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## Accounting conservatism, Islamic social reporting, and earning responses coefficient: An empirical analysis

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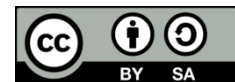
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### ABSTRACT

This research aims to determine the influence of accounting conservatism, sharia-based social performance disclosure and company size both partially and simultaneously against Earnings Response Coefficient (ERC). Empirical study of Sub-sector property and Real Estate companies registered in ISSI on Indonesia Stock Exchange period 2015-2018. The method used is descriptive and verification method with quantitative data. The data collection technique used non-participating observation. The results concluded that partially accounting conservatism was positively and significantly influential on the earnings response, sharia-based social performance disclosure has a positive and significant effect on earnings response, company size positively and significantly affects the earnings response and the simultaneous conservatism of accounting, sharia-based social performance disclosure and company size together have a positive and significant impact on the earnings response.

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## INTRODUCTION

The significance of reported earnings information for users of financial statements, particularly for publicly listed companies, has led company managers to focus on communicating the factors influencing reported earnings figures and managing the expectations of financial analysts (Chen et al., 2022). In essence, the market operates under a semi-strong condition (Bernardo et al., 2019). Consequently, when there are negative earnings surprises or actual earnings falling short of expected earnings, it results in the formation of bad news, which is expected to lead to a decline in stock returns (Shaikh & Huynh, 2022). Conversely, positive earnings surprises or actual earnings surpassing expected earnings generate good news, causing an increase in stock returns. Based on available data,

positive earnings information tends to elicit a more positive response compared to negative earnings information (Aly et al., 2018).

To assess investors' reactions to accounting earnings information, the Earnings Response Coefficient (ERC) is employed (Kim et al., 2018). ERC can be defined as a slope coefficient that measures the extent to which abnormal returns of market securities are influenced by the unexpected earnings components disclosed by companies issuing securities (Widiatmoko & Indarti, 2018). Furthermore, Rizki & Murwaningsari, (2018) define ERC as the impact of each dollar of unexpected earnings on stock returns, typically measured through the coefficients obtained from regressing abnormal stock returns against unexpected earnings.

Companies with negative earnings response coefficients, the market reaction to the company's profits when announced is not good, and if companies with positive earnings response coefficients, the market reaction to company profits is very good (Li et al., 2021). Based on the results of calculations that have been carried out, there are several companies in the property and real estate sub-sector whose market reactions are negative, this is because when the increase or decrease in profit is followed by stock prices that rise or fall every year, thus the market reaction to the company's profits to be less good.

The announcement of earnings in the capital market causes the market to react, however, every increase in profit is not always followed by a positive change in stock prices, even on the contrary when profits decline, stock prices do not always decrease. This indicates that in making economic decisions, investors not only need information about financial conditions but other information in the form of non-profit information (Chen et al., 2022).

One of the non-profit information that can be considered by investors is whether there is information asymmetry that occurs between the principal and the agent (Navqi et al., 2021). This information asymmetry can later lead to agency conflict caused by differences in interests between the principal and the agent. The way to avoid agency conflict is to apply accounting conservatism (Callen et al., 2022). This method can limit agents in practicing earnings manipulation in financial statements so that overstated profits will not occur. There are different research results regarding the effect of accounting conservatism with ERC. Zuhairini (2017) in his research found that accounting conservatism had no effect on the earnings response coefficient. Meanwhile, research conducted by Ahalik et al., (2020) found a positive relationship between accounting conservatism and earnings response coefficients.

In addition to accounting conservatism, other non-profit information that affects the company's profit response is information on reporting on corporate social activities. Husain et al., (2021) revealed that Islamic social reporting is very much needed by the Muslim community as a form of accountability to Allah SWT and increasing the transparency of business activities in the capital market. The form of disclosure of social responsibility is considered to provide legitimacy that is directly related to the continuity of the company (Riduwan & Wahyudi, 2020). This is evident from the research of Istianingsih, et al (2020) which revealed that CSR has a positive effect on the earnings response coefficient. Meanwhile, research by Wulandari and Wirajaya (2014) shows that there is no significant effect between CSR and the earnings response coefficient.

