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The Impact of Managerial Ownership and Independent Board Member on Independent Audit Committee and Its Implication on Audit Quality in the Banking Companies Listed in Indonesia Stock Exchange

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Abstract

This research aims to investigate the impact of managerial ownership and independent board member on the independent audit committee. Furthermore, it aims to examine the impact of managerial ownership, the independent board member and independent audit committee on audit quality. The unit of analysis represents banking companies listed on the Indonesia stock exchange (IDX) from 2010 to 2015. This study is an explanatory research that uses the partial least squared statistic for hypothesis testing. The results showed that the independent board member has a significant impact on the independent audit committee. It is found that managerial ownership and the independent board member have an impact on audit quality. It is necessary to conduct further research on the ideal level of managerial ownership and number of an independent board member to produce a good audit quality on banks in Indonesia.

Keywords: managerial ownership, independent board member, independent audit committee, audit quality

1. INTRODUCTION

The impact of adverse Indonesian banking system in the past had resulted in the government's decision to close down some banks. As rescue effort, in 1999 and 2000 the government held the recapitalization of the 18 banks owned by the central and local government (www.bi.go.id, visited on October 4th, 2016 at 18:23 pm). Banks should be able to function as an agent of trust, an agent of development and agent of service (Docherty & Viort, 2014). The financial system in Indonesia is majorly dominated by the banking sector and the macroeconomics strongly influenced by banking system (Kuncoro & Suharjono, 2012). Bank has a significant contribution in supporting the country's economy (Choudhry, 2011).

Financial Statements are a company's financial records during an accounting period that can be used to describe the performance of the company (Subramanyam, 2014). Concern on the auditing services has been increased lately, especially for public companies. The primary concern related to auditing services is audit quality that is reflected in the audit report released by the auditor (Beisland et al., 2015). Audit quality is essential because quality audit means that the audited financial statements guarantee fair presentation. It is stated that the audit quality has a significant impact on the quality of information disclosure (Nosheen, 2013), reduce the uncertainty and the noise in financial reporting (Balsam, 2002).

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A proper audit quality provides additional values for the capital market because investors often use the audited financial statements to make their investing decisions. Often, the market reacts to the published audited financial statements (Sudsomboon & Vssahawanitchakit, 2009); quality audit can reduce the underpricing on shares outstanding (Beisland et al., 2015). A quality audit has an impact on the better implementation of good corporate governance (Griffin et al., 2008) and also on the better information disclosure (Muhamad et al., 2009). The application of good corporate governance includes quality audit and has a positive influence on disclosure that reduces the level of information asymmetry (Silveira & Barros, 2006). Moreover, it is discovered that the audit failure will create a higher chance of litigation, bad reputation, degeneration of corporate value and the audit fee as well. It means that the audit quality has an impact on both auditor and auditee (Taqi, 2013).

Favere, who researched audit quality, found the need to improve several aspects such as legal aspects of audits, advanced professional auditing and skills in internal quality to increase the level of audit quality in ASEAN countries including Indonesia (Favere, 2000). On the other hand, the increase of managerial ownership gives greater power to management in directing and overseeing the company activities, including to contribute in the appointment of external auditor so as to give impact to audit quality (Kane & Velury, 2005). The board establish an audit committee and assist them in their supervisory function. In Indonesia, the audit committee consists at least 3 persons including an independent commissioner of the issuer and public company (Otoritas Jasa Keuangan Republik Indonesia, No. 33/POJK.04/2014). The role of the independent board as supervisor and advisor to the audit committee is critical and will give a positive impact on audit quality (Hay et al., 2008).

