



5th International CEO Communication, Economics, Organization & Social Sciences Congress

The Determinants of Earnings Response Coefficient (ERC) Evidence From Consumer Goods Companies Listed in Indonesia Stock Exchange for Period of 2016 to 2018

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ABSTRACT

Among all indicators in the financial report, earnings reflect major financial performance benchmarks for a company, which any improper reporting could mislead stakeholder's decision making, particularly in stock market. Earnings Response Coefficient (ERC) reflects the change in stock prices resulting from the announcement of earnings by the company. ERC supports a useful approach to financial reporting as management perceives better understanding of investors' response to financial statements and how investors could benefit from the published information. This study sought to investigate the four determinants of the ERC that accounts for profitability, investment opportunity set, firm size, and capital structure with the purposive data sampling from published audited financial statements of 29 Manufacturing Consumer Goods Indonesian listed companies for period of 2016 – 2018. Multiple regression analysis, supporting statistical data analysis are implemented with Eviews 11.0 and Excel 365 to quantify the relationship. The results indicate that profitability, capital structure, and firm size has a positive significant effect towards ERC, whereas investment opportunity set has no significant effect towards ERC. This paper expects future improvements with other variables and ERC models to be tested as ERC is perceivably insightful to improve investors and stakeholders' confidence in their stock investment decisions.

Keywords: Earnings Response Coefficient, Profitability, Investment Opportunity Set, Firm Size, Capital Structure.

INTRODUCTION

In the decision making process of portfolio investment in the stock market, investors must contain thoughtful and factual information that will considerably affect their investment decision. The most accessible and factual information mostly refers to respective companies' financial reports or statements. There are a number of sources for relevant indicators of investment information obtained from the financial statement that would determine or affect the market or investor reaction when the financial statement is being published (Jane, 2017).

The financial statement has provided decent information required by investors. The key financial ratios such as profitability, liquidity, leverage, efficiency, and market value are intended to provide meaningful relationships between individual values in financial statements (Reilly, Brown, 2006). In addition, it also drives the investment decision of investors when measuring a company's performance. According to Reilly, Brown (2006), a company's performance relative can be compared by aggregate economy; or by its industry; or past performance.

Earnings serve as the performance's benchmark and achievement for firms. This indicator is used by investors to consider the decision making whether to invest or not (Al-Baidhani, et. al, 2017). Investors would be misled if the earning's information is not factual or does not represent the actual company's performance. Hence, such a practical measurement approach for quality of earnings is needed.

One of the tools that evaluate the earnings' quality is Earnings Response Coefficient (ERC). According to Ummah (2012), ERC interprets the relation of stock returns to earnings surprises around the time of corporate earnings announcements. The Earnings Response Coefficient (ERC) is considerably correlated with the responsive strength associated with the information interpreted or contained in the earnings or profit (Collins et al. in Paramita and Hidayanti, 2013). The Earnings Response Coefficient (ERC) is another measure for the abnormal return observed in reaction to unexpected elements of earnings announced by a company publishing its earnings report. In other words, ERC measures the sensitivity of stock markets to the reporting of earnings through a regression slope coefficient between abnormal returns and unexpected earnings (Scott, 2009).

Research on Earnings Response Coefficient (ERC) is helpful for investors in fundamental analysis to determine market reaction on the earnings information of a company. Investors are expected to be able to predict the stock price of the earnings information to have an understanding of the factors that influence the ERC.

LITERATURE REVIEW

The study was conducted based on previous journals and literature studies that examine the determinants of Earnings Response Coefficient (ERC). Majority of previous studies used Earnings Response Coefficient (ERC) as a dependent variable, and other factors such as that most likely affect ERC as an independent variable. A study from Husiano and Suratno (2014) examined Beta, Leverage, Dividend Payout Ratio, and Earnings Persistence effect on Earnings Response Coefficient on the Compass Index 100 in period 2008-2013. The findings of the study were leverage, dividend payout ratio affects the ERC, systematic risk and growth opportunities not significant effect on the ERC. Other researchers; Novianti (2012) and Irawati (2012), used firm size as one of independent variables, with the result of no effect between firm size and

Earnings Response Coefficient (ERC). Meanwhile, The research done by Dewi and Rahayu (2018) found that Firm size has positive significance towards ERC. Result of research by Ambarwati and Sudarmaji (2019) indicates that systematic risks, leverage, and earnings persistence have positive significance towards ERC.

