

CORPORATE RISK DISCLOSURE AND COST OF EQUITY CAPITAL: MODERATING ROLE OF FIRM PERFORMANCE

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Abstract: Investors can use Corporate Risk Disclosure to guide them in assessing a company. Indicators of Corporate Risk Disclosure, based on IFRS 7, include 45 items with the following requirements: (a) General Risk Information; (b) Accounting Policies; (c) Financial Instrument; (d) Derivative hedging; (e) Reserve; and (f) Financial and Other Risks. The current study aims to assess and analyze the impact of Corporate Risk Disclosure on Cost of Equity Capital and to determine whether Firm Performance moderates the relationship between Corporate Risk Disclosure and Cost of Equity Capital. It uses a sample of 86 manufacturing companies listed in Indonesia Stock Exchange in the period 2017-2019. The results indicated that Corporate Risk Disclosure negatively affects Cost of Equity Capital. More risk items disclosed means higher market liquidity as demand for securities is increasing and thereby lowering the cost of equity capital. Firm performance has been shown to strengthen the impact of Corporate Risk Disclosure on Cost of Equity. Underperforming companies tend to disclose more risk information than their well-performing counterparts and the latter, thereby, will have lower cost of equity capital.

Keywords: Corporate Risk Disclosure, Firm performance, Cost of Equity Capital

1. Introduction

Corporate risk disclosure has gained special attention in the global stakeholder communities (Aebi et al., 2012; Beltratti dan Stulz, 2012; Erkens et al., 2012). Studies by Botosan (1997), Lajili (2009) and Linsley and Shrivies (2006) elucidated the costs and benefits of disclosure and maintain that higher level of disclosure leads to more transparency, lower cost of capital, and decreased information asymmetry. An example of this is the mining case of PT. Newmont that produced a large amount of mine tailings, caused pollution, and disturbed the ecological balance of West Nusa Tenggara, Indonesia in 2016. Another example that represents the case of negative externalities as the impact of industrialization is the destruction of natural ecosystem caused by PT. Riau Andalan Pulp and Paper in 2015. High production capacity of PT. Riau Andalan Pulp and Paper requires it to cut down trees in a large scale, which makes the forest condition even worse. Companies lacking real care for environmental issues in their operation will end up causing environmental damages and degrading their business performance.

From a business perspective, disclosing company risk can reduce the cost of capital, because investors believe that business operations run well when uncertainty diminishes (Abraham

and Cox, 2007; Linsley and Shrives, 2006). Disclosure of financial information is mandatory for companies seeking to go public. Positive company information regarding expected returns will influence shareholders and potential investors. Unexpected negative information, on the contrary, will have a negative impact on the market. In a contractual relationship, management has a choice to use a combination of debt and equity financing.

Considering the importance of risk disclosure, standard-setters seek to further reform the existing regulations in recent years, including the issuance of IFRS 7 to regulate and guide accounting disclosure practices—depending on the mandate extended. IFRS 7 comes with the objective that entities shall provide information regarding company's financial position, performance, cash flow, and risks associated with financial instruments and management policies. IFRS 7 includes disclosure about financial instruments applicable to all enterprises as it combines the requirements for disclosure of financial instruments, which formerly regulated under International Accounting Standards (IAS). IFRS 7 requires qualitative and quantitative disclosures for three main risks: credit risk, liquidity risk and market risk.

Qualitative disclosure is intended to describe how the company is exposed to the risks, how the risks arise and how it manages these risks. Quantitative disclosure, on the other hand, is designed to provide information concerning the extent to which an entity discloses the risks based on information provided internally for the management. Capital market regulations serve as regulatory tools to effectively provide the required information. Disclosure may benefit firms through lower cost of capital for the following reasons: (1) Disclosure reduces transaction cost figure. Increase in disclosure helps investors reduce adverse selection component of their bid-ask spreads and cost of equity capital (Botosan, 1997). Disclosure reduces the adverse price impact associated with large-scale trade; reduces information asymmetry between investors, which leads to a higher demand for securities in the market; and reduces cost of transaction and increases liquidity, which in turn reduces cost of equity capital (Amihud and Mendelson, 1986; Botosan, 1997; Verrecchia, 1991). Increased disclosure also lowers uncertainty or estimation risk (Clarkson et al., 1996). Botosan (1997) suggests that firm enhancing disclosure is an attempt to reduce the cost of equity capital by lowering non-diversifiable estimation risk.

