The influence of good corporate governance on financial distress

Werner Ria Murhadi, Felicia Tanugara, & Bertha Silvia Sutejo
University of Surabaya, Surabaya, Indonesia

ABSTRACT: This study aims to analyze the influence of good corporate governance (GCG) on financial distress. This study also aims to create a bankruptcy prediction model by using historical data from non-financial sector companies listed on Indonesia Stock Exchange (IDX) over the period of 2011 - 2015. This study used quantitative approach by using logistic regression. The final sample used in this study were 337 companies with 1,685 years observation. The study findings suggest that the proportion of independent outside directors, audit opinion, size, and ownership type from the category of good corporate governance are incorporated into the model. All the variables are significant. The results suggest that the accuracy of this bankruptcy prediction model was 99.7%.

Keywords: financial distress, good corporate governance, audit opinion, ownership type

1 INTRODUCTION

In an era of increasingly competitive business competition, a company is required to continuously improve as well as develop all aspects of its business. By doing so, the company can create value for the owners/shareholders and other related parties. Shareholder value is a concept that refers to the company's long-term free cash flow. Successful companies are determined, one of them, by the implementation of good corporate governance in corporate management. According to Black et al. (2006) and Hodgson et al. (2011), the implementation of good corporate governance strengthens company performance. At the same time, these implementations may protect the company against the risk of financial distress (Wang & Deng 2006).

In Shahwan's (2015) study about corporate governance, the principal-agent problem used as separation of ownership and control that can lead to a conflict of interest between the of managers and shareholders. Due to importance of corporate governance, many studies have made significant contributions by investigating the role of corporate governance in minimizing the conflicts of interest between two sides. In the study of Li et al. (2008) in China about the impact of good corporate governance on financial distress, it is argued that most financial failure is caused by poor corporate governance. Meanwhile, the Suntaruk (2009) study in Thailand on good corporate governance to

financial distress states that the main cause of firm's failure comes from financial scandals, such as the firm's mismanagement as the consequence of the management decision that reflects self-serving behavior. Another study by Donker et al. (2009) in Manzaneque et al. (2015) in Spain on the influence of good corporate governance on financial distress reports a conflict between management and stakeholders in times of crisis because managers prefer a short-term strategy in order not to lose their jobs. The special characteristics of corporate governance in Spain (unitary board system and voluntary good governance practices) tend to raise serious agency conflicts in financial distress situations.

Miglani et al. (2014) in Australia and Manzaneque et al. (2016) in Spain showed a significant negative effect of institutional ownership on financial distress. Meanwhile, the study of Manzaneque et al. (2016) analyzed the effect of institutional investors on firm survival. His research points out the effectiveness of corporate governance mechanisms to monitor management and its focus on long-term performance. Institutional investors take an important role to control management. Therefore, the higher the institutional ownership, the more likely the company will experience financial distress. However, Shahwan (2015) in Egypt and Suntaruk (2009) in Thailand found no significant effect on financial distress. This is because the institution has an interest in manipulating the financial statements for various purposes. The

quality of good corporate governance practice in Egypt is low so that the results are insignificant.

Li et al. (2008) in China shows no significant impact of managerial ownership on financial distress. On the other hand, Suntaruk's (2009) study in Thailand shows a significant negative impact on financial distress. When there is low ownership of the management on the company's shares, they would have less incentive to align their goals with the owner's objectives. This is because management is not involved in financial results that are the outcome of their decision. They do not act as owners so they are more likely to pursue their self-interests and sacrifice the welfare of the owner. If management owns large enough shares, management will seek to improve the shareholder's (i.e. themselves) well-being. Therefore, the higher the company's stock ownership by management, the less likely the company is experiencing financial distress.

Li et al. (2008) in China and Miglani et al. (2014) in Australia found that in the company they studied, independent director variable is negatively related to financial distress, Meanwhile, Manzaneque et al. (2016) in Spain shows the negative relations of independent directors on financial distress. Companies with a higher proportion of independent directors can reduce the likelihood of financial distress. Thereby, a higher proportion of the independent directors may lead to lower probability of financial distress.

Li et al. (2008) in China and Miglani et al. (2014) in Australia indicated a positive influence of auditor's opinion on financial distress. The unsatisfactory audit opinion is a negative signal regarding the company's financial status and reflects hidden risks within the company. An unsatisfactory audit opinion leads to a higher probability of financial distress.

Shahwan's (2015) study in Egypt shows a significant positive influence of ownership type on financial distress. The ownership type variable is used as control over the ownership structure and included as a dummy variable taking the value of "1" if the firm is state-owned, and "0" if the firm is not state-owned. In his sample firm, Shahwan found that if the firm is state-owned, the probability of a firm experiencing financial distress increases. This is contrary to Li et al. (2008) study in China which affirms that state-owned enterprises are ideally more efficient. In addition, state-owned enterprises will perform the mission of the government in carrying out the nation's responsibility to serve and meet the public needs that have a greater potential for corruption and it is not a problem if the state-owned enterprise suffers from a loss.

Based on the above exposition, this study will examine the influence of GCG on financial distress, where GCG is measured through institutional ownership, managerial ownership, independent director, audit opinion, and ownership type. While the control variable used is size and leverage.

2 RESEARCH METHODS

This research discussed the influence of GCG on financial distress in non-financial sector companies listed in Indonesia Stock Exchange (BEI) over the period of 2011-2015. Financial distress in this study used the dichotomy of "1" when the company experiencing financial distress, and "0" if not. Institutional ownership was measured by dividing the number of shares owned by the institution by the total outstanding shares. Managerial Ownership was measured by the percentage of shares owned by the management team. Independent Director was measured by the number of independent non-affiliated board of directors. Audit opinion is measured by "1" for unsatisfactory audit result (non-fair without exception) and "0" for satisfactory audit result (fair without exception). The ownership type is measured by "1" if it is State-Owned Enterprise (SOE) and "0" if it is privately owned enterprise. For control variable of firm size, it is measured by using natural logarithm of total assets, while leverage is measured by total debt divided by total assets.

