CHAPTER I

INTRODUCTION

1.1 Background

Consideration to corporate governance quality in companies has increased in the past decade, especially since the collapse of large companies in the United States, such as Enron Corporation and Worldcom. In Indonesia, the government's attention to corporate governance was realized by the establishment of Komite Nasional Kebijakan Governance (KNKG) at the end of 2004, which then made General Guidelines for Good Corporate Governance in Indonesia in 2006. The main problem in implementing corporate governance arises because of the separation of ownership from control in a modern company. This problem increases as the company conducts an initial public offering on the stock exchange which will separate the management functions and owner functions. In carrying out its activities, a company will be represented by management (agents) who are appointed by the shareholders (principals). This situation can lead to information asymmetry between the management and the shareholders because of differences in the level of information held by managers who are the operational decision makers of the company.

In practice, there will be conflicts of interest between shareholders as owners of the company and management as agents. The owner has an interest so that the funds he has invested provide a maximum return. While the management has The interest in obtaining incentives for the management of company owners' funds (Lindeer & Foss, 2015). The problem that arises from the conflict of interest between principals and ageagnts is known as agency problem.

Wei et al. (2011) implied that agency problems do not only occur between shareholders and managers, but also among controlling shareholders and minority shareholders, between shareholders and creditors, and between controlling shareholders and other stakeholders, including suppliers and workers, especially in former family-owned companies. A good corporate governance mechanism is expected to create effective protection for all stakeholders in the company.

One of the methods taken to create such protection is by providing information about the company to stakeholders in the form of annual financial reports with a reliable level of reliability. The ways to maintain the level of reliability of these reports include the use of audit services on financial statements. Independent auditors are one of the external mechanisms of corporate governance in mitigating agency problems and reducing the existence of asymmetric information. In this case, the auditor carries out the supervisory function and tests the credibility of the accounting information provided by management.

Audit quality is a factor that is very difficult to measure directly and accurately. One proxy commonly used to measure audit quality is the size of the CPA firm (Francis, 2011). The greater the size of a CPA firm (proxied by the amount of income), the better the quality of the audit provided by the CPA firm. Francis (2011) states that the income of public accounting firms will affect their ability to obtain the necessary resources, for example the number of team members and working hours, to conduct audits which will then have an impact on the quality of audits provided.

Among the several corporate governance components that influence the decision to appoint a public accounting firm as a provider of audit services to companies, this study focuses on the largest shareholding and the size of the board of commissioners refers to a study conducted by Lin and Liu (2009). Previous studies on the largest share ownership, board size, and audit committee as proxy for corporate governance mechanisms still have mixed results and this study intends to fill in the gap. This study is important because these three factors are the main internal mechanisms of corporate governance.

In a study conducted by Lin and Liu (2009), the largest shareholding variable was used as a proxy for oversight of corporate governance in this study because the majority shareholders have the significant influences in forming company policies, including the policy of selecting external auditors. Gomes (2000) stated in his study that in developing countries, which do not provide strong legal protection for minority shareholders, the high concentration of ownership would be the solution to agency conflicts between majority shareholders and minority shareholders, though the majority would not try to expropriate the minority portions. However, Quick et al (2017) implied that the more concentrated the ownership (blockholder) structure of the company, the rules of corporate governance are getting weaker and the increasing the risk of the majority shareholders controlling the firms only for personal interests. This is also supported by the results obtained in the research by Lin and Liu (2009) in

China, that the company that has concentrated shares portion will try to maintain profits that can only be obtained by majority shareholders through financial intransparency. This will lead for the selection of lower quality auditors.

Furthermore, the board of commissioners and audit committee are also proxies of corporate governance in this research because both of these are internal mechanism of the shareholders in supervied the management. The board of commissioners and audit committee have the right to propose names in the appointment of an external auditor for the consideration and then would be approved through the General Meeting of Shareholders (GMS). Regarding the size of boards of commissioners, Quick et al (2017) impled that companies that have high size of boards of commissioner have bad coordination, communication, and decisions making compare with companies that have a smaller board size. However, Lin and Liu (2009) found that a larger board of commissioners would be able to conduct a more effective supervisory function. This will then have an impact on the selection of high-quality public accounting firms to provide audit services for companies.

