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THE IMPACT OF AUDIT COMMITTEE CHARACTERISTICS ON FINANCIAL DISTRESS

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ABSTRACT

This study investigates the impact of audit committee characteristics on financial distress. This study uses four characteristics of audit committee. That is size of audit committee, independence of audit committee, meeting frequency of audit committee and competency of audit committee. Population used in this study is 123 servicing listed firms in Indonesia Stock Exchange in 2013-2015. Based on purposive sampling method, there are 92 samples that consist of 27 financially distressed firms and 65 non-financially distressed firms. Financial distress criteria are measured by a company that has a negative net income for two years in a row. Data are analyzed using logistic regression with SPSS 20. The results show that audit committee competence has significant negative affect with financial distress.

Keywords: Financial distress, audit committee, negative net income for two years in a row

INTRODUCTION

Each company must have a management which serves to manage the activities that occur in the business environment of the company. Corporate environment is the whole factors outside the company that affect both the company organizations and activities. Corporate environment can be divided into two type, that is the general environment (political, legal, social, economic, cultural, educational, technological, and demographic) and special environment (suppliers, customers, competitors, technology, and socio-political). The company visions not only to obtain the optimal profit but also to provide welfare for the environment, and to achieve these goals, companies need to apply the right strategy.

Of course, there must be obstacles or barriers that happen on implementation of the company's activities. This obstacle can cause the company's success or failure in maintaining continuity. One of the company's failure characteristic is financial difficulties *(Financial Distress)*. Brigham and Daves (2003) stated that financial difficulties divided into two types, namely the economic failure and the financial failure. Economic failure occurs due to the company's failure to cover the operating costs. The financial failure caused by two things. The first is *technical insolvency*, a situation where the company failed to pay their maturing obligations, but assets larger than the total debts owed. Second, the bankruptcy situation occurs when companies failed or no longer be able to fulfill their obligations to the creditor. Because the company lack of funds to continue their operation, so that the company cannot achieved their economic objective.

The company's failure to overcome financial distress indicate the company's poor corporate governance, like improper decisions taken by the management or lack of effort in monitoring the financial condition so that there is a lack of proper use of funds.

THEORETICAL FRAMEWORK AND HYPOTHESIS DEVELOPMENT

Agency theory approach is an important basis for creating corporate governance. According to Jensen and Meckling (1976), in the Agency Theory define an agency relationship as a contract of cooperation (nexus of contract) in which one or more principal use of another person or agent to run the company's activities. Shareholders or owners or investors are the principal, while the manager or management agent who manages the company.

Conflicts can only be caused by delegating decision-making authority from the principal to the agent. Delegation of authority to make the owner cannot supervise all decision-making

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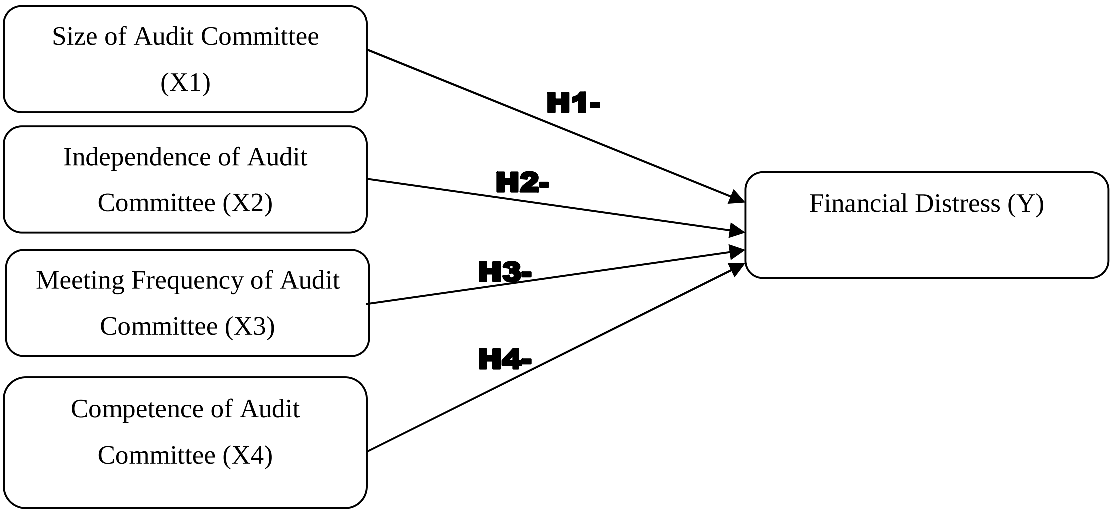
activities undertaken by management making it possible for managers to commit fraud. One of the efforts to prevent fraud and forming a good supervision is establish an audit committee. Audit committee can improve the quality and credibility of annual financial statements and help the work of the Board of Commissioners in charge of maintaining and promoting the interests of shareholders. This study aimed to compare between Services Companies that experiences financial distress and non-financial distress. The images below will show framework of the research concept. This framework will show the relationship between the study variables.

