CHAPTER I

INTRODUCTION

1.1. Background

The important role of the implementation of Corporate Governance can be seen from the side of one of the important goals in establishing a firm that in addition to improving the welfare of its owners or shareholders, also to maximize shareholder wealth through increasing corporate value (Brigham and Houston, 2001). High corporate value can increase prosperity for shareholders, so that shareholders invest their capital into the firm. To maximize firm performance, investors generally give their management to professionals as managers. The management of the firm must try to maximize the welfare of shareholders through the authority given in making policies within the firm.

According to agency theory,managers as firm managers have different objectives, especially in terms of increasing individual achievement and compensation to be received (Jensen and Meckling, 1976). If the manager carries out selfish actions by ignoring the interests of investors, it will cause investors to fall in hopes of the return on investment they have invested. Therefore, an understanding of how relationships between stakeholders and firm managers is needed, and understanding how corporate governance works within the firm is needed. So that the firm goals to achieve maximum profits and prosperity of the owner of the firm or shareholders can be achieved well.

Corporate governance explains the relationship between various participants in the company that determines the direction of the firm's performance. The IICG (The Indonesian Institute for Corporate Governance) defines the concept of Corporate Governance as a series of mechanisms to direct and control a firm so that the firm operations run by the expectations of stakeholders. Furthermore, IICG defines the notion of good corporate governance as a structure, system and process used by corporate organs as an effort to provide added value to the firm on a sustainable basis in the long term. The definition contains the conclusion that Corporate Governance is a series of mechanisms by which the mechanism consists of structures, systems and processes that are used by the internal organs of the firm to direct and control the operations of the firm to run as expected. (Bukhori, 2012).

Firms that implement Corporate Governance should have good performance. Effective implementation of Corporate Governance can increase efficiency and economic growth as well as investor confidence. Increasing the application of Corporate Governance is a fundamental need because investment will follow sectors that adopt efficient governance standards (OECD, 2004).

Seeing the companies' awareness of the importance of the quality of the application of the principles of Corporate Governance that are increasingly increasing, the need for the Audit Committee should also increase. But unfortunately, the understanding of the functions, duties, and responsibilities of the Audit Committee to date still feels very varied. This diversity of understandings can trigger the ineffectiveness of the Audit Committee in carrying out its functions, which in turn can lead to the failure to realize the quality of the application of the principles of Corporate Governance optimally. This condition resulted in the existence of the Audit Committee not being optimal and encouraging companies to form an Audit Committee solely because they had to fulfill the rules of Corporate Governance alone (IKAI, 2002).

Firms that are listed on the Indonesia Stock Exchange (IDX) are generally firms that have separate organizational structures between the owners and managers. The owner consists of shareholders and stakeholders, while the management consists of management appointed by the owner to carry out firm activities. The management of firms in Indonesia that are listed on the IDX is considered to be ineffective, it was stated by Kurniawan & Indriantoro (2000) in Nuraini 2010 that because of the ownership structure of firms that are dominated by families, so there is no clear separation between ownership and corporate arrangements, causing management firms tend to only side with one owner.

Among the various types of firm sectors listed on the IDX, manufacturing firms are one of the firm’s sectors that are expected to have bright prospects in the future because of the rapid population growth and economic development in Indonesia which makes the manufacturing sector the most strategic land to benefit high in investing. Based on the Indonesian

Capital Market Directory (ICMD) in 2008, the manufacturing sector is the largest number of issuers compared to the number of listed firms listed on the IDX, which amounted to 150 firms. This shows that manufacturing firms have a significant influence on the dynamics of trade on the IDX.

The firm performance will be good if the firm can control the behavior of the firm's top executives to protect the interests of the firm's owners (shareholders), one of which is the presence of the Audit Committee. The Audit Committee is expected to be able to oversee financial reports, supervise external audits and supervise the internal control system by the Decree of the Minister of State-Owned Enterprises Number: 117 / MMBU / 2002.

The importance of the Audit Committee in the firm was put forward by McMullen (1996), which states that firms with the Audit Committee will experience fewer financial misstatements and reporting compared to companies that do not have an Audit Committee. The corporate governance mechanisms related to the Audit Committee include many things, such as the independence of the Audit Committee, expertise of the Audit Committee, meeting of the Audit Committee and the number of Audit Committees. With the existence of one of the mechanisms of the Audit Committee, it is expected to be able to monitor firm managers, to be more effective to improve firm performance (Leonissa, 2015).

The existence of the Audit Committee is a concern in many countries, such as Indonesia. Post-crisis in 1998, the Indonesian government issued several regulations, such as the establishment of an Audit Committee issued by the Capital Market Management and Supervisory Agency (BAPEPAM) on 1 July 2001 which regulated the formation of Independent Commissioners and Audit Committees. Regulations require listed firms to have an Audit Committee.

The Audit Committee must have three members, one of whom has expertise in accounting. One member of the Audit Committee must come from an Independent Commissioner who also serves as chairman of the Audit Committee. The duties of the Audit Committee are related to financial reporting quality, because the Audit Committee is expected to be able to assist the Board of Commissioners in carrying out their duties, namely overseeing the financial reporting process by management.

