The Effect of Income Smoothing, Earnings Presistence, and Other Factor on The Coefficient of Earnings Response

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ABSTRACT

The purpose of this study is to empirically examine the factors that affect earnings response coefficient (ERC). This study uses company growth, earnings growth, income smoothing, earnings persistence, profitability and leverage variables as independent variables and uses the earnings response coefficient (ERC) variable as the dependent variable.

The research was conducted on 43 consumer non-cyclicals and consumer cyclicals companies listed on the Indonesia Stock Exchange in the period 2020 to 2022 by producing 129 data obtained using purposive sampling method. All samples and data were tested and analyzed using the multiple regression method.

This study uses 6 independent variables and has 3 variables that affect the earnings response coefficient. The results of this study indicate that earnings growth has a positive effect on earnings response coefficient, income smoothing has a negative effect on earnings response coefficient, and leverage has a positive effect on earnings response coefficient while company growth, earnings persistence and profitability variables have no effect on earnings response coefficient (ERC).

KEYWORDS – Earnings Response Coefficient, Company Growth, Earnings Growth, Income Smoothing, Earnings Persistence.

1. INTRODUCTION

Financial statements serve as one of the primary means by which a company communicates its financial information to the public, particularly to investors and other stakeholders. These reports provide insights into a company's financial status, managerial performance, and changes in financial position, all of which are crucial for investors when making decisions (Nathaniel & Arfianti, 2020). Investors typically review a company's financial reports to assess its performance, with profit levels serving as one of the key indicators of company performance. Profit is often viewed as a reflection of a company's achievements and is used by both investors and creditors as a basis for decision-making (Fitriah, 2020).

Announcements of profit in the capital market can trigger market reactions, which are reflected in stock price movements and investment decisions. Market reactions are visible through changes in stock returns at the time of profit announcements. Significant fluctuations in these returns indicate the presence of abnormal returns, the difference between actual returns and expected returns. Abnormal returns, along with unexpected earnings, indicate the difference between actual profit and the expected profit of a company. The higher the abnormal return, the greater the expected stock return.

The focus of this research is on the Earnings Response Coefficient (ERC), which measures the relationship between stock returns and unexpected earnings. ERC reflects how changes in stock returns are associated with unexpected earnings announcements (Sun et al., 2021). A higher ERC suggests that profit announcements contain more informative value, whereas a lower ERC indicates less informative value in the earnings announcement. Thus, ERC can be a critical tool in evaluating the quality of earnings information presented in financial reports, helping investors make more informed decisions.

This research investigates several factors that may influence the Earnings Response Coefficient. Building on prior research by (Indah Sari & Rokhmania, 2020), which focused on company growth and earnings growth, this study expands the scope by examining four additional independent variables: income smoothing, earnings persistence, profitability, and leverage. The aim is to determine how these factors influence ERC and how they contribute to investor reactions to earnings announcements.

The selection of company growth and earnings growth as key variables in this study is based on the belief that companies with strong growth potential are more likely to generate future profits, attracting long-term investors (Indah Sari & Rokhmania, 2020). This study also includes income smoothing as a variable, considering its role in stabilizing reported earnings, which may appeal to investors by providing an impression of consistency (Herawaty & Prabowo, 2020). Earnings persistence is another factor examined, as it reflects a company's ability to maintain consistent profits over time, a trait that can be highly valued by investors (Kristanti & Almilia, 2019). Profitability and leverage are included as they are critical financial indicators that influence investor perceptions of a company's financial health and risk profile.

In this study, the research focuses on companies in the non-cyclical and cyclical consumer sectors listed on the Indonesia Stock Exchange (IDX) from 2020 to 2022. This contrasts with previous studies, which primarily focused on manufacturing companies. By focusing on this different sector, the research aims to provide fresh insights into how these variables affect the ERC in different industries.

2. THEORITICAL FRAMEWORK

2.1 Theoretical Framework

2.1.1 Agency Theory

According to (Herawaty & Prabowo, 2020), agency theory explains the contractual relationship between members of a company, particularly between the owners (principals) and the managers (agents). Under certain conditions, company management and investors may pursue their own personal gains, which cannot guarantee that agents will always act in the best interest of the principals (Yunietha & Palupi, 2017). This divergence of interests between principals and agents can lead to what is known as the agency problem. Agency problems arise when agents prioritize their own interests over those of the shareholders. To address this, principals must incur agency costs (Junitania & Prajitno, 2021). Management can provide financial reports as a form of accountability and a performance record to shareholders each period, helping to prevent agency problems. Shareholders can use the financial reports prepared by managers to make informed decisions (Valentina & Jin, 2021). However, company management has the ability to manipulate accounting figures in financial reports in various ways, as corporate performance is often evaluated based on the profits generated. Such practices, intended to present a favorable financial outlook to investors, can reduce the quality of reported earnings information, leading to discrepancies in the expectations of financial report users (Maulia & Handojo, 2022).

