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# The Effect of Audit Committee Size, Independent Commissioner Size, and Shareholder Equity Ratio on Financial Distress Avoidance: A Study on Public Companies in Manufacturing Sector Listed in IDX during 2015-2017

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## ABSTRACT

This study aimed to reveal the effect of Audit Committee size, Independent Commissioner size, and Shareholder Equity Ratio on Financial Distress Avoidance. In this study, Audit Committee size, Independent Commissioner size, Shareholder Equity (SHE) Ratio, and Financial Distress were measured by using the Altman Z-Score Model. The research subjects were public companies listed in Indonesia Stock Exchange (IDX) during 2015-2017. These samples were selected by using the purposive sampling method and the secondary data was analyzed by using multiple regression method, and finally there were 19 companies that met the requirements. As research result, the Audit Committee effectiveness as proxied by Audit Committee size and the number of Independent Commissioner do not positively affect financial distress avoidance. Meanwhile, the SHE ratio positively and significantly affect financial distress avoidance.

**Keywords:** Audit Committee, Independent Commissioner, Shareholder Equity Ratio, Financial Distress Avoidance

## 1. INTRODUCTION

Shareholder Equity (SHE) ratio measures the proportion of total assets obtained not from debt, but from investors' funds. This ratio is used to describe the ability of management to use assets based on the amount of capital owned [1]. Company size can be assessed from the total assets owned. If a company is bigger, then there is a tendency that it can use large external funds and one alternative to fulfill the available funds is using the external funding (Hendriani, 2015) in [2]. If the company tends to seek funds through external parties, in this case from investors, it is unlikely that large long-term debt will arise and the company does not lead to financial distress. Corporate governance handles the ways whereas all parties are involved in the organizational well-being, which are the efforts ensuring that leaders and other insiders can take actions or adopt the mechanisms that protect the stakeholders' interests. Corporate governance refers to a set of rules and incentives in which the company management is directed and controlled [20]. Corporate governance is a system used by companies to mobilize and control their operations. In corporate governance, the Board of Directors is responsible for its implementation. Corporate governance is a principle which directs and

controls the company in achieving an equality between the strength and authority in providing the accountability to stakeholders in general and shareholders in particular.

Manufacturing companies are dominated by inventories, which are part of total assets and assets are the company's main resource for earning profits, thus total assets are expected to reflect the size of the company.

The elements to estimate financial distress are the major signs, sources, as well as the suggested ways to eradicate these undesirable consequences. The methodology used is the critical analysis based on empirical literatures. As the findings in this study, a basis for addressing financial distress conditions is provided by restructuring the financially distressed projects. The findings also mean that the restructuring can be viewed in four main dimensions, which are financial, asset, operational, and managerial dimension [3].

Leverage is proxied by the total debt ratio. This ratio illustrates the ratio of total debt to total assets [2]. The low debt ratio illustrates that the company's funding is dominated by shareholder funds, thus preventing the company from seeking funds through debt. With the smaller possibility of a company seeking funds through debt, the smaller the liabilities in form of principal and interest on debt that must be paid by the company, so that the company is less likely to experience default or

financial problems, thus it can avoid financial distress. Liquidity is proxied by the current ratio. This ratio illustrates how much the ability of the company's current assets to cover its current liabilities [2]. When current assets are greater than current liabilities, the company does not experience liquidity problems or the company is still able to pay-off its current debt. When the company is still liquid, financial problems will not arise. In this condition, the company shows no signs of experiencing financial distress.

[4] stated that when a company does not realize that it is experiencing financial distress, 2-5 years later it will go bankrupt. In this condition, the government will suffer losses from the tax revenue sector.

