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TABLE OF CONTENT

The Conference History.....	ix-x
Greeting from the Conference Chair.....	xiii
Conference Program.....	xiv
Concurrent Session Program.....	xv-xxix
Keynote Speaker Papers.....	xxx-iv
List of MIICEMA 2011 Organizing Committee.....	lvi
List of MIICEMA 2011 Reviewers.....	lvii
FULL PAPERS	
ECONOMICSTRACK	
MIICEMA Unib-4 Bilateral Trade Relations Of Malaysia And Saudi Arabia - An Analysis	1-14
MIICEMA Unib-7 Keberkesanan Menyeluruh Agihan Zakat: Kes Bantuan Modal Kepada Asnaf Fakir Dan Miskin	15-26
MIICEMA Unib-11 How Instant Messaging Improves Real Life Interaction: Case Study Of Blackberry User Group	27-38
MIICEMA Unib-17 An Optimal Model Of Monetary And Fiscal Policy Interaction	39-55
MIICEMA Unib-23 Analysis Of Life Insurance Demand In Malaysia	56-62
MIICEMA Unib-28 Small And Medium-Sized Enterprises Development In The First Malaysia Plan Through The Tenth Malaysia Plan	63-72
MIICEMA Unib-41 Investigating the 'Goldilocks Phenomenon' In Branding: What Size and What Place?	73-89
MIICEMA Unib-50 Short And Long Run Causality Relationship Between Indonesian Human Resources And Investment Since 1985 Until 2007.....	90-108
MIICEMA Unib-52 Searching For Monetary Policy Indicators In Islamic Financial System.....	109-122
MIICEMA Unib-53 Pengumpulan Modal Manusia Dan Kesannya Terhadap Pertumbuhan Ekonomi.....	123-134
MIICEMA Unib-56 Dampak Ekonomi Sektor Pariwisata Di Provinsi Kepulauan Bangka Belitung.....	135-148
MIICEMA Unib-64 Implication of SBI Interest Rates On Banking Industry In Indonesia.....	149-162
MIICEMA Unib-73 An Empirical Application To Regionalism On ASEAN Trade: A Temporal Cross-Section And Panel Analysis With The Gravity Model.....	163-181
MIICEMA Unib-82 Technical Efficiency And Input Productivity Of Small And Medium Enterprises In The Malaysian Food Processing Industry.....	182-195
MIICEMA Unib-91 Studies On The Performance Of Microfinance: Local Diversity.....	196-202
MIICEMA Unib-95 Household Debt Decision: The Role Of Aspiration, Social Comparisons And Attitude Towards Debt.....	203-223
MIICEMA Unib-105 The Impact Fiscal Deficit And Macroeconomic Variables On Inflation In Indonesia.....	224-238
MIICEMA Unib-108 Empowering Women To Reduce Poverty Through Microfinance.....	239-256
MIICEMA Unib-117 Firm-Level Investment And Monetary Policy In A Small Open Economy: Evidence From Malaysia.....	257-270
MIICEMA Unib-120 Performance Comparison Civil Servants Region Before	271-

	And After Expansion In The Province Riau	285
MIICEMA Unib-129	Socioeconomic And Gender Differences In Access To Health Care In Malaysia: A Non-Linear Decomposition Approach.....	286-311
MIICEMA Unib-131	The Implementation Of Export Subsidies Elimination By Developed Countries And It.....	312-325
MIICEMA Unib-132	Fiscal Sustainability, Public Debt, And Economic Growth.....	326-340
MIICEMA Unib-135	Trade Flows Of Agricultural Commodities Of Indonesia Between Malaysia And China.....	341-352
NON-4	Gender Role Allocation In Selected Coffee Postharvest Activities In Rejanglebong And Lebong District, Bengkulu Province.....	353-360
NON-15	Determinants Of Foreign Trade: A Comparative Study Between Indonesia And Malaysia.....	361-373
NON-17	Factors Affecting Indonesian Potato Farmers Contracting Decision.....	374-379
NON-18	Political Influence On Economic Decision-Making In Government-Owned Companies: A Qualitative Assessment.....	380-400
NON-22	The Disparity Of Economic Development Among Provinces In The Region Of South Sumatra In The Era Of Regional Autonomy.....	401-425
NON-23	How Indonesian Crude Palm Oil Export Demands Respond To Exchange Rate Volatility?: An Error Correction Model Approach.....	426-438
NON-31	Ifemale Participation In The Labor Market In Bengkulu City.....	439-448
NON-34	Development Of Forest Area Society Participation In Business Activity Based On Environmental Conservation.....	449-456
NON-36	Lokalisasi Pengagihan Zakat Dan Cadangan Khidmat Sosial: Satu Tinjauan Awal.....	457-475
NON-37	Vulnerabiliti Pekerja Malaysia Dalam Persekitaran Kehadiran Pekerja Asing.....	476-490
NON-39	A Conceptualization Of The Cost Of Equity Of Islamic Banks.....	491-499
NON-41	Foreign And Domestic Shocks: Macroeconomic Responses Of Asean-3 Countries.....	500-522
NON-42	Public Spending And Health Service Performance In Indonesia.....	523-539
NON-45	An Integrated Model Proposed For Entrepreneurship Education And Development For Students In Bengkulu University.....	540-557
NON-48	Spatial Concentration Of Manufacturing Industry In Java Island.....	558-568
NON-49	Strategy Behavior In The Economies Of Coffee Farmers Using Protected Forests: Case Study In Protected Forest Bukit Pedinding Hill And Serdang Hill In Sub District Lebong.....	569-580
NON-52	Islamic Bank Practices: Idealism And Reality.....	581-592
NON-53	The Challenges Of Sustainable Transportation: Malaysian Experience.....	593-611
NON-55	Empowering Micro Business: Program Effectiveness Assessment Of KPN In Lhokseumawe.....	612-625

MANAGEMENT TRACK		
MIICEMA Unib-6	Budaya Organisasi Islam modern:kajian kes Bank Islam Malaysia Berhad.....	626-637
MIICEMA Unib-9	Entrepreneurial Motivation: The cases of Indian restaurant owners in Selangor and Kelantan, Malaysia.....	638-647
MIICEMA Unib-12	Consumer Perception towards Online Shopping: Case Study of Online Store in Bandung.....	648-658
MIICEMA Unib-20	Quality Management In PT. Consobiz Ventures.....	659-681
MIICEMA Unib-27	Resilience Of Islamic And Conventional Stock Markets Of Indonesia During The 2007 Global Financial Crisis: A Comparative Empirical Examination.....	682-704
MIICEMA Unib-41	Investigating The 'Goldilocks Phenomenon' In Branding:What Size And What Place?.....	705-720
MIICEMA Unib-42	Modelling The Causal Relationship Of Organizational Justice, Job Satisfaction, And Organizational Citizenship Behavior.....	721-734
MIICEMA Unib-48	The Impact Of Transformational Leadership On Absenteeism: Mediating Role Of Psychological Empowerment.....	735-747
MIICEMA Unib-59	A Study On The Effect Of Iran Mercantile Exchange On Accepted Metals Prices.....	748-755
MIICEMA Unib-67	Effectiveness of Inventory Management of Minute Maid Pulpy Orange at Coca Cola Bottling Indonesia West Java Operation.....	756-771
MIICEMA Unib-69	Critical Review on Measuring Financial Constraints: Multicriteria Approach.....	772-787
MIICEMA Unib-75	Exploring The Relationship Between Job Satisfaction And Nurse Performances.....	788-798
MIICEMA Unib-76	Dilemma Of Business Ethics: The Solution.....	799-804
MIICEMA Unib-79	Comovements And Stock Market Integration In Asia: Post Financial Crisis 1997.....	805-818
MIICEMA Unib-87	The Effect Of Consumer Materialism Behavior Toward Consumer Purchase Decision On Private Label Products.....	819-827
MIICEMA Unib-98	How Are China's Fruit Perceived By Indonesian Consumer?.....	828-838
MIICEMA Unib-100	A Cross-Cultural Testing The Applicability Of Status Consumption In Indonesia And Malaysia.....	839-846
MIICEMA Unib-109	Do Human Resource Practices Influence Employees To Engage In Deviant Work Behavior? An Empirical Investigation In Malaysian Companies.....	847-856
MIICEMA Unib-112	Branding Malaysia As 'Halal Hospitality': A Conceptual Paper.....	857-863
MIICEMA Unib-119	Tri Dharma Philosophy Upon Budi Santoso's Leadership In Suara Merdeka Newspaper.....	864-876
MIICEMA Unib-122	Financial Stress, Agility And Multiple Crises: Premillinary Study On Aim.....	877-892
MIICEMA Unib-127	Reviewing Outsourcing Controversy In Indonesia: An Exploratory Study Of Human Resources Outsourcing Controversy In Semarang City.....	893-902
NON-2	A Comprehensive Review Of Trading Strategies: In Search An Excellent Strategy For Traders In The Indonesia Stock Exchange.....	903-913

