The impact of leverage on the earning response coefficients

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ABSTRACT

This study aims to examine whether there is an influence of leverage on earnings response coefficients with corporate governance as moderation. This study uses 108 data of manufacturing companies listed on the Indonesia Stock Exchange (IDX) during the year of observation 2016 to 2018. The analysis technique used in this study is a moderated regression analysis using SPSS version 24. The results of this study provide empirical evidence that leverage has an effect but not significant on the earnings response coefficient. This study also provides empirical evidence that corporate governance is unable to strengthen or weaken the effect of leverage on the earnings response coefficient.

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Introduction

The company will definitely have a debt to maintain the company's financial balance. Financial balance is important for companies, one of which is to maintain investor confidence in investing their funds. Investors will always consider the financial condition of the company to calculate the level of risk if an investor provides investment in the company. Investors will like companies that have high profits, but different things happen to leverage, namely the higher the debt of a company, investors will not like it, so there is a weak relationship between leverage with earnings response coefficient (Khoshtinat & Falah, 2006).

The phenomenon that occurs in the PT Tiga Pilar Sejahtera Food Tbk company, namely PT Indo Beras Utama (PT IBU) in 2017 has an impact on the company's stock price. PT IBU is accused of fraud by selling medium rice for premium rice, namely Rooster and Chicken. Rice which is supposed to cost Rp. 9,000 per kilogram is sold at Rp. 20,000 per kilogram. After the circulation of the sealing news, the AISA issuer's shares fell (autorejection) by 24.92% (Caesario, 2017).

The most highlighted thing is the existence of material transactions such as not paying off the purchase debt and interest, which has an impact on the company's performance decline. In addition, the purchase of 99% of PT Jaya Mas shares was assessed as not being carried out according to the correct procedures. The phenomenon shows the existence of debt and corporate problems will affect the company's stock price. This is supported by the Elkington's concept (Elkington, 1998) about the triple bottom line (profit, people, planet), thus encouraging researchers to examine the effect of leverage on market reaction and use corporate governance as a moderating variable to measure the strength (strengthen or weaken) interactions between the two variables.

This research is supported by the latest research conducted by Hasanzade et al. (2013) which gave the result that there was no significant relationship between financial leverage and earnings response coefficients. Different result found by Khoshtinat & Falah (2006) which gave the result that financial leverage negatively affected the earnings response coefficient. Furthermore, the efficient market theory and signal theory are used as a basis to support this research.

The motivation of this research is based on the phenomenon that occurs if the company is unable to pay debts, this causes a decrease in the company's stock price. This is an important phenomenon to be investigated for several reasons. First, the issue is to ensure

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market efficiency theory and signal theory. In the theory of market efficiency, investors like companies that can manage debt well. In signal theory, a company with good management will attract investors' attention. Second, this study uses corporate governance as a moderating variable that has not been used in previous studies. This is because corporate governance is also an important consideration by investors in assessing the viability of a company's financial statements.

Literature Review

Leverage is the use of assets and sources of funds by companies that are useful to increase the potential profits of shareholders (Firmansyah & Herawaty, 2019). Leverage is the amount of debt taken in order to finance the resources needed to obtain the required assets (Hasanzade et al., 2013). Companies with high DER levels show the composition of the total debt is greater than the total own capital so that the impact on the increasing burden on the outside of the company (Nurcahayani, 2014). Companies with high leverage will profit more channeled to creditors to repay debts. Information on earnings announcements was reacted quickly by creditors, but responded negatively by shareholders because investors assumed that companies preferred debt payments rather than dividend payments (Delvira & Nelvrita, 2013).

Signal theory is one of the capital structure theories developed to take into account the fact that companies generally have more complete information compared to outside investors. Ratios of financial statements such as Current Ratio, Debt to Equity Ratio, Return On Assets, one of which is used to analyze leverage will be very beneficial for investors as one of the bases of analysis in investing (Husiano & Suratno, 2008).

Earnings response coefficient is an effect of every dollar unexpected earnings on stock returns and is usually measured by the coefficient in the regression of abnormal returns and unexpected earnings. Earnings response coefficient is useful for investor valuation in determining market reaction to company earnings information (Cho & Jung, 1991). Earnings response coefficient is a value that shows a measure of the relationship between stock returns and corporate profits. Earnings response coefficient is useful in fundamental analysis, which is an analysis to calculate the actual value of shares using company financial data that can be the basis for investors' assessments to determine market reactions to company earnings information (Putri & Azhari, 2017).