Financial distress is measured using the Altman Z-Score Model [5]. The working capital to total assets ratio measures the ratio of the net working capital position to the total assets owned by the company. The net working capital position represents the excess of current assets against the company's current liabilities. The greater the working capital to total assets ratio means that the company has sufficient net working capital for operational activities and its current assets can cover the company's current liabilities. When current liabilities can be covered, the company's operations can continue and it will not experience financial problems, hence the company may not experience financial distress. Retained earnings to total assets is a measure of the cumulative profitability of the company. The ratio of retained earnings to total assets also illustrates how much retained earnings can finance the acquisition of assets. The greater the ability of retained earnings to finance the assets, the less likely the company will be in debt for the assets acquisition and the less likely it will be default due to the small amount of liabilities. In these conditions the company can avoid financial distress. The five ratios that have been described above are calculated based on the equation formed. According to [4], companies that have a Z-Score less than 1.81 are classified as experiencing financial distress and those that have a Z-Score more than 3 are categorized as not experiencing financial distress. If the company has a Z-Score between 1.81 and 3, then it is classified as a gray area, or in other word, the company may or may not experience financial distress.

If the effectiveness of the board of directors and audit committee is affected by such characteristics, then comprehensive measure must be done based on such characteristics by a score or index. This can enable a better measurement on the effectiveness of the role and power (strength) of the governance structure provided to the board and audit committee as a whole compared to each characteristic's measurement [19]. The audit committee's effectiveness, which is proxied by independent commissioners, can be seen from the number of commissioners, which is at least one person. The more independent commissioners are, the higher the objectivity of the audit committee will be, so the management has confidence in the performance of the audit committee and the solutions to the proposed financial problems are believed to be the company's interests, hence supporting

the objectivity of decisions made by management regarding the problems in the company's operations. When the management is objective in making decisions, the company can avoid financial distress. Research conducted by [26] stated that if the independence of the audit committee increases, the more likely the companies will not experience financial distress.

## 2. LITERATURE STUDY

### 2.1. Financial Distress

[1] stated that, "Financial distress is financial condition that happens before bankruptcy and liquidity." [6] added that financial distress is a situation in which the company's operating cash flow is not sufficient to pay-off current liabilities (such as trade payables or interest expenses). From financial reporting, there are three conditions that cause financial distress, namely insufficient capital or lack of capital, large debt and interest expenses, and losses suffering. [7] stated that there are two solutions that can be given if a company has negative cash flow, namely:

1. Debt restructuring

Management requests an extension of time from creditors to pay-off the debts until the company has sufficient cash to pay-off the debt.

2. Change in management

If necessary, the company can replace the management with more competent persons. This way, it's possible that stakeholder trust can return to the company. This is to prevent potential investors from running into financial distress.

[4] stated that financial distress can be measured using the Altman Z-Score Model, which consists of 5 financial ratios, i.e. working capital to total assets, retained earnings to total assets, EBIT to total assets, market value of equity to book value of debt, and sales to assets. The Altman Z-Score Model is in accordance with the original research on financial distress predictions conducted by Edward I. Altman. The working capital to total assets ratio measures the liquidity of total assets and the position of net working capital [8]. Retained earnings to total assets measures the cumulative profitability which implicitly states the age of the company [4]. [4] also revealed that earnings before interest and taxes to total assets is a measure of the productivity of the company's real assets regardless of taxes or leverage factors. Meanwhile, [9] stated that the market value equity to book value of debt illustrates the company's ability to meet its long-term total liabilities.

### 2.2. The Effectiveness of Audit Committee Size

[22] indicates that a large audit committee provides more top management monitoring resources and financial reports quality. This can enhance the internal governance practices and improve the resources of internal monitoring activities. Previous studies found combined-results in the

relationship between audit committee and company's financial performance. Another study [23] found that large audit committee improves the quality of financial reporting, because its effectiveness increases along with the existence of experienced and knowledgeable members (24). This is an evidence that the ideal-sized committee can use its experience to help the monitoring process. In the opposite, a weak association was found between the audit committee size and company's performance (25).

The Audit Committee consists of at least 3 (three) members from Independent Commissioners and parties from outside the Issuer or Public Company [10]. [8] stated that the audit committee effectiveness will increase if the committee size increases.

H<sub>1</sub>: The audit committee effectiveness as proxied by the audit committee size, positively affects financial distress avoidance.

