*Original Article*

# The Effect of Level of Disclosure and Audit Quality on the Cost of Equity Capital Moderated by Financial Distress Prediction

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**Abstract** - *The present research investigated the prediction of bankruptcy (financial distress) as a factor that can moderate the level of disclosure (annual report disclosure) and audit quality on the cost of equity capital. Bankruptcy prediction (financial distress) was analyzed using the first Altman model (Z-score). Meanwhile, to test the level of financial reporting (disclosure), this study examined the 5 elements used in Botosan's research (1997). The results of this study revealed that: 1) the level of disclosure in manufacturing companies in Indonesia affects the cost of equity capital, 2) audit quality has no effect on the cost of equity capital, 3) prediction of financial distress moderates the relationship between the level of disclosure and the cost of equity capital and the relationship between audit quality and the cost of equity capital.*

**Keywords** - *Bankruptcy; Level of the disclosure; Cost of equity capital; Altman Z-score.*

## I. INTRODUCTION

In a developing country like Indonesia, the country's economic sector largely depends on the existing industries, which can be classified into two groups, i.e., the manufacturing and service sector. The manufacturing industry is relatively stable and one of the supporting sectors for its economy, contributing significantly to economic growth amidst global economic uncertainty. Also, the sector is an industry that creates a significant contribution and is in demand by investors. Furthermore, companies categorized as the manufacturing industry are encountering such conditions that require more transparency for information disclosure; thus, it is a good idea for the decision-makers to anticipate the increasingly turbulent conditions[1].

Meanwhile, the information disclosure in the financial statements/reports is classified into two aspects, namely mandatory and voluntary disclosure [2]. Financial reports play a crucial role for investors in company assessment and decisions making. Without an audit of financial statements, investors will be uncertain about the reliability of financial information a company provides. Thus, an external auditor has an indispensable role in increasing investors' confidence/trust regarding the information provided in the company's financial statements[3], [4].

Moreover, investors can assess whether a company is a high or low risk based on financial reports. If the investors consider a company to be high risk, their expectation of the return rate will increase, and the increased risk it imposes. In the end, it will impose a high cost of equity [5]. Meanwhile, the cost of equity capital has different meanings from some points of view. From an investor's point of view, the cost of equity capital is related to the return rate on their investment in the company. On the other hand, from the company's point of view, its cost is to obtain resources funds required[6]–[8].

The research results conducted by Sumaryati and Tristiarini [9]revealed that financial distress and firm value significantly affect the cost of equity; yet, this study did not prove financial distress as a moderator between the cost of equity and firm value. On the other hand, the results of research conducted by Pratiwi and Supriadi[10] found that the cost of equity capital and prediction of financial distress do not affect. However, an increase in equity capital cost does not affect the decreased prediction about financial distress.

This study will test the prediction of financial distress using the Altman Z-score model. Based on the research conducted by Ramadhani and Lukviarman [11], in which they compared the three Altman models, the study concluded that the first Altman model is the most accurate in comparison with the other two models. To analyze the level of the financial report), testing the 5 elements used in Botosan [12]–[14] research is carried out.

## II. LITERATUR REVIEW
### A. Theoretical Review
### Agency Theory

According to Kurniawansyah et al. [15], company owners are interested in improving their welfare through dividend distribution or an increase in the company's stock performance. On the other hand, managers have their

interests through their increased compensation. Such a condition motivates the managers not to provide information that harms their interests [4], [16]. When agents become increasingly averse to risk, based on research conducted by Habib et al. [17], high information risk will impact increasing the cost of equity capital.

### *Signaling theory*

Regarding the relationship between a signal theory with disclosure and information asymmetry, it can be said that bad information will have negative effects since it is considered unfavorable information (bad news). Therefore, it can undermine the investors' confidence who wish to earn high profits. Nuryanto et al. [18] stated that increased information disclosure would enhance market liquidity, reducing equity capital cost. According to Botosan (1997), one which affects the cost of equity is the level of disclosure or financial statement information.

