EFFECT OF CORPORATE GOVERNANCE ON COST OF EQUITY BEFORE AND AFTER INTERNATIONAL FINANCIAL REPORTING STANDARD IMPLEMENTATION

Chandra Situmang 1, Erllna 2, Athar Maksum 1 & Tati Supriatna 1
1 Doctoral Programme School of Economic and Business, Universitas Sumatera Utara, Medan, Indonesia
2.3 Faculty of Humanities and Business, Universitas Sumatera Utara, Medan, Indonesia
Correspondence email: chandraicitsumang@gmail.com

We suggest you to cite this article as:

Abstract
The ability to compete between companies at the time of intercompany production efficiency is no longer a differentiator, the determinant of competitiveness includes the aspect of funding to be one of the determinants of competitiveness. One of the company's competitiveness capabilities is determined by the capital cost or the discount rate used in evaluating a project. The higher the cost of capital will be the lower the competitiveness of the company. There are many factors that determine the cost of a company's capital, but this research focused only on the aspects of Corporate Governance (CG). Investors will assume that the risk in companies that have good CG quality will be smaller than companies that do not have good CG quality. On the other hand, IFRS implementation has a variety of purposes including improving the implementation of CG in a company, so it is theoretically supposed that IFRS implementation will increase CG's influence on CoE. The approach used is to study the capability of the linear regression model formed and to conduct a comparative analysis among regression models established by data from manufacturing companies listed on the Indonesia Stock Exchange during 2007-2011 at data prior to IFRS implementation and 2012-2015 for data after IFRS implementation. Based on the results of data processing obtained evidence that Corporate Governance negatively affect the Cost of Equity (CoE). This contradicts the theory because the better the CG value of a firm the CoE will be to decrease. When compared to the period before and after IFRS implementation, there is no evidence of a relationship between CG and CoE.

Keywords: Corporate Governance; Cost of Equity; IFRS
JEL Codes: 533, E44, F14, H63.

1. INTRODUCTION

The level of inter-company competition that occurs today is higher without being restricted by state borders. This condition requires companies to improve competitiveness to survive and thrive in a global business environment. As it becomes easier to duplicate products, competitiveness is determined not only by product characteristics, but also by internal efficiency in the production process. This perspective, the company will strive to achieve relatively low production costs, so that the company can implement various strategies based on price advantages. Efficiency is not only determined by the technical process of production, but also determined by the ability to obtain an optimal cost of funds. Theoretically, all funds used by the company bear the cost of both capitals derived from the owner and the debt obtained from the creditor. The cost of capital deposited by the owner / investor is referred to as the Cost of Equity (CoE) and the cost component of the debt obtained from the creditor is referred to as the Cost of Debt (CoD). The focus of this article is the CoE measured by estimation that has a variety of approaches (Ross, Westerfield & Jordan, 2010). CoE is the risk premium set by the investor for the investments invested in the company. The risk premium is determined based on various considerations including determined by the quality of information obtained by investors in decision making. Such information can be obtained from various sources where the financial statements become one of the main sources. If reviewed from the basic purpose of the financial statements is to provide information pertaining to the financial position, financial performance, cash flow, which is useful for investors in economic decision making (Financial Statement Presentation and Framing Framework Paragraph 7, PSAK 2010). If the financial reporting process runs ideally, financial statements can be an adequate source of information for investors to make investment decisions. But practically, investors are aware that the financial statements are not fully informed of the real conditions that can be used for forecasting future cash flows. This happens because investors believe there is a difference in the quality of information they have than those of management. As compensation for such low informative risk, investors demanded a higher rate of return because they assume relatively large uncertainties (Bhattacharya, Ecker, Olsson, & Schipper, 2012; Song, 2007).

One of the factors suspected to play a role in increasing the information asymmetry is the difference in standards used in various countries. To anticipate this, there is an attempt to reduce information asymmetry by designing and encouraging the implementation of the same standards worldwide. Preparation of financial statements will give a good impact from both sides of the substance of information contained in the financial statements will become more standardized around the world and encourage investor interpretation with smaller variations because it has a relatively similar reference. Based on that, Indonesia began to adopt in 2001 and implemented International Financial Reporting Standard (IFRS) in 2012. Turkli, Wali, & Boujelbene (2016) research who sampled companies in Europe concluded that IFRS implementation has been able reduce information asymmetry and improve the reliability of financial statements in predicting future circumstances.