### 2.3. Commissioner Independence in Audit Committee

The audit committee is chaired by an independent commissioner. Independent commissioners are parts of the board of commissioners coming from outside the company. [11] stated that the independence is meant to maintain the integrity and objective view in the report and recommendations preparation submitted by the audit committee. Therefore, another hypothesis was developed.

H<sub>2</sub>: The effectiveness of the audit committee, which is proxied by the number of independent commissioners in the committee, positively affects financial distress avoidance.

### 2.4. Shareholder Equity (SHE) Ratio

According to [12], shareholders' equity is divided into two parts:

1. Paid-in Capital, usually called contributed capital or share capital, is the equity distributed by shareholders to the company. Paid-in capital includes the par value of the shares and additional paid-in capital.

2. Retained Earnings, is a part of equity in the form of revenue from the company's operations and is not used to be distributed as dividends.

[1] suggested that the variable of SHE ratio in stock equity describes the management's capability in using assets from the existing shares and it is important to creditors, because they need to measure the companies' ability in paying its fixed assets by using the equity. If the proportion of equity to total assets is low, shareholders will have a low investment in the company and the proportion of corporate debt will dominate. When the proportion of debt dominates, the SHE ratio will decrease and increase the probability of financial distress. Therefore, the next hypothesis was formed, namely:

H<sub>3</sub>: Shareholder equity ratio positively affects financial distress avoidance.

## 3. METHOD

### 3.1. Dependent Variable

We used the factor of Financial Distress (FD) as dependent variable. Financial distress is measured by using a ratio scale, namely the Z-Score which is less than 1.81 as measured by the Altman Z-Score Model.

### 3.2. Independent Variables

1. Audit Committee size (ACSIZE) is measured using a ratio-scale data, namely the number of Audit Committee members.
2. Independent Commissioner size (ACCOMINDP) is measured by using a ratio-scale data, namely the percentage of independent audit committee members to the total number of audit committee members.
3. Shareholder Equity (SHE) Ratio is measured by using a ratio scale, which is the ratio of total shareholder equity to total assets

### 3.3. Overview of Research Objects

The object of this research was public manufacturing companies of all sectors listed in the Indonesia Stock Exchange during the period 2015-2017.

### 3.4. Research Methods

The method used in conducting this research is the causal research method. Financial distress is measured by using a ratio scale, namely the Z-Score, which is less than 1.81 as measured by the Altman Z-Score Model.

### 3.5. Data Collection Technique

The data used this research is secondary data. [13]. In this study, the data used was in form of a list of manufacturing companies in the 2015-2017 period, the annual reports of manufacturing companies in the 2015-2017 period, and the stock prices of manufacturing companies in the 2015-2017 period. All data was obtained on the site [14], which is the official website of IDX [15], and the Yahoo Finance website [16].

### 3.6. Sampling Techniques

The sampled companies used in the study were selected by purposive sampling technique. The criteria used were as follows:

1. Manufacturing companies had gone public or were listed in the Indonesia Stock Exchange (IDX), the period 2015-2017 respectively.
2. The company issued consecutive annual reports that ended on December 31<sup>st</sup>.



3. The company presented financial statements denominated in Rupiah currency.
4. The company explains the amount of interest expense in order to calculate the ratio used in the research.
5. The company has complete data regarding the number of meetings of the audit committee members in one year, at least one member of the audit committee had financial knowledge, and at least one member of the audit committee was an independent commissioner.
6. The company had a Z-Score less than 1.81.

