

# Corporate governance mechanism and profitability: A special assessment on the board of commissioners and audit committee

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## Corporate governance mechanism and profitability: A special assessment on the board of commissioners and audit committee

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### ABSTRACT

*This study aims to examine the effect of corporate governance mechanisms on the percentage of profits in manufacturing companies. The population in this study is manufacturing companies in the industrial & chemical sector, which are listed on the Indonesia Stock Exchange (IDX) during the 2017-2019 period. The samples were selected using purposive sampling method and resulted in 34 manufacturing companies in the industrial and chemical sectors. Data were taken from the Indonesia Stock Exchange for the 2017-2019 period. The independent variable in this study is corporate governance with a focus on the board of commissioners and the audit committee, while the dependent variable is the effect of profit percentage on manufacturing companies. This study used simple linear regression analysis. From the regression analysis in this study, the two corporate governance proxies which include the board of commissioners and the audit committee have a significant positive effect on company profits. These results provide evidence that the existence of a board of commissioners and an audit committee in manufacturing companies in Indonesia has been effectively associated with the company's profit percentage gain.*

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## Introduction

The Good Corporate Governance (GCG) mechanism brings about two important focuses: ensuring the owner's right to obtain real information, and the management's obligation to report company information quickly and accurately. In the hands of the company's board of directors, GCG is implemented to ensure the smooth operation of the corporate governance mechanism by complying to the predetermined rules. Most companies in Indonesia generally have two management bodies that have different duties and functions, namely the board of commissioners and the board of directors. The implementation of corporate governance is one of the key elements in upgrading economic efficiency, which includes a series of relationships between company management, the board of commissioners, the audit committee, shareholders, and other stakeholders. Corporate governance also provides a structure that facilitates the determination of goals of a company, and to determine performance monitoring techniques (Denis et al., 2003). Suwardjono (2006) stated that one of the objectives of financial reporting is to provide useful information to investors, creditors, and other users in assessing the amount of net cash flow, and the uncertainty of net cash flow to the business entity concerned. Chairi and Ghozali (2007) highlighted that financial reporting aims to provide financial information on the company in generating profits (Earning Per Share). In making such decisions, a company must present financial statement information based on the actual condition of the company, which could reflect the actual financial performance of the company based on real facts. One of the indicators to assess the company's performance is the level of profitability as reflected by the ratio Return on Equity (ROE) (Lumbanaraja, 2021; Fitriyani, 2021; Prayanthi & Laurens 2020). ROE is a ratio calculation that indicates the company's ability to generate net income

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by using its own capital and generate net income available to owners or investors. ROE can be used as a measure of a company's financial performance. ROE information can be obtained from the information presented in the financial statements. The financial statements serve as a source of information to assess the company's performance. A summary of financial transactions that occurred during the relevant financial year is called an annual financial report.

The National Committee on Governance Policy publishes general guidelines for good corporate governance that convey corporate sustainability by applying principles of transparency, accountability, responsibility, independence, and fairness, which are the fundamental principles of the implementation of good corporate governance (National Committee on Governance Policy, 2006). To realize transparency and accountability, a supervisory function is needed by way of appointing a board of commissioners and an audit committee. A company must have a board of commissioners who are assisted by independent commissioners to protect shareholders. The number of independent commissioners in a company must comply with the applicable regulations. The management of the company depends on the performance of the board of directors, which is the party responsible for the running of the company's activities. To increase control over the company's financial statements, it is necessary to form an audit committee. The audit committee can ensure that management works in the interests of shareholders and stakeholders (Rimardhani, Hidayat & Dwiatmanto, 2016). This study was conducted to analyze the effect of corporate governance mechanisms on profits in manufacturing companies. Mechanism of corporate governance is proxied by board of commissioner and audit committee.

## Literature Review

### Theoretical and Conceptual Background

#### Agency Theory

The main theory related to corporate governance is agency theory (Chinn, 2000; Shaw, 2003). Jensen and Meckling (1976) explained that the connection between agencies in the agency theory refers to the fact that the company is a collection of contracts between owners of economic resources and managers who manage the use and control of resources. Agency conflict can also occur because of information asymmetry. Information asymmetry occurs when the principal and agent distribute information that is not the same, and thus causing problems Jensen and Meckling (1976) stated that these problems are: (1) moral hazard, if the agent does not carry out the things that are mutually agreed upon in the work contract, and (2) adverse selection, if the principal cannot know whether a decision taken by the agent is based on information obtained or occurs due to negligence in the task.

