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The Influence Of Audit Commite Characteristics and Ownership Structure On Financial Distress With Leverage As A Control Variable

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Abstract

Financial distress signals a dire state for a company's finances, often heralding potential bankruptcy. In this study, financial distress is gauged through the interest coverage ratio. The research aims to explore how Ownership Structure measured by managerial and institutional ownership and audit committee characteristics such as committee size, meeting frequency, and independence affect manufacturing companies listed on the Indonesia Stock Exchange. SPSS logistic regression model is employed for analysis. With a sample of 37 qualifying companies, findings reveal that neither the size of the audit committee, meeting frequency, nor independence, alongside institutional ownership, managerial ownership, and leverage, significantly impact the likelihood of financial distress. Moreover, dominant test results indicate that these points do not exert a dominant influence on financial distress probability.

Keywords: Audit committee characteristics; Financial distress; Ownership structure, Leverage

1. Introduction

Investors will consider the financial condition of the company when making their decisions. Unstable and relatively declining financial conditions are among the challenges faced by companies. According to the Finance Minister in Kompas (2019), "companies may face financial threats if their leaders are not careful in managing debt. This happens because company debt adds costs if not managed properly." Financial distress can be prevented by improving the system and financial management within the company. According to Mselmi et al. (2017), financial distress is when the available cash flow cannot meet the financing obligations that must be paid by the company according to existing contracts. During this situation, the company experiences inefficiencies in its cash flow. This can occur due to unpaid company receivables from customers or abnormal conditions that cause the company to spend more money, leading to an inability to pay off contracted debts. If this continues without management policies to rectify the situation, the company may become one with the potential for bankruptcy. When financial distress and the potential for bankruptcy persist over a long period, the situation will continue to deteriorate uncontrollably. This is one of the conditions that can lead a company to be delisted from the Indonesia Stock Exchange. According to Bredart (2014), financial distress is one of the reasons for delisting companies that are already listed. On the Indonesia Stock Exchange itself, many companies have been delisted due to their declining and struggling financial conditions. One of the causes of financial distress is the inadequate management of the company's corporate governance. This is because companies with good governance will consider many points before making decisions, and specific components in supervision and management also support the effectiveness of good corporate governance (Iskamto, 2022; Iskamto et al., 2020; Jaenudin & Fauziana, 2022; Puteri, 2023).

Brigham and Daves (2003) assert that financial challenges emerge from a cascade of errors, faulty decision-making, and interlinked vulnerabilities, which can stem directly or indirectly from managerial oversight shortcomings or inadequate efforts to oversee financial health, resulting in misallocation of funds (Fachrudin, 2008). Platt and Platt (2002) as well as Atmini (2005) define financial distress as a phase of worsening financial state encountered by a company, preceding bankruptcy or liquidation. This condition is generally marked by delayed shipments, declining product quality, and deferred bill payments from banks. If this state of financial distress is identified, it is hoped that

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actions can be taken to improve the situation so that the company does not reach more severe difficulties, such as bankruptcy or liquidation.

In the realm of effective corporate governance, the audit committee stands out as a pivotal mechanism for implementing internal controls. Bapepam, in circular letter No. SE-03/PM/2000, advocates for the establishment of audit committees in public companies. This directive underscores the committee's role in supporting the board of commissioners by offering impartial professional insights to enhance operational excellence and mitigate managerial deviations within the organization. Furthermore, Regulation Kep-339/BEJ/07-2001 mandates that all companies listed on the Indonesia Stock Exchange institute an audit committee. Various provisions of a proficient audit committee are aimed at bolstering the management quality of companies, some of which include:

a. The Good Corporate Governance Guidelines (March, 2001) advocate for the presence of an audit committee in Indonesian companies.

b. According to Regulation Kep-103/MBU/2002 and Kep-117/M-MBU/2002, all state-owned enterprises (BUMN) are obligated to establish an audit committee.

c. Regulation Kep-29/PM/2004 outlines the formation and operational guidelines for audit committees. These committees are responsible for offering insights on accounting matters, financial reporting, internal control frameworks, and independent auditors (FCGI, 2001).

