Effect of corporate governance on cost of equity before and after international financial reporting standard implementation

Chandra, Situmeang and Erlina, Erlina and Maksum, Azhar and Supriana, Tavi

Universitas Sumatera Utara, Medan, Indonesia

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

Chandra Situmeang [1], Erlina [2], Azhar Maksum [3] & Tavi Supriana [4]
[1)] Doctoral Programme School of Economic and Business, Universitas Sumatera Utara, Medan, Indonesia.
[2,3,4)] Faculty of Economics and Business, Universitas Sumatera Utara, Medan, Indonesia
[1]Correspondence email: chandrasitumeang@gmail.com

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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 focuses 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 suspected 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 as 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: *D53, E44, F34, 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. In this perspective, the company will strive to achieve relatively low production costs, so that the company can implement various strategies based on price advantage. 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 hereinafter 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 users of the report 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 2008 and implemented International Financial Reporting Standard (IFRS) in 2012. Turki, Wali, & Boujelbene (2016) research who sampled companies in Europe concluded that IFRS implementation has been able reduce asymmetry information 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 management and others have the same relative information quality. As a consequence that the financial statements which area summary of management performance prepared by management then in the process of preparation is vulnerable to arise conflict of interest. In an effort to minimize the negative impact of the 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, 2006; Bhojraj & Sengupta, 2003; Patro & Kanagaraj, 2016; Piot & Missonier-Piera, 2010; Strobl, 2013). In contrast, some other studies like Mc Innis (2010) and Juniarti & Natalia (2012) study conducted in Indonesia do not support the conclusion that a good corporate CG increase will decrease CoC. 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 increase 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 measurements 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 (1993) as a refinement of CAPM, residual Income Valuation Model Developed by Gebhardt, Lee, & Swaminathan (2001), Claus & Thomas Method (CT) built by Claus & Thomas (2001), Value Line Model developed by Brav, Lehavy, & Michaely (2005), Price Earning Growth (PEG) Model developed by Easton & Monahan (2005), Gode & Mohanram Method (GM) developed by Gode & Mohanram (2003) and Modified Ohlson & Juettner-Nauroth Method (OJ) developed by Ohlson & 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 contained various indicators to assess the quality of corporate CG. Zitouni (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 tools, laws, market mechanisms, record standards, referral practices and efforts of all parties within the company. Boards of directors, auditors, consultants law, financial advisors, and other parties will safeguarding interests and increasing shareholder wealth while protecting the interests of other stakeholders.

The protection of the owner's interests is the problem discussed in agency theory. Conflicts of interest that occur between managers and shareholders allegedly have created many problems within the company. Various studies have concluded that many crises are not only triggered by economic or financial problems but also management issues (Segrestin & Hatchuel, 2011; Zollo & Freeman, 2010). As explained in agency theory, the problem is triggered because managers often make decisions that do not fully lead to an increase in owner wealth. One way to minimize the negative impact is by implementing good corporate governance.

Academics believe that good CG increases the likelihood of executing control mechanisms over management so that managers are expected to make decisions to achieve the same goals as those of the company owner. Correct CG activities will create accountability, improve the reliability of financial information, and strengthen the effectiveness of the capital market, thereby increasing investor confidence in making decisions (Gompers, Ishii, & Metrick, 2003). CG can be seen as a very important instrument not only in the viewpoint of protecting existing owners but also to encourage the creation of reliable information for the use of various other parties including prospective owners to make decisions on their funds.

As a result of a large number of internal and external factors affecting good Corporate Governance (CG) practices, the CG size varies widely between countries, so it is not possible to produce a common definition and measurement tool (Zuckweiler, Rosacker, & Hayes, 2016). In the framework of research objectives in the field of CG study, measurement of the quality of CG implementation becomes a very important thing. In general, measurements can be divided into two types: measurements using a single indicator or a combination of several CG indicators as described above and using a checklist of a series of indicators derived from those aspect aspects.