Jensen (1986) further highlighted that agency conflict may be attributed to someone's selfishness. The conflict then creates the problem of agency costs. According to Jensen and Meckling (1976), agency costs consist of (1) monitoring costs or costs incurred by the principal to monitor the behavior of agents by measuring, observing, and controlling. Examples of these costs are audit fees, compensation policies (compensation costs for managers), and restrictions (budget limitations), and operating rules; (2) bonding cost is the cost borne by the agent to comply with the mechanism to ensure that the agent performs in accordance with the main interest; and (3) residual loss or a decrease in the level of prosperity of the principal and agent with the agency relationship. The parties related to the residual loss are shareholders and managers in the company. A concept needed between the two parties to minimize the occurrence of information asymmetry is the concept of good corporate governance

#### Good Corporate Governance

Good corporate governance is a structure related to the responsibilities of stakeholders, directors, commissioners, and managers. These parties motivate competitive performance to achieve the company's main goals. According to the Indonesian Institute for Corporate Governance (IICG), good corporate governance is essentially a structure, systems and processes used by corporate organizations to provide long-term added value to the company.

Syakhroza (2003) defined corporate governance as a system used by the "board" to direct and control and supervise the management of organizational resources that is carried out efficiently, effectively, economically, and productively with the principles of transparency, accountability, responsibility, independence, and reasonableness to achieve an organizational goal. From the above definition, corporate governance is a method that regulates the company's supervisory process to increase the value of shares as well as a form of attention to stakeholders, employees, creditors, and to the community. The stock price goes along with the level of profitability obtained by the company. Thus, the higher the stock price, the higher the profitability of the company.

#### Corporate Governance Mechanism

The corporate governance mechanism refers to a control mechanism that utilizes the company's duties to meet stakeholder expectations. It particularly points out at the tools that cover the capital market and money market competition. In active-role-based goods and services markets, consumers must be responsive and understand their rights and obligations. The implementation of corporate governance for the earning management of small companies tends to contain more practical factors than that of large companies. Therefore, small companies are seeking to showcase the condition of the company to ensure its constantly good performance to attract investors' intention to invest in the company. In contrast, grabbing the public attention is much easier for large companies since the community pays much more attention to the company (Nasution & Setiawan, 2007).

The corporate governance mechanism is implemented through external and internal mechanisms. External Mechanisms are influenced by the company's external factors, which include investors, public accountants, lenders, and legalizing institutions. Meanwhile, the internal mechanism refers to a mechanism that is influenced by the company's internal factors, including: board of commissioners, institutional ownership, managerial ownership, and audit committee.

The Corporate Governance mechanism is implemented through external and internal mechanisms, including the followings:

- i. External mechanisms are influenced by company external factors, including investors, public accountants, lenders, and legalizing institutions legality.
- ii. The internal mechanism is influenced by the company's internal factors which include, among others, the followings:
  - a. Board of commissioners: Board of commissioners is part of the company structure that is collectively in charge and responsible for supervising and giving advice to directors as well as ensuring that company conducts good corporate governance. However, the board of commissioners may not participate in making operational decisions in the company. Law of the Republic of Indonesia Number 1 of 1995 concerning Limited Liability Companies, in article 1 paragraph 5 stipulates that: "Commissioners are company organs tasked with carrying out general and or specific supervision and providing advice to directors in running the company" (Pemerintah Republik Indonesia, 1995) The role of the board of commissioners is to oversee the implementation of risk management and ensure that the company has determined an effective risk management program. Although risk management is the responsibility of management, the board of commissioners must create an environment conducive to implement risk management.
  - b. Institutional ownership: Institutional ownership is the company's shareholders by the government, financial institutions, legal entities, foreign institutions, and other institutions. The presence of institutional ownership in a company will encourage the supervision of management performance. The bigger the institutional ownership, the greater the strength and encouragement of institutions to finance the management supervision. The good management supervision will provide greater input for management to optimize the company's performance and align the interests of management with shareholders or stakeholders.
  - c. Managerial ownership: Managerial ownership refers to the number of shares owned by the management of the company. Managerial ownership can be measured by calculating the percentage of shares owned by the company's management with the total outstanding number of company shares. One of the corporate governance mechanisms that can be used to reduce agency costs is to increase share ownership by investors' management.
  - d. Audit community: An audit committee is a committee formed by the board of commissioners to perform tasks in the supervision and management of a company. The audit committee is an important new component in the company's control system. Membership of audit committee shall at least consist of three people, including the chairman of audit committee. Verschoor (1993) stated that supervision the external audit is expected to increase the independence of the auditor to improve the effectiveness of the audit. In the field of corporate governance, the audit committee is responsible for ensuring that the company's operations comply with applicable regulations, conduct its business ethically, and carry out effective supervision of conflicts of interest and fraud committed by company employees. In the field of financial reports, the audit committee ensures that the financial statements prepared by management provide a real picture of the financial condition, results of operations, and long-term commitments.

### **Profitability**

Profitability is used to determine the effectiveness of the company's performance as seen from the level of income earned. One element that is used to measure the level of company profitability is Return on Equity (ROE). Profitability is used by companies to see the development of company performance in increasing profits through sales, assets, and own capital. Enhancement of profitability will become the power to attract investors to invest their capital in the company (Lumbanraja, 2021). Financial performance can be seen from the generated profit value, in which the higher the earnings, the better the performance (Anjani & Yadnya, 2017). It is necessary to monitor and evaluate the company's performance, to ensure the effective and efficient company management. These functions can be performed by the board of commissioners and the audit committee.

### **Empirical Review and Hypothesis Development**

From the perspective of agency theory, the board of directors represents the main internal mechanism to control management's opportunistic behavior to help align the interests of shareholders and managers. The board of commissioners serves to supervise the implementation of company management by company management. The corporate governance can improve management supervision in the company. Making decisions based on relevant information will improve the company's performance and increase company profits. The better performance of the company also indicates the good operation of corporate governance in accordance with the

implementation of the National Committee on Governance Policy. The Board of Commissioners and the Audit Committee have a supervisory function on the company's management, to create a supervision that can realize good governance.

Lestari (2021) further elaborated that independent commissioner influence profitability. The result of this study reinforces the agency theory by indicating that independent commissioners, who are members of the board of commissioners, shall be able to supervise and act independently on the behavior of company managers to comply with regulations and minimize conflicts of interest. The board of commissioners plays a key role in overseeing the behavior of managers so that they can improve company performance which will have an impact on increasing company profitability. Lestari (2021) is supported by some research, which highlighted that independent commissioner have a positive and significant impact on ROE (Lumbanraja, 2021; Fitriyani, 2021; Prayanthi & Laurens, 2020). On this basis, the first hypothesis is proposed as follows:

**H1:** *The board of commissioners has a positive effect on the percentage of profits in the company.*

The agency theory predicts that the formation of an audit committee serves as a way to solve various agency problems (Salehi et al, 2018). This is because the main function of the audit committee is to review the company's internal controls, to ensure the quality of financial reports, and to improve the effectiveness of the audit function. Matters related to the various functions of the audit committee encourage the company's management to work as effectively as possible, which will ultimately have an impact on increasing company performance, one of which is maximizing company profits.

In this line, Anjani and Yadnya (2017) articulated that the audit committee has a positive and significant effect on the profitability of banking companies listed on the IDX. Therefore, it can be concluded that the audit committee can improve company performance by way of reducing management's unhealthy behavior and increasing investor's confidence in the banking sector. The audit committee also plays a role in assisting the board of commissioners in supervision that bridges the gap between external and internal auditors. Thus, the second research hypothesis is proposed as follows:

**H2:** *Audit committee has a positive influence on the profit percentage of the company.*

#### **Research and Methodology**

This is quantitative research that analyzes secondary data obtained from the annual report of manufacturing companies for the period of 2017–2019, which is made to be published to the public and presented on the Indonesia Stock Exchange. The research population is a manufacturing company. The samples were selected using the purposive sampling method based on the following criteria: 1). The companies are listed on the Indonesia Stock Exchange (IDX) for the period of 2017-2019; 2) The companies have issued annual financial statements for the period of December 31, 2017-2019 and 3). The companies have a disclosure of corporate governance mechanisms.

