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ypietricia@phillipsfoods.com

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Income smoothing on market reaction: Environmental performance as a moderation variable

Yovita Pietricia, Cahya Helinawati, Lindrianasari & Reni Oktavia
Universitas Lampung, Lampung, Indonesia

ABSTRACT: This study analyzes income smoothing with environmental performance on market reactions on the Indonesia Stock Exchange for manufacturing companies in 2016-2018. It uses a purposive sampling technique. This is a conceptual paper that discusses sensitive issues related to income smoothing and environmental performance. The Eckel Index and abnormal returns are used as a proxy for income smoothing and evaluating market reactions using moderating regression analysis (MRA). Hypothesis includes income smoothing with a positive effect on market reactions and environmental performance as a moderating variablea

Keywords: income smoothing, environmental performance, market reactions

1 INTRODUCTION

Indication of smoothed management can be proven from the size of the company's profits, which are relatively stable yearly and dynamic price changes that call for smoothing. For earning to be an important goal, profit should be used as a basic measurement of efficiency, success, or guidelines for decision making (Sherlita and Kurniawan, 2013). Income smoothing is a management tool used to reduce earnings fluctuations artificially (accounting methods) and in real (transactions) to enhance the company's performance and predict the future.

Income smoothing is done by increasing low reported profits and decreasing when they are relatively high when an announcement containing the information and market reacts. Market reaction is felt after announcement leading to changes in the price of stock securities, which are reflected in abnormal returns. It is a reaction caused by investors and triggered by income smoothing, as seen in several cases, including PT. Lippo Karawaci Tbk in 2018, Toshiba, in 2015, PT. Bank Bukopin Tbk in 2016, British Telecom in 2016, and PT. Garuda Indonesia, in 2019, illustrated that income smoothing is done to increase market reaction at the time of earnings announcement. The concept of earnings management starts from the approach agency and signaling theory discussing human behavior that has rational limitations and tends to resist risk. Income smoothing is done to reduce abnormal earnings within limits allowed in accounting practices and management principles.

In addition to income smoothing, environmental issues are the center of attention of various parties, including the government, the general public, and investors. Disclosure of environmental, social, and financial performance in the annual report reflects the level of accountability, independence, and transparency. Environmental damage is the company's responsibility due to its operational activities. Therefore, they should be considerate when carrying out economic activities to avoid the boycott of some products. Nevertheless, the investors did not react to the company include the case of Eldorado in Brazil in 2007, APP in 2015.

2 RESEARCH ISSUE

This conceptual paper discusses the effect of income smoothing with environmental performance as a moderating variable to market reaction. It will further show a framework as a basic assumption of thought and discussion on the issue.

3 THEORETICAL FRAMEWORK

3.1 *Agency theory*

Agency theory assumes that all individuals act in their interests. However, there is a conflict between the principal and the agent, triggering agency costs. This information asymmetry triggers agents to hide some information from the principal and influence the numbers presented in the financial statements by performing earnings management or dysfunctional behavior for better performance.

3.2 *Signaling theory*

The signaling theory emphasized the importance of information that describes the state of a company as a basis for investment decision making. Capital market participants will analyze the information announced as good or bad news and its encouraging changes in market response. This theory passes signals from managers to investors regarding the company's quality through annual reports to enhance its value when selling its shares. A good quality company gives a signal to the market, which allows it to distinguish the good from bad quality.

3.3 *Efficient securities markets*

The market theory asserts that the market reacts quickly to newly released information, so it is important to know when to declare a net profit report publicly. Good and bad news in net income statements is evaluated relative to investors' expectations since good news triggers changes in investor confidence based on company performance.

3.4 *Legitimacy theory*

Legitimacy is considered to equate the perception that actions taken by an entity are desirable based on socially developed norms, values, beliefs, and definitions. It is based on the notion of a contract implied between social institutions and society. According to this theory, the company exists if the community realizes it operates with an equal value of the system itself. The legitimacy theory ensures the society accepts company activities and performance. The company uses an annual report to describe social and environmental responsibility so that it is accepted in the community, thereby increasing its value and profit.