NON-3	Consumer Ethnocentrism On High Involvement And Low Involvement Products.....	914-925
NON-9	Structure Of Formality As Moderating On Relationship Between Strategy Implementation And Firm Performance In Indonesia.....	926-943
NON-11	Examining The Effects Of Transformational Leadership In Indonesia And Australia.....	944-960
NON-12	The Role Of Leadership In Managing Individuals' Career Anchors: A Theoretical Perspective.....	961-974
NON-19	The Effect Of Good Corporate Governance Practices And Bond Rating On Bond Yield To Maturity.....	975-1005
NON-33	The Role Of Work Motivation As Mediating Variable On The Relationship Between Leadership Styles And Job Satisfaction At Regional Office Bengkulu Province.....	1006-1015
NON-38	Exchange Rate-Interest Differential Relationship: Evidence From Selected East Asian Countries.....	1016-1023
NON-40	Faktor-Faktor Yang Mempengaruhi Pengunjungan Pasar Raya Besar: Suatu Tinjauan Di Sebuah Pasar Raya Besar Di Melaka.....	1024-1052
NON-43	The Impact Of Internal Marketing And Customer Orientation To Service Quality And Their Implication On Customers Satisfaction Of Hospital Service Management.....	1053-1064
NON-44	Consumers's Perception and Brand Image In Creating Brand Loyalty.....	1065-1072
NON-46	Examining Relationships Among Leadership, Innovation Competencies And Operational Effectiveness.....	1073-1088
NON-47	Marketing Study Of Fisheries And Marine Products On Sea Coastal Management Of Bengkulu City.....	1089-1096
NON-50	Identification Of Training Effect On Small Business Performance.....	1097-1115
NON-56	The Influence Of Customer Orientation, Competitive Orientation And Coordination Functions Of Cross Product Innovation (Case Study On Small And Medium Craft Aceh Industries)	1116-1123
NON-57	An Analysis Of Prospective Collegians Perception To Develop Marketing Opportunities Of Higher Education In South Sumatra.....	1124-1131
ACCOUNTING TRACK		
MIICEMA Unib-3	Perceptions Of Accountants, Users, Organizers, And Students On Indonesian Education Standard For Professional Accountants.....	1132-1156
MIICEMA Unib-15	Budgetary Participation and Managerial Performance: A Study in Ministry of Home Affairs (MOHA), Malaysia.....	1157-1174
MIICEMA Unib-19	Malaysian Code of Corporate Governance:The Impact on Quality of Reported Earnings of Kuala Lumpur Composite Index (KLCI) Components.....	1175-1196
MIICEMA Unib-22	The Effect Of Capital Structure On Profitability: The Extended Analysis Of Biotechnology Companies Listed On The Bursa Malaysia.....	1197-1206
MIICEMA Unib-29	The Influence Of Capital Structure And Growth Of Company To Firm Value At Company In Indonesian Stock Exchange.....	1207-1216

MIICEMA Unib-39	A Conceptual Framework for Characterizing Strategic Management Accounting and Its Implementation.....	1233-1243
MIICEMA Unib-40	Pengaruh Leverage, Pertumbuhan Aktiva, Dan Ukuran Perusahaan Terhadap Risiko Sistematis.....	1244-1254
MIICEMA Unib-45	Earnings Management Practices In Companies Listed In Jakarta Islamic Index-Indonesian Stocks Exchange.....	1255-1271
MIICEMA Unib-46	Earnings Management Practices: The Comparative Studies Between Syariah Index (JII) And Conventional Index (LQ-45) In Indonesian Stock Exchange.....	1272-1282
MIICEMA Unib-61	The Relationship between Religiosity and Tax Morale.....	1283-1296
MIICEMA Unib-68	Identification Of Earnings Management On The Company Listed On The Index LQ 45 In Indonesia Stock Exchange.....	1297-1306
MIICEMA Unib-81	Pecking order theory of capital structure: empirical evidence from panel generalized method of moments.....	1307-1319
MIICEMA Unib-83	Early Warning Model Of Financial Distress.....	1320-1336
MIICEMA Unib-85	Simultaneous Relationship between Managerial Ownership, Institutional Ownership, Debt Policy and Dividend Policy in the Agency Problem Mechanism.....	1337-1353
MIICEMA Unib-88	Factors Associated With Auditor Choice: The Case Of Kingdom Of Saudi Arabia.....	1354-1378
MIICEMA Unib-96	Financial Behavior And Financial Position: A Structural Equation Modelling Approach	1379-1392
MIICEMA Unib-97	Board Of Directors, Audit Committee, Audit Characteristics And Timeliness Of Financial Report In Listed Companies In Indonesia.....	1393-1408
MIICEMA Unib-104	Director Diversity And Company Performance: A Review Of Literature.....	1409-1424
MIICEMA Unib-128	Effect Of Changes In World Oil Prices And The Monetary Variables Towards Composite Stock Price Index, Period January 2007 S / D December 2010 Through "Error Correction Model" Approach.....	1425-1437
NON-6	Trends In Management Accounting Research Topics Of Bengkulu University Students.....	1438-1452
NON-7	Perception Of Accounting Community About Creative Accounting.....	1453-1464
NON-8	Managerial Performance And Performance Measurement System.....	1465-1473
NON-13	Antecedents And Consequences Of Comfort Participating In Class Discussion In Management Accounting Course.....	1474-1484
NON-14	The Effect Of Budget Participation To Managerial Performance Using Information Technology Use, Motivation, Job Satisfaction And Stress as Moderating Variables.....	1485-1502
NON-16	Response Asymmetries In The Mena Stock Markets.....	1503-1511
NON-19	The Effect Of Good Corporate Governance Practices And Bond Rating On Bond Yield To Maturity.....	1512-1543