2.1.2 Signaling Theory

Signaling theory explains that companies tend to provide reliable financial information to external parties to address information asymmetry between management and external stakeholders (Agustina, 2017). According to this theory, companies convey important information to external parties as an effort to overcome this imbalance. Signaling theory highlights the importance of information for investors, as it provides insights into the company's past, present, and future financial condition, as well as its impact on business sustainability. Complete, accurate, and timely information is crucial for investors in the capital market to analyze and make investment decisions (Sun et al., 2021). Management's actions in providing signals affect future investor decisions (YAP & Firnanti, 2018). The earnings response coefficient (ERC) is related to signaling theory, as this theory explains how investors respond to the information disclosed by companies in their financial reports. A positive or negative signal can lead to changes in a company's stock price (Kristanti & Almilia, 2019).

2.2.1 Company Growth and Earnings Response Coefficient

Fauzan & Purwanto (2017) Found that company growth positively impacts the earnings response coefficient (ERC), as high growth signals rising stock prices, leading to increased profits. This profit growth is met with a favorable investor response, enhancing the ERC. In contrast, (Widiatmoko & Kentris Indarti, 2018) and (Suhandi & Sutrisno, 2022) argue that company growth negatively affects ERC because investors prioritize short-term gains like capital appreciation over long-term growth. Rapidly growing companies often distribute lower dividends, as they allocate funds for investment rather than payouts to shareholders. (Herawaty & Prabowo, 2020) suggest company growth has no effect on ERC, as companies with high growth potential tend to reinvest profits to support operations rather than distribute dividends, reducing immediate investor gains and thus influencing ERC less.

H1: Company growth affects earnings response coefficient.

2.2.2 Earnings Growth and Earnings Response Coefficient
Several studies, including (Davin, 2017), (Indah Sari & Rokhmania, 2020), and (Irawan & Talpia, 2021), demonstrate that earnings growth has a positive effect on ERC. This is because growing earnings send a positive signal to investors, who expect higher future returns (Herdirinandasari & Asyik, 2016). However, (ivon and widyasari, 2022)found a negative effect, where investors did not respond positively to increasing earnings. (Fransiska, 2023) reported no significant effect, suggesting that low earnings growth might indicate suboptimal financial performance, thus failing to garner market support, which dampens the ERC.

H2: Earnings growth affects earnings response coefficient.

2.2.3 Income Smoothing and Earnings Response Coefficient
Herawaty & Prabowo (2020) and (Palupi, 2021) found that income smoothing positively impacts ERC by increasing earnings stability, attracting investors. Conversely, (Tucker & Zarowin, 2006)and (Fuadi et al., 2022) argue that income smoothing negatively affects ERC by reducing earnings informativeness. (Rori et al., 2021) found no significant effect, attributing this to the complexity of detecting income smoothing in financial reports and other more immediate investor concerns, such as stock performance, debt, and regulatory changes.

H3: Income smoothing affects earnings response coefficient.

2.2.4 Earnings Persistence and Earnings Response Coefficient
Delvira, (2013) and (Saputra & Suhendah, 2021) observed that earnings persistence positively influences ERC, as consistent earnings growth over time encourages positive investor reactions. However, (Kristanti & Almilia, 2019) found a negative effect, suggesting that investors prioritize earnings informativeness over persistence. (Adam et al., 2019) argue that earnings persistence has no effect, as investors focus more on current earnings than on the company's ability to maintain consistent earnings over time.

H4: Earnings persistence affects earnings response coefficient.

2.2.5 Profitability and Earnings Response Coefficient
Research by (Kristanti & Almilia, 2019), (Rahmawati, 2020), (Awawdeh et al., 2020) and (Wahasusmiah & Indriani, 2022) shows that profitability positively impacts ERC. Higher profitability indicates effective capital utilization, boosting investor confidence in future earnings. In contrast, (Gurusinga & Pinem, 2019) report a negative effect, where stock prices tend to drop after earnings announcements, lowering ERC. (Suhandi & Sutrisno, 2022) found no significant effect, noting that profitability does not always provide strong signals for predicting market reactions.