One important aspect in reducing information asymmetry is Corporate Governance (CG). In addition to the main things that are the objectives of CG such as internal control, supervision of strategic policy, etc., one of the things to be achieved is the presentation of financial statements that provide complete information so that between the management and owners have the same relative information quality. As a consequence that the financial statements which are summary of management performance prepared by management (Strobl, 2013). Preparing a report that is vulnerable to arise conflict of interest. In an effort to minimize the negative impact of a conflict of interest, a CG mechanism is developed that will theoretically reduce the opportunity to take advantage of itself. In terms of CG's influence on CoE, several studies with relatively similar results have been performed: good enterprise management will reduce CoE (Ashbaugh-Skaife, Collins, & LaFond, 2005; Wu et al., 2013; Pradhan & Kangaru, 2016; Plot & Mominneker Piem, 2013; Strobl, 2013). In contrast, some other studies like Mc Imnis (2010) and Juntiari & Natalia (2012) study conducted in Indonesia do not support the conclusion that a good corporate CG increase will decrease CoE. However, the research results of...
Juniarti & Natalia (2012) have weaknesses because they only review from companies that volunteer to participate in Good Corporate Governance survey. The above description ranging from real phenomena in business practices and the results of various previous studies both in accordance with the theory and various research results that are not in accordance with the theory to make researchers interested in analyzing the relationship between the implementation of corporate governance with cost of equity. In addition to elaborating on these results, this study also aims to analyze whether there are differences in CG relationships to CoE after IFRS implementation.

2. LITERATURE REVIEW

A. Cost of Equity (CoE)

In simple terms, it can be said that Cost of Equity (CoE) is the return expected by shareholders by investing funds in the company. Return can be obtained from dividends or from the appreciation in the value of shares owned. Return for investors to be cost for the company. Although conceptually it is quite simple, it is very difficult to calculate it mathematically. CoE estimation calculations have been studied by many researchers by offering several measurements to coefficient CoE.

As pointed out in the previous section, CoE measurements are the measurement that many researchers discuss with varying measurement approaches. This is because the variable is not fully observable, so the calculation is an estimate that also depends on the estimation of other data. Here are some measurements that have been formulated to measure CoE: Discounted Dividend Model developed by Gordon & Shapiro, (1956), Capital Asset Pricing Model (CAPM) by Sharpe, (1964), Fama and French Three-Factor Model developed by Fama & French (1995) as a refinement of CAPM, Residual Income Valuation Model developed by Gebara, Lee, & Swaminathan (2001), Claas & Thomas Method (CT) built by Claas & Thomas (2001), Value Line Model developed by Brav, Lehavy, & Michael (2005), Price Earning Growth (PEG) Model developed by Eston & Monahan (2005), Gode & Mohamm Method (GM) developed by Gode & Mohamm (2003) and Modified Olsson & Juettner-Nauroth Method (OJ) developed by Olsson & Juettner-Nauroth (2005).

B. Corporate Governance (CG)

Corporate Governance (CG) has attracted many academic and practitioners' interest in management and accounting sciences. In the academic area, interest in CG involves a multidisciplinary of science that generates a lot of research within this area of study. The CG study was initially triggered by the publication of Cadbury's reports in 1992 under the terms "good behavior" which combined various indicators to assess the quality of corporate CG. Zikmund (2016) states that CG is an effort to establish standards to direct the board of directors and related committees to protect the interests of investors and provide information needed by all stakeholders. The definition focuses on the process of drafting the standards that will be the basis of a good CG implementation.

Another definition focuses on activities that have been implemented. Rezaee (2008) states that CG is a process influenced by regulatory bodies, laws, market mechanisms, regulations, internal practices, and efforts of all parties with the company. The involvement of directors, auditors, consultants law, financial advisors, and other parties will safeguarding interests and increasing shareholder wealth while protecting the interests of other stakeholders.
increase disclosure of information that reduces information asymmetry and thus reduces risk.

