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The factors that Influence Earning Response Coefficient: In the Context of Indonesian Capital Market in Year 2015-2018

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ABSTRACT

Investing in a business that consistently generates profits is what every investor undoubtedly wants to do. Investors want to put their money into profitable businesses, without a doubt. The effective application of operations management and financial regulations has led to these high-quality results. When building an investment portfolio, investors should be far more knowledgeable of and devote attention to the quality of profits and internal control of the firm. With Corporate Governance serving as the moderation variable and earning response coefficient serving as the dependent variable, this empirical study aims to determine the relationship between Conservatism, which is a way of presenting numbers in financial statements, return on assets, asset turnover, and Ectivity Performance. In this study, manufacturing companies in the basic and chemical industries that have been registered on the National Stock Exchange of india (IDX) between 2015 and 2018 were examined using purposeful selection and panel data regression analysis. The main conclusions of this study were that asset turnover, return on assets, and Conservatism all significantly affect the earning response coefficient. Additionally, it was shown that the earning response coefficient is influenced by earnings quality, which is tempered by Corporate Governance.

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1. INTRODUCTION

The World Bank and IMF estimate that Indonesia might have the fifth-largest economy in the world by 2024 (Kencana, 2020). This suggests that even if investors and economic potential are now behind, Indonesia's capital market is quite capable of dramatically improving. Typically, obtaining a high capital return is the goal of investing in the stock market (Alexander, Nico, 2013).

Investors frequently perform financial analyses as part of their planning for the purchase of shares in order to determine the expected return, such as analyzing the data from corporate financial statements by converting them into different financial ratios, such as the return on assets, asset turnover, debt to equity ratio, and others. Additionally, via sound Corporate Governance, investors should gauge the caliber of company earnings and internal controls.

When investing in the stock market, investors undoubtedly want to make money. They do not, however, want to put their money into businesses whose financial statements are merely window

dressing or earnings management. The financial accounts' figures do not accurately reflect the company's success because of the management of the company's window-dressing actions. Due to the fact that the statistics in the financial statements are improving and being adjusted such that profits and growth for each period of the firm improve, investors will likewise be incorrect in their investment decisions as a result of this window-dressing effort.

The amount of a company's earnings is one of the important factors in evaluating its value. Companies with a high earnings quality can evaluate the aspects of the earnings cycle that are crucial for decision-making (Dechow, 2010). This is true because profit is a metric that may be used to gauge how effectively a business is run.

Earnings data may reveal if a company is successful or unsuccessful in achieving its stated operating objectives. According to Siallagan, Hamonangan dan Machfoedz (2006) Conservatism is viewed as an accounting approach that will result in the following outcomes when financial statements are being made: delayed revenue recognition, direct expense recognition, asset valuations that are lower than their actual values, and obligation valuations that are higher than their actual values.

Opportunistic managerial conduct in real earnings management may be minimized by having strong Corporate Governance. Good Corporate Governance (GCG) emphasizes management that upholds the principles of impartiality, equity, and equality in order to advance the achievement of business sustainability (KNKG, 2006). The term "Corporate Governance" can refer to how the board of directors, board of commissioners, business management, and shareholders behave in specific circumstances, Indonesian Forum for Corporate Governance (FCGI, 2001)

This study makes two scientific contributions, at the very least. This study first attempts to do an integrated study. In contrast to other studies, this one focuses on the link between Corporate Governance, information content of profits (measured by the earnings response coefficient), and Ectivity Performance (with or without earning management).

The majority of current research solely looks at the connections between Corporate Governance and Ectivity Performance, Ectivity Performance and earning response coefficient, and Ectivity Performance and earning response coefficient. One of the rare studies that attempts to explore the connection between the three in an integrative study is this one.

CONCEPTUAL FRAMEWORK

To understand the principles of Corporate Governance practices, one must understand the agency theory idea. According to agency theory, managers working as agents and shareholders acting as principals are connected in some way (Puteri & Rohman, 2012). The principle is the person instructing the agent to act on the principal's behalf. The agent is the person assigned by the principal to manage the company. A form of conflict called agency conflict can develop in an agency relationship. Agency conflicts are caused by the separation of the agent's and principal's roles and by competing interests.

a. Conservatism

The tendency of accountants to accept negative news before positive news is known as Conservatism (Basu, 2005). The implementation of this theory demonstrates that Conservatism increases as verification requirements for profit recognition increase. According to Hille (2011) accounting Conservatism is a mismatch between the verification of positive and negative cash flows. Basu's assertion is consistent with Watts (2003) assertion that "the requirement for differential verifiability in order to recognize profit vs. loss is what is known as Conservatism."