The dependent variable in this study is the percentage of profit on proxy company with ratio profitability as measured by use ratio return On Equity (ROE). One of the factors that increase the percentage of profit in the company is financial ratios. In this study, the authors used financial ratios using Return on Equity (ROE) (Lumbanraja, 2021)

$$\text{ROE} = (\text{Earnings After Taxes} / \text{Total Equity}) \times 100\% \quad ; (\text{ROE} = \text{Return on Equity}; \text{EAT} = \text{Earnings After Tax})$$

The independent variable in this study is the mechanism of corporate governance proxied with member of the board of commissioners and the audit committee. Assessment of the board of commissioners and the audit committee was viewed from three aspects, namely degree, competence, and professionalism. The competence of board of commissioner could be measured based on their educational background and experience in carrying out their duties and examining and analyzing measurable financial statements with their degree, competence, and professionalism (Bara, 2016). Each aspect was measured based as the followings: 1). Bachelor's degrees were scored with 1, Master's degrees were scored with 2, and Doctoral degrees were scored with 3, and 0 if their degree was below undergraduate level or did not achieve any academic degree; 2). Those with competency certification were scored with 1 and 0 for those without any competency certification; and 3). Those being a member of an association or organization was scored with 1 and 0 for those who did not participate in any associations or organizations.

The analytical method to determine the relationship between the variables in this study was multiple linear regressions. Descriptive statistical analysis and classic assumption test consisting of from test normality, test heteroscedasticity, test autocorrelation, and test multicollinearity, as well as Adjusted R Square Test (Adj. R 2) and Model Test were conducted before the regression test. The multiple linear regression formula was as follows:

$$PL = \alpha + \beta_1 DK + \beta_2 KA + e$$

Information: PL = Profit Percentage;  $\alpha$  = Constant;  $\beta_1$  = Regression Coefficient; DK = Board of Commissioners;  $\beta_2$  = Regression Coefficient; KA = Audit Committee; e = Error term, namely the level of error in the study.

## Findings and Discussions

### Description of Research Object

34 companies were selected as the research samples based on the predetermined criteria using purposive sampling method. Observations were conducted for 3 years and generated the data of 102. Table 1 presents information on the sample selection stage of this research

**Table 1:** Research Sample Data

Information	Amount
Manufacturers of industrial & chemical sectors listed on the Indonesia Stock Exchange for the 2017-2019 period.	61
Companies that issue financial statements without ending on December 31 <sup>st</sup>	0
Manufacturing companies in the industrial & chemical sector that do not have complete data for 2017-2019	(27)
Total sample of manufacturing companies in the industrial sector & chemistry for 3 years of observation	34
Total data of manufacturing companies in the industrial & chemical sector processed during 3 years of observation (3x34)	102

### Results of Data Analysis

The data in this study passed all the standard regression assumption tests. In regard of coefficient determination test, based on the table 2, the adjusted R<sup>2</sup> value was of 0.20 or 20%, which means that the model in manufacturing companies could explain the dependent variable of 20%, but other remaining factors of 80%, which were not examined, could affect the profit percentage of the company.

**Table 2:** Coefficient Determination Test Results of Manufacturing Company

Model	R	R <sup>2</sup>	Adjusted R <sup>2</sup>	Std. Error of the Estimate
I.	.464	.216	.200	.06793850

In regard of Hypothesis testing, the simple linear regression equation is as follows:

$$PL = 0,003 + 0,004 DK + 0,007 KA + e$$

Thus, the following conclusions are presented as follows:

- i. The board of commissioners (DK) variable has a regression coefficient value of 0.004, meaning that if the DK variable increases by 1 unit, the effect of the ROE percentage will increase by 0.004 units. The p-value of 0.000 is smaller than the 0.05 significance level. Getting a Key from the Board of Commissioners has a positive and significant effect on the percentage of ROE in the company, and thus H1 fails to be rejected.
- ii. Independent audit committee variable (KA) was marked with the coefficient of 0.007, which indicates that if the variable KA increases by 1 unit, the effect of the ROE percentage will increase by 0.007 units. The p-value of 0.000 is smaller than the significant level of 0.05. It is thus conclusive that the audit committee has a positive effect on the percentage of profits in the company, so H2 fails to be rejected. Table 3 present the result of multiple regression test.

