CHAPTER II
LITERATURE REVIEW

2.1 Agency Theory

Agency theory can be defined as the relationship between shareholders (the principal) and the management of a corporate (the agent). According to Jensen and Meckling (1976), the agency relationship can act as a contract in which individuals or groups (the agent) are being engaged by the other persons (the principal) to give or to perform some services on their interest and the agent will assign the principal to delegate decision making liberty in terms of sustainability of the organization.

Most of agency relationship will incur positive monitoring and bonding costs (monetary and non-monetary) between principal and the agent (Jensen and Meckling,1976). It is also expected that the management's (agent's) decision will maximize the welfare of the shareholders (principal). Since the relationship between the stockholders and the managers of a corporation fits the definition of a pure agency relationship, it should come as no surprise to discover that the issues associated with the "separation of ownership and control" in the modern diffuse ownership corporation are intimately associated with the general problem of agency. Companies should seek to minimize these situations through solid corporate policy. The role of corporate governance is also important to minimize the problem. When the problem encountered, the risk in the company will be well-managed.

The decision making authority that agents have can lead them manage the risk within the company. However, in managing risk-taking decision, it is not only the agent can deal with it. The principals (shareholders) also have influence to the corporate risk-taking (Faccio, Marchica, & Mura, 2011). As what Koerniadi *et al* (2014) stated, large shareholders can facilitate a higher rate of risk-taking decision of the firm. It is exactly beneficial that the large shareholders, with high level of funding, will increase the level of corporate risk-taking because with the high risk that they took, the agent will be motivated to perform better every period of time.

Haider and Fang (2016) stated in their research that board of directors' role in the company is to reduce the problem arise from the agency theory between the shareholders and the management by monitoring, supervising and evaluating the leading executives. By monitoring the executives, it is expected that the risk management will avoid them from excessive risk-taking behavior.

In the other study, Eling and Marek (2014) believed that the relationship between shareholders and managements can be aligned with compensation schemes. When shareholders provide the managers with high bonus, it triggers the executives to manage high risk. It leads to positive correlation between level of compensation over the business risk.

Jermias & Gani (2014) asserted in their study that based on the agency theory view, it assumed that audit committee with a regular meeting and qualified members have controlling role toward the boards' behavior. Besides, the agency theory also assumed that a strong audit committee can manage an organization to

distinguish themselves with others through improving risk-taking behavior (Connelly *et al.*, 2011). The existence of audit committee expected can minimize the conflict of interest in agency theory by controlling boards' behavior within firms.

As Jensen and Meckling (1976) studied in their paper, there might be agency problems arise in the agency theory where the managers who act as the agent engage the activities of decision making on behalf of their self-interest instead of satisfying the principal (shareholders). When the managers make a decision for their own benefit, it might trigger the conflict of interest between the principal and the agent. It will lead the stakeholders that in charge with the operations of the company, hard to manage the risk-taking decision.

2.2 Corporate Governance

Corporate governance is the method of regulations, applications and processes in which a company is led, monitored and supervised. Corporate governance has to care about company's stakeholders, such as investors, board of directors, board of committee, customers, suppliers, creditors, government and the community. Besides, corporate governance also gives the basic concept for attaining a company's objectives.

Komite Nasional Kebijakan Governance/KNKG (2006) stated that good corporate governance is one of the economics market system's pillar. It has a strong dependence of credibility either to the organization that implement the good corporate governance or the markets within the country itself. The

implementation of good corporate governance enforces a good competition among organizations and also creates a conducive market.

The concept of good corporate governance has become a good issue to be discussed in recent years. In early 1990s, USA has already initiated the concept of good corporate governance by publishing the good corporate governance principles. The principles were arranged by Organization for Economic Cooperation and Development (OECD). KNKG (2006) stated that there are 5 principles that should be implemented by the company in order to fulfill the good corporate governance, which are transparency, accountability, responsibility, independency, and fairness.

