

# Analysis of Earnings and Corporate Responses: An Empirical Study for Indonesia

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## Analysis of Earnings and Corporate Responses: An Empirical Study for Indonesia

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### ABSTRACT

The purpose of this research is to examine the influence of firm size, profitability, degree of leverage, and CSR disclosure on Earnings Response Coefficient (ERC). The populations in this research are manufacturing companies that listed on the Indonesia Stock Exchange (IDX) from the period of 2012 to 2014 and samples are determined using purposive sampling method. Total populations used in this research are 141 companies with total samples of 56 companies. The data used in this research are secondary data and the hypotheses are tested using multiple regression analysis models. The result of this research showed that firm size, and profitability have significant positive effect on Earnings Response Coefficient (ERC), but leverage and CSR disclosure do not have significant negative effect.

JEL Classification: G10; G14; M40; M41.

Keywords: Earnings Response Coefficient (ERC); Firm Size; Profitability; Leverage; CSR Disclosure.

### 1. INTRODUCTION

Income statement contains information about the company's profit or loss. Income statement is a report that assesses the performance of management. Income statement can estimate the ability of representative profit in the long term, it forecast earnings, and assess risks in investment or credit. High corporate earnings will get a positive response from investors. Investors expect returns and dividends from each stock investment (Adaoglu & Katircioglu, 2013; Shaeri & Katircioglu, 2018; Shaeri et al., 2016). On the other hand, creditors require a company's income statement for taking lending decisions. Ball and Brown (1968) explains that the companies share price able to respond to the content of the information in the financial statements. One of the content of the information contained in the financial statements can be measured by earnings response coefficients. Earnings response coefficient (ERC), which is used to view the content of the information contained in the financial statements can be an indication of the earnings quality. Cho and Jung (1991) defines the earnings response coefficient is the effect of any currency unexpected earnings on stock returns. Earnings response coefficients are usually measured by the slope of the regression coefficients abnormal stock returns and unexpected earnings. Beaver (1989) defines earnings response coefficient as the "sensitivity of changes in the stock price to changes in accounting profit". Earnings response coefficient (ERC) of each stock has a magnitude different because there are many factors that influence the earnings response coefficient. Several previous studies conducted to look at the factors that influence earnings response coefficient. Some studies earnings response coefficient investigate specific factors relating to the company into research model. Specific factors that include the company's growth, company size, timeliness (Daud and Syarifuddin, 2008), and the quality of the audit (Sandi, 2013).

Research conducted by Hasanzade et al (2013) found results that earnings quality, growth opportunities and profitability of the company significant positive effect on earnings response coefficient. But leverage no significant effect on earnings response coefficient. Research conducted by Moradi et al., (2010) explains that the financial leverage effect on earnings response coefficient. Dewi (2010) conducted a study on the factors that influence earnings response coefficient (ERC) and the study concluded that the size of the company negatively affect earnings response coefficient. Leverage and disclosure positive effect on earnings response coefficient, but the audit committee did not significantly affect earnings response coefficient. Another study tested the effect of firm size is done by Chaney and Jeter (1992). The results showed that the size of the company's positive effect on earnings response coefficient for a longer period. Research conducted Arfan and Antasari (2008) indicates that company size and profitability have significant negative effect on earnings response coefficient (ERC). Research results are not the same as research conducted by Chaney and Jater (1992) who found results that company size has an influence on earnings response coefficient.

Stakeholders will consider the information relating to the company's profit at the time of decision making. Information reported earnings, the company must demonstrate the credibility of the company. Credibility of the company affect on the company's credibility stakeholder trust. Stakeholders trust it relates to the quality of earnings in the financial statements. This research tries to re-investigate the effect of influence firm size, profitability, leverage and CSR disclosure on Earnings Response Coefficient. Based on the background described, the main problem will be investigated in this research is " What do firm size, profitability, leverage and CSR disclosure effect on Earnings Response Coefficient?"

