



## AUDIT COMMITTEE CHARACTERISTICS AND FINANCIAL PERFORMANCE: INDONESIAN EVIDENCE

Sidiq Ashari<sup>1\*</sup>, Krismiaji Krismiaji<sup>2</sup>

<sup>1</sup>mas\_sidiq@yahoo.com, <sup>2</sup>xmiaji@gmail.com

<sup>1,2</sup>Akademi Akuntansi YKPN

\*Corresponding Author

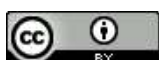
### Abstract

This research investigates the effect of audit committee characteristics, which includes independence (ACIN), size (ACSIZE), competence (ACCO), and frequency of meetings (ACMT) on the financial performance (PERF) of manufacturing firms listed on the Indonesian Stock Exchange for the year of 2016 and 2017. PERF is measured and proxy with the return on assets (ROA); ACIN is measured by the percentage of members from outside the company; ACCO is measured using percentage of audit committee members who have accounting and finance educational background; and ACMT is measured using the number of audit committee meetings in 2016 and 2017. This study uses a sample of 466 observations of publicly listed companies on the Indonesian Stock Exchange for the fiscal year that ends on December 31, 2016 through 2017 which are retrieved for 660 listed companies' population. The study finds that all of the characteristics of audit committee positively affect the company's performance. The research also uses three control variables, which are the quality of auditors (BIG4), financial leverage (LEV) and company size (SIZE). BIG4 and LEV positively affect the company's financial performance, while the financial performance of the company is negatively affected by SIZE.

**Keywords:** Financial Performance; Audit Committee Characteristics

### INTRODUCTION

This research investigates the influence of the audit committee's characteristics on the financial performance of manufacturing companies listed on the Indonesian Stock Exchange in the years 2016 and 2017. The research is encouraged by the fact that financial performance is crucial for the survival of a company (Ibrahim & Ombaba, 2019). Financial performance has implications for the company's future. The effectiveness and efficiency of management in using corporate resources are reflected by high financial performance and in turn contributes to the economy of a company. Most of the research results show that the characteristics of the audit committee are crucial to the company's performance (Abbott, Parker, Peters, & Raghunandan, 2003). The recurring crisis has a considerable impact on audit committee implementation (Eichenseher & Shields, 1985). Since there is an increase in the need of the high quality of accounting information, some jurisdictions have a governance code or code of best practices. One of the rules contained therein is the obligation to have an audit committee



that has a primary mission to strengthen the credibility of financial information by monitoring the preparation of financial statements and monitoring the effectiveness of internal control procedures.

As an important corporate governance element, audit committee helps supervise the practices of management (Afify, 2009). Also, the audit committee helps increase the financial reporting quality and reduce the risk (Contessotto & Moroney, 2014). The audit committee plays an important role in the supervision and monitoring of corporate management to protect the owner's interests (Kallamu & Saat, 2015). The audit committee effectiveness can be measured from the firm's performance and its competitive power, markedly in the transforming business environment, which is uncontrollable for the company (Herdjiono & Sari, 2017).

The audit committee's duty in controlling the company's financial performance until recently is still an interesting issue to be examined. Previous research studying the effect of the audit committee on the company's financial performance can be separated into two groups (Bouaine & Hrichi, 2019). The first group investigated the associations between the implementation of the audit committee and the company's financial performance (AlMatrooshi, Al-Sartawi, & Sanad, 2016). The second group investigated the effect of the audit committee's characteristics on the company's financial performance, including the following characteristics: the independence of the committee (Al-Mamun, Yasser, Rahman, Wickramasinghe, & Nathan, 2014; Chen & Li, 2013; Dinu & Nedelcu, 2015; Guo & Yeh, 2014; Gurusamy, 2017; Mohammed, 2018), committee size (Aldamen, Duncan, Kelly, Mcnamara, & Nagel, 2012; Yah, 2006) expertise of Audit Committee members in Finance and Accounting (Abernathy, Beyer, Masli, & Stefaniak, 2014; Guo & Yeh, 2014; Singhvi, Rama, & Barua, 2013) and the number of committee meetings (Dinu & Nedelcu, 2015).

