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Analysis of Factors Affecting Income Smoothing of Sharia and Non-Sharia Stock Companies

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Abstract

This study examines the factors impacting income smoothing practices in both Sharia-compliant stock companies and non-Sharia stock companies. The study utilizes the Eckel index to calculate income smoothing. Among the findings, 116 Islamic stock companies and 43 non-Sharia stock companies were identified as engaging in income smoothing. The independent variables considered in this study include family ownership and tax avoidance, while firm size and leverage are used as control variables. The research employs panel data regression for data analysis. The study results reveal that the factors influencing income smoothing in Islamic stock companies are similar to those in non-Sharia stock companies, though they have differing effects. Family ownership exhibits a positive and significant impact on income smoothing in both Sharia and non-Sharia stock companies. However, tax avoidance has a positive and significant effect on income smoothing in Sharia stock companies, while it has the opposite effect on non-Sharia stock companies. As for the control variables, firm size does not significantly influence income smoothing in either type of company, and neither does leverage.

Keywords: Family Ownership, Tax Avoidance, Firm Size, Leverage, Income Smoothing.

1. Introduction

Investors generally favor companies that demonstrate stable earnings since such stability is commonly associated with strong corporate performance [1]. Income smoothing is considered attractive by the company, where by doing income smoothing the company can reduce significant fluctuations in its financial statements which will give the impression of good financial stability so as to increase investor confidence and a good reputation in the market [2]. Income smoothing is one part of earning management that reflects the allocation of income and expenses, where income smoothing is done by not reporting profits in high periods by making them reserves and reported in low periods to maintain the stability of these profits. Income smoothing actually also has a specific purpose to produce a consistent increase in company income, where by doing income smoothing, the reported profit experiences small changes that are needed to smooth cash flow [3].

Income smoothing is actually still considered reasonable, but this income smoothing practice is basically not recommended in correct accounting practices, because income smoothing involves manipulating earnings to create an impression of stability that is not true, this is contrary to the principles of transparency and conservatism in financial reporting, where the concept of correct accounting emphasizes the importance of producing accurate and reliable financial statements [4]. Conversely, accounting regulators are likely to make efforts to restrict management's capacity to engage in income smoothing practices. Income smoothing is sometimes also done by management to hide the poor performance of the company. Managers demonstrate a high level of proficiency in applying income smoothing strategies, leading them to frequently employ such tactics for diverse reasons related to capital market motivations, compensation and bonus systems, and the conditions of debt or loan agreements that hinge on the company's financial performance [5].

Income smoothing may occur as a consequence of information asymmetry between the agent and the principal. In the context of agency theory, it is elucidated that the agent and the principal hold distinct levels of control, with one of them, typically the agent, possessing greater access to information [6]. Agents have more access to financial reports. As a result of this difference, agency conflict will arise [7]. Where, in practice the principal is not always the person responsible for carrying out the company's operational activities, they usually appoint people who have more expertise in managing the company, namely the agent. Thus, agents who are in the company every day to carry out company operations, agents who are richer in information in the company [8]. This can be utilized for personal interests, one of which is by practicing income smoothing. The agency conflict can be reduced by an ownership structure mechanism called convergence of interests, where ownership here refers to family ownership, in his research he explained that when ownership is more concentrated in the family, where family ownership will cause less encouragement for managers to behave opportunistically, because family members who control the company tend to have a long-term view and are more concerned with the long-term welfare of the company [9].

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When the companies have high family ownership, families can monitor company managers more closely so that managers do not act in their personal interests [10]. If the family ownership can have a strong effect on the way the company operates and interacts with stakeholders, where the existence of family ownership can reduce agency conflict.

Agency conflicts can also lead to tax avoidance, which in turn can influence the practice of income smoothing. Tax avoidance refers to a company's deliberate efforts to minimize its tax liability [11]. Companies will usually try to find ways to avoid taxes by paying less tax in bad economic conditions so that their expenses are reduced and will increase their income [12]. It is found that there is a significant influence between income smoothing and tax avoidance. The same thing was also stated by The act of tax avoidance has an impact on the strategy of profit manipulation employed by businesses [13]. It is stated that variations between tax regulations and accounting principles related to profit recognition provide management with opportunities to manipulate profits.

In this research, control variables such as company size and financial leverage are employed. That larger companies often adopt income smoothing practices, primarily due to their typically more varied income streams. Which suggests that larger companies are more inclined to engage in earnings manipulation. Emphasized that leverage can incentivize earnings management behaviors [14]. This is because earnings figures play a significant role in the financial ratios used in debt agreements, prompting managers to potentially manipulate earnings upwards to avoid violating predetermined financial ratios in debt agreements and safeguard the company's position in debt negotiations.

