

The Effect of Growth Company Growing Opportunities Capital Structure and Company Size to the Quality of Financial Statements with Earnings Management as Moderating Variables

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Abstract

This study examines the effect of growth company, growing opportunities, capital structure and company size to the quality of financial statements from the perspective of investment decision by analyzing the earnings informativeness namely by looking at the ability of earnings information in influencing the market value of the company with earnings management as moderating variables. The study uses secondary data time series with observations of manufacturing company financial statements in IDX from 2009 to 2011 so that the results obtained are both the independent variable and the moderating variable not having a significant effect on the dependent variable. This shows the limitations of the earnings information in influencing investment decisions.

Keywords: growth company, growing opportunities, capital structure, company size and earning response coefficient

1. Introduction

The financial statements are the primary means for companies to communicate financial circumstances to the outsiders of the company. The financial statements are also one of the important accounting information for making economic decisions of investors. The issues contained in the financial management aspects of the company by the management is the issue of accountability to stakeholders. A financial statement can be said as qualified if the presented financial statements can achieve the expected goals, namely to provide information to the users of financial statements. Schipper and Vincent (2003) stated that the quality of financial statements in general was important for those who use financial statements for the purpose of the contract and investment decisions.

However, the parties concerned with a company may have information that is not the same. One party can have more information about the company compared to the other party. The incidence is called the asymmetric information.

According to Scott (2000), there are two kinds of asymmetric information, namely:

1. Moral Hazard, that the activities carried out by a manager is not entirely known by shareholders and lenders, so that the manager can perform actions outside the knowledge of shareholders which violates the contract and in actual by ethics or norms may not be worth doing.
2. Adverse selection, that managers and other people inside the company usually know more about the state and prospects of the company compared to the outsiders investor. And the fact which may influence the decision to be taken by the shareholders of the information is not submitted to the shareholders.

Copeland and Galai (in Krinsky and Lee, 1996) found that when the quality of accounting information increased, then the asymmetric information will decrease. Asymmetric information indicates an imbalance of information obtained by investors and manager of the company. The condition of imbalance information or asymmetric information directed to the relationship between principal and agent.

There are many cases about manipulation of financial statements made by the management. The classic example of financial fiasco that happened in the United States was the case of Enron which revealed in December 2001. In the case of Enron was known to occur manipulation of financial statements with a record profit of US\$600 million, when the company suffered a loss. The manipulation of profits due to the company's desire that the stock remains attractive to investors.

The occurrence of financial scandal is a phenomenon that shows the failure of financial statements to meet the information needs of the users of the report. Schipper and Vincent (2003) stated that the financial statements that did not present the true facts about the economic condition of the company resulted information which expected to be useful in the decision-making became questionable quality.

Earnings is one part of the financial statements that gets a lot of attention. Earnings information as accurate financial information can improve the quality of financial statements itself and increase the trust of investors and creditors in particular and other stakeholders in general. Early studies on the relationship between accounting earnings and stock prices performed by Ball and Brown (1968). The results of their research showed

a statically significant positive relationship between accounting earnings and the market reaction / stock price. This means that fluctuations of the accounting earnings will affect the fluctuations of stock prices in the same direction. The good news about the issuer will generate a positive market reaction, and conversely the bad news will generate a negative market reaction. Positive market reaction can be seen from the abnormal return value which is greater than what the company has expected, so that the stock price of the issuer company will be higher compared with the previous period. And vice versa, if the market reacted negatively because of the 'bad news' about the issuer, it can be seen from the abnormal return value which is smaller than expected, so that the company's stock price is lower than the previous period.

The quantity that indicates the relationship between earnings and stock returns is called the Earnings Response Coefficient (ERC). ERC shows the magnitude of the slope coefficient in a regression that links the profit as one of the independent variables and stock returns as the dependent variable. Miller and Rock (1985) in Kim et al. (2000) examined the direction of the expected non-profit relationships and stock returns, while Kormendi and Lipe (1987) showed the magnitude of this relationship was positively related to the expected future earnings revisions and which obtained from univariate time series models.

