THE INFLUENCE OF BUSINESS STRATEGY, CORPORATE GOVERNANCE AND FIRM CHARACTERISTICS TO THE RISK DISCLOSURE ON THE SMALL AND MEDIUM ENTERPRISES

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DECLARATION OF ORIGINALITY

I, Nadhilla Mazaya, hereby declare that this thesis is real and accurate to be my own work initially written for the partial requirement to complete Undergraduate Program of Accounting, and has not been presented on any other occasion before. I bear full responsibility for my undergraduate thesis.

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MOTTO AND DEDICATION

“ Alla h does not lay a responsibility on anyone beyond his capacity. In his favor shall be whatever good each one does, and against him whatever evil he does.[...]

-Qs. Al-Baqarah: 286

“Always try your best in every situation, the result will not betray your efforts”

-Anonymous

I dedicate this undergraduate thesis for:

My Father, Badrul Fadhil
My Mother, Erlina Ramli
My Sister, Keumala Filzahira
My Family
And All My Friends
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ABSTRACT

This study aims to examine the influence of business strategy, corporate governance and firm characteristics to the risk disclosure. Each factor can be extended to several variables, which are the barriers to entry, cost leadership, board of commissioner size, ownership concentration, liquidity, industrial profile and auditor type. Hence, this study examines those variables to the risk disclosure.

Total sample used in this study are 96 samples which collected from 2008 until 2015. The samples are companies which listed in Indonesian Stock Exchange and incorporated in PEFINDO 25 Index. The criteria of the sample are conducted using purposive sampling method. This study used multiple regression analysis to examine the influence of business strategy, corporate governance, and firm characteristics to the risk disclosure.

The result of this study shows that there is an influence from barriers to entry, board of commissioner size, ownership concentration, industrial profile and auditor type to the risk disclosure. However, cost leadership and liquidity are proven to not have an influence to the risk disclosure. The result of this study is expected to give contribution for further research, government, the management of the company and investor about the risk disclosure practices.

*Keywords: Risk Disclosure, Business Strategy, Corporate Governance, Firm Characteristics*
Penelitian ini bertujuan untuk menguji pengaruh strategi bisnis, tata kelola perusahaan dan karakteristik perusahaan terhadap pengungkapan risiko. Faktor-faktor tersebut dapat diperluas menjadi beberapa variabel, yaitu hambatan masuk, kepemimpinan biaya, ukuran dewan komisaris, konsentrasi kepemilikan, likuiditas, profil industri dan jenis auditor. Oleh karena itu, penelitian ini menguji variabel-variabel tersebut terhadap pengungkapan risiko.


Hasil penelitian ini menunjukkan bahwa ada pengaruh dari hambatan masuk, ukuran dewan komisaris, konsentrasi kepemilikan, profil industri dan jenis auditor terhadap pengungkapan risiko. Namun, biaya kepemimpinan dan likuiditas terbukti tidak berpengaruh terhadap pengungkapan risiko. Hasil penelitian ini diharapkan dapat memberikan kontribusi untuk penelitian lebih lanjut, pemerintah, manajemen perusahaan dan investor mengenai praktik pengungkapan risiko.

*Kata Kunci: Pengungkapan risiko, Strategi bisnis, Tata kelola perusahaan, Karakteristik perusahaan*
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CHAPTER I

INTRODUCTION

1.1. Background

Financial statements that provide information used by company’s internal and external users are one of the statements contained in the annual report. The company’s management uses financial statements to evaluate the company’s performance, making decisions, and planning the strategies for the company’s future performance to achieve its goals. External users such as investors use the information in financial statements to assess the amount, time and uncertainty of cash flow in the future; while, suppliers use the information in it to assess the likelihood of the payment of company's debt when due (Warren, Reeve, and Duchac 2009). Other external users are creditors, supplier, government, customers, and society. However, the needs for the information in financial statements are different among these parties as the elements of the financial report are different.