## 2. LITERATURE REVIEW

Managers have opportunity to choice and use accounting policies, method and principles in the company. The opportunity is given to managers that can cause earnings reported by the manager does not provide real information. Earnings doesn't provide the real information about the company can affect the quality of earnings. There are differences of interest between shareholders (principal) and managers (agent) who lead agency problems. Jensen and Meckling (1976) states that there is a contract between manager (agent) and investor (principal). Principal is the person who gives credence to the agent to manage the company. Agent is someone who is empowered by the principal to manage the company. Agency contract is due to the separation between the principal and agent. Scott (2000) explains that there are some contracts that occurred in the companies represented by the manager with various stakeholders such as the employment contract between the company and the employee, a contract between the company and the creditors, and the contract between managers and shareholders. The employment contract is called the agency or agency contracts. The manager as agent have more and detailed information about the company. Shareholder as principal only has less information than the manager. This leads to asymmetry of information. The asymmetry of information that occurs between managers and shareholders resulting in the manager can perform earnings management.

Adnantara (2013) explains that company gives a signal to the capital market refers a good quality of capital market. At the time the company announced the information to the capital markets and capital market participants know the information because the companies give the signal to capital market participants. They can make the interpretation and analysis of that information as a good news or the bad news. If investors can make the interpretation from the company announcement as a good news, the volume of stock trading can changes. Signaling theory is used to explain and predict the behavior patterns of communication to the public managers. Market participants can make economic decisions on the basis of information publications, announcements and press conference in the capital markets (Jaswadi, 2004: 298). Investors need information about the company's prospects for investing their fund in the firm. Investors don't have information greater than the manager does. Firm managers who have better and greater information, they give a signal to investors about the company's prospects for the future. Signaling theory indicates that the firm financial reporting is a signal that can affect the firm value. The presence of a signal of the company led investors the right interpretation to anticipate. In general, managers are motivated to give a good news to stakeholders quickly. The information is expected to give a signal that the public was impressed and reflected in the stock prices of securities.

Earnings in the financial statements have an important role in assessing the performance of the company, measuring the value of the company and assess the firm's equity. Several studies in the stock market show the effect of earnings information on stock prices in the secondary market. If earning of the company is increased, the company's stock price and stock return can be predicted increase will automatically. The relationship between earnings and stock returns are generally tested using event study and the method of association. Event study method allows researchers to separate the influence of other information that may reduce the validity of research results. Association method using a longer window, causing the possibility of other information participate in influencing stock prices. Therefore, the results indicate the association method doesn't relate earnings and stock returns. Association method explains the earnings ability to catch relevant events that are useful in the study stock prices (Collins and Kothari, 1989). The investors can make investment decision in financial instruments and they hope to get expected return. Stock returns (Robert, 1997) are the the level of income earned by investors. Stock return consists of two types is yield and capital gain. Yield is the profit earned through periodic payments such as interest payments on deposits, interest on bonds, dividends. Capital gain is the difference between the selling price and the purchase price of shares.

Cho and Jung (1991) defines Earning Response Coefficient (ERC) as the effect of each dollar of earnings surprises on stock returns. This shows that the Earning Response Coefficient (ERC) is a reaction to earnings announced company. Earnings response coefficient also called sensitivity accounting profit coefficients.

Earnings response coefficient is a measure of stock price changes to changes in earnings. Earnings response coefficient (ERC) derived from regression between CAR (Cumulative Abnormal Return) with the EU (Unexpected Earnings). Cho and Jung (1991) classifies the theoretical approach of earnings response coefficient into two groups. First, earnings response coefficient based on the assessment mode<sup>16</sup> economic information and earnings response coefficient based on valuation models on earnings time series. Assessment mode<sup>16</sup> based on economic information shows that investor response to the signal strength of the earnings information (ERC) is a function of the uncertainty in the future. The worse the signal information content of earnings and investor perception of information systems (meaning the lower the quality of earnings), the smaller the earnings response coefficient. Valuation models that are based on earnings time series (time series based valuation model) developed by Beaver et al (1980). This model assumes that the earnings response coefficient is a function of the time series processes as information variables that can predict the amount of dividend.

