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The Effect of Profitability and Liquidity on Earning Response Coefficient Moderated by Accruals Earning Management: Empirical Study of Companies in the Indonesia Stock Exchange

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Abstract:
This study aims to explain the phenomenon in Indonesia stock exchange where the shares are most actively traded. The motivation of this research is to analyze the response of investors in making decisions after the management publishes the company's financial statements. This study selected 20 companies using a purposive sampling method based on panel data, namely annual time series data and cross-sectional companies selected as samples. To test the research hypothesis, a linear regression model is used and non-linear, while the research variable consisted of two independent variables, one moderator variable and two control variables. The findings in this study, namely the profitability variable has a negative and significant effect on the earning response coefficient, mainly because after five days since the financial statements were published, investors or speculators release their shares, especially for stocks that experience saturation of price growth so that prices tend to decline on the fifth day and so on. Liquidity has a positive and significant effect on the earning response coefficient, because the company increases its ability to meet financial obligations and is increasingly trusted by banks and third parties, so that investors in the capital market respond positively.

Keywords: Financial management, earning management, and strategic management

1. Introduction

This study has the primary objective to examine the phenomenon obtained by the response of the investors' in the capital market. This has been become more prominent after the financial statements are announced by the company's management. Depending on the financial statements and due to other reasons the share prices of many companies have shown fluctuations. This study tries to explore all the factors that re mainly the concern of the investors. These factors generally affect the affect the response of the markets after the company announces its profit. This is also called earning response coefficient (ERC). ERC is the indicator of the market responses regarding the profit figures reported by companies in the capital market. Bad news related to the achievement of profitability. Earning response coefficient or ERC will be determined based on the slope or regression coefficient of unexpected earnings on abnormal stock returns. Unexpected earnings are net profit growth from time to time, while abnormal returns are the difference between stock returns and market returns within a certain observation period or event window, for example 5 days before to 5 days after the earnings announcement.

In connection with the earnings response, the profit achieved by the company is a determining factor of interest to decision makers in the capital market. Another factor that determines the level of response is the company's liquidity level or the ability to meet maturing financial obligations which can increase the confidence of third parties such as banks and suppliers. Earnings reports reported by companies have the opportunity to practice earnings management in it and strengthen the influence of profitability and liquidity on investor response in the capital market. Therefore, this study uses earnings management as a moderating variable, and to limit the variables outside the study, a control variable that is closely related to investor response is used, namely the leverage variable and firm size variable. Previous research related to the earning response coefficient or ERC has been carried out using certain variables that are relevant to elements relevant to financial performance, namely: (a) Collins and Kothari's (1989) research uses the independent variables of stock return, growth, risk and size. This study uses a group of small, medium, large companies, and the group as a whole, (b) Murwaningsari's research (2008) uses independent variables of leverage and firm size, (c) Nofianti's research

(2014) uses capital expenditure as an independent variable, (d) research by Yushita, Rahmawati, and Triatmoko (2013) using the independent variable liquidity.

2. Literature, Hypotheses, and Conceptual Framework

2.1. Agency Theory

This theory is related to shareholder investor decisions based on financial statement information, while company management has an interest in investor assessment so that the reports presented must be able to provide information that is attractive to investors and fulfills the interests of shareholders. Agency theory put forward by Jensen and Meckling (1976), suggests that in an agency relationship there is a contract between the owner of the company or the principal and the manager or agent, which assigns the agent to do a job running the company. The principal gives full authority to the agent to run the company and make decisions according to the principal's expectations. In practice, agency theory often creates conflicts between the principal and the agent and asymmetric information occurs, so that the principal needs to supervise so that the decisions made by the agent are in accordance with the wishes of the principal.

2.2. Signaling Theory

This research is related to the response of investors in the capital market after the company gives a signal through the presentation of financial statement information, so that the company's management must provide quality information and more detailed disclosures so as to be able to provide a signal to convince investors' decisions. Signaling theory according to Bhattacharya (1979) in Santoso (2015) signal arises because firms have incentives to provide financial information to external parties, and signaling theory emerged because of the problems of asymmetric information or imbalance of information about the company earned in the market. Myers & Majluf (1984) suggested that signaling is a combination of investment decisions and funding decisions and managers are assumed to know the company's value in the future better than other parties. Jogiyanto (2010) revealed that signaling theory is an event that is considered to have information content, and this event causes market participants to carry out trading reactions that cause an increase in returns caused by abnormal returns. Based on this view, signaling theory as a theory is closely related to information content that can cause market responses and produce different interpretations depending on the perspective of individual market participants.

