

The Effect of Corporate Governance Mechanism on Cost of Equity Capital

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Abstract—This study aims to examine the effect of corporate governance mechanisms on cost of equity capital with earnings quality as a mediating variable. The corporate governance mechanism is affected by the composition of independent commissioners and the size of the audit committee. This study adds a control variable in the form of intellectual capital disclosure and information asymmetry. The population in this study were manufacturing companies listed on the Indonesia Stock Exchange in 2017. The research samples were selected using the purposive sampling method with criteria used based on judgment sampling and obtained 91 companies that met the research criteria. The analytical method used is path analysis. The results showed that the composition of independent commissioners and the size of the audit committee had a positive effect on earnings quality. This is because the composition of independent commissioners and the size of the audit committee have a role in carrying out the supervisory function of management performance in producing company financial statements, especially company profits. However, the composition of independent commissioners and the size of the audit committee does not directly affect the cost of equity capital. This is due to the performance of the composition of independent commissioners and the size of the audit committee unable to guarantee management performance in reducing the cost of equity capital. In this study the level of the company's cost of equity capital is influenced by the quality of earnings. Earnings quality successfully mediates in full the influence of the composition of independent commissioners and the size of the audit committee on the cost of equity capital. The results of the study of the control variables of intellectual capital disclosure and information asymmetry have a positive effect on the cost of equity capital.

Keywords—*component, corporate governance, equity capital, intellectual capital*

I. INTRODUCTION

Activities in the capital market, companies must consider fundamental issues regarding the company's financial statements. Financial statements are company financial information that describes the performance of a company in a certain period used to make economic decisions in business. In accordance with SFAC No. 8 financial information must be able to help investors and creditors in making decisions about providing resources for these entities.

The level of risk considered by the company depends on how well and the amount of information reported by the company. Good information will cause a lower cost of equity capital due to good alignment between corporate investment opportunities and investment choices [1]. The harmony of

information from companies and investors can increase the number of investors because the level of investor confidence in the company is very high. According to Merton [2] explains that increasing the number of investors can reduce the cost of equity capital. According to [3] the motivation of companies trying to reduce the cost of equity capital is to increase company value and investor wealth. So, managers are faced with the importance of cost of equity capital. Cost of equity capital arising from funding decisions is a consequence that directly arises from decisions made by managers [4] state that the cost of equity capital represents the rate of return expected by investors and will be a reference in determining term investment decisions. their length. In addition, the cost of equity capital is able to determine the value of the company's current shares. This study focuses on the cost of equity capital of the company. In this study the cost of equity capital will be influenced by corporate governance mechanisms with earnings quality as a mediating variable. Corporate governance mechanisms are proxied by independent commissioners and audit committees.

Both are part of management control tools to bridge the conflict of interest between principals and agents so that management presents information that is in accordance with stakeholder needs so as to improve the quality of earnings and reduce the level of cost of equity capital issued by the company. In addition, according to [5] independent commissioners are those who oversee corporate governance carried out by management. Meanwhile, the audit committee is the party responsible for the board of commissioners in terms of controlling corporate governance. The importance of independent commissioners and audit committees as management control tools is based on agency theory. This is because according to [6] when agency problems occur will cause information gaps caused by personal interests between the agent and the principal. According to [7] through the role of the board of commissioners and the company's audit committee in financial reporting will limit management fraud through earnings management. Through these variables prove that independent commissioners and audit committees have a role in earnings management and control management's opportunistic attitude so as to improve the quality of earnings. Likewise with the opinion of [8] that corporate governance mechanisms can improve the quality of earnings which ultimately lowers the company's cost of capital. This is because, the quality of earnings is one of the information in investment decision making that is able to show the level of stock returns and the rate of cost of equity capital [9]. Therefore, through the corporate governance mechanism management opportunist actions to maximize

their interests and result in low quality of earnings can be reduced so that it can reduce the cost of equity capital.