NON-20	The Effect Of Budgetary Participation On Managerial Performance Through The Organizational Commitment And Work Motivation As The Intervening Variables.....	1544-1557
NON-21	Effect On Corporate Governance Audit Qualification.....	1558-1572
NON-24	The Impact Of Cost Management Knowledge On The Relationship Between Partication Budget And Managerial Performance.....	1573-1585
NON-25	Impact Of Risk Evaluation On Auditor-Auditee Negotiation Outcome.....	1586-1598
NON-26	Analysis Of Effect Of Investment Opportunity Set, Free Cash Flow, Corporate Governance And Firm Size On Debt Policy.....	1599-1614
NON-27	The Factors Influencing Of Equity Risk Premium Of Indonesian Public Listed Companies.....	1615-1634
NON-28	The Influence Of Corporate Governance And Risk Factors On Equity Risk Premium Of Indonesian Public Listed Companies.....	1635-1650
NON-29	The Influence Of Understanding Financing Staff And Personnel Preparation Of Financial Statements Based On The Governmental Accounting Standards Of Quality Financial Report (Studies In Satuan Kerja Perangkat Daerah (SKPD) Bengkulu City).....	1651-1660
NON-30	The Effect of Effectiveness Taxes against Increased Revenue Bengkulu City.....	1661-1673
NON-32	The Effect Of Delegation Of Authority Between Budget Participation And Managerial Performance On Private University In Indonesia.....	1674-1684
NON-54	The Influence Of Political Factors And Organizational Culture To Utilization Information Performance.....	1685-1696
NON-1	Female Workers Migration And Mistreatment In Malaysia: A Case Of Housemaids From Central Java.....	1697-1715
MIICEMA Unib-116	Social Capital, Cognition And Risk Perception As Determinants Of Entrepreneurial Opportunity Recognition.....	1716-1730
MIICEMA Unib-32	Impact of Higher IFRS Compliance In Bursa Malaysia.....	1731-1751
NON-35	Seasoned Equity Offerings: Between Agency Theory, Windows Of Opportunity, And Firm Performance.....	1752-1770

THE FACTORS INFLUENCING OF EQUITY RISK PREMIUM OF INDONESIAN PUBLIC LISTED COMPANIES

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ABSTRACT

The purpose of this study is to examine the impact of audit tenure, firm size, book to market equity ratio, leverage, beta and earnings quality on equity risk premium of Indonesian public listed companies. Based on purposive sampling method, 45 manufacture companies was selected from Indonesian public listed companies. This study found that book to market equity and leverage positively and significantly influence equity risk premium, while beta negatively and significantly influence equity risk premium. These findings indicate that equity risk premium increase as book to market equity increase, because the highest book to market equity ratio show that companies is not growth, so company's risk will be high. Meanwhile, the highest leverage ratio show that companies have financial distress and its will increase the company's risk. In contrast, higher beta lead to lower equity risk premium, it may be effected by emerging market in Indonesia feature.

Keywords: Capital Asset Pricing Model, Auditor Tenure, Book to Market equity, Leverage, beta, and Equity Risk Premium.

1. INTRODUCTION

The capital market is one place of the transfers of funds, from those excess funds to those who need it. There are two main functions of capital markets, first as a means of funding the business for the company to obtain funds from public investors with the purpose of business development, additional working capital or other, and the second function is as a means for people to invest in financial instruments such as stocks, bonds, mutual funds and the other with a view to profit (return) in the future.

Investment in capital markets world filled with elements of uncertainty or risk, because investors do not know with certainty the results to be obtained from the investment is doing. Investors just estimated how much the expected profit from investments, and how likely the actual future results will deviate from the expected results. Tandelilin (2001) suggested that the risk is the possibility of actual return that is different from the expected return.

Investment risk can be influenced by economic, political, market, customer, internal company and other factors. These factors will increased or decreased risk and return that will alter investor confidence and response, as well as the effect on stock price changes and will ultimately affect the market beta and the company's stock return variance. Tandelilin (2001) states that there are two types of investment risk in the systematic risk (Systematic risk) and unsystematic risk (unsystematic risk).

Systematic risk is a risk that can not be diversified because of this risk depends on various factors such as economic and political changes that affect all companies, while non-systematic risk is the risk that can be eliminated by establishing a well diversified portfolio (Hartono, 2009).

Investors realize that the willingness to bear risk will result in consequences of the return. The higher the risk taken by investors who are willing to return to the higher obtained. If the return obtained by investors does not exceed the return derived from risk-free investments like government bonds and bank interest, then investors will not be willing to invest in shares. Therefore, the willingness of investors to bear the risk of investing in stocks should be paid to the additional return that investors would be obtained from investing in the stock. Additional return is called the equity risk premium (ERP). High and low ERP influenced by several factors.

Specific financial information is one of the companies' important internal factors that can affect the investors to invest. This information is included in the risk factors that can not be diversified (systematic risk). Risk information related to the possibility of specific financial information company that is rated at a lower quality in investor decisions. Leuz and Verecchia (2005) found that the low quality of corporate financial information will increase the risk of information and result in higher ERP. High and low quality of corporate financial information may be influenced by the auditors conducting audits on companies. Auditors play a role carrying out its credibility by giving an independent verification of the readiness of the financial statements to improve the quality of manager-specific information by providing the integrity of corporate financial accounting reports. When audit quality is a measure of risk information associated with the company's financial accounting statements, the higher the audit quality, the integrity of corporate financial accounting reports will be higher. Thus, the risk will lower the company's information, and ERP in the company is also getting lower.

The quality of the audit has been linked with the auditors who perform audits of financial statements. According to DeAngelo (1981) audited financial statements of the company's

auditors (Big Four or Big Five) will have a better quality compared with the audited financial statements auditors of small companies. DeAngelo said that it is caused because the company auditors are great if not provide a high quality audit will lose his reputation, and if this happens then he will experience greater losses with the loss of clients.

In addition, Febrianto (2008) states that audit quality could be improved if the auditor is replaced periodically. The goal is to maintain the independence of auditors to minimize the chances of economic dependence of auditors on the client. While Boone, Khurana and Raman (2008) believes that the long relationship could cause auditors have a tendency to lose its independence. Thus, the longer the period of audit, auditors will result in dependence on the client that causes the auditor to lose its independence, it will result in the magnitude of potential quality of financial information reported to be low which will ultimately increase the ERP.

According to Gebhardt, Lee, and Swaminathan (2001) there are other factors that affect ERP. They explain the existence of information more available and more liquid stocks in large corporations lead to the risk of enterprise information is becoming increasingly low, thus causing the lower ERP. Their results showed that the size of the company generally has a positive effect on the ERP, but not significant. Moreover, Fama and French (1992) confirmed that the company's size, price earnings ratio, the ratio of debt to equity, and book-to-market equity ratios have significant explanatory power to the average level of return. Shares of the issuer with the size of a small firm and book-to-market equity ratio high is a company that has a bad performance and tend to experience financial difficulties (financial distress), the cost of equity capital to be higher resulting in increased ERP participate, and investors will ask for compensation risk premium this reason.

Bhandari (1988) in his study stated that the leverage ratio has a positive relationship to the level of expected stock returns. Because the increase in debt is usually followed by increases in working capital in the company, it will lead to increased capital costs and ultimately increase the ERP. Also mentioned in the Fama and French (1992) that the effect of beta with an average rate of return disappeared for several years (1963-1990) on the stock on the New York Stock Exchange (NYSE). Their results found that the beta has a weak influence on the average rate of return. But Boone, et al. (2008) says that in the context of the capital asset pricing model (CAPM) beta is the systematic risk that influence positively to ERP. In addition, research Francis, LaFond, and Olsson (2004) stated that the high and low quality of earnings will be seen on the ERP. Their results found that the higher quality of earnings, the ERP will be lower.