This research focuses on investigating the effect of the audit committee on the company's financial performance, particularly the characteristics of the audit committee. This will distinct with previous research described in previous paragraph. This research focus on the four characteristic of audit committee because we belief that such characteristics play important role in the succeed of audit committee in performing its duties. Corporate governance literature always assumes that the audit committee participates in ensuring that auditors are independent of management. Thus, the audit committee can be used as an instrument to reduce agency problems (Jensen & Meckling, 1976). The composition and characteristics of the audit committee play an important role in affecting the quality of organizational performance (Lloyd, 1991). To date, there is still little (if any) research investigating the effects of the audit committee characteristics on the financial performance that focus on the manufacturing companies in underdeveloped countries such as Indonesia. This condition provides opportunities for research to complete similar literature. Therefore, research problems are formulated in the form of the question as follows:

**RQ1:** What is the effect of the audit committee's characteristics on the financial performance of manufacturing companies listed in the Indonesian Stock Exchange for the year 2016 and 2017?

This manuscript is arranged as follows. After describing the background and formulation of the problem in part one, in part two the manuscript briefly describes the literature review of the relationship between the characteristics of the audit committee with the company's financial performance and the development of hypotheses. Data, variable measurements, model specifications, and econometrics approaches used are presented in part three. Part four describes the results and discusses some policy implications. The manuscript is ended with part five that presents conclusions, implications, limitations, and further research opportunities.

## **LITERATURE REVIEW**

This research uses agency theory since the existence of the audit committee is to ensure the quality of financial statements so that the asymmetric information issues between principals and agents can be minimized. The agency theory is a theory that predicts and explains the behavior of agents and principals (Jensen & Meckling, 1976). A conflict of interest between managers and principals is affected by the separation of ownership and control in the modern business. Therefore, to reduce agency costs and asymmetry information, among others by forming an audit committee, the company has to use control mechanisms (Kalbers & Fogarty, 1998). Pincus & Wong (1989) argue that the audit committee is used mainly in conditions where the cost of the agency is high to enhance the quality of information moves from the agent to the principal. According to the agency theory, to ensure the effectiveness of the audit committee, managers are encouraged to compile adequate financial statements to determine the return generated by the company. Beasley (1996); McMullen (1996) and Felo, Krishnamurthy, & Solieri (2003) based on agency theory found a positive relationship between the audit committee's existence and the quality of financial statements. The agency theory states that the audit committee's presence is sufficient to ensure the reliability of financial statements. Yet, Beasley (1996) concluded that the presence of the audit committee alone does not necessarily mean that the committee is effective in carrying out its oversight role.

Recently, there are many efforts to know the nature of corporate governance mechanisms and their influence on the company's performance (Pratheepkanth, Hettihewa, & Wright, 2016). Researchers generally measure the effectiveness of corporate governance using the proprietary structure, the structure of the board of directors, or the characteristics of the audit committee (Bucktowar, Kocak, & Padachi, 2015). The audit committee is a corporate governance (CG) instrument because the audit committee covers the quality, credibility, objectivity, and integrity of the company's financial statements (Oroud, 2019). The audit committee becomes an important CG mechanism as the board has delegated a series of important functions, such as CG supervision and financial statements (Dhaliwal, Naiker, & Navissi, 2010). Because all members of the audit committee have responsibility for overseeing the process of preparing the company's financial statements, then the characteristics of the audit committee can improve the effectiveness of the implementation of the task. Previous research has documented that earnings management (Jean Bédard, Chtourou, & Courteau, 2004) and financial fraud

(Sharma, Naiker, & Lee, 2009) can be reduced by an effective audit committee and its relevance to the company's financial reporting quality.

### **Audit Committee Independence**

Extant research considers the audit committee independence as one of the main characteristics and it is mandatory for the audit committee to ensure the quality of financial information (Jean Bédard et al., 2004). The audit committee members will be allowed by the board of directors' independence to properly conduct supervisory roles. Previous research suggests that the existence of external members in the audit committee are able to decrease of manager's opportunistic behavior, increase company's quality and transparency of information by decreasing counterfeit in the reported information (De Vlaminc & Sarens, 2013; Sultana, Singh, & Van der Zahn, 2015) and improve performance (Dinu & Nedelcu, 2015; Kallamu & Saat, 2015). Based on the description, the following hypotheses are stated:

**H1:** The audit committee independence positively affects the company's financial performance.

### **Audit Committee Size**

The second characteristic of an audit committee that is often investigated in various empirical studies is the number of the audit committee. The small number of audit committee member may be effective to affect financial performance because they more focus to discuss important financial issues faced by a company. Yah (2006) report a significant effect of audit committee size on the financial performance of the firm. Wu, Habib, & Weil (2012) find that audit committee with a smaller number of people are more effective to protect the interest of shareholders and to ensure the financial information quality. Moreover, audit committee with a larger number of people is not effective which in turn does not affect financial performance of the firm (Aldamen et al., 2012). Based on the description, hypotheses are formulated as follows:

**H2:** The size of audit committee affects negatively the financial performance of the firm.

### **Audit Committee Competency**

One of the audit committee responsibilities is to control the financial information quality. To perform thus duty, audit committee members must have adequate competence especially in the field of finance and accounting. Consequently, Lee & Stone (1997) argue that the effect of audit committee competence on financial performance of the firms is necessary to be tested. AC members must have finance and accounting knowledge and skill adequately (Yang & Krishnan, 2005). Accordingly, McDaniel, Martin, & Maines (2002) argue that audit committee should have at least one member with finance and accounting competence in order to ensure the quality of profit as well as financial statements. Extant research have shown the positive impacts of accounting and finance competence on the quality of earnings and financial reporting accuracy (Kallamu & Saat, 2015; Velte, 2017). Dinu & Nedelcu (2015) argue that this condition, in turn, increases the financial performance of the firms (Dinu & Nedelcu, 2015). Based on

the description, hypotheses are stated as follows:

**H3:** Competence Audit Committee members in finance and accounting affect positively the company's performance.

### **Frequency of Audit Committee Meeting**

Meeting is an instrument to discuss and solve issues and problems faced by companies. The more meeting, the more problems can be resolved. According to [Menon & Williams \(1994\)](#), the meeting frequency of audit committee is a measure of audit committee effectiveness. Therefore, [Bédard & Gendron \(2010\)](#) and [DeZoort, Hermanson, Archambeault, & Reed \(2002\)](#) argue that the more meetings are performed, the better indicator for audit committee member in achieving their goals. Agency theory state that the frequency of meetings is only useful for the company when its benefits more than its costs ([Jensen & Meckling, 1976](#)). Yet, previous research did not state the ideal number of AC meetings. In Indonesia, an audit committee should meet at least four times a year ([Krismiaji, Aryani, & Suhardjanto, 2016](#)). The frequency of meetings could enhance the earnings quality, identify a potential deception and increase firm's financial performance ([Beasley, Carcello, Hermanson, & Lapedes, 2000](#)). Based on the description, hypotheses are stated as follows:

**H4:** The number of audit committee meetings affect positively the company's financial performance.

## **RESEARCH METHODOLOGY**

This study uses samples of manufacturing firms available on the Indonesia Stock Exchange (IDX) for the years of 2016 and 2017. The samples are retrieved from 662 listed companies population. The study uses the non-probability sampling (purposive sampling) method to choose samples. Some criteria must be met for inclusion in research samples. Firstly, the company is a public company listed in IDX for the year of 2016 and 2017. Secondly, companies are manufacturing companies. Manufacturing companies are chosen because of their complex business activities that can represent all other industries. The third criterium is that the company has publicly accessible data. Data is obtained from the following sources: (1) The Indonesian Capital Market Directory (ICMD); (2) IDX website ([www.idx.co.id](http://www.idx.co.id)); and (3) the website of sample company.

This research uses model (1) below to test all research hypothesis:

### **Formulae 1. Research Model**

$$PER_{it} = \alpha_0 + \alpha_1 ACIN_{it} + \alpha_2 ACSZ_{it} + \alpha_3 ACCO_{it} + \alpha_4 ACMT_{it} + \alpha_5 BIG4_{it} + \alpha_6 SIZE_{it} + \alpha_7 LEV_{it} + \varepsilon_{it} \quad \dots (1)$$

PERF is the firm's performance which is being proxy with ROA and measured by dividing net profit with total assets. ACIN is the audit committee independence measured by the percentage of independent members relative to the total members. ACSZ is the audit committee size measured by the total members of audit committee.

ACCO is the competency of AC members measured by the percentage of members who have skill in accounting and financial, and ACMT is the number of AC meetings which is measured by the frequency of meetings conducted by the Audit committee in one year. The research uses three control variables, BIG4, Size, and Lev. BIG4 is an external auditor measured with a dummy number that is worth 1 if the financial auditor is come from BIG4 accounting firm and are worth 0 if otherwise. Size is firm's size and is measured logarithm of firm's total asset, and Lev is leverage which is measured by the ratio between total liabilities and total asset.

