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Earnings Response Coefficient, Sharia Online Trading System, and Firm Value: An Inference from Indonesia

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Abstract

This research aims to examine the nexus between Earnings Response Coefficient (ERC), Sharia Online Trading System (SOTS), and firm value. The research sample was all companies listed on the Jakarta Islamic Index (JII). The research model used path analysis employing the regression with common, fixed and random effect models as well as the robustness check through Generalized Method of Moment (GMM). The result demonstrates that ERC and SOTS can't determine the level of firm values. This research found no effects of ERC and SOTS on firm value, but nexus between ERC and SOTS was found. These findings indicate that ERC and SOTS have no effect at all on the firm value, meanwhile ERC has the negative effect on SOTS. Nevertheless, the result of this research found no intervening effect of SOTS on the ERC and firm Value. It shows that SOTS can't mediate the nexus between ERC and firm value.

Keywords: ERC; Firm Value; Signal; SOTS

JEL Classifications: M41; N25

Introduction

Earnings Response Coefficient (ERC) measures abnormal stock returns in response to unexpected earnings components. Alternatively, in other words, ERC can explain changes in stock prices to earnings information generated by the company (Scott, 2011, 2015). As stated by Ball & Brown (1968), profit is considered in decision-making. They implied that the movement of stock prices by investors' wish in the future has a significant impact on decision-making. However, Patell (1989) stated that earnings do not always positively impact on decision-making. It could be that earnings tends to be manipulated by company management, which is called income smoothing, so that beside earnings, other information is needed to predict stock returns. Furthermore, Suwarjono (2010) defined ERC as the sensitivity of stock returns to unexpected earnings in providing information that the market has not caught to react to earnings announcements. Investors have expressed divergent reactions to the earnings information presented in the financial statements.

Earnings quality is increasingly becoming the center of attention because several financial scandals in public companies have involved financial statement issues, especially earnings problems. In Indonesia, cases of Lippo and Kimia Farma companies involving financial reporting, detecting earnings manipulation are phenomenon in this research. It shows that financial scandals are a failure of financial statements to fulfill the information of report users. The profit doesn't show real conditions (Ujiyantho & Agus Pramuka, 2007).

For companies that issue shares in the capital market, the price of shares traded on the stock exchange indicates firm value at the stock price. The higher the stock price, the higher the company's value. On the contrary, a stock price that is too low indicates firm performance is bad (Weston & Copeland, 1995). For investors, earnings are considered to have information that analyzes the shares issued by the issuer. Unreal incomes mislead the users of the report. If investors use this kind of profit to form the company's value, then the profit cannot explain the company's actual market value. The low quality of earnings will lead to errors in the decision-making of users such as investors and creditors so that the value of the company will decrease. Thus, the strong market reaction to earnings information is reflected in the high ERC. If the reported earnings has the power of response, then the resulting earnings also has high quality. Quality of earnings are able to create high corporate value. According to Muid (2009), the higher the company's value, the level of welfare of shareholders is also higher so that the company seeks the role of ERC, which is measured by the level of abnormal stock returns in responding to the component of unexpected earnings in the capital market.

This research is led to consider an empirical model that tries to link the Earning Response Coefficient (ERC) with Sharia online trading systems (SOTSs) as a mediating variable measured by ISSI closing prices. The research aims to investigate and provide empirical evidence whether companies that have high earnings quality will have a high company value through Sharia online trading systems.

This research is opposed to previous research. It includes SOTS as a mediating variable because it is still scarce to examine these variables. In addition, the existence of Islamic stocks in the form of ISSI, JII, and JII70 is supported by many DSN MUI fatwas that regulate sharia stock transactions, one of which is DSN-MUI Fatwa No. 80/DSN-MUI/III/2011. The fatwa has explained in full and clearly and specifically some of the rules in the Islamic capital market. Siregar (2020) stated that SOTS is here for the first time in the world to make it easier for sharia investors to conduct Islamic stock transactions. Based on research conducted by Alawiyah & Setiyaningsih (2021) that the strong performance of ISSI, one of which is a selective stock, preferred stock, which in the Islamic capital market has been selected by the SOTS which is a conversion from the MUI Fatwa No. 80/2011. Of course, the only screened transactions are shares and transactions with sharia principles, no indication of usury, manipulation (maisir), gharar, margin trading, or short selling. The objectives of this research are to test the effect of ERC on SOTS, ERC on company value, and through the Sharia Online Trading System. This research uses path analysis to find the effects of nexus between variables.