Establishing an audit committee serves the objectives of independently overseeing the financial reporting process and the execution of external audits, providing independent supervision of risk management and control procedures, as well as overseeing the implementation of corporate governance practices. Effective corporate governance mechanisms play a crucial role in enhancing a company's financial performance, thereby helping it steer clear of financial pitfalls. The efficacy of an audit committee's operations can be evaluated based on attributes like its size, independence, and level of activity. Committee size pertains to the number of its members, while independence reflects the extent of members' involvement in company affairs. The committee's activities are evidenced by the frequency of its meetings annually. It is anticipated that these favorable attributes of the audit committee will exhibit a substantial inverse correlation with financial challenges (David et al., 2023; Novita et al., 2022; Shafira et al., 2023; Srimulatsih, 2021).

A crucial component of corporate governance pertains to share ownership within the company, encompassing managerial and institutional ownership. The ownership framework, comprising both institutional and managerial ownership, is anticipated to mitigate the risk of financial adversity. Institutional ownership is anticipated to foster heightened scrutiny of managerial performance, thereby curbing agency expenses. Managerial ownership can mitigate agency issues inherent in a company. The higher the percentage of ownership vested in management (directors or commissioners), the greater the accountability of said management in overseeing the company's affairs.

Extensive research has been carried out to examine the impact of ownership structure and financial performance on financial distress. Findings from studies conducted by Li, Wang, and Deng (2008); Chung, Firth, and Kim (2005); and Manzaneque, Priego, and Merino (2015) suggest a notable effect of institutional ownership structure on financial distress. Conversely, research conducted by Dewi Retno (2010) suggests that ownership structure does not exert a significant influence on financial distress (Rama Nopiana & Rusmiati Salvi, 2022; Soesetio, 2023).

As the company's debt increases, the probability of encountering financial distress also rises. Previous studies examining the relationship between leverage and financial distress have yielded consistent findings. Putri's (2020) research indicates a positive correlation between leverage and financial distress, aligning with Mafiroh & Triyono's (2016) findings. Conversely, Yoon & Jang's (2005) study suggests a significant negative impact of leverage.

The author's interest in conducting this study has been piqued by the diverse and conflicting findings on the aforementioned variables. Given the overview provided, the author is inclined to pursue research on "The Influence of Audit Committee Characteristics and Ownership Structure on Financial Distress with Leverage as a Control Variable." (10 font)

2. Literature Review

2.1 Agency Theory

Agency Theory, also referred to as contracting theory, stands out as a prominent research avenue in contemporary times. A key proposition of agency theory suggests that management endeavors to optimize their personal benefits by reducing the agency expenses linked with overseeing and enforcing contracts (Bastian, 2006: 213). This theory encapsulates a contractual relationship wherein one or more individuals (principals) engage another individual (agent)

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to carry out a service and entrust decision-making authority to the agent. Therefore, the principals (shareholders) hire the agent (manager) who is given the authority to manage the business and make the best decisions for the principals (Jensen and Meckling, 1976). Shareholders or principals hire agents to perform tasks, including making economic decisions, in uncertain environments such as companies experiencing financial distress.

2.2 Financial Distress

Platt and Platt (2002) define financial distress as a phase of declining financial health that precedes bankruptcy or liquidation. Conversely, Whitaker (1999) characterizes financial distress as occurring when a company sustains negative net operating income over successive years. Beaver et al. (2010) assert that financial distress arises when a company fails to meet its due financial obligations. Hence, it can be inferred that financial distress denotes a situation wherein a company starts to struggle to meet its commitments. Companies undergoing financial distress typically breach debt repayment agreements, subsequently curtailing or suspending dividend payments to shareholders.

2.3 Audit Committee

The inception of audit committees in Indonesian public companies was formalized in June 2000, following the issuance of BEJ Board of Directors Decision No. Ke-315/BEJ/06/2000, which pertains to Listing Regulation Number I-A: General Provisions for Equity Securities Listing on the Exchange. This regulation mandates, as part of good corporate governance, that companies listed on the Jakarta Stock Exchange (now Indonesia Stock Exchange) must incorporate independent commissioners, an audit committee, a company secretary, transparency, and sector-specific financial reporting standards. The establishment of audit committees is grounded in Law No. 19 of 2003 Article 70, with further details provided in Bapepam Decision No. 29 of 2004 Article 2. This formation involves the evaluation of the company's internal control system, ensuring the accuracy of financial reports, and bolstering the efficacy of the audit process. The audit committee's role encompasses oversight and advisory contributions to the board of commissioners in devising a supervisory mechanism (FCGI, 2002).