b. Earnings Quality

To deliver accurate information, financial statements' earnings must be of exceptional quality (Bandi, 2009). Give accurate information, financial statements' earnings must be of a high standard. Quality earnings must be able to provide sustainable earnings in the future, which are determined by the accrual and cash components, in order to correctly depict the company's genuine financial performance (Sadiah, H. & Priyadi, 2015). The quality of earnings is defined as "higher quality earnings convey more information about the parts of a firm's financial performance that are crucial to a given decision made by a specific decision-maker." (Dechow, 2010).

c. Activity Performance

The asset turnover ratio is one factor that may be taken into account when making investment decisions in order to observe the activities carried out by the firm; this might cause changes in stock returns. When business activity is low, a particular level of sales will lead to more surplus money being entrenched in unproductive assets, which might lead to a drop in total asset turnover (Ika, 2012). An asset turnover proxy can be used to evaluate how effectively assets are utilised. Asset turnover ratio measures how well a corporation uses its assets to produce sales. The asset turnover ratio is calculated by dividing the total sales by the total assets of the firm.

d. Operating performance

Investors usually consider the profitability aspect known as return on assets. The ROA ratio assesses a company's ability to produce earnings or profits from its own assets (Kasmir, 2010). Compared to return on ordinary shareholders' equity, return on assets (ROA) measures a company's profitability by relating shareholder and creditor returns to all of its assets (Simamora, 2000). The higher the firm's profit margin and its position in terms of asset utilization, the higher the ROA. If a firm can more efficiently use its assets, investors will be more enticed to buy its stock. The price of the company's shares will increase due to the sharp increase in investor interest.

e. Earning Response Coefficient

Several factors, including earnings persistence, beta, business capital structure, growth prospects, and the informational value of pricing, influence how the market reacts to profits (Sayekti & Wondabio., 2007). Higher earning response coefficient values are anticipated for companies with more stable future earnings. If a business can keep making money, the market will react more favorably. The market's reaction demonstrates the accuracy of the company's disclosed earnings data. This explains why the ERC value would be higher the better the Ectivity Performance.

f. Corporate Governance Mechanism

According to agency theory, conflicts that have an effect on a company's earnings can arise from the division of labor and differences in interests between agents and principals. Profit reports tend to be produced by agents or management who have personal agendas rather than the interests of the principle. In a situation when there is an agency conflict like this, a control system that can balance the competing interests of the two parties is necessary. According to Boediono (2005) the Corporate Governance system has the ability to deliver a financial report that contains earnings information.

2. RESEARCH METHOD

The population of the research consists of 35 manufacturing companies operating in the basic and chemical sectors that have been listed on the Indonesia Stock Exchange (IDX) between 2015 and 2018. 140 pieces of data are used as a sample. Secondary data was acquired and retrieved from the company's annual financial statements for the 2015–2018 period, which are accessible on the company's website, as well as www.emiten.kontan.co.id, www.idx.co.id, and www.finance.yahoo.com. These financial statements were independently audited.

The objective of the empirical study model is to determine if Corporate Governance has a substantial impact on the link between Ectivity Performance and earning response coefficient. It also seeks to identify these effects. This study makes use of panel data regression modeling (panel data regression analysis). The mode of empirical investigation is as follows.

The hypothesis that Conservatism influences earning response coefficient will also be tested using model 1, which examines how Operational Performance and Activity Performance affect earning response coefficient. The following research methodologies will be used:

2.1 Model I

$$CAR_{it} = \alpha + \beta_1 UE_{it} + \beta_2 AT_{it} + \beta_3 UE_{NOACC_{it}} + \beta_4 ROA_{it} + \epsilon \qquad (1)$$

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2.2 Model II

$$CAR_{it} = \alpha + \beta_1 UE_{it} + \beta_2 UE * EQ * CG_{it} + \beta_3 AT_{it} + \beta_4 UE\_NOACC_{it} + \beta_5 ROA_{it} + \epsilon \quad (2)$$

Information:
CAR : Cumulative Abnormal Return
UE : Unexpected Earnings
EQ : Ectivity Performance
CG : Corporate Governance
SIZE : Company size
AGE : Company age
ATT : Asset turnover
ROA : Return on Asset
NOACC: Conservatism
ε : Error

