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2 investor reaction to earnings announcements moderated by management discussion and analysis

(MD&A)

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ABSTRACT: This study aims to find empirical evidence of MD&A (Management Discussion and Analysis) information content on investors' reactions to earnings announcements. MD&A disclosures using Annual Report Award (ARA) index by The Financial Services Authority (OJK) on a sample of large capitalized companies five days after earnings announcements in 2014-2016 were examined. It was found that the low net profit value and complete MD&A information could influence investors' decisions which led to the increase of stock trading volume and trading frequency. Conversely, investors' reactions were low with high earnings announcements and reinforcement of complete MD&A disclosures. It is because the earnings announcements employed net income only and were not measured by other profits or by samples from all types of companies. However, the MD&A actual disclosure is qualitative information content, which is greatly useful for investors in making decisions to invest, particularly on low earnings information and earnings information in MD&A disclosures, which provide clear and comprehensive views of future earnings.

Keywords: Investor, earnings announcements, management discussion, and analysis (MD&A)

1. INTRODUCTION

Earnings have high information content, such as a measure of performance often used by companies, investors, creditors, and a benchmark for investing in companies. According to SFAC No. 8 (FASB, 2010), profit is an important income statement for the wearer because it has predictive value. A study conducted by Ball and Brown (1968) revealed the existence of market reactions due to accounting information reactions. Furthermore, Scott (Scott, 2015) stated that earning information can be useful if it can change investor confidence and previous actions. Also, the level of its usefulness can be measured from the extent of price changes after the publication of profit information. Investor's reactions can be examined from the size of shares traded by company issuers. The higher the investor's reaction to a company's shares, the higher the level of sales and trade transactions. According to Lindrianasari et al. (2017), capital market conditions are strongly influenced by external and internal company information, one of which is information on the management discussion analysis (MD&A) presented in the company's annual report. MD&A is a part of the company's annual report containing various aspects of explanation, such as the manager's point of view about the company to help investors to understand financial statements and to discuss trends, risks, and other aspects. Scott (2015: p87-88), Arnold, Sutton et al. (2012), and Amel et al. (2016) concluded that MD&A is a disclosure that helps investors to provide information that can reduce information asymmetry and become a rational decision for investors. Brown (2011) and Lindrianasari et al. (2017) argued that companies with greater economic changes modify MD&A better than companies with smaller economic changes. The magnitude of the stock price response for 10-K is positively related to MD&A scores. However, analysts reveal that investors do not always use MD&A information.

Indonesian capital market conditions in 2016-2017 depicted an increase in investor growth, with an increase of 44% in the number of investors from IDR 1,691 trillion to IDR 1,958 trillion or arise from 4.3% in 2016 to 15.79% in 2017 with frequency trading rose 20%, which enabled the capital market to be more liquid (Okezone.com, 2017). The year of 2018 was a - great year for investor growth increased 100 SID (Single Investor

Identification) to 250 SID per year (WAREZA, 2018). The increased number of investors in company shares in Indonesia is because of several factors, one of which is “Yuk Nabung Saham” or “Let’s Save Shares” project initiated by OJK. MD&A disclosure needs to be met by company issuers through Annual Report Award (ARA) by OJK, which has a 22% rating or the second rank after Good Corporate Governance (GCG), which has 35% rating. Research of Beaver (Beaver, 1968) found that earnings announcements contain sources of information that can be seen from the greater variability in stock price changes at earnings announcements compared to before the earnings announcements. Research by Lindrianasari et al. (2017) showed that MD&A disclosure has a positive effect on stock trading volume. Meanwhile, Suropto (2014) revealed that management’s internal attribution is a part of MD&A disclosure, which has a positive influence on earnings perceptions. This study was developed from the research of Lindrianasari et al. (2017), which emphasizes the element of earnings announcements, in which the disclosure of high MD&A will strengthen investors’ reaction in trading stocks with higher volumes. Management discussion analysis becomes a moderating variable because only a few studies are investigating MD&A available, which can provide information to strengthen investor reaction to earnings announcements. MD&A can be used as information to examine companies clearly; thus, investors can make good investment decisions. The aim of this study is to find empirical evidence of MD&A content information on investors’ reactions to earnings announcements.

2. LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

The theory used the Market Hypothesis Efficiency Theory (EMH). Fama (1970) stated that in an efficient market, the price would fully reflect on available information; thus, as an implication, the price will react immediately without any bias towards new information. Beaver (1989) suggested that “Market efficiency is the relationship between the prices of stock securities and the availability of information.” Securities market efficiency has important implications in financial accounting, one of which is that it has direct implications for the full disclosure concept. Furthermore, the information content of the Accounting Number (Earnings Announcements) is defined as an exchange of expectations about event expectations. In the context of research by Beaver (1968), corporate earnings reporting is believed to possess information content if it can influence changes in investor valuation of future probability distribution results, which can affect the value of current security price balance. Ross (1977), introducing the theory of Signal (Signaling Theory), stated that company executives who have better information about their companies would be compelled to convey this information to potential investors so that the company’s stock price would increase. The existence of financial information signals can be seen from financial statements disclosure, one of which is MD&A disclosure. MD&A (Management of Discussion and Analysis) is a mandated form of disclosure. MD&A as adopted in the SEC (Scott, 2015) has several functions, such as assisting investors now or later to understand financial statements; discussing information that does not fully reflect financial statements; discussing trends, risks, and matters affecting company performance; and providing information about quality, potential variables, income, cash flow to help investors determine whether past performance will represent future one. Based on several studies from Bamber et al. (2011), Wang et al. (Wang and Yang, 2013), Pevzner et al. (Pevzner, Xie and Xin, 2015), Baron et al. (2015), Chi et al. (Chi and Shanthikumar, 2017), and Farichah (Farichah, 2018), they examined investors’ reactions to earnings announcements by providing evidence when earnings announcements have a role in increasing trading volume. Thus, the hypothesis in this study is formulated as follows:

H1: Earnings announcements have a positive effect on investor reactions.

In research conducted by Begley and Fischer (1998), Bagnoli, Kross, and Watts (2002), Sedor (2002), Sengupta (2004), Bowen, Davis, and Matsumoto (2005), Muslu et al. (2010), Brown and Tucker (2011), Davis and Sweet (2011), Lindrianasari et al. (2015), Mayewetal. (2015), Amel et al. (2016), Lee and Park (2018), Lerman et al. (2019), they investigated MD&A disclosure as an information content has an effect by providing clear and

complete information. Hence, this disclosure has a positive impact on the market, which results in the trading volume of shares increase. Thus, the second hypothesis can be formulated as follows.

H2: MD&A disclosure has an effect on investor reaction towards earnings announcements.

3. RESEARCH METHODOLOGY

This study used a purposive sampling method in companies publishing 2014-2017 annual reports. Data were accessed on the internet, including 50 large capital companies. Based on the criteria, from 2014-2017, only 39 companies successively were sorted out of 156 available samples.

Earnings announcements were created based on the fastest earnings announcement from three sources of announcement, namely (1) companies' website; (2) newspapers; and (3) web-site of IDX. These criteria are established to minimize biased investor responses to earnings announcements if certain sources are used. This study assumes that investors will react immediately to the financial information they obtain as predicted in the efficiency market (EMH) hypothesis. The MD&A disclosure variable employed disclosure index compiled by the Financial Services Authority (OJK). This criterion was used in the implementation assessment in Annual Report Award (ARA), consisting of 17 criteria with 53 explanatory sub-chapters (2016 award criteria). The dependent variable in this study was investor reaction, measured by the volume of stock trading and stock trading transactions within five (5) days after the earnings announcement and examining the difference within 5 days before and after the earnings announcement.

4. RESULTS

This study found that the information content of MD&A provides investors' reactions to earnings announcements. The value of net income, however, does not affect investors' reactions, particularly in stock trading volume, which allows them to make decisions in purchasing shares, not only based on net income but profit levels of different sizes. On the other hand, the value of earnings strengthened by the MD&A disclosure of affects volume and trade frequency. Furthermore, the result also revealed a negative value indicating that low profits supported by the MD&A disclosure have an influence on high trading volume and frequency. The results of this study are the implications of Hussainey's research results (2004). In his study, it was found that clear and complete earnings information in MD&A disclosures provides a view of future earnings. Thus, it becomes useful information for investors in making investment decisions. In different test results, different stock trading volume activities and frequency of stock trading five days before and after earnings announcements occurred. Hence, it can be concluded that earnings announcements reinforced by MD&A disclosures have a strong influence on investors' reactions. According to Feldman (2010), research on MD&A issues that found additional information content of MD&A and financial information is highly needed by investors.

5. CONCLUSIONS

These results indicate that the qualitative analysis or the disclosure of Management Analysis and Discussion (MD&A) is a useful information content that serves to help investors in making decisions regarding company shares ownership. Furthermore, qualitative information can be a solution in making stock decisions for numerous naive investors. This study has several limitations, including the number of the sample which has not been evenly distributed to all types of companies. Thus, future research can compare between large and small companies, roles of the company for lower risk levels, or the influence of high performance and company growth on MD&A as information content.

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