2.4 Ownership Structure

Ownership structure represents a shareholder's commitment to partially relinquish managerial control. This concept underscores that significant points influencing capital structure encompass not only debt and equity but also the proportion of shares held by management and institutional entities.

2.5 The Influence of Audit Committee Size on Financial Distress

FCGI stipulates that the company's audit committee must comprise a minimum of three members. Having more than one member is necessary to facilitate meetings and promote the exchange of diverse opinions, given the varying corporate governance experience and financial expertise of each member (Anggraini, 2010). According to Nuresa (2013), the size of the audit committee does not adversely affect financial distress. Conversely, in Galuh's (2012) study, an increase in the audit committee's size enhances its effectiveness, providing the committee with more resources to address company challenges. Hence, it is anticipated that a larger audit committee size will correspond to reduced financial distress within a company. This leads to the formulation of the third hypothesis:

H1: The size of the audit committee has a negative impact on Financial distress.

2.6 The Influence of Audit Committee Activities on Financial Distress

Collier and Gregory (1999) suggest that research indicates a positive correlation between the frequency of audit committee meetings and the effectiveness of financial oversight and monitoring. This heightened frequency facilitates better supervision of financial activities, encompassing the preparation and reporting of company financial information. The consistent application of internal control systems by such committees enables prompt identification and resolution of issues, potentially minimizing errors in managerial decision-making. Consequently, it is proposed that increased frequency of audit committee meetings corresponds to reduced financial distress within a company. This leads to the formulation of the fourth hypothesis:

H2: The activities of the audit committee have a negative impact on financial distress.

2.7 The Influence of Audit Commite Independence on Financial Distress

The primary objective of this autonomous audit committee is to promote integrity and impartiality in its deliberations and recommendations, as independent individuals are typically equitable, unbiased, and objective in addressing matters (FCGI, 2002). Ariesta's (2013) previous research indicates that audit committee independence

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correlates negatively with financial distress. It is anticipated that the presence of an independent audit committee will inspire investor confidence and mitigate the risk of financial distress within the company. Galuh's (2012) research also supports the notion that audit committee independence correlates negatively with financial distress. The existence of such an independent audit committee is poised to bolster investor trust in financial disclosures and diminish the likelihood of the company encountering financial difficulties due to lapses in corporate governance. Hence, it is hypothesized that a greater number of independent audit committee members will correspond to reduced financial distress within the company. Therefore, the first hypothesis is as follows:
H3 : Audit committee activities have a negative impact on financial distress.

2.8 The Influence of Managerial Ownership on Financial Distress

Previous research has established a notable correlation between managerial shareholders and company performance in financial terms, as well as the probability of encountering financial challenges. Active involvement in company ownership enables board members and managers to make informed decisions, thereby positively influencing financial performance and reducing the likelihood of financial difficulties. Wang and Deng (2006), Elloumi and Gueyie (2011), and Al-Tamimi (2012) concluded from their studies that an upsurge in the number of managerial owners, particularly directors, correlates with a diminished likelihood of financial distress within the company. Consequently, the author posits the following hypothesis:
H4: Managerial ownership has a negative impact on financial distress.

2.9 The Influence of Institutional Ownership on Financial Distress

Institutional investors are now considered a group in the capital market with power and influence. Compared to insider shareholders, institutional investors have a greater influence on managers to maximize their performance for the best interests of shareholders. Uwuigbe et al. (2011) and Alfaraih et al. (2012) presented findings highlighting the considerable favorable effect of institutional ownership on firm performance. Hence, it can be inferred that managerial supervision by institutional investors has the potential to bolster a company's financial performance and mitigate the risk of default. Conversely, Daily and Dalton (1994) illustrated that institutional ownership exerts a detrimental effect on the probability of encountering financial challenges. Consequently, the author suggests the following hypothesis:
H5: Institutional ownership has a negative impact on financial distress.