Furthermore, the firm size can also affect the response of investors to the profits generated by the company. The bigger the company, the greater the opportunity to generate profits. In addition, the firm size also makes the information disclosed to investors also wider. Sasongko et al., (2013) states that there is a positive influence between firm size and ERC. Meanwhile, Al-Quraan et al., (2020), and Zuhairini's (2017) states that firm size has a negative effect on the earnings response coefficient.

Based on the existence of different research results, it encourages further research, besides that accounting conservatism, Islamic Social Reporting and firm size are factors that are considered to be able to influence earnings response or earnings response coefficients. Thus, this study seeks to further

analyze how these three variables can affect the earnings response coefficient, which makes this research important because, this study examines investor reactions to earnings which are closely related to the progress of the Islamic capital market in Indonesia.

## **Literature Review**

### ***Earnings Response Coefficient (ERC)***

Earnings Response Coefficient (ERC) is a measure of the abnormal return of a stock in response to the abnormal earnings component (unexpected earnings) reported by the company that issued the stock. [Cheng and Nasir \(2010\)](#) stated that ERC is an estimate of changes in the company's stock price as a result of the company's profit information announced to the market. [Cho and Jung \(1991\)](#) says that the ERC for companies that are losing money is generally smaller than the ERC for companies that are profiting. A high ERC reflects quality earnings. ERC is a coefficient obtained from the regression between stock price proxies and accounting earnings. ERC is commonly used as a surrogate measure for the quality of earnings in numerous research studies. These studies consistently demonstrate that the ERC possesses robust predictive capabilities, particularly when it comes to fundamental earnings ([Mehrani et al., 2017](#)).

### ***Accounting Conservatism***

According to [Givoly and Hayn \(2000\)](#) Conservatism is recognizing expenses and losses earlier and delaying recognizing revenues and gains. Meanwhile, another understanding of conservatism is the principle of prudence in financial reporting where companies are not in a hurry to recognize and measure assets and profits and immediately recognize losses and debts that may occur. The application of this principle results in the choice of accounting methods that report lower income or assets and report higher debt ([Angela & Ishak, 2020](#)).

### ***Islamic Social Reporting***

[Chandra \(2020\)](#) said that specifically the ISR index is an extension of social reporting which includes people's expectations not only about the role of companies in the economy, but also the role of companies in a spiritual perspective. According to [Khoirudin \(2013\)](#), many Islamic economic studies measure CSR disclosure using Islamic Social Reporting. Therefore, ISR is a form of reporting on social activities to improve corporate social disclosure or known as CSR by adding spiritual aspects.

### ***Firm Size***

Company size is a scale that determines the size of a company. [Othman et al. \(2009\)](#) and [Husain et al. \(2020\)](#) stated that the larger the size of the company, the more information available to investors. With the larger the size of the company, there is a tendency for more investors to pay attention to the company ([Mulyani et al., 2007](#)). In addition, companies with large sizes will always try to give a positive signal to investors. So that before the company's earnings announcements are made, investors have put their trust that profits will be in line with expectations.

## **Hypotheses Development**

### ***Accounting Conservatism and Earnings Response Coefficient***

The definition of accounting conservatism is the principle of prudence in financial reporting where companies do not rush to recognize and measure assets and profits and immediately recognize losses and liabilities that may occur. The application of this principle results in the choice of accounting method aimed at the method that reports lower income or assets, and reports higher debt. The freedom to choose accounting methods can result in different numbers in the financial statements which in turn

will lead to profits that tend to be conservative and profits that tend to be optimistic/liberal. Fluctuating earnings result in unstable earnings or non-persistent profits in each current year (Gupta et al., 2022). Non-persistent earnings will have low predictive power.

A decrease in the predictive power of earnings can result in the current year's earnings information being less useful in predicting future earnings. Conservative accounting principles reflect the minimum profit that can be obtained by the company, so that profits prepared using a conservative method are not profits that are exaggerated in value, and thus can be considered as quality earnings. Good earnings quality can be measured using ERC, which is a form of measuring the information content in earnings or reactions to earnings announced by the company (Embuningtyas, 2018). According to Suryani, A (2016), and Wulandari (2015) conservatism has a positive and significant influence on ERC.