Larger companies more attractive to investors because the company's profit will affect the market response associated with stock returns. The larger company also noticed better performance because it tends to be the subject of public research more closely, so the need to respond more open to requests stakeholders. The larger company will provide disclosure of more information than the small companies. Firm size has relation with earnings quality. If the firm is large, non-accounting information available other than financial statements information. Financial information about earnings will be responded positively by investors at the time of the earnings announcement. Profitability is business performance measurement. Arfan and Antasari (2008) explains that company's profitability is the ratio between profit with assets. Profitability is the company's ability to generate profits for a certain period. Profitability has a relationship with the market reaction to the company's profit. Profitability can measure the effectiveness company's performance and demonstrate the company's ability to generate profits for a certain period. Profitability is used to determine the rate of return obtained by investors in investment decisions.

Brigham and Houston (2010: 14)<sup>6</sup>, explains that the financial leverage is a measure that indicates the extent to which fixed income<sup>21</sup> securities (debt and preferred stock) used in the company's capital structure. Financial leverage indicates the proportion of the use of debt to finance investment. The leverage ratio is the proportion of total debt to equity shareholders. The ratio is used to provide an overview of the capital structure of the company, and the risk of a debt can not be collected (Almilia and Retrinasari, 2007: 4). Additional leverage ratio is the proportion of debt to total assets of the company. Companies that have a high leverage ratio means the company uses debt and other liabilities in large amounts to finance assets. Companies that have high leverage ratios have a higher risk than companies with lower leverage.

Principles of Corporate Social Responsibility is at the core of business ethics. This principle explains that the company not only has the economic and legal obligations, but the company has an obligation to stakeholders. Corporate social responsibility with regard to all parties include the company's relationships with all stakeholders, including customers, employees, communities, owners<sup>15</sup>, or investors, government, suppliers and even competitors (Nurlela and Islahudin, 2008: 2). World Bussiness Council for Sustainable Development (2002) defines CSR as: the commitment of business to sustainable economic development, working with employees, reviews their families, the local community and society at large to improve reviews their quality of life.

Cho and Jung (1991) support<sup>22</sup> positive relationship between earnings response coefficients and firm size. This research explained there was a positive relationship between firm size and earnings response coefficients, because a large firm provide more extensive information about firm economic profit. The more information available about the activities of large companies, the easier for the market to interpret the information in the financial statements. But the other researcher, Collins and Kothari (1989) found that company size is negatively related to earnings response coefficient. The negative relationship occurs because the amount of information available throughout the year at the company, when the market reacted poorly to earnings announcement<sup>23</sup>s. Murwaningsari (2008: 10) expresses that firm size has effect on the issue of earnings response coefficient (ERC) is used as a proxy for the stock price informativeness. The results showed that firm size significant negative effect on earnings response coefficient. Based on this theory and previous research, the hypothesis is formulated as follows :

H1: There is significant positive effect firm size on Earnings Response Coefficient (ERC)

Naimah and Utama (2006) explained the effect of firm size, growth, and profitability on earnings response coefficient for the companies with high profitability, and the effect of accounting earnings to share price will be greater than the company with low profitability. Arfan and Antasari (2008) stated that the profitability doesn't have a significant effect on earnings response coefficients.

The results of this study are not consistent with research conducted by Burgstahler and Dichev (1997) and Naimah and Utama (2006) which shows that the profitability of the company affect earnings response coefficient. Based on theory and previous research, the authors propose the following hypothesis as follow:

H2: There is significant positive effect profitability on Earnings Response Coefficient (ERC).

Murwaningsari (2008) states there is a negative effect leverage on earnings response coefficient (ERC). Research results according to Dhaliwal et al., (1991) which proves that leverage negatively affect earnings response coefficient. Companies have a more leverage means the companies have more debt than capital. If the company has more earnings, the debtholders will be profitable. But the other side, this condition means shareholders have negative response, because profit was earned by firm means it was benefit for creditors. Based on theory and previous research, the authors propose the following hypothesis:

H3: There is significant negative effect leverage on Earnings Response Coefficient (ERC).

