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# EARNINGS MANAGEMENT, INFORMATION ASYMMETRY AND COST OF EQUITY

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***Abstract:*** *This study aimed to examine the effect of earnings management and information asymmetry to the cost of equity in companies listed on stock exchanges in Indonesia. The samples are 55 companies listed in Indonesia Stock Exchange during 2010-2013. The results show that there is a positive and significant impact to the earnings management cost of equity in the company, while the effect of information asymmetry to the cost of equity showed no significant effect.*

***Keywords:*** *Earnings Management, Information Asymmetry, Cost of Equity*

## INTRODUCTION

The rapid development of the times encourage owners/management to maintain the existence of the company in a competitive business, various efforts were made by the management company. Ranging from business expansion, product innovation, product differentiation that in turn have an impact on the need for increased fund. Therefore, it takes another party that is able to provide financing to companies such as investors or creditors. Capital market could be an alternative for companies to seek financing company information, because in the capital market the company must publish its circumstances.

Capital market in Indonesia is progressing so rapidly. This led to a growing number of companies on BEIthat need information. The information required by investors to see the company's prospects and is associated with the costs to be incurred by the investor to invest (Putri, 2013). Investors prefer companies that disclose more information about the company, so they assume the risk of the company is low. If the company is considered a low risk by the investor, the lower the required rate of return as well (Tandelilin, 2001).

The financial statement is one of the sources of information used to assess the financial position and performance of the company. Financial statement consists of balance sheet, income statement and statement of changes in equity which prepared

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on an accrual and cash flow statements which prepared on the accrual basis and cash flow statements which prepared on a cash basis. In the financial reports provided an opportunity for managers to modify financial statements to produce the desired amount of earnings. Generally accepted accounting principle (GAAP) or the generally accepted accounting principles also gives freedom to managers to choose accounting methods that will be used in preparing financial statements.

Investors in investing into the company, of course, require information about the chosen company to invest. Such information should be disclosed by the company through annual reports. Company continue to operate, so that the company gets a better performance, so investors want to invest into the company. Information about the company's performance in the future more widely known by the company management than the investor, resulting in gaps regarding the information. According Supriyono (2000), information asymmetry is a situation that is formed by the principal (shareholders) do not have enough information about the performance of agents (managers) so that the principal cannot determine the contribution of the efforts of the agent to the results of a real company. According Suwardjono (2005), due to management and investors / creditors are parties to the relationship between the two parties is seen as an agency relationship, it is feared will happen information asymmetry between the two parties with management as a party that knows more information. Information asymmetry causes risks to be faced by investors is also higher, so the uncertainty of investors in the future bigger and capital costs are also high.

According Saputro and Setiawati (2004), earnings management is to intervene in the management of external financial reporting process in order to reach a certain income level with the aim to benefit himself or his own company. The same thing also expressed by Scott (2003), "Given that managers can choose from a set of accounting (for example, GAAP), it is natural to expect that they will choose policies so as to maximizetheir own utility and / or the market value of the firm ". From these definitions can be explained that earnings management is the choice of accounting policy by managers in order to achieve certain goals. Therefore, it is reasonable that managers choose those policies to maximize its utility and market value of the company. Meanwhile, according to (Copeland in Utami, 2005), earnings management businesses include the management to maximize or minimizeearnings, including the smoothing of income in accordance with the wishes of management.

Each capital invested, will issue capital costs of its own. Cost of equity capital is the rate of stock returns required by investors is the minimum return rate desired by the providers of funds (investor) to want and are willing to invest in the company. The concept of capital costs closely related to the concept of the level of profitability required (required rate ofreturn) that can be viewed from two sides, namely investors and companies. Side investors, the amount of required rate of return is the rate of earnings (rate of return) which reflects the level of risk of the assets owned. Side companies using funds (capital), the amount of required rate of return is the cost of

capital which must be removed to get the capital. In general, that a high risk company result to the rate of earnings demanded by investors is also high and capital costs are also high. (Martono and Harjito, 2005) Investors provide the capital hoping to get the minimum of the rate of return on the capital they ask, where the required return reflects the cost of capital for companies. While in the research ofUtami (2005) explained that the cost of equity capital is the amount of rate used by investors to discount the expected dividends received in the future, as measured by the company according to valuation models (Weston and Copeland in Dhiba, 2006), the company can obtain equity capital in two ways, ie retained earnings and issuing new shares. Based on the background of the problems described above, the authors propose the formulation of the problem is "The Effect of Earnings ManagementandInformationAsymmetryon Cost of Equity."