H1: Accounting conservatism has a positive influence on the earnings response

### ***Islamic Social Reporting and Earnings Response Coefficient***

In addition to financial information, investors also pay attention to non-financial information to assess the company's prospects in the future. Financial information is usually disclosed by companies with corporate social responsibility by showing the public about the company's activities and their impact on society. According to Jensen and Mackling (1976), the higher the level of disclosure, the higher the informative of the stock price as measured by the earning response coefficient. The assumption is that companies that disclose a lot of information on social activities are companies that have good news, which have more persistent profits and higher ERC. The results of research by Istianingsih, et al (2020) and Daud and Syarifuddin (2008) prove that there is a positive influence between Corporate Social Responsibility disclosure on earning response coefficient.

H2: ISR disclosure has a positive influence on the earnings response

### ***Firm Size and Earnings Response Coefficient***

Large companies generally have large total assets, besides that companies are also considered capable of continuously improving company performance which can improve the quality of company profits. Thus, the larger the company, the more interested investors will be to invest their capital in the company. Mulyani et al. (2007) show that firm size has an effect on ERC. This is because, the larger the size of a company, the higher the ERC value.

H3: Firm size has a positive influence on the earnings response

## **METHOD**

### **Research Design**

The research method used in this research is descriptive and verification method with a quantitative approach. The population used in this study is the property and real estate sub-sector companies listed on the Indonesian Sharia Stock Index for the 2016-2018 period, with a total sample of 39 companies. Determination of the number of samples in this study using purposive sampling technique in order to obtain research observation data amounted to 124, with a period of 3 years. The data obtained in the form of secondary data taken from the Indonesia Stock Exchange (IDX) and also the website of each company. The operational definition of variables from this research is as follows:

### **Participants/Sample Selection and Data Sources**

Determination of the number of samples in this study using purposive sampling technique in order to obtain research observation data amounted to 124, with a period of 3 years. The data obtained in the form of secondary data taken from the Indonesia Stock Exchange (IDX) and also the website of each company. The operational definition of variables from this research is as follows:

### Earnings Response Coefficient (ERC)

Cheng and Nasir (2010) stated that ERC is an estimate of changes in the company's stock price as a result of the company's profit information announced to the market. ERC is obtained from the regression between cumulative abnormal return (CAR) and unexpected earnings (EU) as stated in the following model:

$$CAR_{it} = \beta_0 + \beta_1 + UE_{it} + e_{it} \dots \dots \dots (1)$$

Information:

$CAR_{it}$  = Abnormal cumulative return of company  $i$  during the observation period  $\pm 5$  days from the publication of financial statements

$UE_{it}$  = Unexpected Earning

$\beta_0$  = Constant

$\beta_1$  = Coefficient indicating ERC

$e_{it}$  = Component error in the model for company  $i$  in period  $t$

### Accounting Conservatism

The application of the concept of conservatism will produce fluctuating profits, where fluctuating profits will reduce the predictive power of earnings to predict future cash flows (Sari and Adhariani, 2009). The purpose of using the concept of conservatism is to neutralize the optimism of entrepreneurs who are too excessive in reporting their business results. In this study, conservatism was measured using the Givoly and Hayn (2000) model, which was calculated by the following formula:

$$AC = \frac{(NP - Depreciation) - OCF (-1)}{TA} \dots \dots \dots (2)$$

Information:

AC = Accounting Conservatism

NP = Net profit

OCF = Operating cash flow

TA = Total Assets

### Islamic Social Reporting

In this study, the disclosure of sharia-based social performance is measured using ISR, where ISR is a conceptual framework for reporting social responsibility in accordance with Islamic principles. ISR can assist Muslim stakeholders in evaluating organizations regarding organizational social responsibilities, and can help organizations fulfill their obligations to Allah SWT and society. In this study, the approach that will be used in assessing the level of disclosure of Islamic social reporting uses a disclosure score which will be classified into 4 categories referring to the research of Othman et al. (2009) and Sawitri et al., (2017), and the ISR variable. can be obtained by the following formula:

$$ISR = \frac{\text{Number of Items Fulfilled}}{\text{Maximum Number of Items}} \times 100\% \dots \dots \dots (3)$$

