THE RELATIONSHIP BETWEEN FINANCIAL LEVERAGE, DEBT COVENANT AND DIVIDEND PAYOUT RATIO TO INCOME SMOOTHING PRACTICES
(Empirical Study On Companies Listed In Indonesia Stock Exchange On 2006-2011)

Skripsi Oleh:

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Akuntansi

Diajukan Sebagai Salah Satu Syarat Untuk Meraih
Gelar Sarjana Ekonomi

KEMENTERIAN PENDIDIKAN DAN KEBUDAYAAN
UNIVERSITAS SRIWIJAYA
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LEMBAR PERSETUJUAN UJIAN KOMPREHENSIF

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Disetujui untuk digunakan dalam ujian komprehensif

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Tanggal : 7 Maret 2013

Anggota : ____________________
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LEMBAR PERSETUJUAN SKRIPSI

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Judul	: The Relationship Between Financial Leverage, Debt Covenant, and Dividend Payout Ratio to Income Smoothing Practices (Empirical Study on Companies Listed in Indonesia Stock Exchange on 2006-2011)

Telah kami periksa cara penulisan, grammar, maupun susunan tensesnya dan kami setuju untuk ditempatkan pada lembar abstrak.

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Adalah benar hasil karya Saya sendiri. Dalam skripsi ini tidak ada kutipan hasil karya orang lain yang tidak dsebutkan sumbernya.
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ABSTRAK

The Relationship between Financial Leverage, Debt Covenant And Dividend Payout Ratio To Income Smoothing Practices (Empirical Study on Companies Listed In Indonesia Stock Exchange On 2006-2011)

Oleh :
Emilia Nurhuda

Laporan Keuangan digunakan ***stake holders*** untuk mengambil keputusan berdasar informasi-informasi yang terkandung di dalamnya. Seperti investor yang dapat menggunakan informasi keuangan tersebut untuk menanamkan modalnya atau tidak pada perusahaan. Untuk menarik perhatian, manajemen perusahaan dapat melakukan strategi seperti Income Smoothing.

Penelitian ini bertujuan untuk menganalisis pengaruh Financial Leverage, Debt Covenant dan Dividend Payout Ratio terhadap Praktik Perataan Laba (Income Smoothing) pada perusahaan yang terdaftar di Bursa Efek Indonesia periode 2006-2011. Jumlah sampel untuk observasi hasil dari tes Indeks Eckel adalah 18. Tes hipotesis menggunakan t-test untuk menguji regresi secara parsial dan F-test untuk menguji regresi secara simultan. Model regresi yang digunakan adalah multiple regression.

Hasil penelitian menunjukkan bahwa financial leverage, debt covenant dan dividen payout ratio secara signifikan tidak mempengaruhi praktik perataan laba (income smoothing) baik uji hipotesis secara parsial maupun secara simultan. Hal ini disebabkan karena keterbatasan-keterbatasan dari penelitian ini seperti jumlah variabel sedikit dan jumlah sampel yang didapat hanya 18 sampel perusahaan karena pembatasan pada perusahaan yang diobservasi yang tidak memasukkan sektor manufaktur dan perbankan dan terdaftar di BEI. Oleh karena itu, disarankan untuk melakukan penelitian lebih lanjut pada faktor-faktor lain selain rasio keuangan yang mungkin mempengaruhi praktik perataan laba dan meneliti semua perusahaan tanpa terkecuali, jika memungkinkan, juga pada perusahaan di luar negeri.

Keyword: *income smoothing, financial leverage, debt covenant, dividend payout ratio.*

ABSTRACT

The Relationship between Financial Leverage, Debt Covenant And Dividend Payout Ratio To Income Smoothing Practices (Empirical Study on Companies Listed In Indonesia Stock Exchange On 2006-2011)

Oleh :

Emilia Nurhuda Emilia Nurhuda; Mukhtaruddin, SE,M.Si,Ak as first script supervisor;Abukosim, SE,MM,Ak as second script supervisor

Financial statements is used by stake holders for making decision based on the information within. For examples, investors use the information to decide whether holding or the investment to the company or not. In attracting the attention, management has strategy such as Income Smoothing.