Agency theory is rooted in the dynamics between two parties: the principal, who delegates specific responsibilities and choices, and the agent, The core principle of agency theory revolves around the assumption that agents might exhibit opportunistic behavior, particularly when their interests clash with those of the principal, as pointed out. The agent problem manifests when the agent is confronted with a choice between acting in the principal's best interests, their own self-interest, or finding a middle ground when these interests are not aligned. Agency theory serves as a framework to anticipate how individuals will act when the principal entrusts them with tasks, expecting them to make decisions that align with the principal's interests [15].

Earnings management is a strategy employed by managers to manipulate financial results in order to meet specific targets determined by the managerial team [16]. Propose that earnings management involves the utilization of accounting policies by management to align them with the manager's objectives, enabling them to attain desired outcomes. Inncome smoothing refers to a method employed by management to minimize variations in earnings through the application of specific accounting policies management engages in income smoothing because both management and investors prefer consistent profits over fluctuating ones.

Family ownership refers to a situation in which a significant portion of a company's ownership or management is controlled by members of identify family ownership, it's common to consider a shareholding threshold of 20% or higher, along with the participation of family members on the company's BOD [17]. Tax avoidance encompasses actions that lower a corporation's tax burden compared to its pre-tax earnings. In a conceptual sense, tax avoidance represents a spectrum of measures employed to diminish tax obligations, ranging from complete adherence to tax code requirements to engaging in tax sheltering and illegal tax evasion [18]. As a company departs from full tax compliance, the degree of tax avoidance escalates, often adopting a more aggressive stance.

There are two theories expounding the connection between family ownership and the practice of managing earnings. The first theory is the alignment theory, which posits that businesses owned by families are inclined to provide more transparent information and curtail their engagement in earnings manipulation tactics [19]. Second, the entrenchment effect theory, this theory states that companies with high family ownership can cause a lack of good information disclosure and low earnings quality, because family members who have control over the company tend to have great capacity and influence over the company's operations, so they will be encouraged in negative practices, one of which controls managers to carry out income smoothing which has a negative impact on minority shareholders. Concluded that family ownership indeed leads to a decrease in earnings management practices [20]. H1a is The presence of family ownership significantly and negatively influences the utilization of income smoothing techniques in Sharia stock companies. H1b is The presence of family ownership significantly and negatively influences the utilization of income smoothing techniques in Non-Sharia stock companies.

Tax avoidance constitutes a legally sanctioned strategy employed by companies to reduce their tax obligations. Propose that tax avoidance involves organizations retaining funds within the company that would otherwise be owed to the government, thereby enhancing firm value. This practice of tax avoidance is often influenced by agency theory, where the division of authority between managers (agents) and company owners (principals) can create opportunities for managers to exploit tax avoidance strategies. H2a is Tax avoidance significantly and positively influences the practice of income smoothing in Sharia stock companies. H2b is Tax avoidance significantly and positively influences the practice of income smoothing in Non-Sharia stock companies.

2. Research Method

In this study, quantitative research techniques were utilized, making use of secondary data. The data for this research were sourced from the financial reports of companies publicly traded on the Indonesia Stock Exchange, covering both Sharia-compliant and non-Sharia-compliant organizations, for the period from 2019 to 2021. The research encompassed all publicly listed stock companies on the Indonesia Stock Exchange (IDX) from 2019 to 2021, regardless of whether they were Sharia-compliant or not. The sample for the study was carefully selected using a purposive sampling technique. As a result, the study incorporated 116 Sharia-compliant stock companies and 43 non-Sharia-compliant stock companies, all of which displayed income smoothing patterns determined through the Eckel index calculation.

In this research, panel data regression analysis was applied, involving the examination of three separate models: the common effect model, fixed effect model, and random effect model. The selection among these models was made following a series of tests carried out to determine the most appropriate one. Specifically, the study used the Chow test, Hausman test, and Lagrange multiplier test as essential elements in the model selection process.

3. Result and Discussion

The research have a statistic descriptive presented in Table 1.

Table 1. Descriptive Statistic of Sharia Stock Company

Variable	Obs	Mean	Std,Dev	Min	Max
Income smoothing	348	0.23	0.53	-0.96	0.99
Family ownership	348	0.34	0.47	0	1
Tax avoidance	348	0.30	0.53	0	8.61
Firm size	348	23.28	5.28	13.06	31.65
Leverage	348	0.97	1.59	0.03	24.84

The research have Descriptive Statistic of Non-Sharia Stock Company presented in Table 2.

