existence of a conflict of interest between the management and the owner of the company, where they both wanted to maintain the level of prosperity they wanted. Moreover, Scott (2000) had idea that earnings management can be done by: Taking a bath, Income minimization, Income maximization, Income smoothing. From the various types of income smoothing practices, according to Rahmawati (2012) the most frequently used earnings management practice is the practice of income smoothing.

Income smoothing is a technique used by managers to meet managerial expectations, and to reduce high profits in good years and conversely increase low profits in bad years so that reported earnings never appear too high or too low (Ozili & Outa, 2018). It can be said that income smoothing is carried out by management to reduce abnormal variations in earnings in a way that is still permitted in accounting practice. Management that runs the financial numbers game will get a reward, and the reward is likely to encourage managers to practice income smoothing. Mulfrod and Comiskey (2002) said that there are rewards from the financial numbers game.

Investors take a great attention to the level of profitability. It is what drives managers to practice income smoothing (Asih and Gudono, 2000). The COVID-19 pandemic that has occurred around the world has brought economic conditions into crisis. During the economic crisis due to the COVID-19 pandemic, it is possible for companies to make some adjustments to accounting policies in order to cope with the impact of the economic crisis that has occurred (Ching, Pei & Yu, 2017). When economic conditions decreases, managers make some choices to increase profits until economic conditions recover (Graham et al. 2005). The same thing was also expressed by Kim & Yi (2006), managers are more likely to manipulate earnings in times of crisis. Sadka (2011) mentioned that the financial crisis played a major role in reporting corporate profits. In other words, the company's profit reports will be greatly influenced by global financial conditions.

The research of Baik and Farber (2019); Wijaya and Hadi (2020); Sutrisno and Fikri (2020) found that profitability influenced the practice of income smoothing. The research of Yang, Boon and Xiaoming (2012); Herdjiono and Paulus (2019) also revealed that in addition to profitability, financial risk also affects income smoothing practices. The COVID-19 pandemic has caused many companies to experience a decline in profitability. In addition, the company's financial risk also increases due to uncertain economic conditions. These kinds of conditions make management be motivated to practice income smoothing. It is done to show that management has a good performance. The practice of income smoothing is carried out by management to be on view that even in times of crisis, the company still has stable profits so that stakeholders can give good value to management performance. Thus the practice of income smoothing will increase during this covid 19 pandemic. From the description, the researcher took the following hypothesis:

Ho: There is no difference between the practice of income smoothing before the covid 19 pandemic and during the covid 19 pandemic.

Ha: There is a difference between the practice of income smoothing before the covid 19 pandemic and during the covid 19 pandemic.

METHODS OF RESEARCH

The population in this study were banking companies listed on the Indonesia Stock Exchange in the period 2018 and 2020. The sampling technique used in this study is purposive sampling with the following criteria: Banking companies that issue quarterly financial reports in 2018 and 2020, and Banking companies listed on the Indonesia Stock Exchange for the period 2018 and 2020. This study only used one variable, namely income smoothing. Income smoothing is a management action in minimizing fluctuations in profit levels from time to time. This study used the same dummy variable as the research conducted by Suwito and Arleen (2005). The dummy variable in this study is a value of 1 (one) for companies that do not practice income smoothing and a value of 0 (zero) for companies that practice income smoothing.

The practice of income smoothing is calculated using the Eckel Index (1981) using the Coefficient Variation (CV). The formula for calculating the Eckel Index is as follows:

$$Income\ smoothing\ index = \frac{CV\ \Delta I}{CV\ \Delta S}$$

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Where: $CV\,\Delta I$ = Profit changes in a period; $CV\,\Delta S$ = Selling changes in a period; CV = The variable coefficient of variation is the standard deviation divided by the expected value; If Eckel index > 1, then the company does not perform income smoothing; If Eckel index < 1, then the company performs income smoothing.

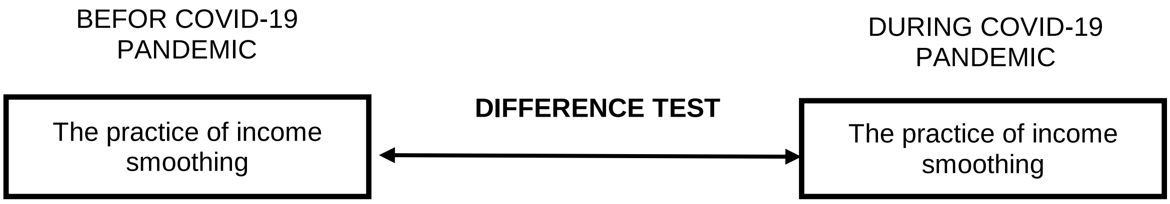

Figure 1 – Research Model

This study examines one variable that is categorical (nominal or non-metric). To test this nominal variable, Mc Nemar's test (1947) was used. Mc Nemar test is a statistical test used on paired data. This test is applied to a 2 x 2 contingency table to determine if rows and columns have the same marginal frequency. The formula for calculating the Mc Nemar statistical test value is as follows:

$$:\boldsymbol{x^2} = \frac{(|\boldsymbol{b-c}| - \mathbf{1})^2}{\boldsymbol{b+c}}$$

The calculated x^2 value will be compared with the x^2 table value with *df* 1. If the calculated x^2 value is greater than the x^2 table value with df 1 then *Ho* is accepted and *Ha* is rejected.