### B. Hypothesis
### *a) Effect of level of disclosure on the cost of equity capital*

The level of disclosure is the extent to which a company strives to provide signals to investors regarding the company's condition. This effort can improve an investor's confidence to estimate a low risk to the company. The risk level reflects the return rate to investors and creditors, which can burden the company with a higher equity capital cost. According to Botosan (1997), the cost of equity is influenced by the level of disclosure, risk (BETA), and equity market value. Likewise, Botosan (1997) research results supported the existence of a negative relationship between the level of disclosure and the cost of company equity. Given such information, the first hypothesis is proposed as follows:
H1: The level of disclosure hurts the cost of equity capital.

### *b) Effect of audit quality on the cost of equity capital*

Companies audited by qualified public accounting firms can reduce the potential of misstatement found in its financial statements. It is assumed that a financial report, which is supported by a quality audit, can minimize risk, leading to reduce the level of return required by investors[19]. The decrease in the required rate of return will lower the company's cost of equity capital. Therefore, the higher the company's audit quality, the lower the cost of equity capital. Based on this explanation, the second hypothesis is proposed as follows:
H2: Audit quality harms the cost of equity capital.

### *c) Financial distress decreases the negative effect of the level of disclosure on the cost of equity capital*

Financial distress can result in excessive spending cost of equity capital. Moreover, it encourages the management to work efficiently to increase their profitability and believes that companies need to reduce equity capital costs to avoid financial distress. To avoid a bankruptcy state, companies must predict financial distress. If the results of financial distress predictions indicate that the company is in bad shape, the management will tend to cover up its condition, which, in turn, can affect the level of disclosure.

Based on this explanation, the third hypothesis is proposed as follows:
H3: financial distress decreases the negative effect of disclosure on the cost of equity capital.

### *d) Prediction of financial distress decreases the negative effect of audit quality on the cost of equity capital*

Management often has to deal with the situations in which the company faces failure, leading to its future survival in uncertainty. Financial distress is defined as when a company faces difficulty in funds either in cash or working capital. Even in certain cases, the company can experience a prolonged crisis. Companies that experience financial distress tend to replace public accounting firms because they need to hire a higher quality auditor than the previous one to elevate stakeholders' trust and increase their confidence [20]. Based on this elucidation, the hypothesis is proposed as follows:
H4: Predicted financial distress reduces the negative effect of audit quality on the cost of equity capital.

## III. METHODOLOGY
### A. Research variables and operational definitions

This study uses a quantitative method with two independent variables: the level of disclosure and audit quality. Meanwhile, the moderating variable predicts financial distress, whereas the dependent variable is the cost of equity capital.

### B. Dependent variable

According to Sugiyono [21], a dependent variable is affected or the result of the independent variable. In this study, the dependent variable is the cost of equity capital measured using CAPM (capital asset pricing model). The model is calculated using the following formula: $K_S = R_{RF} + \beta i\ (R_M - R_{RF})$.

### C. Types and sources of data

In this study, secondary data were used and obtained from: a) annual reports of manufacturing companies listed on the Indonesia Stock Exchange in 2018, b) the company's daily stock price, c) the company's daily composite stock price index (IHSG), d) Bank Indonesia Certificate (SBI).

### D. Population and sample

In this study, the population consists of companies listed on the Indonesia Stock Exchange (BEI), while the samples are manufacturing companies listed on the Indonesia Stock Exchange in 2018. The data in this study were obtained from several sources, namely finance.yahoo.com, the Indonesia Stock Exchange (www.idx.co.id), the official website of Bank Indonesia (www.bi.go.id), and several official websites of the manufacturing companies. The sample criteria are as follows: 1) go public companies listed on the Indonesia Stock Exchange classified as manufacturing companies, 2) published the 2018 annual report on the Indonesia Stock Exchange website (www.idx.co.id), 3) published audited financial statements for 2018, 4) the companies continued to trade shares on the IDX during the estimated period, 5) the companies did not halt their activities on the stock

market, did not cease their operations nor merge, change their industrial sector.