### 3.7. Data Analysis

Data analysis in this study used the multiple linear regression model with SPSS software version 21. Before analyzing the data, first the descriptive statistical results of each variable were presented and then the data quality test

**Table 1 Descriptive Statistics**

	N	Range	Minimum	Maximum	Mean	Std. Deviation
ACSIZE	88	5	2	7	3.16	.676
ACCOMINDP	88	52.3812%	14.2859%	66.6669%	35.560067%	9.3950687%
SER	88	1.3697	-.4069	.9628	.516814	.2480971
Valid N (listwise)	88					

Source: Data Analysis Results (2020)

### 4.2. Normality Test

The normality test was conducted by using the *Kolmogorov-Smirnov* test. If the value of asymp sig (2-tailed) is greater than or equal to 0.05, then the residual data is normally distributed. The test result of data normality can be seen as follow:

**Table 2 Data Normality Test**

**One-Sample Kolmogorov-Smirnov Test**

		Unstandardized Residual
N		88
Normal Parameters <sup>a, b</sup>	Mean	.0000000
	Std. Deviation	.25234334
	Absolute	.070
Most Extreme Differences	Positive	.058
	Negative	-.070
Kolmogorov-Smirnov Z		.661
Asymp. Sig. (2-tailed)		.775

a. Test distribution is Normal.

b. Calculated from data.

Source: Data Analysis Results (2020)

The result of data normality test in Table 2 show that the asymp sig (2-tailed) is 0.775, which is greater than 0.05. This means that the residual data has been normally distributed.

and classical assumption test would be carried out in form of normality test, multicollinearity test, autocorrelation test, and heteroscedasticity test. After the regression model had fulfilled all the classical assumptions, then the coefficient of determination ( $R^2$ ) test, simultaneous significance test (F-test), and individual significance test (t statistical test) was carried out.

## 4. DATA ANALYSIS AND DISCUSSIONS

### 4.1. Descriptive Statistics

Table 1 describes the descriptive statistics for each of the variables in this study. Descriptive statistics explains the minimum, maximum, range, mean, and standard deviation values of each research variable.

### 4.3. Classical Assumption Tests

#### 4.3.1. Multicollinearity Test

This test is conducted to test the correlation between independent variables (independent). Multicollinearity in the regression model is indicated by the Variance Inflation Factor (VIF). The cut-off value commonly used to indicate multicollinearity is the Tolerance Value  $\leq 0.10$  or the same as the VIF value  $\geq 10$ . Next is the results of the multicollinearity test:

**Table 3 Multicollinearity Test 1**

Model		Collinearity Statistics	
		Tolerance	VIF
1	(Constant)		
	ACSIZE	.688	1.454
	ACCOMINDP	.665	1.504
	SER	.004	272.105

Source: Data Analysis Results (2020)

Based on Table 3, the independent variable of SHE Ratio and the control variable Leverage (LEV) have a Tolerance Value less than 0.10 and a VIF value more than 10. This means that there has been a multicollinearity effect between the independent variables in this study, namely between the independent variables of SHE Ratio, Size of the Audit Committee (ACSIZE), and Independent Commissioner of the Audit Committee (ACCOMINDP), which have a Tolerance Value more than 0.10 and a VIF value smaller than 10. This indicates that the multicollinearity exists between these variables. Therefore,

the results of the second multicollinearity test after eliminating the leverage control variable are as follows:

**Table 4 Multicollinearity Test 2**

Model		Collinearity Statistics	
		Tolerance	VIF
1	(Constant)		
	ACSIZE	.690	1.448
	ACCOMINDP	.667	1.499
	SER	.715	1.398

Source: Data Analysis Results (2020)

Table 4 shows that Tolerance Value more than 0.10 and a VIF value smaller than 10. This means that there has been no multicollinearity effect among all independent variables and all control variables in this study.

#### 4.3.2. Auto-Correlation Test

**Table 5 Auto-Correlation Test**

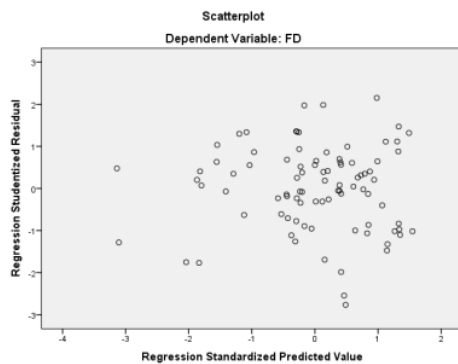
Model	Durbin-Watson
1	1.938

a. Predictors: (Constant), LIQ, ACSIZE, ACCOMINDP, SER  
b. Dependent Variable: FD

Source: Data Analysis Results (2020)

Based on Table 5, the Durbin-Watson Statistics shows a figure of 1.938, in which there is no positive or negative autocorrelation, or in other word, there is no autocorrelation at all.