Picture 1
Framework



The Size of Audit Committee and Financial Distress

The size or numbers of the audit committee are less support effectiveness of the audit committee performance. In order to create an effective audit committee to controlling and monitoring the activities of top management, the committee should have enough members to carry out the responsibilities (Vinten and Lee, 1993). Results of previous studies showed that the size of the audit committee and the company's performance was not conclusive. Dalton (1999) found that the audit committee is too large then there is a tendency to less focus, and there are some working passive members compared with a smaller size the audit committee. In addition, when there is too much number of the audit committee, it could be a conflict in decision-making process because it is very difficult to make a deal with many people and made it to do the job to the fullest. But if the size of the audit committee only in small quantities, there is a tendency of members could not handle the job as much as possible due to lack of skills or knowledge. The right number of the audit committee will allow members to use their experience and expertise for the benefit of stakeholder.

The number of audit committee is being expected according to government regulations setting. It aims to make the opinion is not too wide or narrow. The thought of some people in audit committee be expected to reduce the information asymmetry that often occurs in the company (agency theory). So that information from management as agents can be delivered effectively to the principal, thereby reducing any indication of *financial distress.* Then the hypothesis can be developed:

H1: There is a significant negative relationship between size of an audit committee and financial distress.

Independence of Audit Committee and Financial Distress

According to the agency theory, an independent member of the supervisory can reduce information asymmetry and bridging interests between owners and management. Independent members can be regarded as a good watchdog because it is considered more objective and critical in relation to the management policies. In addition, the independent members have interest for increase their reputation to be the good supervisor. Therefore, an independent member will reduce the occurrence of financial distress. IDX's Regulation and guidelines on corporate governance in the formation of an effective audit committee stated that the audit committee consisting of minimum three members of the independent majority is at least one independent commissioner and at least two other members from outside the company. Audit committee members must have come from an independent external party of company, should consist of independent individual and not involved with the everyday tasks of corporate management, and has the experience to accomplish their oversight functions effectively. This independence is aimed at preserving the integrity and objective view in the report and recommendation preparation made by the audit committee, because independent individuals tend to be fair and impartial and objective in dealing with a problem (FCGI, 2002).

The results of several previous studies have shown the positive influence on the committee members structure are dominated by independent parties on the performance of the audit committee. Such as research and Raghunandan McMullen (1996), this proves that the non-executive directors will reduce the possibility of financial statement manipulation.

The number of independent members as a majority of the audit committee members will increase independence of committee and will optimize the committee's reputation audit as good monitor, because independent member be able to provide independent opinions, more objective and more capable offer criticism toward the policies conducted by the management (Porter and Gendall, 1993) in Grace, et al. (2008). It is estimated that in the presence of an independent audit committee, it will increase investor confidence in the financial statements and will reduce the possibility company in condition trouble finance because a case deviation system manage company. Based on explanation above, can be formulated hypotheses. The more the number of independent members of the audit committee, the less financial distress occurs in a company.

H2: There is a significant negative relationship between the independence of audit committee and financial distress.

