1. Are there any differences in cumulative average abnormal return between companies that conduct income smoothing and those that do not?

2. Do income smoothing and company size affect the cumulative average abnormal return?

1.4 Problem Limitation

In order to provide a clear description and to be able to impart useful information, restrictions on this research are outlined as follow:

1. The object of this research is all of non-manufacturing companies listed in JSX.

2. Estimation period is from year 1997 through 2002, considering that before 1997 the companies condition listed in JSX was not good enough because of monetary crisis.

3. This study only used two independent variables which are: company size and income smoothing, while type of industry as in Michelson *et al* (2000) study is not being used. This because there are a lot of industry sectors listed in JSX that only have few company members, so that it was hard to represent the sector.

can be defined as a tool which is used by the management to curtail the variability of perceiving target order, because of the existence of all accounting variables manipulation on real transaction (Konch in Salno and Baridwan, 2000). While Beidman (in Cairi and Ghozali, 2001:326) defined income smoothing as intentional action to smoothing or fluctuating earning level in order to be considered as normal for a company.

According to Heyworth (1953), income smoothing has purpose to fix the relationship with creditors, investors and labors also to smooth business cycle through psychological process. Whereas, according to Gordon (1964) proposed preposition related to income smoothing are:

- The criterion used by the company's management in choosing accounting method is to maximize the satisfaction or welfare.
- Satisfaction is in the form of job security, level of raising salary, and also the growth of company size.
- Stakeholders' satisfaction and the improving of company performance can increase manager's status and reward.
- The equality of satisfaction depends on growth level and company's earning stability.

2.1.2 Test of Incentive Earning Management

Beside the popular tact about earning management, the researchers found it hard to convince. This problem occurs merely to identify whether earning has been

There are several studies testing earning management before management buyouts. De Angelo (1988) reported that earning information is important to estimate management in buying all shares, make hypothesis to the managers in that company to reduce earning. He found evidence in the earning management from company acquisition of the changes tests in accrual post. The last study was conducted by Perrry and Williams (1944), which tested the control of unexpected accrual post due to change in income and capital depreciation. The result shows that unexpected accrual post is negative (income decreasing) before a buyout management.

The latest study also been tested whether the managers "over pushed" earning in period before offering property right. Founding shows that the positive things from company report (income increasing) are unexpected post accrual before property right offering (Teoh, Welch and Wong1998B), the first general offering (Teoh, Wong and Rao 1998) and the receiving of stock financed (Erricson and Wang 1998). There also evidence of a reversing unexpected accrual post which following the first general offering (Teoh, Wong and Rao 1988) and stock financial acquisition (Erricson ad Wang 1998). Finally Dechow et al (1996) reporting that the company obeyed action held by SEC to those who reporting financial offence which usually make offering of seasoning property right which in the following to the offence but before its detection.

This is clear that managers are motivated to manage financial data in general and advantage or earning in specific. All of this is connected with effort to maximize their utility and to obtain private gains. Because external focuses only for earning stated in income statement, manipulation of accounting information is very possible to be conducted by the management. This is merely because of asymmetry information, so that management has the right to choose certain accounting method if there is an incentive and motivation to do it with earning manipulation. Accrual base give numerous alternatives toward management to conduct earning management because of the management possibility to choose alternative method used. Foster (1986) classified the element of financial statement which becoming the target of that manipulation:

1. Sales element, is when the making of incoming receipt period reported in this period or the making of fictive order and down grading product.

2. Cost element, by split up receipts and journalize prepayment as product.

Ayres (1994) stated that there are three factors which could be connected with the appearance of those practices:

a. Accrual management is related with all activities that affecting cash flows and private gains as manager competence.

b. The adoption of mandatory accounting changes, related with manager decision of the adoption of mandatory accounting changes

The other study from earning management is for stock exchange reason, which showed that earning management had been arranged to find the management or financial analyst expectancies (which is authorized by general earning prediction) as the example. Burgstahler and Earnes (1998) found that company had arranged their earning to find earning prediction. In their specialties, Burgstahler and Earnes (1998) found that the managers begin their action to arrange increasing earning to avoid lower earning report from those of the analyst prediction. Abarbanell and Lehavy (1998) used financial analysis stock recommendation (for example: buy or sell) to predict the earning management direction. They disprove and found that those companies accept "buying" recommendation, so that it will be possible to arranged income to get expectation analyses from earning. Whereas, companies which accepted "sells" recommendation has more possibility to show the negative side of unexpected accrual post. Kaznik (1999) found consistent evidence which can be definite in the weaknesses of an earning management prediction which uses unexpected post accrual to arrange the increasing earning.