This research aims to analyze the relationship between financial leverage, debt covenant, and dividend payout ratio to income smoothing practices on companies listed on Indonesia Stock Exchange (IDX) on 2006-2011 periods. The amount of samples for the observation as the results of Eckel Index are 18 companies. Hypothesis tested by t-test to test regression partially and F-test to test regression simultaneously. The regression model used is multiple regression.

The results of research show that financial leverage, debt covenant and dividend payout ratio do not significantly influence income smoothing practices partially and simultaneously. This caused by many limitation of this research such as the amount of variables are few and the amount of samples are only 18 samples because the delimitation of companies observed which excludes manufacturing and banking companies and lists on IDX. Therefore, the suggestion for next researcher to analyze more about other factors besides financial ratios that could be influencing income smoothing practices and research on all companies with no exception, if there is chance, on the other country.

Keyword: *income smoothing, financial leverage, debt covenant, dividend payout ratio.*

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CHAPTER 1

INTRODUCTION

1.1. Background

Financial statement provides information for the owner and the stakeholder in order to making decision. For example, investors examine whether the company is trustworthy in making high profit or not from the financial statement. Meanwhile, the owner can use financial statement to evaluate the management's work and the company's financial performance. One of the parameter used in evaluating company's performances is earnings.

Management uses many ways in making the company could face the globalization such as expanding the business with short and long term business strategy. In this day, there are a strategy trends to expand the company by joining the stock exchange (go public). Based on *Indonesia Stock Exchange*, in early 2000, there were 259 companies listed go public (Wangi, 2010). It gradually increases until in 2012, there are 453 companies (*www.idx.co.id*).

In order to attract investors buying the shares, the management tries showing the earnings power. In increasing the attraction, they will mark up the earnings power by do earnings management. The reason is the stock price of a company significantly influenced by earnings, risk and speculation. Therefore, a company that profits always have increase from period to period will consistently lead risk. This company had a greater reduction than the percentage increase in profit. This has resulted in many companies managing and setting profit as an effort to reduce risk (Wangi, 2010).

This study focuses on the practice of opportunistic earnings management, one of the ways that can be used in the practice of earnings management is to use income smoothing technique (income smoothing). Belkaoui (2000, in Amanza 2012) suggests that income smoothing understanding by management is a deliberate effort in order to minimize fluctuations in the rate of profit according to the company are considered normal. Because the investors prefer the stable profit. The stable the profit, the stable dividend and wealth will be gained. For the management, the stable profit shows good signal to the creditor that the management performance is on stable state.

In this case the income smoothing shows a company's management efforts to reduce the allowable limits in the practice of accounting and management principles are reasonable. The practice of income smoothing is a common phenomenon that occurs as a management effort to reduce fluctuations in reported earnings (Nasir et al., 2002 in Amanza 2012). According to Purwanto (2005, in Amanza 2012), income smoothing can be defined as the way in which the management to reduce the fluctuations in reported earnings to match the desired target both artificial (through accounting method) or by real economic transactions.

There are many factors that affect management practice income smoothing. But for this study, there are financial leverage, debt covenant and dividend payout ratio. When the earnings manipulated, the financial ratios in the financial statements will also be manipulated. Finally, when a user of financial statements is using the information that has been manipulated for the purpose of decision making, the decision is manipulated indirectly. On the other hand, the financial statements are used by investors in making economic decisions.

According to Sartono (2001 in Budiasih 2009) financial leverage shows proportion of debt to finance its investment. Another leverage ratio is debt equity ratio or debt covenant. It illustrates company's capability to guarantee the debt with its own equity and the proportion of company's expenditure which is financed by shareholders (equity) and loans. High Leverage Company has big risk to suffer losses because the higher leverage cause the higher financing proportion of a company from debt or loans. So it tends to break loan's agreement because company cannot pay the debt on due date. The larger the firm's debt, the greater the risk faced by investors so that investors will ask for higher profits. Due to these conditions companies tend to practice income smoothing.

Joining the *Indonesia Stock Exchange* means companies sell the shares or obligations to public. Instead, the companies have to pay dividend to shareholders. The Dividend Policy set dividend distribution to investors or shareholders. The amount of the dividend depends on the amount of profits. From the dividend ratio, investors probably interest to invest. One of dividend policy is constant dividend payout ratio. The DPR imply the amount of dividend may be changed according to the earnings with constant dividend ratio. Investor typically assume the stable profit will effect to the stable dividend (Hepworth (1953, cited

Rachmawati 2002). So companies tend to do income smoothing practices in order to make the fluctuation of earnings is stable.