Prior research has examined the relationship between disclosure level (financial and social) and cost of equity capital, and the results have been varied because of the disclosure validity and certain measures used to measure the cost of equity capital (Al-Tuwaijri et al., 2004). Negative relation exists between financial disclosure and cost of equity capital (Botosan, 2004; Healy and Palepu, 1999; Richardson and Welker, 2001). However, there is a significant positive relation between social disclosures and the cost of equity capital because some biases in social disclosure might benefit companies through its impact on organizational stakeholders rather than on other investors (Richardson and Welker, 2001). Lambert et al. (2007) examined the direct and indirect effects of disclosure quality on the cost of capital. Higher quality disclosures affect the firm's assessed covariances with other firms' cash flows and also indirectly affect the company's investment decisions in the future. The results of study showed that disclosures have a direct negative impact and an indirect positive impact on cost of capital.

Information disclosure is an attempt to bring a harmony of interests between stakeholders and managers by lowering agency cost and, thus, improve company's performance (Solomon et al., 2000). Healy and Palepu (1999) maintained that disclosure communicates corporate governance and firm performance to stakeholders. Previous studies provide evidence that voluntary disclosure provides an important mechanism that improves firm performance (Healy and Palepu, 1999; Miller and Noulas, 1996). Agency theory suggests that the

relationship between business principals and their agents requires efficient use of information to minimize information asymmetry (Eisenhardt, 1989). Agency theory explores two potential problems (adverse selection and moral hazard) that may arise in the manager-shareholder relationship for low corporate disclosure. Foerster et al. (2014) found that corporate management disclosures in Canada have been positively related to firm value in two aspects: reducing business risk and changes in investors' perceptions of future cash flows. Callahan and Smith (2004) found that financial disclosure is positively related to future performance of corporate industries.

Results of study related to corporate risk disclosure and those that moderate risk disclosure, cost of capital and performance remain limited (Aebi et al., 2012). The current study analyzes the relationship among three variables—risk disclosure, cost of capital and performance—in developing country settings where disclosing risk information is a matter of options rather than obligations. Based on the above mentioned phenomenon, we formulate the research problem as follows:

- a) Does corporate risk disclosure affect cost of equity capital?
- b) Does firm performance strengthen the impact of corporate risk disclosure on the cost of equity capital?

2. Literature Review

Literature Review

Corporate Risk Disclosure

Cabedo and Tirado (2004, 184) define risks as a series of internal and external factors that condition a corporation's wealth, challenges, opportunities and threats. By the term risk they mean the possible loss or potential enhancement in corporations' wealth that arise from the interaction of these factors. Linsley and Shrivies (2006) add that risk is a characteristic of every opportunity, prospect, danger, threat, which impacts the company in the future. While there are relevant concerns over potential losses, it is clear that risk must consist of two-sided volatility concerns about both potential gains and losses. Corporate risk disclosure is defined as the reporting of conditions that may cause the company's value to increase or decrease as well as the steps to be taken to minimize these risks (Hassan, 2009).

Firm Performance

Performance is the output or accomplishment of company's operational activities in utilizing the available resources. The company's strategy from a financial perspective will affect shareholder value in the long run. Return on Assets (ROA) serves to indicate how profitable a company is relative to its assets or the resources it owns. According to Lestari and Sugiharto (2007) ROA is a financial ratio that indicates the net profit that a company earns in relation to its assets. To put it another way, the higher the ratio the better the asset productivity is in obtaining net profits. The higher the ROA figures, the better the firm performance is, because its rate of return on investment of will be higher.

Cost of Equity Capital

Cost of equity capital (COC) is the cost to pay for the spending resources (source of financing). Cost of equity capital can be identified as the minimum return required to pay for the equity capital invested (Modigliani and Miller, 1958). Cost of equity correlates with the risk of investing in company shares. Things assumed in estimating the cost of capital are business and financial risks that remain constant (or relatively stable). Companies can raise equity capital in two ways: (1) retained earnings, and (2) issuing new shares. This is done to raise new funds required for the company's operation (Brigham and Houston, 2006: 105).