II. RESEARCH OF PROBLEMS

This study focuses on the issue of reducing the company's cost of equity capital because it is a cost that must be borne by the company in financing activities. In this study replication of previous studies was carried out regarding factors that influence the decrease in cost of equity capital. One of the factors that influence the cost of equity capital is the role of corporate governance mechanisms. The importance of corporate corporate governance mechanisms is one of the most important parts that affect the cost of capital. This is because, corporate governance mechanisms have a role in increasing the level of investor confidence so as to reduce the cost of equity capital. In this study the influence of corporate governance mechanisms on cost of equity capital will be mediated by the quality of earnings. From the description, the researcher formulated the research question as follows: 1. Does the corporate governance mechanism affect the quality of earnings? 2. Does the corporate governance mechanism affect the cost of equity capital? 3. Does the quality of earnings affect the cost of equity capital? 1.4 Research Objectives The research objectives to be achieved in this study are: 1. To test and analyze the influence of corporate governance mechanisms affect the quality of earnings 2. To test and analyze the influence of corporate governance mechanisms affect the cost of equity capital 3. To test and analyze the influence quality of earnings affects the cost of equity capital.

III. RESEARCH METHODS

This study aims to examine the effect of corporate governance mechanisms on cost of equity capital with earnings quality as a mediating variable. Based on the purpose of the study, this study uses a quantitative approach (positivism) and includes types of explanatory research. Explanatory research is a study that examines causality relationships between research variables formed from the structure of the theory and through testing hypotheses in explaining causality [10]. Therefore, the position of the variables used and the influence between these variables will be explained through hypothesis testing.

A. Population and Sample

Population namely a group of people, events, or everything that has certain characteristics [11]. The time dimension used in this study involves one particular time with many samples (cross sectional). Therefore, the population used in this study is a manufacturing company that was listed on the Indonesia Stock Exchange (IDX) in 2017. Manufacturing companies were chosen as the population because it is the largest sector in the Indonesia Stock Exchange and a company that is developing very rapidly in innovating and creativity. to meet global competition [12] The 2017 period was chosen because it is actual data, describes the latest capital market conditions, and the company has effectively implemented IFRS in financial reporting compared to previous years. In addition, 2017 is the actual data on the company's stock price and the systematic risk level of the company's portfolio. The sample is the selection of a number of certain items from all items

that exist with the aim of studying some of these items to represent all the items. The sampling process must be able to produce accurate and precise samples [13]. In this study the sampling method was non-probability, namely in the form of purposive sampling. Purposive sampling is done by taking samples from the population based on certain criteria. Criteria used based on judgment sampling, namely purposive sampling with criteria in the form of certain considerations [14].

Data used in this study are secondary data. Secondary data is a source of research data obtained by researchers indirectly through intermediary media (obtained and recorded by others), such as evidence, records or historical reports that have been compiled in published and unpublished archives Secondary data used in this study are published documentary data, namely the annual report of manufacturing companies listed on the Indonesia Stock Exchange in 2017. The annual report chosen in this study is because financial statements are an important source of information for external parties such as stakeholders, and the level of disclosure in annual reports positively correlate with the amount of information communicated, both to the capital market and stakeholders using other media [15].

B. Dependent Variable

Reasons for using CAPM as a proxy for cost of equity capital because the CAPM method can explain and provide precise predictions about the balance relationship between the level of risk systematic with the rate of return expected by investors on an asset [16] Use of the inner CAPM approach this study refers to the research of [17], [18]. The CAPM formula can be written as follows:

$$COEC = R_{ft} + \beta_i (R_{mt} - R_{ft}) \quad (1)$$

R_{ft} : Risk-free return that is proxied by the interest rate 1 Month Bank Certificate (SBI)

R_{mt} : Stock market returns obtained from a joint stock price index (CSPI) on day t plus CSPI on day t-1 divided by JCI on day t-1

β_i : Non-systematic risk for each company stock i

Beta (β) is a systematic risk of a security or portfolio relative to market risk. Beta measurements in research are measured by use regression as follows:

$$R_{it} = \alpha + \beta_i R_{mt} + \epsilon_{it} \quad (2)$$

Information:

R_{it} : The company's monthly return i in the estimated period t, which is calculated with the formula:

$$R_{it} = (P_{it} - P_{it-1}) / P_{it}$$

P_{it} : Stock closing price at the end of the month t.