The audit committee has an essential role in overseeing financial reporting process, including the appointment of external auditor. The existence of an independent audit committee contributes to better supervision and improve audit quality (Mohamed & Mohamed, 2012). Open communication between the audit committee and external auditor is needed in order to improve the audit quality and report transparency (Murphy, 2014), which also assist the audit committee to evaluate the effectiveness of audit firm in its engagement (Brooke 2014). There is a positive and significant correlation between audit committee characteristic and audit quality (Yasin & Nelson 2012). Based on the description of the background and condition of audit quality, it is important to doing research related to managerial ownership, the independent board member, the independent audit committee and audit quality the banking companies in Indonesia. This research aims to discover the impact of managerial ownership and the independent board member on the independent audit committee and its implication on audit quality.

2. LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

The separation between a company as a separate entity from the owner means that the function of management is separated from the owner (Belkaoui, 2004). The agency problem arises when there is a conflict of interest between the owner and manager of the company (Nasution & Doddy, 2007). There is a need of third independent party to act as a mediator between principals and agent and to ensure that the agent is acting in the best interests of the principals. The use of an independent external auditor is a mechanism to restrict the agents to act arbitrarily. The quality audit and understanding the audited financial information are an essential element to other parties. The quality of financial information is necessary to increase the confidence of the users of financial information, including investors (Murphy, 2014).

De Angelo defined quality audit as the ability of the auditor to find and disclose the infringement on their clients' report (De Angelo, 1981), which has been adopted by many other researchers (Velnampy et al., 2014; Hapsoro, 2012). The ability to find infringements depends on the technical ability and competence of the auditor (Brooke, 2014). The larger the size of the public accountant office, the better the audit quality that is produced based on existing regulations (Beisland et al., 2015). Based on the description above, the quality audit is increasingly seen vital to increase the confidence of various parties that will be presented with financial information. The management of the company will act in a way that benefits both the agent and owner through effective monitoring (Herawaty, 2008).

The audit committee is formed to develop recommendations for improving the quality of financial reporting and to conduct effective monitoring, including in financial reporting (Hamdan et al., 2013). In the condition where management also acts as owner, management should be in coordination with the board of commissioner in appointing an independent member of the audit committee so that supervision of financial reporting and audits by the audit committee can be done effectively. Furthermore, it can be said that the improvement of managerial ownership will increase the number of independent member of the audit committee.
Ha1: Managerial ownership has a significant impact on the independent audit committee.

In the financial services authority regulation No. 33 / POJK.04 / 2014 stated that in order to support the effective implementation of tasks and responsibilities, the board shall establish an audit committee and may establish other committees (Otoritas Jasa Keuangan Republik Indonesia, No. 33/POJK.04/2014). The audit committee in Indonesia consists of at least three people including the independent member of boards of the issuer or public company. The audit committee is responsible for reviewing the financial information, including compliance with laws and regulations.

The audit committee is also responsible for reviewing the audit implementation by the auditor and overseeing the follow-up implementations by the directors based on the auditor's findings (Badan Pengawas Pasar Modal, Keputusan Ketua Bapepam-LK No. Kep-643 / Bl / 2012).The role of audit committees in ensuring the quality financial reports has become the highlight ever since the society drew their attention to accounting scandals (Kusnadi et al., 2016). As one of the corporate governance mechanisms, the existence of an audit committee should reduce the practice of fraud and manipulation in the financial statements (Nasution & Doddy, 2007).

The board is responsible for ensuring that the established committee to perform its functions effectively. Independent audit committees are seen to be more effective in financial reporting supervision (Baxter & Cotter, 2009). To monitor the company's operations and financial reporting supervision, the company needs the independence of the board member (Kirkpatrick, 2009). The independent board member will form supporting committees for monitoring, including the audit committee, to function more effectively and independently. It can be said that the increase of independent board member will increase the independence of the audit committee.
Ha2: Independent board member has a significant impact on the independent audit committee.

When the management also functions as the owner of the company, the opportunistic behaviour of the management will decrease. Managers are expected to act on the principal's wishes that the managers will be motivated to perform efficiently and effectively and this will lower the agency problems in the company. The increasing of managerial ownership means that the management has a more considerable influence through their voting power, including the ability to influence the selection of the external auditor in charge. That means that managerial ownership will affect the audit quality (Kane & Velury, 2005).