Companies have an obligation to disclose financial information which certainly has an impact on the incurred costs. Therefore, the cost of equity capital referred to in this study is the cost incurred by the company for providing information to the public; shareholders, investors, government, creditors, and the general public (Tarjo, 2008).

The cost of capital is calculated on the basis of the long-term sources of funds available to the company. There are four long-term sources of funds: (1) long-term debt, (2) preferred stock, (3) common stock, and (4) retained earnings. Long-term cost of debt is the current after-tax cost of debt to borrow long-term funds through loans. The cost of preferred stock is the annual dividend of preferred stock divided by the proceeds from selling the preferred stock. The cost of common stock capital is the rate used by investors to discount dividends that are expected to be paid out in the future. The measurement of cost of common stock capital (cost of equity capital) is affected by the company valuation model used. The following are valuation models for cost of equity capital (Utami, 2005):

- 1) Constant Growth Valuation Model or Gordon Growth Model. The rationale for this model is that the stock value equals the cash value (present value) of all dividends to be received in the future at a constant growth rate indefinitely.
- 2) Capital Asset Pricing Model (CAPM). Based on this model, the cost of ordinary share capital is the rate of return expected by investors as compensation for undiversifiable risk as measured by beta coefficient.
- 3) Ohlson Model. The model is used to estimate firm value based on book values and cash value of abnormal earnings.

The present study used Cost of Equity Capital measured using Capital Asset Pricing Model (CAPM). The latter is the rate of return expected by investors as compensation for undiversifiable risk as measured by beta coefficient. In this study, we employed CAPM to measure cost of equity capital because it generates accurate and correct estimation.

Research Model

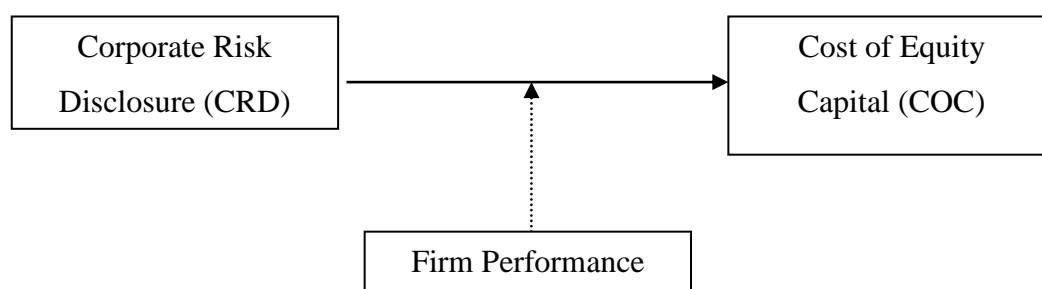


Figure 1 : Research Framework

3. Method

Population and Sample

The population in this study consisted of all manufacturing companies listed on Indonesia Stock Exchange for the period 2017-2019. We use purposive sampling techniques to collect samples that meet the following criteria: (1) companies publishing annual report; (2) companies using rupiah; (3) companies reporting their earnings during study; and (4) companies not getting delisted. The study uses a sample of 86 companies per year. The table below details the sampling criteria:

Tabel 1. Population and sample

Sampling Criteria	Number
Total number of manufacturing companies.	145
Companies not publishing annual report	(15)
Companies using currency other than Rupiah.	(17)
Companies reporting net loss.	(18)
Companies not getting delisted.	(9)
Total	86

Sources: Indonesia Stock Exchange

Variables and Measurments

1) Corporate Risk Disclosure

As adopted in Hassan (2009), Corporate Risk Disclosure is the number of financial risks that firms present in their annual reports that consist of 45 items. Risk disclosure can be divided into: (a) General Risk Information; (b) Accounting Policies; (c) Financial Instrument; (d) Derivative hedging; (e) Reserve; and (f) Financial and other risks. The extent of financial risk disclosure in this study is indicated by scores: 1 is assigned when the items are presented in the annual report; and 0 is assigned when the items are not presented in the annual report. Financial risk disclosure can be measured by summing up the total score of disclosure for each annual report. The equation used to quantitatively measure the extent of financial risk disclosure in this study is presented below:

$$CRD = \frac{1}{MAX} \sum SCORE$$

Where, CRD = Disclosure score

MAX = Maximum value a company can achieve

SCORE = Score for each item of corporate risk disclosure
(1 and 0 for available and not available, respectively).

