The Role of Audit Committee and Risk Monitoring Committee on Firm's Hedging Practice

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ABSTRACT

This study aims to analyze the role of audit committee and risk monitoring committee (RMC) on firm risk management measured by hedging. Firm with both committee will have better governance in monitoring risk. The population of this study is companies listed in IDX. This study uses samples of 104 non-financial companies. Using panel data regression, we found that composition of audit committee members that have financial and/or accounting background have a significantly positive effect on hedging, means that audit committee with higher such a composition will encourage firm to hedge more to reduce risk exposure. Meanwhile meetings and size of audit committee is insignificant. The presence of RMC has a negatively significant effect on firm hedging, means that firm is more capable in identifying risk to determine the most appropriate way to mitigate risk, where not all risk can be mitigated by hedging.

Keywords: Audit Committee; Risk Monitoring Committee; Hedging

e-ISSN 2302-8556

Vol. 33 No. 10
Denpasar, 31 Oktober 2023
Hal. 2675-2685

DOI:
10.24843/EJA.2023.v33.i10.p10

PENGUTIPAN:
Zafira, A. P., & Hermawan, A. A. (2023). The Role of Audit Committee and Risk Monitoring Committee on Firm's Hedging Practice. *E-Jurnal Akuntansi*, 33(10), 2675-2685

RIWAYAT ARTIKEL:
Artikel Masuk:
12 Juni 2023
Artikel Diterima:
23 September 2023

Peran Komite Audit dan Komite Pemantau Risiko Terhadap Praktik Hedging Perusahaan

ABSTRAK

Penelitian ini bertujuan untuk menganalisis peran komite audit dan komite pemantau risiko (RMC) terhadap manajemen risiko perusahaan yang diukur dengan hedging. Perusahaan dengan kedua komite tersebut akan memiliki tata kelola yang lebih baik dalam memantau risiko. Populasi penelitian ini adalah perusahaan yang terdaftar di BEI. Penelitian ini menggunakan sampel sebanyak 104 perusahaan non keuangan. Dengan menggunakan regresi data panel, ditemukan bahwa komposisi anggota komite audit yang memiliki latar belakang keuangan dan/atau akuntansi berpengaruh positif signifikan terhadap lindung nilai, artinya semakin tinggi komposisi komite audit maka perusahaan akan semakin banyak melakukan lindung nilai untuk mengurangi eksposur risiko. Sedangkan jumlah rapat dan ukuran komite audit tidak signifikan. Kehadiran RMC berpengaruh signifikan negatif terhadap lindung nilai perusahaan, artinya perusahaan lebih mampu mengidentifikasi risiko untuk menentukan cara yang paling tepat dalam memitigasi risiko, dimana tidak semua risiko dapat dimitigasi dengan lindung nilai.

Kata Kunci *Komite Audit; Komite Pemantau Risiko; Lindung Nilai*

Artikel dapat diakses : https://ojs.unud.ac.id/index.php/Akuntansi/index

INTRODUCTION

Every company from various industries will be exposed to business risks that can affect the company's operations and performance. Companies need to carry out management strategies that can reduce the adverse effects of risk or can be called risk management. Hedging is one of the actions taken by companies to carry out risk management. Hedging is a way or technique to reduce risks that arise or are expected to arise due to price fluctuations in financial markets (Bank Indonesia, 2013). The instruments used for hedging are derivatives, while the forms can be foreign exchange hedges, interest rate hedges, and commodity hedges (Eiteman et al., 2016). Strong corporate governance mechanisms, either by effective monitoring or by providing appropriate incentives, encourage managers to pursue optimal hedging activities that are consistent with maximizing shareholders' wealth (Sikarwar, 2022).

From any type of risk that is exposed to one firm, some may only affect one specific firm. On the other hand, some risk can only be exposed to a specific industry or market. There are three area that have potential for escalate company risk management, namely 1) incorporating risk management thinking into the strategic planning process; 2) clearly defining the function of risk management; and 3) implementing it within the company (Servaes et al., 2009). Therefore, it is important to know the company's risk exposure to find out the most appropriate way to overcome it.