## RESULT AND ANALYSIS

### Univariate Analysis

Table 1 presents descriptive statistics for all variables. The results show that all variables used in the scoring model have a rational degree of variation. Table 1 shows that the mean of PERF is 0.03 and the standard deviation of PERF is 0.24. Having minimum value -2.08 and a maximum value 3.19, the range of PERF data does not spread too wide, thus it is likely to have a very small outlier. The mean of ACIN is 0.99. This value approaches its maximum value of 1.00. With the standard deviation value of 0.04, the variation is very small and it can be presumed that the AC on the company being researched has an excellent degree of independence, approaching the number 100%. The mean of ACSZ is 3.04 whereas its maximum and minimum value are 6.00 and 1 respectively. It can be assumed that the data variation of the number of AC members is quite large, it can be confirmed by the standard deviation which has a value of 0.47. The mean of ACMT is 6.52 whereas its maximum and minimum value are 39 and 1 respectively. This shows that AC meeting frequency in average does not too often but the level of data variation is quite large. It can be seen from the standard deviation rate of 5.38. The mean of BIG4 is 0.4 whereas its minimum and maximum value 0 and 1. Because this variable is a dummy variable, then the number indicates that the companies studied fewer are audited by public accountant BIG4 than companies audited by public accountant firms outside of BIG4.

Table 1. Descriptive Statistic

	Minimum	Maximum	Mean	Std. Dev.
ACIN	0.50	1.00	0.99	0.04
ACSIZE	1.00	6.00	3.04	0.47
ACCO	0,20	1.00	0.71	0.25
ACMT	1.00	39.00	6.52	5.38
BIG4	0.00	1.00	0.40	0.49
Size	3.98	8.47	6.48	0.70
PERF	-2.08	3.19	0.03	0.24
LEV	0.02	20.71	0.65	1.18

Source: Self Processed (2019)



**Bivariate Analysis**

Table 2 presents bivariate correlation which is calculated by Pearson correlation. Table 2 indicates the absence of a correlation coefficient above 0.8. The highest value only occurs in the correlation between ACSIZE and ACMT i.e. 0.419. It shows that there is no problem multicollinearity. Moreover Table 2 presents the individual correlation between each independent variable and PERF. The results indicate that two of the independent variables are significantly correlated with the dependent variables (PERF), the ACSIZE and BIG4 variables, while the other two variables are ACCO and ACMT correlated insignificantly. However, these correlation indications will be tested deeper again with a multivariate regression to test the hypotheses.

Table 2. Bivariate Correlation

	ACIN	ACSIZE	ACCO	ACMT	BIG4	Size	PERF
ACSIZE	0.320						
ACCO	0.098*	-0.132**					
ACMT	-.034	0.419**	-0.149**				
BIG4	-.128**	0.271**	-0.031	0.228**			
Size	-0.061	0.301**	0.095*	0.349**	0.403**		
PERF	0.023	0.106*	0.034	0.039	0.113*	0.020	
LEV	-0.003	-0.177**	0.046	-0.052	-0.151**	-0.088	-0.274**

\*\* , \*: Bivariate correlation is significant at 1% and 5% respectively (2-tailed).  
Source: Self Processed (2019)

**Multivariate Analysis**

The regression analysis results to test hypotheses are presented in Table 3. The regression results indicate that the research model used has a significant F-value statistic ( $p < 0.01$ ) and has an Adj.R<sup>2</sup> value of 0.553 so that it can be concluded that this model describes the relationship between dependent and independent variable of 55%.

To test hypothesis 1, the variable tested is the ACIN. Table 3 presents the coefficient of ACIN is 0.235 and is significant at 1% level. These results indicate that ACIN positively affects PERF. Thus, the 1st hypothesis which stated that the audit committee independence positively affects the company's financial performance is proven and supported by empirical data. These results confirm the results of previous research that found that the existence of external members in the audit committee are able to decrease of manager's opportunistic behaviour, increase company's quality and transparency of information by decreasing counterfeit in the reported information (De Vlaminc & Sarens, 2013; Sultana, Singh, & Van der Zahn, 2015) and improve performance (Dinu & Nedelcu, 2015; Kallamu & Saat, 2015).

Table 3. Regression Analysis

$$PER_{it} = \alpha_0 + \alpha_1 ACIN_{it} + \alpha_2 ACSZ_{it} + \alpha_3 ACCO_{it} + \alpha_4 ACMT_{it} + \alpha_5 BIG4_{it} + \alpha_6 SIZE_{it} + \alpha_7 LEV_{it} + \varepsilon_{it}$$

Variable	Coefficient	t-Statistics
Intercept	-0.334 ***	-4.446
ACIN	0.235 ***	3.586
ACSIZE	0.021 ***	4.499
ACCO	0.063 ***	16.485
ACMT	0.001 ***	10.165
BIG4	0.040 ***	16.987
LEV	0.074 ***	156.694
Size	-0.006 ***	-35.694
Adj. R <sup>2</sup>	0.553	
F-statistics	82.252 ***	