Based on the formulation of the main problems thatthe authordid notdeviate and that it be directed research, the authors propose the following research questions:

1. Is there anyeffect ofearnings managementto thecost of equityincompanies listedon the stock exchangeIndonesia?
2. Is there anyinfluence ofinformation asymmetry on thecost of equityincompanies listedon the stock exchangeIndonesia?

## THEORETICAL FRAMEWORK AND HYPOTHESES DEVELOPMENT

### 1. Agency Theory

Agency theory is the basis of the theory underlying the company's business practices are used for this. The theory stems from the synergy of economic theory, decision theory, sociology, and organizational theory. The main principle of this theory suggested a working relationship between the parties that the investor authorizes the parties to whom the authority (agency) is the manager.

The separation of owners and management in the accounting literature called the Agency Theory. This theory is a theory that emerged in the development of accounting research which is a modification of the development of financial accounting model by adding aspects of human behavior in economic models.

Agency theory describes the relationship between shareholders as a principal and as an agent management. Management is a party contracted by the shareholders to work in the interests of shareholders. Because they are selected, then the parties should be accountable for the management of all its work to the shareholders.

In the agency theory, the agency relationship arises when one person or more (principal) employs another person (the agent) to provide a service and then delegate decision-making authority to the agent. The relationship between the principal and the agent can lead to an imbalance condition information (asymmetrical information) because the agent is in a position that has more information about companies compared with the principal. Assuming that individuals act to maximize self-interest, then with

its information asymmetry will encourage agents to hide some information that is not known to the principal. The asymmetry in the conditions, the agent can affect the accounting numbers presented in the financial statements by way of earnings management.

### 2. Earnings management

Setiawati and Na'im (2000) stated that earnings management is an interference in the external financial reporting process with the aim to benefit themselves. Earnings management alone can result in a lack of credibility of financial report, add bias in the financial statements and could make users of financial statements believe the earnings figures as a result of engineering without modifiedearnings figures. The definition of earnings management into two, ie:

1. Narrow definitions

   Earnings management in this case only with regard to the selection method of accounting. Earnings management in the narrower sense is defined as the behavior of managers to "play" with the discretionary component of accruals in determining the amount of earnings.

2. Broad definition

   Earning management is the manager's actions to improve/reduce reported earnings today on a unit where the manager is responsible, without resulting in an increase (decrease).

According to Healy and James M. Wahley, in Aprilia (2010), there are three important aspects in earnings management, among others:

1. Reasons or justifications submitted by managers to estimate future events, such as the age of the machine, the residual value (salvage value) long-term assets, tax deferral or loss as a result of their bad debt. Managers are also required to choose some method of depreciation, determining policy on the management of working capital, to decide, to admit or defer income and expense, and are required to establish whether specific treatments should be used in connection with structuring transactions of large companies (corporate transaction) for example in the case of mergers and the lease contract use.
2. Earnings management is used to describe something that is not true to shareholders (to mislead stock holders) or multiple tiers of shareholders on actual economic performance. This can happen when the majority shareholders do not have the ability to express, or part does not care atearnings management practices.
3. Justification by managers to use earnings management, not only have implications for the benefits but also the cost of means of earnings

management has two immediate implications, i.e. benefit costs (cost and benefit).

Under conditions of the company will sell shares of public constraints, managers need to provide information to the public about financial condition. This encourages managers to manage earnings. This condition occurs when companies do offer additional shares (rights issue).

Copeland in Utami (2005) defines earnings management as, "*some ability to increase or decrease reported net income at will*". This means that the earnings management businesses include the management to maximize or minimizeearnings, including the smoothing of income in accordance with the wishes of the manager.