Auditors appointed in the assignment of auditing should provide the quality audit, thereby will increase the confidence for various parties towards the company (Griffin et al., 2008). When the number of managerial ownership increases, then the company's control through using of big audit firm also increases (Kane & Velury 2005). The increasing of managerial ownership will improve audit quality.
Ha3: Managerial ownership has a significant impact on audit quality.

The board that is formed in the financial industry or other industries have the same function, namely as supervisors and instructors to top-level management (Harris & Raviv, 2008). It is stated that there is a larger number of the independent board member compared to other industries, due to tighter monitoring of bank (Adams, 2011). There is a perspective in the banking industry that independent member of board commissioner is more likely to experience attendance problem at the board meeting (Adams & Ferreira, 2011). Another deficiency of the existence of the independent member of the board is that they lack relevant or quality information (Coles et al., 2008; Lehn et al., 2009). Another perspective suggests that in reality measuring independence of an independent board member in the banking industry is not easy, this is because that the board member may also be the customer or somehow related to the bank (Graham et al., 2011).

The role of the company's board as advisor and supervisor are deemed essential. The composition of the independent board member is needed for more effective supervisory and advisory functions (Hermalin & Weisbach, 2003). The larger the number of independent member of board the more effective the supervision, thus creating higher value (Andres & Vallelado, 2008). Some measures need to be done to improve the function of the board (Kirkpatrick, 2009). When the size of the audit firm is used as a proxy for audit quality, the characteristics of the board and their independence have a significant impact on audit quality (Hay et al., 2008). In such situation, the board will cooperate with the audit committee in selecting large audit firms, due to better qualification in obtaining a better audit quality. In order to protect the reputation and to avoid legal problem resulting from a low quality of audit, the board will appoint a large audit firm. The more independent the board members, the more likely they will emphasize on better audit quality (Carcello et al., 2002). The increase of the independent board member will increase the audit quality.
Ha4: Independent board member has a significant impact on audit quality.

The audit committee plays a role in determining the rotation of auditors who will perform the audit services (Ronald, 2003). The existence of the audit committee is seen as a mechanism that can reduce the level of asymmetry of information and improve the quality of publicly presented financial information (McDaniel et al., 2002). The effort to improve audit quality through the role of the audit committee has been increasing (Murphy, 2014). Communication between the audit committee and the public accounting firm needs to be built regarding audit quality indicators, so that could improve audit quality (Brooke 2014).

Audit fees tend to be higher with big audit firm compared to smaller audit firm because the big audit firm is deemed to produce better audit quality compared to the small audit firm. Thus, the size of an audit firm is frequently used in measuring the audit quality (Hapsoro, 2012; Kane & Velury, 2005). It is found that there is a significant and positive correlation between the independent audit committee toward audit quality (Yasin & Nelson 2012). An independent audit committee will work more effectively in financial supervision and appointment of the external auditors who will generate reliable information thus resulting in better audit quality (Vlaminck & Sarens, 2013). Furthermore, it is found that the independent audit committee members can improve the effectiveness of the supervision of corporate financial reporting practices through selecting good external auditor thus will impact the audit quality (Hamdan et al., 2013).
Ha5: Independent audit committee has a significant impact on audit quality.

3. RESEARCH METHOD

3.1 Population, Samples And Operational Variables

This research is a descriptive business research with explanatory hypothesis testing which provides conclusions to address the problems directly (Sekaran, & Bougie, 2010). This research provides an overview of the occurring phenomenon and to explain the influence of variables through hypothesis testing to understand the implication of the problem (Sreejesh et al., 2014). The research population was banking companies listed on IDX, and the samples were Indonesian banking companies listed on the IDX, which are consistently issuing their annual report during the year of 2010 to 2015. Among 41 banks listed on IDX, 12 banks listed after 2010 were excluded, and only 29 banks were used as a sample of this research.

