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The Effect of risk disclosure on the cost of equity and firm

20**value (an Empirical study** of **manufacturing companies listed on the Indonesia Stock Exchange period**

2015-2017) Eka Sri Sumardani, Rr Sri Handayani Universitas Diponegoro Semarang, Central Java, Indonesia ABSTRACT

15**This Study examines the effect of corporate** risk disclosure **on**

cost of equity capital and firm value. It uses the ratio of market value to book value, the ratio of leverage, consumer price index, growth, firm size, independent audit committee and net profit during the study period and net

17**profit in the previous year** as control variable. **The**

population consists of all

14**manufacturing companies listed on the Indonesia Stock Exchange for period 2015 – 2017. The sample was** taken using a **purposive sampling** method, with total sample of 99 firms-years. The data were analysed using multiple regression analysis to the test the hypothesis. The results indicate that corporate risk disclosure has negative effect on the cost of equity capital and corporate risk disclosure has positive effect on firm value ABSTRAK Penelitian ini menguji pengaruh pengungkapan risiko perusahaan terhadap biaya modal ekuitas dan nilai perusahaan. Penelitian ini menggunakan rasio nilai pasar ekuitas terhadap nilai buku ekuitas, leverage, indeks harga konsumen, pertumbuhan perusahaan, besaran perusahaan, komite audit independen, laba tahun berjalan periode penelitian dan laba tahun berjalan periode tahun sebelumnya sebagai variable kontrol. Populasi penelitian ini terdiri dari seluruh

6**perusahaan manufaktur yang terdaftar di Bursa Efek Indonesia periode 2015 – 2017. Sampel** diambil **dengan** menggunakan metode **purposive sampling,**

yang terdiri dari 99 perusahaan. Data dianalisis menggunakan regresi berganda untuk pengujian hipotesis. Hasilnya menunjukkan bahwa pengungkapan risiko perusahaan berpengaruh nrgatif terhadap biaya modal ekuitas tetapi pengungkapan risiko perusahaan berpengaruh positif terhadap nilai perusahaan. 1. INTRODUCTION Every company needs funds to carry its business activities. The company obtains their fund from equity and debt. Yet, the capital and debt acquisition will lead to a capital cost. If the company gets their capital from equity, it will lead to a cost of equity, while if the comoany gets the capital from debt, it will result in a cost of debt. According to Ifonie (2012), the cost of equity capital is how much the return targeted by investors and creditors. The cost of equity capital is an important factor in deciding the right financial structure (Dhaliwal et al., 2011). In addition, Utami in Ningsih and Ariani (2016), stated that the cost of equity capital is the amount of rate used by investors to discount the expected dividends in the future. The cost of equity capital also deals with investment risk from the stocks of the entity. One of the factor affecting the cost of equity capital is the existence of unbalanced information. Unbalanced information is the existence of unequal information between the manager and principal, or the organizer or manager knows more

24**information about the condition of the company than the principal** does. This makes **the**

manager obliged to convey a signal through disclosure of accounting information

4**about the condition of the company to the owner**

or stockholders. Firms value (FV) is very important because with a high firm value, the company also have a high level of shareholder prosperity. A stock price has a relationship with the investors' perceptions about the level of a company's success or known as firm value. A high stock value will lead to an increase in the firm value and the market confidence toward the company's performance in the future. Investor who have more extensive information and more confidence in the company can judge more accurately about the company's value than the investors who have little information. Miihkinen (2013) found that disclosure can reduce information asymmetry, and low information asymmetry is usually found to be associated with higher firm value (FV) (Maizatulakma et. Al., 2015). Therefore, a company manager has a duty to manage the risk is his company because the uncertainty or risk will always has a relationship with the company's activities. Risk always comes up whenever and wherever. Risk is the possibility of loss with indicates an uncertainty condition. Therefore, the company should manage the risk in order they can minimize losses. Every company always deals with business risk and non-business risk. Business risk is the risk that can not be controlled by the company. There are many ways that companies do to avoid the risk that occur, that is. By applying