### E. Method of analysis
Descriptive statistical analysis

In this study, descriptive statistical analysis was used to provide an overview or description of the maximum value, minimum value, mean value, and standard deviation of the level of disclosure, audit quality, prediction of financial distress, and the cost of equity capital.

Classical assumption test

The classical assumption test for the regression model used in this study was performed to evaluate whether the regression model was feasible or not. In this study, the classical assumption test consists of the normality test, multicollinearity test, autocorrelation test, and heteroscedasticity test.

## IV. RESULTS AND DISCUSSIONS
### A. Description of the research object
This study's objects were several manufacturing companies listed on the Indonesia Stock Exchange (IDX) in 2018. The purposive sampling was used to collect samples, by which the samples were determined based on certain criteria. The following table describes the sampling criteria in this study.

**Table 1. Companies which meet the sample criteria**

| Remarks | Total number |
|---|---|
| Manufacturing companies listed on the IDX 170 | 170 |
| Incomplete data: | |
| - Chemicals industries | 7 |
| - Miscellaneous industries | 3 |
| - Consumer goods sector | 8 |
| Data processible | 152 |

*(Source: Indonesia Stock Exchange, data processed)*

### B. Descriptive statistics
Data descriptive statistics refer to those along with the minimum value, maximum value, mean and standard deviation. The descriptive statistics of the data in this study are presented in the table below.

The variable level of disclosure (X1), calculated using the disclosure item proposed by Botosan (1997), has a value range of 0.08 to 0.65. The lowest score is attributed to PT Nipress Tbk (NIPS), while the highest score is exhibited by PT Charoen Pokphand Indonesia Tbk (CPIN). The average value of the company's financial statements' disclosure level indicates 0.4589, while the value of standard deviation is 0.10707.

**Table 2 Descriptive data of research variables**

| Descriptive Statistics | | | | | | | |
|---|---|---|---|---|---|---|---|
| | N | Minimum | Maximum | Sum | Mean | | Std. Deviation |
| | Statistic | Statistic | Statistic | Statistic | Statistic | Std. Error | Statistic |
| X1 | 152 | .08 | .65 | 69.75 | .4589 | .00868 | .10707 |
| X2 | 152 | .10 | .20 | 20.90 | .1375 | .00394 | .04857 |
| Y | 152 | .01 | .37 | 12.06 | .0793 | .00530 | .06533 |
| Z | 152 | .10 | .30 | 32.10 | .2112 | .00677 | .08343 |
| Valid N (listwise) | 152 | | | | | | 0.06533 |

(Source: Output SPSS 22)

The variable of audit quality (X2), calculated using a dummy variable with a value of 2 for 'big four public accounting firms' and 1 for non-big four public accounting firms' has a value range of 0.10 0.20. 57 companies hired big four public accounting firms, while the others chose to use non-big four public accounting firms. The average value of audit quality is 0.1375, while the standard deviation shows a value of 0.04857.

The variable cost of equity capital (Y), calculated using CAPM (capital asset pricing model), has a value range of 0.01 to 0.37. The lowest score is owned by PT Prima Cakrawala Abadi Tbk (PCAR), while the highest score is attributed to PT Multi Prima Sejahtera Tbk (LPIN). A low cost of equity capital indicates a low-risk level, by which there is a low risk-return of investors' expectations. The average value of the equity capital cost is 0.0793, while the standard deviation indicates a value of
.

It turns out that the prediction variable of financial distress (Z), which is calculated using the Altman Z-score

method, has a value range of 0.10 to 0.30. The average value of this variable prediction accounts for 0.2112, while the standard deviation is 0.08343.

### C. Analysis of the level of financial statement disclosure
The test results for each indicator, as discussed in Botosan (1997), are described as:
1. Company background. The level of disclosure to the company's background is quite high, reaching 83%. Of these items, the business's explanation is the one most disclosed by the companies with a disclosure score percentage of 94%.
2. Summary of historical results. Almost all companies disclosed a summary indicator of historical results with a percentage of 99%. It is because that this indicator disclosure is mandatory in Indonesia.

