THE EFFECT OF CORPORATE GOVERNANCE, FINANCIAL RATIO, FIRM SIZE AND AUDIT QUALITY ON BOND RATING

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Abstract: *This purpose of this research is to examine the effects of corporate governance, financial condition, firm size and audit quality on corporate bond ratings in Indonesia. Corporate governance is explored in term of institutional ownership, managerial ownership, independent commissioner, and audit committee. Moreover, several accounting ratios including current asset, return on asset, debt to equity, and interest coverage are used to reflect corporate financial condition. Data are collected from PT Pefindo and Indonesia Stock Exchange during 2005 until 2009. The result shows that institutional ownership, managerial ownership, audit committee, return on asset, debt to equity ratio, firm size and audit quality have a significant influence on bond ratings. This finding suggests that the implementation of good corporate governance, maintaining a sound financial condition, firm size and audit quality are very important for getting better corporate bond ratings in Indonesia.*

Keywords: Bond ratings, corporate governance, financial condition, firm size, audit quality.

Abstrak: Tujuan penelitian ini adalah untuk mengetahui pengaruh tata kelola perusahaan, kondisi keuangan, ukuran perusahaan dan kualitas audit terhadap peringkat obligasi perusahaan di Indonesia. Tata kelola perusahaan yang dibahas dalam penelitian ini adalah kepemilikan institusional, kepemilikan manajerial, komisaris independen dan komite audit. Selain itu, beberapa rasio akuntansi termasuk aktiva lancar, *return on asset*, *debt to equity*, *interest coverage* digunakan untuk mencerminkan kondisi keuangan perusahaan. Data dikumpulkan dari PT Pefindo dan Bursa Efek Indonesia selama tahun 2005 sampai dengan tahun 2009. Hasilnya menunjukkan bahwa kepemilikan institusional, kepemilikan manajerial, komite audit, *return on asset, debt to equity ratio*, ukuran perusahaan dan kualitas audit berpengaruh terhadap peringkat obligasi. Temuan ini menunjukkan bahwa penerapan tata kelola perusahaan yang baik, menjaga kondisi keuangan yang sehat, ukuran perusahaan dan kualitas audit sangat penting untuk mendapatkan peringkat obligasi perusahaan yang lebih baik di Indonesia.

Kata kunci: Peringkat obligasi, tata kelola perusahaan, kondisi keuangan, ukuran perusahaan, kualitas audit.

INTRODUCTION

In this study, authors are interested to learn what factors that influence bond ratings. Previous research by Bhojraj and Sengupta (2003) showed that corporate governance is one factor that can affect bond ratings. According to Almilia and Devi (2007), the company's financial condition as reflected in the financial ratios also affects the bond ratings.

Bonds are securities issued by companies as a source of funding. Investors who invest in bonds intended to obtain security in the presence of a certain rate of return. Although the company in financial difficulties, as yields on interest payments to investors' remains to be done. On the other hand, if the company in financial difficulties, the distribution of dividends to stock-holder is not mandatory (Hadianto and Herlina 2011).

Conversely, if the company is in good condition, earnings increase, the company did not give more yields to the bondholder (the bondholders). In this condition, the stockholders are wins. It is extremely important for the bond-holder to know how big the company's ability to repay the loans and interest to investors, because if the company got bankrupt, the bondholder cannot demand their rights. To help answer these problems, all bonds issued by the company must first ranked by independent rating agencies.

Good corporate governance is a rule or mechanism to ensure that management actions directed and controlled to maximize profitability and corporate value in the long term without ignoring the interests of other stakeholders (Indaryanto 2004). Optimal value of the company is expected to provide a better bond rating. The financial statements of the company is also an important instrument for investors, because of the financial statements reflect the company's condition. Measurement of financial statements through financial ratios is a good indicator in assessing the financial health of the company (Harahap 2001).

Institutional ownership is believed to have the ability to monitor the actions of management that is better than individual investors, because of institutional legal entity is considered more skilled and experienced than the individual investor. The amount of institutional ownership show positive relationships with bond rating (Bhrojaj and Sengupta 2003) so it is expected to provide benefits to stakeholders, including bondholders.

One of the important elements of corporate governance is the transparency or disclosure (Setyapurnama and Norpratiwi 2007). Openness is not easy to do if management has an interest and private information that supports their interests. Conditions like this can happen if the companies have management that has contributed as an owner (managerial ownership). The greater percentage of managerial ownership, then it is likely to do little more openness so that the company is more risky, so as to give effect to the bond ratings.

Independent commissioner serves to motivate management to be objective, con-sidering the welfare of all stakeholders, and improve efficiency and performance companies (Setiawan 2009). The existence of independent commissioners is creating a more objective and independent and also maintain "fairness" and able to provide a balance between the interests of a majority stake and the protection of minority shareholder interests, even the interests of other stakeholders. Number of independent commissioners is expected to have significant positive impact on bond ratings (Bhrojaj and Sengupta 2003).

