

## ***The Effect of Financial Performance, Fraudulent Statement and Company Size on Costs of Equity***

Ina Mutmainah

Department of Shariah Accounting, Faculty of Islamic Economics and Business,  
IAIN Pekalongan, Central Java, Indonesia

email: [ina.mutmainah@iainpekalongan.ac.id](mailto:ina.mutmainah@iainpekalongan.ac.id)

### **ABSTRACT**

*The Company will determine the capital to be spent to make their investment. This study tries to analyze the influence of the profitability, leverage, fraudulent statement, company size, on the cost of equity. The research was conducted during the period 2016-2018 in the manufacturing companies listed in Indonesia Stock Exchange. Researchers collected data by technical documentation which is currently processing using SPSS 23. By purposive sampling, researchers have collected 45 samples from 15 manufacturing companies that fit the criteria of research. The analytical method used is multiple linear regression with classical assumption including normality test, multicollinearity, heterokedasitas, and autocorrelation. The dependent variable is the cost of equity, and the independent variable is profitability, leverage, fraud, company size. The results, profitability, leverage, fraud, company size, effect simultaneous to the cost of equity in manufacturing companies in the period 2016-2018. Partially, company size and profitability of a significant effect on the cost of equity, while fraud and leverage do not significantly affect the cost of equity in the companies listed in Indonesia Stock Exchange 2016-2018.*

**Keywords:** *Cost of equity, profitability, leverage, fraudulent statement, company size.*

History of Article. Received: Desember 2020, Revised: Desember 2020, Published: Desember 2020

### **INTRODUCTION**

PSAK 15 states A financial statement is a structured presentation of an entity's financial position and financial performance. The purpose of financial statements is to provide information relating to the financial position, performance of entities, and cash flow of entities that are beneficial to most users of reports in economic decision making. In order to achieve these objectives, i.e. useful in economic decision making, the information contained in the elements of financial statements must be able to assist investors in making decisions rationally. One of the elements contained in the financial statements is profit. Costs of equity capital are opportunity costs for the use of funds (capital) in a project (company). All owners of funds used (invested) in the company hope to obtain a satisfactory return. The profit (return) payable by the company will be a condition of the use of funds by the owner of the fund (source of funds). Thus, the cost of equity capital will be a hurdle of rate (limiter) to determine a profitable company investment or not.

Composition in costs of equity capital in the form of debt capital costs and costs of equity capital. Profitability is an ability that the company achieves in a given period. The basis of profitability assessment is financial statements, which can be determined by analysis of a number of ratios and subsequently used to assess certain aspects of the company's operations. Profitability analysis aims to measure the company's ability to make a profit, both in its relationship with sales, assets, and

own capital. Profitability results can be used as a benchmark or an overview of the effectiveness of management performance is reviewed from the profit earned compared to the results of the sale and investment of the company.

Leverage is a tool to measure how much a company depends on creditors in financing the company's assets. Companies with high levels of leverage rely heavily on outside loans to Mulyati Research (2018) stated that leverage has a significant influence on Cost of Equity Capital. Finance their assets. Meanwhile, companies with lower leverage are more likely to finance their assets with their own capital. The level of corporate leverage thus describes the financial risks of the company. The quality of profit can be said to be of high quality if the reported profit can be used by users to make the best decision, and can be used, to explain or predict the price and return of shares (Safiq,et.al, 2018).

The size of the company is a variable guess that is widely used to explain the variation in disclosure in the company's annual report. The size of the company is also a factor that affects equity costs. There are two views on the size of the company towards equity costs. First, small companies are considered to do more profit management practices than large companies. This is because small companies tend to want to show the condition of companies that always perform well so that investors invest in them. Kurnia & Arafat research (2015) states that company size has a significant effect on the cost of equity capital.