Firstly, the principle is transparency. It gives understanding that the company should be objective in doing the business, has to provide material and relevant information that is accessible and understandable to the stakeholders. The information that provided by the company has to be prepared timely, clearly, accurately and comparably so that the stakeholders can access it easily. The company should disclose the information, but not limited to, the vision, mission, business target and company's strategies, financial condition, boards' structure and compensation, controlling shareholders, risk management system, internal control and monitor system, GCG implementation system, and significant events that can affect the company's condition.

The second principle is accountability. The company has to keep the responsibility of its performance fairly and transparently. Thus, the company has

to be managed properly and measurably so that it can fulfill the stakeholders' needs. To be considered as accountable, the company should determine the job lists and responsibility of all the stakeholders within company's structure clearly and in line with the vision, mission, corporate values, and the strategies. The company should ensure that all the stakeholders within company's structure have the ability in doing the job, responsibility, and their roles in the implementation of good corporate governance.

Then, responsibility is also one of the principles of the good corporate governance. The company has to follow the regulations and be responsible to society and the environment so that the good business environment can be maintained. The company should implement social responsibility by considering the society interests and environment sustainability.

The fourth principle of good corporate governance is independency. The company has to be managed independently so that the company's bodies cannot be predominated and intervened by the other parties. In the implementation, the company's bodies have to avoid a domination by other parties, are not affected by particular interests, are free from conflict of interest and all pressures so that the decision making can be taken objectively.

The fifth principle is fairness. In doing the business, the company has to consider the interests of shareholders and other significant stakeholders based on the fairness values. The company should give fair and equivalent treatment to stakeholders in accordance with the benefits and the contributions that the

company gets. The five principles have to be fulfilled by the company to implement the good corporate governance.

Based on a study done by Venuti & Alfiero (2016), there are several governance mechanisms that have already been controlled the relationship between principals and agents in agency theory. The mechanism is divided into internal mechanisms and external mechanisms. The internal mechanisms supervise the matrix of the organization's activity and correct the actions when the organization jump out from the goals. Some of the internal mechanisms are the characteristics of the board of directors, managerial compensation, insider ownership, debt and dividend policies, and large block holders. Meanwhile, the next terms are included as the external mechanisms, which are financial analysts, investors protection, legal environment, and threat of takeover. The researcher took consideration into internal mechanisms since the objective of the research is to study the effect of corporate governance, which some of the internal mechanisms affected by the agent-principal relationship (agency theory). Meanwhile, the external mechanisms did not get affected that much by the theory used in this research.

In the other studies, it stated that corporate governance mechanisms are essential and need to be considered as the factor in designing regulation as it influences the firm risk-taking (Eling & Marek, 2014). Besides, corporate mechanisms affect the executives' risk-taking preference and also firm risk which is relevant to owners and policyholders.

Generally, there are already many studies about the analysis of the effect of corporate governance to the company's performance. However, the study about the effect of corporate governance itself to firm risk-taking is still few (Venuti & Alfiero, 2016).

2.3 Risk-Taking

Risk-taking is any consciously, or non-consciously controlled behavior with a perceived uncertainty about its outcome, and/or about its possible benefits or costs for the physical, economic or psycho-social well-being of oneself or others (Trimpop, 1994). The definition refers to conscious and non-conscious behavior, outcome and consequence uncertainty, benefits and losses, intrinsic and extrinsic rewards, individual and societal risks, and the subjective experience of risk.

The dimensions of risk-taking differentiated between physical, monetary, ethical, and social dimensions. Trimpop (1994) stated in his book that the two dimensions of ethical and social will be dealt with combined as psycho-social risk taking, referring to aspects of pride, emotional experience, self-esteem, etc. The physical risk taking dimension refers to injuries, as well as positive physical experiences, such as feeling relaxes and adrenalin highs. Meanwhile, monetary risk taking will be referred to as economic risk-taking and includes any material gain or loss. Since this research covers the economics issue of risk-taking, the monetary dimension can represent this research. The researcher used the concept of risk-taking based on the volatility of firm–level earnings that studied by John *et*

al. (2008). John assumed that riskier corporate operations have more volatile returns to capital.

