

AUDIT COMMITTEE, CEO TENURE AND CAPITAL STRUCTURE

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Submit : 07th May 2020, Revised : 17rd May 2020, Accepted : 7th August 2020

ABSTRACT

The purpose of this paper is to examine the relation between corporate governance and capital structure with CEO tenure as moderation effect in manufacturing firms. The data in this study is collected from the annual report published. The data cover the period from 2013 to 2017. Multiple linear regression model and moderated regression analysis are used in this study. Capital structure as dependent variable is measured by ratio of total debt to total assets are used in this study. Corporate governance is independent variables which is measured by audit committees while moderating variable is CEO tenure. The novelty of this research examines CEO tenure as moderation variables on the influence of audit committees on capital structure which is rarely studied. The results showed that CEO tenure weakens the positive effect of audit committees on capital structure. The results of this study can help the firms to pay attention to the corporate governance and CEO tenure because they can affect the firm's capital structure policy.

Keywords - Capital Structure; Corporate Governance; Audit Committee; CEO Tenure

I. INTRODUCTION

The firm's decision in choosing a source of funding is the important decisions for management because it can impact the value of the firm. According to Brealey et al. (2006: 341-342) there are two alternative sources of firm funds, namely internal and external funding sources. Sources of internal funds come from within the firm (retained earnings), while external sources of funds come from outside the firm (bank loans, bond issuance and shares).

The more a firm develops, the sources of funding used to make investments will also increase. It is not enough for a firm to use its internal funding source because its availability is limited and depends on how much the profit is obtained during the year. The way that firm can

do to overcome these problems is to use external funding sources. The management needs to determine the optimal capital structure that is able to produce maximum firm value in determining the composition of funding sources (Sudana, 2015: 173).

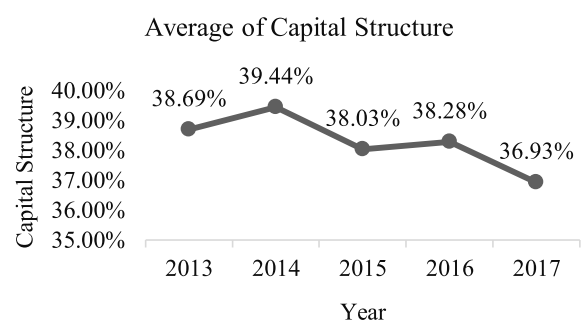


Fig.1 Average Capital Structure of Manufacturing Firms Listed on the IDX between 2013 to 2017.

The ratio of total debt used in the firm to its

total assets is a measurement to calculate level of capital structure. The figure 1 shows the level of capital structure in manufacturing firms in Indonesia. In 2013-2017, the average level of debt used in manufacturing firms in Indonesia fluctuated. The level of debt increased in 2014 and 2016, but decreased in 2015 and 2017. Changes in debt levels indicate that there are some variables or factors that affect the capital structure. In a study conducted by Tarus and Ayabei (2016) explained that capital structure can be influenced by corporate governance.

The governance literature explain that corporate governance can provide solutions in overcoming agency conflict between several parties related to the firm: insiders (managers) and outsiders (shareholders). The agency theory by Jensen and Meckling (1976) explains the contractual relationship between the owner of the firm (principal) who delegates certain decision making to improve his prosperity with the management (agent) who receives the delegation. This often triggers agency conflicts caused by differences in interests between 2 parties: managers and shareholders.

Agency conflict occurs due to information asymmetry. This information asymmetry occurs when managers have relatively more internal firm information and get information relatively quickly than external parties, such as investors and creditors. Therefore, corporate governance mechanism is needed to overcome agency conflict that occurs in a firm.

The number of audit committee members owned by the firm can be used for corporate governance measurement (Tarus and Ayabei, 2016). Audit committee is a mechanism for monitoring to alleviate agency problems. The higher of audit committee shows that the firm has good corporate governance.