2) Firm Performance

To identify firm performance, we use Return on Assets (ROA) as indicated by the following formula:

$$ROA = \text{Net Income} / \text{Total Asset}$$

3) Cost of Equity Capital

By cost of equity capital we mean the cost that the firm has to bear for providing information to the public and, thus, anticipating the risks by increasing the required rate of return on shares. Furthermore, Cost of Capital (COC) in this study is calculated by Capital Asset Pricing Model (CAPM). The method calculating COC using CAPM has been adopted by Mardiyah (2002) and Heriyanthi (2013). COC approximation using Capital Asset Pricing Model (CAPM) is represented in the following formula:

$$COC = R_{ft} + \beta_i (R_{Mt} - R_{ft})$$

Where,

R_{ft} : Free-risk return as proxied by the 1-month Bank Indonesia's interest rate.

R_{Mt} : Market return of the Composite Stock Price Index (CSPI) on day t plus CSPI on day t-1 divided by CSPI on day t-1.

β_i : Unsystematic risk for each company share i

4) Control Variable : Leverage dan Size

The control variables used in this study includes:

- (a)LEV (Leverage) as measured using debt-to-asset ratio. Debt-to-asset ratio has been widely used as leverage proxies in previous studies (Amran et al., 2009; Oliviera et al., 2011). Debt-to-asset ratio is, by definition, the total amount of a company's liabilities divided by the total amount of the company's assets.
- (b)SIZE, is the firm size as measured by Ln Total Asset over the period of the study.

4. Result and Discussion

Corporate Risk Disclosure affects Cost of Equity Capital

Based on the multiple linear regression analysis of Model 1 regression equation, the formula is written as follows:

$$\text{COC} = 0.560 - 0.306 \text{ CDR} + 0.038 \text{ LEV} + 0.008 \text{ SIZE} + e$$

Table 2. Determination Test

R	R Square	Adj R Square	Std Error of the Estimate
0.409	0.167	0.157	0.24667

Sources: processed

Table 3. ANOVA and T-test

ANOVA			
	F		Sig.
	17.010		0.000
Uji t			
Unstandardized Coefficients			Sig.
Constant	0.560		
CRD	-0.306		0.000
LEV	0.038		0.777
SIZE	0.008		0.860

Sources: processed

The adjusted r-squared value, as we can see in Table 1, is 0.157, which means that 15.7% variation in cost of equity capital can be explained by Corporate Risk Disclosure, while the remaining 84.3% can be explained by other variables not included in the model. The results of ANOVA indicate Sig. 000 at $\alpha = 5\%$, which means that the regression model is adequate to estimate the effect of Corporate Risk Disclosure on Cost of Equity Capital. Regression testing for Model 1 in Table 2 indicates the t-test value of 0.306 with Sig. 0.000 at $\alpha = 5\%$. This confirms that the result of this study is consistent with those of Botosan (1997) and Dhaliwal et al (2001). As suggested above, Corporate Risk Disclosure has a negative effect on Cost of Equity Capital. The more extensive the financial risks disclosure is, the lower the cost of equity capital will be. The more items disclosed, the higher the market liquidity is; for the reason that increased demand for securities will decrease the cost of equity capital.

Extensive disclosure lowers unanticipated risks and therefore reduces compensation costs for investors. According to Hassan (2009), risk disclosure that requires (a) General Risk Information (b) Accounting Policies (c) Financial Instrument (d) Derivative hedging (e) Reserve (f) Financial and Other Risks provides crucial information for investors to asses firm capability to survive and to meet its short-term and long-term obligations as well as to

estimate return on their investments. The regression analysis for Leverage as the control variable indicates no effect on cost of equity capital with Sig. 0.777 which is greater than $\alpha = 5\%$. Companies with funding structure that adopts Leverage technique need to maintain their liquidity to enable them to pay short-term and long-term debts. The regression analysis for Size as the control variable indicates Sig. 0.860, which is greater than $\alpha = 5\%$. This indicates that firm size has no effect on cost of equity capital. Both large and small companies incur costs to provide information to stakeholders.