HYPOTHESIS DEVELOPMENT

Signaling Theory

Information asymmetry happens when two parties have access to different information. According to this theory, information asymmetry can be reduced if one party, the sender, must choose whether and how to communicate (or signal) that information, and the other party, the receiver, must choose how to interpret the signal. Thus, signaling theory is generally beneficial to explain the behavior when two parties have different access to information (Jama'an, 2008).

Earning's announcement provides a signal that the company has good prospects in the future (good news), so that investors are interested in investing. The reaction of investors would increase the value of Earnings Response Coefficient (ERC). And vice versa, the absence of a signal indicating the expectation of earnings of companies in the future will make the investors not react, thereby decreasing the ERC.

The effect of Profitability toward Earnings Response Coefficient

Profitability measures the ability of the company's management in generating economic value from its business operations such as sales, total assets and total equity in a form of net income or earnings (Raharjaputra in Risdawati, 2015). There exists such correlation of information asymmetry towards earnings quality or earnings response coefficient in which by practice, investors tend to allocate the resources to firms with higher level of profitability compared to the lower ones or investors put higher expectations to firms with high profitability (Gaol, 2014). Thus, this research will signify that profitability will positively affect earnings response coefficient in terms of Return on Assets calculation which was also done in accordance to the result of Risdawati (2015), Maharani (2017) and Anggraini (2015) related research on profitability, Return on Asset to ERC.

H1: Profitability has positive significant effect towards ERC

The effect of Investment Opportunity Set toward Earnings Response Coefficient

Investment Opportunity Set (IOS) improves expectations towards future earnings that will possibly give higher confidence of investors, the firm itself and other related stakeholders as IOS also reflects the room for growth that will also affect the earnings response coefficient (Scott in Imroatussolihah, 2013). Higher confidence would mean higher chance for positive market reactions after the earnings being announced which is denoted by positive earnings response coefficient (Smith and Watts in Wulansari, 2013). These statements are supported by research of Wulansari (2013).

H2: Investment Opportunity Set has positive significant effect towards ERC

The effect of Capital Structure toward Earnings Response Coefficient

According to Hossain et. al (2012), capital structure may be measured by leverage calculations. Leverage serves as one of the variables of capital structure to describe the percentage of assets funded by the firms' loans. Loans that firms have may correlate with the profitability and

growth the firms could achieve in the future (Keshtavar et al., 2013). This is supported by research of Ambarwati and Sudarmaji (2019), Irawati (2012) leverage of DER has positive significance towards ERC. In addition, the similar research conducted by Husiano and Suratno (2014), Risdawati (2015) showed positive significance of Debt-to-Asset Ratio (DAR) towards ERC.

H3: Capital Structure has positive significant effect towards ERC

The effect of Firm Size toward Earnings Response Coefficient

Confidence level of the investors may also be portrayed from the firm size as the larger and economically healthier tend to be more well-known to public and institutional fund managers. Factual reporting is usually done by these firms as their outgoing information may shift the investors’ decisions (Dechows et. al, 2010). This research may infer that firm size correlates positively towards the earnings response coefficient. This idea is supported by the research conducted by Dira and Astika (2014).

H4: Firm Size has positive significant effect towards ERC

METHODOLOGY

Population and Sample

This paper involves the population amounting to 51 companies whose stocks are traded in Indonesia Stock Exchange (BEI) which are categorized as manufacturing consumer goods during the period 2014 - 2018. The sampling design used for this research is categorized as purposive sampling. There are a total of 29 samples of manufacturing consumer goods listed companies that have fulfilled all of the criteria. List of samples are as follows:

Table 1. List of Samples

No	CODE	NAME OF LISTED COMPANY
1	ADES	Akasha Wira Internasional Tbk.
2	ALTO	Tri Banyan Tirta Tbk.
3	CEKA	Wilmar Cahaya Indonesia Tbk.
4	DLTA	Delta Djakarta Tbk.
5	DVLA	Darya-Varia Laboratoria Tbk.
6	GGRM	Gudang Garam Tbk.
7	HMSP	H.M Sampoerna Tbk.
8	ICBP	Indofood CBP Sukses Makmur Tbk.
9	INAF	Indofarma (Persero) Tbk.
10	INDF	Indofood Sukses Makmur Tbk.
11	KAEF	Kimia Farma (Persero) Tbk.
12	KICI	Kedaung Indah Can Tbk.