2.3. Decision-Usefulness Theory

Staubus, GJ (1954) first proposed Decision-usefulness theory which states that the decision usefulness approach is an approach to financial statements based on historical costs to be more useful for users of financial statements in making decisions (Palea, 2014) . In this case, it is necessary to understand the theory of use of private persons (single-person of decision theory) and theory of investment (theory of investment). Single-person of decision theory is the perspective of investors who must take action under conditions of uncertainty. The theory of investment as a theory about the commitment of a number of funds issued to obtain profits in the future (Tenaya, 2011).

2.4. Earning Coefficient Response (ERC)

Collins and Kothari (1989) research on earning response coefficient (ERC) found that independent return on security (R_{it}) and market to book value of equity (Growth $_{it}$) had a significant effect on ERC. Paramita's research (2012) found that voluntary disclosure had a significant effect on ERC. Diantimala's research (2008) found that conservative accounting, firm size, and default risk have a negative and significant effect on ERC. Meanwhile, this ERC research uses the independent variables of capital structure or leverage and capital expenditure, moderating variables of earnings management, and liquidity control variables and firm size.

2.5. Profitability

Naimah and Utama's research (2006) found that profitability has a positive and significant effect on stock prices. This happens because in general stock investors are motivated to obtain dividends, although some of them speculate to pursue margins through fluctuations in stock market prices on the stock exchange. The research shows that the impact on stock prices is as a result of the response of investors to make purchases so that there is an increase in demand which causes stock prices to rise significantly. Based on these assumptions, this research proposes the following hypothesis H1.

- H1: Profitability has a positive and significant effect on the earning response coefficient of companies in Indonesia stock exchange.

2.6. Liquidity

Yushita, Rahmawati, and Triatmoko (2013) in their research use the independent liquidity variable in analyzing the earning response coefficient (ERC) with the consideration that liquidity conditions are able to provide a signal for investors to see future profitability prospects because the company has a good image for the parties concerned. third parties such as suppliers and banks, which are able to meet their financial obligations that are due in a timely manner. Healthy liquidity occurs because the company has the ability to obtain a surplus of operating cash flow generated from revenue and operating cost efficiency, so that it becomes one of the indicators to be considered by investors in influencing their investment decisions in the capital market.

- H2: Liquidity has a positive and significant effect on the company's ERC in Indonesia stock exchange.

2.7. Accruals Earnings Management

Ridwan and Gunardi (2013) found that earning management has a positive and significant effect on firm value.

- H3: Accruals earning management has a positive and significant effect on the ERC of companies in Indonesia stock exchange.
- H4a: Accruals earning earnings management strengthens the association between profitability and the company's ERC in Indonesia stock exchange.
- H4b: Accruals earning earnings management strengthens the relationship between liquidity and the ERC of companies in Indonesia stock exchange.

3. Framework

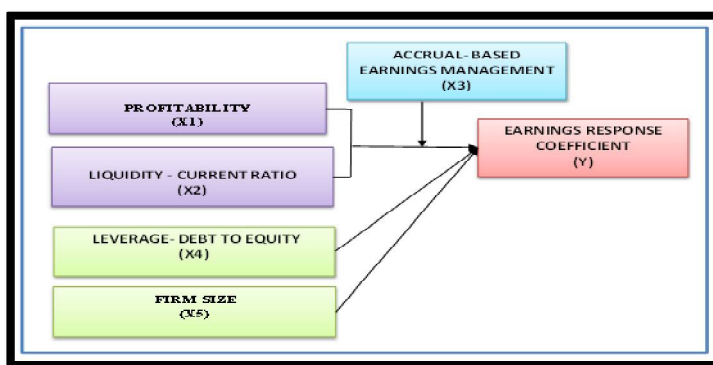### 3.1. The Framework for This Study Has Been Presented Below:

Figure 1: Factors Affecting Earning Response Coefficient

4. Methodology

4.1. Sample Selection

The data collection in this study uses a purposive method, namely selecting a sample that is considered to be in accordance with the objectives and analysis of the problems to be studied or related to the analysis of factors that affect the earning response coefficient of companies in Indonesia stock exchange. This study selected a sample of 20 companies whose shares were most actively transacted in the period 2011 to 2015. The data collected were 100 companies-years, consisting of 5 years of observation and as many as 20 companies as research objects (5 x 20 = 100 companies- year).