P_{it-1} : Stock closing price on the last day of the month t-1

R_{mt} : Stock return obtained from a joint stock price index (CSPI) on day t-1 divided by IHSG on day t-1

C. Independent Variables

Independent variables in this study are corporate mechanisms governance which consists of the composition of independent commissioners and audit committees. The corporate governance mechanism functions as a problem

controller agency that occurs due to a conflict of interest between the principal and agent. When companies have strong corporate governance mechanism will reduce the level cost of equity capital of the company. This is because of the mechanism Strong corporate governance can reduce the risk of agency problems and moral hazard caused by information asymmetry. As for proxy explanations, the corporate governance mechanisms used in this study are:

1) *Composition of Independent Commissioners:* An independent commissioner is a commissioner from a non-party affiliated Composition of independent commissioners in this research is calculated from the percentage comparison between the number of commissioners independent with the total board of commissioners.

2) *Audit Committee:* The audit committee is a committee formed by the board of commissioners for carry out the supervisory function of the company's performance. Internal Audit Committee this research was measured based on the number of audit committee members owned company. The number of audit committee members can basically be adjusted with the condition of the company with regard to company size and function and responsibilities imposed on the audit committee.

However, based on the Decree of the Chairperson of BAPEPAM No. Kep29 / PM / 2004 Regulation Number IX.I.5 dated December 24, 2004 regulates about the establishment of an audit committee, namely the audit committee membership namely at least consists of 3 members, one of them is an independent issuer commissioner who concurrently doubles as the chairman of the audit committee, while the other members are from outside the issuer at least one of them has the ability in accounting or finance. The audit committee measurement in this study is based on research.

D. Mediation Variables

The mediating variable in this study is the quality of earnings. Quality of earnings is one indicator of the quality of the company's financial statements have the ability to reflect profit truth and help predict future profits, taking into account stability and earnings persistence .Very high quality earnings expected by users of financial statements for decision making investation. The measurement of earnings quality in this study is proxied by quality of income.

E. Control Variables

Control variables are used to complement or control relationships the causal is better to get a more complete empirical model and better. This control variable is not the main variable that will be researched and tested but more on other variables that have an effect of influence In this study the control variables used are intellectual capital disclosure and information asymmetry. Disclosure intellectual capital and information asymmetry are expected to control the corporation governance so that it is not influenced by other variables. This is due to the increasing level of intellectual capital disclosure and increasingly the low asymmetry of company information shows that implementation Corporate corporate governance is effective and produces reports quality finance.

F. Intellectual Capital Disclosure

Intellectual capital disclosure in this study will be analyzed using content analysis. Content analysis is done in a way read the annual report for each sample company then provide the code for every information contained in it according to the indicator framework determined intellectual capital. The intellectual capital indicator includes three categories, namely internal organizational capital; external structure (customer/ relational capital); and employee competence (human capital). Items used in the indicator intellectual capital disclosure consists of 25 sub indicators (9 sub indicators about internal capital, 10 sub indicators about external capital, and 6 sub indicator of human capital). The sub-sub indicators can be seen in Table I.

TABLE I. INDICATOR OF INTELLECTUAL CAPITAL

Internal Capital	External Capital	Employee Competence
Intellectual Property	1. Brand	1. know-how 2. Education 3. Vocational qualification 4. Work-relaed knowledge 5. Work-related competence 6. Entrepreneurial spirit
1. Patens	2. Customers	
2. Copyrights	3. Customers loyalty	
3. Trademark	4. Company names	
Infrastructure asset	5. Distribution	
4. management philosophy	6. Business Collaboration	
5. Corporate culture	7. Favorable Contracts	
6. Information systems	8. Lisensing agreements	
7. Management processess	9. Financial contacts	
8. Networking systems	10. Franchising Agreement	
9. Research Project		

IV. ANALYSIS OF RESULT

The procedure for determining non probability sample using sampling method, in the form of purposive sampling with criteria used as shown in Table II.