The task of the audit committee is to provide independent professional opinion to the board of commissioners of the report or matters submitted by the directors to the board of commissioners as well as identify issues that require the attention of the board of commis-sioners. If the audit committee duties can be carried out properly, then the opportunist motives of management can be reduced and quality improved financial transparency, so the company has the default risk and low risk agency, which in turn has positive influence on bond ratings (Turley and Zaman 2004).

Liquidity is the company's ability to pay its obligations that must be met. The calculation of this ratio used to measure a company's ability to resolve its short term obligations. This measurement is done through the current ratio. Current ratio is the ratio between total current assets by current liabilities. Profitability ratios are used to measure the effectiveness of the company in obtaining benefits and assess the performance of the company. Return on Assets (ROA) is a ratio used to measure a company's ability in utilizing its assets to earn income (Manurung et al. 2008).

Leverage ratio is used to measure how big the company's assets financed by debt. The balance between the assets financed through debt and equity is one of consideration of external parties to invest (whether in stocks or bonds). Debt to equity ratio is considered to reflect the value of leveraged by the company. The calculation of debt to equity ratio is the percentage ratio between total debt by total capital (equity) owned enterprise (Manurung et al. 2008).

Interest coverage ratio measures the company's earnings to the cost of fixed assets. Measurement can use the times interest earned ratio, which measures the ability of the company's operations in providing protection against long-term creditors, particularly in paying interest. Interest coverage ratio is calculated as the percentage ratio of earnings before interest and taxes with a total of interest payable.

The greater the company's total assets are expected to increasingly have the ability to settle obligations in the future, so that the test results are expected to total assets is positively related to bond ratings. Of all the companies that issue bonds, almost all audited by KAP Big 4, so that based on research Velury et al. (2003) financial statements audited by Big 4 accounting firm is more qualified because of variations in KAP big 4 and non big 4 are very small.

Research Evans et al. (2002) examined the relationship between the structure of corporate governance and reduction in firm performance with a sample of companies in Australia. Research Evans et al. (2002) reported results that there is no statistically significant relationship between the ratio of independent commissioners with company performance. Research Fuerst and Kang (2004) examine corporate governance and operating performance, showed a positive relationship between independent commissioners with the company's performance. Other studies relating to the independent commissioner is the research.

The hypothesis that is used as follows:

H_1 Institutional ownership affects the bond ratings.
H_2 Managerial ownership affects the bond ratings.
H_3 Independent commissioner affects the bond ratings.
H_4 The audit committee affects the bond ratings.
H_5 Current ratio affects the bond ratings.
H_6 Return on asset affects the bond ratings.
H_7 Debt to equity ratio affects the bond ratings.
H_8 Interest coverage ratio affects the bond ratings.
H_9 Firm size affects the bond ratings.
H_{10} Audit quality affects the bond ratings.

METHODS

The sample selection was conducted using purposive non-probability based on random sampling, ie selection of samples by using specific considerations. The criteria used include (1) bonds issued by companies that are not included in the banking industry, finance and insurance, (2) company that issued the bonds and the rating published by PT Pefindo been published before the year of observation and which are not yet due in the year observation, namely January 1, 2005 to December 31, 2009, (3) companies that have financial statements for the period of observation and publish it on the Indonesian Stock Exchange. In this study uses secondary data. Data obtained from PT Pefindo bond ratings, while data on corporate governance; corporate financial ratios derived from financial statements of companies listed in Indonesia Stock Exchange and the Indonesia Capital Market Directory.

Bond rating (RATING) issued by PT PEFINDO a letter. In order to be processed and used in modeling and processed, then do a conversion mechanism to the ratings issued by PT. Pefindo, namely converting the rating in the form of a letter in the digit (Brandon et al. 2004). Here is a table rating issued from conversion of PT Pefindo:

Tabel 1 Conversion of Bond Ratings

Bond Ratings	Scale
AAA+	21
AAA	20
AAA-	19
AA+	18
AA	17
AA-	16
A+	15
A	14
A-	13
BBB+	12
BBB	11
BBB-	10
BB+	9
BB	8
BB-	7
B+	6
B	5
B-	4
C	3
SD	2
D	1

Institutional ownership (INST) is the proportion of shares held by the institution. This variable was measured by comparing the amount of company stock owned by institutions by total shares outstanding (Bhojraj and Sengupta 2003). Managerial ownership (KMANJ) is the amount of shares owned by shareholders from management that actively participate in decision-making company (directors and commissioners).

Independent commissioner (KIND) is the ratio between the numbers of independent commissioners with the number of commissioners. Audit Committee (KAUD) are effective in a company is three people. Measurement of the audit committee in this study using a dummy, which is 0 for the audit committee less than three persons and 1 for the audit committee composed of three persons or more.

Companies are able to meet its financial obligations in a timely manner means that the company has a current asset is greater than the debt smoothness (Almilia and Devi, 2007). Measuring liquidity ratio (CR) using the current ratio, which compares the current assets owned by the company with current liabilities.