The data used is only 4 years, because the calculation of the earning management variable uses data from changes between periods, so the observation period used in the regression analysis is 4 years (4 x 20 = 80). Finally, the data processed in the regression analysis were 63 observations after deducting data that were biased due to accounting corrections of 17 firm-years.

4.2. Variables and Measurement

This study uses the dependent earning response coefficient, profitability and liquidity independent variables, accruals earning management moderator variables, control leverage variables and firm size which are defined and measured by the following formula.

4.3. Earning Response Coefficient (Y)

The dependent variable earning response coefficient (ERC) in this study is a factor that shows the market reaction to earnings information published by companies such as Collins and Kothari (1989). The measurement of the earning response coefficient variable is carried out in stages as in the research of Santoso (2015), Moradi, Salehi, Erfanian (2010), Diantimala (2008), Wijayanti and Supatmi (2008), Paramita (2012), and Murwaningsari (2008), below.

First, the regression equation that shows the influence of EU on CAR and the magnitude of the earning response coefficient (ERC) is equal to the regression coefficient b1 from the following equation.

$$CAR_{it} = b_0 + b_1 UE_{it} + e_{it} \dotso (1)$$

While the CAR_{it} is calculated:

$$CAR_{it} = CAR_{(-5, +5)} = {}_{it} \dotso (2)$$

The CAR of company i in period t is based on when the company's accounting profit is announced, then calculated in the observation period or event window for 11 days, namely 5 days before the earnings announcement period, 1 day after the earnings announcement, and 5 days after the earnings announcement day. The selection of the observation period is considered capable of detecting abnormal returns which are the impact of the company's earnings announcements.

$$AR_{it} = R_{it} - R_{mt} \dotso (3)$$

$$R_{it} = \frac{P(it) - P(it-1)}{P(it-1)} \dotso (4)$$

$$R_{mt} = \frac{IHSG(t) - IHSG(t-1)}{IHSG(t-1)} \dots\dots\dots\dots\dots\dots\dots\dots\dots (5)$$

While the EU_{it} is calculated:

$$UE_t = \frac{AE(it) - AE(it-1)}{AE(it-1)} \dots\dots\dots \dots\dots\dots\dots\dots\dots (6)$$

Where : ERC_{it}: earning response coefficient, which is obtained from the regression coefficient b1 in the regression equation CAR_{it}, CAR_{it}: cumulative abnormal return, UE_{it}: unexpected earnings, e_{it}: error, AR_{it}: abnormal return, R_{it}: stock return, R_{mt}: market return, P_{it}: closing price of shares, JCI_t: composite stock price index, AE_{it}: earnings after taxes.

Second, from the CAR equation $_{it}$ (1), then calculate the earning response coefficient or coefficient b1 for each observation (n = 63) with the following equation.

$$b_1 = \frac{CARit - b0}{UEit} \dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots (7)$$

Third, the results of the b1 calculation from each observation are then used as input data for the dependent variable earning response coefficient in the regression calculation of the analysis model of this study.

4.3.1. Profitability (X1)

Profitability variable is proxy with return on equity (ROE) indicator which shows the level of company's ability to generate return on equity. Return on equity shows the percentage of profits that will be obtained by shareholders. This variable is an indicator that attracts investors' attention and is able to influence their investment decisions. In this study, measurements of return on equity (ROE) were carried out as used in the following research by Wang, Chen, and Yu (2015).

$$Return\ on\ equity = \frac{Net\ income}{Total\ equity} \dots\dots\dots\dots\dots\dots (8)$$

4.3.2. Liquidity (X2)

The liquidity variable shows the level of the company's ability to meet its maturing financial obligations. The higher the company's liquidity level, the more trusted by lenders such as banks and suppliers, so the company has the opportunity to obtain additional debt to increase its business scale and obtain a greater return. The increase in this variable will be responded positively by investors, so that it has an impact on increasing stock prices in the capital market. On the other hand, if the relative liquidity level decreases, investors will respond negatively which causes a decrease in stock prices in the capital market. The measurement of the liquidity variable is used as in the following research by Yushita, Rahmawati, and Triatmoko (2013).