TABLE II. RESEARCH SAMPLING PROCEDURES

Sampel	Amount
Manufacture company	134
Manufacture company not publication	(8)
Manufacture company not rupiah	(24)
Manufacture company not include variable	(11)
Amount	91

The data will analyzed using descriptive statistics, path analysis assumptions and requirements, and hypothesis testing. The explanation is as follows:

A. Descriptive Statistics

Descriptive statistical analysis describes phenomena or characteristics data. The description or description of a data can be seen from the average value (mean), standard deviation, maximum variance, and minimum of the research variable. The results of the descriptive analysis of the research variables are presented in Table III as follows:

TABLE III. DESCRIPTIVE STATISTIC

	N	Min	Maks	Rate	Std. Dev
COEC (Y)	91	-5.9391	15.8360	5.7913	5.1833
Earning Quality (Z)	91	-3.0046	3.7855	0.5219	1.2971
Independent Commissioner (X1)	91	0.2500	1.0000	0.3911	0.1107
Commit Audit (X2)	91	2.0000	5.0000	3.1098	0.5044
PIC (X3)	91	0.1379	0.8276	0.3865	0.1836
SPREAD (X4)	91	0.0029	5.0397	2.6169	1.3272
Valid N (listwise)	91				

B. Hypothesis Testing

In testing the hypothesis the direct influence will do the testing the influence of independent commissioner composition (KKI) and committee size variables audit (UKA) on the Quality of Profit (KL), the effect of Quality of earnings, composition independent commissioner, size of the audit committee on COEC, and influence variable controls intellectual capital disclosure and information asymmetry against COEC. The output of hypothesis testing results can be seen in Table IV.

TABLE IV. HYPOTHESIS OUTPUT

Hypothesis	Std. Dir. eff	C.R	P-value	P. value
H1a	0.298	2.946	0.003	H accepted
H1b	0.217	2.144	0.032	H accepted
H2a	-0.040	-0.406	0.685	H refused
H2 b	0.090	0.936	0.349	H refused
H3	-0.378	-3.710	***	H accepted

Based on the Table IV the results of hypothesis testing are obtained directly. The explanation of each hypothesis is as follows:

1) *Influence of Independent Commissioners on Profit Quality:* The first hypothesis testing states that the corporate mechanism governance with an independent proxy has a positive effect on the quality of company profits. Based on the test results show that the value p-value of 0.003 (smaller than 0.05). Thus, hypothesis first received. This shows that the higher the level of composition an independent commissioner owned by a company hence the quality of earnings owned will increase. This result is in line with agency theory, which states that Independent commissioner is one of the media to bridge it there is a conflict of interest between the agent and the principal, which is a conflict This can lead to the opportunistic nature of management so that the quality of earnings to be low.

2) *Influence of the Audit Committee on Profit Quality:* The second hypothesis testing states that the corporate mechanism governance with the audit committee proxy has a positive effect on quality profit. Based on the results of testing the path analysis shows the p-value of 0.032 (less

than 0.05), so that it can be concluded that the greater the size of the company's audit committee, the quality of earnings the higher the yield. Thus, the results of this study were successful support the second hypothesis. The results of this study are supported by [16] states that the audit committee influences the quality of earnings because has a role in management supervision and can control management opportunist actions in carrying out earnings management actions so that it can improve earnings quality.