Aside from the financial statements, there are other reports contained in the annual report in which a company might need to disclose as well. These reports extended the information regarding the company’s performance. Eccles et al., (in Mokhtar and Mellett 2013) stated that companies are required not only to report their activities but also to report the risks around the company as well as their ability to manage it. Companies try to satisfy stakeholder need by disclosing more information regarding company’s risks and the sustainability of its operation (Elzahar and Hussainey 2012). There is a strong demand to report corporate risk
among the institutional investors in order to improve portfolio investment decisions (Solomon et al. 2000). Investors assess various risks that the company’s face so that their portfolio investment decisions will be taken based on expected return and risk considerations (Cabedo and Tirado 2004). Moreover, shareholders and stakeholders have drawn more attention to the importance of risk related information due to the companies' failures (P. Linsley, Shreves, and Kajüter 2008; Solomon et al. 2000).

Since companies require disclosing the risk information, they need a framework and regulations in order to satisfy the accounting information user. Global investor and financial analysts will face less likely difficulties in using the reports that use the same accounting language (Cheong and Gould 2012). Therefore, several bodies of regulators tried to find the most suitable regulations for the risk disclosure. In 1997, Securities and Exchange Commission (SEC) announced the disclosure requirements of the market risk on the derivative instrument (Mokhtar and Mellett 2013). However, these reporting requirements cover only a small portion of risks and dominated by the financial risk; therefore, Institute of Chartered Accountants in England and Wales (ICAEW) issued standard guidelines for a comprehensive approach to risk disclosure in 1997 (Cabedo and Tirado 2004). ICAEW listed the company that should provide reliable information about various types of risks so the user of financial statements may assess the company risk profiles.

The process of regulating standards for improving the risk disclosure continues discussed. As a result, In 2009, International Accounting Standards Board issued an exposure draft for global reporting standard entitled International
Financial Reporting Standard (IFRS) (Mokhtar and Mellett 2013). IFRS is then used in almost every companies in more than hundred countries as a guideline not just for risk disclosure but also to other reporting standards (Cahyonowati and Ratmono 2012).

IFRS regulates standard accounting policies among which is IFRS regulation no.7. IFRS no.7 regulates about the financial instrument and the nature and the extent of the risks arising from financial instruments. IFRS no.7 needs to apply by entities within the scope of IAS 39 and entities with any kinds of financial instrument. In Indonesia, IFRS’ no.7 is adopted by Ikatan Akuntan Indonesia (IAI) to Indonesian Financial Accounting Standard (PSAK) no.60. Since PSAK no.60 adopted the IFRS no.7 it regulates the same issues with adjustments to the Indonesian condition (Ikatan Akuntan Indonesia 2010).

Even though the regulation has been issued, the disclosure of the company’s risk still lacking. The quality and quantity of risk reporting disclosure are not positively affected by the adoption of IFRS (Oliveira, Rodrigues, and Craig 2011). Researches indicate that the information regarding risks and uncertainties in financial statements are inadequate (Cabedo and Tirado 2004; Schrand and Elliott 1998). Companies carefully disclose risk information to prevent that information become a counterattack for them. According to Roulstone 1999 (in Mokhtar and Mellett 2013), the disclosure of risks among companies is vague and difficult to understand. Moreover, most companies only give a small brief and statements on their controls environment and risk surrounded (Kendrick 2000). As a result, both
stakeholders and shareholders may not receive relevant information to satisfy their needs (Mokhtar and Mellett 2013).

Management and other internal parties are responsible for identifying the surrounding risk of the company. Therefore, the risk information tend to be more widely known by the internal of the companies, which led to the emergence of the information asymmetries between internal and external parties (Hendriksen and Van Breda 1991). This information asymmetries can trigger a crisis for investors, creditors, and other parties because it would be difficult to assess the company’s risk (Rahman 1998).

The company was able to reduce the information asymmetry by implementing a system known as Corporate Governance. Corporate governance is a set of mechanism intended to reduce the agency risks resulting from the information asymmetries (Ashbaugh, Collins, and LaFond 2004). It increases the protection for stakeholders by minimizing opportunistic behavior of managers (Siagian, Siregar, and Rahardian 2013). Therefore, manager’s opportunistic behavior is limited and their activity will be monitored. They have no option but to disclose the information need to be published for the stakeholders’ interest. As a result, the implement of corporate governance led to a better risk disclosure.