13	KLBF	Kalbe Farma Tbk.
14	LMPI	Langgeng Makmur Industri Tbk.
15	MBTO	Martina Berto Tbk.
16	MLBI	Multi Bintang Indonesia Tbk.
17	MRAT	Mustika Ratu Tbk.
18	MYOR	Mayora Indah Tbk.
19	PSDN	Prasidha Aneka Niaga Tbk.
20	PYFA	Pyridam Farma Tbk.
21	RMBA	Bentoel Internasional Investama Tbk.
22	ROTI	Nippon Indosari Corporindo Tbk.
23	SIDO	Industri Jamu dan Farmasi Sido Muncul Tbk.
24	SKBM	Sekar Bumi Tbk.
25	SKLT	Sekar Laut Tbk.
26	TCID	Mandom Indonesia Tbk.
27	TSPC	Tempo Scan Pacific Tbk.
28	UNVR	Unilever Indonesia Tbk.
29	WIIM	Wismilak Inti Makmur Tbk.

Source: (Author's Analysis, 2020)

Measurement of Variables

Earnings Response Coefficient (ERC)

Earnings Response Coefficient (ERC) represents the earnings expected from the companies that may reflect the investors' confidence towards the stocks when the earnings announcement is published (Ambarwati and Sudarmaji, 2019). ERC represents the regression' coefficient between Cumulative Abnormal Return and Unexpected Earnings (UE).

$$CAR = \alpha + \beta(UE) + e$$

Explanation,

CAR : Cumulative Abnormal Return

β : Coefficient of regression (ERC)

e : Error

Cumulative Abnormal Return (CAR)

CAR represents the market reaction towards the stock price (Soewardjono in Delvira, 2013).

The formula to calculate CAR is, as follows:

$$CAR_{t(-3,+3)} = \sum_{t=-3}^{+3} AR_t$$

Explanation,

$CAR_{t(-3,+3)}$: Cumulative Abnormal Return of the companies during the event window day -3 to day +3.

AR_t : Abnormal Return of the companies on day-t.

The Market-Adjusted Return Model abnormal return can be calculated based on the market price of the stocks (Ambarwati and Sudarmaji, 2019), which can be expressed in the following formula:

$$AR_t = R_t - R_{mt}$$

Explanation,

AR_t : Abnormal Return of the company in period-t

R_t : Return of the company in period-t

R_{mt} : Return of the stock market in period-t

Both return of the company and stock market can further be calculated as:

$$R_t = \frac{P_t - P_{t-1}}{P_{t-1}}$$

Explanation,

R_t : Return of the company in period-t

P_t : Closing price of the company in period-t

P_{t-1} : Closing price of the company in the previous period-(t-1)

Unexpected Earnings (UE)

The UE calculation involves any difference of the achieved earnings compared to the previous year (Husiano and Suratno, 2014):

$$UE_t = \frac{E_t - E_{t-1}}{E_{t-1}}$$

Explanation,

UE_t : Unexpected Earnings in period-t

E_t : Earnings or Net Income in period-t

E_{t-1} : Earnings or Net Income in the previous period period-(t-1)

Profitability

Profitability determines whether a company is profitable or not based on the positivity of the earnings. This research uses return-on-assets ratio to compare quantitative benefits generated from investments (Clayman et. Al, 2012). The formula of the return-on-assets is:

$$Return\ on\ Assets = \frac{Net\ Income_t}{Total\ Assets_t}$$

Investment Opportunity Set (IOS)