In addition to standardization issues, IFRS leads to the improvement of the quality of the company's financial statements. Epstein (Epstein & Mirza, 1999) say that IFRS requires a high standard, transparency, and capability compared with other financial statements to help investors in global markets and other financial statement users. Turkey (Turki et al., 2016) emphasizes one of the benefits of IFRS's focus on the fair value concept by saying that the concept of fair value facilitates investors who need the most up-to-date information in their decision-making as they understand the company's last condition for each forecasting. The two opinions above conclude that IFRS implementation will improve the quality of financial statement information.

Based on the above, theoretically can be said that the implementation of IFRS can encourage the reliability of financial statements because the information presented more informative and updated. Conceptually this will reduce information asymmetry sourced from information differences that are known by management than information that can be obtained by investors including one of the financial statement information. This theoretical concept has encouraged various studies to test these allegations.

Several studies focused on examining the impact of IFRS implementation on the company. Li's research (Li, 2010) and (Daske, Hail, Leuz, & Verdi, 2008) show that the implementation of IFRS encourages a decrease in the cost of equity borne by the firm. Different results are shown by Gao (Gao, 2010) that disclosure of new information presented as a result of IFRS implementation can not improve investors' predictive capabilities.

Turkish Research (Turki et al., 2016) states that IFRS implementation contains key factor that can reduce information asymmetry, thus lowering the cost of equity. Mohammadrezaei (Mohammadrezaei, Mohd-Saleh, & Baniamdi, 2015) conducted a literature study and concluded that the majority of research concludes that IFRS implementation reduces information asymmetry which reduces the cost of equity but still recognizes that some research has led to different conclusions.

2.1. Conceptual Framework

D. Effect of Corporate Governance on Cost of Equity

Based on agency theory there is a conflict of interest between manager and external stakeholder either shareholder or bondholder. Corporate Governance (CG) is one solution to minimize the agency problem. Governance mechanisms can reduce conflicts of interest so that agency costs can be suppressed. Good CG practice will encourage better managerial decisions for the benefit of various internal and external parties. In line with research conducted by some research (Hodges, Lim, & Lin, 2014; Lima & Sanviencete, 2013; Mazzotta & Veltri, 2012; Rantly, 2012; Wu & Lee, 2014) in general result that good CG practices will decrease the company's CoE. Research Huang, Das, & Ferranti (2016) also shows that disclosures conducted as one of the proofs of good governance implementation can decrease CoE while Zhu (2014) study explains that good governance will decrease CoE.

The CG aspect that is the focus of attention in this research is the internal mechanism. This is done because all the variables contained in the model are theoretically influenced by the internal mechanism. In line with the explanation in research conducted by Mazzotta & Veltri (2012) aspects of CG attributes that affect the cost of capital is; the size of the board of directors, the independence of the board of directors, the existence of committees under the board of commissioners, and the independence of those committees. In addition to these indicators in line with various other studies, this study adds attributes of the board of commissioners and the independence of the board of commissioners. The board of commissioners will theoretically influence internal mechanisms within the company. Based on the above explanation, this study suggests that the better CG implementation of a company will decrease CoE.

E. Influence Implementation International Financial Reporting Standards (IFRS)

Implementation of International Financial Reporting Standards (IFRS) will be used as a subset variable forming sample. This means that the researchers suspect there will be differences in influence between variables studied before and after the implementation of IFRS. This is driven by the IFRS development concept that seeks to reduce information asymmetry ([Ball, 2006], (Epstein & Mirza, 1999, Lee et al., 2010)). The decrease in information asymmetry is derived from improving the quality of information and more complete disclosure. Not only have an effect on information asymmetry, but IFRS implementation based on various empirical studies is also able to decrease the cost of equity (Daske et al., 2008; Li, 2010).

The separation of this subsample is also very much in line with the results of (Mohammadrezaei et al., 2015; Nunaimah et al., 2016) and (Turki et al., 2016) that there are significant differences in accounting practice in the areas studied in each of these studies. Due to the compatibility between these various empirical studies with the objective of IFRS implementation to reduce information asymmetry then this research will conduct the multigroup procedure to obtain empirical evidence that implementation IFRS gives a difference for the influence between the variables studied. This procedure will be performed for all pathways to and from the information asymmetry variable.