POJK Number 55 of 2015 Article 1 paragraph 1 explains that the audit committee is corporate governance mechanism that formed by the board of commissioners whose responsibility are helping the task or duties owned by the board of commissioners. Continued in Article 10, the audit committee has the duty and responsibility, one of which is to conduct a review of the financial information to be issued by the issuer to

the public and / or authorities. The reviews made by audit committee including financial statements, projections and other reports of public company.

An increasing audit committee member support the firm in achieving good corporate governance. The task of audit committee is assisting the duties of commissioners in monitoring the performance of the board of directors. According to Salipadang et al. (2017), the audit committee's role is to supervise the audit of financial statements and to ensure that the financial statements comply with regulations so information asymmetry between the firm and external parties can be minimized.

The greater audit committee cause creditors to trust more to provide loans to firms with more accurate financial statements because it will reduce uncertainty about the return of interest and principal of debt. Therefore, firms with an increasing number of audit committee members can obtain external funds more easily because creditors feel that the firm's financial information is more accurate (Detthamrong et al., 2017).

Capital structure decisions can also be influenced by the tenure of the CEO who is leading the firm. The CEO has the responsibility to lead, direct, coordinate, control and oversee the implementation of general policies, regulations and operational tasks of the firm in accordance with the vision, mission, business goals and strategies that are applied. CEO tenure in Indonesia varies greatly and this can affect the level of debt.

If CEO's tenure getting longer, it will make the level of debt in the firm higher. A CEO who has a longer tenure makes the CEO more confident and bolder in taking risks from the use of debt (Orens and Reheul, 2013). Longer CEOs have more knowledge and skills in managing debt. Therefore, creditors will increasingly trust the firm led by the CEO with a longer tenure.

Research conducted by Tarus and Ayabei (2016) examined CEO tenure as a moderating variable in the relationship between audit committees and capital structure. The longer the CEO has served in a firm will cause the positive effect of audit committees on the capital structure will be weaker. This is because firms

are less dependent on their corporate governance in obtaining debt because the role of corporate governance will be replaced by the CEO with a longer tenure. The longer the CEO has served in a firm, the more creditor will believe in providing loan to the firm and less take into account whether the firm to be given the loan has good corporate governance or not. This is because creditors give confidence to the CEO who has long served because the CEO's experience in managing debt is longer.

Besides the main factors previously explained, other factors that can affect the capital structure are the age and the size of the firm. Research that examines the relationship of the number of audit committee on capital structure with CEO tenure as a moderating variable is still rarely a concern of researchers in Indonesia. Therefore, the purpose of this study was conducted to determine the effect of audit committees on capital structure with the moderation effect of CEO's tenure in manufacturing firms listed on the IDX from 2013 to 2017.

Literature review and Theoretical Concept

Capital Structure

Capital structure is a mix of the use of debt and equity in funding firm assets (Tarus and Ayabei, 2016). The measurement commonly used to calculate capital structure of the firm is financial leverage (Detthamrong et al., 2017). Financial leverage shows the level of use of financial resources that causes a fixed cost, in the form of debt which causes interest cost (Sudana, 2015: 180). Total debt to total assets ratio is a measurement that commonly used for measure financial leverage (Detthamrong et al., 2017; Setiawan and Syarif, 2019). Therefore, the measurements used to measure capital structure of the firm is ratio of total debt to total assets.

Corporate Governance

Corporate governance is commonly interpreted as a group of rules governing the relationship among the parties related to the firm: shareholders (both majority and minority shareholders), the directors or management that

lead the firm, creditors, government, employees, and stakeholders who have a relation to their rights and obligations (FCGI, 2001). Good corporate governance needs to be implemented properly and correctly by the firm because it can increase shareholder value in the long run. In Indonesia, corporate governance uses a two tiers system, meaning that the firm has two separate bodies between the board of commissioners who perform supervisory and advisory positions and the board of directors who performs managerial functions.