IOS with MBVA proxy reflects the firm growth in the stock prices itself, and the market perceives the firm growth in respect to its actual asset valuation, which shows growth. The formula to investigate IOS will account for Market to Book Value of Assets (MBVA) as being used in the research by Novianti (2012) as the following:

$$MBVA = \frac{TA - TE + (OS \times CP)}{TA}$$

Explanation,

MBVA : Market to Book Value of Asset Ratio

TA : Total Assets

TE : Total Equity

OS : Outstanding Shares

CP : Stock Closing Price

Capital Structure

Capital Structure implies the certain distribution of equity and debts towards the financing of the company which could ascertain or fuel the earnings obtained from the business. Capital Structure is measured by leverage, which accounts for total debts a company has compared to the level of equity during a period of time. (Dhaliwal *et al.* in Novianti, 2012) states that leverage is calculated as:

$$Leverage_t = \frac{TD_t}{TE_t}$$

Explanation,

$Leverage_t$: Leverage of the company period t

TD_t : Total Debt of the company period of t

TE_t : Total Equity of the company period of t

Firm Size

The size of the firm implies the scale to be used for calculations of financial aspects of the financial statements such as earnings, total assets, and market capitalization. There is the tendency that the higher the size of the company, the easier the company for capital market access as the market capitalization is significant (Kurnia, 2015). Nariman and Ekadjaja (2018), the firm size can be measured with the formula of:

$$Firm\ Size = Ln\ Total\ Assets$$

Explanation,

Ln = Log Natural

Data Analysis Technique

Data analysis techniques used in this research is multiple regression analysis, with the following equation:

$$ERC = \alpha + \beta_1(ROA) + \beta_2(IOS) + \beta_3(DER) + \beta_4(FS) + \mu$$

Explanation,

ERC : Earnings Response Coefficient

α : Constant

$\beta_1 - \beta_4$: Regression Coefficient

IOS : Investment Opportunity Set

ROA : Return on Asset

FS : Firm Size

DER : *Debt-Equity Ratio (Capital Structure)*

μ : *Error*

RESULT AND DISCUSSION

Descriptive Statistics

Descriptive statistics for all variables after the transformation can be seen in Table 2. The Investment Opportunity Set (IOS or MBVA) independent variable shows the mean value of 3.512529 in Table 2. For the maximum value of IOS, 23.28575 or Unilever Indonesia Tbk. (UNVR) in 2017 indicating that the market valuation towards its actual book value of assets is up to 23x showing positive outlook towards UNVR growth. For the minimum value, it may be seen from Mustika Ratu Tbk. (MRAT) or 0.421972 due to the MBVA calculation towards the MRAT Assets. The standard deviation of the IOS variable is relatively the highest among all other variables which is shown at 4.579335 implying the more spread out the data towards the mean.

The Capital Structure independent variable that uses Debt-to-Equity Ratio (DER) shows the mean value of 0.816076 implying that the average of DER of all samples is at 81.61%. The maximum value of this variable is achieved by Unilever Indonesia Tbk. (UNVR) in 2017 at 2.654552. On the other hand, the minimum value is achieved by Sido Muncul Tbk. (SIDO) in 2016 at 0.083299. The standard deviation value of the capital structure variable is calculated to be at 0.576182, no significant dispersion towards the mean is implied for this variable.

The Firm Size independent variable utilizing the calculation of Ln(Total Assets) shows the mean value from samples of 28.80827. As may be seen from Table 2, the maximum value of the firm size is at 32.20096 by Indofood Sukses Makmur Tbk. (INDF) in 2018, and the minimum value is achieved by Pyridam Farma Tbk. in 2017 with the value of 25.79571. The standard deviation of the firm size variable is calculated at 1.591763 to disperse towards its mean value.

Table 2. Descriptive Statistics

	CAP_S_				
	ERC_Y	PRO_X1	IOS_X2	X3	FS_X4
<i>Mean</i>	0.108141	0.089559	3.512529	0.816076	28.80827
<i>Median</i>	0.252617	0.070773	1.606994	0.598159	28.45302
<i>Maximum</i>	1.113832	0.526704	23.28575	2.654552	32.20096
<i>Minimum</i>	-0.745019	-0.176124	0.421972	0.083299	25.79571
<i>Std. Dev.</i>	0.453358	0.127303	4.579335	0.576182	1.591763
<i>Skewness</i>	-0.131432	1.294081	2.363660	0.999571	0.493777
<i>Kurtosis</i>	2.004198	5.182467	8.181602	3.557921	2.322015