One of the ways for companies to implement risk management is by hedging with derivative instruments (forward and future contracts, swaps, and options). When hedging is used properly, it can reduce risk and increase the value of the company, but if it is not used wisely, it can bankrupt even large companies (Smith, 1998). A firm's cash flow, especially to a multinational company, is very sensitive to changes in exchange rates, interest rates and commodity prices. Hedging requires company to take a position -assets, contract, or derivative- whose value will increase or decrease by offsetting the decrease or increase in the value of the existing (Eiteman et al., 2016). Hedging decisions are made by top management such as board of directors and supervised by the board of commissioners assisted by the audit committee and management risk monitoring committee as part of the corporate governance mechanism. Hedging is also required to be recorded in financial statements. So, companies that have oversight from the board of commissioners and committees tend to use derivatives to protect currency exposure and overcome expensive external (Lel, 2012).

In a perfect condition, shareholder as an owner act as a "principal" and management contribute as an "agent" that is responsible for running the company in accordance with the interests of shareholders. Therefore, agents have authority to decide within the company that will affect the shareholders as the principal. Managers may not always act in the best interest of shareholders when corporate control is separate from ownership (Bonazzi & Islam, 2007). This situation makes firm experience agency risk which happen when agent act in their own interests, not shareholders'. To govern agency risk and other firm risk exposure, firms implement corporate governance as a part of risk management. This corporate governance is supervised by the Board of Commissioners as the supervisory organ of the Board of Directors and company management. According to the Financial

Services Authority Regulation Number 33/POJK.04/2014, in carrying out its supervisory duties and responsibilities towards management, the Board of Commissioners is required to form an Audit Committee and may form other committees, such as nomination and remuneration committee and risk monitoring committee.

The Audit Committee is one of the main components in the corporate governance mechanism that forms the basis of stakeholder expectations in limiting the behavior of company managers (Gendron & Bédard, 2006). There are three main components in determining the effectiveness of the audit committee, namely composition, authority, and resources (Dezoort et al., 2002). Combining members who can provide valuable insights to the committee with members who have better knowledge and experience can produce a team that has high (Bromilow et al., 2011). For the audit committee to work effectively, the company must determine the resources needed, such as the number of meetings for a year, the number of audit committee members, and the educational background of the members (Bromilow et al., 2011; Dezoort et al., 2002). In Indonesia, the provisions of the audit committee are regulated in POJK 55/POJK.04/2015. This regulation requires an audit committee to have at least 3 (three) members with 1 (one) member have accounting or finance educational or career background and carry out 1 (one) meeting every 3 (three) months.

The Risk Monitoring Committee is one of the committee under supervision of Board of Commissioners. Based on regulations in Indonesia, this committee is not mandatory for non-financial companies. According to National Committee on Governance Policy who recommend this committee, Risk Monitoring Committee contribute to supervising the risk management strategy, beyond the role of the audit committee, which ultimately plays an important role in the interests of the company's shareholders. This study will further analyze the role of the Risk Monitoring Committee in companies in Indonesia.

In the field of risk management, this paper will focus on Audit Committee and Risk Monitoring Committee, as a part of company corporate governance in monitoring risk. In banking industries, the existence of this committee proved to have a significant impact financially by in increasing the effectiveness of banking risk management as indicated by a decrease in banking BOPO and NPL (Center for Risk Management & Sustainability, 2013). Most of previous literature, specifically in Indonesia, only discuss the importance of risk monitoring committee in the scope of banking industry (Center for Risk Management & Sustainability, 2013; Muafiki & Ismiyanti, 2023) and financial reporting and audit fees (Annabelle & Eriandani, 2021). This study makes unique contributions using panel data regression which provides new evidence about the role of risk monitoring committee on firm risk management through hedging in Indonesia non-financial firm. Moreover, this research complements recent literature that highlights the significance of audit committee characteristics on hedging.

Our first hypothesis is to test whether committee characteristics have an effect on firm hedging. A bigger size of audit committee may not be too efficient to implement. Besides adding cost, the smaller size of audit committee facilitates the transfer of information to be more effective. Communication between members can be more difficult in a big size of audit committee (Tai et al., 2020). However, having more than 3 members can expand experience with expanding audit committee authority (Bromilow et al., 2011). If managed well a combination of more members could gather more insight for the committee which lead to better effectiveness and knowledge. Based on previous findings, size of audit committee also has positive effect to financial disclosure (Setiany, 2018) and reduce of exchange risk (Sikarwar, 2022). Therefore we hypothesize that there is a positive effect of audit committee size to firm hedging.

H_1: Audit committee size positively affects firm hedging.