\*\*\*, \*\*, \* show that coefficient is significant at 0.01, 0.05, and 0.1 respectively

To test hypothesis 2, the variable tested is the ACSIZE which is the proxy of the size of audit committee. Table 3 shows that the ACSIZE coefficient is 0.021 and significant at a level of 1%. This result indicates that ACSIZE positively affect the PERF which is the company's financial performance proxy. Thus, the 2nd hypothesis which stated that the audit committee size was negatively affecting financial performance is not proven and supported by empirical data. This result did not confirm the results of previous research that found that small-sized audit committees were more applicable to protect the interest of shareholders and to certify the financial information quality (DeZoort et al., 2002). Audit committee with a larger number of people is not effective which in turn does not affect financial performance of the firm (Aldamen et al., 2012). We argue that different environment and different culture may affect the result. Therefore, research performed in developing (eastern) countries may report different results compared to that of developed countries. The large number of human resource available in work force market, the rate of salary, and several regulations may affect the need of audit committee member. These situations may result in the need for larger to be effectively affect the firm's financial performance. However, if we look at the data in table 1 that shows that the maximum number of audit committee members in the company is 6 with a mean of 3.04. It means that the size of audit committee is not large, so the results still confirm previous research which found that the size of the audit committee that is not too large tends to be more effective in carrying out its functions.

To test hypothesis 3, the variable tested is the ACCO which is the competency proxy of the audit committee members. Table 3 shows that the ACCO coefficient is 0.063 and significant at the level of 0.01. It means that ACCO positively affect the PERF which is the firm's financial performance proxy. Thus, the 3rd hypothesis that states that competence in the accounting and finance of audit committee members



positively affects the company's financial performance is proven and supported by empirical data. This result confirms the results of previous study that found that financial skills affect the quality of profit and increase financial reporting accuracy (Kallamu & Saat, 2015 and Velte, 2017). This condition, in turn, increases financial performance of the firm's (DeZoort et al., 2002; Dinu & Nedelcu, 2015).

To test hypothesis 4, the variable tested is the ACMT which is a meeting frequency proxy of the audit committee members. Table 3 indicates that the ACMT coefficient value is 0.001 and is significant at 1% level. This result indicates that ACMT positively affects the PERF which is the proxy of firm's financial performance. Thus, the 4th hypothesis which states that the number of audit committee meetings affect positively the company's financial performance is proven and supported by empirical data. These results confirm the results of previous research that found that the frequency of the meeting could increase the relevance of profit and detect fraud and improve performance (Beasley et al., 2000). Although previous literature does not recommend the minimum number of meetings, table 1 shows that the meetings mean performed by the company is 6.52. This indicates that the audit committee in companies performs a high-frequency meeting. It is supported by the maximum number that reaches 39 times in a year.

## **CONCLUSION**

This research examines the influence of the audit committee's characteristics on the financial performance of manufacturing companies listed on the Indonesian Stock Exchange in the years 2016 and 2017. The results showed that four characteristics: audit committee independence, finance and accounting competence of audit committee, the audit committee size, and the number of audit committee meetings positively affect company's financial performance. Hence, hypothesis 1, 3, and 4 are accepted since they are supported by empirical research data, whereas hypotheses 2 is rejected since it was not proven and supported by empirical research data. These results confirm previous literature and previous studies conducted in other jurisdictions which report that the existence of audit committees and their characteristics are effectively able to safeguard the firm's financial performance.

This research has limitations in terms of the scope and the period of the study, which is only for companies listed in IDX for the years of 2016 and 2017. The scope, period, and this research area could narrow down and limit the result's generalizability. Therefore, advance research can be done by expanding the scope of the industry, year and area of study using the data for regional areas as well as a larger area to increase the generalizability of research results. Another limitation of this research is in terms of the measurement of the characteristic variables of the audit committee who only use an individual proxy of some characteristics of the audit committee. This condition can lead to less comprehensiveness studied aspects of the audit committee. Therefore, further research could be done by involving more of the characteristic aspects of the audit committee and the audit committee is measured using an index of the audit committee.

This research has theoretical implications. Theoretically, the existence of audit committees along with their characteristics should have positive effects on the firm's performance, especially financial performance. This happens because financial statements have to be reviewed by an audit committee before they are disclosed to the public. This research shows that audit committee size positively affects firms' financial performance. It means that the larger the audit committee size, the more effective the audit committee is to safeguard the firm's financial performance. This will give an extended perspective about how audit committee size works in the system.

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