$$Liquidity = \frac{Current\ asset}{Current\ liabilities} \dots\dots\dots\dots\dots\dots\dots\dots (9)$$

4.3.3. Accruals Earnings Management (X3)

Earnings management variable is formulated based on accruals, namely as one of the strategies used to increase profits through transactions related to cost accruals and income accruals. Earnings management applications based on accruals or known as accruals earnings management must pay attention to the tolerance limits according to applicable accounting standards. The measurement of the accruals earning management variable is carried out using the Dechow approach (1995), namely accrual earnings management is calculated from residual or abnormal accruals, which is obtained from the results of accruals regression calculations (ACC) through the following equation.

$$ACC_{it} / TA_{t-1} = {}_0 + {}_1 (\Delta REV_t - REC_{it})/TA_{t-1} + {}_2 PPE_{it}/TA_{t-1} + {}_3 CFO_{it}/TA_{t-1} + e_{it} \dots (10)$$

Where: ACC: total accruals or accruals, REV: total revenue, TA: total assets, REC: amount receivable, PPE: total property, plant, and equipment, CFO: cash flow from operation, e: error.

4.3.4. Leverage (X4)

Capital structure or leverage variable shows the percentage ratio of the amount of debt to the amount of equity reported by the company. This ratio means that the greater the level of leverage, the more debt the company uses in funding its operational and investment activities compared to funding through its own capital. To measure the leverage variable, the following formula is used as in the research of Murwaningsari (2008) and Nofianti (2014).

$$Leverage = \frac{Total\ debt}{Total\ equity} \dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots (11)$$

4.3.5. Firm Size (X5)

Firm size variable as the level of capital or business scale of the observed company, and this ratio gives an indication that companies that have a larger business scale can increase efficiency and reduce operating costs, thus providing opportunities to obtain higher returns than similar companies with smaller scale of business (Nofianti, 2014 and Murwaningsari,2008) with the following calculations.

$$Firm\ size = Log\ (Total\ asset) \dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots (12)$$

4.4. Analysis Model

The regression analysis model used to test the hypothesis, consisting of model 1 and model 2 was used to test the hypotheses H1, H2 and H3. While model 3 is used to test the following hypotheses H4a and H4b.

Model for hypothesis H1, H2, and H3

Hypotheses H1, H2 and H3 can be tested using a linear model as model 1 below.

Model 1: $Y_{it} = \beta_0 + \beta_1 X1_{it} + \beta_2 x2x_{it} + \beta_3 X3_{it} + \beta_4 X4_{it} + \beta_5 X5 + e_{it}$ .... (13)

To test the consistency of the calculation results of model 1, a linear regression model is used which specifically measures the effect of the independent variables X1, X2 and X3 on the dependent variable Y as in model 2 below.

Model 2: $Y_{it} = \beta_0 + \beta_1 X1_{it} + \beta_2 x2x_{it} + \beta_3 X3_{it} + e_{it}$ ....(14)

Model for hypothesis H4a and H4b

In testing the hypotheses H4a and H4b, a non-linear model is used to avoid violating the classical assumptions of linear regression, due to the consideration of the interaction between the independent variable and the moderator variable as in model 3 below.

Model 3: $\text{Log } Y_{it} = \beta_0 + \beta_1 \text{Log } X1_{it} + \beta_2 \text{Log } x2x_{it} + \beta_3 X3_{it} + \beta_4 \text{Log } X4_{it} + \beta_5 \text{Log } X5_{it} + \beta_6 \text{Log } X1X3_{it} + \beta_7 \text{Log } X2X3_{it} + e_{it}$ ....(15)

Where : Y : earnings response coefficient, X1 : profitability, X2 : liquidity, X3 : accruals earning management, X4 : leverage, X5 : firm size, X1X2 : interaction of profitability and accrual earning management , X2X3 : interaction of liquidity and accrual earning management , $_1 ... _7$: regression coefficient, e_{it} : error.

5. Results and Discussion

5.1. Descriptive Statistics

The descriptive statistics as shown in table 1 below show several things related to the data structure of the research results.