3. Non-financial information. This indicator is categorized as a voluntary disclosure. The percentage of disclosing non-financial information reaches 62%. Most of the companies did not disclose their order backlogs, i.e., customers' orders which have not been shipped or will be shipped, with a disclosure percentage of 21%.

4. The information about company future projection. This indicator is also classified as voluntary disclosure, consisting of projections of market share, cash flow, capital expenditures or research and development, profits, and sales. The percentage for disclosure information about the company's future projections is 15% and regarded as the lowest disclosure. The items in this disclosure are very useful for investors to know the company's future projections.

5. Management analysis. The level of disclosure on this indicator is relatively high, at 70%, higher than that of non-financial information. In this indicator, changes in gross profit and net income are most frequently subjected to disclosure (88%) and are explained in the management analysis section.

### D. Classic assumption test
### Normality test

Based on the results as presented in Table 3, it is found that the significance value of Asymp. Sig. (2-tailed) 0.200 is greater than 0.05. Therefore, it can be concluded that the data are normally distributed. Thus, the requirements of the assumptions of normality in the regression model have been fulfilled.

**Table 3. Normality test results**

|  |  | Unstandardized Residual |
|---|---|---|
| N |  | 152 |
| Normal Parameters | Mean | .0000000 |
|  | Std. Deviation | .23031804 |
| Most Extreme Differences | Absolute | .061 |
|  | Positive | .061 |
| Test Statistic | Negative | -.044 |
| Asymp. Sig. (2-tailed) |  | .061 |
|  |  | .200 |

a. Test Distribution is Normal.
b. Calculated from data
(Source: Output SPSS 22)

### Multicollinearity test

In Table 4, it can be seen that the VIF value of all variables is less than 10, and the tolerance value is greater than 0.1. Thus, it can be concluded that there is no multicollinearity between the variables in the regression model.

**Table 4. Multicollinearity test results**

Coefficients

| Model |  | Collinearity Statistics | |
|---|---|---|---|
|  |  | Tolerance | VIF |
| 1 | (Constant) |  |  |
|  | X1 | .944 | 1.059 |
|  | X2 | .564 | 1.773 |
|  | X1Z | .944 | 1.059 |
|  | X2Z | .564 | 1.773 |

Source: Output SPSS 22

### Autocorrelation test

Based on the results of the autocorrelation test as shown in Table 5, the comparison of the Durbin-Watson ($D_W$) value with those of table at 5% significance with the formula (k; N). in the test, the number of independent variables (k) is 2 while the number of samples (N) is 152. Therefore, the value of (k; N) is (2; 152). In the Durbin-Watson ($D_W$) table, the dL value is 1.7083, while the dU is 1.7616. The Durbin-Watson ($D_W$) value of 1.924 is greater than the dU limit, yet less than (4-dU), which is 2.2384.

The variable of disclosure level ($X_1$) and the moderating interaction between the level of disclosure and prediction of financial distress ($X_1Z$) is 1.924. Therefore, it can be concluded that the data for the $X_1$ and $X_1Z$ variables do not have autocorrelation. The Durbin-Watson ($D_W$) value on the audit quality variable ($X_2$) and the moderating interaction variable between audit quality and financial distress prediction ($X_2Z$) is 2.028. Hence, it can be concluded that the data variables $X_2$, Z, and $X_2Z$ do not have autocorrelation.