This research replicates Budiasih (2009), that is "Faktor-Faktor Yang Mempengaruhi Praktik Perataan Laba. The differences between this research and previous research are :

- Similar to Budiasih (2009), this research analyze the relationship between financial leverage and dividend policy to income smoothing. But Author put another leverage ratio, that is debt covenant or debt equity ratio. Because of Rahmawati & Muid (2012) research show debt covenant has positive association with income smoothing practices.
- The data of this research are financial statements of companies listed on *Indonesia Stock Exchange* excluding manufacturing and banking sectors. Because of there were many research focus on manufacturing and banking sectors such as Budiasih (2009), Masodah (2007), Rachmawati (2002), Kusumawati (2002), and Rahmawati & Muid (2012). So, this study will examine on agriculture, forestry and fishing, mining and mining services, constructions, securities, insurance, real estate and property, transportation services, telecommunication, whole sale and retail trade, hotel and travel services, holding and other investment companies, and also others sectors.
- This study is a time series research which period from 2006 until 2011. A good quality of research data should be required as accurate, relevant, and up to date.

Therefore, the study took the title **"The Relationship between Financial Leverage, Debt Covenant And Dividend Payout Ratio To Income Smoothing Practices (Empirical Study on Companies Listed In Indonesia Stock Exchange On 2006-2011)"**

1.2. Problems

1. Does Financial Leverage significantly influence Income Smoothing Practices?
2. Does Debt Covenant significantly influence Income Smoothing Practices?
3. Does Dividend Payout Ratio significantly influence Income Smoothing Practices?

1.3. Objectives

1. Examining whether Financial Leverage significantly influences Income Smoothing Practices or not.
2. Examining whether Debt Covenant significantly influences Income Smoothing Practices or not.
3. Examining whether Dividend Payout Ratio significantly Influences Income Smoothing Practices or not.

1.4. Benefits

1. Academia

   For academics, this study supposes to add knowledge about income smoothing (income smoothing) and the existing literature on income smoothing.

2. Stakeholder

   For users of the financial statements of the research, especially investors, it is expected to provides additional information regarding some of the factors that effect on income smoothing measures, so that users of the more aware of the financial statements resulting financial company.

CHAPTER II

LITERATURE REVIEW

2.1. Theoritical Views

2.1.1. Agency Theory

Agency theory is an approach that can describe concept of earnings management which is strongly associated with income smoothing to be discussed in this study. According to Anthony and Govindarajan (2005 in Dewi 2011) agency relationship exists when one party (the principal) hire others (agent) to perform a service and delegate authority to make decisions to the agent.

This theory assumes that the respective individuals motivated solely by self-interest that is a conflict of interest between principal and agent. Shareholders as the principal want high profitability every year to increase the wealth. Managers as agents are motivated to maximize economic needs by doing disfunctional behaviors.

Because each individual has a tendency to maximize its own interests, information asymmetry comes out. It is possible for the management (agent) to hide information from the principals primarily related to management performance within the company even though it does not show the real condition of the company. One of the way used by managers is income smoothing. So this theory support the income smoothing practices.

2.1.2. Signalling Theory

The signaling theory explains why the company has encouragement to provide information on external financial reports so there is asymmetry of information between company and external parties.

Signalling theory describes how companies give signal to the investor that the companies have good future by disclosure the information in financial statement. So the financial statement that published in *Indonesia Stock Exchange* must give relevant, complete and accurate information in order to persuade the investors.

Giving good signal to investors by disclose the ratio of financial statement in order to pull investors attention. For example, the leverage ratio consists of financial leverage and debt covenant or debt to equity ratio. In order to show a good ratio probably manager practices income smoothing.

2.1.3. Contractive Efficient Theory

Transactions contract is a market mechanism is fundamental, especially in the case of maximizing wealth. Posner found no legal intervention in a transaction when the individual actually occupies its part of the agreement. Budiasih (2009) stated that principal function of law contract is to prevent someone from opportunistic actions against perpetrators of other contracts so that economic activity can run optimally. This theory also supports the income smoothing practices.