Measurement of profitability ratios (ROA) use return on total assets. Return on assets deemed to have a positive effect on earnings growth, because the company ability to produce net income based on the total assets owned enterprise (Almilia and Devi 2007). Measurement leverage ratio (DER) using the debt to equity ratio. If this ratio is quite high, indicating high use of debt, so this could make the company experienced financial difficulties in other words, bankruptcy risk is big enough (Manurung et al. 2008).

Measurement coverage ratio (INTCOV) using times interest earned ratio, which is to measure the ability of the company's operations in providing protection against long-term creditors, particularly in paying interest (Manurung et al. 2008). This ratio is an important indicator for investors who want to buy bonds, to determine the ability of the issuer company in paying the interest. Company size (SIZE) is the total value of wealth owned by the company. This variable was measured by using natural logarithm of total assets. Quality Audit (KA), firm size is used to measure the quality of the audit, if the company audited by KAP Big 4, the quality is high; and if audited by the KAP non big 4, then low audit quality (Siregar and Main 2005).

The method used to analyze the data in this study is to use multiple regression analysis. The model in this study is as follows:

$$RATINGS = \alpha + \beta_1(INST) + \beta_2(KMANJ) + \beta_3(KIND) + \beta_4(KAUD) + \beta_5(CR) + \beta_6(ROA) + \beta_7(DER) + \beta_8(INTCOV) + \beta_9(SIZE) + \beta_{10}(KA) + e$$

RESULT AND DISCUSSION

Table 2 Result of Hypothesis Testing

Variable	B	T	Sig.	Tolerance	VIF
Constant	5,316	1,281	0,201		
INST	-0,020	-3,130	0,002	0,723	1,384
KMANJ	1,480	3,851	0,000	0,854	1,171
KIND	-0,017	-1,542	0,124	0,709	1,410
KAUD	1,813	5,223	0,000	0,892	1,122
CR	-0,002	-0,755	0,451	0,772	1,295
ROA	0,231	6,485	0,000	0,729	1,371
DER	-0,002	-2,131	0,034	0,812	1,232
INTCOV	-2.801E-06	-0,352	0,725	0,982	1,018
SIZE	0,244	1,859	0,064	0,652	1,534
KA	2,421	6,630	0,000	0,810	1,235

Based on Table 2 above, shows the significance value for the institutional ownership variable is 0.002, less than 0.05, so H_1 is accepted. This suggests that institutional ownership significant effect on bond ratings. At the managerial ownership variables, the significant value is 0.000, less than 0.05, so the H_2 is accepted. This shows that managerial ownership significantly influence bond ratings.

In an independent commissioner variable, the significance value is 0.124, greater than 0.05, so H_3 is rejected. This indicates that the independent com-missioner no significant effect on bond ratings. At the audit committee variables, the significant value is 0.000, less than 0.05, so H_4 accepted. This indicates that the audit committee significant effect on bond ratings.

In the current ratio variable, the significant value is 0.451, greater than 0.05, so H_5 is rejected. This indicates that the current ratio does not significantly influence bond ratings. On return on assets variable, the significance value is 0.000, less than 0.05, so H_6 is accepted. This shows that the return on assets significantly influence bond ratings. In the debt to equity ratio variable, the significance value is 0.034, less than 0.05, H_7 is rejected. This shows that the debt to equity ratio signif-ficant effect on bond ratings.

On variable interest coverage ratio, the significance value is 0.725, greater than 0.05, so H_8 is rejected. This shows that the interest coverage ratio not significant impact on bond ratings. The firm size that has significant value is 0.064, less than 0.10, so H_9 is accepted. This suggests that large firms tend to receive higher bond ratings. While audit quality has significant value is 0.000, less than 0.05, so H_{10} is accepted. This shows that companies who use KAP big 4 tends to get a high bond rating.

Ratings of bonds issued by the company is expected to provide guidance for investors about the investment quality of bonds that they are interested in, without doing more calculations in financial ratios. Bond rating is a statement about the state of the bond issuer and the possibility of issuing bonds to meet its financial obligations. Bonds as fixed claims should be considered in order to meet the company's consideration of the various interested parties such as creditors, investors, auditors, and others in making decisions, especially in terms of credit.

The result is expected to be used in managing the company's corporate management. Implementation of good corporate governance (particularly of institutional ownership, managerial ownership and audit committee) would affect bond ratings. Similarly, good company financial ratios (such as profitability and leverage) also affect the bond ratings. In addition, company size and use of the big four accounting firm may affect the bond rating companies. This gives an important role for the company, because a good bond rating would provide separate benefits for the company, given the bond is one important source of funding for the company.

CONCLUSION

Based on hypothesis test, it can be concluded that institutional ownership, managerial ownership, audit committee, return on assets, debt to equity ratio, firm size and audit quality affect have influence on bond ratings. While the independent commissioners, current ratio and interest coverage ratio have not influence on bond ratings.

This study only examined the influence corporate governance, financial ratios, audit quality and firm size on bond ratings. For further research is suggested to add the dependent variable such as bond yield. When investing, investors not only pay attention to bond ratings, but also returns that are obtained (yield). Measurement of financial ratios for further research is suggested to add more variables, such as activity ratio.

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