	N	Minimum	Maximum	Mean	Deviation
Y	63	0.001	0.367	0.060	0.060
X1	63	–27.607	6.374	–0.200	3.623
X2	63	0.389	7.236	2.521	1.507
X3	63	–15.799	113.006	1.591	20.039
X4	63	–2.517	8.795	1.039	1.613
X5	63	6.309	11.330	9.813	1.108
Valid N (listwise)	63				

Table 1: Descriptive Statistics
Note: Y: Earnings Response Coefficient, X1: Profitability, X2: Liquidity,
X3: Accruals Earning Management, X4: Leverage, X5: Firm Size

5.2. Correlation Matrix

Pearson (1904) first discovered correlation analysis known as person product moment, suggesting that correlation is a degree of linear relationship between two or more variables. This correlation analysis is intended to explain the phenomenon of the relationship between interrelated variables as shown in table 2, namely: (a) the variable dividend earnings response coefficient (Y) is correlated with the independent variable less than 0.50 with magnitudes X1 = - 0.269 and X2 = 0.270 which means that the degree of relationship between these variables is less strong. The negative correlation of the X1 variable with Y shows the opposite relationship, while the X2 variable is positively related, which means the relationship is in the direction of Y. (b) The moderator variable X3 is correlated with Y of 0.046 or about 4.6% which indicates that the degree of relationship between these two variables is very small compared to other variables. (c) the control variable has a relatively small correlation with Y with magnitudes X4 = 0.144 and X5 = - 0.276, which means the degree of relationship with Y is less strong. (d) the overall correlation between independent variables, moderate variables and independent variables is smaller than 0.50 or ranging from 0.004 to 0.129, which means that the regression model used does not have symptoms of multicollinearity.

	Y	X1	X2	X3	X4	X5
Y	1					
X1	-.269[*]	1				
X2	.270[*]	-.098	1			
X3	.046	.042	.087	1		
X4	.144	-.053	-.040	-.047	1	
X5	-.276[*]	-.020	-.114	.129	.004	1

*. Correlation is significant at the 0.05 level (2-tailed).

Table 2: Correlations Matrix
Note: Y: Earnings Response Coefficient, X1: Profitability, X2: Liquidity
X3: Accruals Earning Management, X4: Leverage, X5: Firm Size

5.3. Hypothesis Test Results H1

The results of the regression analysis model 1 show that the profitability variable (X1) has a negative and significant effect on the earning response coefficient (Y) with a regression coefficient of -0.004 and sig. 0.038**, which means that an increase in profitability will have an impact on a decrease in the earning response coefficient, or each increase in one unit of profitability will reduce the earning response coefficient by 0.004. And vice versa if there is a decrease in the level of profitability, it will increase the earning response coefficient. This occurs mainly because the increasing profit announced by the company will cause a negative market response on the fifth day because investors begin to release their shares and tend to decrease in price compared to the t-5 price or five days before the announcement. The price of t-5 tends to rise because the market response begins to buy shares before the announcement day so that the company's stock price tends to rise, and after the announcement the price tends to increase less and then decrease on day t+5.

5.4. H2 Hypothesis Test Results

From the calculation of regression model 1 shows that the liquidity variable (X2) has a positive and significant effect on the earning response coefficient (Y) with a regression coefficient of 0.009 and sig. 0.078*.

5.5. H3 Hypothesis Test Results

The results of the regression calculation model 1 show that the variable accruals earnings management (X3) in its function as an independent variable shows an insignificant effect on the earning response coefficient (Y). The calculation of the regression model 2 is intended to test the consistency of the results of the regression calculation model 1 both in terms of the level of significance of the influence of these variables and the direction of the influence is negative or positive. Regression model 2 does not take into account the control variables or only focuses on the effect of the independent variables X1, X2 and X3 on the independent variable Y. The results of the regression calculation model 2 are consistent with the calculation of the regression model 1 both in terms of the negative and positive directions of the influence, as well as the significant level of influence. Independent variable on the dependent variable earning resonance coefficient.

5.6. H4 Hypothesis Test Results

Hypotheses H4a and H4b are related to the moderator variable accruals earning management (X3) which is related to the interaction variable between the moderator variable and the independent variable profitability (X1X3) and the moderator variable with liquidity (X2X3). Through model 3, hypotheses H4a and H4b can be tested for the ability of moderator variables to strengthen or weaken the influence of profitability and liquidity independent variables on the dependent variable earning response coefficient. This happens mainly because the practice of accruals earning management can be easily detected by investors in the capital market, so it is not effective in influencing market response both in its function as an independent variable and as a moderator variable through interaction with independent variables.

