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Revisiting Earnings Response Coefficient: Does Earning Stability Play a Role?

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Abstract---*This study aims to examine the effect of earnings stability on the earnings response coefficient (ERC), with the direction of earnings changes serving as a moderating variable, while firm size and sales growth are included as control variables. Using a quantitative approach, this study employs moderated regression analysis on a sample of publicly listed firms in Indonesia over the period 2021–2023. The sample consists of 441 firm-year observations selected through proportional stratified random sampling. Descriptive statistics indicate a high degree of data variability across the observed firms. The empirical results reveal that earnings stability and the direction of earnings changes do not have a significant direct effect on ERC. Furthermore, the interaction between earnings stability and the direction of earnings changes is also insignificant, suggesting that the direction of earnings movements does not strengthen or weaken investors' responses to earnings stability. These findings indicate that investors in the Indonesian capital market tend to react more strongly to transitory earnings information rather than incorporating long-term earnings quality considerations, which is consistent with the semi-strong form of market efficiency theory. Regarding the control variables, firm size exhibits a positive effect on ERC at the 10 percent significance level, implying that investors place greater trust in earnings information disclosed by larger firms. In contrast, sales growth has a significant negative effect on ERC, suggesting that investors may perceive aggressive sales expansion as a source of higher operational risk and cost inefficiency. Overall, this study provides insights for listed firms to place greater emphasis on the quality of sales growth to maintain investor confidence.*
Keywords---*Earnings Response Coefficient, Earnings Stability, Direction of Earnings Change.*

Introduction

Financial statements play a crucial role as the primary source of information for investors and creditors in evaluating funding decisions and investment opportunities. According to the *Statement of Financial Accounting Concepts* (SFAC) No. 8, the primary objective of financial reporting is to provide useful financial information to investors and creditors in making decisions related to the provision of resources (FASB, 2018). The disclosure of financial information directly affects capital markets, as it influences stock prices and trading volumes (Awawdeh et al., 2020), reflecting investors' expectations of firms' future performance (Paramita et al., 2020a).

Among the components of financial statements, accounting earnings receive significant attention from investors as they summarize firms' operating, investing, and financing activities over a reporting period (Awawdeh et al., 2020; Widiatmoko & Indarti, 2018). Investors are particularly concerned with earnings quality and earnings-related risk fluctuations, as these attributes signal future return prospects and uncertainty (Savor & Wilson, 2016). High-quality earnings are perceived to reflect superior managerial performance and provide a more reliable basis for valuation decisions (Pompili & Tutino, 2019). Consistent with rational decision-making behavior, investors incorporate earnings information to balance expected risk and return when making buy or sell decisions (Scott, 2015).

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Market reactions to earnings announcements are largely driven by deviations between reported earnings and market expectations, commonly referred to as unexpected earnings (Mahendra & Wirama, 2017). Seminal evidence by Ball & Brown (1968) demonstrates that investors respond to unexpected earnings information, where positive (negative) earnings surprises are associated with positive (negative) abnormal returns, a finding further supported by Jung & Cho (1991). However, earnings increases or decreases are not always followed by corresponding stock price movements, as investors may have already anticipated such changes or incorporated other information into prices (Baroroh et al., 2022; Dewi & Putra, 2017; Sugiri & Sumiyana, 2009). These phenomena are consistent with signaling theory, which posits that firms convey information to reduce information asymmetry, and investors respond to these signals by adjusting stock prices, reflected in cumulative abnormal returns (Spence, 1973; Paramita et al., 2020a).

Investor responses to earnings information are commonly captured by the earnings response coefficient (ERC), which measures the sensitivity of stock returns to unexpected earnings (Scott, 2015). A higher ERC indicates stronger investor confidence in reported earnings, while a lower ERC reflects skepticism regarding earnings quality (Awawdeh et al., 2020; Baroroh et al., 2022; Dechow et al., 2010; Mahendra & Wirama, 2017; Suwarno et al., 2017; Widiatmoko & Indarti, 2018). From an accounting-based earnings quality perspective, high-quality earnings are expected to be sustainable over time and to provide credible signals regarding firm performance (Gordon et al., 2011). In this context, ERC serves as a market-based proxy for earnings quality, capturing how investors assess the informativeness of earnings announcements (Dechow et al., 2010; Dewi & Yadnyana, 2019).

Despite extensive ERC research, empirical evidence remains mixed regarding the determinants of investor responses to earnings. Prior studies have examined financial disclosure practices (Maharani, 2016; Sari & Daud, 2016; Sudarma & Ratnadi, 2015; Tritiadi & Yuyetta, 2012), firm characteristics (Delvira & Nelvirita, 2013; Mahendra & Wirama, 2017; Widiatmoko & Indarti, 2018), and corporate governance mechanisms (Paramita et al., 2020b; Sujarwati et al., 2022; Wulandari & Herkulanus, 2015), yielding inconsistent findings. These inconsistencies suggest the presence of additional factors that may condition the relationship between earnings information and market responses.

One earnings attribute that has received limited attention in ERC research is earnings stability. Earnings stability reflects the reliability and persistence of earnings over time, where more stable earnings are assumed to indicate higher earnings quality (Rashidi et al., 2017; Siegal et al., 1996). From a signaling perspective, stable earnings may serve as a positive signal of consistent managerial performance and financial stability, whereas highly volatile earnings may increase investor uncertainty and skepticism (Rowena & Rendra, 2017). Empirical findings on the role of earnings volatility and stability remain inconclusive. While some studies document a negative effect of earnings fluctuations on investor responses (Andiani & Gayatri, 2018; Cho, 2022), others find a positive association between earnings volatility and stock price volatility (Prayogiyanto et al., 2020; Zainudin et al., 2018), or no significant relationship between earnings volatility and earnings quality as proxied by ERC (Marsintauli & Pribadi, 2023; Pane & Rahmadhani, 2021).

The inconsistency in prior findings indicates a research gap regarding the direct effect of earnings stability on ERC and the potential role of moderating variables. One plausible moderator is the direction of earnings changes, as investors may respond differently to positive and negative earnings surprises. Prior evidence suggests asymmetric market reactions, where negative earnings surprises often elicit stronger investor responses than positive surprises (Sugiri & Sumiyana, 2009; Choy & Zhang, 2021; Park et al., 2014), although contrasting results have also been reported (Kasznik & Lev, 1995; Shin, 2019). Studies by Maharani (2016) and Santi & Kurniawati (2019) further show that profits (losses) tend to be followed by positive (negative) market reactions, highlighting the relevance of earnings direction in shaping investor behavior.

Addressing these gaps, this study revisits the earnings response coefficient by examining the effect of earnings stability on ERC, with the direction of earnings changes incorporated as a moderating variable. Using Indonesian publicly listed firms during the 2002–2023 period, this study provides empirical evidence from an emerging market context, where investor behavior may differ from that in developed markets. By focusing on the direct relationship between earnings stability and ERC—an area that remains underexplored—this study contributes to the earnings quality and market-based accounting literature. In addition, the inclusion of firm size and sales growth as control variables enhances the robustness of the analysis and allows for a clearer assessment of the role of earnings stability in shaping investor responses to earnings information (Collins & Kothari, 1989).

Literature Review and Hypothesis Development

From a theoretical perspective, earnings stability reflects the reliability and persistence of current earnings, where lower earnings fluctuations indicate higher earnings quality and a stronger ability to sustain performance over time (Rashidi et al., 2017). Stable earnings signal consistent sales performance and effective risk management, thereby reducing investor uncertainty and information asymmetry in line with signaling theory (Ahmed et al., 2020; Spence, 1973). Conversely, highly volatile earnings may be perceived as risky and unreliable, potentially triggering extreme investor reactions and stock price fluctuations (Cahyawati & Miftah, 2022; Sirait et al., 2021). Rational investors seeking to minimize risk tend to favor firms with relatively stable earnings patterns (Phua et al., 2021). In the context of capital market research, investor responses to earnings information are captured by the earnings response coefficient (ERC), which reflects the degree to which stock prices react to unexpected earnings (Scott, 2015). A higher ERC indicates stronger investor confidence in earnings quality, whereas a lower ERC suggests skepticism toward reported earnings (Baroroh et al., 2022; Mahendra & Wirama, 2017; Dechow et al., 2010).

Empirically, prior studies provide mixed evidence regarding the relationship between earnings stability and investor responses. Andiani & Gayatri (2018) and Cho (2022) document a negative effect of earnings fluctuations on investor responses, suggesting that volatile earnings are perceived as bad news and increase uncertainty regarding future performance. In contrast, Prayogiyanto et al. (2020) and Zainudin et al. (2018) find that earnings volatility is positively associated with stock price volatility, reflecting strong market reactions to earnings information, consistent with the seminal findings of Ball & Brown (1968) and Jung & Cho (1991). Other studies, however, report no significant relationship between earnings volatility and earnings quality as proxied by ERC (Marsintauli & Pribadi, 2023; Pane & Rahmadhani, 2021). These inconsistencies suggest that additional factors may condition the relationship between earnings stability and ERC. One such factor is the direction of earnings changes, as investors may react asymmetrically to positive and negative earnings surprises. While some studies find that profits (losses) are followed by positive (negative) market reactions (Maharani, 2016; Santi & Kurniawati, 2019), others show stronger investor responses to negative earnings surprises (Choy & Zhang, 2021; Park et al., 2014; Sugiri & Sumiyana, 2009), though contrasting evidence also exists (Shin, 2019). Grounded in signaling theory and prior empirical findings, this study proposes that earnings stability influences ERC and that the direction of earnings changes moderates this relationship, leading to the formulation of the following hypotheses:

H1: Earnings stability has a positive effect on ERC

H2: The direction of earnings changes strengthens the positive effect of earnings stability on ERC.

Methods

This study employs a quantitative research design to examine the effect of earnings stability on the earnings response coefficient (ERC), with the direction of earnings changes as a moderating variable. The research focuses on publicly listed firms on the Indonesia Stock Exchange (IDX). While the empirical analysis is conducted for the 2021–2023 period, the measurement of earnings stability and ERC relies on a longer observation window from 2002 to 2023 to capture sufficient earnings variability and provide a robust assessment of earnings stability across different economic conditions, including financial crises, market integration, and post-pandemic recovery.

The population consists of all firms listed on the IDX during 2002–2023. Sample selection is conducted using probability sampling with proportional stratified random sampling across industry sectors. Based on the Slovin formula with a 5 percent margin of error, the final sample comprises 160 firms, resulting in 441 firm-year observations. The study uses secondary data obtained from annual financial statements, daily stock prices, and the composite stock price index, sourced from the Indonesia Stock Exchange, Refinitiv Eikon, and Yahoo Finance.

ERC is measured following a two-step procedure commonly applied in market-based accounting research. First, cumulative abnormal returns (CAR) are calculated using the market model with an event window of [-2, +2] days around the earnings announcement date and a 120-day estimation window (Scott, 2015). Second, unexpected earnings (UE) are measured as the annual change in earnings after tax scaled by prior-year earnings. ERC is then obtained from the regression of CAR on UE. Earnings stability is measured as the standard deviation of earnings before interest and taxes scaled by total assets over the 2002–2023 period and is operationalized as a dummy variable, where firms with below-average earnings variability are classified as having more stable earnings. The direction of earnings changes is measured using a dummy variable indicating positive or negative earnings changes. Firm size (natural logarithm of total assets) and sales growth are included as control variables.

Hypotheses are tested using moderated regression analysis estimated with Stata. The empirical model includes earnings stability, the direction of earnings changes, their interaction term, and control variables. Classical assumption tests are conducted to ensure the validity of the regression model. Statistical significance is evaluated

using t-tests for individual coefficients, the F-test for overall model fit, and the coefficient of determination (R^2) to assess explanatory power.

Result and Discussion

Multiple Regression Analysis with a Moderating Variable

Multicollinearity Test Results

The multicollinearity test examines correlations among independent variables using the variance inflation factor (VIF). A model is considered free from multicollinearity when VIF values are below 10, and correlation values are below 0.8. The results are reported in Table 1.

Table 1
Multicollinearity Test Results

Variable	VIF	Correlation	Result
DumEARNSTAB	1.10	-0.030	No multicollinearity
DumEARNINGS	1.03	-0.005	No multicollinearity
SIZE	1.11	0.075	No multicollinearity
SG	1.04	-0.135	No multicollinearity

Secondary Data, 2026

The multicollinearity results show that all independent variables have VIF values below 10 and correlation values below 0.8. Therefore, the regression model does not suffer from multicollinearity and is suitable for analysis. These results indicate no problematic correlation among the explanatory variables.

Heteroskedasticity Test Results

Heteroskedasticity is tested to determine whether the residual variance differs across observations. This study applies the Breusch–Pagan test. The results are presented in Table 2.

Table 2
Heteroskedasticity Test Results

Chi2(1)	Probability	Result
1.67	0.196	No heteroskedasticity

Secondary Data, 2026

Table 2 shows that the probability value is 0.196, which is greater than 0.05. Thus, the model does not exhibit heteroskedasticity.

Regression Analysis Results

The regression analysis is conducted on 441 observations from 155 sample firms. The regression specification is as follows:

$$ERC = \alpha + \beta 1\text{DumEARNSTAB} + \beta 2\text{DumEARNINGS} + \beta 3\text{DumEARNSTAB} \cdot \text{DumEARNINGS} + \beta 4\text{SIZE} + \beta 5\text{SG} + \varepsilon \ldots\ldots(1)$$

This model includes ERC as the dependent variable, DumEARNSTAB as the independent variable, DumEARNINGS as the moderating variable, and SIZE and SG as control variables. The moderated regression results (estimated using STATA) are shown in Table 3.

Table 3
Moderated Regression Results

Variable	Coef.	Std. Err.	t-Statistic	Prob.
(Constant)	-6.205	1.731	-3.58	0.000
DumEARNSTAB	-0.151	0.328	-0.46	0.646
DumEARNINGS	0.202	0.355	0.57	0.569
DumEARNSTAB.DumEARNINGS	-0.193	0.406	-0.48	0.634
SIZE	1.074	0.649	1.65	0.099
SG	-0.169	0.060	-2.81	0.005

Secondary Data, 2026

Based on Table 3, the estimated regression equation is:

$$ERC = -6{,}205 - 0{,}151\ \text{DumEARNSTAB} + 0{,}202\ \text{DumEARNINGS} - 0{,}193\ \text{DumEARNSTAB} \cdot \text{DumEARNINGS} + 1{,}074\ \text{SIZE} - 0{,}169\ \text{SG} + \varepsilon$$

The results indicate that SIZE has a positive coefficient of 1.074 with a probability value of 0.099, suggesting that at the 10% significance level (90% confidence), firm size is positively associated with ERC; larger firms tend to exhibit a higher market response. In contrast, SG shows a statistically significant negative effect, with a coefficient of -0.169 and a p-value of 0.005, implying that more aggressive sales growth is associated with a lower ERC in this sample. Regarding the main independent variable and the moderator, DumEARNSTAB has a negative coefficient of -0.151 (p = 0.646) and DumEARNINGS has a positive coefficient of 0.202 (p = 0.569). Because both p-values exceed 0.05, neither variable has a significant partial effect on ERC. Furthermore, the interaction term DumEARNSTAB.DumEARNINGS is also insignificant (coefficient = -0.193; p = 0.634), indicating that the direction of earnings changes does not significantly moderate the relationship between earnings stability and ERC.
The constant of -6.205 indicates that when DumEARNSTAB, DumEARNINGS, the interaction term, and the control variables (SIZE and SG) are held constant, the average ERC is -6.205.

Model Fit Test (F-test)
The F-test evaluates whether the independent variables jointly explain variations in the dependent variable. The results are shown in Table 4.

Table 4
F-test Results

F statistic (5, 435)	Probability F
2.41	0.035

Secondary Data, 2026

The F-test results show an F-statistic of 2.41 with a p-value of 0.035, which is below 0.05. This indicates that DumEARNSTAB, DumEARNINGS, the interaction term, and the control variables (SIZE and SG) are jointly significant in explaining ERC.

Coefficient of Determination (R^2)
The coefficient of determination (R^2) measures the explanatory power of the regression model. The results are presented in Table 4.

Table 4
Coefficient of Determination (R^2)

R Squared	Adjusted R Square
0.027	0.015

Secondary Data, 2026

Table 4 reports an R^2 of 0.027, meaning that DumEARNSTAB, DumEARNINGS, the interaction term, and the control variables (SIZE and SG) explain 2.7% of the variation in ERC, while the remaining 97.3% is explained by

other factors not included in the model. Given that ERC as a proxy for investor response is typically volatile and influenced by many external factors beyond accounting numbers, the overall explanatory power is relatively small. However, this paragraph in the original text states the variables are significant partially, which is inconsistent with the reported t-test results in Tables 5.6 and 5.9 (where DumEARNSTAB and the interaction term are not significant). Therefore, the appropriate interpretation consistent with the tables is that the model explains a small proportion of ERC variation and that only SG is statistically significant at the 5% level, while SIZE is marginally significant at the 10% level.

Hypothesis Testing (t-test)

Partial hypothesis testing uses the t-test based on p-values at a 0.05 significance level. The results are reported in Table 5.

Table 5
Hypothesis Testing Results

Variable	t-statistic	p-value	Remarks
DumEARNSTAB	-0.46	0.646	Not significant
DumEARNINGS	0.57	0.569	Not significant
DumEARNSTAB.DumEARNINGS	-0.48	0.634	Not significant
SIZE	1.65	0.099	Not significant
SG	-2.81	0.005	Significant (negative)

Secondary Data, 2026

The t-test results show that DumEARNSTAB has a regression coefficient of -0.151 with a p-value of 0.646 (t = -0.46), indicating that earnings stability does not significantly affect ERC. The interaction term DumEARNSTAB.DumEARNINGS has a coefficient of -0.193 with a p-value of 0.634 (t = -0.48), implying that DumEARNINGS is not supported as a moderating variable that strengthens the effect of DumEARNSTAB on ERC.

Moderation Test

The moderation effect is examined through Moderated Regression Analysis, focusing on the interaction term DumEARNSTAB.DumEARNINGS. The interaction coefficient is -0.193 with a p-value of 0.634, which is well above 0.05. Statistically, this indicates that the direction of earnings changes does not function as a moderating variable in this model. This suggests that the relationship between earnings stability and market response (ERC) remains statistically unchanged regardless of whether firms experience earnings increases or decreases. The absence of moderation provides empirical evidence that investors tend to respond to earnings information primarily based on its reported magnitude rather than considering the interaction between earnings direction and the earnings stability attribute in depth.

Conclusion

This study concludes that earnings stability does not have a significant effect on the ERC. From a signaling perspective, earnings stability appears to have low observability for investors and does not constitute a high-cost signal. As a result, earnings stability alone lacks sufficient credibility to differentiate high-quality firms from low-quality firms in the capital market. The findings suggest that investors respond strongly to earnings information only when it provides clear predictive value regarding future cash flows. In the absence of accompanying performance growth, earnings stability is perceived as less informative and therefore insufficient to trigger a meaningful market response.

Furthermore, the direction of earnings changes is not found to moderate the relationship between earnings stability and ERC. This result indicates that whether earnings increase or decrease does not strengthen or weaken investors' responses to earnings stability. The non-significant role of direction of earnings changes as a moderating variable can be explained by the semi-strong form efficient market hypothesis (Fama, 1970). In such markets, stock prices rapidly adjust to all publicly available information, including annual reports. The absence of a moderating effect implies that interactions among accounting attributes do not necessarily enhance the informational content of

earnings for market participants, particularly when such attributes are not directly observable or economically salient to investors.

Regarding the control variables, firm size exhibits a positive association with ERC at the 10 percent significance level, indicating that larger firms tend to receive stronger market responses due to higher investor confidence in information transparency and reporting credibility. In contrast, sales growth shows a statistically significant negative effect on ERC. This finding suggests that excessively aggressive sales expansion may be perceived as increasing operational risk and cost inefficiency, leading investors to respond more cautiously to earnings information. Overall, the results highlight that market reactions to earnings are shaped more by perceived risk and information credibility than by earnings stability alone.

Managerial Implication

The findings of this study provide several important implications for corporate managers, particularly in the context of financial reporting and strategic performance communication. First, the insignificant effect of earnings stability on the earnings response coefficient (ERC) suggests that maintaining stable earnings alone is insufficient to enhance investor confidence. Managers should therefore avoid relying solely on earnings smoothness as a signaling mechanism and instead focus on improving the transparency and economic substance of reported earnings. Clear communication regarding the drivers of performance and future cash flow prospects is essential to increase the informational value of earnings disclosures.

Second, the absence of a moderating effect of the direction of earnings changes indicates that investors do not place additional weight on earnings stability when firms experience either profit increases or declines. This implies that managerial efforts to frame earnings changes as favorable or unfavorable may have limited impact unless supported by credible evidence of sustainable performance. Managers are encouraged to complement earnings announcements with forward-looking disclosures, such as operational guidance and risk management strategies, to strengthen market confidence.

Third, the positive association between firm size and ERC implies that larger firms benefit from higher levels of investor trust, likely due to stronger governance structures, better disclosure quality, and greater analyst coverage. Smaller firms should therefore enhance their disclosure practices and internal controls to reduce information asymmetry and improve market perception. Finally, the negative effect of sales growth on ERC highlights the importance of managing growth strategies carefully. Aggressive sales expansion may raise concerns about operational efficiency and cost management. Managers should prioritize the quality and sustainability of growth rather than pursuing expansion at the expense of profitability and risk control.

Limitations and Future Research

Despite its contributions, this study has several limitations that should be considered when interpreting the results. First, the explanatory power of the regression model is relatively low, reflecting the inherently volatile nature of ERC and the influence of numerous external factors beyond accounting information. Future studies may improve model performance by incorporating additional market-based and firm-specific variables, such as risk measures, analyst forecasts, corporate governance attributes, or macroeconomic indicators.

Second, earnings stability and the direction of earnings changes are measured using dummy variables, which may limit the ability to capture more nuanced variations in earnings quality. Future research could employ alternative or continuous measures of earnings persistence, volatility, or predictability to provide a more refined assessment of their effects on investor responses.

Third, this study focuses on publicly listed firms in Indonesia, which may limit the generalizability of the findings to other institutional settings. Future research may extend the analysis to cross-country or regional samples to examine whether differences in market development, investor sophistication, and regulatory environments influence the relationship between earnings attributes and ERC.

Finally, this study utilizes cumulative abnormal returns to measure short-term stock performance surrounding annual earnings announcement dates. Future research could enhance this by comparing returns against a December 31st baseline, assuming that large investors and firms have already internalised financial outcomes by the fiscal year-end.

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