The data are quantitative data, which is the secondary data obtained from the annual reports of banking company included as a sample. The data collected were in the form of managerial ownership percentage, the number of an independent board member, number of the independent audit committee and list of the public accounting firm that performs an audit of the respective bank; classified as the big-four and non-big-four audit firm. The description of operational variables is presented in Table 1 below.

Table 1. Operational variables

Variables, Definitions and References	Indicators	Scale
Managerial ownership: ownership of shares by the management of the company (Wahba, H. 2014; Santanu et al., 2007; Kane & Velury, 2005).	Percentage shares owned by the manager of the bank concerned (MO).	Ratio
Independent board: members of the board who do not have relationship with financial, management, share ownership and or family relationship with another member of management, that is not affected by the other parties to act independently (RachDi & Ameur, 2011; Renée & Hamid 2011; Carcello et al., 2002; Velnampy et al., 2014).	The number of independent board members in certain periods (BI).	Ratio
Independent audit committee: members of the audit committee who do not have a relationship with financial, management, share ownership and or family relationship with another member of management that is not affected by the other party to act independently (Hamdan et al., 2013; Yasin & Nelson, 2012).	The numbers of audit committee members are independent in certain periods (ACI).	Ratio
Audit quality: the joint probability that the auditor found and reported violations or anomalies in the financial statements of its clients (De Angelo, 1981; Velnampy et al., 2014; Hapsoro, 2012; Kane & Velury, 2005).	Dichotomy data on grouping into the big four audit firm or non-big 4 audit firm (AQ).	Nominal

Source: previous studies

3.2 Data Processing Techniques

Data processing in this research is to find the direct influence of variables using the path analysis model with partial least square (PLS) approach. PLS is a powerful analytical method, although it is not based on many assumptions, but has several advantages, namely: (1) Able to handle complex models with multiple exogenous and endogenous with many indicators. (2) Can manage data with multicollinearity issues between exogenous variables. (3) The results remain robust despite the noise of data and missing data. (4) Can be used on a small sample size. (5) Does not require normally distributed data to be variable and (6) Can handle variables of nominal, ordinal and continuous types simultaneously (Latan & Ghozali, 2012).

4. RESULTS AND DISCUSSION

4.1 Descriptive Statistics

Based on the sample criteria, 29 banks were used as a sample in this research with observation period from 2010 to 2015. Therefore, there were 174 data being processed to obtain the conclusion from the hypotheses testing.

Table 2. Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
Man_Ownership	174	.0000000	.2823000	.0113170	.0368073
Ind_Board	174	.0	6.0	2.931	1.0837
Ind_Aud_Comm	174	.0	6.0	2.218	1.4258
Aud_quality	174	.0	1.0	.690	.4640
Valid N (listwise)	174				

The results of descriptive data indicate that there are many banks that do not have managerial ownership; it is shown by the maximum of managerial ownership of 28.23% and the mean of managerial ownership of 1.13%. There is no regulation that sets the minimum of managerial ownership in Indonesia; but the higher managerial ownership, the higher the management's sense of belonging. There are several banks in Indonesia that do not have independent board member and independent audit committee; it is shown by the mean of an independent board member of 2.9 and the mean of the independent audit committee of 2.2. Indonesian bank overseer needs to oversee the number of independent board member and independent audit committee according to the regulation. According to the regulation of Indonesian Central Bank, the board should consist, at least, two independent members. Indonesian Financial Service Authority and Indonesian Central Bank regulation state that independent audit committee should consist three persons or at least 51% of the total audit committee member. In regards to the audit quality, almost 70% of banks engaged with the big-four audit firms to audit their financial statements and this would increase the user's expectation of reliable financial statements.

4.2 Results of Hypotheses Testing

The results of the adjusted R squared as found in Table 3 indicate that only 8.7% of the independent audit committee is determined by managerial ownership and the independent board member and 22% of audit quality are determined by managerial ownership, the independent board member and the independent audit committee.