2.1.4. Financial Statements

At first Financial report is only a tool of bookkeeping, then be used for determining and evaluating the financial position of a company. furthermore, the evaluation could be used for financial statements users in making decision. So it is necessary to examine the financial position of a company for a certain periods.

Based on Financial Accounting Standard (SAK, 2004):

"*Laporan keuangan merupakan bagian dari proses laporan keungan. Laporan yang lengkap biasanya meliputi neraca, laporan laba rugi, laporan perubahan posisi keuangan (yang dapat di sajikan dalam berbagai cara seperti, sebagai laporan arus kas (cash flow) atau laporan arus dana), catatan dan laporan lain serta materi penjelasan yang merupakan bagian integral dari laporan keuangan. Di samping itu juga termasuk skedul dan informasi tambahan yang berkaitan dengan laporan tersebut, misalnya, informasi keuangan segmen industri dan geografis serta pengungkapan pengaruh perubahan harga*".

There are three types of fundamental of financial reports:

1. Balance Sheet is a systematic financial report about assets, debt and equity of a company for a certain time. Specifically, balnce sheet is supposed to support external party in analyzing company's liquidation dan thecapability in earning profits.
2. Income Statement is systematically report about revenue and expense which company occurred. This report is considered as the most important one in annual report.

3. Cash Flow is giving information about cash receipts and costs in a certain period. The second objective is giving information about the impact of cash from investment, financing and operating activity of a company.

The users of financial statements are:

1. Investors/Shareholders

   Investors as part who funding the capital to the company needs financial information and opearation for evaluating the profit. it used for deciding if they still hold the agreement (work together) with the company or not.

2. Customers

   Customer needs the information about going concern of company , especially if the they long term agreement with the company (they depend on company).

3. Employees/workers

   Worker interested about the stability and profitability of a company. they could examine the company's capability in paying salary, pension and vacancy.

4. Supplier

   Supplier needs information of financial report to decide if the payable of company will be paid on due date or not.

5. Creditur/Bank

   They could decide whether give the loan or not by using information from the financial report.

6. Government

   Government as regulator controls the resources regarding the company activities. They need the information to regulate company activities, decide tax policy and arrange national income statistics.

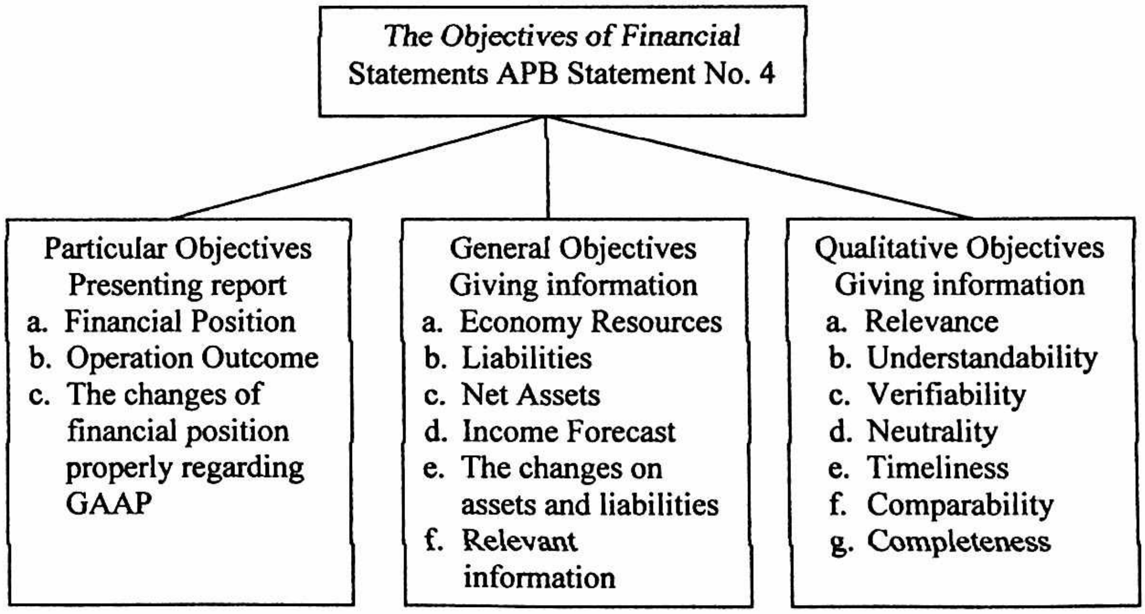
7. Society

   Company influence society in some aspects such as it give contribution for national economy which means it include the worker and domestics investors. Financial report shows how the company contribute the society such give scholarship or free facilitation for healthiness or protect the environment as the CSR (Corporate Social Responsibility).