In addition to using the above approach, there is also an approach using multiple single measures that are integrated into a measurement index of corporate governance practices. Mazzotta & Veltri (2012) uses the number of boards of directors, the number of committees under the board of commissioners, the number of independent directors, and the number of independent committee members to form the CG corporate quality measurement variables.

C. Implementation of International Financial Reporting Standard (IFRS)

The development of a business that leads to globalization has pushed the need for reporting standards so that the financial statements generated by the company can be understood globally. The issue of standardization is a major concern that encourages accounting stakeholders to seek a breakthrough to achieve that goal. After attempting various mechanisms, adoption and harmonization of International Financial Reporting Standards (IFRS) became the way forward to encourage the standardization of financial statements.

Gatsios (Confetti Gatsios, Marcos Da Silva, Jose Ambrozini, Assaf Neto, & Guasti Lima, 2016) states that IFRS is a set of accounting standards issued by the International Accounting Standards Board (IASB). IFRS aims to produce a high quality typical model for international accounting standards to provide information to users of financial statements. Ball (Ball, 2006) states clearly that the presentation of financial statements based on IFRS will make the financial statements more reliable by investors because it is easy to understand so as to reduce information asymmetry. Lee (Lee, Walker, Christensen, & Zhao, 2010) expressed a similar opinion that international standards will

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 cash 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 factors that can reduce information asymmetry, thus lowering the cost of equity. Mohammadrezaei (Mohammadrezaei, Mohd-Saleh, & Banimahd, 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, Lin, & Lin, 2014; Lima & Sanvicente, 2013; Mazzotta & Veltri, 2012; Ramly, 2012; Wu & Lee, 2014) in general result that good CG practice will decrease the company's CoE. Research Huang, Dao, & Fornaro (2016) also explains 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 Standard (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 sub-sample is also very much in line with the results of (Mohammadrezaei et al., 2015; Nurzaimah *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; Sihombing *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:

$$CoE = R_f + \beta(R_m - R_f)$$

Rf: risk free rate
Rm: market return
β: beta saham

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 is greater than the median value, and is assigned a value of "0" otherwise.
8. The eighth dummy variable is the proportion of the number of committee members under the board of commissioners declared independent. The value "1" will be assigned if the number of committees held by one company is 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.

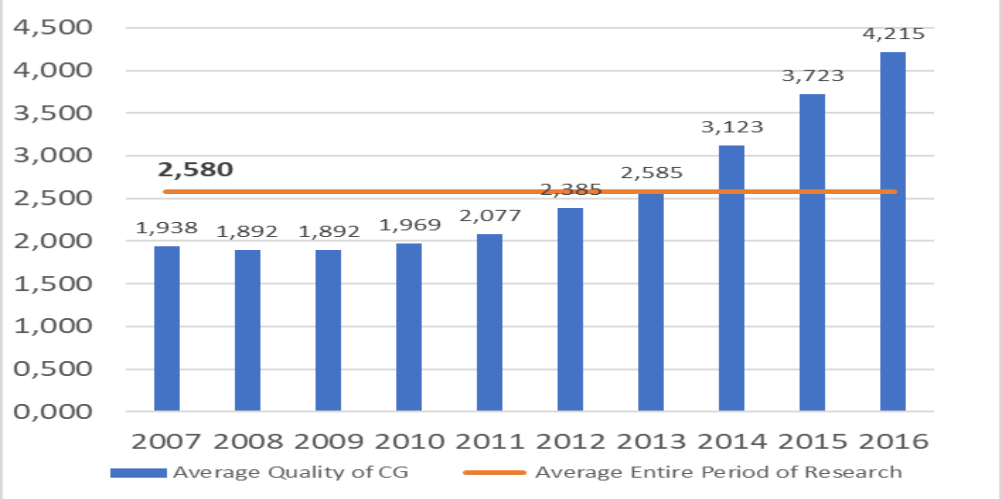
$$CoE = \alpha_1 + \alpha_2 CG + \alpha_3 IFRS + \alpha 4 CGxIFRS$$

CoE: Cost of Equity
CG: Corporate Governance
IFRS: Internasional Finansial Reporting Standar 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”

