CHAPTER I

INTRODUCTION

1.1 Background of The Study

Indonesia is a developing country with significant economic potential, which has not gone unnoticed by members of the international community. As great as Indonesia's potential is, more and more people are interested in investing their money in the hopes of increasing their wealth. The investment itself refers to the purchase of a monetary asset with the idea that this asset will generate more income in the future or later it can be sold at a higher price. Many companies are competing to attract investors to invest in their company because by having investor invest in the company, it allows companies to develop their business and to create more innovation to compete in advancing global trends.

Before purchasing a stock, a good investor will certainly do a thorough analysis of the financial statements first before making their investment decision. Upon publishing the financial statement on the capital market, the stock prices of the company in the stock market will fluctuate depends on how the investor views the company's conditions. If the investor was positive with the earning announcement then the stock price will increase because there will be a lot of investors who want to invest. But if the investor response was negative towards the earning announcement then the stock price will decrease because a lot of investors will sell their shares before their shares decline further.

There are several factors that can contribute to the changes of the investor response towards the earning announcement and earning response coefficient is to measure the relationship between the changes of the investor response towards the changes in a company stock price due to the company earnings announcement. According to Widiatmoko & Indarti (2018), ERC is an estimate of the changes in the company stock price due to the announcement of the company earning information in the market. Earning response coefficient (ERC) measures the sensitivity of the capital market cause by earning announcement through regression slope coefficient between abnormal returns and unexpected earnings. According to Sandi (2013), the earnings response coefficient is a very useful fundamental analysis for calculating the actual stock value by using the company financial data that could be the basis for investor assessment to determine the profit information toward the market reactions in company stock return.

One of the factors that can trigger investor response is leverage. Leverage is to show the use of debt as a financing method to undertake investment or a project. Leverage can be measured through the debt-to-equity ratio. It is a formula that lets us know the likelihood of a company's ability to pay its debt and if the company is capable of taking more debt to grow. According to pecking order theory, management follows a hierarchy when considering sources of financing. First through internal financing which is by using retained earnings (cheapest option), followed by debt and equity as the final resort (external financing). The issuance of debt often indicates an undervalued stock and the management belief that the investment would be profitable. While on the other hand, issuance of equity often sends a negative signal that the stock is overvalued and that management is trying to raise funds by diluting company shares. This is why on a growing company, a higher leverage ratio is more attractive for the investor (at the assumption that the company can fully increase the value of the asset). Because higher leverage means that the company uses more debt to finance its operation than using equity. Because of that investors can earn higher earnings per share. As mentioned before the purpose for an investor to invest is to generate more income, which is why higher leverage is more attractive to the investor. But the higher the leverage ratio, the riskier the investment will be. This is because there is a chance that the company may fail in its operation and cannot pay the debt. Which results in there is a risk of the company to bankrupt.

Earning persistence is earning that can be used as an indicator to show the company's future capability to generate earnings repetitively in the long run (sustainable). Earnings persistence represents the consistency of a company's earnings and demonstrates its ability to retain earnings over time. As a result, higher earning persistence means that the company earnings are increasing continuously. The company's ability to maintain its earnings from year to year is responded by investors as good news when the company reports its earnings. (Fitria, 2013)

Firm size refers to the monetary value of the company's total assets that the company holds. According to Kristanti & Almilia (2019):

> The size of the company is also believed to be able to provide different investor responses. Companies with large size will tend to get more trust from investors and get a better response because they are considered more capable of improving the quality of performance.

Bigger companies can attract more investors to invest because bigger companies can generate higher profits and have a greater reputation that would invite investors in the expectation to receive a higher return.

Previous researchers have conducted many studies on the earnings response coefficient. Based on the previous research results, Assagaf et al. (2019) stated that there is a significant positive effect of leverage toward the earning response coefficient. While Widiatmoko & Indarti (2018) stated that both leverage and firm size have an insignificant effect on earnings response coefficient. While Widiatmoko & Indarti (2018) also stated that Earning persistence has a significant positive effect on the earnings response coefficient. Also, Azizi et al. (2015) stated that leverage has a significant negative effect on earning response coefficient, but firm size has a significant positive effect. And the research from, Kirstanti Almilia (2019) stated that leverage has an insignificant effect, earning persistence has a significant negative effect and firm size has a significant positive effect. The research from Ambarwati & Sudarmaji (2019) stated that leverage has a significant positive effect on earnings response coefficient, while on the contrary earning persistence has a significant negative effect.

The table below shows the condition of several LQ45 index companies.