The objectives of Financial Statements based on APB statement No. 4 (Harahap, 2011) are shown on this chart below :

Chart 2.1

The Objectives of Financial Statements



2.1.5. Earnings Management

Sugiri (1998) in Ardilla (2012) divides definition of earnings management into two, namely:

1. Narrow definition

   Earnings management in this case only relates to the selection of methods accounting. Earnings management in the narrow sense is defined as behavior managers to "play" with the discretionary component of accruals in determine the amount of earnings.

2. A broad definition

   Earnings management is to improve the manager's actions (reduces) today where managers reported earnings of a unit.

The financial statements are prepared based on the assumptions that governed by the standards set by the Financial Accounting Standards Board (DSAK). There is the choice of accounting policies are selected by management, provide sufficient flexibility for management in presenting financial statements (Amanza, 2011).

Earnings management can occur because the manager is given the flexibility to choose the accounting method to be used in the record and disclose financial information private owned. Earnings management is one that can affect the credibility of the financial statements. Earnings management also adds bias in the financial statements and may interfere with the users of financial statements believe earnings figures modified as earnings numbers without engineering.

There are two important perspectives that can be used to explain why earnings management by the manager, the information perspective and opportunistic. Perspective view of the information is advised that earnings management is a managerial policy to disclose the manager's personal expectations about the future cash flow. Efforts to influence the information were done by utilizing the freedom to choose, use, and change accounting methods and procedures. Perspective opportunist is the view that earnings management behavior of managers is to defraud investors and maximize their welfare because they have more information than others (Sulistyono, 2008 in Amanza 2012).

Scott (2000, in Amanza 2012) added the earnings management model, there are :

a. Taking a Bath

This pattern occurs at the time of the reorganization, including the appointment of a new CEO to report a loss in large numbers. This action is expected to increase future earnings. Such a strategy is carried out as if the new manager did an aggressive policy in companies that suffered losses. Technique of taking a bath is done by recognizing the costs in future periods and the losses in the current period. So the management of assets and impose remove some estimates of future costs. As a result, earnings in the next period will be higher than it should be.

b. Income Minimization

Done when the company experienced a high level of profitability so if earnings in future periods are expected to drop dramatically can be overcome by taking profits earlier period.

c. Income Maximization

Do as income decreases. Action on income maximization aims to report higher net income for purposes of the larger bonus. This pattern was made by a company that does debt covenant violations.

d. Income Smoothing

Do companies with flattening reported earnings so as to reduce fluctuations in earnings that are too large because investors generally prefer relatively stable earnings.

Meanwhile, Dewi (2011) stated the category of earnings management are discretionary accrual, income smoothing, manipulation of allocation of revenues / costs, changes in accounting methods and capital structure. Earning management has a broader scope rather than income smoothing, because management believes that market reaction based on the disclosure of accounting information so that the behavior profit is an aspect of determining market risk entity.

Watt & Zimmerman (cited from Rahmawati 2002) described some motivation of earnings management, those are:

a) Bonus Plan Hypothesis

Company has bonus plan disposes to apply accounting method that can increase income.

b) Debt Covenant Hypothesis

Company which has high debt to equity ratio tends to choose accounting method in getting higher income.

c) Political Cost Hypothesis

Big companies which have operation and social responsibility to society, tends to reduce the income.

2.1.6. Income Smoothing

Income smoothing can be defined as an effort to minimize the number of reported earnings if actual income is greater than normal profits, and efforts to increase the number of reported earnings if actual earnings are smaller than normal profits (Amanza, 2012). Belkaoui (2000) defines as income smoothing is a deliberate attempt made to try to reduce the management of abnormal variations in the company's profits in order to achieve a normal level for the company. So it means income smoothing is one of earnings management efforts by reduce the fluctuation in the company's profit.

