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Good Corporate Governance Mechanisms and Financial Performance in Controlling Financial Distress

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ABSTRACT

Purpose – This study aims to investigate the impact of corporate governance mechanisms on financial distress in firms listed on the Indonesia Stock Exchange (IDX). **Methodology/approach –** This study uses secondary data from the financial statements of firms, between 2014 and 2019. The number of samples that met the established criteria was 341 firms unbalanced panel, which were further analyzed using logistic regression and sub-group logistic regression analysis. **Findings –** This study concludes that corporate governance mechanisms (independent commissioners and board size of commissioners), has a mixed impact on financial distress. The larger of board commissioners, the better the company's financial condition, while the proportion of independent commissioners has no significant effect on financial distress. Profitability consistently has a significant effect on financial distress. Ownership i.e. state-owned enterprises (SOE) and non-state-owned enterprises (NSOE) change the direction and impact of liquidity, leverage and board size on financial distress. **Novelty/value –** Sub-group logistic regression using company ownership variables (i.e. SOE and NSOE) is the novelty of this study. In addition, this study provides insight for companies to always pay attention to profitability avoiding financial distress and and selection of independent commissioners who have relevant experience and background in managing the company.

Keywords: Financial Distress, Corporate Governance, Liquidity, Leverage, Profitability

INTRODUCTION

The problem of financial distress began to emerge when the global crisis occurred in 2008. The global crisis that occurred in 2008 was one of the most impactful global crises in the history of the global crisis. This global crisis stems from the crisis that occurred in the United States caused by cheap mortgage loans, systematically wrong asset valuations, and soaring household leverage that put the American banking sector under heavy pressure (Feldkircher, 2014). One of the local banking parties provides credit loans to debtors without considering the level of ability of the debtors to repay their credit. This led to bankruptcy and loss of liquidity for the banks concerned. The deteriorating condition of financial companies in the United States at that time led to the collapse of the stock market on Wall Street, United States. It doesn't stop there, this has also spread to all sectors, and worst of all, this crisis has spread to all corners of the world.

Indonesia is also one of the countries most affected by this crisis. This is because at that time, Indonesia was a country that was still very dependent on the flow of funds originating from foreign investors. These affected investors eventually withdrew their funds from Indonesia and caused the rupiah exchange rate to decline at that time. Furthermore, many companies experience financial distress, where the company is unable to pay its maturing obligations, shows negative performance, negative net income, negative equity book value, and the company enters into a business merger (Mafiroh & Triyono, 2016). Financial distress is more important than bankruptcy (Hapsari, 2012), because financial distress is a condition in which a company experiences a stage of decline in financial condition before going bankrupt (Handriani et al., 2021). According to data from the Indonesia Stock Exchange, there were 40 companies that were delisted in the last 10 years. This proves that companies in Indonesia are vulnerable to problems such as financial difficulties. However, that does not mean that this problem cannot be prevented or overcome, one of which is by implementing good corporate governance.

Corporate governance refers to a set of mechanisms that influence decisions to be taken by managers when there is a separation between ownership and control (Fathonah, 2016). Corporate governance as measured by the board size of commissioners (Agustiningsih et al., 2016; Danoshana & Ravivathani, 2013; Utama & Utama, 2019), and the proportion of independent commissioners (Agustiningsih et al., 2016), has a significant positive effect on the financial performance of companies that have an inverted u-shape effect on financial distress. The same result is shown by Handriani & Robiyanto (2019) where the larger board of commissioners will be better able to carry out their duties, obligations and responsibilities according to the provisions, so that it has a negative impact on financial distress. According to the Organization for Economic Cooperation and Development (OECD), poor corporate governance mechanisms push companies into situations of financial distress. Apart from having a bad governance mechanism, Mselmi et al. (2017) provides evidence that distressed companies are smaller, more leveraged and have lower repayment capacity, liquidity ratios, profitability and solvency than non-distressed companies. The relationship between corporate governance and financial distress has been a topic of considerable interest, especially after the failures of leading companies in both developed and developing countries (Udin et al., 2017).