According to Beaver (1980) and Kormendi and Lipe (1987), the ERC between the companies is relatively fixed. This was proven by Kormendi and Lipe (1987) by examining the effect of unexpected earnings on stock prices. The results of these tests show that the stock price reaction to the accounting earnings does not fluctuate excessively.

However, Easton and Zmijewski (1989), Collins and Kothari (1989) stated that the market response to the accounting earnings of each company may vary, both between companies and between time. It indicates that the earnings response coefficients are not constant. The difference in earnings response coefficient is influenced by the characteristics or the value of the company.

Company profit growth indicates a company's ability in generating revenue that will affect the company in determining the dividend to shareholders. Furthermore, the company's policy that could affect shareholder well-being will eventually affect the performance of the company's stock. The performance of company's stock which is reflected in the fluctuation of stock prices and trading volume of the stock will eventually determine the return of the company. The improved of company revenue usually indicates the opportunity of the company to be able to grow and thrive (Chen, *et. al*, 2005).

The opportunity for the company to grow and earnings response coefficient has been proposed by Collins and Kothari (1989) have a positive relationship. The growing company will have higher earnings response coefficient, because the company has opportunity to obtain higher earnings in the future. The containing of earnings information is a good news so it can increase the market responds. Collins and Kothari (1989) measures the opportunity for the company to grow using the ratio of market value to book value of equity. The results of these studies indicate that the opportunity for the company to grow has positive correlation with earnings response coefficients.

The changes in capital structure will affect the level of risk and the cost of each type of capital which can affect the capital budgeting decisions and the company's stock price. Weston and Copeland (1992) provides a definition of capital structure as permanent financing which consists of long-term debt, preferred stock and stockholders' equity. Capital structure factor is often proxied with leverage. Dhaliwal et al. (1991) showed that the earnings response coefficient is negatively related to the level of leverage. The company with high leverage level means having a greater debt than capital. Thus, if there is an increase in the earnings, then the one which benefited is debtholders.

The size of the company is also one of the factors that can affect the quality of the financial statements. The size of the company can generate different performance in the same conditions of economic stress. In general, large enterprises are more intensive in shaping of capital and more vertically integrated, while small companies are otherwise. The criteria for determining the size of the company (large or small) can be in total assets, sales, number of workers, and so on.

Earnings is one of the most important things in the financial statements. Because of the importance of earnings, it is not surprising that the managers are very interested in how earnings are reported. There are many incidence where managers try to change and interpret falsely regarding financial performance or earnings right and assets of the company with the aim to present a picture of the company's earnings more profitable. By this, the practice of earnings management occurs.

Growth factors, growing opportunities, capital structure and company size is closely related to earnings-forming element. This study also focuses on the usefulness of financial statements information in decision-making in line with the research Schipper and Vincent (2003) for two reasons. First, in FASB, Conceptual Framework states that the purpose of financial statements to provide information that is useful for business decisions and assume that the utility of decision-making is the main criteria for determining the accounting option.

Based on observations of the researcher to the phenomenon that occurs, the researchers intend to

examine the effect of growth company, growing opportunities, capital structure and company size on the quality of the financial statements from the perspective of investment decision by analyzing the earnings informativeness by looking at the ability of earnings information in influencing the market value of the company with earnings management as moderating variables.

2. Research Hypothesis

According to Collins and Kothari (1989), the growth can be measured by looking at a company that continues to grow, which easily attract capital, and constitute a source of growth, earnings information of these companies will be responded positively by investors

H1 : Revenue growth has positive influence on earnings response coefficients.

The growth of the company indicates that the company has favorable prospects in the future. Companies that have future prospects should be attractive to investors and affect the market value of the company.

H2 : The market value has positive influence on earnings response coefficients.

Dhaliwal et al. (1991) showed that the earnings response coefficient is negatively related to the level of leverage. So it can be said that companies with high leverage level have earnings response coefficients which are lower compared to those of companies who has low leverage.

H3 : Leverage has negative influence on earnings response coefficients.

Economic conditions may affect the company's financial performance similarly, but small company's financial performance may differ from large companies. The size of the company can be measured by using the total assets to control the impact of the size to the amount of the performance which created company's economic of scale, monopoly power, and the power supply (Belkaoui, 2003).

H4 : The size of the company has influence on earnings response coefficients.