## **LITERATUR REVIEW**

Lestari & Purnawati (2018) states that profit management has a significant effect on equity capital costs, beta risk, the size of the company has a significant effect on equity capital costs. Triningtyas and Siregar (2014) stated that the effect of discretionary accrual quality is higher than accrual quality only on cost on equity capital. Mulyati Research (2018) stated that leverage has a significant influence on Cost of Equity Capital. Kurnia & Arafat research (2015) states that company size has a significant effect on the cost of equity capital.

### **Agency theory**

The concept of profit management according to Jensen and Meckling (1976) uses an agency theory approach that states that "agency theory is a contract between the manager (agent) and the principal arising out of each party's attempt to achieve or consider the level of prosperity it claims".

### **Cost of Equity**

Capital costs are a dynamic concept influenced by several economic factors. Modigliani and Miller (1958) argued that equity capital costs were the costs incurred to finance the source of financing. Modigliani and Miller were the first to define the cost of equity capital in financial literature.

### **Financial Performance**

According to Subramanyam and Wild (2014) profit (income also called earnings or profit) is a summary of the net results of business operations in a certain period expressed in financial terms. Profit is the most in demand company information in the money market. When a company uses a debt policy in corporate funding, companies that have low risk will be burdened with low cost of debt, and vice versa. Risk is one of the factors that can cause the cost of debt of the company to increase. If the company is unable to show good performance, such as profit not in accordance with the expectations of its users, then management will strive to meet the expectations of those users (Septiani & Taqwa, 2019).

### **Fraudulent Statement**

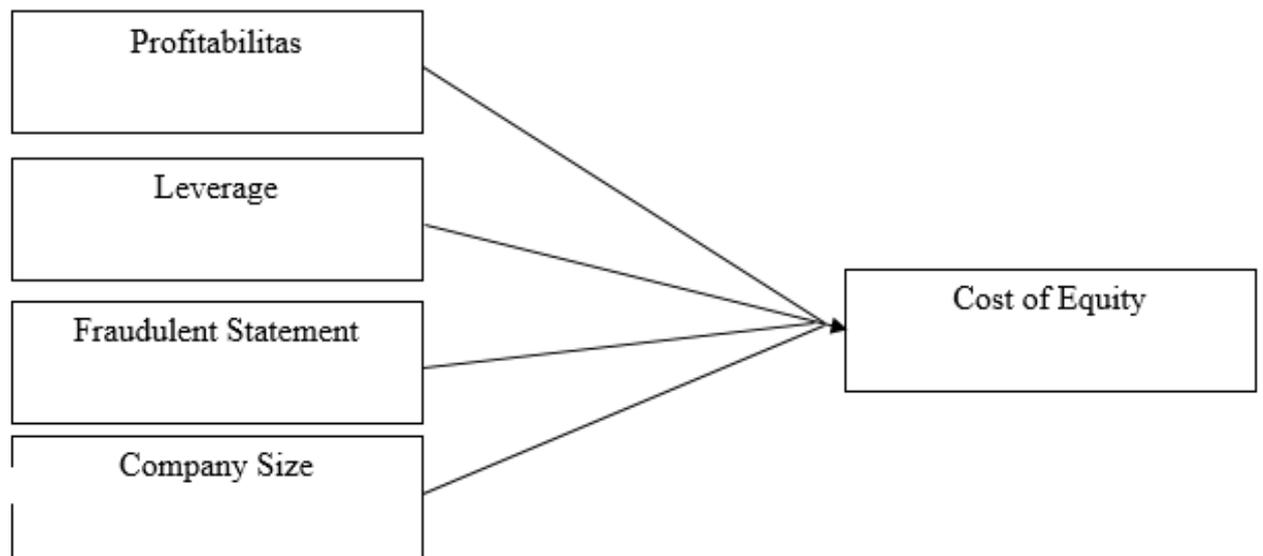
Fraudulent Statement as the selection of accounting policies by managers, or actions that may affect profits, which aim to achieve several objectives in profit reporting. There are two ways of understanding profit management by company managers: first,

it aims to maximize opportunistic behavior. Second, it aims to provide benefits to all parties involved in efficient contracting where profit management gives managers the flexibility to protect themselves and the company in anticipating unforeseen events for the benefit of the parties involved in the contract, if profit management is opportunistic, then such profit information may lead to incorrect investment decision making for investors (Scott, 2015).