Meeting Frequency of Audit Committee and Financial Distress

Previous research use amount of meeting frequency to measure the activity of the audit committee (Menon and Williams, 1994; McMullen and Raghunandan, 1996; Collier and Gregory, 1999). The research findings suggest that more often the audit committee meeting provide oversight and monitoring mechanisms are more effective in financial activities, which include the preparation and reporting of financial information company. It is evident from previous studies that audit committees of companies with financial difficulties did not have meetings as often as those without financial difficulties (McMullen and Raghunandan, 1996). Therefore, the meetings frequency has a significant positive relationship with the effectiveness of the audit committee (Collier and Gregory, 1999; Song and Windram, 2000). This evidence is consistent with the guidelines proposed by the Cadbury Committee (1992) in the UK, BRC (1999) in the United States, and Best Practices Code of Corporate Governance in Malaysia (MICG, 2001).

These guidelines require the audit committee to meet not less than three times a year. The meeting schedule planned properly will ensure a timely the audit committee decision parallel with the audit cycle and the financial statements. The effectiveness of the audit committee role to oversight the financial reporting process and internal controls needs regular meetings (Vafeas, 1999). The meeting should be held at least three or four times a year should be clearly structured and well controlled by the chairman (Hughes, 1999; McMullen and Raghunandan, 1996). A regular meetings that controlled properly will assist the audit committee in examining related the accounting and internal control systems, and in keeping informed top management committee precautions (McMullen and Raghunandan, 1996). The meeting determined not too little or too much in order to avoid irregularity occurrence, and unify the views and information in accordance with the symmetrical existing realities in the company (agency theory). Then the hypothesis can be developed:

H3: There is a significant negative relationship between the meeting frequency of audit committee and financial distress.

Competence of Audit Committee and Financial Distress

Accounting and finance expertise provide a good basis for audit committee members to examine and analyze financial information. Educational background to be important characteristics to ensure audit committees performs their roles effectively. Audit committee members who have financial competence more professional in their approach are more adaptable toward change and innovation (Hambrick and Mason, 1984). Therefore, the audit committee with members who have financial competence expected to adopt high standards of accountability and achievement levels and strive for excellent corporate image and performance. It is clear that the audit committee performs poorly when they have a poor financial competency (Kalbers, 1992). It is also clear that the financial competences are important factors that contribute to the effectiveness of the audit committee in the UK (Collier, 1993). The audit committee with a good financial competence can reduce the number of distressed companies (McMullen and Raghunandan, 1996). From the perspective of the internal auditor, the audit committee needs to include directors who have financial competence as a member, to be effective and efficient (Abdul Hamid et al., 1999).

The audit committee must have at least one member who has an educational background in accounting and has work experience in the financial sphere. Therefore it can be concluded that the member who has the financial competence are those with knowledge in the field of accounting and finance, and with years of relevant experience in the practice. The existence of an accountant who qualifies as a member of the audit committee will be able to provide assistance in controlling and monitoring the role of management to report information in accordance with the actual circumstances (agency theory). Hypotheses that can be developed:

H4: There is a significant negative relationship between the competence of audit committee members and financial distress.

METHODOLOGY

Research variable

Dependent variable is variable that bound and affected by another variable. The dependent variable in this research is financial distress or problems that occur in the company. This study defines the financial distress companies with reference to the research conducted by Salloum et al. (2014) which categorizes companies with financial distress when for two consecutive years experience profit clean negative. The dependent variable in this study is a dummy variable. Scoring in this variable is the value of 1 (one) for financial distressed companies and 0 (zero) for the non-financial distressed.

The independent variables in this study is the size of the audit committee, the independence of the audit committee, the meetings frequency of audit committee, and the financial expertise of audit committee members.

Population and Sample

The population used in this study is a company engaged in infrastructure services, telecommunications and transport are listed in the Indonesia Stock Exchange from 2013 to 2015.

