Corporate Governance and Financial Distress

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ABSTRACT

This paper explores mechanisms of corporate governance (board characteristics, audit committee, and audit quality) of Indonesian listed companies and their influence on the likelihood of a financial distress. This study was conducted between 2012 and 2014. The results confirm that the composition of board of commissioners has a significant impact on the likelihood of financial distress, at least in the Indonesian context; the larger the number of Commissioners, the greater is the likelihood of financial distress. Companies with larger numbers of Commissioners have not been able to coordinate and communicate and engage in decision-making better than those with smaller numbers. In other words, the marginal value of a larger board size is questionable. There is also a significant relationship between the size of the audit committee and financial distress. It is argued the bigger the audit committee, the greater the likelihood the company experiencing financial distress as it appears to divert focus away from the company's operations. Additionally, the relationship between audit quality and the likelihood of financial distress is insignificant. This suggests that variations in the scale of auditing may not have a significant effect on the possible issuance of audit opinion by the auditor or on the likelihood of financial distress.

Keywords: Audit committee, audit quality, board of commissioners, corporate governance, financial distress

INTRODUCTION

Good corporate governance (GCG) may be described in terms of the relationship between stakeholders and agency in the company determining its direction and performance. Agency theory addresses the issue of GCG when the fact that the management of a company separate from its

owners results in certain agency problems. Agency roles refer to the performed by the board of commissioners and the board of directors charged with the responsibility to manage the company's activities and take a decision on behalf of the owners. The interests of agents can be different from those of the owners. Conflicts of interest can be catastrophic to the company as they can lead to financial distress or even bankruptcy (Rahmawati, 2006).

However, such conflicts can be avoided by implementing a mechanism capable of aligning the interests of shareholders with those of the agency, which in this case, comprises the board of commissioners and the board of directors. The GCG is a control mechanism that seeks to regulate and to manage a business venture with a view to increasing prosperity and accountability so that shareholder value is increased eventually. Often, stock prices increase because of the positive market reaction to the company. An optimistic perception will create positive reaction in the market to boost company performance, including in terms of financial performance. Good financial performance indicates that the company is not experiencing financial pressure problems that could be detrimental to shareholders ultimately.

According to Lang, Lins and Miller (2004), the financial crisis hit Asia in 1997 was partly a result of flaws in the fundamental economic structures of the countries involved. In addition to external factors, the crisis was also caused by internal weaknesses such as a lack of institutional oversight and improper investment decisions. They also identified several causative factors such as weak enforcement of regulations, lack of capital markets, and company ownership skewed towards a particular group or party in the ownership of the company. In short, the economic crisis was exacerbated by weak implementation of GCG principles such as transparency, accountability, responsibility, integrity, and fairness.

It is now generally accepted that GCG is an important factor affecting stable economic growth. This paper examines whether the board of commissioners, the audit committee, and audit quality influence the likelihood of the company experiencing financial distress. To this end, data is obtained from companies listed on the Indonesian Stock Exchange and analysed.

LITERATURE REVIEW

Board of Commissioners and Financial Distress

Some studies have examined the importance of corporate governance in overseeing a company's performance. Pathan, Skully and Wickramanayake (2007) examined the size and independence of the board of directors and their influence on banking performance in Thailand. The study indicates that boards with smaller size are more effective in monitoring the bank manager, while larger boards are more vulnerable to agency problems between company owners and managers. Hermalin and Weisbach (2003)

also showed that boards with smaller size are more effective and can provide added value because coordination is easier.

By contrast, Kiel and Nicholson (2002) found a positive relationship between the size of the board and firm performance among large Australian companies. This finding was supported by Abeysekera (2008) who focused on Kenya. The study proved that the number of commissioners nearer to 5 is more effective than one with, say, 14 members. However, other studies have proved the reverse. Studies (Abeysekera, 2008; Nasution & Setiawan, 2007). Andres, Azofra and Lopez (2005) on the contrary suggest the number of commissioners affect control and supervision. According to these studies, a larger board size results in better supervision and management and this helps mitigate financial distress.

Daily and Dalton (1994) investigated the association between two aspects of governance structure - composition of the board and its leadership structure - on company bankruptcy. They concluded that there was indeed a significant correlation between board composition and its leadership structure and the possibility of the company going bankrupt. Hambrick and D'Aveni (1992) pointed out that a dominant Chief Executive Officer (CEO) is more sensitive to bankruptcy of the company. Wardhani (2006) reported the size of the board is positively associated with the likelihood of financial failure. Having more directors lower the chance of the company experiencing financial difficulties, while discharging directors (within limits)

decreases company performance and increases the risks of financial distress. With respect to ownership, Wardhani (2006) showed that the possibility of the company experiencing financial pressure remains essentially the same irrespective of percentage of ownership by other stakeholders in the company. Based on these considerations, we hypothesise that:

H1: Board composition has a positive and significant relationship with the likelihood of the company experiencing financial distress.