Literature Review

Signaling Theory

The signaling theory aims to signal stakeholders to increase the company's value (Wolk et al., 2001). In addition, signal theory states a relationship between long-term earnings and structural shifts, and profitability. The signal given by the company can be a disclosure of financial statements or Good News if there is an increase in income/profitability that exceeds investor expectations (Kaszniak & McNichols, 2002). A company sends a signal to investors with the purpose of showing that it is better than another company (Abbas, 2020; Abbas et al., 2015). In the case of this research, it can be concluded that signal theory is able to inform stakeholders regarding the value of firms. Financial conditions in the capital market can be assessed based on the ERC in the company's annual report. An appreciation obtained by each firm is the reflection of health and will create high company value. The higher the company's value in the Jakarta Islamic Index, the more sharia investors who carry out Islamic stock transactions through Sharia Online Trading Systems, which are decreed based on DSN-MUI No. 80/DSN-MUI/III/2011.

Earnings Response Coefficient (ERC)

ERC is one of the proxies used to measure earnings quality (Paramita, 2012). Suwarno & Zamzami (2017) stated ERC is the effect of unexpected earnings on cumulative abnormal returns, indicated by the slope coefficient in the regression of abnormal stock returns with unexpected earnings, so it can be concluded that ERC is used to explain the market reaction or response to changes in stock prices to the earnings information generated by the company obtained from the regression between cumulative abnormal returns and unexpected earnings.

Firm Value

The company value is the value created to positively impact investors, which is indicated by the movement of stock prices. Companies with higher profits will attract investors to invest their capital so that their value increases in the hope of getting high profits. The greater the profit, the higher the firms' capability to make the expenditure of dividends resulting good profitability of companies in front of investors. Optimizing the value of the company is the company's goal in the long term. The higher the value described by the company, the more prosperous the owner. The implementation of good management system can reach the goals with accurate financial decision (Fama & French, 1998).

Sharia Online Trading System (SOTS)

SOTS is share transaction system considering Islamic principles as implied in DSN-MUI fatwa No. 80, which is converted into a transaction system by sharia principles. The standard features in the SOTS are stock trading features, updates on stock price developments from time to time, indicators for analyzing stock prices, news related to companies, and financial features of capital market participants.

Thus, the launch of SOTS is to increase the number of investors where SOTS can facilitate sharia investors in conducting sharia share transactions. The parameters used in the preparation of SOTS are a description of transactions prohibited by sharia and are contained in the DSN-MUI fatwa no. 80 through ISSI.

Earnings Response Coefficient (ERC), Sharia Online Trading System (SOTS), and Firm Value

Alawiyah & Setiyaningsih (2021) found that during the stock price shock due to the Covid-19 pandemic, that ISSI has a more robust performance compared to the entire stock price index (JCI) in the capital market. (Syaifulah, 2020) also did the same thing in his research showing that the information produced by SOTS has relevance, accuracy, timeliness and is complete in producing information needed by investors related to a company's performance (Haridhi, 2020). This study found that the application of regulations in the SOTSs to transactions performed by investors, contrary to sharia principles, will automatically be cancelled by the system, so it can be concluded that the application of POJK No. 15 can be executed very effectively through the SOTSs. Based on this description, the hypothesis in this study are as follows:

H₁ : ERC has positive effect on SOTS

Ambarwati & Sudarmaji (2020) investigated Earning response coefficient. It obtains no relationship between ERC and profitability. Hartanto & Wijaya (2019) researched the factors affecting the ERC with profitability as a predictor. The research found that the ERC is not influenced by company size and growth but by profitability even though the direction is negative. Profitability also strengthens the relationship between company size and growth on the earnings response coefficient.