Regarding the audit committee, Quick et al (2017) implied that the appointment of an audit committee by the company might only be done to meet the requirements and not to enforce good corporate governance in the company. This was considered because of the short span of time between regulations regarding audit committee considerations.

Previous studies on auditor selection commonly used the Big 4 and non Big 4 dichotomies, on this basis Big 4 auditors have better advantages and will have implications for providing better quality audit services because their reputations are on stakes. This separation is based on the average number of public accounting firms for two years. The public accounting firm which is ranked in the Big 4 for two years of research in Indonesia is considered quite stable and is assumed to be able to represent a high-quality auditor. The control variables used in this study were also conducted in a study conducted by Lin and Liu (2009),which are the logarithm of total assets, as a function of company size, company efficiency, profitability, and leverage. This study will take samples of listed companies in the Indonesia Stock Exchange (IDX) on 2017 – 2018.

1.2 Problem Statements

The formulation of the problem in this research is as follows:

1. Does the majority shareholder have a negative influence on the selection of the company's external auditor?
2. Does the number of board of commissioners members (supervisory board) have a positive influence on the selection of the company's external auditor?
3. Does the effectiveness of the audit committee have a positive influence on the selections of company external auditor?

1.3 Objective of the research

The purpose of this study is to know empirically:

1. The negative influence of the majority shareholder on the selection of the company's external auditor,
2. Positive influence on the number of board of commissioners members (supervisory board)towards the selection of the company's external auditor,
3. The positive effect of audit committee effectiveness on the selection of the company's external auditors.

1.4 Contribution of research

The benefits of this research are as follows:

1. For academics and researchers, it can be a reference for further research that is more deeply related to the factors of corporate governance that can influence auditor selection,
2. For companies, it can be a reference for making company policy at the General Meeting of Shareholders regarding the selection of external auditors in order to signal to the market regarding the implementation of good corporate governance in the company,
3. For external auditors, it can be a reference to find out the characteristics of a company that is a leading factor in the selection of a public accounting firm and then can be taken into consideration by

the public accounting firm to determine its strategy in carrying out its business,

4. For investors and potential investors, it can help in analyzing the application of good corporate governance mechanisms through the selection of external auditors, that can assist them in making investment decisions.

1.5 Scope of the research

The researcher limits this study for the period of one year, which the period 2017-2018. The data used are data of companies listed on the Indonesia Stock Exchange for the period 2017-2018 in Bank subsector. The corporate governance indicators used are the largest share ownership, the number of boards members, and the effectiveness of the audit committee. The data used as corporate governance indicators and financial data are used as control variables derived from annual reports and company audited financial reports published on the Indonesia Stock Exchange website. The income data of the public accounting firm that is used as proxy for auditor quality is obtained from the Center for Assessment of Accountants and Services, Ministry of Finance of the Republic of Indonesia (Ministry of Finance of RI). In addition, to support this research, the authors took other information from books, journals, sites, and other scientific publications.

1.6 Systematics of Writing

In consideration of moderating the content, this research will be divided into five chapter:

Chapter I Introduction

This chapter will describe the background of the problem, the formulation of the problem, the scope of the research, the purpose and benefits of the research and the systematics of writing. This chapter aims to provide an overview of overall content of this research.

Chapter II Literature Review

This chapter will describe the theoretical basis used in this study, which the theory of corporate governance, ownership structure, board of commissioners, audit committee, external audit function and concepts that discuss the relationship between corporate governance mechanisms of a company and the selection of public accounting firms as external auditor. This matter will be used in formulating the research hypothesis.

Chapter III Research Method

This chapter will explain the stages in this study as well as data, samples, and operationalization of the variables that will be used. this chapter explained about the method that will be used in data processing as well.

Chapter IV Result And Discussion

In this chapter the researcher will describe an analysis of data processing that been carried out in Chapter 3 as well as a discussion of the interpretation of the results of data processing. Interpretation of the results of this study will provide answers to the problems in this study.

Chapter V Conclusion

This chapter is the closing part of this writings. This chapter contains a summary of all the results of data processing and interpretation that answer the predetermined problem formulation. In addition, this chapter will also include limitations and provide suggestions and input for further research