2.3 Dependent Variable

As a proxy for measuring capital market views of information in earnings, the earning response coefficient (ERC) was assessed in this study. The model put out by Teets (1996) is used in the earnings response coefficient construct

$$CAR = \beta 0 + \beta 1 UE + \varepsilon \quad (3)$$

Abnormal Return (AR) is accumulated into CAR, which is computed daily with a 15-month interval beginning on January 1, 2015, and ending on March 31, 2019. The difference between the company's daily stock return and the daily market rate of return is used to determine the daily abnormal return.

$$CAR_{it} = R_{it} - RMt \quad (4)$$

Additionally, Sayekti & Wondabio (2007) scaled their definition of unexpected earnings (UE) by the share price at the end of the prior year in this study.

$$\boldsymbol{UE_{it}} = \frac{\boldsymbol{EPS_{it} - EPS_{it-1}}}{\boldsymbol{EPS_{it-1}}} \quad (5)$$

2.4 Independent Variable

a. Ectivity Performance

Discretionary accruals can be used to evaluate the quality of earnings (DACC). Total accruals are made up of both discretionary and non-discretionary accruals, and discretionary accruals can be defined as follows:

$$\mathrm{DACC_t} = \left|\frac{\mathrm{TACC_t}}{\mathrm{TA_{t-1}}}\right| - \mathrm{NDACC_t} \quad (6)$$

Information:
DACCt : Discretionary accruals in year t (absolute value)
TACCt : Total accruals in year t
TAt-1 : Total assets for sample firm i at the end of year t-1
NDACCt : Non-discretionary accruals in year t

b. Conservatism

The study's proxy for measuring Conservatism is found in Givoly & Hayn (2002) work as well as in Andreas et al (2017) paper.

$$\mathrm{KA_{it}} = \frac{\mathrm{NI_{it}} - \mathrm{CFO_{it}}\,\mathrm{X}(-1)}{\mathrm{TA_{it}}} \quad (7)$$

c. Operating Performance

In this study, operating performance is measured using the return on asset ratio. A company with high earnings will attract investors due to its higher rate of return. To put it another way, the

higher this ratio, the more capable the assets are of producing net profits. As shown below, the return on asset variable is computed.

$$Return\ on\ Asset = \frac{Net\ Income}{Total\ Asset} \quad (8)$$

d. Activity Performance

Therefore, the asset turnover ratio's value increases with the efficiency with which the organization uses its available assets. On the other hand, if the value is low, it is necessary to make the most of the asset's many functions.

$$Asset\ Turnover = \frac{Net\ Sales}{Total\ Asset} \quad (9)$$

2.5 Moderating Variable

a. Corporate Governance mechanisms

The moderating factors in this study were Corporate Governance procedures. Corporate Governance cannot be properly measured since it is a qualitative quantity.

Academics will be able to assess how the Corporate Governance procedure influences Ectivity Performance and how the market reacts to it by calculating the CG score. In order to estimate the Corporate Governance mechanism in this work, which is compatible with (Klapper & Love, 2004), (Shah et al., 2009), and (Wahidahwati, 2012), the following equation has been used:

$$\mathrm{CG} = \mathrm{f}(\mathrm{KI}, \mathrm{KA}, \mathrm{KM}, \mathrm{IN}) \quad (10)$$

Provided information:
KI : Independent commissioner
KA : Audit committee
KM : Managerial ownership
IN : Institutional ownership

Table 1. Scoring Criteria for Corporate Governance

Scoring standards	Weight (%)
Independent commissioner (KI)	45
Audit committee (KA)	20
Managerial ownership (KM)	20
Institutional ownership (IN)	15

2.6 Hypotheses

a. Conservatism on the earning response coefficient

Conservatism that prioritizes caution in fast realizing profits can result in financial statement statistics that are not inflated, ensuring that the information content of earnings reflects the company's operational success in genuine terms. Additionally, earning response coefficients that indicate information content with profit will be more accurate and relevant in reporting.

Ha1: Conservatism has a significant negative effect on the earning response coefficient.

b. Activity Performance (asset turnover) on earning response coefficient

The asset turnover can reveal whether or not a corporation is effective at utilising its assets to produce profits for the business. Investors will be extremely thrilled if the firm's earnings rise each year since it will mean that the company in which they invested in shares is becoming more profitable. It is anticipated that the company's stock price would rise along with its profits. The market response and emotion toward these equities will also be better and more prevalent in the market as a result of the growth in stock prices.

Ha2: Asset turnover has a significant positive effect on the earning response coefficient.

c. Operating performance (return on asset) on earning response coefficient

Investors will be extremely thrilled if the firm's earnings rise each year since it will mean that the company in which they invested in shares is becoming more profitable. It is anticipated that the company's stock price would rise along with its profits. The market response and emotion toward these equities will also be better and more prevalent in the market as a result of the growth in stock prices.