In contrast to research conducted by Abbas (2018) which shows that banking earnings management impacts increasing firm profitability. The same thing was tested by Nichols & Wahlen (2004) concerning the impact of earnings persistence on stock returns. The test results found that stock returns are associated with increased earnings, and this relationship is greater for companies with high persistence than for companies with low persistence. The finding discloses that earnings quality can affect stock returns. Kawatu (2009) tested the effect of earnings quality proxied by discretionary accruals with company value as measured by Tobin's Q. The results showed that earnings quality has a positive effect on firm value. Thus, earnings quality has a role in reducing the cost of equity. The higher the earnings quality, the lower the cost of equity. In determining the value of shares, the lower the cost of equity, the higher the value of the shares. Conversely, the higher the cost of equity, the lower the stock price (Francis et al., 2004).

H₂ : ERC has positive effect on the firm value

Haridhi (2020) found that SOTS is certified by the DSN-MUI, which is the actualization of the DSN fatwa No. 80 of 2011 concerning the application of sharia principles in the mechanism of trading equity securities on the stock market of the stock exchange. The main feature of SOTS consists of several criteria, namely only sharia shares that can be transacted, sharia share purchase transactions can only be done in cash so there can be no margin transactions, cannot make transactions for buying and selling sharia shares that are not owned, sharia share ownership reports are separated from each other. ownership of money so that the sharia shares owned are not counted as capital (money) which is Sharia-compliant transactions. This research is also supported by prior research conducted by Syaifullah (2020) who show that the SOTs, which was built with the main objective of processing information in the form of quality stock transactions would be useful for management in making decisions. Stocks with high quality come from quality of earnings so that they are able to create high company value.

H₃ : SOTS has intervening effect on the nexus between ERC and Firm Value.

Research and Methodology

All companies listed on the Jakarta Islamic Index (JII) were sample in this research. The observation was conducted during five years, starting from 2015 – 2020. The samples in this research were taken based on the following provisions:

- Companies listed on JII during the 2015-2020 observation period.
- Presenting annual reports and complete financial reports for the 2015-2020 observation period and published in JII.

The firm value is measured using Tobin's Q, which reflects the stock market reaction to the company.

$$Q = \frac{(EMV + Debt)}{Total Assets}$$

Where,

Q : Firm Value

EMV : Equity Market Value

Debt : Total debts

$CAR_{it} = \beta_0 + \beta_1 UE_{it} + e_{it}$

Where:

CAR_{it} : The cumulative abnormal return of company i during the observation period $\pm$ 5 days from the publication of the financial statements.

UE_{it} : *unexpected earnings*

β_0 : constant

β_1 : coefficient indicating ERC

The Sharia Online Trading System (SOTS) is actualized through the DSN-MUI fatwa No. 80 of 2011. It can be measured through the Indonesian Sharia Stock Index (ISSI).

Data Analysis Technique

The research model is path analysis using panel data, a combination of time series and cross-section data. The classical assumption test is needed to determine whether the regression estimation results are truly free from the presence of heteroscedasticity and multicollinearity. The model of regression in this research has no heteroscedasticity and multicollinearity (Gujarati, 2004, 2015).

The analysis test of the panel data regression model consists of several steps used in analyzing the Earning Response Coefficient (ERC), Company Value, and Sharia Online Trading System (SOTS). The form of the initial equation is:

$$M_{it} = \alpha + \beta_1 X_{1it} + e_{it}$$

$$Y_{it} = \alpha + \beta_1 X_{1it} + \beta_2 M_{2it} + e_{it}$$

With the following description:

Y_{it} : Firm Value
 α : Coefficient
 β_1 : Coefficient
 X_{1it} : Earning Response Coefficient (ERC)
 M_{it} : Syariah Online Trading System (SOTS)
 e_{it} : Error term

Result and Discussion

Result of Data Analysis

Panel data analysis requires treating the regression model according to its effect (CEM, FEM, or REM). The selection of the path analysis effect test with mediation was carried out using two-equation models as follows.