Variable	Predict.	Model-1: Linear		Model-2 : Linear		Model-3: Non Linear	
		Coeff.	Sig.	Coeff.	Sig.	Coeff.	Sig.
(Constant)		0.175	0.011 **	0.035	0.018 **	0.180	.012 **
X1	+	-0.004	0.038 **	-0.004	0.047 **	-0.009	.444
X2	+	0.009	0.078 *	0.010	0.052 *	0.009	.079 *
X3	+	0.000	0.505	0.000	0.770	0.001	.562
X4	+	0.005	0.225			0.006	.203
X5	+	-0.015	0.028 **			-0.015	.028 **
X1X3	+					-0.001	.673
X2X3	+					0.000	.809
Adj-R2		.155		0.090		.127	
F-Statistic		2.292		3.036		2.292	
Prob F-Statistic		0.012		0.036		0.012	
Durbin-Watson		1.739		1.639		1.726	
Total Observation		65		65		65	

Table 3: Factors Effecting the Earning Response Coefficient with Accruals Management as Moderator

$$\text{Model 1: } Y_{It} = B_0 + B_1 X1_{It} + B_2 X2x_{It} + B_3 X3_{It} + B_4 X4_{It} + B_5 X5_{It} + E_{It}$$

$$\text{Model 2: } Y_{It} = B_0 + B_1 X1_{It} + B_2 X2x_{It} + B_3 X3_{It} + E_{It}$$

$$\text{Model 3: } Log\, Y_{It} = B_0 + B_1 Log\, X1_{It} + B_2 Log\, X2x_{It} + B_3 X3_{It} + B_4 Log\, X4_{It} + B_5 Log\, X5_{It} +$$
$$B_6 Log\, X1x3_{It} + B_7 Log\, X2x3_{It} + E_{It}$$

*** Significant of 1 Percent, ** Significant Of 5 Percent, * Significant of 10 Percent*

Note: Y: Earnings Response Coefficient, X1: Profitability, X2: Liquidity, X3: Accruals Earning Management, X4: Leverage, X5: Firm Size, X1x2: Interaction X1 And X2, X2x3: Interaction X2 and X3

6. Discussion

The regression equation for model 1 shows results that are consistent with model 2, although in model 2 it only focuses on measuring the effect of the independent variable or does not take into account the control variable. The calculation results in table 3 show that the H1 hypothesis test is not supported because the regression coefficient of the profitability variable (X1) is negative and significant. This happens because the price before the earnings announcement tends to increase or over estimate, then after the earnings announcement the price tends to decrease, especially on day t+5, so that an increase in profitability has an impact on a decrease in the earning response coefficient.

The calculation results of model 1 and model 2 support the hypothesis H2 proposed in this study, namely liquidity (X3) has a significant effect on the earning response coefficient.

Hypothesis H3 is not supported by the calculation of model 1 and model 2 with the result that the moderator variable has no significant effect on the earning response coefficient. This happens because the practice of accruals earning management is not effective in influencing market response, especially because the practice has been detected by investors through disclosure of information on components of financial statements and online information related to the company's performance.

Hypotheses H4a and H4b are not supported by the calculation of model 3 with the result that the interaction variables X1X3 and X2X3 have no significant effect on the earning response coefficient (Y). This is closely related to the practice of accruals earning management which has been detected in more detail by investors in the capital market so that the accruals earning management variable does not affect the earning response coefficient either directly through independent variables or indirectly through interaction with independent variables.

7. Conclusion

The results of the analysis and hypothesis testing of this study can be concluded as follows: liquidity has a negative and significant effect on the earning response coefficient, mainly due to overestimation which has an impact on the increase in stock prices before the announcement of earnings.

Based on the results of the analysis, it can be stated that the implications for decision makers in the capital market need to pay attention to the quality of financial reports before responding to avoid the risk of misinterpreting the components of financial statements related to the current profitability and future prospects of the company. The implications of this study are very important for management in the practice of accruals earnings management because these actions can be detected by investors in the capital market.

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