3) *The effect of Independent Commissioners on Cost of Equity Capital:* The second hypothesis testing states that the corporate mechanism governance with an independent proxy has a negative effect on cost of equity capital. Based on the test results the regression analysis shows p-value of 0.685 (greater than 0.05) so that it can be concluded that the participation of the company's independent commissioners has no effect to the level of cost of equity capital that the company will spend in investment financing activities. Thus, the third hypothesis can be declared to be rejected. The results of this study doesn't match with statement that the active role of the commissioner can independently reduce the risk of investors and potential investors and risk this can be reflected in the low level of cost of equity capital of the company [7]. However, the results of this study are consistent with the results of the study conducted by [8] states that the commissioner independent does not affect the cost of equity capital.

4) *The influence of the Audit Committee on Cost of Equity Capital:* The second hypothesis testing (b) states that the corporate mechanism governance with the audit committee proxy has a negative effect on the cost of equity capital. Based on the results of testing the regression analysis shows the value of p value of 0.389 (greater than 0.05) so that it can be concluded that no matter how many audit committees the company has had influence to the level of cost of equity capital that the company will spend in investment financing activities. Thus, the hypothesis when it can declare to be rejected. This result does not support the statement of [7] which states that with the active role of the audit committee, the financial statements will be trusted thereby increasing the demand for securities and prices the company's stock market, which in turn can reduce the cost of equity capital.

5) *Effect of Earnings Quality on Cost of Equity Capital:* The third hypothesis testing states that earnings quality influences negative to the cost of equity capital. Based on the results of analytical testing The regression shows a p-value of 0,000 (smaller than 0.05) and with a negative direction so that it can be concluded that the higher the level the quality of the company's earnings then the level of cost of equity capital the company will drop. Thus, the third hypothesis can be stated for be accepted.

The results of this study are consistent with the results of [8], who prove that earnings quality has a negative influence on the cost of equity capital. This is indicated that companies that have poor earnings quality will have a cost of high

equity capital compared to companies that have earnings quality the good one.

V. CONCLUSION

This study aims to examine the effect of corporate mechanisms governance that is proxied with independent commissioners and audit committees to the cost of equity capital by testing the effect of earnings quality as mediating variable. Based on the results of research and discussions conducted in the previous chapter, it can be concluded that the level of cost of equity the capital of manufacturing companies in Indonesia is not proven to be affected by corporate governance mechanism. However, the cost of equity capital is proven influenced by the quality of earnings.

The results of the study show that the cost of equity capital is not affected directly by the corporate governance mechanism both by composition independent commissioner and size of the audit committee. The results of this study are not can prove the existing theory that corporate governance mechanisms has a role in the supervisory function so as to produce a cost of equity low capital. Through the results of this study indicate that the composition of independent commissioners and the size of the audit committee cannot guarantee company management performance as a consideration in determining return on investment through the level of cost of equity capital.

The results showed that the level of cost of equity capital the company is influenced by the quality of earnings. The higher the level of quality of earnings company, the level of cost of equity capital of the company will tend down. In addition, the importance of quality earnings for companies can indicates that management acts in accordance with interests stakeholders so that they can be used as determinants of returns from investment activities.

The results also show that the cost of equity capital is affected by the control variables used in this study, namely first, the cost of equity capital is positively influenced by intellectual capital disclosure. The results of this study indicate that the disclosure is getting higher The company's intellectual capital will increase the level of cost of equity capital. Likewise with the results of the second control variable research, namely the cost of equity capital is influenced by information asymmetry. The lower the level the information asymmetry conveyed by the company will reduce the cost of company equity capital.

The results showed that the cost of equity capital was more dominant influenced by the composition of independent commissioners through earnings quality, i.e. with the total effect of -0.153 compared to size Audit committee through smaller earnings quality, that is by the amount of influence a total of 0.008. The results of this study indicate the quality of earnings mediating full influence of the composition of independent commissioners and the size of the audit committee against the cost of equity capital.

In this study successfully proved the importance of cost of equity capital for companies and investors in decision-making actions as well knowing the rate of return on investment activities. Therefore, through this study can contribute to considering factors which affects the level of the company's cost of equity capital in investment activities.

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