In developing countries, many studies have been conducted to study the relationship between corporate governance and financial distress (Dhamija et al., 2014; Hassan Al-Tamimi, 2012; Lajili & Zeghal, 2010; Younas et al., 2021). The studies mentioned above unanimously agree on the fact that the company success is related to good governance, transparency of business contracts, ethical standards, legal and constitutional agreements, effective decision-making, and disclosure of financial information which can actually reduce financial distress. However, using a sample of manufacturing companies listed on the IDX during 2011-2014, Mafiroh & Triyono (2016) found no significant impact of corporate governance as measured by the proportion of independent commissioners and audit committees on financial distress.

Therefore, this study aims to examine the effect of good corporate governance mechanisms (i.e. independent commissioners, board size) and financial performance (i.e. liquidity, leverage, and profitability) on the possibility of financial distress. In addition, a split sample using company ownership, state-owned enterprises (SOE) and non-state-owned enterprises (NSOE) variables is the novelty of this research. SOE companies have an advantage over NSOE companies in their support system. SOE companies have more advantages because all forms of company losses will be borne by the government, so even though the company has poor performance and human resources, it will not have a significant impact on financial distress. Therefore, by doing a split sample, was expected on SOE firm, several independent variables will not have a significant effect on financial distress. Thus, this research is expected to contribute to companies in preventing or overcoming financial distress at the level of policy makers.

LITERATURE REVIEW

This study is based on agency theory. According to Jensen & Meckling (1976) Agency relationship is a contract between the manager (agent) and the investor (principal). Agency theory argues that a company's financial performance can be improved by separate ownership and control structures

(Shahwan & Habib, 2020). In practice, there are agency conflicts that occur due to differences in goals and interests between principals and agents, as well as the emergence of costs incurred by companies that are not small in supervising agents. Shareholders want to increase company earnings, while agents (managers) pursue their own interests, such as bonuses, prerequisites, and other incentives at the expense of shareholder wealth. This manager's selfish behavior will ultimately reduce the company's financial performance and increase the possibility of financial difficulties. Good corporate governance is needed to reduce agency problems between owners and managers and reduce information asymmetry and financial distress. The adoption of good corporate governance mechanisms is used as a tool to control agency problems, maintain a high level of corporate performance and protect the company from the risk of financial distress (Oteng-Abayie et al., 2018).

Corporate governance is generally defined as a system, through which companies are directed and controlled (Danoshana & Ravivathani, 2013). Lukviarman (2016) states that corporate governance is a system that controls and directs a company with the aim of achieving a balance between power and authority to ensure its continued existence and accountability to shareholders. According to the Organization for Economic Cooperation and Development (OECD), poor corporate governance mechanisms push companies into situations of financial distress. Good corporate governance practices can improve financial performance and reduce the possibility of financial difficulties (Hodgson et al., 2011). Good corporate governance can be defined as a system that regulates and controls the company to create value-added for each stakeholder (Effendi, 2016). Furthermore, good corporate governance practices protect shareholder rights and improve company performance by reducing the cost of capital (Reddy et al., 2010). As well as Luqman et al. (2018) argues that the adoption of good corporate governance practices reduces the possibility of financial distress. In addition, corporate governance will increase the efficiency of the company because the implementation of corporate governance will establish a system of direction, control and supervision that is right on target (Andreas & Zarefar, 2022; Hamad et al., 2020; Wahyudin & Solikhah, 2017).

METHOD

This study uses a quantitative approach. The method used to determine the sample was purposive sampling with the following conditions: (1) All companies listed on the Indonesia Stock Exchange. (2) Sample companies that publish complete financial reports from 2014 to 2019. This is done because it makes it easier for researchers to collect data and shows companies that are consistent in fulfilling their obligations as public companies. Based on these criteria, there were 679 companies that met the requirements as a population and a sample of 341 unbalanced panel companies was obtained. The type of data used is secondary data. The company's annual report and financial statements are obtained from the Indonesian Stock Exchange website or the company's official website. Measurements of each variable are presented in detail in the table 1.