Audit committee must hold an annual meeting atleast 4 times a year to make sure exchange of information is effective (OJK, 2015). It is impossible to do an effective monitoring when audit committee is not active (Menon & Deahl Williams, 1994). Committee that holds meetings more frequently and independently have a lower probability of earning management (Vafeas, 2005), so that audit committee meetings can be used as a monitoring mechanism for financial decisions or corporate financial reporting (Setiany, 2018). Audit committee meetings makes the committee easier in evaluates and exchange information about risk management. Thus, this study formulates the following hypothesis.

H_2: Audit committee meetings positively affect firm hedging.

Certain qualifications and competencies are required to become part of the audit committee. Apart from being regulated in POJK, member who have an accounting or finance competency is important so that the audit committee can carry out its duties effectively to assist the board of commissioners to the fullest (Krishnan & Lee, 2009). Members of audit committee that have competency in accounting and/or finance will be more effective in conducting supervision because they have experience and also previous education in handling hedging. In addition, this background suitability is in accordance with the characteristics of an effective audit committee (Bromilow et al., 2011; Dezoort et al., 2002). Thus, we hypothesize following.

H_3: Competency of audit committee members affect firm hedging.

In Indonesia, risk monitoring committee is not obligated for non-financial and non-governed own companies. However, in 2021, the National Committee on Governance Policy through General Guidelines for Corporate Governance in Indonesia suggest firms to have a risk monitoring committee. The presence of risk monitoring committee considered capable of improving effectiveness of risk management (Ali et al., 2017), quality of hedging information (Hassan et al., 2012), and monitoring of management decisions (Abdullah & Ku Ismail, 2015). In line with previous literature, risk monitoring committee should help firm with monitoring risk management therefore increase firm hedging. Therefore, this research formulates following hypothesis.

H_4: The existence of risk monitoring committee has a positive effect to firm hedging.

RESEARCH METHOD

This study use firm listed in Indonesia Stock Exchange as a population. The empirical test is based on data non-financial firm from IDX (Indonesia Stock Exchange) during the period of 2015 – 2021. Based on purposive sampling, we exclude firms where the annual report is unavailable during the period or have missing variable data. The final sample has 770 observations, which represent 110 firms during the 7-year sample period. First, we collect all financial and accounting data Thomson Reuters Eikon. Then we collect hedging and risk monitoring committee data from firm's annual report using key words such as "risk management", "hedging", etc., and hand collect the data. Finally, we hand collected the data on characteristics of audit committee from the firm's annual report.

We use hedging as primary dependent variable. Variable measurements use natural logarithm of firm's total hedging (LNHEDGE), which common to use in finance research to mitigate high skewness from data. The sum of the notional principal amount of derivatives held for hedging scales is used to measure firm's total hedging (Ameer & Alam, 2010; Chowdhury et al., 2023; Sikarwar, 2022; Tai et al., 2020). These derivative contracts include derivatives for hedging foreign currency, commodity prices, and interest rate exposure.

The primary independent variables are the characteristic of audit committee, include the number of audit committee members (ACSIZE) (Bromilow et al., 2011; Chan & Li, 2008), the number of audit committee meetings per year (MEET) (Setiany, 2018), and audit committee competency (ACCOMP) measured by percentage of audit committee member with accounting or finance background (Lestari & Wardhani, 2015; Setiany, 2018) and existence of risk monitoring committee (RISKCOM) which equal to one for firm with risk monitoring committee and zero otherwise (Abdullah & Ku Ismail, 2015).

To control other factors that could affect firm's hedging, we use four control variables. The first one is firm size, which influences managerial decisions to implement operational hedging because smaller firms may not have the resources to manage international facilities (Chow & Chen, 1998; Dunning, 1980; Luo & Wang, 2018) and may have significant impact on firm's hedging because it can serve as a proxy to bankruptcy cost or financial flexibility (Tai et al., 2020). Firm size measure by natural logarithm of firm's market capitalization (Chowdhury et al., 2023; Luo & Wang, 2018; Sikarwar, 2022). Next is firm growth opportunities measured by firm PPE to total asset (Geczy et al., 1997; Tai et al., 2020). Firms with higher growth opportunities will have more opportunity to use derivative hedging. Leverage is also used to control firms' hedging, measured by dividing long term debt with total asset (Sikarwar, 2022; Ullah et al., 2021). Firm with high proportion of debt tend to hedge more, because of high cost of financial distress (Sikarwar, 2022). Lastly, the proportion of institutions holding company shares increases with the quality of corporate governance (Chung & Zhang, 2011) and have a big incentive for supervise managers effectively (Gillan & Starks, 2000).