#### 4.3.3. Heteroscedasticity Test



**Figure 1** The Result of Heteroscedasticity Test  
Source: Data Analysis Results (2020)

In Figure 1, the residual data is scattered in the entire diagram, which means that there is no heteroscedasticity effect in the research data.

## 4.4. Hypotheses Testing

### 4.4.1. Coefficient of Determination Test

**Table 6 R Square CD Test**

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.565 <sup>a</sup>	.319	.250	2.653433

a. Predictors: (Constant), ACSIZE, SER, ACCOMINDP  
c. Dependent Variable: FD

Source: Data Analysis Results (2020)

Based on Table 6, the correlation coefficient (R) is 0.565, which is greater than 0.5. This shows a strong positive relationship between the independent variable and the dependent variable. The coefficient of determination (Adjusted R-Square) is 0.25. The variable of audit committee effectiveness as proxied by the size of the audit committee, the independent commissioners of the audit committee, as well as SHE ratio, with control variables on firm size and liquidity, are able to explain financial distress avoidance as much as 25%, while the remaining 75% of variation in financial distress avoidance is explained by other variables out of the scope of this study.

### 4.4.2. Simultaneous Test (F-Test)

**Table 7 F-Statistics ANOVA<sup>a</sup>**

Model	Sum of Squares	df	Mean Square	F	Sig.
1 Regression	2.604	8	.325	4.623	.000 <sup>b</sup>
Residual	5.562	79	.070		
Total	8.166	87			

a. Dependent Variable: FD  
b. Predictors: (Constant), ACCOMINDP, ACSIZE, SER  
Source: Data Analysis Results (2020)

Based on Table 7, the F-value is 4.623 with a significance level below 0.05, which is equal to 0.000. Thus, the regression model can be used to predict the dependent variable, namely financial distress. In addition, the audit committee effectiveness variable as proxied by the size of the audit committee, the independent commissioners of the audit committee, as well as SHE ratio, with control variables on firm size and liquidity, has significant effects simultaneously on financial distress avoidance.

### 4.4.3. Partial Test (t-Tests)

**Table 8 The Results of t-Tests**

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error			
(Constant)	1.332	.685		1.946	.055
1 ACSIZE	.036	.051	.080	.715	.477
ACCOMINDP	.002	.004	.065	.571	.570

SER	.481	.136	.390	3.551	.001
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Source: Data Analysis Results (2020)

The Audit Committee Size variable (ACSIZE) has the t-value of 0.715 and the significance value of 0.477. This means that the audit committee size does not partially and positively affect financial distress avoidance due to the significance value greater than 0.05. Thus, H<sub>1</sub> was rejected. This result is in line with [8] and [17]. This phenomenon could happen because based on research data, the average number of members of the audit committee is 3.16 which means that the formation of the audit committee is only limited to meeting the rules, namely at least 3 persons. When the number of audit committees is small, the audit committee has few resources to handle the financial problems which are currently faced by the company, so that there are fewer solutions to the problems and the delivery of these solutions to the directors is not optimal. As a result, it is possible that the board of directors cannot solve the financial problems that occur and the company cannot avoid financial distress.

The Independent Commissioner in Audit Committee (ACCOMINDP) variable has a t-value of 0.571 and a significance value of 0.570. This means that the number of independent commissioners in audit committee has no positive effect on financial distress partially, thus H<sub>2</sub> was rejected due to the significance value which is greater than 0.05. The result of this study is in line with the research conducted by [8] and [17]. This phenomenon could happen because based on research data, the average independent commissioner of the audit committee is 27.4845% or about 1 person from the average of three audit committee members. The small number of independent commissioners will affect the policies taken by management. If the number is a minority, then it is possible that the solution made by the independent commissioner will not affect the policies that management will take regarding the financial problems being faced. In other words, the independent commissioner loses the votes to other members of the audit committee who have the right to provide solutions. This condition can lead to the possibility that the solutions taken are not objective and will increase the likelihood of financial distress.

