

CHAPTER 1

INTRODUCTION

The position of Chief Risk Officer, hereafter called CRO, has been gaining popularity since the collapse of mortgage-based financial instruments in 2008. Many people are affected by the broke down of the property bubble, such as people losing their homes, pension, and life savings. The crisis led us to a growing awareness of the importance of risk management techniques and structures within financial organizations. After the economic crisis in 2008, new CROs position has typically emerged at companies that have to deal with industry-specific crises (Vittorio & Rund, 2020). CRO is needed to ensure that the information about the Company's risk exposure reaches the board and is considered while making strategies. According to Deloitte's risk management survey in 2019 (Ruggeri et al., 2019), among US companies that have at least US\$ 500 million in annual sales, 50% of them have CRO to manage second-line risk management functions such as compliance, cybersecurity, health and safety, and operational risk. The report also shows that when CRO is always present in the board meetings, the other senior management leaders have strong or total confidence in the risk data presented at the meeting. It indicates that having a specified position in the C-level for risk management increases the impact where risk can give valuable input in the strategic decision when it is being discussed and made.

In Indonesia, the POJK no.17/2014 has mandated that financial firms have to make Risk Management Committee, hereafter called RMC, as the implementation of integrating the company risk management. The regulation is specified only for financial companies because this sector has more complex risks that could affect the public too, if compared to companies in other industries. RMC has a similar job description to CRO, identifying key risks, assessing the Company's appetite for risks, and measures to recover from unforeseeable crises. The regulation to make RMC is not really appreciated by the business stakeholders as they claimed that having a separate RMC would result in overlapping responsibilities between the RMC and the audit committee (Larasati et al., 2019). The responsibilities of RMC

and the audit committee may seem like overlapping, but the audit committee's primary responsibilities are to supervise and remain independent. They cannot delve directly into the management if things go south. Thus, the existence of RMC is still needed and crucial to mitigate the risk.

However, POJK no. 17 of 2014 article 17 implies that RMC members can have a concurrent position in C-level management. Having a concurrent position means that the RMC member cannot fully dedicate their efforts to analyzing the risks and measures the Company can execute when crises arise. Also, by not designating a place for risk management on the C-level can be implied that the organization is not taking risks as something to be on par with finance, operations, IT, and other C-level management responsibilities despite the same urgency. Companies might be reluctant due to the added costs, but as we are entering rough and unstable times due to the COVID-19 pandemic, having additional measures and manpower to deal with unforeseen risks will be worth it.

Basel Committee has recommended in its 2010 corporate governance practice recommend that RMC led by CRO is responsible for organizing the Enterprise Risk Management (ERM) system, and (Scherbina et al., 2013) show that if CRO reports directly to the board, it shortens the period of reporting, and thus the efficiency of CRO arise. Appointing CRO helps increase the ERM quality by reducing the firm risk (Bailey, 2022; Li et al., 2022). However, the one that is explicitly mandated to the financial institutions in Indonesia is to have RMC, not CRO. The reason behind the financial services authority regulation no.17/2014 mandate on RMC to the financial institution is to integrate the risk that the Company might face due to the complex nature of the industry. RMC must identify risks and make recommendations to the board, including the audit committee, on how to resolve them. The presence of RMC usually indicates a higher quality of risk management disclosure; thus, usually the audit committee corresponds to the risk disclosure by demanding a higher audit quality and resulting in a higher audit fee (Harymawan et al., 2021; Jia et al., 2019; Larasati et al., 2019).

Firm risk is one of the determinant factors that auditor use in proposing audit fees (Widmann et al., 2021). While the existence of a CRO cannot influence the audit committee, it still plays a part in the number of audit fees proposed by the auditors. Auditors evaluate client risk based on client-specific characteristics such as financial condition, corporate governance level, and financial reporting quality. Previous research has found that higher audit fees are associated with higher perceived client risk (Lyon & Maher, 2005; Venkataraman et al., 2008; Yang et al., 2018). The presence of CRO leads to better risk governance as it needs accountability for risk at the highest levels of the organization (Magee et al., 2019). Through more effective risk management, better risk governance can improve risk-adjusted performance. With risk-adjusted performance, the Company is not setting up a goal or strategy with more risk than the Company could handle, thus hypothetically reducing the number of audit fees. Knechel & Willekens (2006) shows that when a company discloses a relatively high level of compliance risk management, audit fees are reduced.

With the logic that reduced risk resulted in a lower audit fee, the existence of CRO should result in a lower audit fee. Recruiting CRO impacts firm risk governance and results in reduced risk and more efficient operational risk (Li et al., 2022). Not only that, the background of CRO can enhance its performance in managing ERM (Magee et al., 2019). So, CROs with adequate educational backgrounds will further lower the audit fee. In this study, the first objective is to obtain empirical evidence on whether CRO existence relates to the amount of audit fee. The second objective is to obtain evidence of whether CRO education background will further influence the audit fee or not.

Several data analysis methods will be used in this study, including Descriptive Statistics, Pearson's Correlation Test, and Fixed Effect Regression. This study used 224 observations from companies listed on Indonesia Stock Exchange from 2011–2020 and categorized in SIC 6 (bank, insurance, and real estate industry). According to the findings of this study, the presence of a CRO on the board of directors is associated with a lower audit fee. On the other hand, CRO expertise did not appear

to be associated with significantly lower fees than variable CRO existence alone. Two-Stage Heckman and Coarsened Exact Matching checks confirm that the result is robust.

This study will contribute to the scholarly literature for the reasons stated above. To begin with, Indonesia has a dearth of research describing how CRO correlates with audit fees. Studies about CRO in general are still understudied because the boom occurred only in the last decade, so hopefully, this study will encourage more researchers to investigate CRO further. Aside from the scholarly contributions, this study could also serve as a basis for companies to consider hiring CROs to improve their risk management.

The remainder of this study is organized as follows: the second chapter discusses the literature and theoretical review that is used as the foundation of this research, which includes audit pricing theory, previous research, the research framework, and hypothesis formulation of the research problem; the third chapter discusses the sample, variables, and methodology used in this study; the fourth chapter presents the results, and the fifth chapter presents the research conclusion.