Data were analyzed using panel data multiple linear regression. Chow, Breusch Pagan LM, and Hausman test were conducted first to determine which regression model will be use between fixed effect model, random effect model, and common effect model. Hypothesis testing with multiple linear regression analysis is formulated as follows.

$$LNHEDGE = \alpha + \beta_1 MEET_1 + \beta_2 ACSIZE_2 + \beta_3 ACCOMP_3 + \beta_4 RISKCOM_4 + \beta_5 SIZE_5 + \beta_6 FARATIO_6 + \beta_7 LEV_7 + \beta_8 INSOWN_8 + \varepsilon \quad \ldots\ldots\ldots\ldots\ldots\ldots (1)$$

Note:
LNHEDGE = firm hedging
MEET = Audit committee meetings per year
ACSIZE = Member of audit committee
ACCOMP = Competency of audit committee
RISKCOM = The existence of risk monitoring committee
SIZE = firm size
FARATIO = Growth opportunities
LEV = leverage
INSOWN = insider ownership

RESULT AND DISCUSSION

There are 728 observations, across 104 firms. Sample consist of 10 industry listed in Indonesia Stock Exchange. Table 1 shows sample distribution categorized based on industrial classification. Basic materials have the highest number of firms that did hedging during sample period. Meanwhile, none of the firms from healthcare and transportation & logistics industry hedge during 2015 – 2021.

Table 1. Sample Distribution

Industrial Classification	No. of firms	% of firms	No. of hedging	% of hedging
Basic Materials	18	17,3	9	23,1
Consumer Cyclical	20	19,2	6	15,4
Consumer Non-Cyclical	17	16,3	8	20,5
Energy	11	10,6	4	10,2
Healthcare	3	2,9	0	0,00
Industrials	8	7,7	4	10,3
Infrastructure	9	8,7	3	7,7
Property & Real Estate	12	11,6	4	10,2
Technology	2	1,9	1	2,6
Transportation & Logistics	4	3,8	0	0,00
Total	104	100%	39	100%

Source: Research Data, 2023

Descriptive statistical analysis of this study shown in Table 2. On average, there are 3,12 members of audit committee with 77% of audit committee members having competency in accounting and/or finance. The minimum value of audit committee indicates that there are atleast one audit committee member have competency required by Indonesia's regulation. Audit committee in Indonesia conducted yearly meetings 7.66 times on average. The risk monitoring committee average is 0.12 shows that most of the firm doesn't have risk monitoring committee.

Next step is to select model through Chow test, Breusch Pagan LM test, and Hausman test. Chow test results provide p-value of 0.000 means that fixed effect model is the best model. Breusch Pagan LM test provide p-value of 0.000 and conclude that random effect model is the best model. This result aligns with

Hausman test result that provides p-value of 0.17. To conclude, random effect model is the best model for this research. Random effect model is able to produce an estimator with BLUE criteria (Gujarati & Porter, 2008), so this research does not require classical assumption test.

Table 2. Descriptive Statistics

Variable	N	Mean	Std Dev	Min	Max
Hedging (in million $)	728	55,94	272,1	0	2.993
Member of Audit Committee	728	3.12	0,44	2	6
Competency of Audit Committee	728	0,76	0,23	0,33	1
Audit Committee Meetings	728	7,66	7,16	2	75
Risk Monitoring Committee	728	0,12	0,33	0	1
Firm size	728	19.44	1.91	14.87	24.22
Growth opportunities	728	0,40	0,25	0,001	1,88
Leverage	728	0,16	0,14	0	0,80
Institutional Ownership	728	0,21	0,15	0	0,77

Source: Research Data, 2023

Table 3. Hypotheses Test Results

Variables	β	z	P>|z|
Audit Committee Meetings (MEET)	-0,001	-0,04	0,485
Member of Audit Committee (ACSIZE)	0,101	-0,20	0,420
Competency of Audit Committee (ACCOMP)	2,61	2,53	0,005***
Risk Monitoring Committee (RISKCOM)	-1,68	-1,46	0,073*
Firm size (SIZE)	0,48	2,37	0,09*
Growth opportunities (FARATIO)	0,72	0,57	0,285
Leverage (LEV)	6,37	3,47	0,000***
Institutional Ownership (INSOWN)	0,55	0,30	0,380
C	-6,51	-1,52	0,065*
Prob > chi2	0,001		
R-Squared	0,083		

Source: Research Data, 2023

This table shows random effect model regression of 728 Indonesia non-financial firm from 2015 – 2021 with hedging as dependant variable. MEET calculated by number of audit committee meetings, ACSIZE is total number of audit committee members, ACCOMP measured by the composition of audit committee member with accounting and/or finance background. RISKCOM shows the existence of risk monitoring committee (1 if firm has risk monitoring committee, 0 if not). Firm size, growth opportunities, leverage, and institutional ownership is a control variable which measure by natural logarithm of market capitalization, PPE/ total assets, long term debt / total assets, and percentage of institutional ownership. *,**,*** shows degree of significance at 10%, 5%, and 1%.