Audit committee

Audit committee is regulated in POJK Number 55 of 2015 about how it was formed and the basis for the work of the audit committee. POJK Number 55 of 2015 Article 1 paragraph 1 explains that the audit committee is described as the committee responsible for, and formed by, the board of commissioners that help their duties and functions.

Article 4 explains that audit committee member in the public firm must consists of at least 3 (three), all members may come from independent commissioners (parties that have no correlation to the firm, directors, other commissioners and controlling shareholders) and other parties outside the firm.

According to Detthamrong et al. (2017), the audit committee formed by commissioners to ensure that financial statements of the company follow the financial accounting standards so the financial statements that will be presented to external parties are correct.

CEO Tenure

The Chief Executive Officer (CEO) is someone who holds the highest position in the firm's operational activities, responsible for strategic plans and decisions and as a liaison between internal and external parties. The CEO tenure shows how many years the CEO has served in the analyzed firm (Morellec, 2012).

The term of office of the CEO is stipulated in POJK Number 33 of 2014 Article 3 paragraph 3 which explains that 1 period of a member of the board of directors is no more than 5 years or until the closing of the annual GMS at the end period.

Members of the board of directors are elected for a specified period and can be re-appointed (UUPT Number 40 of 2007 Article 94).

**Hypothesis Development
Audit Committee and Capital Structure**

There are several good corporate governance principles. One of the five principles in Good Corporate Governance is the principle of accountability (KNKG, 2006). This principle explains that the firm must be able to account for its performance reliably and transparently. The existence of an audit committee can help companies achieve the principle of accountability.

Larger size of the audit committee will improve the quality of the financial statements and provide access to greater resources, thus provide more effective monitoring. Managers will be increasingly supervised when the firm has many audit committees. The probability of managers doing deviant actions (expropriation) will be smaller. It will be easier to get external financing when the firms have more members of the audit committee because the firms have a reliable financial report and better performance, so the lenders will be more confident in lending that firms (Detthamrong et al., 2017).

According to Anderson et al. (2014), creditors will provide a lower cost of debt to the firms with more audit committee members because creditors believe the firms have more transparent financial statements. Creditors also believe that the firm is well managed and monitored so that the firm can repay debt and interest better. This causes firms to be increasingly interested in increasing the use of debt in funding their investments.

H₁: Audit committee has a positive effect on Capital Structure

Effects of CEO Tenure as a Moderating Variable on the Effect of the Audit Committee on Capital Structure

The influence of the audit committee on capital structure can be influenced by the length of time the CEO has served in a firm. The longer the CEO has served in a firm will cause the

positive effect of audit committee on the capital structure will be weaker. The longer CEO in a firm will cause the CEO to be more confident to take on debt because of the experience he has in managing more debt (Orens and Reheul, 2013).

CEOs who have served longer in the firm are considered to have greater experience in fields relevant to the firm's business so they can provide better and more comprehensive strategic decisions. When the firm is led by a CEO with a longer tenure, it will cause creditors to trust more in providing loans because creditors do not take into account whether the firm has good corporate governance or not, which is reflected in the number of members of the audit committee. This is because creditors have given their trust to the CEO who has long tenure because the CEO's experience in managing debt is longer.

H₂: CEO tenure weakens the positive effect of the audit committee on the capital structure

II. RESEARCH METHODS

The secondary data are used in this research. Secondary data is primary data that has been processed before. The data in the study were obtained from Indonesia Stock Exchange (Bursa Efek Indonesia). In this study, manufacturing firms are the population that listed in Indonesia Stock Exchange (IDX) for 2013-2017 period, all of the firms are the object to be selected by purposive sampling in representing the population.