Equation 1:

$ISSI_{it} = \beta_0 + \beta_1 ERC_{it} + \varepsilon_{it}$ Common Effect Model (CEM)

$ISSI_{it} = \beta_0 + \delta_1 D1 + \delta_2 D2 + \varepsilon_{it}$ Fixed Effect Model (FEM)

$ISSI_{it} = \beta_0 + \beta_0 ERC_{it} + \mu_{it} + \varepsilon_{it}$ Random Effect Model (REM)

Equation 2:

$Q_{it} = \beta_0 + \beta_1 ERC_{it} + \beta_2 ISSI_{it} + \varepsilon_{it}$ Common Effect Model (CEM)

$Q_{it} = \beta_0 + \delta_1 D1 + \delta_2 D2 + \varepsilon_{it}$ Fixed Effect Model (FEM)

$Q_{it} = \beta_0 + \beta_0 ERC_{it} + \beta_2 ISSI_{it} + \mu_{it} + \varepsilon_{it}$ Random Effect Model (REM)

The conceptual model framework is described as follows.

Figure 1: Path Analysis

Table 1: Regression Model Test for Equation 1

Regressors	CEM	FEM	REM
ERC	-0.992628.5 -11.70***	-992628.5 -10.70***	-0.992628.5 -11.70***
Constant	147916 23.53***	147916.2 21.53**	147916 23.53***
R-Squared	0.434	0.434	0.434
Number of Observations	180	180	180
***0.01, **0.05, *0.10 Dependent Variable = Q			

When selecting the regression model test, it appears that all models generate the same effect if the independent variable has a significance level less than or equal to 0.01 in a negative direction. By estimating the Generalized Method of Moments (GMM) method, a robustness check can be performed on the model in order to ensure its consistency and unbiasedness. The estimated robustness check is depicted below.

Table 2: GMM for Equation 1

Instrumental variables (GMM) Regression			Number of obs =	180
GMM weight matrix: Robust			Wald chi2 (1) =	350.31
			Prob > chi2 =	0.0000
			R-Squared =	0.4346
			Root MSE =	61163
ISSI	Coef.	Robust Std. Err	z	P> z
ERC	-992628.5	53035.08	-18.72	0.000
_cons	147916.2	6822.217	21.68	0.000

The robustness test results through GMM showed the same effect where the independent variable had a significance at 0.01 level in a negative direction. Thus, ERC negatively affects the Sharia Online Trading System. Following the model of equation 2, this research will choose the suitability of effects, whether Common Effect (CEM), Fixed Effect (FEM), and Random Effect (REM).

Table 3: Regression Model for Equation 2

Regressors	CEM	FEM	REM
ERC	-2.91495 -0.41	-2.91495 -1.00	-2.91495 -1.00
ISSI	-0.0000009 -0.20	-0.0000009 -0.48	-0.0000009 -0.48
Constant	3.2746 4.13***	3.2746 -9.90***	3.2746 4.54***
R-Squared	0.001	0.007	0.0010
F Test	0.09	0.52	1.05
Number of Observations	180	180	180
***0.01, **0.05, *0.10 Dependent Variable = Q			

In selecting the regression model test, it appears that all models give the same effect where the independent variable has a significance level above 0.01 with a negative direction so that no specification test is needed through the Chow test, Hausman test, and the Breusch and Pagan Lagrangian multiplier test. In order that the model can be consistent and unbiased, a robustness check is required.

Table 4: GMM for Equation 2

Instrumental variables (GMM) Regression			Number of obs =	180
GMM weight matrix: Robust			Wald chi2 (1) =	0.17
			Prob > chi2 =	0.9166
			R-Squared =	0.0010
			Root MSE =	3.7974
Q	Coef.	Robust Std. Err	z	P> z
ERC	-2.91495	7.362346	-0.40	0.692
ISSI	-9.25e-07	4.93e-06	-0.19	0.851
_cons	3.274644	0.8843031	3.70	0.000

After obtaining the effect corresponding to the equation model, the next step is the classical assumption test through heteroscedasticity and multicollinearity tests.

Table 5: Heteroscedasticity Test Results

<i>Breusch-Pagan/Cook-Weisberg test for heteroskedasticity</i>	
H0: Constant variance	
Variables: fitted values of Q	
Chi2(1)	3.28
Prob >chi2	0.0701

Based on Table 5, there is no heteroscedasticity in the research model. It obtains 0.07 which is above 0.05 value.