3 RESULTS AND DISCUSSIONS

Table1. Classification Accuracy

Observed		Predicted		
		Financial Distress		
		Non-distressed	Distressed	% Correct
Financial Distress	Non-distressed	1470	1	99.9
	Distressed	3	11	78.6
Overall Percentage				99.7

a. The cut value is .500

A classification table is used to determine the classification accuracy, of 1471 data entered into the non-distress category, there are 1470 data consistent in the non-distress category (99.79%), while the other 3 data are classified into the distress category (0, 21%). Similarly, of 12 company data classified in the distress category, the prediction shows there are 11 data consistent in the distress category (91.66%), while the other datum was classified into non-distress category (8.33%). Thus, the overall prediction accuracy is 99.7%. This shows that the model has good predictive validity because the classification level set is far exceeding 50%.

Table2. Independent Variables model *Financial Distress*

Independent Variable	Coefficient	Significance
IND_DIRC	4,62	0,010**
AUDIT_O	10,54	0,001***
SIZE	-2,06	0,007***
FINANCIAL_LEV	2,39	0,000***
Constant	41,60	0,015

*Significant at the 10% level; ** Significant at the 5% level; and*** Significant at the 1% level

Table 1 presents four variables that are incorporated into the model in which all these variables show a significant influence on financial distress. These variables include independent directors (IND_DIRC), audit opinion (AUDIT_O), size (SIZE), and financial leverage (FINANCIAL_LEV). IND_DIRC, AUDIT_O and FINANCIAL_LEV that have a positive influence on financial distress. The higher this ratio, the greater the likelihood of financial distress happens. Meanwhile, SIZE has a negative influence on financial distress. The higher this ratio, the less likely the financial distress likelihood occurs. Thereby, the models for financial distress are:

$$Ln = [P/(1-P)] = 41.604 + 4.618 \, INDP\_DIRC + 10.537 AUDIT\_O - 2.057 \, SIZE + 2.387 \, FINANCIAL\_LEV$$

Note:
Ln = Natural logarithm
P = Probability
e = the constant of real numbers (2.71828)
INDP_DIRC = Independent director
AUDIT_O = Audit opinion
SIZE = Firm size
FINANCIAL_LEV = Financial leverage

Moreover, Table 1 shows four significant variables that are incorporated into the financial distress model. The following section will describe each significant variable in the model according to the division of the category.

Independent director (IND_DIRC) is the proportion of independent external directors on the number of members on the board of directors within the company. The result showed that independent directors have a positive influence on the financial distress with significance of 0.010. The Adams & Ferreira (2007) study and Joh & Jung (2011) show the positive influence of independent directors on financial distress. Companies with a larger proportion of independent directors can increase the occurrence of financial distress. Independent directors are less informed about the company even though their monitoring are more independent than the internal directors of the company. The results also do not support the initial hypothesis and Manzaneque et al. (2016) study in Spain about the negative influence of independent directors on financial distress. Companies with a larger proportion of independent directors can reduce the likelihood of financial distress.

Audit opinion (AUDIT_O) is a dummy variable which takes value "1" value if there is an unsatisfactory audit opinion and "0" if the audit opinion is satisfactory. The results of this study indicate that the audit opinion has a positive influence on financial distress with significance of 0.001. That is, any 1 quantity of increase to audit opinion will improve the possibility of financial distress. The results of this study are supported by research of Li et al. (2008) in China and Miglani et al. (2014) in Australia that indicates a positive influence of audit opinion on financial distress. An unsatisfactory audit opinion is a negative signal regarding the company's financial status and reflects hidden risks within the company. An unsatisfactory audit opinion leads to a higher probability of financial distress.

Size is a natural logarithm form of total assets. The results of this study indicate that size has a negative influence on financial distress with significance of 0.007. The higher this ratio, the less likely the probability of financial distress happens. The results of this study are supported by Miglani et al. (2014) in Australia that concurs the existence of a good investment opportunity can reduce the cost of financial distress with the condition of the company's growth rate in sectoral profitability. Therefore, the log of the total asset indicates the low probability of financial distress.

Financial Leverage (FINANCIAL_LEV) is a proxy used to measure financial risk calculated by dividing total liabilities by total company assets. The research results showed that financial leverage has a positive influence on financial distress with significance of 0.000. The greater the financial leverage, the greater the financial distress likelihood occurs. The results of this study are supported by Miglani et al. (2014) study in Australia that indicate the greater the level of leverage in the company, the greater the probability of default occurs so that it can increase the likelihood of financial distress.

4 CONCLUSIONS

From the logistic regression analysis, there are four variables incorporated in the financial distress model, they are independent director, audit opinion, financial leverage, and size. From the results of data processing that has been done in the previous chapter, it was found that the financial distress model is able to predict the company's financial distress condition with the accuracy of 99.7%. From the model, it can be seen that one variable has a negative influence on financial distress that is size. In contrast, independent director, audit opinion, and financial leverage have a positive influence on financial distress.

Through this research, interested parties can use the resulting model to determine the financial distress of a company. For the company, this model can be used to look at the overall condition of the company so that it can precisely predict the likelihood of bankruptcy and immediately take various precautions if necessary. If the company succeeds in the improvement efforts, then the company can avoid bankruptcy. Additionally, this prediction model can also help investors in assessing the company condition that needs to be considered before investing. For researchers, this research can add to the understanding of the more accurate prediction model of bankruptcy by using a combination of the dominant variables in GCG. Thus, this research can be a reference material for further research.

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