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THE EFFECT OF EARNINGS CHARACTER AND ITS COMPONENTS ON THE MARKET VALUE OF CONSUMER NON-CYCLICALS FIRMS LISTED ON THE INDONESIA STOCK EXCHANGE

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Abstract:
This study aims to examine the effect of earnings character (the compositional profile of earnings determined by the relationship between operating cash flow, total accruals and net income) and of net income and operating cash flow as its components on the market value of consumer non-cyclicals firms listed on the Indonesia Stock Exchange. The study uses 933 firm-year observations from 134 firms over 2016-2025 under a census sampling approach. Earnings character is classified into three mutually exclusive categories and operationalised through two dummy variables. The dummy regression model is first estimated by pooled OLS and then re-estimated by weighted least squares (WLS) because the Glejser test indicates heteroskedasticity. Earnings character affects market value. Firms whose earnings rely on accruals while operating cash flow is negative are valued about 40% lower than firms with normal earnings character. Firms whose operating cash flow exceeds net income are also valued lower, which is associated with the large share of loss-making firms in that category. Operating cash flow and net income both have positive effects, with operating cash flow having the strongest effect. This study offers a classification approach to earnings character that can be read directly from financial statements as an alternative to continuous earnings quality measures, and provides evidence from a defensive sector in an emerging capital market.

Keywords: Earnings character; Earnings quality; Operating cash flow; Accruals; Market value; Value relevance

INTRODUCTION

Accounting earnings are the most central figure in financial statements and the one most frequently referenced by investors. Ball and Brown (1968) demonstrate that earnings announcements carry information that is reflected in share prices, and Ohlson (1995) gives a formal framework for expressing the market value of equity in terms of accounting figures. However, earnings are an aggregate figure that disguises the diverse nature of their constituents (Kothari, 2001). The usefulness of earnings for decision making is contingent on the degree to which the number captures the underlying performance and the extent to which it is still subject to estimates (Dechow *et al.*, 2010).

Net income is conceptually made up of accruals and operating cash flow. Richardson *et al.* (2005) report that the cash component is more persistent than the accrual component. Dechow and Dichev (2002) provide evidence of a reduction in earnings quality due to the presence of accrual estimation errors. Dechow *et al.* (2010) consider persistence and accrual quality as important measures of earnings quality. Thus, two companies with similar earnings magnitude can tell different economic stories if the composition of their cash and accruals is different.

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This problem can be found in the consumer non-cyclicals sector of the Indonesia Stock Exchange. Based on the data used in this study, PT Unilever Indonesia Tbk (UNVR), which was considered the most defensive issuer in the sector, saw its closing share price fall from IDR 11,180 at the end of 2017 to IDR 1,885 at the end of 2024, a decrease of approximately 83%, although the company posted positive net income in each of the observed years, including IDR 3.37 trillion in 2024, as well as positive operating cash flow. The divergence between continuously positive earnings and falling market value raises the question of whether the market values earnings only by their size or also by how they are formed.

Empirical evidence is mixed on how components of earnings are valued by the market. Francis et al. (2005) show that poor accruals quality is discounted, while Hayn (1995) and Collins et al. (1999) show that the earnings-price relationship is different for profitable versus loss-making firms. In the Indonesian market, Zacharias et al. (2025) find that the value relevance of earnings increases when earnings are disaggregated into their components. Most of these studies treat earnings components as stand-alone continuous variables, and relatively few explicitly classify firms into earnings composition profiles.

This study examines the effect of earnings character and its components on market value using 933 firm-year observations of consumer non-cyclicals firms over 2016-2025. The WLS estimates show that accrual-based earnings accompanied by negative operating cash flow are valued lower, while operating cash flow and net income have positive effects on market value. The study contributes by offering an earnings character classification that is directly observable from financial statements, testing its value relevance in a sector perceived as the most stable, and showing that the interpretation of earnings character categories must take into account whether firms report profits or losses.

Literature review and hypothesis development

Signalling theory, agency theory and value relevance

Signalling theory explains that better-informed parties send signals to less-informed parties, and that such signals are credible when they are difficult for low-quality parties to imitate (Spence, 1973; Ross, 1977). Earnings that are fully covered by operating cash flow constitute a strong signal because cash is objective and hard to manipulate. Agency theory adds that information asymmetry between shareholders and management creates room for discretion, particularly in the accrual component (Jensen and Meckling, 1976), and managers can use judgement in financial reporting to alter users' perceptions of firm performance (Healy and Wahlen, 1999). For differences in signal quality to be reflected in prices, the market must be at least semi-strong form efficient (Fama, 1970), and the Ohlson (1995) framework provides the basis for regressing share prices on accounting numbers (Barth et al., 2001).

Earnings quality and cash-accrual composition

Earnings quality is an umbrella concept that can be proxied through several properties, including persistence, accrual quality and the price response to earnings (Dechow et al., 2010). The larger the share of accruals relative to cash flow, the greater the room for managerial judgement within earnings (Healy and Wahlen, 1999), so accrual estimation errors can reduce earnings quality (Dechow and Dichev, 2002). The cash component is more persistent than the accrual component, and less reliable accruals are associated with larger market valuation errors (Richardson et al., 2005). Francis et al. (2005) also show that poor accrual quality is priced through a higher cost of capital. Hence, the composition of cash and accruals is an established way of reading earnings quality.

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Earnings character

In this study, earnings character is a proxy for earnings quality based on the cash-accrual composition and expressed in categorical form. Based on the identity NI = CFO + TA, where total accruals are computed as the difference between net income and operating cash flow (Hribar and Collins, 2002), there are three mutually exclusive profiles, as presented in Table 1. The classification is hierarchical: observations with CFO > NI are assigned to Category 1; observations that do not meet this condition but have TA > NI are assigned to Category 2; all remaining observations are assigned to Category 3.

Table 1. Classification of earnings character

Category	Condition	Component implication	Interpretation
Category 1	CFO > NI	Negative TA	Conservative earnings, covered by operating cash flow
Category 2	CFO ≤ NI and TA > NI	Negative CFO	Accrual-based earnings; operations drain cash
Category 3 (reference)	Other than Categories 1 and 2	Non-negative CFO and TA; positive earnings	Normal earnings, proportionally supported by cash and accruals

Source(s): Author's own creation

Separating observations by sign-based conditions is common in accounting research. Basu (1997) shows that earnings behave differently for firms with good and poor performance owing to conditional conservatism and separates the two conditions with a dummy variable, while Hayn (1995) shows that losses carry different information from profits. Because earnings character is a categorical variable, it is operationalised through two dummies with Category 3 as the reference group (Suits, 1957); the reason is explained in Section 3.3.

Hypothesis development

Earnings fully covered by cash satisfy the condition of a signal that is hard to imitate, whereas accrual-based earnings with negative operating cash flow can be generated without real cash flows and open room for managerial discretion (Jensen and Meckling, 1976; Richardson *et al.*, 2005). Firms in Category 1 are therefore predicted to be valued higher, and firms in Category 2 lower, than the reference category.

H1. Earnings character affects firms' market value.

Operating cash flows are more persistent and harder to manipulate than accruals since they record cash receipts and payments that have actually occurred (Dechow and Dichev, 2002; Richardson *et al.*, 2005). Francis *et al.* (2005) also find that the market discounts earnings that have poor accrual quality.

H2. Cash flow from operations positively affects firms' market value.

The information content of net income has been consistently demonstrated (Ball and Brown, 1968), and the price response to earnings has been found to increase with their persistence (Kormendi and Lipe, 1987). Earnings are the accounting figure most closely related to share prices, as indicated by value relevance studies (Kothari, 2001; Barth *et al.*, 2001).

H3. Net income positively affects firms' market value.

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METHOD

Data and sample

The population consists of 135 consumer non-cyclicals firms listed in IDX-IC sector D on the Indonesia Stock Exchange for the period 2016-2025. One firm that was listed only in 2026 is excluded from the census sampling, leaving 134 firms. A firm-year observation is included when the firm is listed in that year and its audited financial statements and closing share price are available. This results in an unbalanced panel of 933 observations, of which 711 are profit and 222 are loss (23.8%) observations. Loss observations are retained to reduce selection bias. The net income and operating cash flow of four firms that report their financial statements in US dollars are converted to rupiah using the average annual middle rate of Bank Indonesia. The financial statements and share prices are obtained from the official IDX website and Yahoo Finance.

Variable measurement

Variable definitions are presented in Table 2. Share prices are log-transformed because their distribution is very wide and right-skewed. Net income and operating cash flow are transformed into the natural logarithm of their absolute values because the logarithm is undefined for zero and negative values[1]. This retains the 222 loss observations, since negative earnings carry different information from positive earnings and the market values loss-making firms differently (Hayn, 1995; Collins *et al.*, 1999); excluding them would introduce selection bias. As a consequence, the sign of earnings and cash flows is not reflected in LnNI and LnCFO but is partly captured by the earnings character dummies. Future research may use sign-preserving transformations such as the inverse hyperbolic sine (Bellemare and Wichman, 2020).

Table 2. Variable definitions

Variable	Measurement
Market value (LnMV)	Natural logarithm of the closing share price on the last trading day of the fiscal year
Earnings character (D_1, D_2)	D_1 = 1 if CFO > NI, 0 otherwise; D_2 = 1 if CFO ≤ NI and TA > NI, 0 otherwise; Category 3 as reference
Net income (LnNI)	Natural logarithm of the absolute value of net income (IDR)
Cash flow from operations (LnCFO)	Natural logarithm of the absolute value of operating cash flow (IDR)

Source(s): Author's own creation

3.3 Empirical model

The dummy regression model is estimated as follows:

$$LnMV_{it} = \beta_0 + \beta_1 D_{1it} + \beta_2 D_{2it} + \beta_3 LnNI_{it} + \beta_4 LnCFO_{it} + \varepsilon_{it} \quad (1)$$

Category 3 is not a separate dummy (D_3). $D_1 + D_2 + D_3 = 1$ for all observations, because each observation is assigned to only one of the three categories. Hence, the D_3 column is the same as the constant column minus D_1 and D_2 ($D_3 = 1 - D_1 - D_2$). This perfect multicollinearity due to the inclusion of all three dummies with the constant is termed the dummy variable trap. The coefficients cannot be estimated uniquely, and statistical software automatically drops one dummy (Suits, 1957). However, the model retains Category 3 through the constant β_0 as a benchmark. Replacing the dummy variables with their respective categorical values, equation (1) is broken down into three regression lines with the same slopes but different intercepts:

Category 3 ($D_1 = 0$; $D_2 = 0$): $LnMV = \beta_0 + \beta_3 LnNI + \beta_4 LnCFO$ (2)

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Category 2 ($D_1 = 0$; $D_2 = 1$): $LnMV = (\beta_0 + \beta_2) + \beta_3 LnNI + \beta_4 LnCFO$ (3)

Category 1 ($D_1 = 1$; $D_2 = 0$): $LnMV = (\beta_0 + \beta_1) + \beta_3 LnNI + \beta_4 LnCFO$ (4)

Hence, coefficients β_1 and β_2 measure the difference in market value of Categories 1 and 2 relative to the reference category, interpreted as $(e^{\beta} - 1) \times 100\%$. Because the dependent variable and both continuous variables are in natural logarithms, β_3 and β_4 are interpreted as elasticities. Based on theory, β_1 is predicted to be positive, β_2 negative, and β_3 and β_4 positive.

3.4 Estimation technique

The model is first estimated by pooled OLS and assessed through the Kolmogorov-Smirnov normality test, the Durbin-Watson autocorrelation test, multicollinearity diagnostics (tolerance and VIF) and the Glejser heteroskedasticity test. The Glejser test on the OLS model indicates heteroskedasticity, so the model is re-estimated by weighted least squares (WLS) with weights $W = 1/(\hat{e})^2$, where $\hat{e}$ is the fitted value from the Glejser regression of the absolute OLS residuals (Glejser, 1969). This weighting gives less influence to observations with large residual variance without removing any observation. All reported diagnostic tests, the F-test and the t-tests are based on the WLS model.

RESULTS AND DISCUSSION

Table 3 presents the descriptive statistics. Share prices range from IDR 3 to IDR 83,800 per share, with a mean of IDR 1,947.36 and a standard deviation almost three times the mean, which justifies the log transformation. Net income ranges from a loss of IDR 5.23 trillion to a profit of IDR 15.56 trillion, while operating cash flow ranges from −IDR 4.84 trillion to IDR 20.19 trillion.

Table 3. Descriptive statistics

Variable	N	Min.	Max.	Mean	SD
MV (IDR/share)	933	3	83,800	1,947.36	5,604.39
NI (IDR)	933	−5.234E+12	1.556E+13	6.830E+11	1.956E+12
CFO (IDR)	933	−4.844E+12	2.019E+13	9.704E+11	2.574E+12
LnMV	933	1.099	11.336	6.222	1.628
LnNI	933	16.662	30.375	25.452	2.383
LnCFO	933	17.365	30.636	25.733	2.281

Note(s): E+12 denotes multiplication by 10^{12}

Source(s): IBM SPSS output, author's own creation

The distribution of earnings character is shown in Table 4. Of all observations, 66.7% fall into Category 1, 18.3% into Category 2 and 15.0% into Category 3. All loss observations are in Category 1 (187 observations) and Category 2 (35 observations), whereas Category 3 consists only of profitable firms, consistent with the classification rule.

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Table 4. Distribution of earnings character

Category	N	Percentage	Of which losses
Category 1 (CFO > NI)	622	66.7%	187
Category 2 (CFO ≤ NI and TA > NI)	171	18.3%	35
Category 3 (reference)	140	15.0%	0
Total	933	100.0%	222

Source(s): Author's own creation

The diagnostics of the WLS model are summarised in Table 5. The Kolmogorov-Smirnov Asymp. Sig. for the weighted residuals is 0.200 (> 0.05), indicating normally distributed residuals, which is supported by the bell-shaped histogram (Figure 1) and the P-P plot points following the diagonal (Figure 2). All VIF values are below 10 and tolerance values above 0.10, so multicollinearity is absent. The Durbin-Watson statistic of 0.651 lies below the lower bound, indicating positive autocorrelation. Autocorrelation is not corrected in this study because the data are pooled cross-section and time-series data. The Durbin-Watson test was designed for regressions on a single time series (Durbin and Watson, 1950), whereas in panel data it requires modification because the residuals consist of many firms, each observed over several years (Bhargava *et al.*, 1982; Baltagi, 2021). Autocorrelation in panel data does not bias the regression coefficients but may understate their standard errors (Petersen, 2009; Baltagi, 2021); it is therefore acknowledged as a limitation of this study.

Table 5. Summary of model diagnostics (WLS)

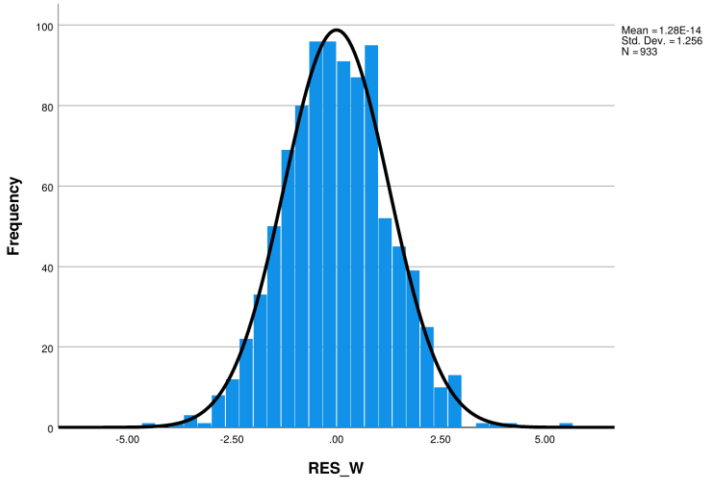
Test	Statistic	Result	Conclusion
Normality (Kolmogorov-Smirnov)	Asymp. Sig.	0.200	Residuals normal
Autocorrelation	Durbin-Watson	0.651	Positive autocorrelation
Multicollinearity: D_1	Tolerance / VIF	0.481 / 2.079	Absent
Multicollinearity: D_2	Tolerance / VIF	0.442 / 2.264	Absent
Multicollinearity: LnNI	Tolerance / VIF	0.353 / 2.830	Absent
Multicollinearity: LnCFO	Tolerance / VIF	0.382 / 2.615	Absent

Source(s): IBM SPSS output, author's own creation

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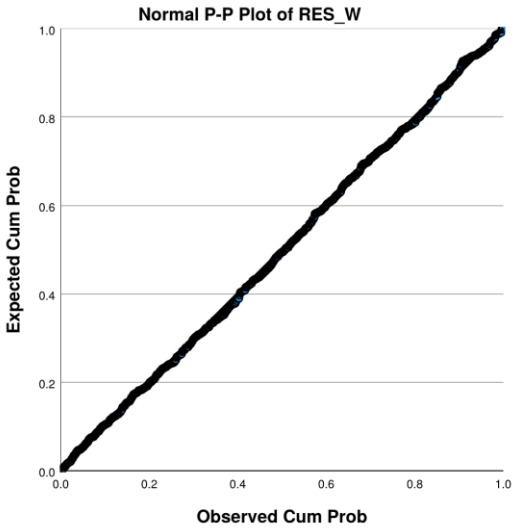
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Figure 1. Histogram of WLS model residuals



Source(s): IBM SPSS output, author's own creation

Figure 2. Normal P-P plot of WLS model residuals



Source(s): IBM SPSS output, author's own creation

Table 6 reports the Glejser test before and after the correction. In the OLS model, LnNI (Sig. < 0.001) and LnCFO (Sig. 0.016) significantly affect the absolute residuals, indicating heteroskedasticity. After WLS estimation, all independent variables have significance values above 0.05, so the residual

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variance is homogeneous. This is supported by the scatterplot in Figure 3, in which the residuals are randomly scattered around zero without a particular pattern.

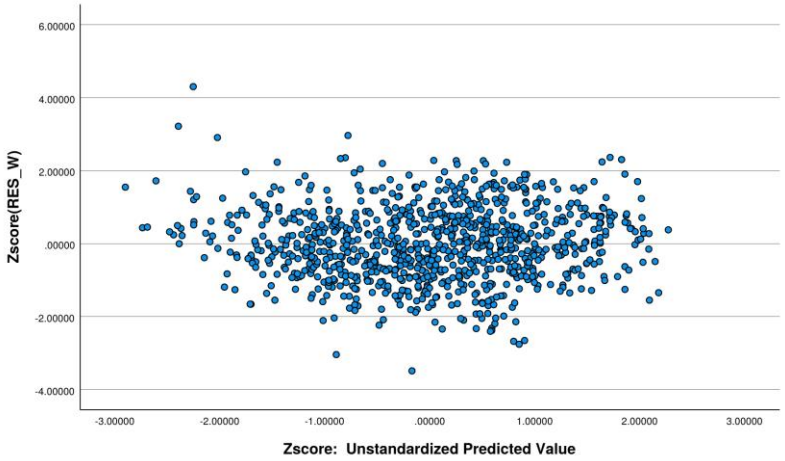
Table 6. Glejser test before and after WLS

Variable	t (OLS)	Sig. (OLS)	t (WLS)	Sig. (WLS)
D_1	1.428	0.154	0.055	0.957
D_2	1.556	0.120	−0.339	0.735
LnNI	4.425	< 0.001	−0.561	0.575
LnCFO	−2.411	0.016	0.629	0.529

Note(s): Dependent variables: absolute OLS residuals (ABS_RES) and absolute weighted WLS residuals (ABS_RESW)

Source(s): IBM SPSS output, author's own creation

Figure 3. Scatterplot of residuals against predicted values of the WLS model



Source(s): IBM SPSS output, author's own creation

4.3 F-test and hypothesis testing

The WLS estimates are presented in Table 7. The F-statistic of 196.086 (Sig. < 0.001) indicates that earnings character, net income and operating cash flow jointly affect market value, so the model is fit for use. The adjusted R^2 of 0.456 indicates that the model explains 45.6% of the variation in market value.

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Table 7. WLS estimation results

Variable	Predicted sign	B	Std. error	Beta	t	Sig.
Constant		−5.443	0.472		−11.524	< 0.001
D_1	+	−0.584	0.114	−0.178	−5.098	< 0.001
D_2	−	−0.517	0.141	−0.133	−3.657	< 0.001
LnNI	+	0.105	0.024	0.176	4.324	< 0.001
LnCFO	+	0.368	0.027	0.524	13.401	< 0.001
N		933				
Adjusted R^2		0.456				
F (Sig.)		196.086				< 0.001

Note(s): Dependent variable: LnMV; weighted least squares estimation with weight W

Source(s): IBM SPSS output, author's own creation

The D_2 coefficient of −0.517 (Sig. < 0.001) indicates that the share price of Category 2 firms is about 40.4% lower than that of the reference category, as predicted. The D_1 coefficient of −0.584 (Sig. < 0.001) indicates that the share price of Category 1 firms is about 44.2% lower, contrary to the positive prediction. Because at least one dummy coefficient is significant in the predicted direction, H1 is supported. The coefficients of LnCFO (0.368) and LnNI (0.105) are both positive and significant at the 1% level, so H2 and H3 are supported.

Based on Table 7, the estimated regression equation is as follows:

$$LnMV = -5.443 - 0.584D_1 - 0.517D_2 + 0.105LnNI + 0.368LnCFO \quad (5)$$

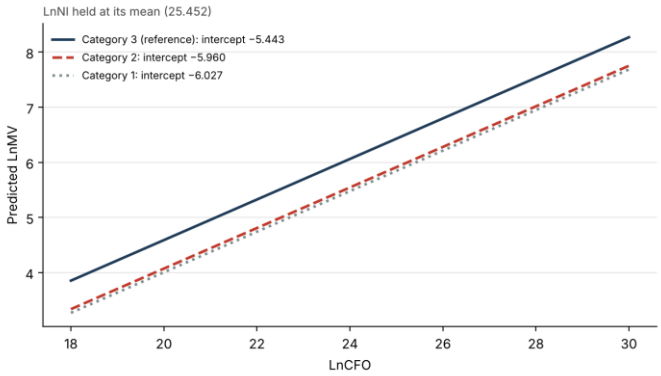
Following equations (2) to (4), equation (5) decomposes into three parallel regression lines:

Category 3: $LnMV = -5.443 + 0.105LnNI + 0.368LnCFO$ (6)

Category 2: $LnMV = -5.960 + 0.105LnNI + 0.368LnCFO$ (7)

Category 1: $LnMV = -6.027 + 0.105LnNI + 0.368LnCFO$ (8)

Figure 4. Regression lines by earnings character category



Source(s): LnNI is held at its mean (25.452). Author's own creation

Figure 4 shows that the three lines are parallel because the LnNI and LnCFO slopes are the same for all categories, and the Category 3 line lies at the top. That is, at the same levels of net income and operating cash flow, firms with normal earnings character have the highest market value. The D_1 and D_2 coefficients are the vertical distances of the Category 1 and Category 2 lines from the Category 3 line. An additional estimation that changes the reference category shows that Categories

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1 and 2 do not differ significantly from each other (B = 0.066; Sig. 0.522), so the meaningful difference lies between Category 3 and the other two categories.

Discussion

Earnings character. The finding that firms with accrual-based earnings and negative operating cash flow are valued lower is consistent with signalling and agency theories: earnings not backed by cash realisation are a weak signal and open room for managerial discretion, and are therefore discounted by the market. This result is consistent with Dechow and Dichev (2002), Francis *et al.* (2005) and Richardson *et al.* (2005). In contrast, the negative Category 1 coefficient can be explained by its composition. Of the 622 Category 1 observations, 187 are loss-making firms, whereas Category 3 consists entirely of profitable firms. For loss-making firms, operating cash flow exceeding net income does not necessarily reflect conservatism but may stem from large non-cash expenses or big bath practices, that is, recognising as many expenses as possible in an already poor year (Healy, 1985). Basu (1997) and Hayn (1995) show that earnings under poor performance and losses carry different information, and Collins *et al.* (1999) show that the market values loss-making firms differently. Because Ln|NI| and Ln|CFO| do not capture the sign of losses, these differences are absorbed by the D_1 coefficient. The absence of a significant difference between Categories 1 and 2 indicates that the market applies a similar discount to both categories relative to firms with normal earnings character.

4.4.2 Cash flow from operations. Operating cash flow has the most important impact (Beta 0.524). If operating cash flow increases by 1%, the share price will increase by about 0.37%. This is consistent with Indonesian evidence that the value relevance of earnings components is increased when disaggregated (Zacharias *et al.*, 2025) and supports the argument that operating cash is objective and verifiable information (Dechow and Dichev, 2002; Richardson *et al.*, 2005).

4.4.3 Net income. Net income has a positive but weaker effect (Beta 0.176; elasticity 0.105). Net income remains informative (Ball and Brown, 1968; Kormendi and Lipe, 1987). Yet, the market attaches more importance to earnings that have been realised in cash, in line with the view that the accrual component is subject to more managerial discretion (Healy and Wahlen, 1999).

Conclusions

This research demonstrates that the Indonesian capital market distinguishes firms based on their earnings character, in addition to the magnitude of their earnings components. Operating cash flow is the earnings component most strongly associated with market value, followed by net income, whereas accrual-based earnings with negative operating cash flow are valued lower. The negative coefficient of the category where operating cash flow is greater than net income implies that the meaning of this category depends on whether firms report profits or losses.

The results suggest that investors should consider a company's capacity to generate cash from its operations as well as its net income. Effective management of cash generation to support earnings is essential to preserving market valuation, and the findings support efforts by regulators to require more transparent disclosure of the composition of cash flows and earnings.

There are a number of limitations to this study. The model still shows positive autocorrelation, the log transformation of absolute values means that the signs of earnings and cash flow are not explicitly captured by the continuous variables, and the reference group consists solely of profitable firms. Future research could use panel data regression or autocorrelation-robust standard errors (Petersen, 2009), explicitly separate the conditions of profit and loss, measure the variables on a per-share basis, and apply the research to other sectors for comparison.

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Notes

[1.] The absolute-value transformation gives the same logarithmic value for profitable firms and loss-making firms of the same size. Some of this directional information is captured by the earnings character dummies, and the residual limitation is dealt with in the conclusions.

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