INTERNATIONAL ACCOUNTING AND BUSINESS CONFERENCE 2015, IABC 2015

The Effect of Corporate Governance and Firm Characteristics on Firm Performance and Risk Management as an Intervening Variable

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Abstract

The purpose of this study is to examine the effect of corporate governance and firm characteristics on the existence of Risk Management Committee and the effect of the existence of the Risk Management Committee on firm performance. In addition, this study also examines the intervening role of Risk Management Committee on the relationship between corporate governance and firm characteristics and firm performance. The population in this study were non-financial companies listed in Indonesian Stock Exchange for the 2013 financial year and purposive sampling is used as sampling method. Data for this study were taken from company’s annual report. The hypotheses were tested by using Partial Least Square (PLS). The result proved that corporate governance and firm characteristics affect the existence of Risk Management Committee, and the existence of Risk Management Committee affects firm performance. The result also proved that Risk Management Committee act as an intervening variable among corporate governance and firm characteristics on firm performance.

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Peer-review under responsibility of Universiti Teknologi MARA Johor

Keywords: Corporate Governance; Firm Characteristics; Risk Management Committee; Firm Performance

1. Introduction

Firm performance shows the achievement of company’s goals. Firm performance should be maintained and enhanced continuously to attract investors and to maintain good relationship with stakeholders. In very high uncertainty and competitive environment, to maintain and improve company’s performance, company is faced with various risks. Achievement of high performance can contain high risk anyway. Therefore it is necessary for management to be aware about those risks, to be able to identify, monitor and control those risks.

Risk management is a way to identify and manage the risks that may affect the achievement of firm performance. An effective risk management system requires an adequate supervision. Currently some companies delegate risk oversight to Audit Committee. Along with the extent of the responsibilities and duties of Audit Committee, it is doubted on whether Audit Committee will function effectively. Therefore, some companies take the
initiative to make a separate committee of the Audit Committee to perform the role of supervision and oversight of enterprise risk management, namely a Risk Management Committee (RMC).

Development of RMC in Indonesia has started to increase, especially after the issuance of several regulations related to the obligation of the establishment of a RMC. Those regulations require the commercial banks and insurance companies to establish RMC. Meanwhile for sectors other than banking and insurance, the establishment of RMC is voluntary. Therefore, not all companies listed on the Stock Exchange form RMC.

Empirical studies show that the establishment of RMC in companies is affected by corporate governance and firm characteristics (Subramaniam, Mc Manus and Zhang, 2009; Andarini and Januarti, 2012; Ratnawati, 2012; Sambere and Meiranto, 2013). Corporate governance in a company will determine management practices and decision-making process including those associated with formation of a special overseeing committee to monitor company's risk management process. Meanwhile, firm characteristics which can be seen from several factors such as firm size, firm complexity, financial reporting risk and leverage would also have effect on risks faced by company. Therefore, to minimize those risks, management will encourage board of commissioners to form a special committee which is responsible for the oversight of risk management processes, namely RMC. The existence of RMC will increase risk management oversight. It will encourage the achievement of effective risk management so that risk can be anticipated and managed for the purpose of enhancing company's value. Increasing company's value is one way of increasing firm performance. Thus, the existence of a RMC will have an effect on firm performance.

Previous researches on firm performance have examined the direct effects of corporate governance and firm characteristics on firm performance (Indarini, 2008; Karyawati, 2013; Widyati, 2013; Wulandari, 2006; Garg, 2007; Saibaba and Ansari, 2011; Ho, 2011; Sahu and Mana, 2013 and Arifani, 2013). Furthermore, the existence of RMC has also been studied (Subramaniam et al., 2009; Andarini and Januarti, 2012; Ratnawati, 2012 and Sambere and Meiranto, 2013). Past researches have studied some factors that affect the existence of a RMC such as corporate governance and firm characteristics, but, corporate governance and firm characteristics are stated in different indicators. In addition, the effect of these variables on firm performance and to the establishment and implementation of risk management, gave inconsistent results.

Based on the discussion above, the purpose of this study is, firstly, to analyse the effect of corporate governance on the existence of a Risk Management Committee. Secondly, to analyse the effect of firm characteristics on the existence of a Risk Management Committee. Thirdly, to analyse the effect of the existence of Risk Management Committee on firm performance. Fourthly, to analyse the role of a Risk Management Committee as mediating variable between corporate governance and firm performance. Last but not least, the fifth objective of this study is to analyse the role of a Risk Management Committee as mediating variable between firm characteristics and firm performance.