H5: Profitability affects earnings response coefficient.

2.2.6 Leverage and Earnings Response Coefficient
(Gurusinga & Pinem, 2019) and (Wayan Nataliantari et al., 2020) assert that leverage positively impacts ERC, as debt financing boosts investor confidence in the company's earnings potential. However, (Awawdeh et al., 2020) and (Tamara & Suaryana, 2020) (Tamara & Suaryana, 2020) found a negative effect, suggesting high leverage decreases investor trust due to increased bankruptcy risk. (Sun et al., 2021), (Fitriah, 2020), and (Sasongko et al., 2020) found no significant effect, with Indonesian investors focusing more on stock market value than leverage-related risks when making investment decisions.

H6: Leverage affects earnings response coefficient.
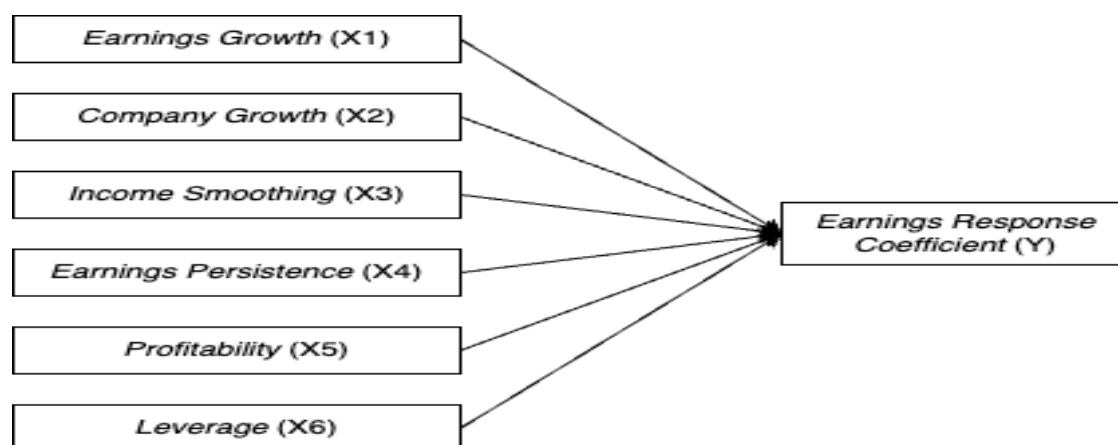
3. RESEARCH METHOD

Fig. Research Model

The objects in this study are manufacturing companies in the consumer cyclicals and consumer non-cyclicals sectors listed on the Indonesia Stock Exchange (IDX) from 2020-2022. The sampling technique in this study used purposive sampling method. This study used 43 companies as samples. sample selection in this study can be seen based on the following table:

Table 1 Sample Selection Table

No	Sample Criteria	Number of Companies	Total data
1.	Non-cyclicals and consumer cyclicals sector companies that are consistently listed on the Indonesia Stock Exchange (IDX) from 2020-2022.	209	627
2.	Consumer non-cyclicals and consumer cyclicals sector companies that do not consistently publish annual reports at the end of the year as of December 31 from 2020-2022	(11)	(33)
3.	Companies in the consumer non-cyclicals and consumer cyclicals sectors that do not consistently use rupiah currency from 2020-2022	(11)	(33)
4.	Companies in the consumer non-cyclicals, consumer cyclicals and basic materials sectors that do not consistently have profit after tax from 2020-2022	(144)	(432)
5.	Non-cyclicals and consumer cyclicals sector companies that are consistently listed on the Indonesia Stock Exchange (IDX) from 2020-2022.	209	627
6.	Companies in the consumer non-cyclicals and consumer cyclicals sectors that do not consistently publish annual reports at the end of the year as of December 31 from 2015-2022	(11)	(33)
	Jumlah sampel penelitian	**43**	**129**

