

CHAPTER I

INTRODUCTION

1.1. Background

There are several issues that influence corporate governance, such as financial reporting scandal of Enron. This scandal causes a crisis of confidence in term of the reliability of financial information and had terrible effects on the stakeholder's behavior. Conflict of interest between the owner and manager became one of the factors of these failures. As a result of recent corporate failures, the corporate governance reformers have considered that the audit committees have an important role in preventing the fraudulent in financial reporting of the company and restoring the confidence of the stakeholders (Salehi & Shirazi, 2016).

The implementation of corporate governance in Indonesia was improving since the financial crisis in 1997-1999 (Basyith, Fauzi, & Idris, 2015; Herdjiono & Sari, 2017). The financial crisis happened because many companies do not apply their corporate governance properly. Thus, Asia financial crisis was one of the factors that force to reform their corporate governance. Hence, it was necessary to find a solution to regulate the actions of all actors involved in companies. The interaction among actors involved in the companies is crucial to achieving this objective. The audit committee is established in order to construct effective corporate governance. Bolton (2012) stated that the role of the audit committee is a link between financial reporting function and the external parties of the companies.

Board of commissioners establishes audit committees to assist their duties and functions. For example, the audit committee was established based on the Regulation of the Minister of SOEs no. PER-12/ MBU/2012 concerning the

Supporting Organizations of the Board of Commissioners/Supervisory Board of SOEs and the Regulation of the Financial Services Authority No. 55/POJK.04/2015 On the Establishment and Implementation Guidelines of the Audit Committee. Hermawan (2011) stated that the objective of audit committee formation in the corporate governance structure is to increase the transparency and accountability of the company in providing relevant and reliable financial information to the investors. Audit committees as part of the board of directors in the company play an important role to oversee financial reporting processes. Hermawan (2011) also stated the role of the Audit Committee is to prevent opportunistic acts of management. Audit committees ensure management in providing a high quality of financial reporting which based on appropriate accounting standards. High quality of financial reporting has minimum information asymmetry which shows the real financial condition of the company that can help investors to make an appropriate investment decision.

The effectiveness of the audit committee can vary in each company. It depends on how the Audit Committee performs its functions. Hermawan (2011) stated several characteristics of the audit committee can influence the effectiveness of the audit committee. The first characteristic is the level of independence when performing their duties which unbiased and consider stakeholders point of view. Second, the larger size of the audit committee can increase work specialization. There is a possibility to have more experts with various expertise. Another characteristic is competence, it means that audit committees should have adequate knowledge and experiences. Al-Shaer, Salama, & Toms (2017) found that the audit committees have a potential effect on improving corporate governance processes

which to increase the quality of financial disclosure and improve the firm's accountability. Eyenubo, Mohamed, & Ali (2018) highlighted the importance of corporate governance recommendation as to the way to strengthen the monitoring and oversight role of the audit committee in the financial reporting process.

Study from Hermawan (2011) measures the effectiveness of the board of commissioners and audit committee in two-tier board structure influences informativeness of earnings with evidence from the listed firm in Indonesia. Indonesia adopts two-tier corporate governance structure that consists of shareholders, supervisory board, and board of management. The two-tier structure separates the executive function of the management board from the monitoring function of the supervisory board. The benefit of adopting the two-tier board structure is to prevent internal fraud in the company. While Arifai, Tung, Moslehpour, & Wong (2018) stated that two-tier board structure implementation in Indonesia provides greater opportunity for majority shareholders to place representatives on the board who can take over the interests of minority shareholders and increase information asymmetry. Another unique characteristic of the companies in Indonesia is the family company which can affect the corporate governance system in Indonesia. Arifai et al. (2018) show that family ownership has a positive influence on company performance. Hence, Arifai et al. (2018) suggest that family involvement in the boards creates a balance between supervisory functions and management functions, resulting in more effective monitoring of company management.

There are numerous studies that found the relationship between audit committee characteristics and company performance with a different result.

Alqatamin (2018) shows that audit committee size, audit committee independence, and gender diversity of the audit committee have a positive significant effect on the company performance. While audit committee experience and frequency of meetings of the audit committee have an insignificant effect on the company performance. This research conducts model from Alqatamin (2018) that study about audit committee effectiveness and company performance in Jordan that will be retested in Indonesia. The impact of audit committee characteristics is expected to affect the firm's performance which is one of the main problems for stakeholders because it helps them to identify factors that influence performance and to consider these factors as indicators of the company's success or failure.