### Company Size

The size of the company is how big the asset is owned by the company. The size of the company is expressed as a determination of the financial structure in almost each study and for a number of different reasons. The size of the company can determine the level of ease of the company obtaining funds from the capital market. The size of the company can be determined based on profit, assets, labor and others which are all highly smeared (Sawir, 2004).

### Hypothesis Development



**Figure 1**  
**Frame of Mind**

Profitability is the company's ability to make a profit within a given period. When the stock is at a profit, the cost of capital decreases. Then investors will choose and invest in the company. Thus the profitability of the company has an influence on equity costs.

#### **H1: Profitability has a significant impact on costs of equity.**

Leverage is the company's ability to meet long-term obligations. Companies with high levels of leverage will tend to use capital costs to measure the company's ability to meet all long-term debt. Thus the leverage of the company has an influence on the cost of equity.

#### **H2: Leverage has a significant effect on costs of equity.**

The quality of accrual can be used as an approach to measure the risk of information contained in the company. The amount of information risk will affect the cost of capital. The higher the risk, the higher the cost of capital of the company. Thus accrual quality has an influence on equity costs.

#### **H3: Fraud has a significant effect on costs of equity.**

The larger the company, the greater the cost of providing information to the public, resulting in increased equity costs. Large companies will be more careful in conducting financial reporting and tend to report financial conditions accurately because it is more considered by the public. Thus the size of the company has an influence on equity costs.

#### **H4: The Size of the Company has a significant effect on costs of equity.**

#### **RESEARCH METHODS**

The type of research used is klausal research. Klausal research is a penelitian that has the main purpose, proving the causal relationship or relationship affects and is influenced by the variables studied (Sugiyono, 2008). The population in this study is a company listed on the Indonesia Stock Exchange (IDX). The research period includes data on 2016-2018. Samples are performed using purposive sampling, The sample criteria to be used are as follows: 1) Manufacturing companies registered with IDX in 2016-2018 with complete financial data. 2) Companies that make a profit during the period 2016-2018. 3) Manufacturing companies that use rupiah denomination. 4) Manufacturing companies that have an equity value of the company are not negative and that have complete financial data. The statistical test is with parametric inference statistical data analysis, classic assumption test and multiple liner regression test with IBM SPSS 23.

#### **Variable Operations**

##### **a. Cost Of Equity**

Calculation of equity costs using CAPM as follows Pure (2004) and Riduan (2009):

$$COE = R_f + \beta R_p$$

COE = estimated cost of equity

$R_f$  = risk free rate proxied with average interest rate SBI for one year

$\beta$  = beta market obtained from the result of regression between the return of the company's shares and the market return proxies with JCI and using weekly data (Wednesday only) for the past year so that it obtained a return for 52 weeks

$R_p$  = market risk premium or ( $R_m - R_f$ ) is defined as an additional return desired by investors for investing in risky securities.

##### **b. Profitabilitas**

ROA = net profit after tax / total asset x 100% (Oyelere et al., 2003)

##### **c. Leverage**

Debt to Equity Ratio = total liabilities / shareholders' equity (Helfert, 1997).