The results of empirical research on the effect of disclosure of Corporate Social Responsibility (CSR) against earnings coefficient response conducted by previous researchers indicate market a appreciation on CSR information on earnings response coefficient still rare and have not shown consistent results. Research conducted by Sayekti and Wondabio (2007), found that the companies have more extensive CSR disclosure, they have a weak correlation eith return earnings. It aims to reduce the information asymmetry caused by earnings coefficient response which is the quality of corporate profits. Widiastuti (2002) conducted a study on the effect of voluntary disclosure in annual reports to the earnings response coefficient. This study did not show consistent results with predictions pect that voluntary disclosure negatively affect earnings response coefficient. Empirical testing actually showed a positive and significant effect of voluntary disclosure to the earnings response coefficient. Results of research conducted by David and Syarifuddin (2008) also showed a positive and significant influence between CSR and earnings response coefficient. Based on the above presentation, then the hypothesis proposed in this study are:

H4: There is significant negative effect CSR disclosure on the Earnings Response Coefficient (ERC).

The following section will describe definition of data and methodology; thenafter, results and conclusion will follow.

### 3. METHODOLOGY

The population in this study are manufacturing companies listed in Indonesia Stock Exchange during the period 2012-2014. The samples in this study are using purposive sampling method. Purposive sampling method is the sample must be representative of the population with a certain considerations (Indriantoro and Supomo, 2002). Based on the purposive sampling method in this study with the following criteria: a) Manufacturing companies listed on the Indonesia Stock Exchange and present audited financial statements completely during the years 2012-2014, b) financial statements of manufacturing companies use Rupiah currency, c) manufacturing company is not delisting during the period 2012-2014, d) manufacturing companies do not undertake mergers, acquisitions, and share trading suspended, e) manufacturing companies that do not earn a loss for the period 2012-2014.

Analysis of the data used in the study is descriptive analysis and multiple regression analysis. Descriptive analysis is used to provide a description of the data which was considered the average (mean), standard deviation, variance, maximum, minimum, sum, range, kurtosis, and skewnes (Ghozali, 2012). Multiple regression test was conducted to determine the effect of independent variables on the dependent variable. Testing the hypothesis used to explain the influence of independent variables on the dependent variable. Data must pass the test classic assumptions to be used in testing the hypothesis. The classical assumption in this research is the normality test, multicollinearity, heteroscedasticity test and autocorrelation test.

Multiple regression test was conducted to determine the effect of independent variables on the dependent variable with the following equation are as follows :

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \varepsilon \quad (1)$$

Where Y = earnings Response Coefficient (dependent variable);  $\alpha$  = constants

$\beta_1, \beta_2, \beta_3, \beta_4$  = regression coefficient independent variable;  $X_1$  = firm size;  $X_2$  = profitability

$X_3$  = leverage;  $X_4$  = CSR disclosure;  $\epsilon$  = error term.

Partial test (T-test) was conducted to determine firm size, profitability, leverage and Corporate Social Responsibility (CSR) disclosure as independent variables individually can predict the earnings response coefficient (ERC). Basic decision-making is done by using a figure of significance, that if the figure of significance  $> 0.05$ , then  $H_0$  is not rejected, which means partially independent variables can not be used to predict the dependent variable with a confidence level of 95%. If the probability of significance  $\leq 0.05$ , then  $H_0$  is rejected and  $H_a$  accepted which means partially independent variables can be used to predict the dependent variable with a confidence level of 95%.

Adjusted R Square used to determine the percentage of variation of the independent variables used in the model is able to explain the dependent variable. The coefficient of determination is between zero and one. If the adjusted R-square value is close to zero, meaning the ability of independent variables in explaining the dependent variable is very limited. If the adjusted R-square close to one, it means that the independent variables are able to explain or provide information needed to predict the dependent variable.

F test shows whether all the independent variables included in the model have influence together on the dependent variable (Ghozali, 2012: 98). This testing is done by looking at the significance of the F value of the ANOVA table. If the value of Prob (F-Statistics) is smaller than  $\alpha$  ( $\alpha = 5\%$ ), or the value of F-statistic greater than F-table, then all the independent variables together significantly influence the dependent variable

#### 4. RESULTS AND DISCUSSION

The classical assumption in this research is the normality, multicollinearity, heteroscedasticity, and autocorrelation test. There are the results of tests performed classical assumption in this study. From Table 1 appears that this research escaped from the classical assumption that can be used to test hypothesis.