16**risk management. Risk management is a structured approach or methodology in managing uncertainty related to**

threats, including assessing the risks, developing strategy to manage them, and mitigating risks using resource empowerment or management. Risk management must be adequate so that they can manage the risk carefully and make appropriate decision making. Requests by stockholders or investors for more transparent disclosures make companies expand their relevant financial and non-financial information. Since 2000, the companies have done in many ways have, especially the financial industry, to implement risk management. For example, in 2010, the Securities and Exchange Commission (SEC) socialized new regulations to increase risk disclosure including annual disclosure and reports. Recognizing that the information on risk disclosure is important, the Indonesia regulatory body made regulations that require companies to disclose information about risks in their annual reports. There are several regulations regarding risk disclosure, one of which is stated in the

3**Decree of the Chairman of Capital Market and Financial Supervisory Agency** (BAPEPAM- LK) **Number: Kep- 431/BL/ 2012 concerning Submission of Annual Reports** by **Issuers or Public Companies.** The regulation **states that** each company **must**

disclose information about overall risk management system, the manner or type of company risk management and

1**review of the effectiveness of** the risk management **system**

conducted by the company. The aims of this research are to understand risk disclosure, researchers should also know find evidence in some researches so that they can discuss more profoundly. However, there still very few studies that discuss the disclosure of risks related to the cost of equity capital and firms value. The result of research on the relationship between voluntary disclosure

12**and the cost of equity capital** shows **that** when **the** level **of** risk **disclosure**

is high, the company will reduce the

2**cost of equity capital (Botosan, 1997).**

Previous studies also found that the main factor that has a role in uncertainty in the current business environment is non-financial risk. However, information about non-financial risks is still less than information about financial risk (Lajili and Zeghal, 2010). The lack of information about non-financial risks can mislead investors in decision making. Miihkinen (2013) found that the disclosure of non-financial risk can reduce information asymmetry, and low information asymmetry is usually associated with higher company value (Maizatulakma et. Al., 2015). This research is based on signalling theory which explain why companies have the drive to provide financial statement information to external parties. Therefore, it is interesting for researchers to further investigate the disclosure of risks related to capital costs and company value. 2. Theoretical Framework and Hypothesis Risk disclosure is an important and useful information for external parties or investors, as consideration in making decisions. Therefore, the Indonesian regulatory body makes regulations that require companies to disclose information about risks management in the annual report.

15**This study examines the effect of** risk disclosure **on the** cost of equity **and**

firm value in manufacturing industry

19**listed on the Indonesia Stock Exchange** (IDX) **period 2015-2017. The** relationship among variables **in this study**

is as on Figure 1. Figure 1. Research Framework Figure 1 illustrates the effect of independent and control

13**variables on the dependent variable.** The independent variables **in this study** is **the**

corporate risk disclosure. The first hypothesis uses the dependent variable of cost of capital of equity, while the second hypothesis uses the dependent variable of firm value. The straight line in Figure 1 indicates that there is an effect between independent variables and the dependent variable, while dotted line indicates that there is association between control variable and the dependent variable. In this study, the control variables are leverage ratio, independent audit committee, ratio of market value of equity to book value of equity, consumer price index, current income of research year, previous year income and company growth. The

27**Relationship between Risk Disclosure and Cost of** Equity **Capital** The relationship between **risk disclosure**

2**and the cost of equity capital**

is very interesting issue in the current economic environment. Stockholders argue that market efficiency depends on transparent disclosures that are comprehensive and relevant in value (Richardson and Welker, 2001). Disclosure of information can benefit companies through lower capital cost based on two aspect. First, disclosure reduce transaction costs. Increased disclosure of information can help potential investors to overcome the choice of differences from adverse bid-ask and reduce the cost of equity capital (Botosan, 1997). Second, increased disclosure reduce uncertainty or estimation risk (Clarkson, Guedes, and Thompson, 1996). This aspect give some benefits to the company. Botosan (1997) argue that companies try to make greater disclosures to reduce the cost of equity capital by reducing the non-diversifiable risk of estimation. Signalling