3.1 *Earnings Response Coefficient*

The Earnings Response Coefficient (ERC) is a coefficient obtained from the regression between stock prices and accounting earnings (Sari & Rokhmania, 2020). Stock prices are proxied by the Cumulative Abnormal Return (CAR), while accounting earnings are proxied by Unexpected Earnings (UE) (Sari & Rokhmania, 2020). The calculation of ERC in this study follows the methodology outlined by as follows:

$$Rit = \frac{(P_{it} - P_{it-1})}{P_{it-1}}$$

R_{it} = Stock return of the company in period t
P_{it} = Closing stock price of the company on the publication day
P_{it-1} = Closing stock price of the company on the day before the publication day

$$Rmt = \frac{IHSG_t - IHSG_{t-1}}{IHSG_{t-1}}$$

Rmt = Market return in period t
$IHSG_t$ = Composite Stock Price Index on the publication day
$IHSG_{t-1}$ = Composite Stock Price Index on the day before the publication day

$$AR_{it} = R_{it} - R_{mt}$$

AR_{it} = Abnormal Return of company i in period t
R_{it} = Stock return of the company in period t
R_{mt} = Market return in period t

$$CAR_{it} = \sum_{-5}^{+5} AR_{it}$$

CAR_{it} = Cumulative abnormal return of company i at time t
AR_{it} = Abnormal return of company i at time t

$$UE_{it} = \frac{E_{it} - E_{t-1}}{E_{t-1}}$$

UE_{it} = Unexpected earnings of company i at time t
E_{it} = Earnings per share of company i at time t
E_{t-1} = Earnings per share of the company before time t

$$CARi_{(-5,+5)} = \beta_0 + \beta_1 UE_{it} + \varepsilon_{it}$$

$CARi$ = Cumulative abnormal return of company i during the observation period of $\pm$ 5 days around the financial report publication date (calculated over an 11-day event window: 5 days before the event, 1 day of the event, and 5 days after the event)
UE_{it} = Unexpected earnings in year t
β_0 = Constant
ε_{it} = Error term for company i in period t

3.2 *Company Growth*

High-growth companies tend to have a higher level of market responsiveness. This reflects the expectation that significant company growth will lead to increased future profits. Company growth can be measured through the price-to-book value as follows:

$$PBV = \frac{market\ price\ per\ common\ stock}{equity\ per\ share}$$

3.3 *Earnings Growth*

Earnings growth refers to the increase or decrease in a company's earnings over a specific period. Earnings growth can be proxied as follows:

$$\frac{net\ income_t - net\ income_{t-1}}{net\ income_{t-1}}$$

3.4 *Income Smoothing*

According to Herawaty and Prabowo (2020), Herawaty and Prabowo (2020) income smoothing is measured using a nominal scale. If an entity that practices income smoothing is given a value of 1, while an entity that does not practice income smoothing is given a value of 0. Income smoothing is proxied using the Eckel index as follows (Herawaty & Prabowo, 2020) :

$$\frac{CV\Delta I}{CV\Delta S}$$

3.5 *Earnings Persistence*

Earnings persistence measures a company's ability to sustain its earnings (Suhandi & Sutrisno, 2022). Earnings persistence can be calculated using the following ratio (Suhandi & Sutrisno, 2022) :

$$X_{i,t} = a + b_{i,t}X_{i,t-1} + e$$

Xi,t = Earnings of company i in period t
Xi, t-1 = Earnings of company i in the previous period (t-1)

3.6 *Profitability*

Company profitability reflects the ratio between income and assets that generates profit (Sasongko et al., 2020). According to the research conducted by (Sasongko et al., 2020), profitability is calculated as follows:

$$ROA = \frac{net\ profit}{total\ asset}$$

3.7 *Leverage*

Sasongko et al. (2020) define the leverage ratio as a measure of the extent to which a company is financed by debt from creditors relative to its equity. According to (Sasongko et al., 2020), leverage can be calculated using the debt-to-equity ratio as follows:

$$DER = \frac{total\ liability}{total\ equity}$$

4. RESULT

The following presents the results of the descriptive statistical test for this study:

Table 2 Results of Descriptive Statistical Test

Variabel	N	Minimum	Maximum	Mean	Std. Deviation
CAR	129	-8,10361	8,23635	-0,03565	1,19900
UE	129	-67,5556	82,3493	0,73571	10,4414
CG	129	0,24706	56,7919	3,51327	7,32056
EG	129	-0,97376	139,1830	1,89235	12,9337
IS	129	0	1	0,48062	0,50157
EP	129	-3,38469	2,31185	0,28937	0,70734
PROF	129	0,00042	0,34885	0,08539	0,06605
LEV	129	0,10240	4,41309	0,99114	0,93505