2. Hypotheses Development

2.1. Corporate governance and RMC

The practices of corporate governance in a company are indicated in several factors. Those factors are the size of board of commissioners, independent commissioners, managerial ownership, concentrated ownership and auditor reputation.

The large size of board commissioners allows for the establishment of various committees including the RMC. (Carson, 2002; Chen, Kilgore and Radich, 2009, in Januarti, 2012). Furthermore, the existence of an independent commissioner will encourage the formation of RMC, because independent commissioners found RMC as an important committee in helping them to exercise oversight responsibilities. Companies with a high proportion of independent commissioners tend to be more concerned with the company's risk compared to the low proportion of independent directors (Sullivan, 1997 in Husaini, Saiful, Fadli, Abdullah and Aisha, 2013).

High percentage of managerial ownership cause greater responsibility for management. Therefore, to minimize losses managers will seek to minimize the risks. Managers then try to encourage commissioners to form a special committee which is responsible for overseeing implementation of risk management such as RMC.

The concentrated ownership is related to business risk. Greater level of concentrated ownership demands more information and explanation on the risks that may be encountered by company such as financial risk, operational risk, reputation, regulatory, and information. This is because the group of controlling shareholders (the largest shareholder) has an interest to monitor risks to prevent possible losses that would occur. Therefore, the largest
shareholder will encourage commissioners to form a special committee who is responsible for overseeing implementation of risk management such as RMC.

Auditors who are members of Big Four audit firms are considered to have a good reputation and expertise to identify risk that may occur. Therefore, when the auditor is assessing the company’s internal risk monitoring system, and identify corporate risk, RMC is seen as an additional support, in which that support will minimize losses due to the reputation of Big Four audit firms failure. Thus, the first hypothesis is proposed:

$H_1$: Corporate Governance affects the existence of RMC.

2.2. Firm characteristics and RMC

Firm characteristics can be seen from several indicators. The first is firm size. In terms of assets, larger company has greater amount of assets. In terms of funding, larger company has more access to provide funding through the capital market. The tendency to use external funds will also increase in line with the increasing firm size (Mirawati, 2014). Thus, the larger the company, the greater risks its will encounter. Therefore, larger company is more likely to establish a RMC.

Second, firm complexity is associated with business segments (Carcello et al., 2005 in Subramaniam et al., 2009). Company with a large number of business segments usually have more production lines, departments or marketing strategies. As a result, greater complexity will increase risks at different levels including operational and technological risks, leading to a greater demand for monitoring risks. It is thus expected that the more complex an organization is, the more likely it has RMC in order to dilute the risks (Subramaniam et al., 2009).

Third, companies with large proportion of receivables and inventories are seen to entail higher financial reporting risks due to the high levels of uncertainty (Korosec and Horvat, 2005 in Subtrmaniam et al., 2009)). For instance, the larger the proportion of receivables, the higher the risk of bad debts and doubtful debts not properly recognised. Likewise, the valuation of inventory obsolescence is higher in larger inventory balances and thus there is higher financial reporting risks (Subramaniam et al., 2009). Therefore, the establishment of a RMC will facilitate company in order to improve the quality of financial reporting risk.

Fourth, companies that have a large portion of long-term liabilities tend to have greater financial risk (Goodwin and Kent, 2006). Higher leveraged firms are more likely to have debt covenants and higher concern about risks. Lenders are more likely to demand better internal controls and related monitoring mechanisms. Consequently, it can be argued that there will be a greater demand for such companies to have RMC to oversight such risks. Thus, the following hypothesis is proposed:

$H_2$: Firm Characteristics affect the existence of RMC.

2.3. The existence of RMC and firm performance

Some previous studies revealed that Enterprise Risk Management (ERM) benefits organizations by increasing stakeholder value, competitive advantage, performance, and the ability of an organization to accomplish their objectives companies, in which it will enhance firm performance (Saedi, Sofian and Rasid, 2014).