### Firm Size

Firm size reflects the total assets owned by the company. In this study, firm size is calculated by the following formula:

$$\text{Size} = \text{Logaritma Natural (Total Asset)} \dots \dots \dots (4)$$

The data processing technique carried out is panel data regression analysis using a tool in the form of a computer program reviews 9.0. The equation model used in this study is:

$$\text{ERCit} = \alpha + \beta \text{ACit} + \beta \text{ISRit} + \beta \text{Sizeit} \dots \dots \dots (5)$$

## RESULTS AND DISCUSSION

### Results

Based on the test results for model selection, it shows that the fixed effect model is more appropriate than panel data regression in this study. Based on the results of the coefficient of determination test, the value of Adjusted R-Square is 0.749872, which means that 74.98% of the change in the Earnings Response Coefficient (ERC) variable can be explained by the variables of Accounting Conservatism, Disclosure of Sharia Social Performance (ISR) and Company Size while the remaining 25, 0128% is influenced by other variables not examined in this study. The results of the coefficient of determination test are shown in [table 1](#).

Table 1. Coefficient of Determination

R-squared	Adjusted R-squared
0.816979	0.749872

Based on the results of simultaneous testing, the calculated F value is 12.17 while the F table value is 2.68. When compared, the value of F count with the value of F table, then  $F \text{ count} > F \text{ table}$  which is  $12.17 > 2.68$ , with a probability value of  $0.00 < 0.05$ , it can be concluded that accounting conservatism, disclosure of sharia social performance (ISR) and firm size (Firm Size) together have a positive and significant effect on the Earnings Response Coefficient. Based on the calculation of the t table with the criteria of a significant level of 0.05 and degrees of freedom ( $dk = n - k = 124 - 3 = 121$ ) obtained t table of 1.65754. Based on the t-test value obtained, partially the effect of each variable is explained in [table 2](#).

Table 2. Hypotheses Results

Variabel	Coefficient	Std. Error	t-Statistic	Prob.	Result
C	-5.499311	0.580306	-9.476575	0.0000	
AC	0.421824	0.060339	6.990902	0.0000	Supported
ISR	0.870392	0.097197	8.954897	0.0000	Supported
FIRM SIZE	1.001522	0.137086	7.305781	0.0000	Supported

The accounting conservatism variable has a t-count value of 6.990902 and a t-table value with a significance level of 0.05 of 1.65754. When compared with  $t \text{ count} > t \text{ table}$ ,  $6.990902 > 1.65754$  with a significance level of  $0.0000 < 0.05$ , it means that  $H_0$  is rejected and  $H_1$  is accepted. Thus, accounting conservatism has a significant positive effect on the earnings response coefficient. The ISR disclosure variable has a t-count value of 8.954897 and a t-table value with a significance level of 0.05 of 1.65754. When compared with  $t \text{ count} > t \text{ table}$ , which is  $8.954897 > 1.65754$  with a significance level of  $0.0000 < 0.05$ , it means that  $H_0$  is rejected and  $H_2$  is accepted, thus the disclosure of sharia social performance (ISR) has a positive and significant effect on the earnings response coefficient.

## Discussion

### *Accounting Conservatism and Earnings Response Coefficient (ERC)*

Based on the results of hypothesis testing with a partial test (t test) shows that the level of accounting conservatism has a positive and significant effect on earnings response (ERC), so that when the level of accounting conservatism increases it will be followed by an increase in earnings response (ERC), on the contrary when the level of conservatism accounting decline will be followed by a decrease in earnings response (ERC). The positive and significant results of testing hypothesis 1 mean that the research results can be generalized to all populations of property and real estate sub-sector companies. Based on agency theory, the way to overcome agency conflict caused by differences in interests between agent and principal is to apply accounting conservatism.

