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THE ROLE OF CORPORATE GOVERNANCE ON FINANCIAL STATEMENT QUALITY AND INVESTOR REACTION

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Abstract: The purpose of this paper is to examine the effect of the number of boards of directors, boards of commissioners, audit committees, the background of the audit committee on the quality of financial statements and the reaction of investors with ROA as a control variable. The population in this study is the annual report of banking company listed on the Indonesia Stock Exchange on 2018. The analysis method in this study is the multiple linear regression analysis using SPSS. Based on simultaneous test results, the number of boards of directors, boards of commissioners, audit committees, the background of the audit committee have a significant influence on the investor's reaction to ROA as a control variable, but had no effect on the quality of financial statements.

Keywords: CG, Corporate Governance, Financial Statement, Investor Reaction

INTRODUCTION

The financial statement is a communication instrument to explain corporate's activities during a certain period. External parties need them to ensure that operational and financial activities are carried out properly and fairly. There are seven companies with the biggest scandal of financial statements, reported in the article okezone.com (Pratiwi, 2013) is a WorldCom scandal in 2002 which contains frauds by top management on corporate assets that estimated loss of USD 107 billion, Enron scandal in 2001 by embezzling employee pension funded by company executives to a loss of USD 74 billion, and in 2011 the retirement scandal of former Olympus Executives (OCPNY) for more than a decade, USD 1.7 billion, etc. such as Petrobas corruption, Libor rigging scandal, Ponzi corruption committed by Bernie Madoff, and Volkswagen emissions scandal. June 2019, in Indonesia reported by finance.detik.com, a financial report was made by PT Garuda Indonesia Tbk, KAP Kasner Sirumpea and KAP Tanubrata, Sutanto, Fahmi, Bambang & Partners were suspected by two Garuda commissioners. Based on the news discussed, in general, all the cases were carried out by the executive and management of the company, when they are supposed to be responsible for carrying out operational activities and information about financial statements that were running correctly, transparently and reliably. This also relates to the weak corporate governance system that is applied.

Good Corporate Governance (GCG), according to the World Bank, a collection of required laws, regulations and rules, which can help fund sources of long-term economic value that is sustainable for shareholders and the surrounding community as a whole. According to Bank of Indonesia, GCG has five basic principles: transparency, accountability, responsibility, independence, fairness that answers every company and employee who works at the level that can carry out these principles following the corporate's good image. GCG is related to information about the roles of the board of directors, the board of commissioners and independent commissioners. The board of directors works on the company, while the board of commissioners works to supervise (Effendi, 2016). Meanwhile, an independent commissioner acts as a balancing force in decision making by the board of commissioners. The commissioning tasks are quite heavy for the commissioners, so they request assistance from several parties, also known as the audit committee, remuneration committee, nomination committee, risk management committee, and other committees.

Based on empirical study, the expertise of the audit board has a significant relationship to financial profitability (Salehi, Tahervafaei and Tarighi, 2017) due to increased asymmetric information which increases the accuracy and quality of corporate financial information. But on the other hand, adding more numbers of boards of directors, boards of commissioners and some boards has increasingly diverse interests and increases insignificant importance to the company's financial profitability. According to Palaniappan G. (2016) explains the existing relationship of an independent board and the frequency of the board to ROA and ROE; and has a significant negative relationship with the number of leaders, company value, ROA and ROE. Based on the facts and studies above, the purpose of this paper is to examine the effect of the number of boards of directors, boards of commissioners, audit committees, the background of the audit committee on the quality of financial statements and the reaction of investors with ROA as a control variable.

LITERATURE REVIEW

Agency Theory

Agency theory is a contract design to motivate rational agents to act based on principal interests when the agent's interests conflict with the principal (Scott, 2015). The company is a legal entity in which there is a collection of contracts (nexus of contracts) between managers, shareholders, suppliers, customers, etc. where each party tends to maximize profits following their interests. This theory was developed by Jensen and Meckling (1976) which states that principals (shareholders) and agents (company management) have different interests and tend to maximize their respective interests. There is a tendency for agents to present information that is not true so that asymmetry information arises and conflicts of interest.