To ensure proper coordination and functionality of risk management system (ERM) so that it can improve firm performance, a senior executive as Chief Risk Officer (CRO) or a committee of experts should be directing or overseeing risk management process (Gatzert and Martin, 2013). Kaplan (2008) also states that companies need to know how to measure risk management and appoint a manager who is responsible for risk management, such as how the manager create and enhance revenue growth and productivity. Furthermore, Kaplan (2008) explains that currently the company has implemented risk management very seriously and have adopted some of the core principles regarding risk management, namely having a risk committee.

RMC is the committee that carry out supervisory duties in risk monitoring. RMC is responsible for checking, supervising and assessing principles and policies, strategies, processes, risk management control, so that risks that are faced by the company can be reduced and even prevented and it will ultimately lead to enhance firm performance. Thus, the existence of RMC will enhance firm performance through its role in inspecting, supervising and assessing principles and policies, strategies, and the processes of risk management. Therefore, from the above discussion, the following hypothesis is suggested:

2.4. Corporate governance, RMC and firm performance

In order to increase shareholder value in particular, and long term value of companies in general, company should be able to enhance firm performance. High firm performance could contain high risk anyway. Therefore, management needs to be able to identify, monitor and control those risks through enterprise risk management. An effective risk management system can help a company to achieve business objectives and improve the quality of financial reporting. It will safeguard company's reputation and ultimately will enhance firm performance. In order to make risk management system work effectively, it needs an adequate supervision. To carry out the role of oversight risk management system, company needs to establish a special committee that is responsible for that duty, and that committee is a RMC.

Empirical research showed that the establishment of RMC in companies is affected by corporate governance (Subramaniam et al., 2009; Andarini and Januarti, 2012; Ratnavati, 2012; Sambora and Meiranto, 2013). The implementation of corporate governance within company can be showed by several indicators, among others, the board of commissioners’ size, proportion of independent commissioners, the managerial ownership, the concentrated ownership and auditor reputation. These five indicators will affect the formation and existence of RMC within the company. The establishment of RMC will improve the effectiveness of enterprise risk management through its supervision. Effective risk management will be able to identify, monitor, control and minimize risks facing the company, which in turn will enhance firm performance. Thus, the fourth hypothesis is as proposed as follows:

H4: Corporate governance affects firm performance through the existence of a RMC

2.5. Firm characteristics, RMC and firm performance

Firm characteristics are specific characteristics inherent in a company that can be seen from several indicators that mark a company and distinguish it from other companies. Characteristics of the company can be seen from several indicators, among others are, the size of the company, the complexity of the company, financial reporting and leverage risk.

The four indicators above will determine how the company and its characteristics would affect the risks faced by the company in carrying out its operations. Risks faced by the company will affect the company's performance, especially in a highly environmental uncertainty and highly competitive business environment.

Risk is one of the factors to be considered in the planning and the company's business decisions as it affects the company's performance. The achievement of high-performance can contain high risk anyway. The type and size of the risks faced by the company in an effort to maintain and improve the company's performance will be influenced by the characteristics of the company. Therefore, it needs management awareness to identify, monitor and control risks. One way to identify, monitor and control risk is to implement enterprise risk management. Enterprise risk management process is influenced by the management, board of directors and other personnel of an organization. Effective risk management system can help company to achieve business goals and improve the quality of financial reporting as maintaining the company's reputation and will ultimately improve the company's performance. In order to make the risk management system work effectively, it needs adequate supervision. To carry out the supervisory role of risk management systems, companies need to form a special committee responsible for the task, which is the committee of RMC.

H5: Firm characteristics affect firm performance through the existence of a RMC.

3. Research Method

3.1. Population, sample and data collecting

The population in this study are the non-financial companies listed in Indonesia Stock Exchange (ISE) for the 2013 financial year. The purposive sampling is used with several criterias, namely, non-financial company, listed on the ISE, published annual reports in 2013 and has complete information. The data in this study data was collected from annual report that is taken from official website of Indonesia Stock Exchange, www.idx.co.id.

3.2. Variables and measurement
This research studied four constructs namely firm performance, the existence of RMC, corporate governance and firm characteristics. The definition and the measurement for those variables are discussed below.