4 DISCUSSIONS

The following cases show income smoothing, including PT. Lippo Karawaci Tbk, Toshiba, PT. Garuda, Indonesia, PT. Bank Bukopin Tbk, and British Telecom in Italy. This is in line with research conducted by Al-Taie et al. (2017), which states that there is a significant influence on the practice of income smoothing on the Iraqi stock exchange. Dimitrapoulos and Asteriou's research (2009) states that there is a significant relevance between income smoothing in returning shares on the Greek stock exchange. Wulandari and Putri (2014)stated that income smoothing had a significant effect on market reaction. Earnings smoothing that is done can improve the quality of revenue, as evident from research conducted by Sherlita and Kurniawan (2013), which states that the profitability of profit and non-profit grading

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companies have significant differences. Research by Suharto and Sujana (2016)states that the magnitude of the value of shares can trigger income smoothing practices because stable earnings trigger investors.

Income smoothing is done to reduce fluctuations and manipulate variables by conducting real transactions and improving the company's image (Dascher and Malcom, 1970). Investors are comfortable if management reports stable earnings because, according to the companies with high levels of earnings, variability tends to have high risks as well (Ball and Brown, 1968). Earnings announcements can be said to contain information if the announced earnings are different from the profits predicted by investors. Under these conditions, the market will certainly react, as reflected in the movement of stock prices in the earnings announcement period. This study analyzes and examines the effect of income smoothing on market reactions in the manufacturing sector.

Blancard and Laguna's research results (2010) revealed losses due to environmental pollution that significantly affected the market price. The study of Dasgupta, Laplante, and Mamingi (2001) concluded that there was a market reaction following the announcement of environmental performance in Argentina, Chile, Mexico, and the Philippines. The study of Lorraine et al. (2004) stated that there was a market reaction to information on environmental pollution, primarily due to the imposition of fines. Research by Hadiningtiyas, Wahyuni, and Mahmud (2017) and Angelia and Suryaningsih (2015) show a significant positive effect of environmental performance on market reaction. The study conducted by Prabandari and Suryanawa (2014) stated that environmental performance had a positive effect on investor reaction.

Several cases of income smoothing abuse the authority and hide the occurrence of accounting lies, which are detrimental to various parties. The occurrence of violation cases are linked to environmental preservation that results in adverse impacts on the issuer. Investors would not believe in the company's performance as a result of bad signals hence become reluctant to buy shares. Generally, companies disclose environmental performance when they receive environmental pressure from stakeholders. A decrease in profits is reported when they are faced with regulations related to environmental performance and stakeholder's pressure (Sarumpaet, 2006). Good environmental performance is a form of value creation that positions companies on a competitive edge (Sarumpaet, Nelwan, and Dewi, 2017). This prompted the research of a hypothesis to provide empirical evidence that income smoothing and environmental performance have a positive effect on market reactions.

5 CONCLUSIONS

Rational investors will make predictions before a decision by observing the signals given by the company, such as announced earnings. Good signals are obtained by sustainable and responsible disclosure of environmental performance as a form of value creation in which companies adhere to themselves due to competition (Hassel et al., 2005 in Sarumpaet, 2017). Investors capitalize on the company's shares when there is good and responsible environmental performance due to a positive effect on market reaction and vice versa.

The result from previous research states that income smoothing had a significant effect on market reaction and returning shares on the stock exchange in some countries. Besides, the magnitude of the value of shares triggers the emergence of income smoothing practices because stable earnings prompt investor interest. There was a market reaction to the announcement of environmental performance, especially due to the imposition of fines for actions of pollution. The public saw businesses as the most significant contributors to the current environmental problems and the resulting impacts. Therefore, the research concludes that income smoothing influences market reactions with environmental performance as a moderating variable.

6 LIMITATION

Difficulty in accessing the first announcement information on Bursa Efek Indonesia (BEI).

7 FUTURE RESEARCH

The addition of control variables to distinguish companies that do income smoothing from those that do not while still considering environmental performance as a moderating variable. This research was conducted to prove whether the addition of control variables results remained to influence market reactions or not. This control variable consists of size, profitability, and leverage.

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