**Table 3:** Multiple Regression Test Results

No.	Variable	B	Sig	Information
1.	Constant	0,003	0.922	
2.	DK	0,004	0.004	Accepted
3.	KA	0,007	0.042	Accepted

## Discussion

The results of the study prove that the Corporate Governance mechanism using the board of commissioners and the audit committee has a positive and significant effect on profitability (ROE). This means that the members of the board of commissioners and audit committee of companies in the industrial & chemical sector listed in the company Manufacturers on the IDX for the 2017-2019 period mostly completed a high educational level, having met the required competence and professionalism in the accounting field, and having an influential impact on improving company performance as reflected by the increase in company profitability.

This research proves that a professional board of commissioners in their respective field was proven to help improve the supervision of management performance in the company. This research revealed the awareness of issuers, improved management performance, environmental response in the implementation of GCG, positive signals by investors, and the functioning of the board of commissioners in supervising the management of the company in an efficient and effective manner with the better role of the board of commissioners which has an impact on increased profitability. The results of the study support previous research which proved that the board of commissioners has a positive and significant effect on profitability (Lumbanraja, 2012; Fitriyani, 2021; Prayanthi & Laurens 2020), as well as research conducted by Lestari (2021), which stated that independent commissioners influence profitability. However, it contradicted the research conducted by Anjani and Yadnya (2017), which revealed that the board of independent commissioners has a negative and significant effect on profitability.

The data analysis disclosed that the audit committee has a positive and significant effect on profitability. The audit committee has a role to assist the board of commissioners in supervision that can bridge the relationship between internal auditors and external auditors (Ariani, 2017). The presence of an audit committee has begun to be considered in the management of a healthy company. The audit committee is a committee formed by the company's board of commissioners, which serves to assist the audits of function directors in the company management. In addition, the audit committee functions as a mediator between shareholders and the board of commissioners. Smooth relations between parties will increase the company performance (Christianto, 2011). The results of the study reinforced Ariani (2017), but contradicted the results revealed by Lestari (2021), Prayanthi and Laurens (2020), and Lumbanraja (2021) who obtained evidence that the audit committee did not influence profitability.

## Conclusion

The results of the study proved that the Corporate Governance mechanism which is reflected in the presence of the board of commissioners and the audit committee had a positive and significant effect on profitability (ROE). This study showed that the board of commissioners who were professional in their respective fields was proven to be helpful in improving the supervision of management performance in the company.

The results of the study supported the agency theory, with independent commissioners who are members of the board of commissioners and audit committees who were able to supervise and act independently on the behavior of company managers to ensure that the company's management complied with the applicable regulations and to minimize conflicts of interest. The board of commissioners and the audit committee were able to supervise the behavior of managers and assist the control process on the foregoing planning so that the company's operational activities were implemented in accordance with the planning. This is expected to improve the company's performance which is expected to increase the profitability of the company.

The members of the board of commissioners and audit committee having a good educational background and adequate competence and professionalism are proven to improve management performance. This fact can serve as a basis for consideration in selecting members of the board of commissioners and audit committee.

Further research is suggested to use other potential factors, such as institutional ownership and managerial ownership, as the proxies of corporate governance besides the board of commissioners and the audit committee. By knowing the various factors that increase the profit percentage of the company in terms of governance, it is expected that the company will run on the right track and achieve its targeted profit. The same is also true for the dependent variable. It is suggested to use other ratio besides profitability, such as return on assets (ROA).

This study implies that the role of members of the board of commissioners and highly educated audit committee members, who have good competence and professionalism, can improve the management performance of the company, and this fact serve as a basis for consideration in selecting members of the board of commissioners and audit committee.

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