The efficient market theory in this study supports the earnings response coefficient variable, namely when there is good news, investors will respond to earnings well and vice versa. When investors have obtained complete information contained in the efficient market, then they do not need to feel abnormal returns (Awuy et al., 2016).

Scott (2015) states that the earnings response coefficient measures the market's unusual rate of return of a security as a response to an unexpected component of the company's reported earnings. Abnormal securities market returns identified by Ball & Brown show the average good news of the company that is shown to be abnormally positive and the company's bad news that is shown to be abnormally negative. Therefore, it is possible that the abnormal returns of some companies are far above average and others are far below average. It can be concluded that the earnings response coefficient is a value that indicates the return of stock prices and accounting earnings to determine the market reaction to company earnings information. The stock price is proxied by Cumulative Abnormal Return (CAR) and accounting profit is proxied by Unexpected Earning (EU) which is then regressed to get the company's earnings response coefficient. Some things that cause different market responses to earnings response coefficients are as follows (Scott, 2015):

- Beta: The more risk the expected rate of return in the future of the company, the lower the value for investors who do not like risk.
- Capital Structure: For companies with high leverage, increasing profits (before interest) adds to the strength and security of bonds and other outstanding debt. This results in the majority of good news in earnings reaching the creditors rather than the shareholders.
- Profit Quality: More and more good news in today's earnings is expected to last in the future. This is because current earnings provide an indication of a better company performance in the future.
- Opportunity to Grow: Good news or bad news on company income can be a prospect of future growth for the company so that it can support the value of the earnings response coefficient better.
- Equation of Investor Expectations: Different investors will have different expectations about the company's earnings for the next period. This depends on the information they have obtained previously and the extent of their ability to evaluate financial statement information.
- Price Informativeness: Proxy for price information is company size. This is because larger companies produce more information.

Corporate governance is important for companies to be able to survive in the business world and be competitive. The application of good corporate governance can increase market confidence so that it will influence investor decisions and stock prices. The implementation of corporate governance is basically to fulfill the rights of shareholders without ignoring the interests of the stakeholders. The more effective the implementation of corporate governance, the more information is disclosed. This is to realize

financial management based on the principles of corporate governance in accordance with the principles of transparency, accountability, responsibility, independence and fairness (Komite Nasional Kebijakan Governance, 2006). Basically, corporate governance is related to various parties both from within and outside the company. The better corporate governance, then the company is successful in managing the rights of shareholders and stakeholders. According to the National Governance Policy Committee (KNKG, 2006) various parties involved in corporate governance are shareholders, board of commissioners, directors, employees, business partners, the public, as well as users of products and services. The principle of corporate governance in accordance with the National Governance Policy Committee consists of:

- Transparency
- Accountability
- Responsibility
- Independence
- Fairness and Fairness

Research Hypothesis

Khoshtinat et al. (2006) examined the effect of financial leverage on earnings response coefficients. The results showed that financial leverage negatively affected the earnings response coefficient. The results showed that at a low level of leverage, financial leverage does not affect the earnings response coefficient, but conversely at a high level of leverage there is a weak relationship between financial leverage and earnings response coefficient. A different result was found by Hasanzade (2013), that there is no significant relationship between financial leverage and earnings response coefficient. The results showed that with increasing or decreasing financial leverage the relationship between changes in dividends and annual stock returns did not change. Theoretically, in companies with high leverage the expected increase in earnings is stronger because securities and other debt can be safer by way of bondholders will welcome the good news about net income (Scott, 2015: 163). Therefore a company with a large enough loan will result in a decrease in the earnings response coefficient compared to companies with little or no debt. A company with a high level of leverage means having a debt that is greater than capital. This will be responded negatively by investors because investors will assume that the company will be more profitable for creditors because it prefers debt payments rather than dividend payments. Investors assume that the better the company's earnings conditions, the more negative the shareholder response. Based on previous research and verification of efficient market theory and signal theory, the first hypothesis is:

H1: Leverage has a negative effect on the earnings response coefficient.

Leverage is a ratio that shows the extent to which businesses depend on debt financing. Company leverage is calculated using a ratio of the ratio of total debt to equity, also known as the debt to equity ratio (DER). Companies with high DER levels show the composition of total debt is greater than the total own capital so that the impact on the increasing burden on the outside of the company (Nurchayani, 2014). In Management Discussion and Analysis (MD & A), management's view, company performance, financial condition, risk, and future prospects are also related to efficient market theory and signal theory. The more complete information disclosed by the company, It will lead to an increase in the company's stock price and subsequently will affect the value of the earnings response coefficient (Ball & Brown, 1968). Companies with good debt financing will affect corporate governance, so that corporate governance is expected to strengthen or weaken the interaction between leverage and earnings response coefficients. Based on verification of efficient market theory and signal theory, the second hypothesis is:

H2: Corporate governance is able to weaken or strengthen the effect of leverage on the earnings response coefficient.