Source: Results of Data Processing using SPSS v.25

Table 3 Results of Frequency Test for Dummy Variable Income Smoothing

		Total	Persentase
No Income Smoothing	0	67	51,9%
Practices Income Smoothing	1	62	48,1%
Total		129	100%

Source: Results of Data Processing using SPSS v.25

The cumulative abnormal return (CAR) ranged from a minimum of -8.10361, recorded by Surya Citra Media Tbk. (SCMA) in 2020, to a maximum of 8.2362, observed by MNC Land Tbk. (KPIG) in 2020, with a mean of -0.03565 and a standard deviation of 1.19900. The unexpected earnings (UE) variable ranged from a minimum of -67.5556 for Nippon Indosari Corpindo Tbk. (ROTI) in 2020 to a maximum of 82.3493 for Bayu Buana Tbk. (BAYU) in 2022, with a mean of 0.73571 and a standard deviation of 10.4414.

The independent variable company growth (CG) from 2020 to 2022 had a mean of 3.51327 and a standard deviation of 732056. The minimum value of 0.24706 was observed for MNC Land Tbk. (KPIG) in 2022, while the maximum value of 56.7919 was recorded by Unilever Indonesia Tbk. (UNVR) in 2020.

Earnings growth (EG) from 2020 to 2022 had a mean of 1.89235 and a standard deviation of 12.9337. The minimum value of -0.97376 was noted for Bayu Buana Tbk. (BAYU) in 2020, and the maximum value of 139.1830 was also recorded by Bayu Buana Tbk. (BAYU) in 2022.

Income smoothing over the period from 2020 to 2022 had a mean of 0.48062 and a standard deviation of 0.50157. The minimum value of 0 was observed for 67 companies, including Sumber Alfaria Trijaya Tbk. (AMRT) in 2020, and the maximum value of 1 was noted for 62 companies, including Millennium Pharmacon International Tbk. (SDPC) in 2020.

Earnings persistence (EP) from 2020 to 2022 had a mean of 0.28937 and a standard deviation of 0.70734. The minimum value of -3.38479 was recorded by Catur Sentosa Adiprana Tbk. (CSAP) in 2021, while the maximum value of 2.31185 was observed for Akasha Wira International Tbk. (ADES) in 2021. Profitability (PROF) from 2020 to 2022 had a mean of 0.08539 and a standard deviation of 12.9337. The minimum value of 0.00042 was observed for Bayu Buana Tbk. (BAYU) in 2021, and the maximum value of 0.34885 was recorded by Unilever Indonesia Tbk. (UNVR) in 2020.

Leverage (DER) from 2020 to 2022 had a mean of 0.99114 and a standard deviation of 0.3505. The minimum value of 0.10240 was recorded by Indospring Tbk. (INDS) in 2020, and the maximum value of 4.41309 was observed for Millennium Pharmacon International Tbk. (SDPC) in 2022.

Table 3 T-Test Results

Variable	B	Sig	Conclusion
(constant)	0,418	0,115	-
UE	-0,278	0,006	Does not affect
CG	-0,022	0,322	Does not affect
EG	0,114	0,422	Does not affect
IS	-0,015	0,942	Does not affect
EP	-0,194	0,287	Does not affect
PROF	3,558	0,135	Does not affect
LEV	-0,140	0,324	Does not affect
UExCG	0,009	0,832	Does not affect
UExEG	0,002	0,029	Affects
UExIS	-0,311	0,038	Affects
UExEP	0,098	0,481	Does not affect
UExPROF	4,735	0,050	Does not affect
UExLEV	0,224	0,008	Affects

Source: Results of Data Processing using SPSS v.25

The company growth (CG) variable has a coefficient of 0.022 with a significance value of 0.322, which is greater than α (0.05), indicating that company growth does not impact cumulative abnormal return (CAR). The earnings growth (EG) variable has a coefficient of 0.114 with a significance value of 0.422, also greater than α (0.05), suggesting that earnings growth does not affect CAR. The income smoothing (IS) variable shows a coefficient of -0.015 with a significance value of 0.942, exceeding α (0.05), implying that income smoothing does not influence CAR. The earnings persistence (EP) variable has a coefficient of -0.194 with a significance value of 0.287, which is greater than α (0.05), indicating that earnings persistence does not affect CAR. The profitability (PROF) variable has a coefficient of 3.558 with a significance value of 0.135, also higher than α (0.05), suggesting that profitability does not impact CAR. The leverage (LEV) variable has a coefficient of -0.140 with a significance value of 0.324, exceeding α (0.05), indicating that leverage does not affect CAR.