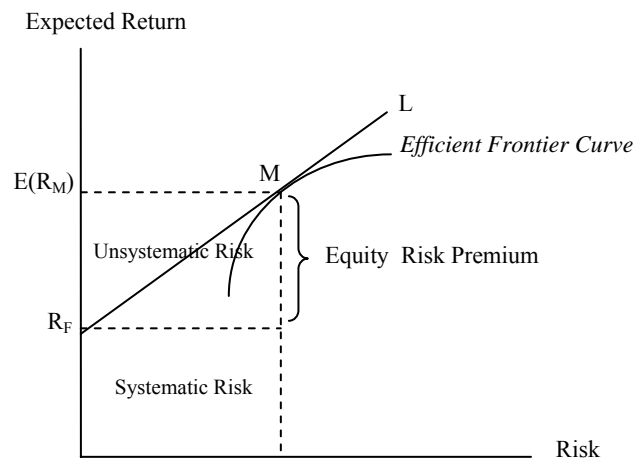
The study aims to test the effect of the assignment of auditors, company size, book to market equity ratio, leverage, beta, and earnings quality of Equity Risk Premium.

2. LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

2.1 Capital Asset Pricing Model

Capital Asset Pricing Model (CAPM) was first introduced by Sharpe, Lintner and Mossin in the mid-1960s. CAPM is a model that links the expected return rate of a risky asset with the risk of that asset in a balanced market conditions (Tandelilin, 2001). In a balanced market conditions, investors will not be able to earn abnormal returns (the extra return) of the price level is formed. Therefore, these conditions will encourage all investors to choose the market portfolio, which consists of all risky assets that exist. The market portfolio will be on the surface lines efficiently (efficient frontier), as shown in the picture below.

Figure 2.1
Efficient Portofolio



Sources: Tandelilin, 2001

Point M is the point of intersection between a line drawn from point R_F (risk-free rate of return) with the point L and form the efficient frontier curve consisting of risky assets. Portfolio that are at the point M is called the market portfolio is a portfolio consisting of all risky assets that have well diversified (Tandelilin, 2001). Thus, only market risk portfolio will consist of only the systematic risk, i.e. risk can not be decreased by diversification. In developing the portfolio theory, Markowitz in Tandelilin (2001) argues that the risks can be divided into two general types of risk, namely the systematic risk and unsystematic risk. Part of risk can be eliminated by diversification is called unsystematic risk or unique risk, unsystematic risk is part of the company changes that can be diversified. This risk is the risk that is unique to a company such as strikes, lawsuits or natural disasters. While risks can not be eliminated by diversification is called systematic risk, a risk associated with macro-economic factors that could affect all the existing securities.

In figure 2.1 above, the line L intersecting the vertical axis at the point R_F is called the capital market line (CML). Difference between the expected level of return on market portfolio ($E(R_M)$) with the risk-free rate of return (R_F) is an abnormal rate of return (extra) which can be obtained by investors as compensation for market risk (M) must bear. The excess market return and risk-free return is also called the market portfolio risk premium or equity risk premium (Equity Risk Premium) (Tandelilin, 2001).

Equity Risk Premium (ERP) is defined as the difference between the expected return on common stock and the return on government securities (Martin and Lillo, 2003). Meanwhile, according to Anin and Falaschetti (1998) defines ERP as a desired reward investors to generate income is not fixed with respect to his equity stake. ERP was measured as the expected shareholder return exceeds the average risk-free asset.

ERP is often described as the most important value in finance and investments, for example, in asset allocation decisions of portfolio managers, the decision how to divide the financial investments between stocks and fixed income securities are affected ERP and their different risk characteristics. In capital budgeting decisions at the enterprise level, ERP is an input in the cost of capital, the discount rate used to calculate the net present value investments. ERP is also an important input in calculating the cost of capital

has a role to determine the maximum prices of goods and services from government utilities (Martin and Lillo, 2003).

ERP reflects the price of risk taken, is a major component of the expected return demanded on risky investments. Expected return is an important determinant of the cost of equity and capital costs, an important input in financial analysis and valuation firm (Demodaran, 2009). ERP as used in the discount rate and analysis of the cost of capital is a concept that looked into the future. Therefore, the ERP is used in the discount rate must reflect what investors think about risk premiums in the future.

There are two common ways to estimate the ERP, the first use of historical data and others use estimates or projections of the market. By using historical data, the assumption is that what happened in the past illustrates what might happen in the future. By using the projection market, the assumption is that for the ERP project can be done through a survey or some other projection models. Most ERP model using historical data and assumes that some past periods provides the best indication of what will happen in the future. Thus, the ERP model that uses future projections as the basis is not functioning properly (Anin and Falaschetti, 1998).

Anin and Falaschetti (1998) using the CAPM in calculating the ERP. They stated that the expected return consists of two main components, namely, risk-free rate of return and risk premiums that can be formulated as follows:

$$R_i = \text{Risk-free asset return rate} + \text{risk premium}$$

$$R_i = R_f + \beta_i [E(R_M) - R_f]$$

Description:

$$R_i = \text{Rate of return expected}$$

$$\beta_i = \text{Stock beta}$$

$$R_f = \text{Risk-free rate of return of assets}$$

$$E(R_M) = \text{Level of the expected market return}$$

To obtain a new equation to be used, namely: :

$$R_i - R_f = \beta_i [\text{Equity Risk Premium}]$$

$$\text{Equity Risk Premium} = \frac{R_i - R_f}{\beta_i}$$

The main problem in the formula is that the formula assumes a perfect integrity in the capital market assumptions is not realistic in the emerging markets (Martin and Lillo, 2003). Research Erb, Harvey and Viskanta (1995) proved this; the research states that there is no influence between the average return and beta in emerging markets. These results are reinforced by Bekaert, Erb, Harvey and Viskanta (1997) which examined determinant of cross-sectional equity returns in emerging markets, their research found that the CAPM fails to explain returns in emerging markets.

In addition there CAPM Fama French Three Factor Model is an extension of the CAPM. Regression equation to estimate the cost of capital using the Fama French Three Factor Model can be written as follows (Anin and Falaschetti, 1998):

$$R_i - R_f = \beta_i (R_m - R_f) + (s_i \times SMB) + (h_i \times HML)$$

Description:

$$R_i - R_f = \text{Risk premium company } i$$

$$\beta_i, s_i, h_i = \text{Regression coefficient of firm } i$$

$$R_M - R_f = \text{Equity Risk Premium Expected}$$

<i>SMB</i>	= Risk factors for firm size. Expected return on a portfolio of small stocks minus the expected return on a portfolio of large stocks
<i>HML</i>	= Factor of financial difficulties, measured by book value of equity divided by equity market prices. Expected return on a portfolio of high stock return minus the expected low on stock portfolios.

ERP is one of three components in the Fama French Three Factor Model. There are three factors in it, namely firm size factor, the factor of financial difficulties, and market risk factors (ERP). The weakness in this model is not allowed to calculate the average return on β company in a short period (Anin and Falaschetti, 1998).