3. Methods

3.1 Data

This study encompasses the entire manufacturing sector listed on the Indonesia Stock Exchange (IDX) from 2019 to 2022 as its population. A sample of 361 data points was drawn from this population. The sampling method employed is purposive sampling, whereby samples are chosen based on predetermined criteria that correspond to the research objectives. The criteria for sample selection to be investigated include:

Description	Total
Population: Manufacturing companies listed on the IDX.	228
Sampling based on criteria (purposive sampling):	
1. Companies not listed on the IDX consecutively from 2019-2022.	(46)
2. Companies that did not report financial statements for the period from 2019-2022.	(11)
3. Companies that do not have managerial ownership.	(91)
4. Companies that do not have institutional ownership.	(7)
5. Companies that do not experience losses.	(35)
6. Companies that do not have complete data on audit committee meetings.	(1)
Sampel Penelitian "Research sample"	37
Total Sample (n x research) (37 x 4 years)	148

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3.2 Emprical Model

In this research, logistic regression is employed to examine all hypotheses, where the independent variables encompass a blend of continuous variables (metric data) and categorical variables (non-metric data). The mixed nature of these independent variables precludes the fulfillment of the assumption of multivariate normal distribution, necessitating the adoption of the logistic function form. This analytical approach obviates the need for normality tests or traditional assumption tests on the independent variables (Ghozali, 2005: 211). The logistic regression equation is formulated as follows:

$$DISTRESS = \beta 0+\beta 1\%\ ACSIZE + \beta 2\%\ ACMEET + \beta 3\ ACINDP + \beta 4\ KI + \beta 5\ KM + \varepsilon i$$

3.2.1 Logictis Regression Analysis

Logistic regression is performed to examine the association where the likelihood of the dependent variable can be forecasted by the independent variables. In this scenario, the dependent variable is dichotomous, indicating it holds binary values. This analytical method does not necessitate normality tests or traditional assumption tests on the independent variables (Ghozali, 2006).

3.2.2 Coefficient of Determination (R^2)

The determination coefficient testing is conducted using Nagelkerke's R square value. This value can be interpreted similarly to the R2 value in multiple regression. The purpose of this test is to determine how well the combination of independent variables can explain the dependent variable.

3.2.3 Simultaneous Testing

his examination is performed to assess whether the independent variables jointly impact the dependent variable. Hypothesis testing entails comparing the probability value (sig) with the significance level (α). The decision to accept or reject H_0 is contingent upon the significance level (α) set at 0.05.

4. Result and Discussion

4.1 Coefficient of Determination (R^2)

The coefficient of determination test is performed to ascertain the extent to which alterations in the independent variables namely size, meeting frequency, audit committee independence, managerial ownership, institutional ownership, and leverage account for fluctuations in the likelihood of financial distress within a company. The outcomes of Nagelkerke's R square test are presented in the table for reference.

Model Summary

Step	-2 Log likelihood	Cox & Snell R Square	Nagelkerke R Square
1	140.491[a]	.074	.116

a. Estimation terminated at iteration number 20 because maximum iterations has been reached. Final solution cannot be found.

The coefficient of determination, as indicated by the Nagelkerke R Square value, yielded a result of 0.116. This implies that 11.6% of the variation in the dependent variable (Financial distress) can be accounted for by the independent variables (size, meeting frequency, audit committee independence, managerial ownership, institutional ownership, and leverage), while the remaining 88.4% is attributed to other variables not included in this research model.

4.2 Hypothesis Testing

The table below presents the results of the logistic regression model for hypothesis testing:

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Variables in the Equation

		B	S.E.	Wald	df	Sig.	Exp(B)
Step 1[a]	SIZE	-9.679	20096.640	.000	1	1.000	.000
	ACT	-.012	.069	.032	1	.858	.988
	INDEP	11.456	20096.640	.000	1	1.000	94513.444
	KM	1.521	1.765	.743	1	.389	4.576
	KI	1.275	1.706	.558	1	.455	3.577
	DER	.003	.006	.332	1	.564	1.003
	Constant	-4.826	3.438	1.970	1	.160	.008

a. Variable(s) entered on step 1: SIZE, ACT, INDEP , KM, KI, DER.

From the hypothesis testing results, the logistic regression model obtained is as follows:
DISTRESS= -4,828 - 9,679ACSIZE – 0,012ACMEET + 11,456 ACINDP + 1,275KI + 0,003KM + εi

In a logistic regression model, the interpretation of research results should be done using odds ratios. The odds ratio is a transformation of variable values into probabilities of occurrence rather than the original values. Odds ratios can be observed from the Exp (B) values. The following are the calculation results of significance as well as the odds ratios for each variable in the research model used in the study. The significance level of the relationships can be assessed by comparing the research's (Sig.) value with the significance level ($\alpha = 0.05$).