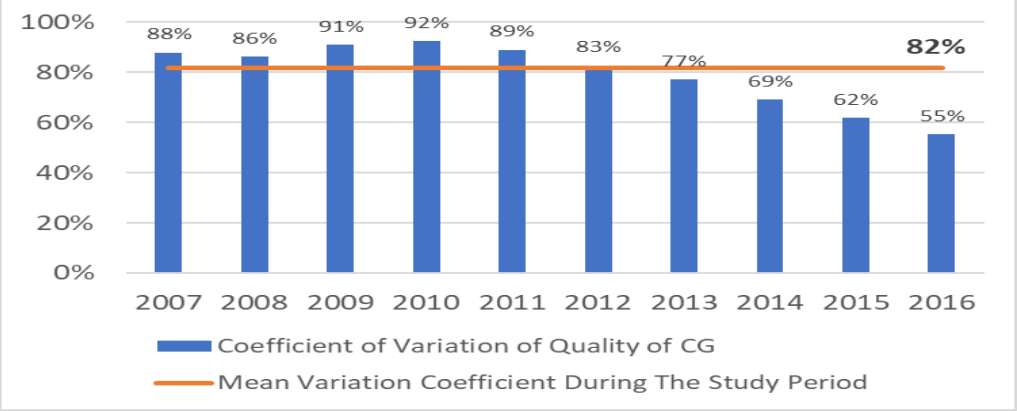
4. RESULTS AND DISCUSION

The first descriptive analysis of the accumulated data supports the allegation that there are very varied funding characteristics between one company and another. This condition certainly makes the competitiveness between companies tend to be very varied. Based on Figure 3, we get some other features. CoE movement does not fully describe or conform to the risk-free interest rate seen from the BI rate chart pattern. Other results also show that the value of Premium Risk which is the difference between CoE and risk free interest rate is not always the same between years. If further analyzed, the data indicate that in the CoE determination, the risk of a riskable country's economy with a risk-free rate is not a single measure that affects but is also influenced by market risks attached to specific risky investments such as stocks. Furthermore, descriptive analysis of the data has been obtained. The descriptive statistics contained in figure 1 and figure 2 show a trend indicating that there has been an increase in CG implementation. It is quite logical because the various CG attributes that were originally voluntary changed into mandatory so that the company must fulfill that aspect. On the other hand, the coefficient of CG variation is quite large which means that the quality of CG implementations between firms tends to vary. However, the trend of the variation coefficient value as shown in graph 5.5 has decreased so there is a suspicion that the implementation process of IFRS encourages the standardization of governance. This will then be elaborated in path analysis testing and multigroup analysis.826/5000



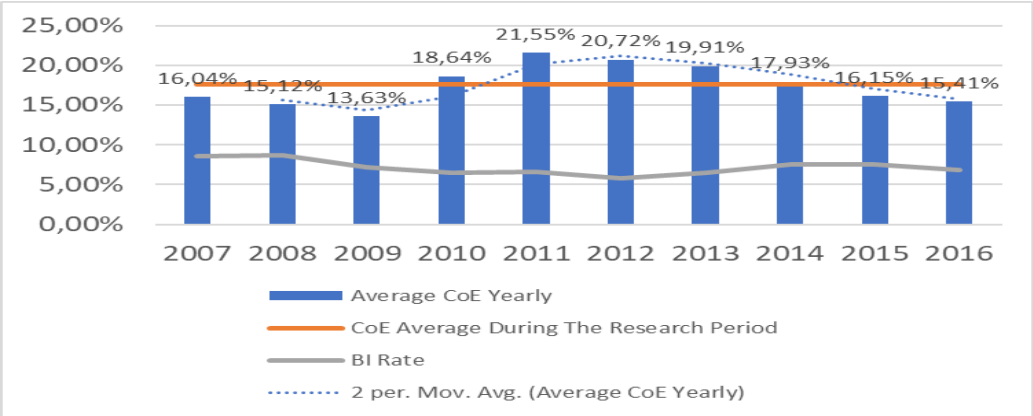
Source: Data Analysis Results

FIGURE 1. AVERAGE CORPORATE GOVERNANCE (CG)