Boone, et al. (2008) suggests an alternative approach for calculating the ERP is based on Ohlson Models & Juettner-Nauroth (2000), as used by Easton (2004). Basically, Easton wear Ohlson framework and Juettner-Nauroth (especially in equation 1):

$$P_t = \frac{EPS_{t+1}}{R} + \frac{EPS_{t+1} \left(\frac{EPS_{t+2} - EPS_{t+1}}{EPS_{t+1}} + \frac{RDPS_{t+1}}{EPS_{t+1}} - R \right)}{R((1+R) - \gamma)}$$

However, Easton uses the additional assumption that $\gamma = 1$ (there are no abnormal growth in earnings beyond the observation period). The result can be written in equation 2,

$$P_t = [EPS_{t+2} + RDPS_{t+2} - EPS_{t+1}] / R^2$$

By using equation 2, R lowered so that the split into the following three equations,

$$R^2 - R(DPS_{t+1} / P_t) - (EPS_{t+2} - EPS_{t+1}) / P_t = 0$$

Description:

P_t	= current stock price
EPS_{t+1}	= forecast EPS a year to come
EPS_{t+2}	= forecast EPS two year to come
DPS_{t+1}	= forecast DPS a year to come
R (in equation 1)	= <i>equity risk premium</i> is realized by OJ
R (in equation 2)	= <i>equity risk premium</i> (R_{PEG}) according to Easton.

Equation 3 assumes that abnormal earnings will always be there and will experience positive changes in earnings estimates. Rated $R, \text{ }_{t+2} EPS > \text{ }_{t+1} EPS > 0$, thus solving the estimates will have a positive sign (Easton, 2004).

Easton stated that his approach into account the differences in short-term earnings growth. Furthermore, he discusses the methodology and evaluate the price-earnings growth (PEG) and suggests that researchers who need ERP estimates on the company relies on its approach.

This study used the approach to estimating the ERP Easton, since based on the above description can be concluded that the CAPM formula can not be used because Indonesia is classified as market is growing, while the Fama French Three Factor Model also can not be used in this study because the study period only one year while the model is not allowed to use on β company in a short period.

2.2 The auditor tenure and the Equity Risk Premium

The period of assignment the auditor is defined as the period between the auditor's engagements with the client, namely the length of the auditor to audit the company's clients. Dutton, Dukerich, and Harquail (1994) states that the longer a person within the

organization or company then he will increasingly become part of the company or organization for personal categorization.

Academics and auditing professions argue about whether auditors should be replaced after some time providing audit services to a company. The case of Enron / Arthur Andersen believed to be originated from the length of the relationship between the auditor with the firm being audited. Since Enron stood for 16 years Arthur Andersen has been the auditor for Enron. Throughout that time they not only provide audit services generally, but also provide non-audit services. Relations Enron / Arthur Andersen was later proven to make auditors Arthur Andersen became independent. Arthur Andersen is believed to allow Enron to choose an extreme method of accounting for losing their independence - in accordance with the predictions of the theory (Kusmayadi, 2009)

Boone, *et al.* (2008) believes that the long relationship that could lead auditors have a tendency to lose its independence. Auditors who have a long relationship with the company being audited is believed will bring the consequences of high dependency or auditor strong economic ties to the company. The higher the auditor's economic bond with the company, the higher the likelihood the auditor allowed the company to choose an extreme method of accounting.

On the other hand, the opposite argument. Febrianto (2008) states that when the first audited the company's auditors, the first time they have to do is understand the company's business environment and corporate audit risk. For auditors are totally blind to both problems, start-up costs will be high that they could raise audit fees. The second, the first assignment proved to have a high possibility of error. Litigation against auditors generally occurs in the first three years of auditing tasks and showed a downward trend after a period of extended auditor assignment. The risk of litigation against auditors is higher than the risk in small auditors, either because of the auditor's wealth. Other supporters argue that the long relationship between the auditor with the firm will make the auditors to be expert and well aware of the business being audited. Thus, the auditors are more alert to the behavior management ekstrem and understand the choices of accounting that is in the business. That is, they do not agree that the behavior of Arthur Andersen will also be the behavior of the other auditors.

The auditor may resign voluntarily from the assignment due to various reasons. One is to avoid litigation risks inherent in the companies they audit. Auditors will voluntarily resign from the company if the company impose a choice of accounting methods that they like but opposed by the auditors. Auditors who resigned because of this reason is considered to have a conservative policy.

Meanwhile, on the other hand, firms change their auditors as well with a variety of reasons. One of them is because they want to get a more efficient auditors and have expertise in accordance with the field of industrial companies. Not infrequently the auditor was selected because the company did not have the same views with the predecessor auditor on accounting methods where appropriate and which are not violated GAAP (Febrianto, 2008).

Research about audit quality when the auditor has a long-term relationships with the companies they audit showed that the length of the assignment which did not reduce audit quality (Myers *et al.* [2003] in Boone, *et al.* [2008]). The research is intended to reject the opinion that the auditor could lose its independence in line with the increasing length of their assignment to one company. However, they do not support the idea that the extension of the auditor's duties will raise the quality of audits.

In other words, the quality of audits (and the integrity of corporate financial accounting reports) may be decreased during a long assignment as a result of threats to auditor independence and objectivity demonstrated by the closeness of the auditor and the company that developed during an extended period. Thus, although the academic arguments predict that audit quality will change in only one direction (eg, increases) with the assignment, the closeness of the relationship between auditors and the company shows that the quality audit can be decreased to a certain point of the assignment because of the independence of auditors and objektivitasnya. Collectively, these theoretical arguments indicate that the relationship between the assignment of auditors and the integrity of corporate accounting reports is expected to be non-linear.

The debate over the issue of replacement auditor is actually originated from the idea that the auditor must maintain independence in the assignment. On the one hand, if the independence of the auditor's reasonable doubt if he has an increasingly long period of assignment to one company. Although he served on behalf of shareholders, however, the auditors selected and paid by the company management. When the relationship is getting longer, the financial dependency on the company's auditors will be increasingly great as well. The higher this financial dependency, it is feared the independence of auditors will increasingly fall. This logic that encourages regulators to prohibit the auditor has a long relationship with the company.

In contrast, replacement of auditors conducted compulsorily performed for reasons such as disagreements on environmental practices voluntarily above replacement. Replacement auditor is required solely on the basis of the rules. One of the countries in the world to enforce this rule is Indonesia. Rule change required is in force since 2003.

The results Boone, et al. (2008) show that the assignment of auditors marked significantly negative, indicating that if the assignment of auditors increases the equity risk premium will decline. Their results are consistent with investor perceptions and views of academics who claim that the longer the period of assignment of an auditor, the higher the integrity of corporate accounting reports, and the lower the risk of information that led to declining equity risk premium. Diaz (2009) who analyze the market reaction to the announcement of the replacement publik accounting firm found that companies that make replacement auditor experienced negative abnormal return. Based on the above description then the hypothesis is:

H1: The auditor tenure negative effect on the Equity Risk Premium.

2.3 Firm Size and the Equity Risk Premium

Large firm size can be expressed in total assets, sales and market capitalization. The larger total assets, sales and market capitalization, the greater the size of the company. The greater the assets, the more capital invested, the more sales the more the velocity of money and the bigger market capitalization, the greater the company is known in the community. Of the three variables, asset values are relatively more stable compared to the value of market capitalization and sales in measuring the size of the company. Therefore in this study of firm size measured by natural log of total assets.

Gebhardt, et al. (2001) showed that there is more publicly available information about the larger companies and their stocks are more liquid. The more information available about the company and more liquid stocks, the lower the perceived risk in the enterprise, the lower the equity risk premium is realized. These results strengthen the statement of Banz (1981) that there are negative effects between firm size and average return. Therefore, this variable has the expected negative sign. Consistent also with the results of Boone, et al. (2008) which stated that the firm size negatively affect the equity risk premium. Based on the above description then proposed a second hypothesis is:

H2: Firm size negatively affects the Equity Risk Premium.