Table 6: Multicollinearity Test Result

Variable	VIF	1/VIF
ERC	1.77	0.565386
ISSI	1.77	0.565386
Mean VIF	1.77	

The tolerance level of each independent variable produces a VIF value below 10.0. This value can be concluded that there is no high correlation between the independent variables, so that this study is declared free of multicollinearity symptoms. Furthermore, path analysis through mediating variables was tested using the Sobel test. ISSI in this research is a mediator in the relationship between ERC and Q. The formula for obtaining the value of the mediation effect is as follows.

$$z = \frac{ab}{\sqrt{(b^2 SE_a^2) + (a^2 SE_b^2)}}$$

The a value obtained in equation 1 is -0.992628.5 with an SE value of 53.035, and the value of b obtained in equation 2 is -0.0000009 with an SE value of 0.0000049. Thus, the results of the Sobel test scores are as follows

$$z = \frac{(-0.992628.5) \times (-0.0000009)}{\sqrt{(-0.0000009^2)(0.0000049^2) + (-0.992628.5^2)(53.305^2)}}$$

$$z = 0.9238$$

The Sobel value of 0.9238, indicating a significance value below 1.96, indicates that the ISSI variable does not mediate the relationship between ERC and Q variables.

Descriptive Statistics

The descriptive statistics shows that the company's value proxied by Tobin's Q has an average range of 3,036. The value of the sample companies is 23.28 at maximum and 0.000 at minimum with a standard deviation of 23.28. The results imply that sampling firms are at a positive value. In the independent variables, the average is 0.50 on the ERC with the maximum and minimum values of 0.142 and -0.016 and 97.623 respectively on the ISSI with the maximum and minimum values of 184.212 and 14,317.

Table 7: Descriptive Statistics

Variable	Obs	Mean	Std. Dev	Min	Max
Q	180	3.036651	3.809924	0.000	23.28575
ERC	180	.0506667	.0541744	-.016	.142
ISSI	180	97623	81569.61	14317	184212

Hypotheses Testing Results

Data analysis through the regressed effects model shows that the ERC variable negatively affects the ISSI variable. In contrast, the ERC and Q variables do not affect the Q variable. The ISSI variable does not affect the relationship between the ERC and Q variables in the mediation model. The following are the results of the research model test. Data analysis through the aggregated effect model shows that ERC variables are ISSI variables, while ERC and Q variables do not affect variable Q. In the mediation model, ISSI variables do not affect the relationship between ERC and Q variables.

Table 8: Hypotheses Testing Results

Model	Result	Significance
ERC→ISSI (Equation 1)	Negative	Yes
ERC→Q (Equation 2)	Negative	No
ERC→ISSI→Q (Mediation)	Positive	No

Effect of ERC on SOTS

The finding of this research rejects the development of H1 stating that ERC has positive effect on SOTS. It indicates some investors are affected in the use of SOTS by looking at ISSI in the annual report in order to increase investor confidence in the profits generated by the company. The signal given by the company can be a disclosure of financial statements or News if there is an increase or decrease in income/profitability that exceeds investor expectations (Kasznik & McNichols, 2002). The results of this study are consistent with research conducted by Alawiyah & Setiyaningsih (2021), that the movement of the Islamic stock price index (ISSI) has a strong performance compared to the entire stock price index (JCI) in the capital market.

Basically, transactions in the Islamic capital market, especially JII, are prohibited by sharia, such as margin trading and short selling, which can impact poor stock fundamentals. In addition, a sharia investor is prohibited from conducting market manipulation transactions (*maisir*) by creating pseudo trades or creating unfair transactions in the capital market, which are categorized as *gharar* transactions. The prohibition of other transactions, such as usury, which in the context of the Islamic capital market is an addition to securities transactions stipulated or agreed in advance and became an inseparable part of the transaction.

The existence of SOTS is very helpful for Islamic investors in conducting transactions in the capital market. Considering that many people still think that investing in the capital market is gambling, so it is illegal. Investment in the capital market is buying and selling ownership assets in shares, not buying and selling money. According to sharia principles, the sale and purchase of assets are allowed except for the sale and purchase of money because money is not an asset, so it cannot be traded. Thus, ERC is able to provide news information to investors by looking at ISSI in the Islamic capital market.