Finally, there was evidence in the earning management to influencing expectation from the specific type of investor. Bushee (1998) reported that companies with high percentage of institutional possessor which specifically do not cut R &D expenses to avoid deterioration in the reported earning. Companies seem to arrange an interesting earning through

2. The management could allocate income and cost for several accounting period.

3. The managements have their tact to classify certain income account in different category. From some research, the instrument which usually used to conduct earning management are pension costs, outstanding posts, tax credit investment, depreciation and fixed costs, exchange rate, and accounting classification and reserved.

Eventhough standard has been arranged by filling in the requirement; it has to be able to decrease asymmetry information and has usefulness information which is able to emerge moral hazard, if there was still conflict of interest amongst all of the parties connected in the financial statement. The other possible action to take is by reducing management freedom to choose many of different accounting tact when a new standard is being implemented to overcome the problem. However, this limitation will also have some economic consequences (Scott, 1997).

2.2 Theoretical Framework

2.2.1 Income Smoothing

Income smoothing topic is tightly connected with earning management concept. The explanation of earning management concept is using agency theory approach, which stated that earning management practice is effected by conflict of interest between management (agent) and owner (principal) that appear when every

Income smoothing is rational behavior based on positive assumption in the accounting theory that agent (in this case management) is rational individual that concern of their interest. In consistent with that assumption, motivation which affected manager choices depends on the value of the company. And manager believes that market based on the accounting nominal. Earning fluctuation and unpredictable incoming earning are the motive of stock or market risk.

In income smoothing literature, it is stated that accounting method chosen will be more useful in decreasing earning fluctuation rather than for maximizing or minimalist reported earning (Moses, 1987). Simpson (1969) tested hypothesis that the variety of accounting practice choices enable company to conduct earning manipulation and in the next it will lead to investor inability to compare the alternative of investment chance properly. The result showed that earning management action was significant and seems to make investors astray. Borneo et al (1976) supported that manager conduct income smoothing of the earning before extra ordinary items (both before and after period expenses) through accounting manipulation of extraordinary items.

Income smoothing can be conducted by using accounting method or estimation (called accrual base manipulation) or with treated transaction that cause reported earning close to the targeted nominal rather than to maximizing cash flow that expected currently (called real manipulation) (Bartov, 1993).

On the other hand, Dascher and Malcolm (1970) stated that reported income smoothing can be reached through real smoothing or artificial smoothing.

Real smoothing means a real transaction to be done or not to be done based on its smoothing effect to the earning. Whereas, artificial smoothing means income smoothing that adopts accounting procedure to replace cost and or income from one period to another period.

So that, income smoothing can be reached through several dimension. **First**, smoothing through event's occurrence and/or recognition. **Second**, smoothing through allocation over time. **Third**, smoothing through classification or classification smoothing (Ronen and Sadan 1975). Through his experiment Koch (1981) prepared some evidence showed that income smoothing mostly conducted by widely held company rather than closely held company. Manager intended more on doing income smoothing if the cost is lower, when it do not decreasing total earning per share, and income smoothing is mostly conducted with artificial variable rather than real variable.

Potential account which can be used to conduct income smoothing are: dividend gained from unconsolidated subsidiaries, selling of fixed assets and long term investment, tax credit investment, unusual gain or losses, investment in the common, and extraordinary item (see Simpson ,1969; Bartov, 1993; Beatty 1994). While Brashaw and Eldin (1989) the difference possibility of exchange rate and income smoothing purposes through allocation and classification.

Beside scientific articles about income smoothing that gave arguments related to the factors stimulating managers conducting income smoothing, empirical research about income smoothing had also been conducted by several researchers.

Most of those researchers focused on the occurrence of income smoothing (including instruments and purposes) and its related factors.

Ronen and Sadan (1975) showed that income smoothing through a certain period can be conducted in three ways. **First**, management can set the time of a certain event through their tact (such as: research and development expense) to decreasing reported earning variation. As the alternative, management is also able to set recognition time of those events. **Second**, management can allocate income or certain cost for several accounting period. **Third**, management has its tact to classify certain income posts in a different category.

Instruments used in income smoothing are income, dividend, change in accounting tact, pension cost, extraordinary item, investment tax credit, depreciation and fixed cost, exchange rate, accounting classification and preserve. While factors that may stimulate income smoothing practice are company size, industrial sectors, bonus plan, entering hamper and ownership.

Albrecht and Richardson (1990) stated that there are three approaches in the study related with income smoothing. Those three approaches are:

1. Classical approach which involving control over relation between variable of income smoothing selection and its effect to the reported earning in searching of income smoothing.

2. Earning variability approach defines income smoothing behavior whether it is imitation or real. So in this approach, point that we should notice is the variability of income smoothing object.

Gordon, Howirtz and Meyers (1966) examine relation between accounting method for investment tax credit (income smoothing instrument) with the growth of earning per share and the stockholders equity (income smoothing target). And the research result showed that there is a significant relationship between the two factors which prove the existence of income smoothing practice.