Methodology

The method used to determine the sample in research is purposive sampling. The criteria to be used in this research is judgment sampling which is purposive sampling with a certain consideration (Hartono, 2013). Data were processed using IBM SPSS Statistics 24. The population in this study were manufacturing companies listed on the Indonesia Stock Exchange (IDX) during the 2016-2018 observation year with 108 of total samples.

The total sample observations are determined by the judgment sampling criteria as follows:

1. Companies that publish annual reports in a row in 2016-2018.
2. Manufacturing companies that use the rupiah in the financial statements.
3. Companies that display complete data, which can be used to analyze research variables.

Variable Measurement

Earnings Response Coefficient

The dependent variable (Y) in this study is the Profit Response Coefficient. Earnings response coefficient is one factor that can be analyzed to see market efficiency. Market efficiency is tested by looking at the abnormal returns. The market is said to be inefficient if one or several market participants can enjoy an abnormal return in a long period of time (Hartono, 2017). Earnings response coefficient is a coefficient derived from a regression between stock prices and accounting earnings. The stock price is proxied with

Cummulative Abnormal Return (CAR). *Abnormal Return* is the advantage of returns that actually occur against normal returns. Normal return is the return expected by investors (Hartono, 2017). Furthermore, the formula for calculating earnings response coefficients is as follows (Homan, 2018):

$$CAR_{it} = \alpha + buEARN_{it} + \varepsilon_{it} \quad (1)$$

Description:

CAR_{it} : Cumulative abnormal return of company i, at the time of the event date t-3 up to the event date t + 3 from the day of publication of the annual report (7 day observation period)

α : Constants

bu : Coefficient which shows the earnings response coefficient

$EARN_{it}$: Unexpected income from company i in year t

ε_{it} : Component error in company i model in year t based timing observation

Leverage

Leverage is an alternative that can be used to increase profits. The use of debt in the form of investment in addition to funding company assets is expected to increase profits to be gained by the company, because the assets owned by the company are used to generate profits (Febria, 2014). Thus the profits available to equity holders are also getting bigger. Leverage is the use of debt by companies to carry out company operations. To calculate leverage, this study uses a debt ratio or Debt to Equity Ratio (DER). The calculation using DER is to divide total debt consisting of current and non-current debt by total equity (Tiffani, 2017). DER can be calculated using the following formula:

$$DER = \frac{(\text{Total Debt})}{(\text{Total Equity})} \quad (2)$$

Description:

Total debt : Total debt of company i in period t

Total equity : Total capital of company i in period t

Corporate governance

Corporate governance in this study is a moderating variable. The moderating variable is an independent variable that will strengthen or weaken the relationship between other independent variables to the dependent variable (Ghozali, 2018). Corporate governance is measured using self-assessment with a measuring tool developed by the Forum for Corporate Governance in Indonesia (FCGI). The following division of scores to determine the value of corporate governance (FCGI, 2001):

Table 1: Assessment of Corporate Governance Using FCGI

Field of Assessment	Score
1. Shareholder Rights	20%
2. Corporate Governance Policy	15%
3. Corporate Governance Practices	30%
4. Disclosure	20%
5. Audit	15%
Total	100%

Data analysis technique

Data analysis is a process of finding, compiling, and processing systematic data obtained from the results of data collection. In the data analysis step, the data collected is analyzed statistically to see whether the hypotheses produced have been supported (Sekaran & Bougie, 2016). This research is a quantitative study with research problems that will be analyzed with descriptive statistics, classical assumption tests, and Moderated Regression Analysis (MRA). The classic assumption test consists of normality test, autocorrelation test, multicollinearity test, and heterokedasticity test. The model of data analysis in this research is as follows:

Equation 1

$$Y = \alpha + \beta_1 X_1 + \varepsilon \quad (3)$$

Equation 2

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_1 Z_1 + \varepsilon \quad (4)$$

Description:

Y : Earnings response coefficient

α : Constants

X_1 : Leverage
 Z_1 : Corporate governance
 β_1 - β_2 : Regression coefficient
 ε : Standard Error (error rate) 5%

Result and Discussion

The results of the descriptive statistical test showing the characteristics of the data distribution in this study are shown in Table 1:

Table 1: Analysis Results Descriptive statistics

Information	N	Minimum	Maximum	The mean	Std. Deviation
LEV (X)	108	0.1092	7.5014	1.3911	1.2873
ERC (Y)	108	-0.0628	0.0678	-0.0010	0.0255
X * Z	108	0.0663	5.12125	1.0513	0.9637

Based on the table above, variable leverage yields a minimum value of 0.1092, a maximum value of 7.5014, an average value of 1.3911, and a standard deviation of 1.2873. Earnings response coefficient produces valueminimum of -0.0628, the maximum value of 0.0678, the average value of -0.0010, and the standard deviation of 0.0255. Leverage has been moderated by corporate governanceproduce a minimum value of 0.0663, a maximum value of 5.8125, an average value of 1.0513, and a standard deviation of 0.9637. Based on the results

Residual Normality Test

Normality test is used to test whether the residual data in the normally distributed regression model. Testing the normality of the data using the Kolmogorov-Smirnov one sample test by looking at the significance level of 5%. If the asymp.sig probability > 0.05 then the residual data is normally distributed.

Table 2: Normality Test Equation 1

Information	Unstandardized Residual
N	108
Normal Parameters ^a , b	
The mean	0.0000000
Std. Deviation	0.02523961
Most Extreme Differences	
Absolute	0.090
Positive	0.077
Negative	-0.090
Statistical Test	0.090
Asymp. Sig. (2-tailed)	0.051c
<i>a. Test distribution is Normal.</i>	
<i>b. Calculated from data.</i>	

Table 3: Normality Test Equation 2

Information	Unstandardized Residual
N	108
Normal Parameters ^a , b	
The mean	0.0000000
Std. Deviation	0.02518326
Most Extreme Differences	
Absolute	0.088
Positive	0.084
Negative	-0.088
Statistical Test	0.088
Asymp. Sig. (2-tailed)	0.058c
<i>a. Test distribution is Normal.</i>	
<i>b. Calculated from data.</i>	

Based on the table above, have the value of Sig. = 0.051 > 0.05 in equation 1 and Sig. = 0.058 > 0.05 in equation 2. This shows that the data is normally distributed. Other test results to see the normal distribution of data can be seen in the following figure:

Figure 1: Histogram Equation 1

Figure 2: Histogram Equation 2

In the histogram image of equation 1 and equation 2 above it gives a sloping graph and a normal curve so that it can be concluded that the assumption of data normality is met.

Figure 3: Normal PP Plot Equation 1

Figure 4: Normal PP Plot Equation 2

In the PP plot equation 1 and equation 2 above show that the points are spread in a direction following a diagonal line so that it can be concluded that the assumption of normality of data is met.

Autocorrelation Test

Autocorrelation arises because of sequential observations over a period of time related to one another. Autocorrelation test needs to be done to determine whether in the linear regression model there is a correlation between the error of the intruder in period t and the error of the intruder in the previous period ($t-1$). Whether autocorrelation is present or not can be determined by comparing Durbin Watson's calculated statistical values. The basis for decision making is that if $DU < DW < 4 - DU$, the regression model is free from autocorrelation problems (Ghozali, 2018: 111).

Table 4: Autocorrelation Test Equation 1

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	0.195a	0.024	0.015	0.02536	1,773
a. Predictors: (Constant), LEV (X)					
b. Dependent Variable: ERC (Y)					

Table 5: Autocorrelation Test of Equation 2

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	0.209a	0.028	0.010	0.02542	1,894
a. Predictors: (Constant), X * Z, LEV (X)					
b. Dependent Variable: ERC (Y)					

The autocorrelation test results in equation model 1 explain that the DU value is 1,705, the DW value is 1,773, and the DL value is 1,668, then it fulfills the $DU < DW < 4 - DU$ autocorrelation assumption is $1,705 < 1,773 < 4 - 1,705$. Furthermore, the equation 2 model explains that the DU value is 1,724, the DW value is 1,894, and the DL value is 1,649, so it fulfills the $DU < DW < 4 - DU$

autocorrelation assumption, which is $1,724 < 1,894 < 4 - 1,724$ so that both models of the regression equation have fulfilled the assumptions free of autocorrelation.

Multicollinearity Test

This study uses VIF (Variance Inflation Factors) in testing multicollinearity to determine whether there is a high correlation between the independent variables in the formed regression model. The results of the multicollinearity test can be seen in table 6:

Table 6: Multicollinearity Test

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Collinearity Statistics	
		B	Std. Error	Beta			Tolerance	VIF
1	(Constant)	-0.005	0.004		-1,475	0.143		
	LEV (X)	0.003	0.002	0.155	1,618	0.109	1,000	1,000

a. Dependent Variable: ERC (Y)

The test results will be accepted if the VIF value < 10 and tolerance value > 0.10 . In the table above shows a VIF value of $1,000 < 10$ and a tolerance value of $1,000 > 0.10$, it is concluded that there are no symptoms of multicollinearity. Equation 2 does not do a multicollinearity test because there is an interaction between the independent variable and the moderating variable so that it will produce a high correlation value.