The analytical model used in this study is multiple linear analysis and moderated regression analysis. Testing of the analysis model is carried out to determine how the effect of audit committee members on capital structure that is moderated by CEO tenure and controlled by firm size and firm age. Furthermore, the data process has been done by SPSS. Model to examine the hypothesis in this study are:

Model 1:

$$TDTA_{i,t} = \alpha + \beta_1 AUCOM_{i,t} + \beta_2 SIZE_{i,t} + \beta_3 AGE_{i,t} \tag{1}$$

Model 2:

$$TDTA_{i,t} = \alpha + \beta_1 AUCOM_{i,t} + \beta_2 TEN_{i,t} + \beta_3 (AUCOM * TEN)_{i,t} + \beta_4 SIZE_{i,t} + \beta_5 AGE_{i,t} \quad (2)$$

Where:

- α = Constant
- $TDTA_{i,t}$ = Capital structure firm i in year t
- $AUCOM_{i,t}$ = Audit committee firm i in year t
- $TEN_{i,t}$ = CEO tenure firm i in year t
- $SIZE_{i,t}$ = Firm size firm i in year t
- $AGE_{i,t}$ = Firm age firm i in year t
- $\beta_1 \dots \beta_5$ = Regression coefficient
- $e_{i,t}$ = Error firm i in year t

Table 1. Research Variables and Measurement

| | Measurement |
|--|---|
| Capital Structure (Detthamrong et al., 2017) | $TDTA_{i,t} = \frac{\text{Total Debt}_{i,t}}{\text{Total Assets}_{i,t}}$ |
| Audit Committee (Detthamrong et al., 2017) | $AUCOM_{i,t}$ = Number of Audit Committee _{i,t} |
| CEO Tenure (Morellec, 2012) | $TEN_{i,t}$ = Current year _{i,t} - Year became CEO _{i,t} |
| Firm Size (Setiawan and Rachmansyah, 2019) | $Size_{i,t} = \ln(\text{Total Assets})_{i,t}$ |
| Firm Age (Thanh, 2017) | $AGE_{i,t}$ = Research year _{i,t} - Establish year _{i,t} |

III.RESULT AND DISCUSSION

This study used secondary data from manufacturing firms listed on the Indonesia Stock Exchange for 2013-2017. This research uses 250 observations (exclude outlier data). Table 2 showed a statistical description of the research sample. The regression results from panel data processing are shown in table 3, and parameter values can be estimated, which shows the effect of the independent variables on the dependent variable.

Table 2 bellow gives an overview of the overall characteristics of the sample. Capital

structure (TDTA) in this study has a maximum value of 92% which gives the highest value of capital structure. The minimum value of TDTA of 7% determines the lowest value of capital structure.

Table 2. Descriptive statistics results

| | N | Min | Max | Mean | Standard Deviation |
|-------|-----|-------|-------|-------|--------------------|
| TDTA | 250 | 0.07 | 0.92 | 0.38 | 0.17 |
| AUCOM | 250 | 2 | 5 | 3.04 | 0.40 |
| TEN | 250 | 1 | 37 | 10.03 | 8.43 |
| SIZE | 250 | 25.62 | 33.10 | 28.17 | 1.54 |
| AGE | 250 | 4 | 86 | 34.16 | 13.10 |

Based on the table 3, the panel data regression test result from the manufacturing firms that has been sampled can be explained as follows:

Table 3. Panel data regression test results

| Dependent Variable: Regression: Analysis Model: | TDTA | |
|---|----------------------------|-----------------------------|
| | MLR | MRA |
| | (1) | (2) |
| Intercept | -0.246 (0.277) | -0.689*** (0.002) |
| AUCOM | 0.061** (0.024) | 0.175*** (0.000) |
| TEN | | 0.059*** (0.000) |
| AUCOM*TEN | | -0.017*** (0.001) |
| SIZE | 0.020** (0.022) | 0.019** (0.017) |
| AGE | -0.002* (0.056) | -0.001 (0.131) |
| Observation | 250 | 250 |
| R-Square | 0.070 | 0.256 |
| F-Statistics | 4.636*** (0.001) | 13.953*** (0.000) |

***Significant at 1%level, ** Significant at 5% level,
* Significant at 10% level

Hypothesis 1

Audit committee has a significant positive effect on capital structure (coefficient 0.061 with a significance <5%). The significance value of audit committee as an independent variable is below a significant level. It means **H₀ is rejected, while H₁ is accepted**. This shows that if the number of audit committee members in the firm increases, the debt level owned by the firm will be higher.