Ha3: The earning response coefficient is significantly positively impacted by return on assets.

d. Good Corporate Governance on relationship between Ectivity Performance and earning response coefficient

In their investigation of the effects of such mechanisms on earnings quality and firm value, Siallagan, Hamonangan dan Machfoedz, (2006) employ managerial ownership, the board of commissioners, and the audit committee as proxies for Corporate Governance structures. The quality of the firm's earnings are expected to be more positively reflected in the market response to the information content of accounting results the higher the company's Corporate Governance system is evaluated.

e. Ha4: Good Corporate Governance has a significant positive effect on relationship between Ectivity Performance and earning response coefficient

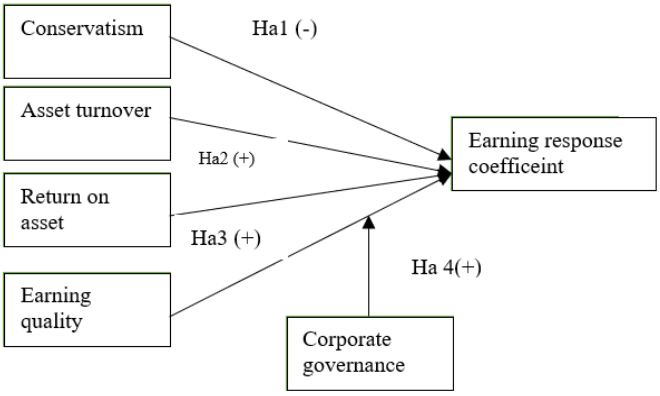

Figure 1. Thinking Framework

3. RESULTS AND DISCUSSIONS

3.1 Test Results for Selection of the Best Model for Regression Equation 1.

a. Chow Test Results

Between the common effect model and the fixed effect model, the Chow test was performed to find the optimal regression model to be employed in regression equation 1. The following are the hypotheses for the Chow test:

Table 2. Chow Test Result Regression Equation 1

Effects Test	*Probability*
Cross-section F	0.00

According to the Chow test findings in the table, the probability value in the cross section chi square is 0.00; in this situation, H0 is rejected while H1 is authorized because the value is less than 0.05, hence the fixed effect model was chosen. Because it is a fixed effect model, the chosen Chow test result will also be verified again using the Hausman test.

b. Hausman Test Results

The random effect model versus the fixed effect model was compared using the Hausman test to determine which was the appropriate regression model to utilize in regression equation 1.

Table 3. Hausman Test Result Regression Equation 1

Test Summary	*Probability*
Cross-section random	0.00

According to the results of the Hausman test in the table, the probability value as in the random cross section does have a value of 0.00 which indicates that such value is less than 0.05. Since the result will be smaller than the 0.05 significance criterion, H0 will be rejected and H1 accepted, the fixed effect model is the one that was chosen in regression equation 1.

c. Fixed Effect Model,

The regression results are as follows:

Table 4. F Test Result

Regression Equation	*Probability* (F-statistics)
1	0.00
2	0.00

3.2 Test Results for Selection of the Best Model for Regression Equation 2

a. Chow Test Results

Table 5. Chow Test Results Regression Equation 2

Effects Test	*Probability*
Cross-section F	*0.00*

According to the Chow test findings in the table, the probability value in the cross section chi square is 0.0002, in which case H0 is rejected while H1 is approved because the value is less than 0.05. As a consequence, the fixed effect model was chosen. Because it is a fixed effect model, the chosen Chow test result will also be verified again using the Hausman test.

b. Hausman Test Results

Table 6. Hausman Test Result Regression Equation 2

Test Summary	*Probability*
Cross-section random	0.00

The probability value as in random cross section does have a value of 0.0005, which signifies that such value is less than 0.05, according to the findings of the Hausman test in table. In regression equation 2, the fixed effect model was chosen since the outcome will be smaller than the 0.05 significance level, which indicates that H0 is rejected and H1 is accepted.

c. Fixed Effect Model,

the regression results are as follows:

Table 7. F test result

Regression Equation	*Probability* (F-statistics)
1	0.00
2	0.00

3.3 Multicollinearity Test Results

a. Multicollinearity Test Results Regression Equation 1

Table 8. Multicollinearity Test Results Regression Equation 1

Variable	Coefficient Variance	Uncentered VIF	Centered VIF
C	0.002630	1.68	NA
UE	0.000664	1.13	1.12
ROA	0.379482	1.16	1.01
AT	0.000665	2.23	1.56
UE_NOACC	0.003233	1.73	1.69