Signaling Theory

This theory explains how companies give signals of expectations and desires in the future to investors. Companies that have good performance and expect high growth will give a signal to investors that the company is in good condition. This will affect the stock price and the value of the company (Godfrey et al.,2010). The result of asymmetric information, investors find it difficult to judge objectively about the quality of the company (Himawan and Christiawan, 2016). This causes the company will try to provide more information to investors. One way to reduce asymmetric information is to provide reliable financial information and reduce uncertainty about the company's future prospects.

Management in Corporate Governance

The role of some company leaders is very important in overseeing the functions and control of corporate governance so that it runs well according to procedures. There are some of the top management parties in the company that was the focus of this study (Lukviarman, 2016):

1. Board of Directors (BOD)
   The role of BOD is as a 'bridge' between shareholders as the owner of the company and management as the party who will carry out the company's activities. From a governance perspective, BOD's main function is to ensure that the corporation has been appropriately run by management to achieve the stated company goals.
2. Board of Commissioners (BOC)
   Legally following the provisions of the company law, the board of commissioners directs various company activities but isn't responsible for managing corporate operational activities.
3. Audit Committee
   The basic idea of the audit committee originated in the United States in the 1970s aimed at reducing the dominance of the audit or inspection process by senior executives and as a bridge between public accountants and the board of commissioners. Considering the board of commissioners' duties in overseeing the running of the company is quite heavy, so several committees were formed to increase the effectiveness in the framework of implementing good corporate governance (Effendi, 2019). Audit Committee membership usually comes from an independent party that has no relationship with the executive and comes from outside the company. This organization is usually led by an independent commissioner.

Investor's Reaction

Disclosure of financial reporting information by the company management to external parties, especially investors. This information can affect investor reactions. Investors will respond to this information as a signal of certain events. Investors' responses to financial statement disclosures can be either positive or negative. Investors will give a positive response if the information published is good news and investors will give a negative response if the information published is bad news (Mooduto, 2013). The response given can be seen in the company's stock price. Changes in stock prices, usually up or down at a certain time (Siregar and Rahayu, 2018). This change depends on the strength of demand and supply, if a stock experiences an increase in demand, the stock price tends to rise. Conversely, if there is an increase in supply the stock price will tend to fall.

Hypothesis Development

Based on prior research, the expertise of the audit committee has a significant relationship to financial profitability (Salehi, Tahervafaei and Tarighi, 2017) because it reduces information asymmetry that increases the accuracy and quality of corporate financial information. But on the other hand, it is said that the more complex the number of boards of directors, boards of commissioners and several committees the more diverse interests and has an insignificant influence on the company's financial profitability. Ntim and Broad (2017) also revealed the existence of a governance system and committee members to increase accountability and transparency in educational institutions in the UK. Meanwhile, according to Palaniappan G. (2016) explains the existence of an independent board relationship and the frequency of meetings on the company's ROA and ROE and has a significant negative relationship with the number of company leaders, company value, ROA and ROE. Meanwhile, it was also found that the size of the board of directors and the composition of the board have a positive and significant effect on earnings quality. However, the proportion of non-executive directors has a negative and significant effect; while CEO duality is positive and statistically significant (Egbunike and Odum, 2018). A significant positive relationship was also found between the proportion of the board of directors and fraud in the financial statements (Nasir, et al, 2019). They also found that companies that commit fraud significantly increase the proportion of independent directors on the board of directors, increase the frequency of board meetings, audit committees and reduce duality after financial statement fraud is detected compared to non-fraud companies.