Audit Committee and Financial Distress

Pierce and Zahra (1992) found that the effectiveness of the audit committee will be increased if the size of the committee increased; this is because the committee will then have more resources to tackle the issues faced by the company. Rahmat, Takiah and Saleh (2008) examined the relationship between the size of the audit committee and financial distress. It was found the size of the audit committee has no significant effect on financial distress. A bigger audit committee distracts the focus of the company to oversee its operations. Therefore, the following hypothesis is proposed:

H2: Audit Committee has positive and significant relationship on the likelihood of financial distress.

Audit Quality and Financial Distress

Mutchler, Hoopwood and McKeon (1997) found that a large-scale public accounting firm (KAP) is more likely to issue audit

opinion regarding 'going concern' on a company experiencing financial difficulties. However, Ramadhany (2004) finds that the issue of variable scale auditor (Big Four and Non-Big Four) has no significant effect on the possible issuance of audit opinion regarding 'going concern' and the possibility of financial distress. Therefore the following hypothesis is proposed:

H3: Audit quality has negative and significant relationship with the likelihood of financial distress.

METHODS

Research Model

This study used *Structural Equation Model* (SEM) and *Confirmatory Factor Analysis* (CFA). The approach measures a latent variable by one or more variables observed. The latent variables in this study are the board of directors, audit committees, audit quality and financial *distress*. Figure 1 shows the research model (using CFA).
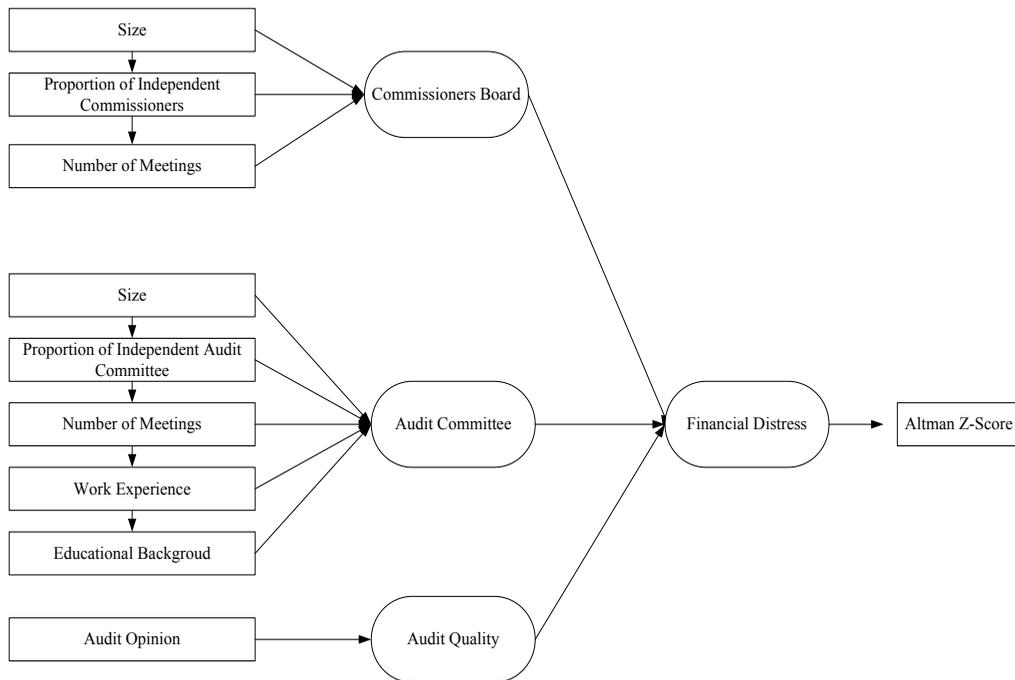
Figure 1. Research model

Latent variables are key variables representing the focus of this study. This type of variable can only be observed indirectly and imperfectly through its effect on the observed variables (Wijanto, 2006).

Board of Commissioners is measured by three indicators, namely board size, the proportion of independent board members, and the number of board meetings. Audit committee is measured by five observed variables, namely size of audit committee, the proportion of independent audit committee, the number of audit committee meetings, audit committee members' experience working as an auditor, and the educational backgrounds of the audit committee's members. Audit quality is measured by two observed variables, 0 namely the external auditor's opinion and the size of audit firm.