From the above definition can be concluded earnings management is a manager's actions in considering the financial reporting through accountancy development policy with the aim of maximize and minimizeearnings.

In Positive Accounting Theory there are three driving factors behind the occurrence of earnings management, namely:

- Bonus Plan Hypothesis: Management will choose accounting methods that maximize the utility that high bonuses. Manager of a company that gives a big bonus based on earnings more using accounting methods that boost reported earnings.
- Debt Covenant Hypothesis: Corporate managers who violate credit agreements tend to choose accounting methods that have an impact increase earnings (Rahmawati *et al.*, 2006). This is to keep their reputation in view of external parties.
- Political Cost Hypothesis The larger the company, the more likely the company is to choose a method of accounting that lowered earnings. This is due to the high earnings government will soon take action, such as: wearing antitrust rules, raising the corporate income tax, and others.

### 3. Information Asymmetry

Agency theory implies the existence of information asymmetry between managers as agents and owners (shareholders) as principal. Information asymmetry arises when managers more aware of the internal information and future prospects of the company compared to shareholders and other stakeholders. Therefore, principals need to create a system that can monitor the behavior of agents in order to act in accordance with expectations. This activity includes the expenses for the creation of standards, the cost of monitoring agency, the creation of accounting information systems and others. This activity raises the cost of the so-called agency cost.

Quality accounting information is useful for investors to reduce information asymmetry. Information asymmetry arises when managers more aware of the internal

information and future prospects of the company compared to shareholders and other stakeholders. When the information asymmetry arises, decisions made by the manager phrase could affect the stock price because of information asymmetry between investors more informed and less informed investors raises transaction costs and reduce the expected liquidity in the market for stocks (Komalasari, (2001) in Siti, (2004). Liquidity in the market has a variety of definitions and interpretations. The simplest definition of liquidity is the ability to perform transactions without spending a significant cost.

As the manager of the company managers more aware of internal information and prospects of the company in the future compared to the owners (shareholders). Therefore, as the manager, the manager is obliged to provide a signal about the state of the company to the owner. Given signal can be done through the disclosure of accounting information such as financial reports. Financial statements are intended for use by various parties, including the management of the company itself. However, the most concerned with the actual financial statements is the external users (outside management). The financial report is important for external users primarily because this group is in a state of the greatest uncertainty (Ali, 2002). The internal users (the management) have direct contact with entities or his company and knowing significant events that occurred, so the degree of reliance on the information is not accounting for external users. This situation will lead to the emergence of a condition known as information asymmetry. That is a condition in which there is an imbalance between management information acquisition as a provider of information (prepaper) with the shareholders and stakeholders in general as the user information (user).

### 4. Cost of equity

Cost of equity capital is a concept that is influenced by several economic factors and the total cost is measured as the rate of interest from a variety of sources of capital are each weighted according to its role in capital structure and capital used by the company (Ismaya, 2006).

Cost of equity capital is the rate of stock returns required by investors, i.e. the minimum return rate desired by the providers of funds (investor) to want and are willing to invest in the company.

Cost of capital is the weighted average of the rate of return (cost) invidual required. Required rate of return for an equity rate of return is the minimum necessary to attract investors to invest in company stock.

The cost of capital is a dynamic concept that is influenced by several economic factors. The structure of capital costs are based on several assumptions related to risk and tax. The basic assumption used in the estimation of the cost of capital is business risk and financial risk is still (relatively stable). Capital costs are calculated on the basis of long-term funding sources available to the company. There are four long-term funding sources, i.e.: (1) long-term debt, (2) preferred stock, (3) common shares,

and (4) retained earnings. Cost of long-term debt is the cost of debt after taxes at this time to obtain long-term funding through loans. Cost of preferred stock is an annual preferred stock dividend divided by the sale of preferred stock. Cost is the amount of ordinary share capital rate used by investors to discount the expected dividends received in the future.

### 5. Effect of Earnings Management and Information Asymmetry to the Cost of Equity

According to Copeland in Utami (2005), earnings management businesses include the management to maximize or minimize earnings, including the smoothing of income in accordance with the wishes of management. While understanding the magnitude of the cost of equity is the rate that is used by investors to discount the expected dividends received in the future (Utami, 2005). Leuz et al research in Utami (2005) on international comparative studies of earnings management and investor proxies, prove that the level of earnings management of issuers in Indonesia is relatively high and protection against the investor relatively low.