**Table 1. Results of Classic Assumption Test**

Normality Test		Multicollinearity Test		
One-Sample Kolmogorov-Smirnov Test	Unstandardized Residual	Collinearity Statistics		
Kolmogorov-Smirnov Z	0.752	Model	Tolerance	VIF
Asymp. Sig. (2-tailed)	0.624	Firm size	0.715	1.399
<b>Autocorrelation Test</b>		Profitability	0.873	1.146
Runs Test	Unstandardized Residual	Leverage	0.844	1.185
Asymp. Sig. (2-tailed)	0.439	CSR Disclosure	0.767	1.304
<b>Heteroscedasticity Test</b>				
Model		t	sig	
Firm size		-0.449	0.654	
Profitability		-0.722	0.472	
Leverage		0.541	0.589	
CSR Disclosure		-0.683	0.495	

The results of multiple linear regression analysis with SPSS for Windows on this research as follows :

$$Y = -28.817 + 8.117X_1 + 0.350X_2 - 0.374X_3 + 0.090X_4 + \epsilon \quad (2)$$

From this results of multiple regression can be explained below:

- a. Constant value of -28.817 which means that if the firm size, profitability, leverage, and CSR disclosure are equal to zero, then earnings respon coefficient amounted to 28.817.
- b. <sup>12</sup> X<sub>1</sub> coefficient of 8.117 that the firm size has a positive relationship with the earnings respon coefficient. It indicate that the increase in the firm size of the variable will raise variable earnings respon coefficient at 95 percent confidence level, and vice versa. If an increase in the firm size of a variable by one percent will raise variable earnings respon coefficient by 8.117 percent
- c. X<sub>2</sub> coefficient of 0.350 that the profitability has a positive relationship with the earnings respon coefficient. It indicate that the increase in the profitability of the variable will raise variable earnings respon coefficient at 95 percent confidence level, and vice versa. If an increase in the profitability of a variable by one percent will raise variable earnings respon coefficient by 0.350 percent
- d. X<sub>3</sub> coefficient of -0.374 that the leverage has a negative relationship with the earnings respon coefficient. It indicate that the increase in the leverage of the variable will decline variable earnings respon coefficient at 95 percent confidence level, and vice versa. If an increase in the leverage of a variable by one percent will decline variable earnings respon coefficient by 0.374 percent
- e. X<sub>4</sub> coefficient of 0.090 that the CSR disclosure has a positive relationship with the earnings respon coefficient. It indicate that the increase in the CSR disclosure of the variable will raise variable earnings respon coefficient at 95 percent confidence level, and vice versa. If an increase in the CSR disclosure of a variable by one percent will raise variable earnings respon coefficient by 0.090 percent.
- f. Adjusted R square of 0.153, means that 15.30 percent of the variation fluctuation earnings respon coefficient is explained by firm size, profitability, leverage and CSR disclosure , and 84.70 percent was explained by other variables not investigated.

T-test used to determine whether the firm size, profitability, leverage and Corporate Social Responsibility (CSR) disclosure as independent variables partially can predict the earnings response coefficient (ERC). Basic decision-making is done by using a figure of significance, that if the figure of significance > 0.05, then Ho is not rejected, which means partially independent variables can not be used to predict the dependent variable with a confidence level of 95%. Meanwhile, if the probability of significance ≤ 0.05, then Ho is rejected and Ha accepted which means partially independent variables can be used to predict the dependent variable with a confidence level of 95%.

Based on the results of data processing are shown in Table 2, firm size has a significance value of 0.001 which is smaller than the significance level of alpha ( $\alpha = 0.05$ ). Therefore, it can be concluded that H<sub>1</sub> accepted, which means the firm size has a significant positive effect on earnings response coefficient (ERC) with a confidence level of 95%.

<sup>9</sup> **Table 2. Result of Multiple Regression Outputs**

Models	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
Model	-28.817	8.677		-3.321	0.001
Firm size	8.117	2.496	0.274	3.252	0.001
Profitability	0.350	0.113	0.236	3.099	0.002
Leverage	-0.374	0.308	-0.094	-1.213	0.227
CSR Disclosure	0.090	0.350	0.021	0.258	0.797
Adjusted R Square	0.153				

Dependent variable: ERC

The results support the argument that the more extensive information available on large companies provide a better form of consensus on economic profit. In large companies, there are many non-accounting information throughout the year. The information is used by investors as a means to interpret financial statements with better, so it can be used to predict cash flow and reduce uncertainty. At the time of the earnings announcement, the earnings information will be responded positively by investors.