The results of this research are supported by Tarus and Ayabei (2016), which shows that there is a positive relationship between the audit committee and the capital structure. The audit committee makes the quality of the firm's financial statements more transparent, more accurate, and trustworthy (Detthamrong et al., 2017). This is considered good by creditors as a consideration in providing loan to the firms.

The audited financial statements provide additional important information about credit risk for creditors to the firm to be given a loan. Therefore, the more members of the audit committee, the firm can obtain external funds more easily with lower debt costs because the firm has more transparent financial statements (Anderson et al., 2014).

Hypothesis 2

Interaction between audit committee (AUCOM) and CEO tenure (TEN) has a significant negative effect on capital structure (coefficient -0.017 with a significance <1%). **This result accept H₂.** CEO tenure weakens the positive effect of the audit committee on the capital structure.

On the creditor side, the decision to make a loan does not take into account how many members of the audit committee the firm had when the firm was led by the CEO with a long tenure. Creditors will be more confident in providing loan to the firm with a longer CEO tenure because the ability of the CEO is better so that the role of the number of audit committee member will be replaced by the CEO with a longer tenure.

CEO who has long served in a firm shows that the CEO has longer experience in managing the firm. The CEO is also believed to be able to manage resources better because he has known the characteristics of the firm for a longer time and has better access to firm information. A CEO who already has experience leading a firm will be judged to be more able to improve firm performance.

A longer CEO may cause the firm to be less dependent on the merits of corporate governance. This is because CEO who have long tenure has

confidence and courage in taking risks from the use of debt (Orens and Reheul, 2013). This causes the role of corporate governance to be replaced by the CEO with a longer tenure.

Effect of control variables on capital structure

Firm size (SIZE) has a significant positive effect on capital structure. These results are consistent with research conducted by Sheikh and Wang (2011). Larger firms have lower financial difficulties and bankruptcy risks. Firms with lower financial difficulties can obtain debt more easily at low cost because creditors believe the firms are able to repay their debt well (Lardon et al., 2017). This will attract firms to increase their use of debt in funding their investments.

Firm age has a significant negative effect on capital structure in model 1. The results support the research of Kieschnick and Moussawi (2018). A firm that has long been established has a lower debt level because the firm has a low growth rate and the firm already has accumulated internal funds in a longer timeframe (Lardon et al., 2017). Therefore, compared with the use of funds from external sources through debt, old firms tend to use internal funds.

IV.CONCLUSION

This research was conducted to determine the effect of corporate governance proxied by audit committee on the capital structure with CEO tenure as moderating variables. The results from this study showed that the number of audit committee members have a significant positive effect on capital structure. The more members of the audit committee, the higher the level of debt in the firm. Furthermore, CEO tenure weakens the positive effect of the audit committee on the capital structure.

The results can help the firms to pay attention to the corporate governance and CEO tenure because they can affect the firm's capital structure policy. In addition, creditors need to pay attention to the number of audit committee members in making lending decisions to the firms.

Limitation of this study lies in the use of

samples that only manufacturing firms on Indonesia Stock Exchange (IDX) and this study only use audit committee as corporate governance mechanism. Next study may include non-financial firms and other corporate governance mechanisms. Better sample might represent population characteristics. the greater level of confidence desired, the more samples are needed. Suggestions for future researchers to add factors that affect capital structure so that the analysis can provide more accurate inference.

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