When the company presents financial statements by generating profits that increase every year and using the principle of conservatism, the company will get a good response from investors to the company's profits and vice versa if the company in presenting financial statements does not use the principle of conservatism, the company will get an unfavorable response. from investors to company profits. This research is in line with the results of research conducted by [Marlina \(2018\)](#), [Ayu \(2015\)](#), [Wulandari \(2015\)](#) which state that conservatism has a positive and significant effect on the earnings response coefficient (ERC).

### *Islamic Social Reporting and Earnings Response Coefficient (ERC)*

The results of hypothesis testing using a partial test (t-test) indicate a positive and statistically significant relationship between the Islamic Social Reporting (ISR) and the earnings response coefficient (ERC). When the disclosure of sharia social performance increases, it leads to an increase in the value of the earnings response (ERC). Conversely, a decrease in the disclosure of sharia social performance is followed by a decrease in the value of the earnings response (ERC). The significant and positive findings of hypothesis 2 suggest that the results of this study can be generalized to all companies in the population of the property and real estate sub-sector.

The magnitude of the disclosure of sharia social performance (ISR) implies that the company engages in ISR activities and discloses them in the financial statements in accordance with the prescribed guidelines. In this study, the authors employed a checklist of 48 ISR disclosure items found in the annual reports of property and real estate sub-sector companies listed on the Indonesia Stock Exchange. The disclosure of ISR demonstrates the company's recognition of its responsibilities towards the environment and the social context in which it operates. The findings align with signal theory, which posits that when a company provides information on sharia-based social activities or discloses Islamic social reporting in the annual report, it sends positive signals to investors and financial statement users, aiding their decision-making processes. Conversely, the absence of social reporting produces a negative signal and can adversely impact the company by reducing the level of market response to its profits. This research is consistent with a study by [Angela and Iskak \(2020\)](#), which establishes a positive effect of Islamic social reporting on the earnings response or earnings response coefficient (ERC).

### *Firm Size and Earnings Response Coefficient (ERC)*

The findings of the hypothesis testing reveal a positive and statistically significant relationship between company size and the earnings response coefficient (ERC). This implies that as the size of a

company increases, there is a greater investor response to the company's profits. Conversely, when the company size decreases, the investor response to profits diminishes. In this study, company size is measured using the logarithm of total assets, as a larger company size often facilitates access to funding sources. This, in turn, provides a positive signal to investors about the company's growth prospects, leading to increased demand for shares, higher stock prices, and enhanced investor response to company profits. These results align with previous research conducted by Mulyani et al. (2017), which also demonstrates the positive and significant impact of company size on the earnings response coefficient. Furthermore, the research conducted by Kusumawardhani and Nugroho (2010) also confirms the influence of firm size on the earnings response coefficient.

## CONCLUSION

Based on the results of hypothesis testing and analysis of research and discussion results, the results of this study indicate that the accounting conservatism variable has a positive and significant effect on the earnings response coefficient. This explains that, if the company presents conservative earnings in the financial statements, the higher the value of the company's ERC will be. This explains that investors will respond well to the profits presented in the company's financial statements. The Islamic Social Reporting (ISR) has a positive and significant effect on the earnings response coefficient. This shows that the more companies that report their social activities, the higher the ERC value, which explains that the more investors respond to the earnings reported in the financial statements well. Firm size has a positive and significant effect on the earnings response coefficient. This means that the size of the company assessed from total assets has an influence on investor response to company profits. Thus, the greater the total assets owned by the company, the higher the investor's response to the company's profits presented in the published financial statements.

This study has several shortcomings and limitations. The main limitation of this research is that this research was conducted only for the period from 2015 to 2018, the reason being that financial data above 2018 is feared to be disrupted due to the COVID-19 pandemic. Future research is expected to increase the research time period and the addition of other independent variables not examined in this study, for example, variables such as capital structure, profitability, leverage and other variables. Further researchers can also conduct further studies related to conducting a deeper analysis of the difference between the earnings response on the principle of accounting conservatism carried out by the company before the pandemic and during the pandemic, both in conventional companies and Islamic companies.

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