Heteroskedasticity Test

Heteroscedasticity test aims to test the existence of unequal variable variance from residuals of one observation to another.

Figure 5: Scatterplot Equation 1

Figure 6: Scatterplot Equation 2

Results Heteroscedasticity test in equation 1 and equation 2 shows that the points that appear spread randomly above or below the Y axis so that it can be concluded that the regression model in this study is free from the problem of heteroscedasticity.

Moderated Regression Analysis

This research uses Moderated Regression Analysis. The results of the moderated regression analysis can be seen in the following Table 7:

Table 7: Moderation Regression Test Results

Information		Coefficient	Sig t	R Square
Equation 1	Constant	-0.005	0.143	0.024
	LEV (X)	0.003	0.109	
Equation 2	Constant	-0.006	0.128	0.028
	LEV (X)	-0.006	0.649	
	LEV * CG	0.013	0.494	

The regression equation obtained from the analysis in the above table is as follows:

$$Y = -0.005 + 0.003 X + \varepsilon_i \quad (4)$$

$$Y = -0.006 - 0.006 X + 0.013 XZ + \varepsilon_i \quad (5)$$

- Hypothesis 1 test can be seen in the significance of the t value contained in table 7. The results of t test on the independent variable X shows that leverage (LEV) has an effect but is not significant on Y (ERC) with p-value 0.109 which is greater than 0.050. This shows Hypothesis 1 rejected, it means increasing or decreasing financial leverage did not change the relationship between leverage and annual stock returns. The results of this study are following the signal theory which states that a good quality company will provide a signal to the market in the form of information so that the market is expected to be able to differentiate between good and bad quality companies. This study is following the efficient market theory and signal theory which even though this research has an effect but is not significant, it is important to note that companies that do not manage their debt well will affect stock prices.
- Hypothesis 2 test results in table 7 produces a regression coefficient of 0.013 with a significance of t of 0.494. Significance value greater than 0.05 explains that corporate governance is not able to strengthen the effect of leverage on the earnings response coefficient so hypothesis 2 is rejected. The results of the study explained that corporate governance cannot be used as a moderating variable between leverage and earnings response coefficients. The results of this study are following the signal theory which states that the role of company management in improving company performance will affect the score of corporate governance. This was also reflected in Management Discussion and Analysis (MD & A). The results of this study indicate that good corporate governance may not necessarily reflect the value of good leverage and good returns for the company.

The results of this study contradict the previous research conducted Khoshtinat & Falah (2006) which provides the results of that study that leverage has a negative effect on the earnings response coefficient, but according to research by Hasanzade et al (2013) which provides research results that there is no significant relationship between leverage with earnings response coefficient.

Coefficient of Determination

The coefficient of determination is the ability of the independent variable (variable X) in influencing the dependent variable (variable Y).

Table 8: Coefficient of Determination

Equation	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.195 _a	0.024	0.015	0.02536
2	0.209 _a	0.028	0.010	0.02542

The results of the R Square value in equation 1 is 0.024 (2.4%) and the value of R Square in equation 2 is 0.028 (2.8%). This shows that the ability of leverage to influence earnings response coefficient is 2.4%. Together abilities leverage and the interaction between leverage and corporate governance in influencing earnings response coefficient of 2.8%.

Conclusions

The results prove that increasing or decreasing financial leverage does not change the relationship between leverage and annual stock returns. This shows that with increasing or decreasing the value of leverage, the relationship between annual stock returns and annual unexpected profits does not change.

Companies with high levels of leverage can give a bad signal in the market and can reduce the value of the company's earnings response coefficient so this makes the corporate governance structure unable to moderate the interaction between leverage and earnings response coefficients.

The limitation during conducting this research that the research requires a longer time in analyzing because there need to be observations for five years by collecting cumulative abnormal returns for 7 days each year and collecting unexpected earnings of the company which are then regressed to get the earnings response coefficient.

Future researchers are suggested to be able to use moderation variables that can also directly influence the earnings response coefficient. Further researchers can also use other measuring instruments such as Trading Volume Activity (TVA) so that they can see the market reaction through shares and the number of shares outstanding and get better results because without the need to do two stages of regression.

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