Corporate Risk Disclosure and Firm Performance affect Cost Of Equity Capital

Based on the multiple linear regression analysis of Model 2 regression equation, the formula is written as follows

$$COC = 0.471 - 0.278 CDR + 0.132 FP - 0.171 CDR*FP + 0.102 LEV - 0.02 SIZE + e$$

Model 2 adds up Firm Performance to determine the effect of Corporate Risk Disclosure on Cost of Equity Capital.

Table 4. Determination Test

R	R Square	Adj R Square	Std Error of the Estimate
0.488	0.238	0.223	0.23683

Sources: processed

Table 5. ANOVA and T-Test

ANOVA			
	F		Sig.
	15.780		0.000
t-test			
Unstandardized Coefficients			Sig.
Constant	0.471		
CRD	-0.278		0.014
FP	0.132		0.000
LEV	0.102		0.434
SIZE	-0.02		0.969
MODERATE	-0.171		0.000

Sources: processed

The adjusted r-squared value, as can seen in Table 3, is 0.223, which means that 22.3% variation in Cost of Equity Capital can be explained by Corporate Risk Disclosure and Firm Performance, while the remaining 77.7% can be explained by other variables not included in the model. The results of ANOVA indicate Sig. 0.000 at $\alpha = 5\%$, which means that the regression model is adequate to estimate the effect of Corporate Risk Disclosure and Firm Performance on Cost of Equity Capital. Regression testing for Model 2 in Table 4 indicates that Corporate Risk Disclosure affects Cost of Equity Capital with Sig. 0.014 at $\alpha = 5\%$. In addition, Firm Performance affects Cost of Equity Capital with Sig. 0.000 at $\alpha = 5\%$. Leverage and Size have no effect on Cost of Equity Capital. This confirms that the Model 2 regression analysis is consistent with Nahar and Azim (2017) stating that Firm Performance as the moderating variable is indicated with Sig. MODERATE of 0.000 at $\alpha = 5\%$. Firm Performance strengthen the effect of Corporate Risk Disclosure on Cost of Equity Capital as indicated by negative coefficient of -0.171 and increased Adjusted R-Squared Value of 0.157 (Table 1) to 0.223 (Table 2).

Corporate Risk Disclosure items are more commonly presented by poor-performing firms, because more extensive risk disclosure may avoid surprising information that leads to a negative market reaction. Investors' assessment of the company profile can be indicated by

the level of transparency. Sophisticated and knowledgeable investors can assess firm performance more accurately (Deumes and Knechel, 2008) and risk disclosure helps companies improve their performance. Corporate Risk Disclosure is not mandatory for companies in developing countries. Based on agency theory, management needs shareholders' supervision to ensure that the business process runs effectively and efficiently (Jensen and Meckling, 1976). Contractual relationships require transparency with regard to positive and negative information about the expected returns. Corporate management can determine the best combination of financial structures through debt or equity. Debt and equity are important components in decision making concerning the financial structure of a business (Dhaliwa et al., 2011). Shareholders will react positively if the return on investment is greater than the cost of capital, which in turn improves the company's performance. The cost of capital is an important factor in determining the best company's financial structure (Dhaliwal et al., 2011).

5. Conclusions

The above analysis and discussion have led us to the conclusion that:

Corporate Risk Disclosure affects Cost of Equity Capital

Higher levels of Corporate Risk Disclosure can lead to lower Cost of Equity Capital. Extensive disclosure reduces unpredictable risks and therefore lowers the cost of compensation for investors. Risk disclosure practices require disclosing of: (a) General Risk Information; (b) Accounting Policies; (c) Financial Instrument; (d) Derivative hedging; (e) Reserve; and (f) Financial and Other Risk. This provides investors with crucial information to assess firms' capability to survive and to meet their short-term and long-term obligations, as well as to estimate their return on investments.

Firm Performance strengthens the impact of Corporate Risk Disclosure on Cost of Equity Capital.

Corporate Risk Disclosure items are more commonly presented by poor-performing firms, because more extensive risk disclosure may avoid surprising information that leads to negative market reactions. Investors' assessment of the company profile can be indicated by the level of transparency. Corporate Risk Disclosure is not mandatory for companies in developing countries.

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