The sample used is a sample of companies experiencing financial problems with financially healthy company. Sample determination on this research use purposive sampling, which samples have compatibility characteristics with sample selection criteria that have been determined. Those criteria are:

a. Service companies listed in Indonesia Stock Exchange from 2013 to 2015.
b. Companies have reported annual report covers the characteristics of the full audit committee

Types and Sources of Data

This study use secondary data. Secondary data used consists of financial data and the data which contain the audit committee characteristics, (such as the size of the audit committee, the independence of the audit committee, the audit committee meeting frequency, and the competence of the audit committee) on the company's annual report 2013 -2015.

Analysis method

Logistic regression used in this study to test the entire hypothesis. In the logistic regression, the independent variable is a combination of a continuous variable (metric data) and categorical (data non-metric). The equation is formed using logistic regression are as follows:

$$\text{Ln} \frac{FD}{1-FD} = \beta_0 + \beta_1 \text{ ACSIZEi} + \beta_2\% \text{ ACINDPi} + \beta_3 \text{ ACMEETi} + \beta_4 \text{ACEXP}$$

Information:

DISTRESSED = A value of 1 (one) for companies have financial distressed, and the value 0 (zero) for companies have non-financial distressed.

β_0 = Constant

ACSIZE = The number of audit committee members

ACINDP = Independence of the audit committee or the proportion of independent members on the audit committee of the whole number of audit committee members

ACMEEET = The number of meeting held per year

ACEXP = The number of members who have a financial knowledge

RESULTS

Research Object Description

In this study, researcher has 92 samples obtained during the observation of three-year study. Furthermore, a number of the data were used for data analysis and hypothesis testing.

Table 1
Details Sample

Criteria	2013	2014	2015
Service companies listed on the Stock Exchange	41	41	41
Not reporting the characteristics of the full audit committee	(10)	(10)	(11)
Samples	31	31	30
Total sample		92	

Source: Secondary data were processed, 2016

Grouping the data as Table 4.2 shows that the 92 companies that can be analyzed for the year 2013 to 2015 there were 27 companies or 29.3% were experiencing financial distress and 75 other companies, or 70.7% did not experience financial distress.

Table 2
Classifying Financial Distress Company

Company	amount	Percentage
Non Financially Distressed (Non FD)	65	70,7 %
Financially Distressed	27	29,3 %
Total	92	100%

Source: Secondary data were processed, 2016

Descriptive statistics

Table 3
Descriptive statistics

		N	Mean	Std. Deviation	Minimum	Maximum
ACSIZE	Non FD	65	3,1538	0,3636	3.0000	4,0000
	FD	27	3,1852	0,3958	3,0000	4,0000
	Total	92	3,1630	0,3714	3,0000	4,0000
ACINDP	Non FD	65	0,9885	0,0529	0,7500	1,0000
	FD	27	1,0000	0,0000	1,0000	1,0000
	Total	92	0,9918	0,0446	0,7500	1,0000
ACMEET	Non FD	65	8,2308	8,1735	1,0000	48,0000
	FD	27	6,4444	5,3589	2,0000	31,0000
	Total	92	7,7065	7,4738	1,0000	48,0000

ACEXP	Non FD	65	0,6821	0,2149	0,3333	1,0000
	FD	27	0,5679	0,1534	0,3333	0,7500
	Total	92	0,6486	0,2048	0,3333	1,0000

Source: Secondary data were processed, 2016

According to the table 3 of the 92 sample companies, average size of the audit committee (ACSIZE) of the sample companies, measured by the number of audit committee shows the average for the entire sample is equal to 3.16. This means that the number of audit committee of the company sample average is closer to 3 people. The number of audit committee is at least as much as 3 people and most are as many as four people. If the comparison between group companies are experiencing *financially distressed* by the experience *of non-financially distressed* shows that companies are experiencing *financially distressed* have an audit committee members as much as 3.185 more than the *non-financially distressed* company is equal to 3.154.

The existence of an independent audit committee (ACINDP) has the average of the total sample is obtained by 0.9918. This means that 99.18% of audit committee members are from the sample company’s independent commissioner. Independent audit committee lowest value was 0.75 and the largest independent audit committee is 1.00. If the comparison between groups companies are experiencing *financially distressed* by the experience *of non-financially distressed* shows that companies are experiencing *financially distressed* have an independent audit committee of more than 1,000 is equal to 0.9885.