3. RESEARCH METHODS

Quantitative research is the research that is intended to express the symptoms in a holistic-contextual manner through the collection of data from the natural setting by using the researcher self as a key instrument. Quantitative research is descriptive and tends to use inductive approach analysis. Process and meaning are more highlighted in qualitative research. Quantitative research is more prominent in the form of a narrative that is creative and deep and shows the characteristics of naturalistic full of authentic values (Lutfi et al., 2016; Shohming et al., 2017; Muda et al., 2017, 2018). This study was conducted on manufacturing companies listed on the Indonesia Stock Exchange during the period of observation 2007 to 2016. The sample companies were selected as many as 65 companies with the number of observed financial statements of 650 10-year financial statements. The CoE measurements in this study will follow the approach that can be used is the Capital Asset Pricing Model (CAPM) (Sharpe, 1964) with the following formula:

$$\text{CoE} = \beta \times (R_m - R_f) + R_f$$

Where:
- \(\beta\): beta stock
- \(R_m\): market return
- \(R_f\): risk-free rate

The measurement of corporate governance in this study followed the research of Mazzotta & Veltri (2012) by making some modifications based on the input of several other studies. The focus of measurement is the internal mechanism of the company. Based
on these studies, it was stated that in the examination study of governance effectiveness of CoE empirically better by using CG attribute related to internal mechanism. Based on this, then compiled the following calculation steps:

1. The first dummy variable is the number of boards of commissioners. It is rated "1" if the total number of boards is greater than the median sample of the company during the study period and the value of "0" otherwise.
2. The second dummy variable is the number of boards of directors. It is rated "1" if the number of boards of directors is greater than the median sample of the company during the study period and rated "0" otherwise.
3. The third dummy variable is the number of independent board of commissioners. It is rated "1" if the number of independent board of commissioners is greater than the median sample of the company during the study period and rated "0" otherwise.
4. The fourth dummy variable is the proportion of independent board of commissioners. It is rated "1" if the proportion of independent commissioners is greater than the median sample of the company during the study period and is rated "0" otherwise.
5. The fifth dummy variable is the number of independent board of directors. Rated "1" if the number of independent board of directors is greater than the median sample of the company during the study period and assigned a value of "0" otherwise.
6. The sixth dummy variable is the proportion of the independent board of directors. It is rated "1" if the proportion of the independent board of directors is greater than the median sample of the company during the study period and rated "0" otherwise.
7. The seventh dummy variable is the number of committees brought by the board of commissioners. In general, the company has the following committees: audit committee, remuneration committee, and nomination committee. The value "1" is given if the number of committees held during the study period is greater than the median sample of the company, and is rated "0" otherwise.
8. The eighth dummy variable is the proportion of the number of committee members the board of commissioners declared independent. The value "1" will be assigned if the number of committees held by one company above the median value, and is rated zero otherwise.

The entire dummy value is then summed so that the minimum value is "0" and the maximum value is "8".

Hypothesis testing will be used with regression analysis whereas to see the effect of IFRS implementation will use regression analysis with dummy variable.

\[ CoE = \beta_0 + \beta_1CG + \beta_2IFRS + \beta_3CG\times IFRS \]

CoE: Cost of Equity
CG: Corporate Governance
IFRS: International Financial Reporting Standards Implementation

Period between 2012 to 2016 when IFRS has been implemented will be rated "1" while the period 2006 to 2011 when IFRS has not been implemented will be rated "0".

4. RESULTS AND DISCUSSION
there is a change in the relationship between CG and COE before and after IFRS implementation. Both of these are the goals and focus of the study. Based on the above results, it can be seen that the CG effect on COE increases the value of COE by 0.9%, this value is relatively small when compared to the increase in the value of CG by using the mechanism used in this study. Compared with descriptive analysis, it is true that the upward trend in CG values over time has decreased the value of COE. Nevertheless, these results have indicated that improving the implementation of CG in Indonesia needs to be improved in its analytical coverage because it has only been applied to a limited way so that the results are less reliable by the community.

6. CONCLUSION

Based on the results of data processing and discussion conducted in the previous section, it can be concluded that corporate governance (CG) reduces the cost of equity (COE). However, the allegation that the implementation of International Financial Reporting Standard (IFRS) will increase CG's influence on COE cannot be proven so far. That is to say that IFRS implementation cannot reduce the COE of manufacturing companies in Indonesia.

References