Table 2. Descriptive Statistic of Non-Sharia Stock Company

Variable	Obs	Mean	Std,Dev	Min	Max
Income smoothing	129	0.47	0.40	-0.56	0.99
Family ownership	129	0.20	0.40	0	1
Tax avoidance	129	0.26	0.42	0	4.05
Firm size	129	22.43	5.34	11.37	31.74
Leverage	129	1.97	2.24	0.003	11.33

Examining the table provided, it becomes evident that income smoothing values for sharia stock companies exhibit a range of variations. The minimum recorded income smoothing value is -0.56, indicating that certain sample companies decreased their profits by this extent as part of their income smoothing practices. Conversely, the maximum income smoothing value is 0.99, signifying that certain sample companies enhanced their profits by up to 0.99 through income smoothing. On average, income smoothing contributed to a profit increase of 47% (average value of 0.47) in the sample companies, and the variability in these figures is reflected by the standard deviation of 0.40.

The research have Chow Test Results of Sharia Stock Companies presented in Table 3.

Table 3. Chow Test Results of Sharia Stock Companies

Effect Test	Prob
Cross section F	0.00000
Cross section Chi-square	0.00000

In the table, it's evident that the probability value < 0.05, then , FEM is chosen. The research have Chow Test Results of Non-Sharia Stock Company presented in Table 4.

Table 4. Chow Test Results of Non-Sharia Stock Company

Effect Test	Prob
Cross section F	0.00000
Cross section Chi-square	0.00000

Based on the table above, it is apparent that the probability value < 0.05. Therefore, the selected model is FEM. The research have Results of the Hausmen Test of Sharia Stock Companiespresented in Table 5.

Table 5. Results of the Hausmen Test of Sharia Stock Companies

Test Summary	Prob
Cross section random	0.0000

In the table above, it is evident that the probability value < 0.05. Then, FEM is chosen. The research have Results of the Hausmen Test for Non-Sharia Stock Companies in Table 6.

Table 6. Results of the Hausmen Test for Non-Sharia Stock Companies

Test Summary	Prob
Cross section random	0.1387

In the table above, it's apparent that the probability value > 0.05, which indicates that the chosen model is REM.

Table 7. Lagrange Multiplier Test Results of Sharia Stock Companies

Test Summary	Prob
Breusch-pagan	0.0000

The findings from the Lagrange multiplier test presented in the table reveal that the cross-section Breusch-food value < 0.05. However, it's important to note that both the Chow test and the Hausman test have previously indicated that the fixed effect model (FEM) is the most suitable model for this study. Therefore, based on these earlier results, the optimal model for this study remains the fixed effect model (FEM). The research have Lagrange Multiplier Test Results of Non-Sharia Stock Companies presented in Table 8.

Table 8. Lagrange Multiplier Test Results of Non-Sharia Stock Companies

Test Summary	Prob
Breusch-pagan	0.0000

In the table, it's evident that the Breusch-Pagan value > 0.05. Therefore, the most suitable choice for this research is REM. The research have Results of the Coefficient of Determination (R2) of Sharia Stock Companies presented in Table 9.

Table 9. Results of the Coefficient of Determination (R2) of Sharia Stock Companies

Weighted Statictics	
Adjusted R-squared	0.9960

According to the test results employing the fixed effect model, the coefficient of determination R-square, as presented in the table, is calculated as 0.9960. This signifies that the independent variables, including family ownership and tax avoidance, along with the control variables firm size and leverage, collectively account for approximately 99.60% of the variation in the dependent variable, which is income smoothing among Sharia stock companies. The remaining 0.40% of the variation is attributed to other variables that are not considered within the scope of this study. The research have Results of the Coefficient of Determination (R2) of Non-Sharia Stock Companies presented in Table 10.

Table 10. Results of the Coefficient of Determination (R2) of Non-Sharia Stock Companies

Weighted Statictics	
Adjusted R-squared	0.0784

Based on the test results utilizing the fixed effect model, the coefficient of determination R-square, as displayed in the table, is computed as 0.0784. This implies that the independent variables, including family ownership and tax avoidance, in addition to the control variables firm size and leverage, collectively account for approximately 7.84% of the variation in the dependent variable, which is income smoothing among Islamic stock companies. The remaining 92.16% of the variation is attributed to other variables that are not considered within the scope of this study. The research have Statistical T Test Results of Sharia Stock Companies with Fixed Effect Model presented in Table 11.