The number of audit committee meetings (ACMEET) within one year of the sample companies an average of all samples obtained for 7.7065 times, the audit committee meetings smallest 1 times and the audit committee meeting is at most 48 times. There is more meeting will give greater intensity to the manager. If the comparison between the group of companies that experience with *financially distressed to non-financially distressed* shows that companies are experiencing *financially distressed* have an audit committee meeting less that 6.4444 compared with 8.2308.

The size of the audit committee membership (ACEXP) within one year of the sample companies an average of all samples obtained at 0.6486. Thus, it means that 64.86% of the committee members have a background in finance or accounting education Economics. Total competence of the audit committee is the lowest of 0.3333, or 33.33%, and the largest is 1.0 or 100%. If the comparison between group companies are experiencing *financially distressed* by the *non-financially distressed* shows that companies are experiencing *financially distressed* competencies smaller audit committee that is equal to 0.5679 compared with 0.6821.

Discussions and Results of Logistic Regressions Analysis

Logistic regression was used to examine the effect of the size of the audit committee, the independence of the audit committee, the audit committee meeting frequency and financial competence of the audit committee toward the possibility of financial difficulties. In testing the significance of independent variable coefficient using the *p-value (probability value)* with a 5% significance level (0.05). If the significance value less than 0.05 then the regression coefficient is significant. Hypothesis testing results are presented as follows:

Table 4
Result of logistic regressions

		B	S.E.	Wald	df	Sig.	Exp(B)
Step 1	ACSIZE	0,776	0,705	1,212	1	0,271	2,172
	ACINDP	85,842	9,280	0,000	1	0,999	1,908
	ACMEET	-0,040	0,043	0,865	1	0,352	0,960
	ACEXP	-2,923	1,285	5,175	1	0,023	0,054
	Constant	-86,984	9,280	0,000	1	0,999	0,000

Source: Secondary data were processed, 2016

Hypothesis 1

The results of logistic regression showed that variables ACSIZE not significantly affect the possibility of the company is in financial distress. It is seen from the hypothesis test where

ACSIZE significant value at 0, 271 where the value is greater than 5% significance level (0.05). Its mean the first hypothesis (H1) has been rejected, which states that the size of the effect on the audit committees of financial distress.

Based on the results of this study can be said that the size or number of the audit committee are less able to support the effectiveness of audit committee performance. The results of this study are essentially contrary to the theory put forward Pierce and Zahra (1992) where it should be when the size increases, the effectiveness of the audit committee is also increasing, because it has more resources to address the problems facing the company (Anggarini, 2010). But the results of this study are consistent with research conducted by Salloum et al. (2014) which provides empirical evidence that the size of the audit committee did not significantly affect financial distress. Based on the test results it can be said that the size of the audit committee to be less effective when the size is too small or too big. When the number of audit committee members is too large then there is a tendency to focus less and there are some members of the more passive work than the audit committee with a smaller size. In addition, when the number of audit committee a lot, then it could be a conflict in decision-making because it is very difficult to unify deal with large numbers and made it difficult to do the job to the fullest. But if the size of the audit committee only in small quantities, there is a tendency members could not handle the job as much as possible due to lack of skills or knowledge. Thus, the size of the audit committee has no effect on company financial distress.

Hypothesis 2

Variable Audit Committee Independence has a significance level greater than 0.05, which is. 0.999. This indicates that there is no significant relationship between the variables of the Audit Committee Independence and variable Financial Distress. In other words, H2 rejected. Similarly, research conducted by Salloum et al. (2014), which shows the results of the audit committee independence variable, did not significantly influence the effectiveness of Financial Distress. However, the results of testing this hypothesis is contrary to research conducted by (Porter and Gendall, 1993) which concluded that the number of members as a majority of independent members of the audit committee will increase independence committee and will optimizing the committee's reputation audit as monitor that good, because member that independent able to provide opinions that independent, more objective and more capable offer criticism in relation to the policies conducted by the management.