Klein (1998) stated that the Audit Committee affect firm performance. The more independent of the Audit Committee, the more firm performance will increase. The influence of the Audit Committee of the firm also stated by Aanu (2014) that the Independence of the Committee Audit is important in the firm to improve firm performance, if the size of the Audit Committee is large then the supervisory function of the Audit Committee on accounting and financial reporting processes will increase, so that it will improve firm performance. However, Yermack (1996) declared that the larger size of the Audit Committee will slow down the decision-making process due to a lot of debate between them. Thus, it will decrease the firm performance. Then, in agreement with Aldermen (2011) said that the size of the Audit Committee is not a factor that affects firm performance. The research found out that the firm performance depends on the quality of the audit committee itself. Even though the firm has a small size Audit Committee member, but filled by people who are competent in the field of finance (financial expertise), it would be better in contributing more to improve company performance compared to those who have large Audit Committee members, but filled by people who are not competent in the field of finance (financial expertise). So the better the Expertise Audit Committee, the better the company's performance.

The meeting of the Audit Committee is also one of the characteristics of the Audit Committee. According to Al-Matari, Abdullah, and Faudziah (2012), the Audit Committee meeting had a significant effect on increasing firm performance. The more meetings conducted by the Audit Committee, the Audit Committee will be better able to carry out their duties to control and supervise financial reporting by management (McMullen, 1996). Furthermore, Siallagan and Machfoedz (2006) argued that the existence and activities of the Audit Committee in supervising both the operations and the process of preparing financial statements is a sign for investors that the firm has good CG so that it responds well also through the increase in market prices of firm shares, which reflect the firm's performance.

Firm performance can be measured using financial ratios. Investors make one investment by looking at profitability ratios (Prasinta, 2012). The profitability ratio used in this research uses Return on Assets (ROA) because it can describe the level return on profits that can be obtained by investors for their investment (Prasinta, 2012). In addition to ROA, investors can see how the company optimizes the use of its assets to be able to maximize profits which is also the goal of CG to use assets efficiently and optimally (OECD, 2004). Several studies have been conducted on the effect of corporate governance on firm performance by Al-Matari (2012), Shehata (2014), Ziaul (2012), Afza (2014), Huang (2014), firm performance proxied by ROA, ROE, and Tobin's Q.

Based on the study of the previous empirical literature (previous studies), the authors found the research gap, namely the influence of the characteristics of the Audit Committee on firm performance is still ambiguous or not conclusive. In other terms, some researchers found that the characteristics of the Audit Committee had a significant effect on firm performance and some researchers found that the characteristics of the Audit Committee had no significant effect on firm performance. Afza and Nazir (2014), Al-Matari, Abdullah, and Faudziah (2014), Aanu (2014), Amer (2014), Caylor (2006), Joanne (2008), Foyeke (2014), Ayemere (2015), Ghabayen (2012).

In the context of empirical research, when using linear regression analysis, to avoid bias in the regression results, control variables are used. Control variables are defined as variables whose factors are controlled by researchers to neutralize their effects (Sekaran, 2016). If not controlled, these variables will affect the symptoms being research. The researcher must eliminate or neutralize the influence that can disrupt the relationship between the independent variable and the dependent variable (Kriswanto, 2009). Based on these opinions, the authors consider the variable board size as a control variable where the board size in the previous study was tested as a characteristic variable of the Audit Committee's performance on firm performance (Afza, 2014; Al-Matari, 2014; Amer, 2014; Ayemere, 2015).

1.2. Problem Definitions

Various results obtained from research on the influence of the Audit Committee on firm performance. Therefore, the problem definitions to be examined in this study are as follows:

a) Does the independence of the audit committee have an influence on determining firm performance?

b) Does the financial expertise of the audit committee have an influence on determining firm performance?

c) Does the audit committee meeting have an influence on determining firm performance?

d) Does the size of the audit committee have an influence on determining firm performance?

1.3. Research Objectives

Research on audit committee and firm performance aims to obtain empirical evidence about:

a) The influence of independence of the audit committee on the firm performance

b) The influence of financial expertise of the audit committee on the firm performance

c) The influence of the audit committee meetings on the firm performance

d) The influence of size of the audit committee on the firm performance

1.4. Research Benefits

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

1. For researcher

   The results of this research are expected to provide knowledge and insight and be able to empirically prove the influence of the independence, financial expertise, meetings, and the size of the audit committee on company performance.

2. For Firm Board and Managers

   This results of this research is expected can give contribution to enhance firm performance through considering the characteristic of effective audit committee.

3. For reader and others

The results of this research are expected to develop the knowledge and insight of the reader regarding the influence of the audit committee adopted to companies in Indonesia on firm performance so that this research can be used as a reference for future research.

1.5. Scope of Research

This research was conducted to analyze the audit committee factors that influence firm performance. This research focuses on the factors of independence, financial expertise, meetings, and the size of the audit committee.

1.6. Writing Systematic

The discussion in this research is described in five chapters with a systematic discussion to make it easier for readers in understanding this research. Writing systematic gives an overview of each chapter.

The introduction will discuss the general description that becomes the basis of this research. It consists of background, problem definition, research objectives, research benefits, research scope, and writing systematic.

Next, the theoretical basis discusses the theory that has the relationship with the research problem. This is useful as a rationale for solving problems. Furthermore, this chapter also looks previous research, theoretical framework, and the hypothesis that will be tested in this research.

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

Afterward, this chapter will discuss the description of the research object and analysis as well as discussion of the research results regarding the independence, financial expertise, meetings, and size of audit committee on firm performance.

The last chapter will discuss conclusions. Conclusions are drawn from the research results, limitations of this research, and also the suggestions forfurther research.