RESULTS OF STUDY

The results of data processing of banking companies using the Eckel index produce the following data:

Table 1 – Contingency Table

		During COVID-19 Pandemic		
		0	1	Row Sum
	0	*3*	*5*	*8*
Before COVID-19 Pandemic	1	*2*	*21*	*23*
	Column Sum	*5*	*27*	*31*

Source: Data processed, 2022.

Data from the table if the value of $\frac{1}{2}$ (b + c) > 5 then the statistical test value to be read is the chi-square value, but if the value of $\frac{1}{2}$ (b + c) < 5 then the statistical test results to be read are the binomial test values and not the chi square value. From the calculation results obtained the following results:

$$\frac{1}{2}(b + c) > 5$$
$$\frac{1}{2}(5 + 2) > 5$$
$$\frac{1}{2}(7) > 5$$
$$3{,}5 < 5$$

From these results, the reading of the data from the statistical test results is the binomial test. The following are the results of the Mc Nemar test:

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Table 2 – McNemar Test Before and During the Covid-19 Pandemic

Before COVID-19 Pandemic	During COVID-19 Pandemic	
	Making Income Smoothing Practices	Not Making Income Smoothing Practices
Making Income Smoothing Practices	3	5
Not Making Income Smoothing Practices	2	21

Source: Data processed, 2022.

Table 3 – Test Statistic

	Before And During The Covid-19 Pandemic
N	31
Exact Sing (2-tailed)	.453[b]

Source: Data processed, 2022.

The contingency table results exactly match to the manually calculated contingency table results. Hypothesis testing has been done by reading the results of the Statistical Test table, namely the Exact Sig. (2-tailed), which shows the number 0.453. This value will be compared with the value of (5%). The results reveal that the significance value is 0.453 > the value of (00.05) then *Ho* is accepted. It indicates that there is no difference in the practice of income smoothing in banking companies before and during the Covid-19 pandemic.

DISCUSSION OF RESULTS

The absence of differences in the practice of income smoothing in banking companies before and during the COVID-19 pandemic is possible because management experience that their performance would not be overly assessed by stakeholders. Stakeholders have the perception that the company's poor performance is the impact of the global economic crisis that affect the world due to the COVID-19 pandemic. With this perception, management is not motivated to practice income smoothing but adopts other earnings management patterns. The data in the contingency table shows that the banking companies that practiced income smoothing before the COVID-19 pandemic amounted to 8 companies, but during the COVID-19 pandemic it fell to 3 companies. It is possible because the company prefers to carry out another pattern of earnings management, namely in the form of big bath earning management or income minimization to maximize management profits during the COVID-19 pandemic.

During the COVID-19 pandemic, the economy experienced a decline, including in Indonesia. This creates an opportunity for management to carry out earnings management. Earnings management that is carried out is not only income smoothing but also more extreme earnings management, namely big bath earning management. Management assumes that during this pandemic there will be no problem if the company experiences a significant decrease in profit because the most of companies also experience a decrease in profit. Stakeholder perceptions of management performance have changed during this COVID-19 pandemic. In normal times, stakeholders have the perception that if a loss occurs it is due to poor management performance. However, during this pandemic, the perception of stakeholders has changed, namely if the company suffers a loss, it becomes a natural thing. It makes management dare to do big bath earning management. Management assumes that instead of just doing income smoothing, management should do the big bath earning management as well.

Management prefers to do a big bath earning management pattern rather than income smoothing because management assumes that stakeholders will not blame management if the company experiences an extreme decline in profits during the pandemic since the economic condition has been experiencing a decline. With the big bath earning management pattern, management tries to shift future costs to the current period. The impact could be that current costs will be large and of course profits will decrease drastically. In the financial statements of the next period, there will be a decrease in costs because they have been absorbed in this period and the effect is a significant increase in profit. This significant increase in profit will be responded positively by stakeholders, which will ultimately benefit management. Stakeholders will appreciate the performance of management that is considered able to increase profits significantly.

The earnings management pattern used by managers during this pandemic is the income minimization pattern. The goal is clearly to reduce tax payments to the government. This income minimization pattern is almost similar to the big bath earning management pattern but in a less extreme form. With this income minimization pattern, the level of profit reduction is not too extreme, but the goal of saving tax costs is still achieved. The performance of management that follows this pattern will still be considered good by stakeholders because the decline in profits is not too extreme in the midst of this declining economic condition.

Implications of Research Results

The results of this research show that there is no difference between the practice of income smoothing before and during the covid 19 pandemic. Thus, there is a possibility that management will carry out other earnings management methods such as big bath earning management or income minimization as a response to the covid 19 pandemic.

CONCLUSION

Based on the results of the Mc Nemar test that has been carried out with a sample of banking companies listed on the IDX for the period 2018 and 2020, a sample of 31 reveals that there is no difference in the practice of income smoothing in banking companies before and during the COVID-19 pandemic. It means that the average income smoothing practice that occurred before the COVID-19 pandemic with the average income smoothing practice during the COVID-19 pandemic in banking companies are the same. This study has limitations that is only testing one earnings management variable in the form of income smoothing, although there are other methods for conducting earnings management. For further research, it is expected to be able to test other various earnings management methods such as big bath earning management or income minimization as a form of management action in dealing with the COVID-19 pandemic situation

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