The variable SHE Ratio has a t-value of 3.551 and a significance value of 0.001. So, the SHE ratio variable partially and positively affects financial distress avoidance, because it has a significance value greater than 0.05. Thus, H<sub>3</sub> was accepted. This result is in line with [1] and [18].

The multiple linear regression equation, based on data in Table 4.8, could be formed as follow:

$$FD = 0,080ACSIZE + 0,065ACCOMINDP + 0,390SER$$

FD : Financial Distress

ACSIZE : Audit Committee Size

ACCOMINDP : Independent Commissioner in Audit Committee

SER : Shareholder Equity Ratio

The ACSIZE regression coefficient value is 0.080, which means that each increase of one unit of Audit Committee Size (ACSIZE) will increase the value of financial distress by 0.080 or 8%.

The ACCOMINDP regression coefficient value is 0.065. This means that every increase of one unit of the Independent Commissioner of the Audit Committee (ACCOMINDP), it will increase the value of financial distress by 0.065 or 6.5%.

The SER regression coefficient value has a number of 0.390 meaning that the increase of one unit of SHE Ratio will increase the value of financial distress by 0.390 or 39%.

## 5. CLOSING

### 5.1. Conclusions

H<sub>1</sub> was rejected, which means that the effectiveness of audit committee as proxied by the size of audit committee does not positively affect financial distress avoidance, because the average number of audit committees is limited to meeting the rules, namely 3 people. As a result, the audit committee experiences a lack of resources in finding solutions to the financial problems found, so that the formation of solutions by the audit committee is not optimal. The result of this study is in line with the research conducted by [8] and [17], namely the size of the audit committee is unable to avoid the possibility of financial distress in the company.

H<sub>2</sub> was rejected, which means that the audit committee effectiveness as proxied by the number of independent commissioners in audit committee does not positively affect financial distress avoidance, because the average number of independent commissioners is small, namely 1 person, which makes the independent commissioners lose their votes to those of other audit committee members, so that they can reduce the objectivity of the solutions presented to the board of commissioners related to financial problems and this will increase the likelihood of financial distress. This is in line with [8] and [17], which concluded that the independent commissioners' proportion in the company cannot avoid the possibility of financial distress.

H<sub>3</sub> was accepted, which means that the SHE ratio has a positive and significant effect on financial distress. A high SER indicates that there is a small possibility of obtaining assets from debt, so it is less likely to default and avoid financial distress. This result is in line with [1] and [18], which stated that the greater the SER is, the more it can predict the occurrence of financial distress in a company. Simultaneously, the audit committee effectiveness variable as proxied by the size of the audit committee, the number of independent commissioners in the audit committee, as well as the SHE ratio, with the control variables on firm size and liquidity, significantly affect the financial distress avoidance.

As the implication of this research, the existence of an audit committee is not recognized as a mean to improve

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the company's performance quality. The audit committee is useful for supporting the board of directors in carrying out the company's operations in form of delivering solutions to the financial problems found. However, the audit committee was formed only as a formality so that the committee does not have partial influence on the company's financial performance and could not prevent the company from experiencing financial distress.

### 5.2. Limitations

- 8
1. The lack of Audit Committee effectiveness and the number of Independent Commissioners affect the ability of the independent variables to explain the dependent variable. This can be viewed from the Adjusted R-square value of 25%.
  2. The research results can be used for the manufacturing sector only and cannot be generalized to company in other sectors, such as service sector.

### 5.3. Suggestions

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Based on the conclusions and limitations in this study, the suggestions can be provided as follows:

1. Adding other independent variables to measure the effect on financial distress avoidance, such as inflation, return on assets, and debt-to-equity ratio.
2. Expanding the sector under study such as the service sector, because financial distress is considered important to all types of company.

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