If no correlation-centered VIF score less than 10 demonstrates that there is no relationship between the research's independent variables, the study is said to be free of multicollinearity issues.

b. Multicollinearity Test Results Regression Equation 2

Table 9. Multicollinearity Test Results Regression Equation 2

Variable	Coefficient Variance	Uncentered VIF	Centered VIF
C	0.002488	1.68	NA
UE	0.001361	2.45	2.43
ROA	0.362746	1.17	1.02
AT	0.000630	2.24	1.56
UE_NOACC	0.003127	1.77	1.74
UE_EQ_CG	0.001345	2.25	2.20

If correlation-centered VIF score less than 10 demonstrates that there is no relationship between the research's independent variables, the study is said to be free of multicollinearity issues.

c. Test Results for Hypothesis testing of the Model for Regression Equation 1

Table 10. t Test Results

Variable	Regression Equation 1		Regression Equation 2	
	Coefficient	Probability	Coefficient	Probability
C	0.28	0.00	0.28	0.00

UE	0.06	0.00	0.15	0.00
UE_NOACC	-0.21	0.00	-0.25	0.00
ROA	4.98	0.00	4.73	0.00
AT	-0.18	0.00	-0.20	0.00
UE_EQ_CG			0.18	0.00

The first hypothesis examining the connection between Conservatism and the earning response coefficient is disproved. This is evident from the fact that UE NOACC has a significant value of 0.00, which is lower than the alpha value of 5%. The first hypothesis (H1), according to which Conservatism has an impact on the earning response coefficient, is thus accepted. The second hypothesis, which examines operational effectiveness in terms of earning response coefficient, is approved. This is indicated by the substantial ROA value of 0.0000, which is less than the alpha value of 5%. H2 is therefore acknowledged, which indicates that Operational Performance impacts the earning response coefficient.

Accepted the third hypothesis, which investigates the affect between Activity Performance and the earning response coefficient. This is evident from the significance level of AT, which is 0.00 and below the alpha value of 5%. Since Activity Performance has an impact on the earning response coefficient, hypothesis number three is accepted.

d. Test Results for Hypothesis testing of the Model for Regression Equation 2

The interaction variable UE_EQ_CG, which explores the impact of Corporate Governance on the link between Ectivity Performance and earning response coefficient, is used to measure hypothesis H4, which is accepted. This is evident from the significance value of 0.00, which is noteworthy at an alpha level of 5%.

Because the coefficient value is also positive, the link between Ectivity Performance and earning response coefficient can be mediated by the function of Corporate Governance.

3.4 Overview of research results

This study examines the effect of Conservatism, Operational Performance, Activity Performance, and the moderating effect of Corporate Governance on the relationship between Ectivity Performance and earning response coefficient. ERC is an indicator of capital market perception of the information content contained in earnings. The existence of good quality earnings quality can strengthen the market's perception of this earnings information content, depending on whether the capital market interprets the existence of earnings management in these quality earnings. However, regardless of the quality of earnings generated by the company, it is expected that the disclosure of Corporate Governance can moderate the relationship between the two so that the market perception of the information content of earnings quality (measured by the presence or absence of earning management) remains strong or can be strengthened. This study regresses cumulative abnormal return on unexpected earnings, total accruals for Conservatism, return on assets for Operational Performance, activity ratio for Activity Performance, and discretionary accruals.

4. CONCLUSION

Conservatism practices have a negative effect on earning response coefficients, because Conservatism makes the numbers in the financial statements biased and does not reflect the real numbers because it makes losses higher while gains are recognized to be more careful.

Activity Performance in this case asset turnover affects the earning response coefficient, but rejects the hypothesis because the regression results found that asset turnover has a negative effect on the earning response coefficient. This can be caused during the 2015-2017 period there was a change in PSAK 71 which resulted in lower asset turnover figures. Companies that apply PSAK 71 will cause asset turnover to be lower so that the market response will be better, because the market responds that this company is obedient in preparing its financial statements according to applicable regulations.

Operating performance, in this case measured by return on assets, has a positive effect on the earning response coefficient. The higher the return on assets value, the better the earning response coefficient, which reflects the market response.

The moderating role of Corporate Governance has a positive effect on the relationship between Ectivity Performance and earning response coefficient. This is because with the role of good internal control supervision carried out by Corporate Governance, it can oversee the role of agents, in this case management, to be able to carry out their duties properly in producing quality earnings so that the market will respond well to the quality earnings generated by company management.

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