2.4 Book to Market Equity Ratio and Equity Risk Premium

Book to market equity ratio is a ratio used to find firm value by comparing the book value of the company's market value. The book value is calculated by looking at historical cost or value of its accounting firm, while the market value reflected in the company's stock price. Gebhardt, et al. (2001) states that the ratio of book to market equity is the most important variable in explaining firm value. Consistently market requires a higher discount rate for companies that have a book to market equity ratio is high.

Moreover, Fama and French (1992) interpreted the book to market equity ratio as a risk factor for equities, that is, the higher the book-to-market equity ratio, the higher the risk of equity. Therefore, this variable has the expected positive sign. In accordance with the results of Boone, et al. (2008) which states that the book-to-market equity significantly positive effect on the equity risk premium. Based on the results of research on the third hypothesis proposed is:

H3: The ratio of book to market equity has a positive effect on the Equity Risk Premium.

2.5 Leverage and the Equity Risk Premium

Leverage ratio is the ratio between total debt to total assets. This ratio calculates how far the funds provided by creditors. High ratio means that firms use financial leverage (financial leverage) is high. The use of high financial leverage will increase the profitability of the share capital quickly, but on the contrary, if sales are down, earnings of capital stock will decline rapidly as well. The risk of companies with high financial leverage will be higher as well (Hanafi and Halim, 2000). Bhandari (1988) suggest that leverage has a positive relationship to the level of expected return. Findings stated that stocks with high leverage ratio value has a relatively high level of return on its market beta. High leverage ratio is a signal to distinguish between good companies and bad, because only a healthy and strong company that could owe to bear the risk. The high level of leverage will increase the likelihood of insolvency (bankruptcy) and will further increase the risk of the company, according to the statement Baxter (1967) in the Fama and French (1992) that the addition of debt to a certain point will increase the value of the company, but when passing through the optimal point, the addition of debt will lead to bankruptcy, thus decreasing the value of the company.

In addition, Gebhardt, et al. (2001) states that higher levels of financial leverage is expected to increase the perceived risk and increase the company's equity risk premium. Consistent with Boone et al. (2008) who find that leverage is significantly positive effect on the equity risk premium. Based on the findings above, the fourth hypothesis proposed is:

H4: Leverage has a positive effect on the Equity Risk Premium.

2.6 Beta and Equity Risk Premium

CAPM assumes that there is a linear relationship between the ERP in an asset with systematic risk or beta. Based on the CAPM, the variation rate of return of shares that are expected to occur can be explained by the beta (Lin, 2009).

Beta is a measure of systematic risk of a security or portfolio relative to market risk (Jogiyanto, 2000). Beta stocks are used to determine how much risk there is in a stock. Beta value of the securities described the volatility of returns on market returns. Normally, the beta of a stock tends to approach one. Stocks with a beta greater than one stock is very sensitive to market changes, such shares are referred to as the aggressive stock, fluctuations in stock returns is greater than the fluctuations of the market return. Conversely, if the beta is smaller than one then the stock is not sensitive to market changes, called defensive stocks, fluctuations in stock returns is smaller than fluctuations in the market return (Hanafi and Halim, 2000).

In the equilibrium model CAPM, beta values greatly affect the expected return rate, the higher the beta value and the market return, the higher the return required by investors. As a result, the beta is expected to correlate positively to the expected level of return. Boone, *et al.* (2008) found that beta-significant positive effect on the equity risk premium. Based on the above description then the fifth hypothesis is:

H5: Beta has a positive effect on the Equity Risk Premium.

2.7 Quality of Earnings and the Equity Risk Premium

The quality of earnings may be indicated as the ability of earnings information to respond to the market. In other words, profits are reported to have a response force. The strong market reaction to earnings information indicates that reported earnings quality. Earnings quality is measured by the value of discretionary accruals (DACC). In calculating the DACC, used Jones Model (1991) which has been modified by Dechow and Dichev (2002) in Boone, *et al.* (2008). Model calculations are as follows:

$$\begin{aligned} TACC_{it} &= EBXT_{it} - OCF_{it} \\ \frac{TACC_{it}}{TA_{i,t-1}} &= \alpha_1 \left(\frac{1}{TA_{i,t-1}} \right) + \alpha_2 \left(\frac{(\Delta REV_{it} - \Delta REC_{it})}{TA_{i,t-1}} \right) + \alpha_3 \left(\frac{PPE_{it}}{TA_{i,t-1}} \right) + \varepsilon_{it} \\ NDACC_{it} &= \alpha_1 \left(\frac{1}{TA_{i,t-1}} \right) + \alpha_2 \left(\frac{(\Delta REV_{it} - \Delta REC_{it})}{TA_{i,t-1}} \right) + \alpha_3 \left(\frac{PPE_{it}}{TA_{i,t-1}} \right) \\ DACC_{it} &= \frac{TACC_{it}}{TA_{i,t-1}} - NDACC_{it} \end{aligned}$$

Keterangan,

$DACC_{it}$: Discretionary accruals firm i period t
$TACC_{it}$: Total accruals firm i period t
$EBXT_{it}$: Income before extraordinary item of period t firm i
OCF_{it}	: Operating cash flow firm i period t
$TA_{i,t-1}$: Total assets of company i period t - 1
ΔREV_{it}	: Changes in Revenue i period t
ΔREC_{it}	: Change in receivables company i period t
PPE_{it}	: The value of fixed assets of company i period t
$NDACC_{it}$: <i>Nondiscretionary accruals</i> firm i period t

Firms with high accruals indicate earnings of low-quality firm, and vice versa. Francis, LaFond, Olsson, and Schipper (2004) investigated the relationship between the quality of earnings and the equity risk premium indicates that the higher the quality of corporate earnings, the lower the equity risk premium of the company. Research results show that the decline in the quality of earnings has increased the role of equity risk premium. In addition, Leuz and Verrecchia (2005) stated that high quality will improve cash flow and lower capital costs. This will reduce the company's equity risk premium. Consistent also with the results of Boone, *et al.* (2008) which states that the higher accrual earnings showed a low-quality companies that will lower the company's equity risk premium. Based on the results of these studies proposed the sixth hypothesis is:

H6: the quality of earnings negatively affects the Equity Risk Premium.

3. RESEARCH METHOD

3.1 Sample Selection

The sample used in this study were manufacturing companies listed on the Indonesia Stock Exchange with the observation period in 2006, while data that is needed is a manufacturing company that is listed on the Indonesia Stock Exchange from 2005-2008.

Selection of the sample using purposive sampling method with k riteria used are:

1. The company does not lose in the first year and second year after the observation period, in accordance with the terms of ERP calculation approaches Easton (2004) that the value of $EPS_{t+2} > EPS_{t+1} > 0$;
2. In 2006 the company's equity is positive. Point is based on the assumption that companies that have negative equity has been impacted by economic events that is temporary in nature (Hermeindito, 2008). It can be concluded if the events do not occur then the equity is negative, this will have an impact on investor assessment of the performance of the company in general, so it is estimated that the condition is not good in predicting the company's ERP.
3. Beta company in 2006 is positive. Point is based on the statement of the Hanafi and Halim (2000) that theoretically if the beta of a stock is negative, the required return for stocks will be smaller than the risk-free return. It can be concluded that the negative beta can not identify the size of the ERP in the company.
4. The company is not delisted during the period of 2006 and year ending December 31;
5. The Company has issued and published audited financial statements in a row and have the necessary data during the study. The data used in this study are the independent auditors' report and financial statements of companies in 2005-2008, as well as daily stock prices and JCI in 2006.