4**theory emphasizes the importance of information released by companies on investment decisions of parties outside the company.** All investors need **information**

released by companies to evaluate the relative risk of each company so they can diversify portfolio and investment combination with desired risk preferences. If the signal or information received indicates good news, it has an effect on the increase in price and demand for the securities in the market. This can reduce transactions cost and increase liquidity, thereby reducing capital costs because transaction costs fall so that the

8**adverse selection component of the bid-ask spread**

is reduced and in the end the

21**cost of equity capital** also decrease. **The** results **of**

previous research

8**on the relationship between the level of** information **disclosure and the cost of** equity **capital**

show that the more level of accounting disclosure made by company, the lower the cost of equity capital. A study by Juniarti and Yunita (2003) also proves that voluntary disclosure can reduce the cost of equity capital. This means that the wider the disclosure

1**of financial information, the lower the**

of equity capital because investors' demand for compensation and transaction costs decrease.

1**Based on the** explanation described **above, the** hypothesis **can be formulated as** follos: **H1:**

There is

2**negative relationship between level of** corporate risk **disclosure** (CRD) **and the cost of equity capital**

of the company. The

21**Relationship between** Risk **Disclosure and Firm Value** Firm value **is**

highly depends on investor perceptions related to the ability of manager to manage the company. To be able to increase the company's credibility, management will

17**provide a positive signal to investors. The** signal is **in**

the form of information disclosure in the annual report which can be a positive signal or good news for investors. The more extensive the disclosure of information, the more consideration for analysing the compny's prospects in the future. With more consideration, the error in predicting the company's performance will decrease, then increasing the investor confidence in making a stock request. The increased stock demand makes stock price also go up. An increasing in stock prices indicate an increase in firm value. In the recent years, the use of signalling theory to describe behavioural effects

5**when two parties have access to different information**

has gained a great attention (Connelly et.al., 2011). In this theory, there are parties who act as senders, assumed to choose

5**how to communicate or signal information; and**

parties, who act as recipient, assumed to

5**choose how to interpret the signal (Connelly et.al., 2011).**

Studies on risk disclosure and firm value have been carried out. Some studies in developing countries show that voluntary disclosure has a positive effect on firm value (Uyar and Kilic, 2012). Risk management disclosure also has positive effect on firm value (Maizatulakma et.al., 2015). Therefore, it can be concluded that companies that disclose non-financial risk management information provide better disclosure quality and consequently can attract more investos and increase the company value. This study,

22**based on the** explanation **above,** formulates **the hypothesis as follows:** H2: **there is a** positive relationship **between**

level of corporate risk disclosure (CRD) and firm value (FV) 3. RESEARCH METHOD Research Variables The dependent variable is the variable influenced by

13**the independent variables. The dependent** variables used **in this study**

are

12**cost of equity** capital **and** firm value. **The cost of equity**

capital is the amount of return expected by investors in the future when investing in the form of ordinary stock in a company. The cost of equity of equity capital for a company is calculated based on the Price/ Earning Growth Ratio Formula in Easton et.al. (2004) and recommended by Botosan & Plumee (2002) as follow: Costit = $PERir\ GrkwrhEPRir$ Note: Costit = Cost of Equity Capital