Younas & Zafar (2018) in their study believed that corporate risk-taking is operationalized as value enhancing investment. It is known that not all risks a tend to be undesirable and that favorable risks tend to reduce the uncertainty and come up with positive returns on investments (Stulz, 2015). As studied by Younas *et al.* (2017), though it is not that simple in measuring risk as *ex ante*, it is known that better risk management will closely relate to good governance structure of a corporate, i.e. concentrated ownership structure and better capital regulations. The statement is supported by Faccio *et al.* (2011), they observed the effect of big shareholders' ownership on risk-taking of firms and concluded that diversified institutional ownership structures are more tendentious toward higher risk-taking as compared to non-diversified large shareholders. However, to control the exaggerated behavior of corporate risk-taking, an Act called Sarbanes Oxley Act (SOX) was published in USA in 2002. In the SOX, it regulates the provision on additional internal controls that suggested to safeguard the shareholders' interests from excessive corporate risk-taking behavior.

2.4 Audit Committee

Audit committee here refers to the auditor working in a certain company. Based on the *Komite Nasional* Good Corporate Governance (2002), audit committee objectives are to independently supervise the process of financial statement and external audit, to control the risk management in a company and also the good corporate governance. The audit committee in Indonesia is consist

of at least three members and chosen by independent commissioner. The official IIA in Bender (2007) stated that audit committee helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes. It argued that the audit committee's role is to mitigate if there are potential problems and also recommend ways in improving risk management and internal control. Then, a regulation in section 407 of SOX requires that an IPO company has to disclose at least one of the audit committee members is a financial expert (Bargeron, Lehn, & Zutter, 2010).

The agency theory assumed that a strong audit committee with qualified members and effective meetings has contributed a good control over directors' behavior (Jermias & Gani, 2014). However, the result of some studies are still varied on audit committee. For example, Jermias and Gani (2014) found that there is a negative association between audit committee and risk-taking. Elamer *et al.,* (2018) found that there is negative and insignificant effect of audit committee to risk-taking. However, A study done by Sun and Liu (2014) believed that audit committee effectiveness toward risk management in monitoring executives has been increasing in the scope of not only financial risk, but also non-financial risk.

2.5 Ownership Concentration

Ownership concentration refers to the amount of stock owned by individual investors and large-block shareholders (investors that hold at least 5 per cent of equity ownership within the firm). Nguyen (2011) found that there is a positive correlation between ownership concentration and idiosyncratic risk in

Japanese firms. The result showed that the more concentrated ownership the higher the return will be delivered. Another study from Rossetto and Stagliano (2015) showed that high ownership concentration can reduce firms' risk. However, the results found that there is a consideration of no other block holders. With block holders inside, the results in their study positively affect the firms' risk. Therefore, in this case, the higher concentration of the ownership that corporates have, they will be able to manage the risk that they take. In vice versa, the corporate risk-taking will be lower due to the low ownership concentration within the firms.

2.6 Board of Director Size

Board of directors' size refers to the total number of directors on the board of the firms which is inclusive of the CEO and Chairman for each accounting period. The board of directors' size here will include outside directors, executive directors and non-executive directors. According to Venuti & Alfiero (2016), the larger the board of directors' size which means the higher total number of executive directors, non-executive directors and outside directors within the firm, the less risk the firm would take since larger board finds more difficult to converge to very risky projects. They argued that the smaller board of directors' size will take riskier in the decision making. A study by Haider and Fang (2016) to the firms in China also showed that the larger the number of boards of director had led to low risk-taking issue. From the statements, it can be argued that negative correlation between the board of directors' size and risk-taking within the firms can arise.

2.7 Managerial Compensations

Managerial compensations here refer to the both financial and non-financial compensation that managers get as a repayment from the service that they did for the firms. It can be in terms of bonuses, benefits, shares or call option on the firm's stock and also mixture of salary. According to Eling and Marek (2014), in a free market with utility-maximizing managers, managers work for companies in which they receive the highest utility. In this case, the level of compensation will be positively correlated with business risk. The higher probability of losing a job due to insolvency calls for higher compensation. Thus, the managers with higher compensation will take higher risks for the company.