A company’s business strategy needed to be based on risk consideration. Strategy and risk are related as a flip side in a coin because strategy requires some level of risk-appetite since risk impact in every objective of both financial and non-financial strategy map (Smart et al. 2015). Furthermore, companies need to
associate strategy and risk to prevent the risk will harmed the companies. Risk in the business world is seen as catastrophes (Smart et al. 2015). Risk generally associated as a bad news for the companies. Therefore, management tends to hold bad news to prevent the shock to the value of the company’s stock (Rigoglioso 2012). Through a good business strategy, companies are more likely disclose risk information because; A good business strategy minimizes the occurrence of risk (Porter 1980).

Another factor that could lead to a better risk disclosure is the company’s characteristics itself. Company’s characteristics vary depending on how a person views the company. For example, financial characteristics, industrial characteristics, corporate culture, etc. Each of those characteristic contains different information. Such information might help accounting information user to assess the future risk of the company (Abraham and Cox 2007). The quality of this disclosure made the company looks desirable not just for the investor but also to the capital market regulators (Laidroo 2009).

This research tried to implemented studies from Mokhtar and Mellet (2013) in Indonesia, but focusing on the Small and Medium Enterprise (SMEs). The difference is that this research uses the annual report on 2008 to 2015. The reason for choosing the year 2008 until 2015 is because, within the length of time, Indonesia is facing three steps before fully implemented IFRS into the PSAK (Lestari 2013). IFRS is adopted to increase the level of financial reporting in Indonesia. Since IFRS is principle based, the quality of financial statement should be increased (Lestari 2013). However, there are many arguments whether adopting
IFRS truly increased the quality of accounting information or not (Cahyonowati and Ratmono 2012). Hence, the researcher is interested in examining the risk disclosure during this period.

The list of companies collected from PEFINDO 25 INDEX 2016 period August 2016 to January 2017. This index launched on 18 May 2009 under the cooperation between IDX and PT Pemeringkat Efek Indonesia (PEFINDO) for Small and Medium Enterprises (SMEs) with good fundamental performances and liquidity. The reason for choosing the SMEs is because the prior researchers examine the risk disclosure on most likely on large and small companies. Those researchers stated that large companies tend to disclose more information than the smaller companies do (Amran, Bin, and Hassan 2009; Oliveira, Rodrigues, and Craig 2011). Whereas, there is other classified of a firm that is Small and Medium Enterprises (SMEs). There are SMEs that have go public and are required to report the risks because their share is available in the securities market (PT Bursa Efek Indonesia 2016). In the academic journal, there only a few researches which, focus on the risk disclosure among SMEs that have go public.

This research eliminates two independent variables from Mokhtar (2013) research that is role duality and firm size. Role Duality is not relevant to Indonesian situation as regulated in Law no. 40 year 2007 about the incorporated company. Moreover, this research eliminates firm size because the sample is collected from an index that it did not disclose information which company considered as small or medium enterprises.
1.2. Problem Formulation

A number of researchers had discussed risk disclosure. Researchers like, Amran, Bin, and Hassan (2009); Oliveira, Rodrigues, Lima, and Craig (2011); Elzahar and Hussainey (2012); Mokhtar and Mellett (2013), had published their research about risk disclosure. However, the results among them probably indicate a research gap; inconclusive or contradictory result among the same variables in different research (Dissanayake 2013). Researches by Amran, Bin, and Hassan (2009) and Oliveira, Rodrigues, Lima, and Craig (2011) stated that firm size and industrial profile are the main determinants of risk disclosure. However, other researchers conclude different results. Researches by (Beretta and Bozzolan 2004; Amran, Bin, and Hassan 2009; Mokhtar and Mellett 2013) indicates there is a non-significant association between firm size and risk disclosure. Meanwhile, Beretta and Bozzolan (2004), Konishi and Ali (2007), Amran, Bin, and Hassan (2009) and Mokhtar and Mellett (2013) research results indicate that industrial profile has no impact on risk disclosure. Auditor types found to have a positive significant relationship with risk disclosure (Oliveira, Rodrigues, and Craig 2011; Mokhtar and Mellett 2013) while liquidity found to has a nonsignificant association to risk disclosure (Mokhtar and Mellett 2013).