Effect of ERC on Firm Value

The test result showed that the earning response coefficient has no significant effect on company value. This is in line with research conducted by previous scholars (Abbas, 2018; Ambarwati & Sudarmaji, 2020)) say that disclosure of information does not fully assist investors in making decisions to invest because the capital market in Indonesia has not been information efficient in a semi-strong-form. Empirical research on the relationship between returns/earnings growth in annual reports shows that although investors use profit information, the usefulness of that profit information for investors is very limited. Patell (1989) implied that there are unstable condition obtained in the level of stock returns and low contribution generated by firms earnings to estimate it. In addition, The low level of disclosure of companies' financial statements in the Islamic capital market makes investors interested in seeing the information in the financial statements as investment decision-making. So that makes investors more interested in investing in companies with small profits but a growing company value because investors can get a high rate of return, and investors can get

high returns from their investment returns. In addition, high stock returns than individual company returns cause investors not to be interested in investing.

Effect of ERC on Firm Value through SOTS

The result of the test showed that the earning response coefficient doesn't affect firm value through sharia online trading systems, which means that SOTS, as measured by ISSI, cannot mediate between ERC and firm value. This study contradicts research conducted by Alawiyah & Setyaningsih (2021) that ISSI has a strong performance compared to the entire stock price index (JCI) in the capital market. So that the research indicates that investors perceive ISSI information as good news. In addition, Paramita (2012) found no effect of earning response coefficient (ERC) with ISSI. Similarly, Muid (2009) states that there is no difference in market reactions to companies that do earnings management with companies that do not. According to Puspitasari (2016), earnings quality on market reactions is due to low operating cash flow rates, low levels of correlation with company profits which will affect earnings quality, and inconsistent company earnings quality. This is in line with Puspita (2017), which states that the Indonesian capital market is still inefficient. Investors still consider conditions outside the company and outstanding issues as factors in making an investment decision. Therefore, investors believe that the financial information presented by the management is very concerned about the level of Sharia compliance of a company. So that investors use this belief as a consideration in making decisions.

This research assumes that the rules that require investors to consider this aspect in conducting sharia share transactions have not been further regulated in the OJK regulations. Existing regulations cannot guarantee the morals or ethics of an investor in conducting transactions in the sharia stock market. Besides, among the 30 companies implementing SOTS, only one company, namely PT. MNC Securities. Although companies registered with JII do not carry out the prohibited aspects of stock transactions in the Islamic capital market, an Islamic stock investor must also consider the aspect of rationality in making investment decisions. Suppose an investor conducts transaction on the sharia exchange without considering the rationality aspect, such as only carrying out a buy low sell high transaction scheme. In that case, it is feared that the investor can be categorized as carrying out prohibited transactions in sharia, such as *gharar* or *maisir*, even though the issuer being transacted is an issuer listed in the JII. The researcher also sees that the Islamic capital market has not been able to implement sharia principles because the Islamic capital market is under the auspices of the Indonesian stock exchange. No securities institution stands alone as a sharia securities institution except only to issue a shariah online trading system.

Conclusions

The finding of this research discloses that ERC affects SOTS. This means that some investors get a signal in the use of SOTS by looking at ISSI in the annual report in order to increase investor confidence in the profits generated by the company. Thus, ERC is able to provide news information to investors by looking at ISSI in the Islamic capital market. Other results show that ERC has no effect on the firm value, meanwhile the SOTS cannot serve as intervening variable. A sharia stock investor must consider the aspect of rationality in making investment decisions. Suppose an investor conducts transaction on the sharia exchange without considering the rationality aspect, in this case such as only carrying out a buy low sell high transaction scheme. Overall, findings of this research that ERC and SOTS can't be determinants of firm values.

The results of this study are addressed to the government, especially the financial authority of OJK, in making new regulations that are more comprehensive in managing the procedures for investors to conduct sharia share transactions by sharia principles themselves. So that it encourages the application of sharia principles in the capital market and can be implemented as by both issuers and investors. In addition, future study can also examine the level of consideration of rationality aspects in investing by Islamic stock investors so that the level of conformity of Islamic stock investors who transact on the stock exchange with Islamic principles itself can be seen.

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