This study focuses on audit committee effectiveness because the audit committee is the element for overseeing the interest of shareholders through financial report. Shareholders used the financial report to know the real financial condition of the company that reflects the company performance. Buallay, Hamdan, & Zureigat (2017) study about company performance that consists of financial, operational, and markets performance. They used ROE to measure financial performance, ROA to measure operational performance, and Tobin's Q to measure markets performance. This studies used Return on Assets (ROA) to measure company performance. ROA shows how efficiently the company uses the resources. This research aims to find the relationship between audit committee characteristics with company performance in Indonesia with recent data sample period for the year 2015, 2016, and 2017. This study focuses on measuring the impact of audit committee characteristics, which are audit committee size, audit

committee independence, audit committee experience, gender diversity of audit committee, and frequency of meetings of the audit committee.

1.2. Problem Definitions

- a) Has size of an audit committee has positive and significant effects on company's performance?
- b) Has an independent audit committee has positive and significant effects on company's performance?
- c) Has audit committee member with background and experience in accounting or finance has positive and significant effects on company's performance?
- d) Has gender diversity on the audit committee has positive and significant effects on company's performance?
- e) Has frequency of meetings of audit committee has positive and significant effects on company's performance?

1.3. Research Objectives

This research aims to obtain empirical evidence about:

- a) The influence of size of an audit committee on company's performance.
- b) The influence of an independent audit committee on company's performance.
- c) The influence of audit committee member with background and experience in accounting or finance on company's performance.
- d) The influence of gender diversity on the audit committee on company's performance.

- e) The influence of frequency of meetings of audit committee on company's performance.

1.4. Research Benefits

This research is expected to provide benefits in the form of:

- a) For researcher

The results of this research are expected to obtain insight and knowledge about the association of size of the audit committee, independent audit committee, the audit committee member with background and experience in accounting or finance, gender diversity on the audit committee, and frequency of meeting of the audit committee on company's performance.

- b) For Investor

The results of this research are expected can protect shareholder's interest through providing useful information about the factor that can influence company's performance in form of Return on Assets (ROA) that can give a contribution to the investors in making a credible investment decision.

- c) For the company's board and managers

The results of this research are expected can give a contribution to enhancing the company's performance by considering the characteristic of an effective audit committee and corporate governance mechanism.

- d) For readers and others

The results of this research are expected to obtain insight and knowledge about corporate governance in terms of the relationship of audit

committee characteristics and company's performance that can give a contribution to further research's references.

1.5. Scope of Research

This research focuses on ten variables to be tested. Dependent variable includes the company's performance. Independent variables include audit committee size, audit committee independence, audit committee experience, gender diversity, and frequency of meetings of the audit committee. There are also four control variables that may affect the company's performance, including firm size, industry type, leverage ratio, and dividends ratio. The researcher limits the research context by focusing on non-financial company listed on Indonesia Stock Exchange.

1.6. Writing Systematics

The research contains five chapters with writing systematic to build the reader's understanding of the research. Writing systematic gives an overview of each chapter.

The introduction will discuss the general description of the topic as the basis of research presentation. The introduction presents the background, problem definitions, research objective, research benefits, the scope of research, and writing systematics.

Next, the literature review discusses the related theory from previous studies with the research problem. This is useful as a rationale for solving problems. This chapter looks at previous research, theoretical framework, and the hypothesis that will be tested in this research. Moreover, the previous study also can support the hypothesis generation of the study.

Then the research method provides an overview of the plan for conducting the research. This chapter includes the research design, research model, operational definition and research variable, population and sampling, data and data collection method, and analysis method.

Afterward, results and discussion will discuss the description of the research object and analysis as well as discussion of the research results regarding the influence audit committee size, audit committee independence, audit committee experience, gender diversity of audit committee, and frequency of meetings of the audit committee on company performance.

And the last chapter will discuss conclusions. This chapter is drawn from the research results, limitations of this research, research implications, and also the suggestions for further research.