The audit committee size variable exhibits an odds ratio of -9.679, with a significance value of 1.000. Given that the research significance is > 0.05, it suggests a lack of significant correlation between the audit committee size variable and the likelihood of financial distress. Consequently, H_0 is rejected, and the alternative hypothesis H_1 is accepted, indicating that variations in the audit committee size do not influence the probability of financial distress among the manufacturing companies examined in the study.

The audit committee meeting frequency variable demonstrates an odds ratio value of -0.012, accompanied by a significance value of 0.858. With the research significance of 0.858 being greater than 0.05, it suggests a lack of significant association between the audit committee meeting frequency variable and the likelihood of financial distress. Consequently, H_0 is upheld, and the alternative hypothesis H_1 is dismissed, leading to the conclusion that fluctuations in the audit committee meeting frequency do not impact the probability of financial distress among the manufacturing companies included in the study.

The audit committee independence variable shows an odds ratio value of 11.456, alongside a significance value of 1.000. Given that the research significance is 1.000, which exceeds 0.05, it suggests an absence of significant correlation between the audit committee independence variable and the likelihood of financial distress. Consequently, H_0 is affirmed, while the alternative hypothesis H_1 is negated, leading to the conclusion that alterations in the audit committee independence value do not influence the probability of financial distress among the manufacturing companies examined in the study.

The managerial ownership variable displays an odds ratio value of 1.521, accompanied by a significance value of 0.389. With the research significance value of 0.389 being greater than 0.05, it suggests a lack of significant association between the managerial ownership variable and the probability of financial distress. Hence, H_0 is affirmed, while the alternative hypothesis H_1 is refuted, leading to the conclusion that variations in managerial ownership value do not impact the probability of financial distress among the manufacturing companies included in the study.

The institutional ownership variable exhibits an odds ratio value of 1.275, along with a significance value of 0.558. Given that the research significance is 0.558, which exceeds 0.05, it suggests a lack of significant correlation between the institutional ownership variable and the probability of financial distress. As a result, H_0 is upheld, while

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the alternative hypothesis H1 is dismissed, leading to the conclusion that fluctuations in institutional ownership value do not influence the probability of financial distress among the manufacturing companies examined in the study.

The leverage variable yields an odds ratio value of 0.003, along with a significance value of 0.564. With the research significance at 0.564, surpassing the 0.05 threshold, it suggests an absence of a significant association between the leverage variable and the likelihood of financial distress. The results of the logistic regression test indicate that leverage, in this context, does not serve as a controlling variable and does not align with the anticipated outcome. Hence, favorable leverage may not necessarily furnish valuable insights for creditors or investors. This is because leverage, viewed from the perspective of a company's debt, might not be a dependable indicator of impending financial distress. These findings align with those of Ananto et al. (2017), which suggest that leverage does not influence financial distress, in contrast to the assertions made by Putri (2020), Mafiroh & Triyono (2016), and Yoon & Jang, S. (2005), who argued for the impact of leverage on financial distress.

5. Conclusion

This study seeks to gather empirical evidence regarding the impact of audit committee characteristics, encompassing audit committee size and meeting frequency, as well as ownership structure, comprising institutional ownership and managerial ownership, on the probability of a company encountering financial distress. Drawing from the discussion, the conclusions of this research are as follows: The audit committee's size demonstrates limited effectiveness in resolving conflicts, thus failing to adequately address financial difficulties. The existing meeting frequency falls short of providing sufficient oversight to mitigate the incidence of financial challenges. Institutional investors, acting as owners, lack the ability to govern the company during episodes of financial distress. The proportion of managerial ownership within the company remains relatively low, thereby insufficient to diminish the likelihood of financial distress occurring. Furthermore, leverage, assessed in terms of the company's debt, proves inadequate as a yardstick for gauging the occurrence of financial distress.

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Biography

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Muh. Ikbal A is an experienced Accounting lecturer from Tadulako University. With a high level of dedication in his field, he currently serves as the Dean of the Faculty of Economics and Business at Tadulako University. He obtained a Master’s degree in Accounting from Padjajaran University, while he earned his Doctorate from Brawijaya University. His research interest focuses on Auditing.