Then according to Ajiwanto and Herawati (2013), the independent variable represented by institutional ownership, the proportion of the independent board of commissioners and the audit committee together have a significant effect on the dependent variable, namely stock returns. Partially, the institutional committee has a positive and significant effect on stock returns, while the proportion of independent commissioners and audit committees has a negative and not significant effect on stock returns. Whereas based on Yatmi, et all. (2016), accounting earnings have a significant positive effect on stock returns and GCG variables do not affect stock returns.

Some of the prior literature described in the previous sub-chapter still has pros and cons regarding the results of research on the existence of the board of directors, commissioners and audit committee in supporting the quality of financial statements and investor reactions. Therefore research on the topic of corporate governance on the quality of financial statements and investor reactions will again be carried out using different research objects and periods. So the hypotheses that can be arranged are as follows:

H1: There is an effect of the number of boards of directors, the number of boards of commissioners, the number of audit committee members, the background of the audit committee on the quality of financial statements with ROA as a control variable.

H2: There is an influence on the number of boards of directors, the number of boards of commissioners, the number of audit committee members, the background of the audit committee to the investor's reaction to ROA as a control variable.

RESEARCH METHODS

Based on the background and the hypotheses compiled, this research leads to quantitative and causal research. Causal testing is a test that explains the effect of a variable on other variables. So, this study aims to see the effect of independent variables on the dependent variable. This research will use all annual report of banking companies listed on the Indonesia Stock Exchange in 2018 that use the Indonesian Rupiah default currency. The basis for selecting this research sample is because banks have strict and systematic regulations in implementing a corporate governance system based on Bank Indonesia regulations. So it can be concluded that every bank in Indonesia has a system that is almost the same and evenly distributed so that it is easy to study to find the expected research results.

Based on the variables used in this study and the data period, the data analysis technique used is multiple regression analysis, using SPSS version 24 statistical software.

Tabel 1. Operational Table Variable

Variable	Variable Name	Indicator	Scale
X1	Number of boards of directors	The number of board members listed on the 2018 annual report	Ratio
X2	Number of boards of commissioners	The number of board commissioners listed on the 2018 annual report	Ratio
X3	Number of audit committee members	The number of audit committee members listed on the 2018 annual report	Ratio
X4	The background of the audit committee	HHI: LBa2 + LBb2 + LBc2 + …+ LBn2 Notes: LB: number of the background of the audit committee	Ratio
C	Profitability	Return On Assets (ROA)= Net Income Average Assets	Ratio
Y1	Quality of financial statements	Discretionary Accrual (DA) = DAit = TAit/Ait-1 - NDAit	Ratio
Y2	Investor's reaction	Share Return= Share Pricet – Share Pricet-1 Share Pricet-1	Ratio

FINDINGS AND DISCUSSION

The following are companies that use to be the sample of this study:

Table 2. Company Sample

No.	Code	Company Name
1	AGRO	PT Bank Rakyat Indonesia Agroniaga Tbk
2	AGRS	PT Bank Agris Tbk
3	BABP	PT Bank MNC Internasional Tbk
4	BBHI	PT Bank Harda Internasional Tbk
5	BBKP	PT Bank Bukopin Tbk
6	BBMD	PT Bank Mestika Dharma Tbk
7	BBRI	PT Bank Rakyat Indonesia (Persero) Tbk
8	BBCA	PT Bank Central Asia Tbk
9	BCIC	PT Bank Jtrust Indonesia Tbk
10	BDMN	PT Bank Danamon Indonesia Tbk
11	BGTB	PT Bank Ganesha Tbk
12	BINA	PT Bank Ina Perdana Tbk
13	BJBR	PT Bank Pembangunan Daerah Jawa Barat dan Banten Tbk
14	BMAS	PT Bank Maspion Indonesia Tbk
15	BNBA	PT Bank Bumi Arta Tbk
16	BNLI	PT Bank Permata Tbk
17	BACA	PT Bank Capital Indonesia Tbk
18	BBNI	PT Bank Negara Indonesia (Persero) Tbk
19	BBTN	PT Bank Tabungan Negara (Persero) Tbk
20	BTPN	PT Bank BTPN, Tbk
21	DNAR	PT Bank Dinar Indonesia Tbk
22	INPC	PT Bank Artha Graha International
23	MCOR	PT China Construction Bank Indonesia
24	MEGA	PT Bank Mega Tbk
25	NISP	PT Bank OCBC NISP Tbk
26	NOBU	PT Bank Nationalnobu Tbk
27	PNBN	PT Bank Pan Indonesia Tbk
28	PNBS	PT Bank Panin Dubai Syariah Tbk
29	SDRA	PT Bank Woori Saudara Indonesia 1906 Tbk
30	BMRI	PT Bank Mandiri (Persero) Tbk
31	BNGA	PT Bank CIMB Niaga Tbk
32	BNII	PT Bank Maybank Indonesia Tbk
33	BJTM	Bank Pembangunan Daerah Jawa Timur Tbk
34	BSIM	Bank Sinarmas Tbk
35	BSWD	Bank of India Indonesia Tbk
36	BKSW	PT Bank QNB Indonesia Tbk