Bartov, Givoly and Hayn (2002) and Skinner and Sloan (2002) find that the company with earnings management which indicated the presence of earnings reports which is bigger than expected will experience a significant increase in stock price and vice versa, companies that fail to meet the expectations of earnings reports will experience a significant decrease in stock prices

H5 : There is influence in growth, market value, leverage, and company size on earnings response coefficient to be moderated by earnings management.

3. Object And Research Methodology

3.1 Analysis Unit Description

The study population includes all companies listed on the Indonesia Stock Exchange. The sample selection is determined by purposive sampling. In this technique the sample taken is a sample that has certain criterias. Sampled companies are companies that meet the following criteria: (1) Manufacturing companies that publish the audited financial statements every December 31, in 2009 period to December 2011, (2) The issuers whose stock are usually active in trading on the Indonesia Stock Exchange during the period of observation, because the issuers whose stock are not actively traded will interfere the process of analysis, so it is excluded. The selection of the manufacturing sector as a sample refers to the study of Chen, et. al (2005) and for the purpose of homogeneity of the sample so biased results can be avoided.

Based on the data obtained from www.idx.co.id there are 131 active companies listed on the Stock Exchange during the period observed, namely in 10 days around the date of the financial statements for 2009-2011. However, between these companies there are some companies that do not meet the criteria and do not have complete data, so that based on purposive random sampling were obtained a sample of 82 companies manufacturing as the number of observations of the study.

3.2 Variable Operational Definition of Research and Measurement

3.2.1 Earnings Response Coefficient (ERC)

The ERC magnitude is obtained by performing some calculation stage. The first stage calculates cumulative abnormal return (CAR) of each sample and the second stage calculates the unexpected earnings (UE) samples.

1). Cumulative Abnormal Return (CAR). Cumulative abnormal Return (CAR) is a proxy of the stock price or market reaction.

$$Ab(R) = Rit - RI$$

In which :

- Ab(R) : Abnormal return securities to-i in period event to t
- Rit : Stock return to-i in period event to t
- Ri : Expectation of return securities to-i in period event to t

Actual return is the revenue that have been received by investors in the form of capital gains obtained from the calculation:

$$Rit = P_t - P_{t-1} / P_{t-1}$$

In which :

- Rit : Actual return company stock i on day t
- Pt : Stock price on day t
- Pt-1 : Stock price on day t-1

Return expectations models used to estimate the abnormal return is mean-adjusted return (Brown and Warner, 1985) which are defined:

$$R_i = \frac{\sum_{J=t1}^{T2} E(R_{it})}{T}$$

In which:

- Ri = Return expectations of securities to-i in period event to-t
- E(Rit) = Return realization of securities to-i in period event to-t
- T = The length of the estimation period, which is from t1 to t2

The estimation period used in this study was 100 days. The reason to use this observation period is to minimize the possibility of confounding effects that probably affect the behavior of the data.

CAR calculation formula is:

$$CAR_{it} = \sum AR_{it}$$

-ARit = abnormal return to stock i on day t

2). Unexpected Earnings (UE) measured as follows:

$$UE_{it} = \frac{(E_{it} - E_{it-1})}{E_{it-1}}$$

In which:

- UEit = unexpected earnings company i on period (year) t
- Eit = Accounting profit companies i on period (year) t
- Eit-1 = Accounting profit companies i on period (year) before (t-1)

3.2.2 Growth in Revenue

Growth in revenue (GR) measures changes in the company's revenue. The improved of company's revenue usually indicates the opportunity for the company to grow and thrive (Chen, et. Al, 2005). The formula used in this study refers to the formula used by previous studies (Chen, et. Al, 2005), namely:

$$GR = \left\{ \left(\frac{\text{Sales revenue in year } t}{\text{Sales revenue in year } t-1} \right) - 1 \right\} \times 100\%$$

3.2.3 Market Value

The market value is the variable which describes the company's growth prospects in the future. This variable is proxied and measured from the market-to-book value ratio (Collins and Kothari, 1989) of each company at the end of the financial period.

$$\text{Market to book ratio} = \frac{\text{Market Value of Equity}}{\text{Book Value of Equity}}$$

Book value of equity obtained from the balance sheet of the year, while the market value of equity is calculated by multiplying the stock price (closing price) on the first day of trading with total stocks circulated at the end of the year (unless there is a change in the number of stocks circulated during the first day of trading).