The results of hypothesis test are presented in Table 3. There are two variables significantly affecting firm's hedging: competency of audit committee (p-value = 0,005) and existence of risk monitoring committee (p-value = 0,073). Based on the regression results, competency of audit committee is proven to increase firm's hedging. Meanwhile, the existence of risk monitoring committee has opposite directions means tend to reduce firm's hedging. Thus, this finding supports H_3, but does not support H_1, H_2, and H_4. The result of control variables shows that leverage and firm size affect firm's hedging.

The result in Table 3 shows that audit committee meeting does not affect firm's hedging. Findings show difference with earlier research by Tai et al. (2020), who use S&P 500 firms as a sample. Meetings of audit committee can be use as a governance mechanism for firm financial decision or financial reporting (Setiany, 2018). Difference result in this research may occur because not all meetings is dedicated to hedging, considering audit committee responsibilities not limited to hedging.

According to previous literature, audit committee with more members can more efficiently supervise firm's management (Tai et al., 2020) and expand experience and responsibility (Bromilow et al., 2011). On the other side a large audit committee have a potential to reduce focus during meetings, complicate communication, and increasing cost (Bromilow et al., 2011; Chan & Li, 2008; Tai et al., 2020). In the sample data, there are 20% of the firm that have more than 3 members of audit committee. Most of it reduce the number of member back to 3 members, this indicates that 3 members of audit committee still considered as the optimal number for a non-financial firm in Indonesia.

Composition of audit committee have a significant affect on the firm's hedging. According to Indonesia's policy, atleast one member of audit committee need to have accounting and/or financial background. Member with such competencies can consider firm financial risk exposure effectively because of their prior experience and/or prior education. Competency is important so that audit committee could effectively do their responsibilities (Bromilow et al., 2011; Dezoort et al., 2002; Krishnan & Lee, 2009). Dionne & Triki (2005) found that audit committee with a financial background have more influence on the company's risk management than audit committee members with an accounting background. Hedging is a corporate strategy where there is a risk of loss in its use if the company is unable to apply effective and appropriate hedging. The competence of the audit committee is important to consider because it can provide more detailed and appropriate related input and views so that it can implement more effective hedging.

The existence of risk monitoring committee negatively affects hedging, meaning we reject H_4. This result differs from previous similar literature who use disclosure of hedging activity as sample and found it insignificant (Abdullah & Ku Ismail, 2015). Negative correlation between risk monitoring committee and hedging shows that the presence of risk monitoring committee is reducing firm hedging. Firms with risk monitoring committee are assumed to have higher capabilities of risk management monitoring because the function of risk monitoring is already focused on one special committee. Risk monitoring committee helps firm more effectively identified risk and choose the most appropriate mitigation strategy, where not all risks can be solved by hedging. On this basis, companies that have a risk monitoring committee may choose another path, besides hedging, in carrying out risk management. Lastly, the control variable result shows that only firm size and leverage have significant effect on hedging.

CONCLUSION

This research investigates the role of audit committee and risk monitoring committee on firm's hedging. Results show that only competency of audit committee members and existence of risk monitoring committee affect hedging. Audit committee members who have accounting and/or financial background can give a broader perspective to hedge and implement successful hedge, thus have positive effect on hedging. Meanwhile the existence of risk monitoring committee reduces firm's hedging by choosing other risk management strategy options and avoid hedging.

The limitations of this research include hedging result and the method used to measure audit committee's competencies. This study does not consider the results of the hedging and only calculates the amount of the hedge notional value. The derivative instrument used for hedging makes have zero-sum game nature so there is a possibility that the company's hedge will experience loss. Apart from that, further research can consider the results of hedging carried out by the company to deepen the research analysis. This study uses information gathered from annual reports to measure audit committee's competencies, which may not reflect the real competency of the members and can be subjective. Future research should use other approach to measures audit committee members competency, such as survey or interviews.

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