<i>Jarque-</i>					
<i>Bera</i>	3.845106	41.54882	178.3375	15.61594	5.201604
<i>Probabilit</i>					
<i>y</i>	0.146233	0.000000	0.000000	0.000406	0.074214
<hr/>					
<i>Sum</i>	9.408241	7.791658	305.5900	70.99865	2506.319
<i>Sum Sq.</i>					
<i>Dev.</i>	17.67590	1.393718	1803.447	28.55077	217.8990
<i>Observatio</i>					
<i>ns</i>	87	87	87	87	87

Source: (Eviews 11.0, 2020)

Hypothesis Testing

Most fit model for panel data in this study was conducted by using Chow test. If the probability of the result of the Chow test shows less than 0.05, it implies that H_0 is rejected, meaning the Fixed Effect Model is a better fix to use in the research. On the other hand, if the Chow test result yields more than 0.05, then H_0 is accepted, meaning the Common Effect Model is the better fit.

Table 3. Likelihood/Chow Test Results

Redundant Fixed Effects Tests			
Equation: Untitled			
Test cross-section fixed effects			
<hr/>			
	<i>Statistic</i>		
<i>Effects Test</i>		<i>d.f.</i>	<i>Prob.</i>
	5.70616		
<i>Cross-section F</i>	2	(28,54)	0.0000

	119.705		
<i>Cross-section Chi-square</i>	784	28	0.0000

Source: (Eviews 11.0, 2020)

Based on the likelihood/chow model estimation test observed in Table 3, it may be seen that the probability value of Cross-section F is 0.0000, and the probability value of Cross-section Chi-Square value is also 0.0000. These two probability values do not exceed 0.05 which implies that H_0 is rejected and H_a is accepted. Based on the theory, this results in the proper data panel to be used for this research is the *Fixed Effect Model*.

Table 4. Multiple Regression Analysis

Dependent Variable: ERC_Y_
 Method: Panel Least Squares
 Periods included: 3
 Cross-sections included: 29
 Total panel (balanced) observations: 87

Variable	Coefficient	Std. Error	t-Statistic	Prob.
	-			
C	20.32676	8.547372	-2.378129	0.0210
PRO_X1_	2.323973	1.136155	2.045472	0.0457
	-			
IOS_X2_	0.042535	0.048756	-0.872407	0.3868
CAP_S_X3_	0.468066	0.173216	2.702212	0.0092
FS_X4_	0.694043	0.295314	2.350188	0.0224

Source: (Eviews 11.0, 2020)

Based from the coefficients mentioned in Table 4, the multiple regression equation may be written as the model:

$$Y = -20.32676 + 2.323973 (\text{PRO}) - 0.042535 (\text{IOS}) + 0.468066 (\text{CAP_S}) + 0.694043 (\text{FS}) + \mu$$

Based from the equation above, the equation represents the whole correlation of all independent variables towards the dependent (ERC) which it may be observed that when all coefficients of the independent variables have respective value of 0, the value of alpha (α) is -20.32676, or the value of earnings response coefficient is -20.32676.

Table 4. shows the coefficient result of profitability reflects at the value of 2.323973. The positive coefficient result indicates the positive correlation between profitability and the dependent variable or ERC. By theory, it may be inferred that when there occurs an increase in profitability numerical figure of 1 in regards that the other coefficient remains constant, it would impact the value of ERC by 2.323973. In other words, for every 1 increase in profitability, will yield 2.323973 value of ERC, directly proportional.

For the coefficient of the Investment Opportunity Set (IOS) which is shown as having - 0.042535, indicating negative correlation between IOS and the dependent ERC. When other coefficients and variables remain constant, for every increase in IOS value by 1, it would result in -0.042535 value of ERC or inversely proportional.

The coefficient of capital structure or Debt-Equity Ratio (DER) shows the positive value of 0.468066. This positive coefficient value validates the positive correlation between capital structure towards the ERC as when the DER value increases by 1, it would return 0.468066 increase in ERC value given the other constants or variables remain unchanged. The positive correlation also applies to the Firm Size with the coefficient value of 0.694043 implying that for every 1 value of increase in Firm Size, will yield 0.694043 increase in ERC value.