The research conducted by Copeland and Licastro (1968) was based on Gordon's hypothesis. Variable tested in this research is unconsolidated income dividend from the branch and its relation with accounting to journalize that unconsolidated income dividend. The result from this research is that relation between dividend and earning disapprove of a significant income smoothing practice.

Beidelman (1973) research showed that incentive compensation, pension cost, research and development expense, sales and advertising expense were also be used to smooth.

Research which is pointed at factors related with income smoothing was conducted by Smith (1976), also Kanin and Ronen (1978) in the result that company which controlled by manager has more likely to conduct income smoothing rather than company that controlled by the owner.

Ronen and Sadan (1981) concluded that company in different industry will smooth their income in a different level. The high level of income smoothing was found in oil and gas industry and also pharmacy. Belkaoui and Picur (1984) also found the same result where companies in peripheral industry have a high

tendency to conducting income smoothing compare to company in industry essential sector.

Moses (1987) found that income smoothing can be related with company size, difference between real earning and expected earning and the existence of bonus compensation plan. This research has purpose to identify factors which can be related with income smoothing. Moses research gave the same result as the previous research by Healy (1985).

Dye (1988) had also conducted research which has relation with earning management that has similarity with income smoothing. This research has purposes to explain condition needed in conducting earning management, to identifying the effect from internal and external demand over earning management, to identifying the effect from internal and external demand over earning management at the tact of optimum announcement of company's earning also its advantage and disadvantage to shareholders from earning manipulation action. The result is that manager avoids the risks free from debt and loan in stock market intensively to smooth if it is viewed from agency definition.

In their research, Trueman and Titman (1988) focused the explanation about the possibility of income smoothing to be examined and how can it resulted in increasing of stock price. And the result from their research was that company's manager conducted income smoothing rationally in purpose to decrease claims from stockholders over economic earning variation which in the end can effected company's market value.

Albrecht and Richardson (1990) in their research can not prove that there was difference between core sector company and peripheral in its relation with income smoothing. Approach used in this research was earning variability.

Beatty and friends (1994) had also conducted research related with income smoothing in England that based on positive accounting approach. The focus in the research was accounting numbers that based on statistic properties and time series without to recall on rational economics. Meanwhile, the object of income smoothing was income before extraordinary item. Another result is that there is significant positive relation between earning variability, dividend payment, stock option, and diffuseness of stock ownership.

Michelson and friends (1995) conducted their research in America which was aimed to test the relation between income smoothing and market performance. The tested factors including the tendency of headquarters in conducting income smoothing, the difference of stock average return from stock among smoothing company and non-smoothing company and expected market risks with income smoothing. The result was that smoothing company has lower annual average return compared with company of non-smoothing company. Beside that, this research had also showed that smoothing company has smaller beta and high market equity value compared to non-smoothing one.

The researches about income smoothing practice in Indonesia were only conducted by Ilmainir (1993) and Zuhroh (1996). Ilmainir (1993) tested earning factors and economic consequences factors that effected income smoothing

practice in the public company in Indonesia. Earning factors tested is difference between actual earning and normal earning and the effect of changing accounting tact toward earning. Whereas, economic consequences factors tested are company size, the existence of bonuses and stock price. The result was that of both two earning factors stimulating the occurrence of income smoothing practice, while from the three consequences factors tested only stock price that stimulate income smoothing practice.

Zuhroh (1996) examined factors which can be related with the income smoothing occurrence by sampling on public company listed in Jakarta Stock Exchange. From the three tested independent variable, which are company size, company profitability and company operation leverage, the resulted result conclude that only company's operation leverage that effected in income smoothing practice in Indonesian company.

2.3 Hypothesis Formulation

This research is a replication from the previous research by Michelson, Jordan, and Wotton (2000) about the effect of income smoothing toward risk-adjusted return. Refering to the theoretical review, previous research about income smoothing is especially taken from the research done by Michelson, Jordan, and Wotton (2000) so that the hypothesis used in this study are:

Ha1:   The average abnormal return of the company conducting income

smoothing is different from the average abnormal return of those

non-smoothing company.

Ha2:   Income smoothing and company size affected cumulative

average abnormal return.

3.4 Research Variables

Variables used in this study are income smoothing, company size, and cumulative abnormal return.

1) Income Smoothing

Income smoothing variable is an indicator counted as ratio between profit coefficient variation and sales coefficient variation. If the ratio's value is greater than 1, so the company is categorized as non-smoothing company, but if the ratio is valued as 1 or less then the company categorized as smoothing company. Income smoothing variable is a dummy variable, which valued as 0 for non-smoothing company and it would valued as 1 for smoothing company.

2) Cumulative Abnormal Return

Cumulative abnormal return is total summation from abnormal return in a certain window period. Whereas, abnormal return is the difference between actual return and expected return.

3) Company Size

Company size is the extent of company's market value of equity; is total outstanding stock multiplied by stock price.

3.5 Research Procedures

In order to answer the research problem, it is imperative to construct research procedures. The procedures are arranged as follows: