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THE EFFECT OF EARNINGS CHARACTERISTICS ON FIRM MARKET VALUE (CLOSING STOCK PRICE): EVIDENCE FROM CONSUMER CYCLICALS COMPANIES (IDXCYCLIC) ON THE INDONESIA STOCK EXCHANGE

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Abstract:
Purpose – This study aims to investigate the effect of Net Income, Cash Flow from Operations (CFO) and Total Accruals (TA) on firm market value, proxied by closing stock price, in consumer cyclicals companies (IDXCYCLIC) listed on the Indonesia Stock Exchange for 2016–2025. Design/methodology/approach – The study uses a quantitative approach of the causal associative type with secondary data and purposive sampling. Multiple linear regression combining dummy variables with continuous independent variables is applied to 660 observations, with Category 3 (CFO < NI and TA < NI) as the reference category. Findings – CFO has a positive and significant effect on firm market value and is the variable with the largest effect (Beta = 0.482). Net Income has a significant negative effect (B = −0.098). Firms with CFO > NI (D1) and firms with TA > NI (D2) have significantly lower market values than the reference category. Simultaneously, the variables significantly affect market value, with an Adjusted R^2 of 17.8%. Originality/value – This study tests Net Income, CFO, and TA in one integrated model in the cyclical sector, and shows that the Indonesian capital market appreciates operating cash flow more than accounting earnings.
Keywords: Earnings characteristics; Net income; Cash flow from operations; Total accruals; Firm market value

INTRODUCTION

The Indonesian capital market is developing continuously, as evidenced by the increase in the number of investors, the number of listed companies and the intensity of stock trading on the Indonesia Stock Exchange (IDX). The capital market investors were more than 17 million Single Investor Identification (SID) to reflect the increasing public interest in the investment instruments in the capital market that are based on equity capital. This makes the investors more skeptical when it comes to analysing the companies before investing in them. Investors consider the firm market value to be one of the most significant indicators because it indicates the market's view of how well a firm has performed and how much potential the firm has (Bui et al., 2023). There are numerous methods of calculating the firm value. One of them is the stock market price of the company (Thesing & Velte, 2021). The closing price of the stock will represent the sum of investor opinions about the par they bought, over a period of time, as an indicator of the market's performance.

Investors make intensive use of the available information during stock valuation. Mainly the information coming from financial statements is used. Earnings is one of the most looked at parts of a financial statement. It is assumed to represent the performance of a firm and forms the basis of forecasting the profit generating capacity of the firm. But it should be known that net income is not the true reflection of a firm's economy since the income is earned based. Net income is not always an appropriate metric to measure performance and is highly limiting. However, investors must consider the net income decline but also factor in the source of the income. Cash flow from operations (CFO) is a measure of firm's ability to generate and use cash in operating activities and total accruals (TA) is the measure of the portion of earnings due to the timing difference between

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cash realization and accounting recognition. So net income, CFO and TA are three complementary elements that show the nature of company earnings.

In Indonesian capital market there are several unusual phenomena. If the CFO is greater than the net income, then TA is negative and this can indicate aggressive income decreasing accruals or earnings that have many discretionary non-cash expenses. From a financial analysis perspective, it is more concerning when the magnitude of TA is larger than net income itself, which essentially indicates that most or all of reported earnings are nothing but accounting constructs (Ochiai & Nacher, 2022; Jansen, 2021; Baig et al., 2020). The consumer cyclicals sector (IDXCYCLIC) is a very dynamic and volatile sector, as the products are very dependent on the economic conditions and the purchasing power of the public (Kaczmarek et al., 2021). Hence, the sector offers a useful setting for examining the link between earnings characteristics and firm market value.

Previous studies on the effect of earnings components on firm market value still show significant inconsistency. Budagaga (2017) and Jansen (2021) found that net income and CFO have a significant positive effect on market value, whereas Walkshäusl (2020) and Phuong and Hung (2020) stated that under high information asymmetry net income often loses its predictive power over stock prices because it is contaminated by discretionary accruals. Most previous

studies test the accrual component separately or in cross-sectoral analysis, thus ignoring the unique characteristics of the consumer cyclicals sector. The research questions are: (1) whether Net Income affects firm market value; (2) whether CFO affects firm market value; (3) whether firm market value differs between firms in Category 1 (CFO > NI) and the reference category (CFO < NI and TA < NI); (4) whether it differs between firms in Category 2 (TA > NI) and the reference category; and (5) whether Net Income, CFO and TA simultaneously affect firm market value in consumer cyclicals company at IDX period 2016-2025.

The study is expected to contribute to the literature on the relationship between Net Income, CFO and TA and its implications for firm market value in the Indonesian capital market. It provides practical inputs for investors, company management, academicians and regulators on quality of earnings so that investors are not easily fooled by superficial earnings figures.

Literature review and hypothesis development

Agency theory and signalling theory

Jensen and Meckling (1976) defined agency relationship as a contract between the principals (one or more people) and the agent (one person). Because management manages the company separately from shareholders, there is a possible difference of interests. Information asymmetry is a condition where management has more information on the company's condition than shareholders do, and this increases agency problem. Agency theory arises from differences of interest and information asymmetry between management and investors, which requires a quality financial information to be able to subsequently compare and assess the interests at a later stage. Agency theory doesn't directly address how the information is received and what the market does with it (Jensen & Meckling, 1976; Baig et al., 2020).

The first application of signaling theory to explain how the informed signal to the uninformed was by Spence (1973). The company is able to communicate with external parties through financial statements. The accounting numbers are giving no signal, either good or bad. If the information can make the investors more confident in the condition and prospect of the company, it can be regarded as the positive signal. If it can make the investors more concerned, it can be regarded as the negative signal. One can interpret the movements of stock prices as the perception of information by investors (Ochiai & Nacher, 2022).

Firm market value and earnings characteristics

The value of the company when assessed by the market is the firm value, which is shaped by market mechanisms. The dependent variable is the firm market value represented with the closing

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price of the stock. According to Thesing & Velte (2021) the closing price of the stock reflects the market's evaluation of information about the firm during a period.

Earning characteristics also characterize the nature of the company's earning process and how much the earning reflects the true economic situation of the company (Phuong & Hung, 2020). They are viewed as having three aspects. Net Income, which is the profit after all operating costs, interest, taxes and other costs were taken off in a given accounting period (Budagaga, 2017); because it is prepared on an accrual basis, it does not show the money actually received or spent. Cash Flow from Operations is the cash flow generated from the company's main business activities and is not affected by the accrual accounting method (Jansen, 2021; Baig et al., 2020). Total Accruals reflect the difference between net income and operating cash flow, that is, the part of earnings not realized in cash in the period concerned; high accrual level may reflect the risk of earnings management practices that lower the quality of financial information (Phuong & Hung, 2020).

Previous studies

Baig et al. (2020) revealed that accounting quality can be linked to occurrence of stock price in the market. Jansen (2021) reports a positive relationship between cash flow growth and stock returns. Thesing and Velte (2021) provide a conceptual basis that accrual-based information and quality of financial reporting are important elements for the evaluation of firm information. Ochiai and Nacher (2022) show that the elements in financial statements are structurally interrelated, which supports using Net Income, CFO, and TA simultaneously. Walkshäusl (2020) examines internationally how company financial fundamentals affect performance and market value.

Hypothesis development

Net income is the outcome of the company's performance over a period of time and this plays an important role when it performs well, as per signaling theory, it can be a positive sign for investors. CFO indicates firm's cash inflow from operations, Budagaga (2017) concluded that the positive effect of cash flow on firm value, Jansen (2021) found cash flow and stock return to be positively related. Accordingly:

H1: Net Income has a positive effect on firm market value in consumer cyclicals companies listed on the Indonesia Stock Exchange for 2016–2025.

H2: Cash Flow from Operations (CFO) has a positive effect on firm market value in consumer cyclicals companies listed on the Indonesia Stock Exchange for 2016–2025.

In Category 1, a company's CFO is greater than the reported net income, which results in negative total accruals. Signalling theory states that the higher operating cash flow than accounting earnings is a positive indicator that the accounting earnings are of good quality and investors are willing to value the accounting earnings at a higher price. In Category 2, when total accruals are greater than net income, CFO is mathematically negative, so the reported earnings are not supported at all by cash from operating activities; investors may doubt the company's ability to sustain that performance (Ochiai & Nacher, 2022; Thesing & Velte, 2021; Walkshäusl, 2020).

H3: There is a positive difference in firm market value between companies with Category 1 earnings characteristics (CFO > NI) and the reference category.

H4: There is a negative difference in firm market value between companies with Category 2 earnings characteristics (TA > NI) and the reference category.

H5: Net Income, Cash Flow from Operations (CFO), and Total Accruals (TA) jointly have a significant effect on firm market value in consumer cyclicals companies listed on the Indonesia Stock Exchange for 2016–2025.

METHOD

Research type, population, and sample

This study employs a quantitative approach with a causal associative type of research, used for describing the cause and effect relationship of the independent variables and dependent variable (Creswell & Creswell, 2017). The population consists of all companies which are listed in IDX in

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2016-2025 in IDXCYCLIC sector. The period covers the stable economic period before the pandemic (2016–2019), the COVID-19 pandemic disruption (2020–2021), and the period of recovery (2022–2025). Purposive sampling is used with these criteria: (1) consumer cyclicals companies consistently listed on the IDX during 2016–2025; (2) companies that routinely publish complete annual financial statements audited by an independent auditor; (3) companies with complete data on Net Income, Cash Flow from Operations, Total Accruals, and year-end market data; (4) companies that did not experience delisting; and (5) financial data presented in Indonesian Rupiah.

The data in this study is secondary data. Secondary data is data obtained from the annual financial statements, cash flow statements and data from the capital market that can be accessed in public on IDX (http://www.idx.co.id) and the company's website by documentation method.

Variable definitions

The dependent variable is the firm market value (MV) which is proxied by the closing stock price (LnMV). Net Income (NI) is measured as natural log of net income (LnNI) and Cash Flow from Operations (CFO) as natural log of operating cash flow (LnCFO). Total Accruals is a derived variable, calculated as the difference between net income and operating cash flow (TA = NI − CFO). Three types of earnings characteristics are identified based on empirical relationship between NI, CFO and TA. Dummy D1 equals 1 if CFO > NI (Category 1) and 0 otherwise; dummy D2 equals 1 if TA > NI (Category 2), which mathematically means that CFO is negative, and 0 otherwise. Since the Category 3 (CFO < NI and TA < NI) represents the reference point of normal and good health in the reporting of data, it is not represented by a dummy variable or indicator to avoid the dummy variable trap.

Data analysis technique

All data were analyzed by SPSS. The analysis starts with Descriptive Statistics and classic tests of assumptions: Normality (Kolmogorov-Smirnov test on the residuals; significance > 0.05), Heteroscedasticity (Glejser test; all significance values > 0.05), Multicollinearity (Tolerance > 0.10 and VIF < 10) and Autocorrelation (Durbin-Watson test). Then, multiple linear regression is used with the following model:

$$LnMV = a + \beta 1 LnNI + \beta 2 LnCFO + \beta 3 D1 + \beta 4 D2 + \varepsilon$$

The hypotheses are tested at a significance level of $\alpha = 0.05$ using the coefficient of determination (Adjusted R^2), the simultaneous significance test (F test) and the partial significance test (t test).

RESULTS AND DISCUSSION

Descriptive statistics

As can be seen in Table 1 the number of observations (N) is 660. The average market value for the firms is LnMV = 6.0448 and the standard deviation is 1.4038. The average of net income (LnNI) is 24.9317 and the average of operating cash flow (LnCFO) is 24.8530. The mean of LnNI is higher than the mean of LnCFO. It means the sample firms on average accounting earnings are marginally higher than the operating cash flow. All variables have a standard deviation less than the average so the data do not spread too broad

Table 1. Descriptive statistics

Variable	N	Min	Max	Mean	Std. Dev.
LnMV	660	1.9459	9.9641	6.0448	1.4038
LnNI	660	16.2134	29.6089	24.9317	1.9692
LnCFO	660	17.8586	29.4194	24.8530	2.2470

Source: Author's data processing (SPSS).

As can be seen in Table 2, most of the observations (68.9%) are in Category 1, i.e. the situation when the operating cash flow is higher than the net income. The distribution of accrual-backed earnings (TA > NI) is 15.8% in category 2, the normative (reference) category, is 15.3%. This discovery

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corroborates the presence of an abnormal phenomenon in the relation between NI, CFO and TA in the Indonesia capital market, the motive of this research.

Table 2. Distribution of earnings characteristic categories

Category	Criteria	Frequency	Percentage
Category 1 (D1 = 1)	CFO > NI	455	68.9%
Category 2 (D2 = 1)	TA > NI	104	15.8%
Category 3 (reference)	CFO < NI and TA < NI	101	15.3%
Total		660	100%

Source: Author's data processing (SPSS).

Classical assumption tests

The residuals are normally distributed (Kolmogorov-Smirnov statistic 0.029; Asymp. Sig. 0.200 > 0.05). The initial Glejser test on the ordinary least squares model showed heteroskedasticity in D1 (sig. 0.014) and LnCFO (sig. 0.004); the model was therefore re-estimated using Weighted Least Squares (WLS), after which all independent variables have significance between 0.719 and 0.957, so the homoskedasticity assumption is met. All variables have Tolerance between 0.536 and 0.565 and VIF between 1.769 and 1.865, so the non-multicollinearity assumption is met. The Durbin-Watson value is 0.521, which indicates positive autocorrelation; but, due to being cross section and time series data as it's many companies with 660 observations, auto correlation test doesn't apply here (Baltagi, 2021).

Multiple linear regression results

Table 3. Multiple linear regression results (dependent variable: LnMV)

Variable	B	Std. Error	Beta	t	Sig.
(Constant)	1.359	0.705		1.929	0.054
LnNI	−0.098	0.034	−0.138	−2.862	0.004
LnCFO	0.301	0.029	0.482	10.264	0.000
D1 (CFO > NI)	−0.364	0.145	−0.120	−2.503	0.013
D2 (TA > NI)	−0.625	0.185	−0.162	−3.388	0.001

Source: Author's data processing (SPSS). Adjusted R^2 = 0.178; F = 36.602 (Sig. 0.000).

The regression equation is LnMV = 1.359 − 0.098 LnNI + 0.301 LnCFO − 0.364 D1 − 0.625 D2 + ε. A 1% increase in net income decreases market value by 0.098%, other factors being constant, a 1% rise in operating cash flow, results in an increase of 0.301% in the value of the market.

Companies with CFO > NI have an LnMV 0.364 lower than Category 3 (about 30.5% lower), and companies with TA > NI have an LnMV 0.625 lower (about 46.5% lower).

Hypothesis testing

R value of 0.427 shows a moderate relationship between the independent variables and market value. The Adjusted R^2 of 0.178 suggests that 17.8% of the variation of firm market value is explained by LnNI, LnCFO, D1 and D2, while 82.2% is explained by other factors outside the model such as firm size, capital structure and macroeconomic conditions. The F value of 36.602 with a significance of 0.000 (< 0.05) showed that LnNI, LnCFO, and the earnings characteristics (D1 and D2) simultaneously had a significant effect on the market value of the company, so that the model was feasible to use and H5 was supported. Partial tests are summarized in Table 4.

Table 4. Summary of hypothesis testing

Hypothesis	Coefficient	t	Sig.	Direction	Conclusion

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H1: NI → MV (positive)	−0.098	−2.862	0.004	Negative	Significant; opposite direction
H2: CFO → MV (positive)	0.301	10.264	0.000	Positive	Supported
H3: D1 (CFO > NI) (positive)	−0.364	−2.503	0.013	Negative	Significant; opposite direction
H4: D2 (TA > NI) (negative)	−0.625	−3.388	0.001	Negative	Supported
H5: Simultaneous	F = 36.602		0.000		Supported

Source: Author's data processing (SPSS).

Discussion

Net income is very significant (sig. 0.004 < 0.05) with a negative direction (B = −0.098). Increases in net income are associated with decreases in market value when operating cash flows are controlled for. This means investors are not accepting "earnings on paper" without the corresponding cash flow, and that's what the market calls "low-quality" earnings, which are not valued by the market. It is in line with Mostafa and Dixon (2024), who found that cash flow becomes more important for valuation as accruals become extreme.

Operating cash flow has a positive and significant effect (sig. 0.000; B = 0.301) and is the variable with the largest effect (Beta = 0.482). To investors, cash generated from operating activities is a better gage of performance and the ability to pay dividends than earnings based on accruals. The result is consistent with Albuquerque et al. (2023) who found cash flow measures have a greater impact on stock prices than profit or loss. It is consistent with Wilson (1986) and Bernard and Stober (1989) who showed the incremental information content of operating cash flow beyond accrual earnings.

The effect of D1 is significantly negative (sig. 0.013; B = −0.364), which means that the market value of companies with CFO exceeding NI is lower than the reference category. In general, CFO > NI is considered an indication of quality earnings, so the negative direction contradicts the theoretical expectation (H3). A possible explanation is that in many sample companies CFO

> NI describes low earnings or high non-cash expenses (such as depreciation), so investors do not give additional appreciation.

The effect of D2 is significantly negative (sig. 0.001; B = −0.625), making it the dummy with the largest effect. The market value of companies whose earnings are mostly supported by accruals is about 46.5% lower than the reference category. This is in line with Sloan (1996), who stated that earnings containing a high accrual component are less persistent than cash-supported earnings and therefore receive a lower valuation from the market. In general, the Indonesian capital market favors the value of operating cash flow over accounting earnings and the characteristics of accrual-based earnings or the condition of CFO > NI are not always seen positively by investors.

Conclusion

This study proves that Net Income, Cash Flow from Operations, and Total Accruals simultaneously have a significant effect on the market value of consumer cyclicals companies on the Indonesia Stock Exchange for the period 2016-2025. Most dominant variable is operating cash flow, and has positive effect, net income has a significant negative effect, and companies with CFO > NI or TA > NI have lower market values than the reference category, with the lowest values in companies with accrual-dominant earnings. The model explains 17.8% of the variation in market value; other factors such as firm size, capital structure, and macroeconomic conditions should be considered in future research.

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