3.2.4 Capital Structure

This variable in accordance with the research of Dhaliwal et al, 1991 stating that the company's default risk is measured with the leverage. Leverage is the ratio of total debt to total assets of the company.

$$\text{Lev it} = \frac{TU_{it}}{TA_{it}}$$

In which :

- TU = Total debt of the company i in year t
- TA = Total assets of the company i in year t

3.2.5 Company Size

Company size (UP) variables measured by the natural log of total assets (Collins and Kothari, 1989).

$$\text{Size} = \text{LNTotal Assets}$$

3.2.6 Earnings Management

Earnings management is a condition in which the management do the intervention in the process of preparation of financial statements for external parties, thus leveling, raising and lowering the earnings statements. The measurements of earnings management use Discretionary Accrual Earnings Management (DAC). In this study the

use of discretionary accruals as a proxy for earnings management is calculated using the Modified Jones Model (Dechow et al., 1995). To measure the DAC, at first the total accruals will be measured. Total accruals are classified into discretionary and nondiscretionary component of the stages:

a. Measuring the total accrual using the modified Jones model.

Total Accrual (TAC) = net income after taxes – cash flow from operating.

b. Measuring the accruals value nilai accruals which estimated by the regression equation OLS (Ordinary Least Square):

$$TAC_t / A_{t-1} = \alpha_1(1 / A_{t-1}) + \alpha_2((\Delta REV_t - \Delta REC_t) / A_{t-1}) + \alpha_3(PPE_t / A_{t-1}) + e$$

In which:

TAC_t : total accruals of the company i in period t

A_{t-1} : total assets for company's sample i at the end of the year t-1

REV_t : changes in company earnings i from year t-1 to year t

REC_t : changes in the company accounts i from year t-1 to year t

PPE_t : fixed assets (gross property plant and equipment) company year t

c. Measuring the nondiscretionary accruals model (NDA) as follows:

$$NDA_t = \alpha_1(1 / A_{t-1}) + \alpha_2((\Delta REV_t - \Delta REC_t) / A_{t-1}) + \alpha_3(PPE_t / A_{t-1})$$

In which:

NDA_t : nondiscretionary accruals in year t

α : fitted coefficient obtained from the regression results in the calculation of total accruals

d. Measuring discretionary accruals as follows:

$$DAC_t : (TAC_t / A_{t-1}) - NDA_t$$

In which:

DAC_t : discretionary accruals company i in period t

4. Hypothesis Testing

The hypothesis testing is done by regression analysis. The multiple regression analysis in this study is intended to look how is the effect in growth, market value, leverage, and company size on earnings response coefficient. Earnings response coefficients variable is a regression results between earnings on stock prices and the coefficient which is its coefficient. In addition, because this study used moderating variables such as earnings management, then the earnings management variables also interacted with independent variables which has already been interacted with earnings variable. For the purposes of testing the hypothesis then the adopted regression equation is an equation adopted in accordance with Dhaliwal et al, 1991 (Kim, Willet and Jang, 2002). The regression equations for hypothesis testing are as follows:

$$CAR_{it} = \beta_0 + \beta_1 UE_{it} + \beta_2 Grit + \beta_3 MtBV_{it} + \beta_4 LEV_{it} + \beta_5 LNNTA_{it} + \beta_6 UEGrit + \beta_7 UEMtBV_{it} + \beta_8 UELEV_{it} + \beta_9 UELNTA_{it} + \beta_{10} DAC_{it} + \beta_{11} DACUEGrit + \beta_{12} DACUEMtBV_{it} + \beta_{13} DACUELEV_{it} + \beta_{14} DACUELNTA_{it} + \epsilon_{it}$$

In which :