2.8 Table of List of Previous Study

No.	Authors, Year, and Title	Research's Variables	Research Goals	Research Methodology	Research Findings
1.	Francesco Venuti; Simona Alfiero, 2016, The impact of corporate governance on risk taking in European insurance industry	Dependent Variable: Industry risk taking Independent Variables: Publicly traded & privately traded, ownership concentration, board of directors compensations, size of the board, gender diversity of the board, board nationality, company dimension, technical reserves, profitability, part	To develop an empirical research on the nature and consequences of corporate governance on Eurozone Insurance Industry risk taking attitude.	Regression model.	The results provide quite strong evidence that, coherently with the Agency Theory, publicly traded insurance companies with more concentrated ownership are less risky than the corresponding privately held. Most of the findings provide negative significant correlation except for company dimension and technical reserves

No.	Authors, Year, and Title	Research's Variables	Research Goals	Research Methodology	Research Findings
		of a group, international activity			that provide positive significant correlation
2.	Nguyen Pascal, 2011, Corporate governance and risk-taking: evidence from Japanese firms	Dependent Variable: Corporate risk-taking Independent variables: Family control, ownership concentration, and bank control	To examines the influence of corporate governance on the risk taking of Japanese firms.	This research uses correlation matrix, descriptive statistics and regression model.	The results showed that family control and ownership concentration are associated with higher idiosyncratic risk, whereas bank control has the opposite effect, which means a negative correlation.
3.	Martin Eling; Sebastian D. Marek, 2014, Corporate governance and risk taking: evidence from the U.K. and German insurance markets	Dependent variable: corporate's taking risk Independent variables: compensation, monitoring, blockholder, size, country, type(life), type(nonlife), type(reinsurance), accounting standard	To analyse the impact of factors related to corporate governance (i.e., compensation, monitoring, and ownership structure) on risk taking in the insurance industry	A structural equation model.	Higher levels of compensation, increased monitoring (more independent boards with more meetings), and more block holders are associated with lower risk taking which means it is significant negative. Our empirical results provide justification for including factors related to corporate governance in insurance regulation.
4.	Koerniadi, Hardjo Krishnamurti, Chandrasekhar Tourani-Rad, Alireza, 2014,	Dependent variable: firm risk taking Independent variables: Block holders, Board of	To analyze the impact of firm-level corporate governance practices on the riskiness of	Regression model.	Research findings show that block holding has positive and statistically significant impact

No.	Authors, Year, and Title	Research's Variables	Research Goals	Research Methodology	Research Findings
	Corporate governance and risk-taking in New Zealand	director size, ownership concentration	a firm's stock returns in a setting that can be considered as less conducive to managerial risk-taking.		on risk taking and also consistent with the view that smaller board of director sizes are associated with higher risk-taking. Finally, concentrated shareholding by insiders is associated with lower levels of risk-taking.
5.	Wen-Yen Hsu; Pongpitch Petchsakulwong , 2010, The Impact of Corporate Governance on the Efficiency Performance of the Thai Non-Life Insurance Industry	Dependent variable: Efficiency Performance Independent variables: Board independence, diligence, firm size, audit committee size, board tenure, board age, board ownership	To examines the relation between corporate governance and efficiency performance of public non-life insurance companies in Thailand over the period 2000–2007	Used truncated bootstrapped regression model.	The results show that the board independence, diligence, and firm size have a positive impact on the efficiency performance of the Thai non-life insurance companies. However, audit committee size, diligence, divergence between voting rights and cash flow rights, board tenure, board age, as well as board ownership have a negative impact on the efficiency performance.
6.	Huang, Ying	Dependent	To investigates	Regression	The results of the

No.	Authors, Year, and Title	Research's Variables	Research Goals	Research Methodology	Research Findings
	Sophie Wang, Chia Jane, 2015, Corporate governance and risk-taking of Chinese firms: The role of board of director size	variable: corporate risk taking Independent variables: board composition	the systematic relationship between board of director size and firm's risky policy choices.	model.	study indicated that firms with smaller boards experience larger variability in future firm performance which will affect the higher risk taking of those corporate.