**Table 5. Autocorrelation test results**

**Model Summary**

| Model | R | R Square | Adjusted R Square | Std. The error of the Estimate | Durbin-Watson |
|---|---|---|---|---|---|
| 1 | .264[a] | .070 | .057 | .04081 | 1.924 |

a. Predictors: (Constant), X1Z, X1
b. Dependent Variable: Y
   Source: Output SPSS 22

**Model Summary**

| Model | R | R Square | Adjusted R Square | Std. The error of the Estimate | Durbin-Watson |
|---|---|---|---|---|---|
| 1 | .192[a] | .037 | .024 | .04153 | 2.028 |

a. Predictors: (Constant), X2Z, X2
b. Dependent Variable: Y
   Source: Output SPSS 22

**Heteroscedasticity test**

**Table 6. Heteroscedasticity test results**

| Model | Unstandardized Coefficients | | Standardized Coefficients | t | Sig. |
|---|---|---|---|---|---|
| | B | Std. Error | Beta | | |
| 1 (Constant) | .025 | .004 | | 7.008 | .000 |
| X1 | .016 | .022 | .061 | .707 | .481 |
| X2 | -.007 | .041 | -.018 | -.163 | .870 |
| X1Z | .001 | .006 | .081 | .204 | .839 |
| X2Z | .017 | .026 | .071 | .624 | .533 |

a. Dependent Variable: ABS2
Source: Output SPSS 22

Based on the results of the heteroscedasticity test presented in Table 6, it can be seen that the significance value of all variables is greater than 0.05. Therefore, it can be concluded that heteroscedasticity does not occur.

*E. Regression analysis*

     Based on Table 7 shows that the value of adjusted R square is 0.102 or 10.2%, meaning that 10.2% of variations or changes in the cost of equity capital can be explained by variations of the variables in the model, i.e., the disclosure level, audit quality and prediction of financial distress, the interaction between the variable of the level of disclosure with the prediction of financial distress, and the interaction of variable of audit quality with the prediction of financial distress.

**Table 7. Regression coefficient test results Model summary**

| Model | R | R Square | Adjusted R Square | Std. The error of the Estimate |
|---|---|---|---|---|
| 1 | .356[a] | .127 | .102 | .03981 |

[a]   Predictors: (constant), $X_2Z$, $X_1$, $X_1Z$, $X_2$

Source: Output SPSS 22

**Table 8. F test results ANOVA[a]**

| Model | Sum of Squares | df | Mean Square | F | Sig. |
|---|---|---|---|---|---|
| 1 Regression | .033 | 4 | .008 | 5.192 | .001[b] |
| Residual | .227 | 143 | .002 | | |
| Total | .260 | 147 | | | |

a. Dependent variable: Y
b. Predictors: (constant), $X_2Z$, $X_1$, $X_1Z$, $X_2$

Source: Output SPSS 22

Based on the results of the simultaneous test of the multiple linear regression model (F test) in Table 8, it shows that the results of moderation regression obtained a significance value of 0.001, which is less than the level $\alpha = 0.05$. Given such data, it means the variable level of disclosure, audit quality, the interaction variable of the level of disclosure with the prediction of financial distress, and the interaction variable of audit quality and prediction of financial distress significantly affect the cost of equity capital. This indicates that the model used in this study is feasible.

**Table 9. Multiple linear regression test results Coefficients**

| Model | Unstandardized Coefficients | | Standardized Coefficients | t | Sig. |
|---|---|---|---|---|---|
| | B | Std. Error | Beta | | |
| 1 (Constant) | -.091 | .005 | | -18.842 | .000 |
| $X_1$ | -.063 | .030 | -.167 | -2.076 | .040 |
| $X_2$ | .031 | .056 | .058 | .556 | .579 |
| $X_1Z$ | -.029 | .008 | -.299 | -3.631 | .000 |
| $X_2Z$ | -.094 | .036 | -.278 | -2.601 | .010 |

a. Dependent variable: Y

Source: Output SPSS 22

Based on the results of the multiple linear regression test, as shown in the table above, the regression equation can be expressed as follows:

**CoEC = (-0,091) – 0,063 TD + 0,031 KA – 0,029 TD PFD – 0,094 KAPFD**

### F. Testing of Hypothesis 1

The calculation results of the regression coefficient test (T-test) are shown in Table 9. It shows that the regression coefficient value X1 or the disclosure level is -0.063 with a significance level of 0.040, which is less than $\alpha = 0.05$. In addition, after observing the t count, which is -2.076, less than those of t table of -1.97612, it indicates that the level of disclosure has a negative and significant effect on the cost of equity capital. Therefore, the hypothesis which states that the level of disclosure has a negative and significant effect on the cost of equity capital is accepted. It states that the higher disclosure of financial statements in the company can affect and reduce the value of equity capital.