Explanation of the hypothesis test results states that the independence of audit committee variables did not affect the financial distress. From these results due to the independent audit committee of a company that is observed only as a formality to meet the regulations just so in practice independent audit committee does not work optimally accordance to the role that should be implemented. As mentioned in the regulations Keputusan Bapepam No. Kep-29 / PM / 2004. If the condition is only to meet regulatory formalities, the existence of an independent audit committee is not properly do monitoring function and also does not use its independence to oversee director’s policy. Thus, the independence of the audit committee has no effect on company financial distress.

Hypothesis 3

The test results of logistic regression showed that the variable frequency of audit committee meetings (ACMEET) does not affect the possibility of the company are in financial distress. The test result of the hypothesis that ACMEET value is 0.352, which means the value, is greater than the significance level of 5% or 0.05. This study therefore rejects the third hypothesis (H3) which states that the frequency of audit committee meetings did not affect the financial distress. The results of this study differ from research conducted Salloum et al. (2014) which states that the meeting frequency of audit committee (MEET) has a significant negative relationship toward financial distress. But the test result is consistent with research conducted by Grace (2008) which states that the meetings frequency of audit committee does not have a significant negative relationship in financial distress. Rahmat (2008) stated that in Malaysia frequency level meeting would not have been improving the quality of discussions by members of the audit committee.

Therefore, the frequency of audit committee meeting does not have any impact on the company financial distress.

Hypothesis 4

The results of logistic regression showed that the variable of financial competence of the audit committee (AC EXP) effect on the possibility of the company is in financial difficulty. Based on the hypothesis test result shows that the significant value AC EXP at 0.023 where the value is smaller than the significance level of 5% or 0.05. The fourth hypothesis (H4) has received in this study, which stating that the competence of the audit committee financial effect on the financial distress. The research result is consistent with research conducted by Grace (2013) who states that the audit committee with competence good financial direct impact on financial distress due to the lack of knowledge and experience in accounting and finance as a result not many members of the audit committee of certified MIA (Malaysia Institute of Accountants). But the result of this study is inversely related to the research conducted Triskawati (2012) in which the financial competence of the audit committee (LITERACY) does not have a significant relationship to financial distress.

The role of the audit committee is as supervisor and giving input to the board of directors in order to create a good oversight mechanism. Members of the audit committee are educated and experienced in the field of accounting or finance can minimize the risk of misstatement of financial statements, as the controlling and monitoring of quality performance. Thus, the competence of the audit committee has an influence on company financial distress.

CONCLUSIONS AND LIMITATIONS

Conclusion

From the analysis of the data from the previous chapter, it can be concluded as follows:

1. The size of the audit committee does not have a significant negative influence on the *financial distress.*
2. The independence of the audit committee does not have a significant negative influence on the *financial distress.*
3. Number of audit committee meeting does not have a significant negative influence on the *financial distress.*
4. Audit committee financial competency has a significant impact on the *financial distress.*

Limitation

Limitations of this study include:

1. Much of the information regarding the audit committee at the company's annual report is not complete, so the number of samples less than total population.
2. Some of the listed company did not provide complete data on their financial statements.
3. The existence of the audit committee is implemented in a service company although it has become Bapepam regulations, but there are still some companies that do not implement it. This has an impact on the number of samples in each year there are different.
4. The ability of independent variables to explain the model for only 16%.

Suggestion

1. For further research, is expected to better measure the characteristics of the audit committee with other qualitative factors such as the quality of discussion, the culture and dynamics of the audit committee meetings that may have an impact on the performance of the audit committee. In addition to qualitative factors, for further research are expected to use all types of companies listed on the Indonesian Stock Exchange as the population so that later results are more generalized and more significant results. Besides research can then try to use a proxy other than negative earnings two consecutive years in the determination of financial distress. It is expected to further research using a longer time frame in order to have more number of samples and the results are different.
2. For Bapepam, supervision obligation existence of audit committee in each company services must be operated with a more rigorous and assertive. For further research, in addition to the annual report using the information companies can use information from the audit committee characteristics of other data as a complement to research data. The use of other data can be obtained directly from the issuer.

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