According to Eckel research (1981, in Dewi 2011) income smoothing can be caused by two types, namely:

1. Natural Smoothing

Stating that income smoothing process is inherently generate a stream of flat income. It means the income will be smooth by itself without the intervention of other parties.

2. Intentional Smoothing/Designed Smoothing

Stating income process is influenced by other parties' actions, such as management. Designed smoothing is divided into two, there are artificial smoothing and real smoothing. Artificial smoothing is income smoothing process from doing such manipulating the accounting. Real smoothing is the process how management's actions to control the economy activities.

2.1.7. Some Reasons Management Conduct Income Smoothing

There are some reasons management conduct income smoothing. Hepworth (1953, cited Rachmawati 2002) states motivation that pushing for income smoothing is to improve relations with creditors, investors, and employees as well as smoothing the business cycle through a psychological process. Hepworth (1953) said income smoothing is used to:

1. Reduce the tax
2. Enhance investor confidence, as investors typically assume that stability of income will affect the stability of the dividend.
3. Maintain good relations between managers and workers. If the company reported a sharp increase profits, they (workers) will demand higher wages and salaries.

The purpose of income smoothing itself according to Foster (1986) is as follows: improving the company's image in the eyes of outsiders that the company has a low risk, providing relevant information to make predictions on earnings in the future, increasing the satisfaction of the business relationship, improving the external perception of the ability of management, and increasing compensation for management.

2.1.8. Financial Leverage and Debt Covenant

Leverage ratio is a ratio used by the company in order to assess the extent to which firms use borrowed money. Ratios contained in the leverage ratio, among others:

1. The ratio of debt to equity/debt covenant

   It shows how the company will return to its shareholders.

2. The ratio of debt to total assets

   This ratio emphasizes the crucial role of debt financing for the company to show the percentage of assets financed by debt of company.

3. The ratio of debt to total capitalization

   This ratio tells us the relative proportions of capital contributed by creditors and by the owner.

Financial Leverage is the important thing to determine the capital structure of a company. Riyanto (1995, in Dewi 2011) stated financial leverage as the use of expenses with fixed cost. While West (1996, in Dewi 2011) said financial leverage or called leverage factors is total debt ratio to total assets.

Companies that use the funds to fixed charges is said to produce favorable financial leverage or positively effect if the income received from the use of these funds greater than the fixed charges of the use of the funds. Unfavorable financial leverage is if the company unable to generate revenues from the use of these funds as fixed charges to be paid.

According to Sartono (2004, in Budiasih 2009), financial leverage the proportion of debt to finance the investment. The bigger the company the more debt and the greater risk by the company to increase the level benefit. In order to raise the level benefit to attract investor, company tends to do income smoothing.

According to debt covenant hypothesis that describe company tends to increase the income if the debt to equity ratio is higher and decrease it if the ratio is lower. Rahmawati (2002) and Masodah (2007) research that there is relation between debt equity ratio and income smoothing.

2.1.9. Dividend Payout Ratio

Dividend is one of motive of investors to buy shares of a company. Company should decide an attractive dividend policy so investor has interest to buy or hold the shares. Dividend Policy is a policy of company how to distribute dividend in amount and form.

There four kind of dividend policy are :

1. Stable Dividend Per Share Policy: the amount of dividend each year is always the same in order to pull investor's attention.

2. Constant Dividend Payout Ratio: the amount of dividend changes as the earnings with the ratio of dividend keep constant.
3. Compromise Policy: composite stable dividend per share policy and constant dividend payout ratio and a certain percentage in the years with highest profit.
4. Residual Dividend Policy: dividend will be paid when the earnings keep getting high.

According to Hepworth (1953 cited from Rahmawati 2002), investors consider if the earnings is stable, it will impact the dividend become stable. So motive of company does income smoothing is to smooth the fluctuation of earnings and keep the dividend ratio constant. Kustono (2009) did not find that DPR influences income smoothing. Meanwhile, Budiasih (2009) shows that dividend payout ratio has significant influence to income smoothing practices.

2.2. Previous Research

This research replicates Budiasih (2009) with some differences. The title is "Faktor-Faktor Yang Mempengaruhi Praktik Perataan Laba". Budiasih (2009) researched about factors influence income smoothing on manufacturing companies listed on Indonesia Stock Exchange in 2002-2006. The analyzed factors are company size, profitability, financial leverage and dividend payout ratio. The research used Eckel index to measure income smoothing. The results showed that company size, profitability and dividend payout ratio has influences to income smoothing and only financial leverage was not affecting.