Table 3. The Coefficient of Determination

	R Square	R Square Adjusted
Independent audit committee	0.100	0.087
Audit quality	0.236	0.220

The correlation between the variables can be found in Table 4. It is found that there is a weak and positive correlation between managerial ownership and the number of independent members of the audit committee. Managers, who are also the shareholders of the bank, indirectly contribute supervision by providing input to the board to increase the number of independent audit committees. It is also found that an increase in the number of an independent board member is accompanied by an increase in the size of the independent audit committees with the magnitude of the relationship between the two variables is low. The number of independent members of the board will perform its function better by increasing the number of independent audit committees, which is believed to have better control of finance and accounting.

An increase of managerial ownership is accompanied by a tendency to elect the public accounting firms beyond the big 4 on a low level of relationship. This suggests that the big amount of managerial ownership thus the manager who is also the owner of the bank will implement better internal controls and improvise supervision by the board and the audit committee, thus there is no need to perform audit engagement with big public accounting firms with high audit fees. An increase in the number of an independent board member is accompanied by an increase in audit quality with a medium level correlation. A large number of independent board member will have better financial supervision. On the occasions like this, the independent board member will cooperate with the audit committee in an effort to maintain the audit results, including in the appointment of a large accounting firm to perform better audit quality.

This research also found that an increase in the size of the independent audit committee is accompanied by increased audit quality with a shallow level correlation. When the size of the independent audit committee increases, this particular committee will tend to increase supervision to obtain good audit results, which includes using sizeable public accounting firms in auditing the banks.

Table 4. Correlation Test Result

	Correlations
managerial ownership <---> independent audit committee	0,007
independent board <---> independent audit committee	0,311
managerial ownership <---> audit quality	-0,301
independent board <---> audit quality	0,422
independent audit committee <---> audit quality	0,138

The processed PLS research model illustrated in Figure 1, which shows the influence of managerial ownership and independent board member towards the independent audit committees and its implication on audit quality. The results of these test calculations directly with the PLS approach is presented in Table 5.

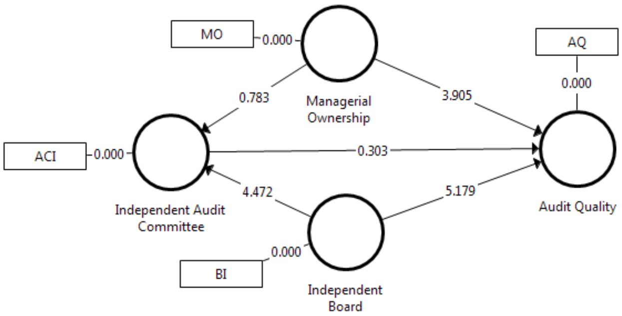

Fig. 1. Path analysis model (smart PLS result)

The PLS approach suggests that the hypothesis is accepted when p-value <0.05, with α = 5%, or if the value of the t statistic > t critical value (1.96), otherwise the hypothesis is rejected. The results show that two hypotheses are rejected; the result is that managerial ownership does not significantly affect the independent audit committees and independent audit committee does not significantly affect audit quality (see Table 5). In more detail, the results of path analysis test showed that the increase of managerial ownership does not significantly affect the increase in the number of independent audit committees to perform better financial supervision. With the high managerial ownership, the manager will conduct the better supervision and not rely on the appointment of larger number of the independent audit committee. The results of this research are not by the findings of Kane & Velury, (2005) found that the management who is also as the owner will perform better supervision through coordination with the board as the main supervisor, including the appointment of larger number of the independent audit committee.