Table 11. Statistical T Test Results of Sharia Stock Companies with Fixed Effect Model

Variabel	Coefficient	Std.error	t-statistic	Prob
Cosnt	0.0014139	0.0720463	0.02	0.984
Family ownership	0.1665924	0.080513	2.07	0.040*****
Tax avoidance	0.8072951	0.0403763	19.99	0.000*
Firm size	-0.1349625	0.378385	-0.36	0.722
Leverage	0.3279948	0.3509362	0.93	0.351

Based on the test results using the fixed effect model, as summarized in the table above, it is evident that the dependent variable family ownership (X1) exhibits a statistically significant positive effect on income smoothing, with a coefficient of 0.1665924. This implies that for every 1% increase in family ownership, there is a corresponding reduction in income smoothing by 16.65%.Additionally, the independent variable tax avoidance (X2) demonstrates a statistically significant positive effect on income smoothing, with a coefficient of 0.8072951. This suggests that for every 1% increase in tax avoidance, there is an associated increase in income smoothing by 80.72%. The research have Statistical T Test Results of Non-Sharia Stock Companies with Random Effect Model presented in Table 12.

Table 12. Statistical T Test Results of Non-Sharia Stock Companies with Random Effect Model

Variabel	Coefficient	Std.error	t-statistic	Prob
Cosnt	-0.09510815	0.9123606	-1.04	0.297
Family ownership	0.2452931	0.1185197	2.07	0.038*
Tax avoidance	-0.1907813	0.0848469	-2.25	0.025*
Firm size	0.4439895	0.5203723	0.85	0.196
Leverage	0.1355638	0.1049366	1.29	0.861

Based on the test results using the random effect model, as summarized in the table above, it is evident that the independent variable family ownership (X1) exerts a statistically significant influence on income smoothing, with a coefficient of 0.2452931. This implies that for every 1% increase in family ownership, there is an associated increase in income smoothing by 24.52%. Furthermore, the independent variable tax avoidance (X2) demonstrates a statistically significant negative effect on income smoothing, with a coefficient of -0.1907813. This suggests that for every 1% increase in tax avoidance, there is a corresponding reduction in income smoothing by 19.07%.

The Impact of Family Ownership on the Practice of Income Smoothing in Sharia-Compliant Stock Firms. The findings of this study reveal a contrasting outcome, wherein family ownership has a positive and significant effect on income smoothing. This is supported by the coefficient result of 0.1665924, which is statistically significant at the 0.040 significance level. In practical terms, this suggests that for every 1% increase in family ownership, there is a corresponding increase in income smoothing by 16.65%. Consequently, based on these results, the initial hypothesis must be rejected. The findings of this study contradict the research which also suggested that when a company possesses high levels of family ownership, the family can exercise closer monitoring over company managers to prevent them from pursuing personal interests.

The results of this study align with the entrenchment, This theory suggests that companies with high family ownership can lead to insufficient information disclosure and lower earnings quality. This occurs because family members who wield significant control over the company may possess considerable power and influence over its operations, potentially encouraging negative practices. Among these practices is the control of managers to engage in income smoothing, which can adversely affect minority shareholders.

The Impact of Family Ownership on the Practice of Income Smoothing in Non-Sharia-Compliant Stock Firms. The test results contradicted the initial hypothesis, indicating that family ownership actually has a positive and significant impact on income smoothing within non-sharia stock companies. This is substantiated by the statistically significant coefficient value of 0.2452931 at the 0.038 significance level.

Therefore, in light of these findings, the initial hypothesis needs to be rejected.

The findings of this study are consistent with the entrenchment, This theory posits that companies characterized by high levels of family ownership may experience challenges related to inadequate information disclosure and diminished earnings quality. Such issues arise because family members who wield significant control over the company tend to possess substantial capacity and influence over its operational activities. Consequently, they may be more inclined toward negative practices, including exerting control over managers to engage in income smoothing, which can ultimately have adverse consequences for minority shareholders.

The results of this study are also in line with research Their research highlights that a high level of family ownership in a company can empower the family to effectively oversee managers and wield influence over the decision-making process. It is precisely this influential power held by the family that can give rise to agency conflicts within the company. The Impact of Tax Avoidance on the Practice of Income Smoothing in Sharia-Compliant Stock Firms The results confirm that tax avoidance indeed has a positive and significant effect on income smoothing among Islamic stock companies. This is supported by the coefficient value of 0.8072951, which is highly statistically significant at a p-value of 0.000. In practical terms, this implies that for every 1% increase in tax avoidance, there is a corresponding increase in income smoothing by 80.72%. Therefore, the hypothesis is accepted.