R-Squared Test

Table 5. R-Squared Test Results

<i>R-squared</i>	0.764990
<i>Adjusted R-squared</i>	0.625726

Source: (Eviews 11.0, 2020)

Based on the results from Table 5, it may be seen that the regression model used to correlate the dependent ERC variable is calculated at 0.625726 or 62.57% in percentage. This numerical result implies that 62.57% compiled from the profitability, investment opportunity set, capital structure, and firm size affect the regression model. Meanwhile, the other 34.38% would be further explained by other variables excluded from this regression model discussed in this research.

F-Test

Table 6. F-Test Statistic Results

<i>F-statistic</i>	5.493059
<i>Prob(F-statistic)</i>	0.000000

Source: (Eviews 11.0, 2020)

Based on the F-statistic result shown in Table 6, it may be seen that the probability value is calculated at 0.000000. The p-value does not exceed 0.05, implying that the independent variables used in this research are jointly correlated or significant towards the dependent ERC variable. The regression model used in this research is in a good-fit or acceptable as a whole.

T-Test

Table 7. T-Test Results

Variable	Coefficie			
	nt	Std. Error	t-Statistic	Prob.
	-			
C	20.32676	8.547372	-2.378129	0.0210
PRO_X1_	2.323973	1.136155	2.045472	0.0457
	-			
IOS_X2_	0.042535	0.048756	-0.872407	0.3868
CAP_S_X3_	0.468066	0.173216	2.702212	0.0092
FS_X4_	0.694043	0.295314	2.350188	0.0224

Source: (Eviews 11.0, 2020)

Based on the results shown in Table 7, the statistical power of 0.05 will determine the significance of respective independent variables towards the dependent ERC variable. It may be numerically concluded that profitability has the p-value of 0.0457 which is lower than 0.05 implying that its H_a is accepted, profitability has positive significant effect towards the ERC. On the other hand, the investment opportunity set variable shows the p-value of 0.3868 which is higher than 0.05 which implies the acceptance of H₀ or the IOS has no positive significance

towards the ERC. For the capital structure variable, it may be seen as having a p-value of 0.0092 which is lower than the statistical power 0.05 indicating the acceptance of H_a , the capital structure has positive significance towards the ERC. Lastly, the variable of firm size shows the t-test p value of 0.0224, lower than 0.05 benchmark meaning the acceptance of H_a , the firm size has positive significance towards the ERC variable.

CONCLUSION AND RECOMMENDATIONS

Conclusion

The purpose of this paper is to provide empirical evidence about how chosen independent variables, such as profitability, investment opportunity set, capital structure, and firm size have statistically significant effects towards Earnings Response Coefficient (ERC) as the dependent variable and how the results may be considered for investment decisions.

The research proves that the independent variables of profitability, capital structure, and firm size have positive significant correlation towards the ERC dependent variable which illustrates direct proportionality. Meanwhile, the investment opportunity set has no significant correlation towards the ERC dependent variable for this research model.

This research strengthens the practical idea that Earnings Response Coefficients are related to the signaling theory. The research generally describes the flow of information and interaction between the management and principal (investors) about managerial progress incurred by the firms reflecting the contractual relationship between related parties. Above all technical processes or information chain, the succeeding theory of Signaling takes place where such quality of information received by principals or other stakeholders such as investors would contribute to determining the market price, called market reaction.

Recommendation

Some recommendations that could be drawn from the study, are the following:

1. **Provide more comprehensive independent variables**

Future analysis from more variety of independent variables is strongly recommended for more holistic knowledge improvements.

2. **Use samples from one certain industry or directly for the entire index**

Since indexes of stocks in Indonesia Stock Exchange constantly change, it would be more effective to use samples coming from one particular industry or conclusively for the entire indexes or listed companies (IHSG) as a conclusive study, such that all companies are included in the samples.

3. **Extend the observation window for the dataset**

For further empirical improvement, it would be better to consider the most recent secondary data from audited financial statements over an observation window of approximately five years

and a more complex approach of ERC calculation, such as Mean Adjusted return or Market and Risk adjusted return).

4. Factual reference for financial statements related investment decisions

For practical benefits, this related study may serve as a factual reference with four investigated variables in analyzing or considering stock investment decisions by the time the financial statements of the companies are published, particularly for stakeholders examining numerical figures.

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