Table 5. Path Analysis Result

	Sample mean (M)	T statistics (|O/STDEV|)	P values	Hypotheses
managerial ownership --> independent audit committee	0,044	0,783	0,457	Rejected
independent board --> independent audit committee	0,315	4,472	0,000	Accepted
managerial ownership --> audit quality	-0,242	3,905	0,000	Accepted
independent board --> audit quality	0,371	5,179	0,000	Accepted
independent audit committee --> audit quality	0,023	0,303	0,789	Rejected

Source: smart PLS testing result

The increase in independent board member will affect increase the number of independent audit committees. The large independent board member will give more concern on the supervision of financial statements report, resulting in the appointment of a larger independent audit committee. Baxter & Cotter, (2009) and Kirkpatrick (2009) also found that independent board member appoints larger number of independent audit committees in order to do better financial supervision.

On the other side, whenever managerial ownership is found to be high, the manager will implement better internal controls, including cooperating with the board and the audit committee. Based on that condition, there is no need to perform audit engagement with large public audit firm with a high audit fee. This finding is contrary to Kane & Velury, (2005) who suggested that high managerial ownership also increases company supervision, through using big audit firm for quality audit services. (Kane and Velury 2005).

The increase in some independent board member significantly affects the increase in audit quality. Hay et al., (2008) and Carcello et al., (2002) also found that the increase in the number of independent board member will have better cooperation with the audit committee in selecting the big public accounting firms to provide better audit quality. The increase in independent audit committee member does not significantly affect the increase in audit quality, which shown by engagement with big-four audit firms. This research found, through descriptive data, that there is no change in the size of independent audit committee member in banking company from year to year, so statistically, it has no significant impact on audit quality shown by the audit firm size. This research is not by the findings of Yasin & Nelson (2012) and Vlaminck & Sarens, (2013) that large independent audit committee work is more effective in supervising the finance and appointing an external auditor in order to generate reliable financial statement information that will result in better audit quality.

5. CONCLUSIONS AND INTERPRETATION

5.1 Conclusions

Based on the discussion and analysis conducted, it is concluded that existing managerial ownership does not significantly affect the appointment of the independent audit committee, who is expected to perform a better financial supervision in the banking companies listed on IDX. With the high managerial ownership, the manager will conduct the better supervision and not rely on the appointment of a considerable number of the independent audit committee. A large number of independent board member will have better supervision on financial statements and the tendency towards the appointment of large number of the independent audit committee. A large number of an independent and objective board member as the supervisor can significantly affect the increase of the independent audit committee that will perform better financial supervision in the banking companies listed on IDX.

Managerial ownership is when the owner acts as the supervisor of the company as well. The increase in the size of managerial ownership will improve the supervision and will reduce the audit costs because the audit committee will have the tendency not to choose the big-four audit firms. Managerial ownership has an impact on audit quality. The increase in the size of the independent board would have an impact on the higher concern of the importance of audit quality. A large number of independent board member will advise the audit committee to engage with the big-four audit firms in auditing the financial statement. Independent board member has an impact on audit quality of the bank listed on IDX. The size of the independent audit committee does not significantly affect the audit quality, based on the size of audit firm appointed, of banking companies listed on IDX. This research also found that there was no change in the number and membership of independent audit committee from year to year; therefore statistically it has no significant impact on audit quality— the audit firm size as a proxy.

5.2 Interpretation and Suggestion for Future Research

It is necessary to improve the supervision on the appointment of independent board member and independent audit committee in banking companies in Indonesia because there were banks that have not met the requirements of Indonesian Bank regulations, namely to have at least two persons the independent board member. In regards of an independent audit committee, there was banks that have not met the OJK (Indonesia Financial Services Authority) and the Indonesia Central Bank regulation that the independent audit committee should consist of least three persons or 51% of the total audit committee member.

Managerial ownership and the independent board member have a significant impact on the audit quality. This research is limited to finding the impact of managerial ownership and independent board member toward audit quality. It is necessary to conduct further research to find the ideal size of managerial ownership and the independent board member to be implemented in Indonesia in order to support and create a good quality audit. This research also finds that there is no significant impact between the independent audit committee toward audit quality because of there was no change in the number and membership of independent audit committees during the period.

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