- CAR_{it} = Cumulative Abnormal Return of the company i *return abnormal* kumulatif perusahaan i during the window period
- UE_{it} = Unexpected Earnings
- Grit = Growth of the company i in period t
- MtBV_{it} = Growth of the company i in period t
- LEV_{it} = Capital structure of the company i in period t
- LNNTA_{it} = The size of the company i in period t
- UEGrit, UEMtBV_{it}, UELEV_{it} dan UELNTA_{it} = Interactions Variavles between unexpected earnings to growth variables, growing opportunities, capital structure and company size
- DACUEGrit, DACUEMtBV_{it}, DACUELEV_{it}, DACUELNTA_{it} = Interactions Variavles between unexpected earnings to growth variables, growing opportunities, capital structure and company size which interacted with moderating variables of earnings management

4.1 Test coefficient of determination (R²)

The coefficient of determination was used to test the goodness of-fit of the regression model, which is how much influence of the independent variables on the dependent variable. Based on Table 1 it can be seen that the value of Adjusted R² is equal to 0.117 which means that 11.7% variation in the dependent variable can be explained by the variation of the independent variable. Therefore, it can be concluded that 11.7% earnings response coefficients which proxied by earnings regression coefficient on stock prices influenced by variables of growth, growing opportunities, capital structure, the size of the company with moderating variables of earnings management. While for 88.3% influenced by other variables in addition to the variables used in this research model.

Table 1. Test coefficient of determination (R^2) Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.342 ^a	.117	-.100	.0001498

a. Predictors: (Constant), DACUELNTA, LEV, LNTA, GR, UE, UEMtBV, DAC, DACUEGR, UEGR, MtBV, DACUEMtBV, UELEV, DACUELEV, UELNTA
 source : processed data

4.2 T-test

Table 2. T-test Result Coefficients^a

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	.000	.000		.592	.556
	UE	-8.086E-5	.000	-.441	-.238	.813
	GR	.000	.000	-.156	-1.034	.305
	MtBV	2.742E-6	.000	.107	.366	.716
	LEV	-6.974E-5	.000	-.086	-.517	.607
	LNTA	-1.617E-6	.000	-.021	-.109	.914
	UEGR	.000	.000	.306	1.319	.192
	UEMtBV	-4.000E-5	.000	-.454	-1.031	.307
	UELEV	.000	.000	.611	.883	.381
	UELNTA	-5.040E-6	.000	-.401	-.191	.849
	DAC	9.053E-5	.000	.054	.258	.798
	DACUEGR	-.001	.002	-.048	-.211	.834
	DACUEMtBV	.000	.000	-.347	-1.049	.299
	DACUELEV	.000	.003	.082	.105	.917
	DACUELNTA	-2.424E-5	.000	-.148	-.173	.863

a. Dependent Variable: CAR
 source : processed data

T-test aims to determine whether the independent variables in the regression model respectively (partial) have a significant effect on the dependent variable. Uji t bertujuan untuk mengetahui apakah dalam model regresi variabel independen masing-masing (partial) berpengaruh signifikan terhadap variabel dependen. If t-count > t-table then H_0 is rejected, H_a accepted. T-table value with $df = 63$, at $\alpha = 5\%$ is equal to 1.669.

$$CAR_{it} = .000 - 8.086E-5UE_{it} + .000GR_{it} + 2.742E-6 MtBV_{it} - 6.974E-5LEV_{it} - 1.617E-6LNTA_{it} + .000UEGR_{it} - 4.000E-5UEMtBV_{it} + 0.000UELEV_{it} - 5.040E-6UELNTA_{it} + 9.053E-5DAC_{it} - 0.001DACUEGR_{it} + 0.000DACUEMtBV_{it} + 0.000DACUELEV_{it} - 2.424E-5DACUELNTA_{it} + \epsilon_{it}$$

Regression coefficients in a regression equation indicates the direction of change of independent variables on the dependent variable. The positive sign indicates a change in the same direction or proportional between the independent variables on the dependent variable. The negative sign indicates the direction of the opposite or inverse between the independent variables on the dependent variable.

From the table above it is also found that all the independent variables have t-count < t-table with a significance greater than 0.05, then H_a rejected. It means partially either variable growth, growing opportunities, capital structure and company size had no significant effect on earnings response coefficients.