These findings align with the research which explains that tax avoidance involves companies retaining cash resources that would otherwise be owed to the government. This retention of resources can lead to an increase in the overall value of the firm. Furthermore, this practice of tax avoidance is rooted in agency theory, which stems from the separation of authority between agents (managers) and principals (company owners). This separation can create opportunities for managers to exploit tax avoidance strategies. Consequently, companies may also employ tax avoidance as a means to engage in income smoothing.

The Impact of Tax Avoidance on the Practice of Income Smoothing in Non-Sharia-Compliant Stock Firms. The results reveal that tax avoidance actually exerts a negative and significant effect on income smoothing within non-sharia stock companies. This is substantiated by the coefficient value of -0.1907813, which is statistically significant at a significance level of 0.025. In practical terms, this implies that for every 1% increase in tax avoidance, there is a corresponding decrease in income smoothing by 19.07%. Therefore, the initial hypothesis is rejected. This negative effect can occur because it is possible that tax avoidance and income smoothing have conflicting goals, where tax avoidance seeks to reduce profits, income smoothing seeks to create the impression of profit stability, in an effort to achieve one of these goals may interfere with the achievement of other goals. In addition, tax avoidance practices can increase the risk of tax audits by tax authorities, so that if the company is more closely monitored by the tax authorities, this can reveal inappropriate practices in the financial statements, thereby reducing efforts to perform income smoothing.

The findings of this study run counter which identified a significant relationship between tax avoidance and income smoothing. Similarly, earnings management is influenced by tax avoidance. Moreover, nearly all sample companies employed earnings management strategies to mitigate tax liabilities. These discrepancies in results could be attributed to variations in tax regulations and accounting principles. Tax avoidance can indeed impact management actions that, in turn, affect earnings, potentially affording management opportunities to manipulate earnings due to these differences.

Tax avoidance has a positive effect on income smoothing of Islamic stock companies and a negative effect on income smoothing of non-sharia stock companies. This can be caused perhaps because these sharia stock companies operate based on sharia principles, so that sharia stock companies tend to pay attention to their reputation in the eyes of sharia investors who care about ethical values, they may maintain their reputation in the eyes of investors by doing income smoothing to avoid significant profit fluctuations due to high tax avoidance. Therefore, if tax avoidance in this Islamic stock company is high, it will result in high income smoothing as well. Non-sharia stock companies find different results, this is because non-sharia stock companies where they do not have regulations that are as strict as sharia stock companies or do not prioritize the principle of transparency so that they are freer in practicing tax avoidance without any pressure to reduce profit fluctuations, maybe even because in non-sharia stock companies profit fluctuations are considered part of normal business.

The Effect of Firm Size and Leverage Control Variables on Income Smoothing of Sharia and Non-Sharia Stock Companies. Based on the conducted tests, it is observed that the control variable, firm size, does not exhibit a statistically significant effect on income smoothing in Sharia stock companies. This is evident from the coefficient value of -0.1349625, which is not statistically significant at the 0.722 significance level. These findings appear which suggested that income smoothing is more commonly practiced by larger companies. According to their research, larger companies, facing greater scrutiny in the capital market and striving to maintain a favorable image among investors, tend to avoid earnings volatility and, as a result, engage in income smoothing.

4. Conclusion

Based on the findings of this study, several notable conclusions can be drawn. Firstly, family ownership exerts a considerable and favorable impact on income smoothing in both Sharia and non-Sharia stock

companies. This suggests that higher levels of family ownership are linked to an increased inclination for income smoothing in both types of firms. However, the effect of tax avoidance on income smoothing differs between these two categories. In Sharia-compliant stock companies, tax avoidance is associated with a positive and substantial influence on income smoothing, while in non-Sharia stock companies, tax avoidance is linked to a negative and significant effect on income smoothing. Additionally, the control variables, namely firm size and leverage, do not demonstrate a significant influence on income smoothing in either Islamic stock companies or non-Sharia stock companies. For future researchers, it is advisable to consider expanding the sample size and extending the research duration beyond the scope of this study. Additionally, researchers should take into account variations in regulations and rules specific to Islamic stock companies, as these can influence income smoothing practices. These enhancements in research design may contribute to obtaining more comprehensive and refined results in future studies.

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