Meanwhile, Widyaningdyah (2001) with title is "Analisis Faktor – Faktor yang berpengaruh terhadap *Earning Management* pada Perusahaan *GoPublic* di Indonesia". The variables are auditor's reputation, the amount of CEO, leverage, percentage of offered shares on IPO, and earnings management. The result shows only leverage has significant influence to earnings management.

Masodah (2007) studied about income smoothing in banking and finance company with data from 1992 until 2004. The title is "Praktik Perataan Laba Sektor Industri Perbankan dan Lembaga Keuangan Lainnya dan Faktor-Faktor Yang Mempengaruhinya". The analyzed factors are political cost, bonus plan, debt to equity and profitability. The study found that only debt to equity which is significant influencing income smoothing on banking and finance company. The others have no significant influence to income smoothing.

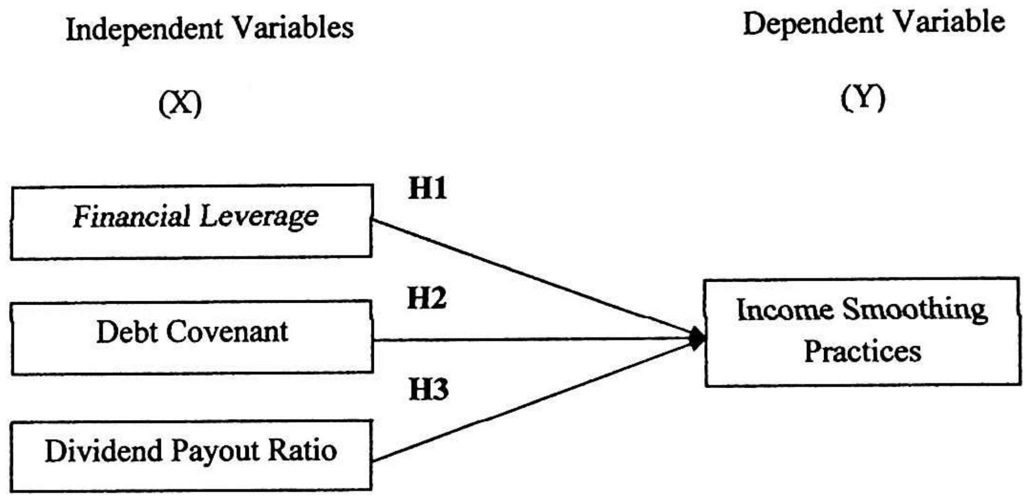
Rachmawati (2002) studied about factors that influence income smoothing and the comparison between return stock of company who do income smoothing and company who do not. The title is "Analisis Faktor-Faktor Yang Mempengaruhi Praktik Perataan Laba dan Hubungannya dengan Return Saham Perusahaan Yang Melakukan dan Tidak Melakukan Perataan Laba Pada Perusahaan Yang Listing Di Bursa Efek Jakarta". With Eckel index, Rachmawati differenciate company who did income smoothing or not on 1997-2000. The factors are firm size, winner/loser stock, debt to equity and sectoral group. The study shows that debt to equity and sectoral group influence significantly while firm size and winner/losser stock do not.

Kustono (2009) research's title is "Pengaruh Ukuran, *Devidend Payout*, Risiko Spesifik, dan Pertumbuhan Perusahaan terhadap Praktik Perataan Laba pada Perusahaan Manufaktur Studi Empiris Bursa Efek Jakarta 2002–2006". The first, second, third, fourth hypothesis assumed firm size, dividend payout ratio, firm specific-risk, and growth of firm influenced income smoothing. The results showed only growth of firm that influenced the income smoothing practical. Instead, the others factor haven't influenced it.

Rahmawati & Muid (2012) research title is "Analisis Faktor-Faktor Yang Berpengaruh Terhadap Praktik Perataan Laba (Studi Pada Perusahaan Manufaktur yang Terdaftar di BEI Tahun 2007—2010)". The variables used in this study is the size of the company, net profit margin, and debt to equity ratio. In the multivariate analysis for the three independent variables, only variables of firm size that have a significant effect on the practice of income smoothing. While the net profit margin and debt to equity ratio does not significantly influence the practice of income smoothing.