9**for the company (i)** in **period (t)**

PERit = Ratio of stock price to stock

9**income for the company (i)** in **period (t)**

GrowthEPSit = Ratio of earning growth per stock

9**for the company (i)** in **period (t)** Firm value **is the**

company's performance reflected by the stock price that is due to the demand and supply in capital markets that reflect the public's assessment of the company's performance. Research is conducted by Maizatulakma et.al. (2015) using market capitalization (MCAP) to measure firm value (FV)> MCAP took into account overall market value of the company. Maizatulakma et.al. (2015) calculated MCAP by multiplying the company stock in circulation with the market price per company stock. The independent variable in this study is Company Risk Disclosure (CRD). The level of company risk disclosure is calculated using the method of content analysis of the annual report. Measurement of the level of risk disclosure is carried out by giving the same weight to ech category, in which point '1' is given for the risk disclosure as required and point '0' is given for the category that is not disclosed on each identified item. These points are added to get a final score for each company every year. The risk disclosure category is this study refers to research conducted by Linsley and Shrives (2006) where there are 6 risk disclosure categories. Calculating the level of risk disclosure as follow: Level of Risk Disclosure =$\sum$ *rha aaraakry ka rirk airakkrrra ay rha akkkaky* $\sum$ *Rkrak rirk airakkrrra aaraakriar* This study uses several control variables with the aim of avoiding mis-specification of empirical models that can cause the invalid statistical inference. Control variables used in This study are those as previous studies used and related to risk disclosure, cost of equity capital, and firm value. Population and Sample The population are the manufacturing companies which were into three sectors: the basic and chemical industry sector, various industry sector, and the consumer goods industry; and have a complete annual financial reports published in 20015-2017. It used a purposive sampling method to determine the sample based on the specified criteria. Types of Data and Sources The data used were the

23**secondary data** with **the annual reports of manufacturing companies** in the **period** 2015 **-2017. The**

study obtained the data by accessed from the

6**official website of the Indonesia Stock Exchange (IDX).** The **data**

for this study were from the Indonesia Stock Exchange and the Bloomberg terminal. Analysis Data This Study tested the hypothesis using a regression model as follows: Costit = β0 + β1CRDit + β2BETAit + β3LEVit + β4MBit + β5ACIit +Ɛ (1) FVit =β0+β1CRDit+β2BLEVit+β3SIZEit+β4PROFITit+β5PROFITit-1+β6GROWTHit + Ɛ (2) Note: Costit = Cost of Equity Capital company i year t CRDit = Company Risk Disclosure company i year t BETAit = Systematic Risk LEVit = Leverage MBit = Ratio of Market value to Book value FVit = Firm Value company i year t SIZEit = Firm Size PROFITit =

25**Net profit the current year** PROFITit-1 = **Net Profit for the previous year**

GROWTHit = Company growth Ɛit = error term 4. DATA ANALYSIS AND DISCUSSION Description of the Research Object The object of

10**this research** is **manufacturing companies listed on the Indonesia Stock Exchange in** 2015-2017. **The** research **sample** was **the** companies selected **based on** the **predetermined criteria.**

Details of the object and sample of the study are on Table 2. Table 2 shows that from a total of 441 research objects, this study could use only 99 of research sample. The number of samples are limited, because they have to meet the criteria only. Descriptive Statistics Descriptive statistical analysis provides a description of research data that can show the maximum, minimum, standard deviation and mean values. Descriptive statistics and frequency distributions for dummy variables in this study are presented on Table 3.

11**Classical Assumption Test** The **classical assumption test conducted** in this study **consists of normality test, multicollinearity test,** autocorrelation **test and** heteroscedasticity **test.** From all **the** classical assumption **test,**

this study can summarize as follows: i. The normality test using Kolmogorov-Smirnov test shows a probability value of 0.200 for each regression model. This indicate that the residuals are normally distributed because the probability value is greater than 0.05. ii. The multicollinearity test shows that the

18**tolerance value of all variables is greater than 0.10 and** has a **VIF value** below **10.**

This indicates that there is no multicollinearity between the independent and control variables in the regression model. iii. The Heteroscedasticity test using scatter plot graph shows the distribution of point on the graph that do not show a certain pattern. This indicates