Statistical testing begins by ensuring that all independent and dependent variables pass the classic assumption test which consists of a normality test, a heteroscedasticity test, a multicollinearity test, and an autocorrelation test. After testing the classic assumptions successfully, here are the results, the following are the results of testing both hypotheses.

Table 3. Statistical Test Results

Hypothesis		Sig. Value	Test Results
H1	There is an effect of the number of boards of directors, the number of boards of commissioners, the number of audit committee members, the background of the audit committee on the quality of financial statements with ROA as a control variable.	0.754	Rejected
H2	There is an influence on the number of boards of directors, the number of boards of commissioners, the number of audit committee members, the background of the audit committee to the investor's reaction to ROA as a control variable.	0.038	Accepted

Source: SPSS v.24 statistics results

The first hypothesis was rejected in line with research from Yasmeen and Hermawati (2015). This study is not in line with Ely Puji Setianingsih (2013), Mollah, et all. (2019), Nasir, et al. (2019). At present, the quality of financial statements is not sufficiently determined by the composition of the board of directors, commissioners and audit committee and their background. Many other factors can affect the quality of financial statements, such as the transparency of the governance system adopted by the company, disclosure of the quality of governance that protects the interests of investors (Mollah, 2019).

In the second hypothesis, statistical tests prove that the hypothesis is accepted. This result is in line with research conducted by Siregar and Rahayu (2018), Ajiwanto and Herawati (2013). This research is not in line with Yatmi, et all. (2016). Furthermore, a partial test was conducted and found the results that the background of the members of the audit committee (sig. value 0.045) and ROA (sig. value 0.002) had a significant influence on investor reaction. The response to investors depends on the transparency of the competence of audit committee members as one of the non-financial factors and the value of ROA as a financial factor to assess the company's ability to generate profits and survive for a long time. A positive response from investors will lead to an increase in investment and an increase in the company's stock price which is profitable.

So from the results of the study above, it found that the existence of corporate governance affects investors in terms of changes in stock prices compared to the quality of the company's financial statements.

CONCLUSION AND SUGESTION

Based on the statistical results and discussion above, other factors that influence the quality of financial statements are audit quality, board quality, taxes, and sources of funding from external parties (Bauwhede, 2001). Audit quality and company's internal control affect the quality of financial statements (Hai, 2015), so it can be concluded that the existence of external parties in examining financial statements can affect the quality of the report. Assessment from an internal point of view is not enough to guarantee the quality of financial statements and increase in share value. External perspectives also need to be taken into account as a balance between two-sided judgments that give public confidence.

There are some suggestions which is for companies, it becomes an additional reference that every investor and potential investor pays attention to the company's situation not only in financial terms, but also in non-financial terms, one of which is corporate governance. For researchers, an additional reference for further research, to pay more attention to the number of samples and the appropriate indicators, so that it can produce even better research.

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