2.3. Theoritical Framework

Based on literature reviews and previous research, the theoretical framework is presented on this chart below:



2.4. Hypothesis

Financial leverage is defined by *debt to total assets*. It is calculated by dividing *total debt* to *total assets*. The indications of income smoothing practices could exists because the companies avoid debt infringement that implied from the capability of paying debts with the assets. A high leverage company is expected doing income smoothing due to the *default possibility*. So, management make strategy in order to increase the profit.

H1: The financial leverage significantly influences the income smoothing practices

Debt Covenant or debt equity ratio imply the capability of company in paying debt with the equity. The higher the DER, the higher proportion of company finance from debt. It dispose company breaks the loan's agreement due to cannot pay debt on due date. So company practices income smoothing to showing that the company has stable and good profit. According to Rahmawati (2002), debt equity ratio has a positive relation with income smoothing.

H2 : The debt covenant significantly influences the income smoothing practices

Investors choose the company to invest by considering the dividend. Company decides the amount of dividend (dividend per share) that will be given to shareholder by making dividend policy. To enhance investors's confidence, company should show a stable profit that results stable dividend. Because of that, managers could do strategy such income smoothing in stabilizing income.

H3 : The dividend payout ratio significantly influences the income smoothing practices

CHAPTER VI

CONCLUSION AND REMARKS

6.1. Conclusion

This research examined the relationship between Financial Leverage, Debt Covenant and Dividend Payout Ratio to Income Smoothing Practices on companies listed in Indonesia Stock Exchange from 2006 until 2011. This research exclude manufacturing and banking companies so the rest are agriculture, forestry and fishing, mining and mining services, constructions, securities, insurance, real estate and property, transportation services, telecommunication, whole sale and retail trade, hotel and travel services, holding and other investment companies, and also others sectors. The companies observed are 145 companies. In classifying the samples, this research used Eckel Index and it results 26 companies do income smoothing. But some data of 8 companies are not available so the total samples become 18.

Based on the analysis and discussion on Chapter IV, all the hypothesis are rejected. None of financial leverage, debt covenant and dividend payout ratio significantly influence the income smoothing practices partially and simultaneously. The conclusion as follows:

1. Financial Leverage presented as debt to assets ratio does not significantly influence Income Smoothing on the 18 samples might be cause of the samples are on the secondary samples and those still have small growth. It

also may because of the management has worked well controlling the assets and debts of companies.

2. Debt Covenant presented as debt to equity ratio does not significantly influence Income Smoothing practices. The reason might be cause of the facilitation given by PT. Kliring under Bappepam controls in loaning and issuing obligations or shares.

3. Dividend Payout Ratio does not significantly influence Income Smoothing practices because it may be dividend cannot detect by management yet before the general meeting of stock holders (RUPS).

6.2. Limitation

This study has many limitation in some aspects that could influence the results obtained. The limitation are:

1. This research only examined three factors which influence income smoothing practices. They are Financial Leverage, Debt Covenant and Dividend Payout Ratios. There are so many others factors could influence the income smoothing.

2. The samples of this research are companies listed on Indonesia Stock Exchange excluding manufacturing and banking companies. So they are agriculture, forestry and fishing, mining and mining services, constructions, securities, insurance, real estate and property, transportation services, telecommunication, whole sale and retail trade, hotel and travel services, holding and other investment companies, and also others sectors.

Even though the population is 145 companies, those classified by Eckel Index are only 26 samples with 8 samples do not require dividend data. So there are only 18 samples for this research which means this research has few samples.

6.3. Suggestion

In order to overcome the limitation, this research offer some suggestion, as follows:

1. Analyze others factors that influence income smoothing beside financial leverage, debt covenant and dividend ratio. The next researchers can put other factors such as bonus plan, tax policy, and stock return. The other factors could be not financial ratio because of the financial ratio used in this study do not significantly influence income smoothing. Those could be a *CSR* (Corporate Social Responsibility) or GCG factors.

2. Analyze all companies listed in Indonesia Stock Exchange with no exception and also if there is chance, in other country. So the samples are many in amount. The next researcher can analyze not only companies do income smoothing, but also those do not. For the regression, the logistic binary regression can be used.