1**that there is no heteroscedasticity in the regression model,** so that **the**

regression model is feasible to be used for research. iv. The autocorrelation test using Durbin-Watson test shows d-values of 1.807 and 1.541 for each model. These values show that there is no autocorrelation in the first model but there is a positive autocorrelation in the second regression model because the data from this study are panel data or time series where autocorrelation often occur.s Hypothesis Test Hypothesis testing is done using multiple linear regression test with the assumption of ordinary least square. The results of test that has been carried out are on Table 4. Based on Table 4, if the probability value indicates a number less than 0.05, the result of the regression test can be said to support the research hypothesis. The results of statistical test-F indicate the respective p-value of 0.0208 and 0.0003, indicating that all independent variables in the regressions model 1 and 2 can describe the dependent variable. Interpretation of Results Hypothesis 1 The first hypothesis testing is to test the effect of corporate risk

2**disclosure on** the **cost of equity capital in**

manufacturing sector companies in Indonesia. The test results shows that the significance level or p-value is 0.0208, or smaller than 0.05, with a coefficient value of -2,033. Therefore, the first hypothesis is accepted. It can be concluded that corporate risk disclosure has negative affect on the cost of equity capital. The results indicate that level of corporate risk disclosure (CRD) has a negative effect on the cost of equity capital. This means that the extent of information disclosed by the company will reduce the cost of equity capital. Signalling Theory explains that companies have the drive to provide financial statement information to external parties. Based on this theory, wider disclosure of information results in reduced information asymmetry between company and external parties, where the company knows more about the company’s condition and the future prospect than external parties (Investors and creditors). The reduced information asymmetry between the company and external parties makes stockholders more aware of information about the company so that stockholders are willing to reduce the expected return of capital invested in the company which further reduces the cost of equity capital. The result also supports the research conducted by Nahar et.al. (2016). It also shows that transparent disclosure by companies can reduce the cost of equity capital where the market gives appreciation in the form of lowering expected return

7**which in reduces the cost of** equity **capital.**

Hypothesis 2 The next testing is to test the second hypothesis, in which corporate risk disclosure has a positive effect on firm value. Based on the test conducted, coefficient value is 1,280 with significance level of 0.0003 or less than 0.05. Therefore, the second hypothesis is accepted. It can be concluded that the corporate risk disclosure

7**has a positive effect on firm value. With the**

transparent corporate risk disclosure, shareholders will know what risks the company experienced, how the impact will be in the future, and how company manages these risk so as to increase investor confidence which will further increased the firm or company's value. The extent of disclosure made by the company will increased the firm value. These results support the signalling theory which aims to convince investors about the value of the company. Therefore, with a signal in the form of information presented by the company, it will be easier for investors to judge the performance of the company. Thus, making it easier for investors to make further decisions. The results

26**are in line with those** of the **research conducted by** Maizatulakma **et.al.**

(2015). It also indicates that giving a signal to investors in the form of risk information faced by the company is important because it can help investors make better decisions about their investment in the company that can increase the firm or company's value. 5. CONCLUSION, IMPLICATION, SUGGESTION, AND LIMITATIONS The result of data collection, data processing, analysis, and interpretation of test results in this study indicate that the quality of the performance of corporate risk management can be measured by consistently disclosed risk information. In addition, it can also have a good effect on company performance, i.e. the cost of equity capital and firm value. The greater the level of corporate risk disclosure, the lower the cost of equity capital. It also found that the high level of corporate risk disclosure leads to higher positive firm value. The extent of corporate information disclosure will increase the value of the company. The limitation in this study is that there is still 58% of the other factors outside the independent variable of corporate risk disclosure and control variables of leverage, the ratio of equity market

7**value to the** book **value of equity, the**

consumer index and independent audit committee that can predict the dependent variable of the cost of capital equity. Based on the limitation mentioned above, further research should add other variables such as intellectual capital disclosure, systematic risk, information asymmetry, and audit quality that can affect the dependent variable of cost of equity capital.