2.9 HYPOTHESIS FORMULATION

Based on the agency theory, a higher manager compensation will affect the higher risk-taking that the company gets. It is known that the incentives paid to Chief Executive Officer (CEO) to maximize shareholders value tends to motivate them in doing excess risk-taking (Bolton *et al.,* 2015). Besides, it is also expected that the higher compensation that the manager gets will motivate them not only take more risks, but also can enhance the value of the firm itself (Venuti & Alfiero, 2016). Their results also found that there is positive and significant relationship between managerial compensations and company's risk-taking. Accordingly, the researcher expects that the managerial compensation has a positive correlation to the corporate risk-taking. The hypothesis suggested that the higher the compensations that key management received, the higher the risk that company will deal. On the other side, lower compensations tend to not attract managers in taking more risk since they don't have guarantee for their risk-taking behavior (higher compensations). Thus, the hypothesis developed for this variable is as follows:

H1: Managerial compensation is positively associated with company's risk-taking.

According to the agency theory, lower monitoring activity associated with diffused ownership allows managers to take less firm-specific risks (Nguyen, 2011). Higher ownership concentration meaning that more performance boosting encouragement by the owners on the executives, which eventually forced executives taking more risks to achieve good performance. Empirically, larger shareholders are generally associated with higher performances, even if there are some mixed results (Venuti & Alfiero, 2016). Nguyen (2011) stated that there is a positive correlation between ownership concentration and idiosyncratic risk. The higher concentration and better performance will lead to higher risk-taking levels. Meanwhile, lower concentration which means lower percentage of large shareholders will lead to lower risk-taking levels. The hypothesis built for ownership concentration is:

H2: Ownership concentration is positively associated with company's risk-taking.

Based on the theory developed (agency theory), it assumed that audit committee with a regular meeting and qualified members have a controlling role toward the boards' behavior (Jermias & Gani, 2014). The result of studies by some researchers varies toward audit committee. A study by Jermias and Gani (2014) found that there is a negative significant between audit committee and risk-taking behavior. Meanwhile, Sun and Liu (2014) in their study showed that there

is a positive significant between audit committee members with more additional directorships and risk-taking behavior. Adams and Jiang (2016) found that there is no significant association between the variables. Though the result of the study varied, it is known that the control function of audit committee will give effect to risk-taking within the company. Due to control and supervision of risk management function, the higher audit committee size, which means more control, will lead to lower risk-taking behavior that company had. Otherwise, lower members of audit committee, which means less effective of the control function, will affect to higher risk-taking. Thus, the hypothesis developed based on the theory is as follows:

H3: Audit committee size is negatively associated with company risk-taking.

In agency theory, it is argued that too many members of director resulting in less effective control over risk-taking behavior (Jensen & Meckling, 1976). Baccar *et al.* (2013) argued that large size of board directors will find it hard for them to force managers to control their desires in making a decision over the company. Those managers are affected from their psychological biases. When there are too many boards of director, problems may increase because some directors may tag along as free-riders. A study by Nakano and Nguyen (2012) found out that firms in Japan with a larger number of board of directors perform lower bankruptcy risks, though it is not significant compared to the US firms. Haider and Fang (2016) also examined in their empirical studies in China that board of director size is negatively associated with future firm risks. This indicated that the large size of the board will be less effective and resulting in

lower risks that the boards will take for the company. The small size of board will be more effective in working and thus taking risk is good enough for them to improve the performance of the company. Therefore, the hypothesis for the board of director size in risk-taking is:

H4: Board of director size is negatively associated with company's risk-taking.

2.10 Research Model

The research model developed for this study is as follows:

Figure 2.1