This raises the question for investors in considering the amount accrued (a proxy for earnings management) in determining the level of the required stock returns, which returns the required stake is the required return by investors to want to invest in the company, and known as cost of equity. It shows that earnings management affects the cost of equity for the purpose of earnings management itself is to maximize or minimize earnings, this may affect the level of the dividend in the cost of equity. If the earnings management aims to maximize earnings, the dividend the company will be high. However, also the opposite, if the earnings management aims to minimize the earnings, the dividend the company will be low. Because if a company has a low income, the possibility of the company does not distribute dividends. It is not good for long-term investors because investors will not invest anymore because they feel cheated by the returns that should have been larger. For Peme-gang current stock, the cost of capital is very important to look directly -imbal on their investment and only a little give to the pe-future shareholders, but not bias the reference shareholder in predicting future yields on those who would they receive later.

$H_1$: Earnings Management has a positive and significant impact on the cost of equity.

### 6. Effect of Information Asymmetry to Cost of equity

According Khomsiyah (2003) information asymmetry positive effect on the cost of capital, which states that it is consistent with agency theory that the more information that is hidden the agent, the higher the risk to be borne by the owners of capital.

Information Asymmetry where a company better know the company's prospects in the future than the investor, if the company's share price is now higher indicating that the better the performance of the company, the investor has a decision to invest in the company, but investors do not know the company's prospects are more uncertain

future that will come, whether it is better or even worse. If the company's performance in the future worse known only by the management company, the company will issue a greater cost for its actions. In addition, investors will also bear losses on investments, such as the possibility of receipt of the dividend will not come back, so that the capital costs will be higher.

The more transactions conducted, the higher the volatility of stock price due to the emergence of private information. Volatility in financial markets illustrate the level of risk faced by investors because it reflects fluctuations in the stock price movement.

$H_2$: Information asymmetry that is not significant positive effect on the cost of equity.

## RESEARCH METHODS

### 1. Data and Sample

Samples for this study are manufacturing companies listed in Indonesia Stock Exchange (BEI) in the period 2010 -2013.

The sample criteria included in the category of this study are:

a) The company belongs to a group of firms listed on the Indonesia Stock Exchange;

b) Data manufacturing company for 4 years of the study should be complete;

c) the issuer has the fiscal year ended December 31;

d) positive equity book value for 2010 and 2013, as issuers with a negative equity value means insolvent, so it can lead to the condition of the sample is not homogeneous.

Based on the sample selection criteria mentioned above, the sample used in this study as many as 55 companies. The description of the selection of samples are presented in the table.

**Table 1**
**Sample Research**

| *criteria* | *Company number* |
|---|---|
| The number ofcompanies listedon the Indonesia Stock Exchange | 140 |
| Companies thatdelistedin the period 2010-2013 | (11) |
| Companies thatdo notpublishcomplete financialstatementsforthe year 2010-2013 | (29) |
| Manufacturing companiesthat do notuse the fiscal year on December 31 | (7) |
| Companies that have abook value ofnegative equity | (13) |
| The Companydoes not usethe currency ofrupiahin financial statements | (25) |
| total | 55 |

## 2. Hypothesis Testing

The hypothesis of this study suspected positive effect of earnings management and information asymmetry to the cost of equity. The research model used to test the hypothesis is as follows:

$$EQ_{i,t} = a + \beta 1\, EM_{i,t} + \beta 2\, AI_{i,t} + \varepsilon_{i,t}$$

Description:

$EQ_{i,t}$ = Cost of Equity

$EM_{i,t}$ = Earnings Management

$AI_{i,t}$ = Asimetri Informasi

$\varepsilon_{i,t}$ = error terms

## 3. Operationalization of Research Variables

***Earnings Management***

Earnings Management is interference in the management of the financial reporting process with the aim to benefit himself, whose businesses include the management to maximize, or minimize income, including income smoothing accordance with the wishes of the management. Research Dechow *et al.* (in Utami, 2006). DACC calculation with the Modified Jones Model are as follows:

$$TA = N_{it} - CFO_{it} \quad (1)$$

The total value of accrual (TA) is estimated by OLS regression equation as follows:

$$TA_{it} / A_{it-1} = \beta_1 (/A_{it-1}) + \beta_2 (\Delta Rev_t / A_{it-1}) + \beta_3 (PPE_t / A_{it-1}) + e$$

By using the above regression coefficient value, non-discretionary accruals (NDA) can be calculated by the following formula:

$$NDA_{it} = \beta_1 (1/A_{it-1}) + \beta 2(\Delta Rev_t / A_{it-1} - \Delta\, Rec_t / A_{it-1}) + \beta 3\, (PPE_t / A_{it-1}) \quad (3)$$

Further discretionary accruals (DA) can be calculated as follows:

$$DA_{it} = TA_{it} / A_{it-1} - NDA_{it} \quad (4)$$

Description:

$DA_{it}$ = Discretionary Accruals icompany in period t

$NDA_{it}$ = Non Discretionary Accruals icompany in period t

$TA_{it}$ = Total accrual I company in period t

$N_{it}$ = net earnings i in period to t

$CFO_{it}$ = cash flow from operating activities of thei company in period to t

$A_{it-1}$ = Total assets of the icompany in period t -1

$\Delta Rev_t$ = Changes in receivablesi company in period t

$PPE_t$ = fixed assets of the company in the period to t

$\Delta Rec_t$ = Changes in receivables I company in period t

e = *error terms*

**Information Asymmetry**

Information asymmetry is a condition in which there is an imbalance between management information acquisition as a provider of information (prepaper) with the shareholders and stakeholders in general as the user information (user).

Measurement of information asymmetry is done by using the relative bid-ask spread is operated as follows (Yelly, 2008):

**SPREADi, t = (ask i, t - bidi, t) / {(ask i, t + bid i, t) / 2} x 100**

Where:

SPREAD = difference when the ask price at the bid price of i company in year t

Ask i,t = The highest price of the i company's shares ask that occurred in year t

Bid i,t = the lowest bid pricei company's shares that occurred in year t

***Cost of Equity***

The cost of equity capital is proxied by using a modified model of the model Ohlson Utami (2005). The formula cost of equity capital is as follows:

$$r = \frac{(B_t + X_{t+1} - P_t)}{P_t}$$

Description:

P_t = share price in the period t

B_t = book value per share period t

X_ (t + 1) = earnings per share in period t

r = cost of equity capital

**RESEARCH RESULT**

Test results that show how the effect of earnings management and information asymmetry to the cost of equity is presented in the tables below.

**Table 2**
**Results of multiple linear regression analysis**

| *Model* | | *Unstandardized Coefficients* | | *Standardized Coefficients* | | |
|---|---|---|---|---|---|---|
| | | *B* | *Std. Error* | *Beta* | *t* | *Sig.* |
| 1 | (Constant) | .156 | 3.075 | | .051 | .960 |
| | Earnings Management | 9.129 | 3.166 | .306 | 2.884 | .005 |
| | Information Asymmetry | .039 | .320 | .013 | .123 | .902 |

*Source:* Output SPSS

**Tabel 3**
**Results of the analysis of the coefficient of determination**
**Model Summary**

| *Model* | *R* | *R Square* | *Adjusted R Square* | *Std. Error of the Estimate* |
|---|---|---|---|---|
| 1 | .304[a] | .092 | .071 | 14.246243 |

*Source:* Output SPSS

Based on the table 2, the regression coefficient of 9.129 indicates a positive number and $t_{count}$ of 2,884, while $t_{table}$ of 2.000, with a gain value sig (0,005) <0.05, meaning that $t>t_{table}$ and sig <0.05 then there is positive and significant correlation between earnings management of the cost of equity in companies listed on the Stock Exchange Indonesia. For hypothesis testing related to the information asymmetry obtained regression coefficient of 0.039 and 0.123 $t_{count}$ while ttable by 2,000, to obtain a sig (0.902 )> 0.05, meaning that $t < t_{table}$ and sig> 0.05 then there is no significant effect between the information asymmetry on the cost of equity in companies listed on the Indonesia Stock Exchange.