Table 1. Variable Measurement

Variable	Description	Measurement	Source
Financial distress (FD)	Predicting the potential for bankruptcy in a company	Z = 6,56X1 + 3,267X2 + 6,72X3 + 1,05X4 Given value 1 if z-score ≤ 1.81 and 0 otherwise	(Donker et al., 2009; Li et al., 2021; Udin et al., 2017)
Current Ratio (CR)	Measuring the company's ability to pay off its short-term obligations	$CR = \frac{Current\ Asset}{Current\ Debt}$	(Oktariyani, 2019; Putri et al., 2021; Soesetio & Andrian, 2021)
Debt to Asset Ratio (DAR)	Measuring the level of the company's ability to meet	$DAR = \frac{Total\ Debt}{Total\ Asset}$	(Marota et al., 2018; Vernetta, 2021)

	both short-term and long-term obligations using their asset		
Debt to Equity Ratio (DER)	Measuring the level of the company's ability to meet both short-term and long-term obligations using their equity	$DER = \frac{Total\ Debt}{Total\ Equity}$	(Mahardika & Ismiyanti, 2021; Oktariyani, 2019)
Return on Asset (ROA)	Measures the company's ability to generate profits using its assets in a certain period	$ROA = \frac{Net\ Income}{Total\ Asset}$	(Mafiroh & Triyono, 2016; Soesetio et al., 2023)
Return on Equity (ROE)	Measures the company's ability to generate profits using its equity in a certain period	$ROE = \frac{Net\ Income}{Total\ Equity}$	(Restianti & Agustina, 2018; Shafiq et al., 2022)
Independent Commissioners (IC)	The proportion of independent commissioners to total board of commissioners	$\frac{Total\ Independent\ Commissioners}{Total\ Commissioners}\ x\ 100\%$	(Purnamasari & Fachrurrozie, 2020; Soesetio et al., 2022; Widhiadnyana & Dwi Ratnadi, 2019)
Board Size of Commissioners (BSIZE)	Calculate the total number of commissioners in a company	$\sum Total\ Commissioners$	(Soesetio et al., 2022; Widagdo et al., 2021)

The use of two measurements of leverage and profitability are for robustness tests. In addition, this study uses corporate ownership i.e. state-owned enterprises (SOE) and non-state-owned-enterprises to perform sub-group regressions. In SOE companies, all forms of company losses will be borne by the government, so even though the company has poor performance and human resources it will not have a significant impact on financial distress. Therefore, by doing a split sample, was expected on SOE firm, several independent variables will not have a significant effect on financial distress. Logistic regression with panel data and marginal effect analysis is used as an analytical tool to answer hypotheses. The marginal effect was used to see the actual coefficients of the logistic regression results, because the coefficients that came out of the logistic regression results did not show the actual coefficient values. The regression model used:

$$FD_{it} = \beta_0 + \beta_1 CR_{it} + \beta_1 DAR_{it} + \beta_1 ROE_{it} + \beta_1 IC_{it} + \beta_1 BSIZE_{it} + \varepsilon_{it} \quad (1)$$

$$FD_{it} = \beta_0 + \beta_1 CR_{it} + \beta_1 DER_{it} + \beta_1 ROA_{it} + \beta_1 IC_{it} + \beta_1 BSIZE_{it} + \varepsilon_{it} \quad (2)$$

RESULT AND DISCUSSION

Based on table 2, companies listed on the Indonesian stock exchange (IDX) have an average level of financial distress of 0.262, which means that more companies are in a distress zone or experiencing financial difficulties. Although SOE companies tend to have greater leverage ratios in terms of DAR and DER when compared to NSOE companies, the average level of financial distress in SOE companies is 0.174 which means that more companies are still in a safe stage and are not experiencing financial distress compared to NSOE company that

Table 2. Descriptive Statistics Result

Variable	FD	CR	DAR	DER	ROE	ROA	IC	BSIZE
All samples								
Obs	1,016	1,016	1,016	1,016	1,016	1,016	1,016	1,016
Mean	0.262	1.248	0.435	0.811	0.083	0.124	0.386	4.110
Std. dev.	0.440	0.452	0.125	0.338	0.682	0.893	0.138	2.031
Min	0	0.000	0.002	0.002	-0.78017	-0.41021	0.000	1
Max	1	1.999	0.999	1.400	20.38113	19.49212	1.000	25
State-owned Enterprises								
Obs	46	46	46	46	46	46	46	46
Mean	0.174	1.352	0.496	0.935	0.095	0.106	0.357	5.152
Std. dev.	0.383	0.415	0.091	0.255	0.115	0.120	0.139	1.154
Min	0	0.144	0.326	0.456	-0.317	-0.052	0.000	3
Max	1	1.966	0.859	1.400	0.292	0.773	0.600	7
Non-state-owned Enterprises								
Obs	970	970	970	970	970	970	970	970
Mean	0.266	1.243	0.432	0.805	0.083	0.124	0.387	4.061
Std. dev.	0.442	0.453	0.126	0.340	0.698	0.914	0.138	2.051
Min	0	0.000	0.002	0.002	-0.780	-0.410	0.000	1
Max	1	1.999	0.999	1.400	20.381	19.492	1.000	25