3.2. Variable Definition and Measurement Research

3.2.1 Dependent Variables

Dependent variable in this research that equity risk premium (ERP), is a major component of the expected return demanded on risky investments. Expected return is an important determinant of the cost of equity and capital costs, an important input in financial analysis and valuation firm (Demodaran, 2009). In this study, the ERP is calculated using the approach Easton (2004) based Model-Ohlson & Juettner Nauroth as follows:

$$R^2 - R(DPS_{t+1} / P_t) - (EPS_{t+2} - EPS_{t+1}) / P_t = 0$$

Description:

P_t	= current stock price
EPS_{t+1}	= forecast EPS a year to come
EPS_{t+2}	= forecast EPS two year to come
DPS_{t+1}	= forecast DPS a year to come

From these equations will produce two values R with two different signs. By law Easton (2004), the estimated $R_{PEG, t+2} EPS_{t+2} > EPS_{t+1} > 0$ so that the value of having a positive sign that will be taken.

3.2.2 Independent Variables

The independent variables include the following:

1. Auditor Tenure (TENURE)

The period of assignment the auditor is a dummy variable, firms are grouped into two groups, namely companies that change auditors and do not change auditors. A value of 0

is given to companies that do not change auditors during the period of observation, while the value 1 for firms that change auditors.

2. Company size (UP)

Size firms measure with *the natural logarithm* of total assets of the company that became the sample of this study.

$$UP = \ln TA_t$$

3. Ratio Book Value To Market Value Of Equity (BTP)

Ratio Book Value to Markets of Equity measured by dividing the book value of equity at the market value of equity.

$$BTP = \frac{\text{Book value of equity}_t}{\text{Market Value of Equity}_t}$$

4. Leverage ratio (LEV)

Leverage ratio is measured by dividing total debt to total assets.

$$LEV = \frac{\text{Total Debt}_t}{\text{Total Asset}_t}$$

5. Beta (BETA)

Beta value is obtained by dividing the covariance of firm returns and market returns ($Cov R_i, R_M$) on the market return variance ($Var R_M$). Covariance of return the company and the market return ($Cov R_i, R_M$) can be calculated by the following formula (Hanafi and Halim, 2000):

$$Cov R_{it}, R_{Mt} = \frac{\sum (R_{it} - E(R_{it}))(R_{Mt} - E(R_{Mt}))}{x}$$

Description:

R_{it} = return stock i in period t

$E(R_{it})$ = average stock return in period t

R_{Mt} = market return in period t

$E(R_{Mt})$ = average stock return in period t

x = Number of enterprises into the sample

Value of stock return variance ($Var R_M$) obtained by the formula:

$$Var R_{Mt} = \sum (R_{Mt} - E(R_{Mt}))^2$$

So the formula to find the beta is:

$$\beta = \frac{Cov R_{it}, R_{Mt}}{Var R_{Mt}}$$

6. Earnings quality (EQ)

Earnings quality is measured by using the approach Jones Model (1991) which has been modified by Dechow and Dichev (2002). Model calculations are as follows:

$$TACC_{it} = EBXT_{it} - OCF_{it}$$

$$\frac{TACC_{it}}{TA_{i,t-1}} = \alpha_1 \left(\frac{1}{TA_{i,t-1}} \right) + \alpha_2 \left(\frac{(\Delta REV_{it} - \Delta REC_{it})}{TA_{i,t-1}} \right) + \alpha_3 \left(\frac{PPE_{it}}{TA_{i,t-1}} \right) + \varepsilon_{it}$$

$$NDACC_{it} = \alpha_1 \left(\frac{1}{TA_{i,t-1}} \right) + \alpha_2 \left(\frac{(\Delta REV_{it} - \Delta REC_{it})}{TA_{i,t-1}} \right) + \alpha_3 \left(\frac{PPE_{it}}{TA_{i,t-1}} \right)$$

$$DACC_{it} = \frac{TACC_{it}}{TA_{i,t-1}} - NDACC_{it}$$

Keterangan,

$DACC_{it}$: Discretionary accruals firm i period t
$TACC_{it}$: Total accruals firm i period t
$EBXT_{it}$: Income before extraordinary item of period t firm i
OCF_{it}	: Operating cash flow firm i period t
$TA_{i,t-1}$: Total assets of company i period t - 1
ΔREV_{it}	: Changes in Revenue i period t
ΔREC_{it}	: Change in receivables company i period t
PPE_{it}	: The value of fixed assets of company i period t
$NDACC_{it}$: <i>Nondiscretionary accruals</i> firm i period t

discretionary accrual values are high (above the mean) showed a low-quality firm's profits, and vice versa, if the value of discretionary accruals is low (below the mean) showed a high-quality corporate profits.

3.3 Analysis Method

Testing of the hypothesis in this study using multiple regression analysis with regression equations used to test hypotheses are:

$$ERP_t = \alpha - \beta_1 TENURE_t - \beta_2 SIZE_t + \beta_3 BM_t + \beta_4 LEV_t + \beta_5 BETA_t - \beta_6 EQ_t$$

keterangan:

ERP_t	: Equity Risk Premiun company in period t
α	: constant coefficient
$\beta 1-6$: Regression coefficients of independent variables
$TENURE_t$: Substitution auditor in period t t
$SIZE_t$: The size of firms in period t
BM_t	: Book-to-market equity ratio in period t
LEV_t	: leverage ratio of firms in period t
$BETA_t$: Beta firm in period t
EQ_t	: Quality of earnings firm in period t

4. RESULTS AND DISCUSSION

4.1 Research Sample

The sample in this study was chosen based on criteria that have been established. Total companies listed in Indonesia Stock Exchange as many as 344 companies in 2006. Of these there are 134 companies (39%) that fall into the category of manufacturing companies and is the population of the study sample selection. Of the total 134 companies will be selected companies that will be sampled based study sample selection criteria previously mentioned. Based on this observation, as many as 93 companies (27%) excluded because they do not meet the criteria. Total company that became the study sample were as many as 41 companies or 12% of the total companies listed in Indonesia Stock Exchange and by 34% of the total manufacturing enterprise.

4.2 Hypothesis Testing Results

The study consisted of 6 (six) hypothesis is tested to see the effect of auditor changes (TENURE), firm size (SIZE), Book to Market Equity (LN_BM), leverage (LN_LEV), Beta enterprises (LN_BETA) and earnings quality (EQ) Equity Risk Premium of the company.

Table 1
The results of hypothesis testing

Independent Variable	Variablel Dependent (ERP)		
	B	t	, Sig
(Constant)	-, 347	-, 138	, 891
TENURE	, 887	1.343	, 187
SIZE	-, 139	-, 812	, 422
BM	, 584	1.913	, 063 **
LEV	, 686	1.739	, 090 **
BETA	-, 317	-1.825	, 076 **
EQ	-, 176	-, 383	, 703
R ²	279		
F-Test	2.448		
Sig F	, 042 ***		

*** Sig at level 10%*

**** Sig at 5% level*

Table 2 shows that the change of auditors do not have a significant effect on the equity risk premium. This means that there is no difference equity risk premium to companies that change or not change auditors. These results are inconsistent with the original prediction that states that the auditor perngantian can affect large and small ERP companies. This is due to negative investor outlook toward the turn of the corporate auditors, they consider companies that change auditors have a disharmony between the parties manajemen previous auditors of the company. This disharmony eventually lead to a conflict so the company decided to replace its auditors. Change of auditors will be seen as an act of corporate investors to cover the conflict between the auditor prior to the management company. This conflict can be caused because of the possibility of a long opinion by the auditor that does not correspond with the wishes of company management or due to other factors associated with company policy that no longer approved by the auditors.