This study results support those of the research conducted by Botosan (1997), which states a negative relationship between the level of disclosure of financial statements and the cost of equity capital. Furthermore, these findings are also in agreement with those of the research conducted by Dewi et al. [22], which states that voluntary disclosure has a negative and significant effect on the cost of equity capital.

### G. Testing of Hypothesis 2

The calculation results of the regression coefficient test (T-test) can be observed in Table 9. According to the table, the value of regression coefficient $X_2$ (audit quality) is 0.031 with a significance level of 0.579, greater than $\alpha = 0.05$. In addition, by examining the t count, i.e., 0.556, which is less than those of t table of 1.97612, it reveals that audit quality does not affect the cost of equity capital. Therefore, the hypothesis which states that audit quality has a negative and significant effect on the cost of equity capital is rejected. This study states that audit quality does not affect the increase or decrease in the cost of equity capital. Therefore, based on this result, the audit quality is not an effective variable to reduce equity capital cost.

### H. Testing of Hypothesis 3

The calculation results of the regression coefficient test (T-test) are presented in Table 9. The regression coefficient value of $X_1Z$ (the variable of interaction between the level of disclosure and prediction of financial distress) is -0.029 with a significance level of 0.000, less than $\alpha = 0.05$. Furthermore, by observing the t count, the obtained value is -3.631, which is less than that of the t table, i.e., -1.97612. The moderating characteristic of the prediction of financial distress on the level of disclosure and the cost of equity capital is negative, indicating that financial distress's prediction decreases the negative influence between the level of disclosure and the cost of equity capital.

### I. Testing of Hypothesis 4

The calculation results of the regression coefficient test (T-test) are shown in Table 9. The value of the regression coefficient of $X_2Z$ (the variable of interaction between audit quality and financial distress prediction) is -0.094 with a significance level of 0.010, which is less than the level of $\alpha = 0.05$. Besides, by observing the t count, the obtained value is -2.601, which is less than that of the t table of -1.97612. It shows that the prediction of financial distress is a variable that can moderate the relationship between audit quality and the cost of equity capital. The moderating effect of financial distress on audit quality and cost of equity capital has a negative characteristic, which means that the prediction of financial distress can

strengthen the negative relationship between audit quality and the cost of equity capital. Even though the second hypothesis states that audit quality does not affect the cost of equity capital, this study indicates that financial distress weakens the negative effect of audit quality on the cost of equity capital. Based on the results of this hypothesis testing, it is revealed that the financial statements audited with big four public accounting firms and have a high predictive value of financial distress (not experiencing bankruptcy) will reduce the value of the cost of equity capital.

## V. CONCLUSION

Based on the results of hypotheses testing which have been carried out regarding the effect of disclosure level and audit quality on the cost of equity capital with the prediction of financial distress as a moderating variable, the following conclusions can be drawn: 1) The level of disclosure has a significantly negative effect on the cost of equity capital. The improved disclosure of financial statements in companies can affect and reduce the value of the cost of equity capital. 2) Audit quality does not affect the cost of equity capital, while it is an effective variable to reduce equity capital cost. Many other factors can be used to assess audit quality, not merely as a matter of 'big four or non-big four public accounting firms. 3) The prediction of financial distress moderates the negative effect of the level of disclosure on the cost of equity capital. Meanwhile, the prediction of financial distress can reduce the company's risk, thereby reducing the rate of return required by investors of companies with a high level of disclosure of financial statements. As such, the cost of equity capital issued by the company will decrease. 4) Financial distress prediction moderates the negative effect of audit quality on the cost of equity capital. Furthermore, prediction of financial distress can reduce the company's risk, thereby reducing the rate of return required by investors of companies with a good quality of audit (big 4 public); thus, the cost of equity capital issued by the company decreases.

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