Source: data processed (2023)

is equal to 0.266. While the company's profitability tends to be at the same level. The number of commissioners owned by SOE companies tends to be more than 5-6 people compared to NSOE companies which are only 4-5 people, but NSOE companies tend to have more independent commissioners than SOE companies.

Based on table 3, the Hosmer-Lemeshow test for each equation shows a significance value > 0.05, which means that the logit model shows the adequacy of the data and there is no significant difference between the model and the observed value so that the model can predict the observation value.

Effect of Current Ratio on Financial Distress

The results of the marginal effect of logistic regression in table 4 show that the current ratio (CR) has a negative and significant effect on financial distress. Liquidity is the ability of an entity to pay off its current liabilities by utilizing its current assets (Soesetio & Andrian, 2021). The current ratio can be used to measure the excess of current assets over current liabilities which is a guarantee against possible losses arising from business by converting non-cash current assets into cash (Restianti & Agustina, 2018). High company liquidity reflects that the company's ability to pay off its debts is also high, indicating that the company is in good health. If the company's current debt can be repaid, then the interest expense on the debt can also be paid by the company. This can indicate that the company's finances are in good condition (Kazemian et al., 2017; Ufo, 2015). These results support previous studies of Nugrahanti et al. (2020); Setiyawan & Musdholifah (2020); Widagdo et al. (2021) who found that liquidity proxied by the current ratio had a significant negative effect on financial distress.

Contrary, in state-owned enterprises (SOE), CR does not have a significant effect on financial distress. SOE companies have an advantage, especially in their support system, that is the state. When a company has maturing short-term debt, the government will always be ready to help pay off the maturing short-term debt. Sayidah et al. (2020) explains that subsidies are financial assistance provided by the government to business entities, especially state-owned enterprises, to cover operational costs because the selling price is determined by the government. Assagaf et al. (2019) also explained that subsidies provided by the government through the state to help overcome the financial difficulties faced by SOEs in 2017 amounted to Rp. 205 trillion, higher than in 2016 of Rp. 201.3 trillion. Thus, even though the company has a high or low CR ratio, it will not cause the company to experience financial difficulties.

Table 3. Logistic Regression Result

	ALL		SOE		NSOE	
VARIABLES	(1) FD	(2) FD	(1) FD	(2) FD	(1) FD	(2) FD
CR	-2.893***	-3.079***	-1.234	-2.240	-2.997***	-3.167***
	(0.245)	(0.264)	(1.136)	(1.753)	(0.256)	(0.275)
DAR	7.352***		-1.373		7.949***	
	(0.938)		(5.999)		(0.991)	
DER		3.173***		-1.515		3.248***
		(0.339)		(2.576)		(0.349)
ROA		-16.209***		-54.645**		-15.881***
		(1.651)		(23.725)		(1.669)
ROE	-7.055***		-12.103**		-7.060***	
	(0.815)		(5.200)		(0.837)	
IC	0.087	0.295	-2.814	-1.986	0.188	0.388
	(0.715)	(0.745)	(3.632)	(4.336)	(0.742)	(0.768)
BSIZE	-0.108*	-0.154**	0.519	0.135	-0.117*	-0.163**
	(0.058)	(0.065)	(0.522)	(0.554)	(0.060)	(0.066)
Constant	-0.460	0.988*	-0.241	5.903	-0.614	1.010*
	(0.580)	(0.523)	(4.919)	(5.387)	(0.600)	(0.535)
Observations	1,016	1,016	46	46	970	970
Pseudo R2	0.378	0.434	0.318	0.548	0.389	0.438
Prob > chi2	0.000	0.000	0.019	0.000	0.000	0.000
Hosmer-Lemeshow	0.385	0.124	0.799	0.955	0.612	0.548