These results failed to support the research conducted by Boone, et al. (2008) which states that the longer the auditor's assignment will lead to a decreased integrity of financial statements so that the equity risk premium will come down. The results of this study are also inconsistent with the statement Febrianto (2008) that the quality of audits will increase when the auditor is replaced periodically, with the aim to minimize the risk of economic dependence of auditors on the company, the less risk will be followed by the equity risk premium of the smaller companies. In addition, Diaz (2009) who analyze the market reaction to the announcement of a public accounting firm at the turn of a public company in Indonesia found that companies that change auditors experienced negative abnormal stock returns are also not supported.

Test results also indicate that company size has no significant effect on the equity risk premium .. Company size does not significantly affect the ERP suggests that investors in the Indonesian Stock Exchange has not used company size as measured by total assets as a basis for decision making. Komalasari (2000) in Amurwani (2006) showed that the decline in greater information asymmetry experienced by large companies than small companies. This leads to differences between the information obtained by the more-informed investors are less informed investors, the result would lead to transaction costs on the company and reduces the expected liquidity in the stock. This will certainly affect the decisions of investors in investing.

These results do not provide support for the results of research conducted by Gebhardt, et al. (2001) who found that the publicly available information on the company's increasingly larger and more liquid stock they will lower the perceived risk in the company, the equity risk premium will lower. It also does not support research Boone, et al. (2008) which states that firm size negatively affect the equity risk premium.

Other test results showed that the book-to-market equity has a significant positive effect on the equity risk premium. The results of this study, consistent with previous research which states that the book-to-market equity significantly positive effect on the equity risk premium (Boone, et al., 2008). These results are also consistent with research conducted by Fama and French (1992) who interpret the book to market equity ratio as a risk factor for equities, that is, the higher the book-to-market equity ratio, the higher the risk of equity in the company. but it also strengthens the research Gebhard et al. (2001) who found that the ratio of book to market equity has a strong influence on the equity risk premium, it is reflected in the market that consistently apply a high return for firms with book-to-market equity ratio smaller than one or in a state is growing ..

The study also found that leverage has a significant effect on the equity risk premium. The results of this study, consistent with previous research which states that leverage is significantly positive effect on the equity risk premium (Boone, et al., 2008). These results are also in accordance with Gebhardt, et al. (2001), higher levels of financial leverage is expected to increase the perceived risk and increase the company's equity risk premium, also in accordance with the opinion of Baxter (1967) in the Fama and French (1992) stated that the addition of debt to a certain point will increase the value of the company, but when passing through the optimal point, the addition of debt will lead to bankruptcy, thus decreasing the value of the company. Baxter's statement reinforced by the results of his research which found that companies with high leverage ratios have a positive influence on the risk of the company.

The results of this study also suggests that beta has a significant negative impact on the equity risk premium. These results are consistent with previous research which stated that based on the concept of CAPM, the higher the beta the higher the risk will increase the equity risk premium and the company, research results that significant positive effect of beta of equity risk premium (Boone, et al., 2008). These results also support research conducted by Fama and French (1992) which examined the U.S. capital markets from 1963 to 1990, found that beta has little ability to explain the expected return on stocks. In addition, Martin and Lilo (2003) found that there is no influence between the average return expected by the company beta on emerging markets. This is also strengthened by the results of research Bekaert, et al. (1997) that examines the burgeoning markets in 27 countries the period July 1991 - June 1996.

But this study found no effect of earnings quality on equity risk premium. This means that there is no difference between the equity risk premium-quality companies with high earnings and firms with low earnings quality. The results are not significant is because investors consider companies that have high-quality earnings will have a low return rate as a result of a low risk. This makes investors (risk averse) become less motivated to invest in shares in the company.

These results are consistent with previous research which states that the higher accrual earnings showed a low-quality companies that will lower the company's equity risk premium (Boone, et al., 2008). It also supports research Francis, et al. (2004) which examined the cost of equity and earnings attributes found that the higher the quality of corporate earnings, the lower the equity risk premium of the company.

4.3 Assessing Goodness of Fit (F test) A Model

The accuracy in estimating the regression function can be measured actual value of his Goodness of Fit. Statistically, at least it can be measured by the coefficient of determination and statistical value of F. The coefficient of determination (R^2) was essentially measures how much the ability of models to explain variation in the dependent variable. Based on multiple linear regression to test the research model by using the ERP variables R^2 values obtained his value by 0.279 or 27.9%. Thus it can be concluded that 16.5% of the variation can be classified by the ERP variables TENURE, SIZE, BM, LEV, BETA and EQ, while the remaining balance of 83.5% is explained by other variables outside the model.

Based on the results of testing on the F statistical test carried out by using the ERP dependent variable and six independent variables consisting of TENURE, SIZE, BM, LEV, BETA and EQ obtained F value of 2.448 significant at $\alpha = 0.05$ means that the regression model is good enough to predict the Equity Risk Premium companies sampled in this study.

5. CONCLUSION, IMPLICATIONS, LIMITATIONS, AND SUGGESTIONS

5.1 Conclusion

This study found that book to market equity and leverage effect on the equity risk premium is positively and significantly, while the beta effect on the equity risk premium is negative and significant. These findings indicate that the equity risk premium increases when the ratio of book to market equity increases, because the ratio of book to market equity is higher indicates that the company does not grow, so the company will be high risk. Likewise with a higher leverage ratio indicates that the company is experiencing financial difficulties and it will increase the risk of the company. While the beta indicates that if high beta, equity risk premium will be low, it may be influenced by the emerging markets in Indonesia.

5.2 Implications of Research Findings

Although in this study is the assignment of auditors had no significant, but based on previous research can be said that the change of auditor will affect the perception of investors about the quality of audits and their belief in the integrity of financial statements. The study is expected to be a consideration for decision makers in determining the rules regarding change of auditors at the company.

The study is expected to be a consideration in investment decisions of investors. Although this study shows that the equity risk premium is not affected by all the independent variables, previous research (Boone, et al., 2008) showed that all independent variables in this study, namely TENURE, SIZE, BM, LEV, BETA and EQ can affect the equity company's risk premium significantly. Nevertheless, the discussion of this study stated that the term of office of the auditor will affect the integrity of the company's financial statements, company size and earnings-quality companies that increasingly will affect the risk (increases or decreases) that will be faced by the company. otherwise it can be concluded that the systematic risk (beta), the ratio of book to market and leverage will affect the company's change in equity risk premium.

5.3 Limitations of Research

The limitations in this study are as follows:

1. Sample of firms in the study is limited. This is because the criteria that must be met in order for these companies can be used as a sample of this research.
2. Period of this study included only 1 (one) year of observation so that the ERP calculation is less able to represent changes in broader ERP in previous years.

3. Announcement of change of auditors is not all published, so that could be used in the study just published in the auditor change announcement.
4. The way the grouping for the variables TENURE based only on companies that replace and not replace, without considering the tenure of the auditor has audited the company.

5.4 Suggestions for further research

1. It is recommended for further research in order to take samples from different types of companies such as finance companies or service companies that can be seen how the independent variables in this study affect the dependent variable for this type of enterprise services and finance.
2. Extend the observation period of the study to obtain a more accurate calculation of the ERP that is expected to further explain the ERP and the factors that influence it.
3. It is recommended also for further research in order for the variable TENURE grouping based on the length of the assignment the auditor has audited the company, in order to obtained better results.

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