Source: Data Analysis Results

FIGURE 2. COEFFICIENT OF VARIATION OF QUALITY OF CG



Source: Data Analysis Results

FIGURE 3. COE AVERAGE YEAR VERSUS RISK-FREE INTEREST RATE (BI RATE)

Other analysis result obtained from descriptive analysis is even though trend line formed still looks like movement of cycle down and up, but in research period seen down trend. This is in line with national economic policies that seek to reduce the cost of funds used by the company. The decline in the cost of funds is one of the efforts to improve the competitiveness of national companies especially in the era of globalization where companies compete openly with companies from abroad. Another thing to note from the above descriptive analysis is to compare between the risk free data of each year contained in figure 3 with the average return market. The difference between risk free and market return ranges from 6% to 17%. This difference is a description of the excess return desired by investors as compensation for the risk borne by investing in risky securities. After testing the data based on the methodology described earlier, results are obtained as shown in table 1.

TABLE 1 RESULTS SUMMARY

Description	Item	Value	Sig
Model Summary	R^2	0.034	
Anova	F	8,724	0.000
Coeficient (Unstandardized Coefficients)	Contant	0,147	0.000
	CG	0,009	0,001
	IFRS	0.024	0,035
	CG*IFRS	-0.004	0,223

5. DISCUSSION

In general, the regression model tested in this study has a very low coefficient of determination of 3.4%. The coefficient of determination of that indicates that the independent variable of Corporate Governance (CG) does not contribute significantly in the formation of Cost of Equity (CoE). Nevertheless, the results of the ANOVA test indicate that the proposed model is significant enough to explain the formation of CoE. In general, the value of determination coefficient in capital market research, especially using only one free variable is relatively low. This is because the factors that influence the formation of a variable in the capital market involve many other variables.

The focus of this study is not to obtain a large coefficient of determination but to test whether CG influences the CoE. In addition, the focus of the study is to review whether

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 can be seen pahwa CG effect on CoE because p value of CG coefficient of 0.001. However, the effect is contrary to the theory because it should be when the value of CG has increased the value of CoE will decrease. Indeed, if analyzed from the increase of 0.9%, this value is relatively small when compared to increase and decrease the value of one unit of CG by using the mechanism used in this study. Compared with descriptive analysis, it is true that the upward trend in CG increments throughout the study period does not have the same trend with fluctuating COE values over time. In testing whether the IFRS implementation of changing the relationship between CG and CoE can be analyzed by looking at the significance values of IFRS and CGxIFRS variables. If the coefficients of these two variables are significant, it can be concluded that the IFRS implementation has changed the CG relationship to CoE. But in this study based on the results of data processing shown in table 1 shows that only IFRS variable coefficients that proved significant while the CGxIFRS variable coefficient not proved significant. Then the conclusion that can be drawn is that the implementation of IFRS has no effect on CG relationship to CoE. This result needs further elaboration to find whether there are other variables that moderate the relationship between the two variables. This is the focus of further research in this study.

Nevertheless, these results have indicated that improving the implementation of CG especially in the period after IFRS implementation does not directly impact the CoE decline. This is probably due to the increase in the value of CG due to the fulfillment of the normative aspects of the CG gauge but basically the substantive aspect of the CG implementation is not actually achieved. This has prompted the need for the various stakeholders who formulate CG implementation policies to pay more attention.

Related to that, there are some recommendations that can be given. First, professional associations need to encourage an audit process that is capable of reviewing whether CG is effectively implemented. Assessment should not be focused on the normative aspect only. Auditors can provide a complete review of CG implementation on a company. Another thing that can be done is a joint effort in order to have an independent agency that routinely evaluates the entire CG enterprise implementation completely. This Corporate Governance Perception Index (CGPI) which has already started to be known in Indonesia needs to be improved in its analytical coverage because it has only been evaluating some companies in 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 can be concluded that Corporate Governance (CG) effect on 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 that it can be concluded that IFRS implementation cannot reduce the CoE of manufacturing companies in Indonesia.

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