Source: data processed (2023). Note: *, **, *** Significant at 10%, 5%, 1%

Table 4. Marginal Effect of Logistic Regression Result

	ALL		SOE		NSOE	
VARIABLES	(1) FD	(2) FD	(1) FD	(2) FD	(1) FD	(2) FD
CR	-2.893***	-3.079***	-1.234	-2.240	-2.997***	-3.167***
	(0.245)	(0.264)	(1.136)	(1.753)	(0.256)	(0.275)

DAR	7.352***		-1.373		7.949***	
	(0.938)		(5.999)		(0.991)	
DER		3.173***		-1.515		3.248***
		(0.339)		(2.576)		(0.349)
ROA		-16.209***		-54.645**		-15.881***
		(1.651)		(23.725)		(1.669)
ROE	-7.055***		-12.103**		-7.060***	
	(0.815)		(5.200)		(0.837)	
IC	0.087	0.295	-2.814	-1.986	0.188	0.388
	(0.715)	(0.745)	(3.632)	(4.336)	(0.742)	(0.768)
BSIZE	-0.108*	-0.154**	0.519	0.135	-0.117*	-0.163**
	(0.058)	(0.065)	(0.522)	(0.554)	(0.060)	(0.066)
Constant	-0.460	0.988*	-0.241	5.903	-0.614	1.010*
	(0.580)	(0.523)	(4.919)	(5.387)	(0.600)	(0.535)
Observations	1,016	1,016	46	46	970	970

Source: data processed (2023). Note: *, **, *** Significant at 10%, 5%, 1%

Effect of Leverage on Financial Distress

Leverage has a significant positive effect on financial distress. Leverage shows the source of funds used by the company to finance the company's assets and equity. These results indicate that the greater the company's activities financed by debt, the greater the possibility of financial distress, because the greater the company's obligation to pay the debt (Restianti & Agustina, 2018). The trade off theory has the view that when additional debt causes a decrease in company value, it illustrates that additional debt is no longer able to act as a tax shield and turns into a potential financial distress (Kovacova et al., 2022; Suhaibu & Abdul-Malik, 2021). Every use of debt by the company will affect the risk and return. These results support Alifiah (2014); Mafiroh & Triyono (2016); Nugrahanti et al. (2020); Vătavu (2015) who found that leverage has a positive effect on financial distress. The use of high debt will increase the risk, so that the possibility of a company experiencing financial distress will be even greater (Fitriyah & Hariyati, 2013). However, this does not apply to SOE companies.

In SOE companies, the condition of leverage consistently has no significant effect on the condition of the company's financial difficulties. This is strongly suspected because the SOE company has become the identity and icon of the state whose existence must always be maintained as well as one of the means of controlling the livelihoods of many people as mandated in the 1945 Constitution. The government as the owner and regulator always tries to overcome all financial difficulties faced by SOE through APBN as an example are PT Garuda Indonesia Tbk and PT Krakatau Steel. In addition, some SOEs still receive government subsidies. In Indonesia, subsidies are given to SOEs to provide good service to the community. Law Number 19 of 2003 concerning SOE mandates SOEs to carry out public service obligations (PSO). The government can give certain assignments to SOEs to carry out functions for public benefit while keep attention into the aims and objectives of SOE activities. If the project costs the company, the government must compensate for all costs incurred, including the expected margin (Sayidah et al., 2020).

Effect of Profitability on Financial Distress

The results of hypothesis testing show that profitability as proxied by return on assets (ROA) and return on equity (ROE) consistently has a significant negative effect on financial distress. This can be interpreted that the higher the profitability of the company, the less likely the company is to experience financial distress. Companies must earn profits in order to survive and grow in the long term. Companies that earn profits will be trusted by investors as their investment targets. Likewise with creditors, who expect companies to pay their debts from the profits earned (Nyamboga et al., 2014). Altman & Hotchkiss (2006) states that financial distress includes failure, a form of the company's inability to cover its expenses. Financial difficulties occur when the company is unable to make any profit. These results are in accordance with research conducted by Liahmad et al. (2021); Restianti & Agustina (2018) who found that profitability affects the condition of financial distress. Nugrahanti et al. (2020) also revealed that companies that have high profitability mean that they have large profits. This means that the company will not experience financial distress.