5. Discussion

5.1 Company growth with Earnings Response Coefficient

Based on the results of tests performed between the variables of the company's growth and earnings response coefficients, variable growth companies with t-count of -1319, and a coefficient of -0.000 has no significant effect on earnings response coefficient. By moderating variable of earnings management produces t -0.211 and -0.001 coefficient which also does not provide significant results. Although information regarding the positive revenue growth will be pleasant for stakeholders but in this study it does not provide a significant influence on the market reaction so there is no significant effect of revenue growth on earnings response coefficients. However, this is not consistent with the study by Collins and Kothari (1989) which stated that the growth and earnings response coefficient has had a positive correlation, although it is not described further about its significance.

5.2 Growing Opportunities with Earnings Response Coefficient

Based on the results of tests performed between variables opportunity to grow with the earnings response coefficient, variable growth opportunities with t-count -1.031 and coefficient of $-4.000E-5$ has no significant effect on earnings response coefficients. By moderating variable of earnings management produces t-count -1.049 and 0.000 coefficients which also do not provide significant results. The results of this study are not consistent with prior research that is conducted by Collins and Kothari (1989) which stated that the growing company will have higher earnings response coefficients, because the company has chance to obtain higher earnings in the future. However, the results of the studies by Easton and Zmijewski (1989), and Collins and Kothari (1989) shows that the market response to earnings varies depending on the type of company and timescales.

5.3 Capital Structure with Earnings Response Coefficient

Based on the results of tests performed between variable capital structure with earnings response coefficients, variable capital structure with t-count for 0.883 and coefficient of 0.000 has no significant effect on earnings response coefficients. By moderating variable of earnings management produces t-count 0.105 and 0.000 coefficient which also do not provide significant results. The results of this study are not consistent with prior research done by Dhaliwal et al. (1991) which showed that the earnings response coefficient is negatively related to the level of leverage. Companies with high leverage level means having a greater debt than capital. For a company with a lot of debt, increased profits will strengthen the position and security of lenders rather than shareholders.

5.4 The Size of the Company and with Earnings Response Coefficient

Based on the results of tests performed between variable sized companies with earnings response coefficients, variable sized companies with t-count -0.191 and coefficient of $-5.040E-6$ has no significant influence on the earnings response coefficients. By moderating variables of earnings management produces t-count -0.173 and coefficient $-2.424E-5$ which also does not provide significant results. The results are consistent with studies stating that the size variable is not significant in explaining ERC according to Easton and Zmijewski (1989). But Chaney and Jeter (1991) in their research indicates that company size has a significant positive correlation with earnings response coefficients.

5.5 Earnings Management as Moderating Variables

From the results above, it indicates that the presence of earnings management as a moderating variable by using proxy discretionary accruals has no contribution to the effect of growth, growing opportunities, capital structure, as well as the size of the company. This is not same with the studies which link to earnings management practices with investor expectations of earnings made by Bartov, Givoly and Hayn (2002) and Skinner and Sloan (2002). From both of these studies found that companies with earnings management indicated by the presence of higher earnings report rather than expected will experience a significant increase in stock prices for investors and this reflects the possibility of a good future performance.

6. Conclusion

From the analysis which has been done related to the relationship between growth, growing opportunities, capital structure and company size on earnings response coefficient it can be concluded that :

1. There is no significant effect between the variables of growth, growing opportunity, capital structure and company size on earnings response coefficient in the period of time which observed with 24 samples of companies.
2. The use of moderating variables has no significant results on the effect of variables of growth, growing opportunities, capital structure and company size on earnings response coefficients.
3. The findings in this study are not consistent with previous studies, thus the limitations in this study should be disclosed.

In this study, there are limitations as follows:

1. The sample used is relatively small.
2. The time series data only use the data of observation for 10 days around the date of the financial statements and limitation of research timing only 3 years.
3. Data accounting profit of the company using annual earnings instead of quarterly earnings that are likely to provide a more detailed results.

The study about earnings response coefficient is actually a time series research which requires a long period of time observations to obtain earnings response coefficients. The results of study which mostly rejected the research hypothesis which were developed from the research abroad indicates the different probabilities of capital market conditions in Indonesia which are different from the conditions of the capital markets in other

countries whose results are used as reference in this study. The next study can develop this research by including other factors as the moderating factor.

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