F significance value of 0.017., Then sig <0.05. Thus, it can be concluded that there is positive and significant correlation between earnings management and information asymmetry to the cost of equity.

**Tabel 4**
**Test results F**
**ANOVA[b]**

| *Model* | | *Sum of Squares* | *Df* | *Mean Square* | *F* | *Sig.* |
|---|---|---|---|---|---|---|
| 1 | Regression | 1731.785 | 2 | 865.893 | 4.266 | .017[a] |
| | Residual | 17048.258 | 84 | 202.955 | | |
| | Total | 18780.043 | 86 | | | |

## 1. Interpretation Results

From the test results, interpretation of the results of the study concluded that there is a positive and significant effect of earnings management on the cost of equity in

companies listed on the Indonesia Stock Exchange. This is consistent with the theory according to Copeland in Utami (2005), earnings management businesses include the management to maximize or minimize earnings, it shows that earnings management and significant positive effect on the cost of equity. From the interpretation of the above results show that, the results for the effect of earnings management on the cost of equity, hasil tersebut in line with the theory put forward in chapter 2, which means that the results are positive and significant effect of earnings management on the cost of equity.

As for the variable asymmetry of the cost of equity there is no significant positive effect between the information asymmetry on the cost of equity in companies listed on the Indonesia Stock Exchange, it is not in line with the theory put forward by Khomsiyah (2003) information asymmetry positive effect on costs capital, which states that it is consistent with agency theory that the more information that is hidden the agent, the higher the risk to be borne by the owners of capital. So the interpretation is variable information asymmetry on the cost of equity is not consistent with the theory presented in chapter 2, which means there are significant research results were not significant between the information asymmetry on the cost of equity.

## CONCLUSION, LIMITATIONS AND FURTHER RESEARCH

### 1. Conclusions

Based on the results of the description in the previous chapters, the conclusions of this research are:

1. The result of the acquisition of regression coefficient showed a positive figure of 9.129 and 2.884 $t_{count}$, while $t_{table}$ by 2,000, to obtain a sig (0,005) <0.05, meaning $t_{count}$> of $t_{table}$ and sig <0.05 then there is positive and significant earnings management of the cost of equity in companies listed on the Indonesia Stock Exchange.
2. The results of the acquisition of a regression coefficient of 0.039 and 0.123 thitung while $t_{table}$ by 2,000, to obtain a sig (0.902)> 0.05, meaning $t_{count}$<of ttable and sig> 0.05 then there is no significant effect between the information asymmetry of the cost of equity in companies listed on the Indonesia Stock Exchange.
3. Provided significance of 0,017 F, so that F significance value <á (0.017 <0.05). Thus, it can be deduced Ho refused or Ha accepted which means there is simultaneously a positive and significant effect of earnings management and information asymmetry to the cost of equity.
4. Provided determination coefficient of 0.092. From these results, it appears that the contribution of the effect of earnings management and information asymmetry to the cost of equity in companies listed on the Indonesia Stock Exchange was 9.2%.

**2. Limitations and Further Research**

The limitations in this study are, the observation period is relatively short at only 4 years with a limited number of companies that only 55 manufacturing companies and do not include others, variable used in this study only uses two proxies, while there are many proxy other than earnings management and information asymmetry that affects the cost of equity, and measurement of information asymmetry by using the closing stock price (high-low) only the value end of the year.

Future studies may consider some of the following, further research is recommended to consider the use of proxies of earnings management through real activities. That's because the choice of managers to manipulate earnings in opportunistic behavior is not limited to the ways accrual only, but can also be done through the real activity. Earnings management through real activity tends to be more difficult to detect, so that managers tend to choose to use the method in earnings management. In addition, managers can make earnings opportunistically management through real activities during the year, not through any accounting policy. Variable - other variables that could possibly be other factors that affect the cost of equity as the company's growth can be considered in future studies, andmeasurement of information asymmetry using the closing share price per month.

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