Effect of Independent Commissioner on Financial Distress

The proportion of independent commissioners consistently has no significant effect on financial distress. Agency theory considers that an independent commissioner is needed for the board of commissioners to supervise and control the actions of managers in relation to their opportunistic behavior (Jensen & Meckling, 1976). Agency theory also states that the ability of the board of commissioners in an effective oversight mechanism depends on its independence from management (Beasley, 1996). However, the logistic regression results show that the proportion of independent commissioners does not have a significant effect on financial distress. The existence of an insignificant relationship between independent commissioners and financial distress indicates that independent commissioners have not been able to act as an effective mechanism to prevent companies from financial distress. The possibility of the presence of independent commissioners in the company only to comply with regulations in Indonesia without considering the professionalism and independence of supervisors based on their experience and knowledge (Ibrahim, 2019; Wardhani, 2007). In addition, in practice at SOE it shows that the independent commissioner is very vulnerable and has a lot of weight with political connections (Agrawal & Knoeber, 2001; Menozzi et al., 2012), not based on professional experience and relevant educational background in business management (Sidki et al., 2023), so that it does not affect financial distress (Dirman, 2020). The existence of independent commissioners in Indonesia has been regulated by the IDX through the Jakarta stock exchange (BEJ) regulation dated 1 July 2000 which explains that companies listed on the Exchange must have independent commissioners of at least 30% of all members of the board of commissioners. These results support the results of the study Cinantya & Merkusiwati (2015); Dirman (2020); Liahmad et al. (2021), but contrary to Manzaneque et al. (2015) who found a negative effect, and Gunawijaya (2015) who found a positive relationship between the proportion of independent commissioners and financial distress.

Effect of Board Size on Financial Distress

Board size of commissioners (BSIZE) has a significant impact on financial distress. The size of the board of commissioners refers to the number of people who are members of the board of commissioners. The board of commissioners is the highest internal control mechanism responsible for overseeing the actions of top management (Fama & Jensen, 1983; Soesetio et al., 2022). Agree with agency theory, the bigger the board of commissioners, the more they will supervise each other's performance, so that the monitoring process and achieving company goals will run smoothly (Bredart, 2014). Based on the perspective of resource dependency theory, the larger the board of commissioners, the more networks, information, and expertise a company has (Goodstein et al., 1994). In addition, the higher the number of board members, the wider the company's access to important resources (Gales & Kesner, 1994; Nugrahanti et al., 2020), including access to funding when the company experiences financial difficulties. The benefits derived from board size will support the achievement of company goals (Pearce & Zahra, 1992), and prevent the company from financial distress. Bredart (2014); Manzaneque et al. (2015) concluded that the board size of commissioners can reduce financial distress.

Consistent with the results of the CR effect, leverage, and the proportion of independent commissioners on financial distress, in SOE companies, BSIZE has no significant effect on financial distress. Based on the descriptive statistics, the number of commissioners in SOE companies is not as large as the number of commissioners in NSOE companies. Thus, the function of monitoring and evaluation of management by the board of commissioners does not run well, so that the size of the board of commissioners does not have a significant effect on financial distress.

CONCLUSION

Overall, this study presents very interesting results. The government's role as a support system for SOE companies makes the direction and influence of several variables different. Liquidity, leverage, and the size of the board of commissioners which actually have a significant effect on financial distress do not have a significant effect on financial distress. Subsidies are a form of support system from the government in the form of financial assistance provided by the government to business entities, especially state-owned enterprises, to cover operational costs. Furthermore, subsidies are provided by the government to SOE companies through the state to help overcome financial difficulties. In SOE companies, all forms of corporate difficulties arising from providing good services to the community will be borne by the government, so that even if the company has good or bad operational performance it will not have a significant impact on financial distress. However, profitability remains consistent in influencing financial distress, while the proportion of independent commissioners remains consistent and has no significant effect on financial distress.

These results provide an illustration for companies to always pay attention to profitability, because profitability is the only factor that consistently has a significant effect on financial distress in both state-owned enterprises and non-state-owned enterprises. Profitability is an important component for every company and is one of the main concerns of stakeholders, which must also be balanced with the implementation of strict, in-depth, and professional monitoring mechanisms to support sustainability and going concern with good corporate governance insight. The addition of the gender diversity or the use of board of directors can be developed for further research.

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