Table 1. 1 Phenomena Table

Company	Year	Leverage	Firm Size	Earning Persistence	Earning Response Coefficient
Adhi Karya (Persero) Tbk	2017	3.827	30.975	1.587	-0.095635
	2018	3.792	31.036	1.139	0.239008
	2019	4.343	31.229	1.034	-2.140799
Japfa Comfeed Indonesia Tbk	2017	1.153	30.680	0.506	0.077061
	2018	1.255	30.768	1.829	0.044776
	2019	1.200	30.857	0.785	1.481135
PP London Sumatera Indonesia Tbk	2017	0.200	29.908	0.692	0.227127
	2018	0.205	29.937	0.558	0.085159

	2019	0.203	29.956	0.548	1.489343

Source: Prepared by the Writer (2021)

As it been mentioned before, usually higher leverage is more attractive for the investor which results in higher ERC. While for the firm size the larger the firm size, it is more attractive and a higher rate of earning persistence also more attractive for the investor which results in higher ERC. But if we do the analysis based on the data in Table 1.1, it can be seen that the pattern of the relationship shows no consistency. If we see from the leverage on the above table, PT Adhi Karya (Persero) Tbk has the highest leverage out of the three firms, but the earning response coefficient is the lowest out of the three companies. While for the Firm Size, out of three company the firm size of PT Adhi Karya (Persero) Tbk is also the highest but the earning response coefficient rate is the lowest, while Japfa Comfeed Indonesia Tbk has a bigger firm size than PP London Sumatera Indonesia Tbk, but the earning response coefficient is lower. And if we analyze from the earning persistence it is also the same, out of three company the earning persistence of PT Adhi Karya (Persero) Tbk is the highest and Japfa Comfeed Indonesia Tbk has a higher earning persistence than PP London Sumatera Indonesia Tbk, but the earning response coefficient is lower.

Based on the phenomenon and contradiction results from theory and the test results, the writer is interested to conduct research based on three variables above as the independent variables to prove whether the theory is correct while adding profitability as the moderating variables to see whether this variable can help to moderate the effect of the independent towards the dependent variable. Because as we know profitability is part of earning information that shows whether the company gains profit or not, so the writer wanted to see whether profitability can help to amplify the effect of the variable leverage, firm size and earning persistence towards earning response coefficient. So the title of this research is ”**THE EFFECT OF LEVERAGE, FIRM SIZE AND EARNING PERSISTENCE ON EARNING RESPONSE COEFFICIENT WITH PROFITABILITY AS MODERATING VARIABLE ON LQ45 COMPANIES LISTED IN INDONESIA STOCK EXCHANGE**”.

1.2 Problem Limitation

This research will only focus on companies listed in the LQ45 index on Indonesia Stock Exchange. The reason is that companies listed in LQ45 are the most liquid companies that were listed on the Indonesia Stock Exchange and were really good in terms of their financial performance. The dependent variable in this research is earning response coefficient. And the independent variable will only be limited to leverage, earning persistence and firm size with profitability as their moderating variable. The period will only be limited to three years from 2017 – 2019.

1.3 Problem Formulation

Referring to the background of problems stated above, the following problems can be identified:

1. Is there any significant impact of Leverage on Earning Response Coefficient on LQ45 companies listed in the Indonesia Stock Exchange?

2. Is there any significant impact of Firm Size on Earning Response Coefficient on LQ45 companies listed in the Indonesia Stock Exchange?
3. Is there any significant impact of Earning Persistence on Earning Response Coefficient on LQ45 companies listed in the Indonesia Stock Exchange?
4. Is there any significant impact of Leverage, Firm Size and Earning Persistence on Earning Response Coefficient simultaneously on LQ45 companies listed in Indonesia Stock Exchange?
5. Is there any significant impact of Leverage, Firm Size and Earning persistence on Earning Response Coefficient on LQ45 with profitability as moderating variable on companies listed in Indonesia Stock Exchange?

1.4 Objective of The Research

As is described in the problem formulation that has been mentioned above, this research is conducted with the aim of the following list:

1. To identify whether there is any significant impact of Leverage on Earning Response Coefficient on LQ45 companies listed in Indonesia Stock Exchange.
2. To identify whether there is any significant impact of Firm Size on Earning Response Coefficient on LQ45 companies listed in Indonesia Stock Exchange.
3. To identify whether there is any significant impact of Earning Persistence on Earning Response Coefficient on LQ45 companies listed in Indonesia Stock Exchange.

4. To identify whether there is any significant impact of Leverage, Firm Size, Earning Persistence simultaneously on Earning Response Coefficient on LQ45 companies listed in Indonesia Stock Exchange.
5. To analyze whether there is any significant impact of Leverage, Firm Size and Earning Persistence on Earning Response Coefficient with profitability as moderating variables on LQ45 companies listed in Indonesia Stock Exchange.

1.5 Benefit of The Research

This research is conducted in hope that it would be beneficial for several parties such as the management of the companies, investors, the writer and future academicians in different aspects.

1.5.1 Theoretical Benefit

1. For the writer, this research is expected to be able to help the future writer in understanding the concepts of Earning Response Coefficient and what effect of Leverage, Earning Persistence and Firm Size have to do with it.
2. For future academicians, this research is expected to be guidance for academicians in their future research, to complement existing research and to expand academic knowledge.

1.5.2 Practical Benefit

1. For the management of the company, this research is expected to be an insight for the management for their decision making in which that can improve their earnings announcement.

2. For the investor, this research is expected to be information or guidance in determining what investment information they should use by seeing another investor's usual response towards the market.