- Firm Performance
  Firm performance is measured by using two indicators: Return on Assets (ROA) and Tobin’s Q (Coleman, 2007).
- The existence of RMC
  The existence of RMC is measured by giving a value, 1 for the company which report an RMC in their annual report (either a special risk committee or included in audit committee) and 0 for the company which does not report RMC in their annual report (Subramaniam et al., 2009).
- Corporate Governance is measured by five indicators as follows:
  a. Size of Board commissioners is measured by the total number of commissioners on the board (Subramaniam et al., 2009).
  b. Proportion of Independent Commissioner is measured by the percentage of independent Commissioners on the board, calculated by the number of independent commissioners divided by the total number of commissioners on the board (Subramaniam et al., 2009).
  c. Concentrated Ownership is measured by using the largest percentage ownership in the company (in accordance with the formula developed in ICMD), calculated by the largest percentage ownership divided by the total number of share.
  d. Managerial Ownership is measured by calculating the total number of directors and commissioners’ share divided by the total number of share then multiplied by 100%.
  e. Auditors Reputation is measured by giving a value, 1 for external auditor who is a member of the Big Four accounting firms and 0 for external auditor who is not a member of the Big Four accounting firms (Subramaniam et al., 2009).
- Firm Characteristics
  Independent variable firm characteristics is shown by the following indicators:
  a. Firm Size is measured by total assets of the company (Subramaniam et al., 2009). For statistical analysis purposes, firm size was transformed into log of total assets.
  b. Firm Complexity is measured by the number of business units/segments in a company (Subramaniam et al., 2009).
  c. Financial Reporting Risk is measured by dividing the sum of the account receivable and inventory balances with total assets (Subramaniam et al., 2009).
  d. Leverage is measured by dividing the proportion of total long-term liabilities to total assets (Subramaniam et al., 2009).

3.3. Data analysis method

Data of this study was analysed by using Structural Equation Model (SEM) based on Partial Least Square (PLS) with SmartPLS 2.0 M3. PLS model is evaluated by assessing outer and inner models (Latan and Ghozali, 2012).

4. Results and Discussion

Based on the sampling criteria, from 395 nonfinancial companies, only 240 companies meet sampling criteria. From 240 non-financial companies, as many as 71 companies or 30% have RMC, while the remaining (169 companies, or 70%) had not formed RMC.

4.1. Assessing measurement and structural model

Measurement models with reflexive indicators evaluated through Convergent Validity, Discriminant Validity and Composite Reliability. Based on the statistics from the PLS, some indicators have factor loading below 0.5 (concentrated ownership, managerial ownership and leverage). Modification of the model was done by dropping those indicators. Factor loading for modified result is reported in Table 1. Based on modification model, the final indicator for Corporate Governance are number of board commissioners, proportion of independent commissioners
and auditor reputation. Meanwhile, firm characteristics consist of three indicators: firm complexity, financial reporting risk and firm size.

Table 1. Results for loading factor (modified)

<table>
<thead>
<tr>
<th></th>
<th>CG</th>
<th>KP</th>
<th>RMC</th>
<th>Performance</th>
</tr>
</thead>
<tbody>
<tr>
<td>BOC</td>
<td>0.8886</td>
<td>0.454</td>
<td>0.531</td>
<td>0.2554</td>
</tr>
<tr>
<td>BigFour</td>
<td>0.7364</td>
<td>0.5317</td>
<td>0.5877</td>
<td>0.2953</td>
</tr>
<tr>
<td>Ind.Com</td>
<td>0.8448</td>
<td>0.3249</td>
<td>0.4069</td>
<td>0.2787</td>
</tr>
<tr>
<td>Complex</td>
<td>0.5003</td>
<td>0.8786</td>
<td>0.7327</td>
<td>0.2457</td>
</tr>
<tr>
<td>Financial_reporting_risk</td>
<td>0.3095</td>
<td>0.7073</td>
<td>0.5934</td>
<td>0.4112</td>
</tr>
<tr>
<td>Firm size</td>
<td>0.5178</td>
<td>0.8483</td>
<td>0.6894</td>
<td>0.1495</td>
</tr>
<tr>
<td>RMC</td>
<td>0.6321</td>
<td>0.8283</td>
<td>1</td>
<td>0.493</td>
</tr>
<tr>
<td>ROA</td>
<td>0.1583</td>
<td>0.1569</td>
<td>0.2436</td>
<td>0.6435</td>
</tr>
<tr>
<td>Tobins q</td>
<td>0.3425</td>
<td>0.3328</td>
<td>0.4923</td>
<td>0.9239</td>
</tr>
</tbody>
</table>

Discriminant validity is presented in Table 2. It shows that each construct is valid because it had AVE greater than 0.5 and square root of AVE is greater than correlation between constructs in the model. Table 2 also presents that the value of composite reliability for each construct is above 0.7. This indicates that each construct is reliable.