The company has more total assets, it shows that the company has reached a stage of maturity where at this stage the company has good prospects in a relatively long period of time. This will result in the return received by investors is relatively stable, so the market response was rising. This research supports previous research conducted Sandi (2013), Naimah and Utama (2006), and opposite to research conducted by Collins and Kothari (1989), and Murwaningsari (2008). Profitability has a significance value of 0.002 which is smaller than the significance level of alpha ( $\alpha = 0.05$ ). Therefore, it can be concluded that H2 accepted, which means the profitability has a significant positive effect on earnings response coefficient (ERC) with a confidence level of 95.

This research is consistent with the conceptual framework of earnings response coefficient. Based on the conceptual framework, it is expected that the higher profitability, earnings response coefficient will be higher and vice-versa. The increase in profitability can strengthen the relationship between dividend changes and the annual stock return. investors to invest in order to obtain a great return. Investors will be looking for companies that provide a great return on investment. Gain on increase in shares owned by the expectations of investors in the future. Profitable companies capable of completing the operations being carried out at this time, as indicated by earnings. This research supports previous research conducted by Naimah and Main (2006), Hasanzade et al (2013).

Leverage variables have a  $\beta$  of -0.374 which showed a negative direction and a significance value of 0.227 where the significance level is greater than alpha ( $\alpha = 0.05$ ). Therefore, it can be concluded that H3 rejected, which means leverage does not have a significant negative effect on earnings response coefficient with a confidence level of 95%. The results of this study explains that companies that have a high leverage not always the potential losses that lead to bankruptcy. This is because the debt is used to benefit the company in the form of tax shelter. Interest paid by the company to reduce corporate taxes. Companies that have a high leverage will use the proceeds of leverage to gain huge profits for shareholders than the cost of the asset and source of funds. Companies that have a large debt becomes more attractive to investors as investors concentrate on companies that provide return than seeing the company's ability to pay liabilities or debts. This research supports previous research conducted by Wijayanti (2013) and the opposite to research conducted by Moradi et al (2010) and Murwaningsari (2008)

CSR disclosure has a  $\beta$  of 0.090 which indicates a positive direction and a significance value of 0.797 where the significance level is greater than alpha ( $\alpha = 0.05$ ). Therefore, it can be concluded that H4 rejected, which means Corporate Social Responsibility (CSR) disclosure does not have a significant negative effect on earnings response coefficient with a confidence level of 95%. The results of this study explained that CSR disclosure does not have a significant effect on earnings response coefficients. CSR disclosure that the company has done can not fix the level of confidence of investors to invest in the company. Investors still do not have a high level of confidence to believe in CSR disclosure. CSR widening should be able to reduce the uncertainty of the informativeness of earnings in the future regarding the company's prospects. Informativeness of earnings will be even greater when there is uncertainty in the future. With the disclosure of CSR should be lowered earnings response coefficient (ERC). But in this study produced findings that investors still trust the information contained in the financial statements. This research supports previous research conducted by Sukirman and Meiden (2012) and the opposite to research conducted by Sayekti and Wondabio (2007).

## 5. CONCLUSION

The purpose of this research is to examine the influence of firm size, profitability, degree of leverage, and CSR disclosure on Earnings Response Coefficient (ERC). This results of this research show that: 1) There is a significant positive effect firm size on Earnings Response Coefficient, 2) There is a significant positive effect profitability on Earnings Response Coefficient, 3) There is no significant negative effect leverage on Earnings Response Coefficient, 4) There is no significant negative effect CSR disclosure on Earnings Response Coefficient.

This research has limitations as follow that the period of observation is 3 years, so it is necessary to do more research on earnings response coefficients in a long time. Manufacturing companies that the research sample, can not generalize the results for all industries, and adjusted R-square value is small indicate where future research may use other independent variables especially is firm growth, the company's risk, and the persistence of earnings.

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