##### **d. Fraudulent Statement**

Fraud is calculated by the Healy model. The steps in calculating discretionary accrual (according to Sri Sulistyanto) are as follows in calculating the accrual value (TAC), i.e. reducing the accounting profit it earns during a given period with the operating cash flow of the period in question.  $TAC_t = \text{Net income} - \text{Cash flow from operation}$   
To calculate nondiscretionary accruals model Healy divides the average accrual (TAC) by the total assets previously. Therefore the total accrual during the estimation period is a representation of the size of nondiscretionary accruals and formulated as follows:  $NDA_t = \sum TA / T$

Description : NDA = Nondiscretionary accruals

TAC = Total accruals scaled with total assets period t-1

T = 1,2,..., T is the subscript year for the year entered in the estimation period

t = subscript year indicating the year in the estimation period. To calculate the value of discretionary accruals (DA), i.e. the difference between total accrual (TAC) and nondiscretionary accruals (NDA)

$$DA = TAC - NDA$$

##### **e. Company Size**

SIZE = Ln total fixed assets

**RESULTS AND DISCUSSION****Table 1**  
**Research Sample**

No	Criteria	Companies
1	Number of Manufacturing Companies listed on Indonesia Stock Exchange during the period 2016-2018	125
2	Manufacturing Companies that do not publish annual reports	(18)
3	Companies that did not make a profit during the period 2012-2014	(42)
4	Manufacturing Companies that have negative equity values.	(35)
5	Manufacturing Companies that have incomplete data as research materials.	(15)
	Sample manufacturing company 15 x 3 years	45

**Table 2**  
**Descriptive Statistics**

	N	Minimum	Maximum	Sum	Mean	Std. Deviation
Fraudulent Statement	45	-0,52415	0,51332	-0,31941	-0,66544	0,11941
Company Size	45	11,56934	14,66590647	625,79569	13,03741	,73395645
Profitabilitas	45	-1868216,21	14599825,91	45242049,97	942542,70	2598351,75
leverage	45	-7,64	147039,41	228854,18	4767,79	22542,75
Cost of Equity	45	,10	141,48	1421,36	29,61	49,46

**Table 3**  
**Normality Test**

Information	Standardized Residual Value
<i>Asym Sig (2-tailed)</i>	Regresi Linier 0,168 <i>alpha</i> 0,05

**Table 4**  
**Multicolinieritas Test**

Equation	Tolerance	VIF	Keterangan
CE = $\alpha + b_1$	0,911	5,116	Free Multicolinearitas
profitability + $b_2$	0,255	4,413	
leverage + $b_3$	0,588	1,805	
fraudulent + $b_4$	0,402	2,429	
company size + $\epsilon$			

**Table 5**  
**Heteroscedastisitas Test**

<b>Variable</b>	<b>sig</b>	<b>Information</b>
Profitability	0,253	Homoskedastisitas
Leverage	0,087	Homoskedastisitas
Fraudulent Statement	0,087	Homoskedastisitas
Company Size	0,538	Homoskedastisitas

**Table 6**  
**Autocorrelation Test**

<b>Durbin-Watson</b>	<b>Information</b>
1,729	Free Autocoleration

In this study has been conducted a classic assumption test consisting of normality test, multichocollinerity test and heteroskedastity test. As a result of the test that the data distributed normally with a value of Asym Sig (2-tailed) of 0.168, data did not occur multicolnerity with a tolerance value of  $> 0.1$  and a value of VIF  $< 10$ , nor did the data occur heteroskedastity with an alpha value greater than 0.05.

From the results of the analysis contained in table 5.7 shows that dw value is 1,726. DW to  $n = 45$  and  $K = 4$  in alpha table 5% obtained dl value = 1,336 and du = 1,720. Therefore the value  $du < dw < 4 - du = 1,720 < 1,729 < 2,280$  then it can be concluded that there are no symptoms of autocorrelation.

The hypothesis test in this study is to use multiple regression analysis.