Table 2. Results for AVE, square root AVE, latent variable correlations, composite reliability and R square

<table>
<thead>
<tr>
<th></th>
<th>AVE</th>
<th>Square Root AVE</th>
<th>Correlations</th>
<th>Composite Reliability</th>
<th>R Square</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>CG</td>
<td>FC</td>
<td>RMC</td>
</tr>
<tr>
<td>CG</td>
<td>0.6818</td>
<td>0.8257</td>
<td>1</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>FC</td>
<td>0.6639</td>
<td>0.8148</td>
<td>0.546</td>
<td>1</td>
<td>-</td>
</tr>
<tr>
<td>RMC</td>
<td>1</td>
<td>1</td>
<td>0.6321</td>
<td>0.8</td>
<td>1</td>
</tr>
<tr>
<td>PERFORMANCE</td>
<td>0.6338</td>
<td>0.7961</td>
<td>0.3385</td>
<td>0.3301</td>
<td>0.493</td>
</tr>
<tr>
<td></td>
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4.2. Hypothesis testing

Table 3 presents the results of hypotheses testing. Data of this study proved that corporate governance affects the existence of RMC (t = 3.8913, p = 0.01). This indicates that the implementation of corporate governance as indicated by size of commissioners, proportion of independent commissioners and auditor reputation would influence policy and decisions related to the company’s organs including RMC. This study also proved that firm characteristics affect the existence of RMC (t = 11.1892, p = 0.01). It indicates that firm size, firm complexity and financial reporting risk will determine the risks faced by the company and then the obligation of the company to establish a RMC as a special committee for overseeing the implementation of ERM.

This study found that the existence of RMC affects firm performance (t = 3.092, p = 0.01). This indicates that the existence of RMC as part of oversight function over the implementation of ERM had effect on improving firm performance.

Table 3. Results of path coefficients

<table>
<thead>
<tr>
<th></th>
<th>Original Sample (O)</th>
<th>Sample Mean (M)</th>
<th>Standard Deviation</th>
<th>Standard Error (Sterr)</th>
<th>T Statistics (O / Sterr)</th>
</tr>
</thead>
<tbody>
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<td></td>
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</table>
Table 4. presents the Sobel test results. It was proved that the effect of corporate governance and firm characteristics on firm performance is mediated by RMC. It is concluded that corporate governance and firm characteristics affect firm performance through the existence of RMC. As discussed above, corporate governance and firm characteristics would affect the formation and existence of RMC in a company. The establishment of RMC would improve the effectiveness of ERM through its supervision so that the risks facing by the company can be minimized, which in turn will enhance firm performance.

Table 4. Mediation results

<table>
<thead>
<tr>
<th></th>
<th>Sobel Test</th>
</tr>
</thead>
<tbody>
<tr>
<td>CG -&gt; PERFORMANCE</td>
<td>2.5191</td>
</tr>
<tr>
<td>FP -&gt; PERFORMANCE</td>
<td>3.2532</td>
</tr>
</tbody>
</table>

5. Conclusions

This study has several objectives. Firstly, to analyse the effect of corporate governance on the existence of Risk Management Committee. Secondly, to analyse the effect of firm characteristics on the existence of Risk Management Committee. Thirdly, to analyse the effect of the existence of Risk Management Committee on firm performance. Fourthly, to analyse the role of Risk Management Committee as mediating variable between corporate governance and firm performance. And fifthly, to identify and analyse the role of Risk Management Committee as mediating variable between firm characteristics and firm performance. This study found that corporate governance and firm characteristics affect the existence of RMC. The study also proved that the existence of RMC enhances firm performance. The result suggests that the effect of corporate governance and firms characteristics on firm performance are indirect through the existence of a RMC. The results of this study add up to our understanding about the mediating or intervening role of a RMC. The finding of this study has an implication to the company to form RMC since it will contribute to the enhancement of firm performance. Further research can replicate or extend this study by including the Chief Executive Officer turn over (Trisnantari, 2013), as well as the uncertainty of the environment and strategy (Tjahjadi, 2011).

References