The interaction between unexpected earnings and company growth (UExCG) has a coefficient of 0.009 with a significance value of 0.832, which is greater than α (0.05), showing that company growth does not influence the earnings response coefficient. The interaction between unexpected earnings and earnings growth (UExEG) has a coefficient of 0.002 with a significance value of 0.029, less than α (0.05), indicating that earnings growth positively affects the earnings response coefficient. High earnings growth can offer significant returns to investors, attracting their response (Davin, 2017).

The interaction between unexpected earnings and income smoothing (UExIS) has a coefficient of -0.311 with a significance value of 0.038, less than α (0.05), suggesting that income smoothing negatively affects the earnings response coefficient. Companies practicing income smoothing may reduce the in formativeness of earnings, making the information less relevant (Fuadi et al., 2022).

The interaction between unexpected earnings and earnings persistence (UExEP) has a coefficient of 0.098 with a significance value of 0.481, greater than α (0.05), indicating that earnings persistence does not affect the earnings response coefficient. The interaction between unexpected earnings and profitability (UExPROF) has a coefficient of 4.735 with a significance value of 0.050, equal to α (0.05), suggesting that profitability does not influence the earnings response coefficient.

The interaction between unexpected earnings and leverage (UExLEV) has a coefficient of 0.224 with a significance value of 0.008, less than α (0.05), indicating that leverage positively affects the earnings response coefficient. A favorable level of leverage improves market response to a company's stock during earnings announcements compared to companies with high leverage (Wayan Nataliantari et al., 2020).

5. CONCLUSION

This study aims to provide empirical evidence on the impact of income smoothing, earnings persistence, earnings growth, company growth, profitability, and leverage on the earnings response coefficient. Based on the analysis of 129 data samples from 2020 to 2022, the following conclusions can be drawn:

1. **Company Growth**: There is no effect on the earnings response coefficient. This finding aligns with (Herawaty & Prabowo, 2020) but contrasts with (Fauzan & Purwanto, 2017), Tamara and Suaryana (2020), and (Suhandi & Sutrisno, 2022), who found that company growth does affect the earnings response coefficient.
2. **Earnings Growth**: Has a positive effect on the earnings response coefficient. This result is consistent with (Davin, 2017), (Indah Sari & Rokhmania, 2020), and (Irawan & Talpia, 2021), but differs from (ivon and widyasari, 2022), who found a negative effect and (Fransiska, 2023) who found no effect.
3. **Income Smoothing**: Has a negative effect on the earnings response coefficient. This aligns with (Fuadi et al., 2022) but contradicts (Rori et al., 2021), (Herawaty & Prabowo, 2020), and (Palupi, 2021), who reported no effect or a positive effect.
4. **Earnings Persistence**: Does not affect the earnings response coefficient. This is consistent with (Adam et al., 2019) but differs from (Delvira, 2013), (Saputra & Suhendah, 2021), (Herawaty & Prabowo, 2020), and (Kristanti & Almilia, 2019), who found an effect.
5. **Profitability**: Does not influence the earnings response coefficient. This is in agreement with (Suhandi & Sutrisno, 2022) but contrasts with (Kristanti & Almilia, 2019), (Rahmawati, 2020), (Awawdeh et al., 2020), and (Wahasusmiah & Indriani, 2022), who found an effect.
6. **Leverage**: Has a positive effect on the earnings response coefficient. This supports (Gurusinga & Pinem, 2019) and (Wayan Nataliantari et al., 2020) but conflicts with (Awawdeh et al., 2020) and (Tamara & Suaryana, 2020), who found an effect, and (Sun et al., 2021), who found no effect.

In summary, earnings growth, income smoothing, and leverage significantly impact the earnings response coefficient, while company growth, earnings persistence, and profitability do not.

Limitations of this study:
1. The research period is limited to three years (2020-2022).
2. The study focuses solely on non-cyclical and cyclical sectors.
3. The adjusted R^2 value is only 10.9%.
4. The data does not follow a normal distribution.

Recommendations for future research:
1. Expand the scope of the study to include more sectors.
2. Extend the research period.
3. Incorporate additional independent variables.
4. Address data distribution issues through data transformation techniques.

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