**Table 7**  
**Hypothesis Test**

No	Description	Value		
1.	Modal Summary			
	Value R	0,634		
	R Square	0,429		
2.	ANOVA			
	Sig F	2,839		
	F Tabel	2,606		
	Sig	0,037		
3.	Coefficient			
	Konstanta	10,533	0,485	
	t Tabel		2,019	
	Profitabilitas	0,824	2,554	0,024
	Leverage	9,110	0,788	0,454
	Fraudulent Statement	-0,003	-0,810	0,374
	Company Size	1,290	2,391	0,041

The correlation coefficient value in the table above is 0.429, meaning the relationship between an independent variable and a dependent variable is at a moderate relationship level. Judging from the table above: the value of profitability significance of 0.024 is smaller than 0.05 so **H1 is accepted**; leverage significance value of 0.454 greater than 0.05 so **H2 is rejected**; fraudulent statement significance

value of 0.374 is smaller than 0.05 so **H3 is rejected**; the significance value of the company size of 0.041 is smaller than 0.05 so **H4 is accepted**.

Hypothetical result 1 indicates that profitability has a significant effect on equity costs. Profitability represents the ability of business entities to generate profit by using all their capital. The results of this study are in line with Furaida (2010), Safiq, et.al (2018) research stated that profitability affects the capital structure. Thus, companies with high profitability will have more internal funds than companies with low profitability. Satar (2015) Companies with high profitability will use smaller debts because companies are able to provide sufficient funds through withheld profits. In addition, the company will use more of its existing retained profits than it has to issue new equity at a high cost to use its funding.

Hypothetical result 2 indicates that leverage has no significant effect on equity costs. Leverage is the ability of the company to be able to pay off its current liabilities. The company equals zero i.e. the company is operating fully using its own capital. If the leverage level is low, the company has a small risk if economic conditions deteriorate.

The results of this study are in accordance with Bhayani (2009), Al-Tamimi (2013), Pratiwi (2012), Mulyati (2018) research which states that leverage has a positive and insignificant effect on capital costs. Thus it can be concluded that the high leverage of a company does not affect the cost of equity in the company because investors no longer pay attention to the leverage ratio. It is likely that investors pay more attention to profitability ratios because they are considered to have a direct effect on investors. As a result, the company considers leverage to be less important because it does not directly affect decision-making.

Hypothetical result 3 indicates that fraudulent statements have no significant effect on equity costs. The quality of the company's accruals shows the quality of the company's profit. High accruals show poor profit due to the high trend of profit management actions by management. Companies with low accruals show good profit quality due to management actions that report smaller profits that are the form and application of conservative accounting (Kiswanto & Fitriani, 2019).

The results of this study are in accordance with Triningtyas and Siregar (2014), Safiq, et.al (2018) research which states that the quality of accruals has no effect on equity costs. Thus it can be concluded that the quality of accrual is one of the factors considered in the cost of equity because the higher the quality of accruals, the lower the cost of equity. This indicates that in addition to profit management in the company, investors are also unable to interpret the company's profit management well so investors do not realize that profit management practices are widely carried out by issuers.

Hypothetical result 4 indicates that the size of the company has a significant effect on equity costs. The size of the company indicates the size of the asset owned by the company. The size of the company can determine the level of ease of the company to obtain capital market funds. The size of the company plays an important role in the bargaining activities of financial contracts.

The results of this study are also in accordance with the results of research conducted by Ashidiqi (2013), Kurnia & Arafat research (2015) which states that the size of the company has a positive and significant effect on equity costs. Thus the larger the company as measured by the total assets it can reduce the cost of equity. So, large companies will be more careful in doing financial reporting and tend to report financial conditions accurately because it is more considered by the public. Meanwhile, smaller companies have a tendency to increase equity costs by reporting larger profits, thus showing better performance in companies (AlOmar & Al-Okdeh, 2020). It is also in accordance with the theory put forward by Said Kelana (2005: 274) stating the size of the company is a variable considered in many financial research.

This is due to the alleged number of financial decisions or results influenced by the size of the company.

## CONCLUSION

The results of this study show that the profitability and size of the company have a significant impact on equity costs, while fraud and leverage have no significant effect on equity costs.

The limitations in this study are that R Square in this study is being studied for variables. Further research is recommended using other proxies for more precise leverage and fraud. Further research can use variables such as liquidity, activity, good corporate governance, audit quality and others that may affect CSR disclosure.

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