As time goes by, the numbers of risk disclosure issues are increased. Since the public perceptions of risk are increased, the number of risk disclosure issues becomes more rather than less (P. M. Linsley and Shrives 2006). Investor thinks they received not enough information of risk disclosure (Rajab and Schachler 2009). Another view from Buckby, Gallery, and Jiacheng (2015) stated that there
have been criticisms about the inadequate or inaccurate of a company’s disclosure, particularly to the risk management activities. Even in Indonesia, researchers found that the level of risk disclosure is still low compared to other countries (Siagian, Siregar, and Rahardian 2013; Probohudono, Tower, and Rusmin 2013, 2011).

Based on the previous explanation, the quality and level of risk disclosure are still lacking even though risk disclosure has an important role for both internal and external parties of the companies. According to Laidroo (2009), the poor quality of risk disclosure is caused by poor theoretical literature. Whereas, improving risk disclosure increases the stable environment for investment activities (Rajab and Schachler 2009); which can draw more investor to invest in the company. Hence, this research tried to fulfill the research gap through these questions:

1. Do barriers to entry influence company’s risk disclosure?
2. Does cost leadership influence company’s risk disclosure?
3. Does the board of commissioner size influence company’s risk disclosure?
4. Does the ownership concentration influence company’s risk disclosure?
5. Does the liquidity influence company’s risk disclosure?
6. Does the industrial profile influence company’s risk disclosure?
7. Does the auditor type influence company’s risk disclosure?

1.3. Research Objectives

This study aims to examine several factors that affecting companies to disclose the risk and their ability to manage it. It is important to identify the factors that determine risk disclosure in company’s annual report (Mokhtar and Mellett
Among all the factors, many researchers believe that there are main factors affecting risk reporting which explained in next chapter (Amran, Bin, and Hassan 2009; Abraham and Cox 2007; Oliveira, Rodrigues, and Craig 2011; Mokhtar and Mellett 2013). Therefore, the research objectives are:

1. To examine the influence of barriers to entry to the risk disclosure
2. To examine the influence of cost leadership to the risk disclosure
3. To examine the influence of board of commissioner size to the risk disclosure
4. To examine the influence of ownership concentration to the risk disclosure
5. To examine the influence of liquidity to the risk disclosure
6. To examine the influence of industrial profile to the risk disclosure
7. To examine the influence of auditor type to the risk disclosure

1.4. Contributions of Study

As shown before, there are many studies of risk disclosure. However, the result is still questionable. Through this research, the researcher hopes this study could contribute and fulfill the previous research gap. The contribution of this study is based on background, problem formulation, and research objectives. There are several contributions, which stated as follow:

1. For researchers, this study is expected to give a contribution to the effect of company’s strategy, corporate governance and firm characteristics on risk disclosure study of the SMEs in Indonesia.
2. For the government and the regulator, the result of this study is expected to give information about the implementation of risk disclosure regulation among the companies, and as a continuous improvement on risk disclosure regulation.

3. For the management of the company, the result of this study is expected to encourage management’s attention to improve their ability in disclosing the risk.

4. For investors, the result of this study is expected to help investors knowing about SMEs risk disclosure and to help make decisions about their willingness to invest in the company.

5. For society, the result of this study is expected to give knowledge about the extent of company transparency to reporting risk.

1.5. **Structure of the Study**

**CHAPTER I : INTRODUCTION**

This chapter consists of background, problem formulation, research objectives, contributions of study and structure of the study. Background explains about the general problem, research gap and this research difference to the prior research. Problem formulation explains about the problem arising from the background. Research objectives explain about the purpose of this research. The contribution of the study is expected to help people to know the extent of company transparency to reporting risk. Lastly, the structure of the study explains about each chapter that existed in this study.
CHAPTER II: LITERATURE REVIEW

This chapter consists the theories and concepts used in the study. This chapter also explains and summarizes the prior research. Based on the theories, concepts and prior research, this chapter developed the hypothesis used in this study.

CHAPTER III: RESEARCH METHODOLOGY

This chapter consists of research variable and operational definition of the variables, type and source of data, population and sample data collecting method, research object and data analysis.

CHAPTER IV: RESULTS AND DISCUSSIONS

This chapter explains about the description of research object, data analysis and the study of hypotheses test result and its interpretation.

CHAPTER V: CONCLUSIONS AND SUGGESTIONS

This chapter draws conclusions from the analysis result. This chapter also consists the research implications, the limitation of the study and suggestions for the future research.