Data and Sample Selection

Data used in this research consisted of secondary data annual reports and financial statements of 320 companies listed on the Indonesian Stock Exchange between 2012 and 2014. This information was sourced from the official websites of the Stock Exchange (www.idx.co.id), and each company. Data was also drawn from the capital market research centre at the Indonesian Stock Exchange. To test the hypotheses, data was obtained from listed Indonesian companies. However, financial companies were excluded due to their different features and relations pertaining to the regulatory standards, financial reporting standards and compliance. The period of study was between 2012 and 2014, for two reasons:

1. A large proportion of companies had published their Annual Report.

2. A greater number of companies faced economic and financial problems.

RESULTS

Overall Model Suitability

Analysis of the structural model in SEM began with the testing of the overall model fit using the indicators *Goodness-of-fit Index* (GFI) statistics of *output* LISREL (Hair et al., 1995). Table 1 provides a summary of the critical values concerning the overall suitability of the testing model.

Table 1
Test results related to the overall suitability model

Suitability Criteria Model	Suitability Level Indicator	Model Estimation Result	Suitability Level Model
RMSEA	RMSEA < 0.08	0,035	Close fit
RMSEA	P > 0.05	0.77	Good fit
P (close fit)	Smaller Values of	M* = 0.52	Good fit
ECVI	Independence and closer to	S** = 0.65	
	Saturated model	I*** = 12.76	
AIC	Smaller Values of	M* = 104.99	Good fit
	Independence and closer to	S** = 132.00	
	Saturated model	I*** = 2590.85	
CAIC	Smaller Values of	M* = 234.53	Good fit
	Independence and closer to	S** = 417.00	
	Saturated model	I*** = 2638.35	
NFI	NFI > 0.90	0.98	Good fit
NNFI	NNFI > 0.90	0.99	Good fit
CFI	CFI > 0.90	1.00	Good fit
IFI	IFI > 0.90	1.00	Good fit
RFI	RFI > 0.90	0.97	Good fit
RMR	Standardised RMR < 0.05	0.036	Good fit
GFI	GFI >0.90, good fit; 0.90 < GFI > 0.80, marginal fit	0.96	Good fit

The overall estimation results are based on existing criteria and overall gained marginal values. The results of the analysis focused on the reliability of *the output* for testing the entire model. The overall conclusion is that the model is good (has demonstrated good fit).

Measurement Model Suitability

The measurement model fit test was conducted on each construct separately through an evaluation of the construct validity and reliability (Wijanto, 2006). The aim of this testing was to ensure that the constructs used in this study have met the validity and reliability criteria.

Validity Test

Tests on the validity of each question was shown by the t value and standardised loading factor. Each t value should be larger than the critical value (1.96) and the standardised loading factor should exceed the value of 0.5 (Iqbaria et al., 1997). Invalid questions are not included in further tests. Factor loadings against the latent variables for each indicator are presented in the form of the relationships depicted in the diagram path obtained by running the LISREL program.

The validity and reliability values for each construct of observed variables can be seen in Table 2.

Table 2
Validity and reliability model

No	Observed Variables	Confirmatory Factor Analysis			
		Validity		Reliability	
		SLF	t-value	Construct Reliability (CR>0.70)	Variance Extracted (VE>0.50)
1	BoC1	0.76	12:06		
2	BoC2	0.81	13:26		
3	BoC3	0.80	13:04		
BoC (Board of Commissioners)				0834	0626
1	AC1	0.95	17:41		
2	AC2	0.94	17:47		
3	AC3	0.62	9.82		
4	AC 4	0.69	10.97		
5	AC5	0.66	10.66		
AC (Audit Committee)				0885	0615
1	QoA1	1:00	20:00		
2	QoA 2	0:51	7.78		
QoA (Quality of Audit)				0752	0627

Table 2 shows that all indicators have t values above the critical value of 1.96 and all *the standardised loading factors* were above 0.5. This means that all the indicators are valid, so no indicator needs to be discarded.

Reliability Test

A reliability test aims to test the consistency of the grains that has a question / statement in the questionnaire. Testing the reliability of each indicator was done by calculating the construct reliability and variance extracted from each of the observed variables (Hair et al., 1995). To calculate the reliability construct and variance, this study used the following formula:

$$Construct\ Reliability = \frac{(\Sigma std.loading)^2}{\Sigma std.loading^2 + \Sigma e_j} \quad (1)$$

$$Variance\ Extracted = \frac{(\Sigma std.loading)^2}{\Sigma std.loading^2 + \Sigma e_j} \quad (2)$$

Where

std.loading : standardised loading

e_j : measurement error

If construct reliability is greater than 0.70, and extracted variance is greater than 0.50, it can be said that the reliability of the construct is acceptably good (Wijanto, 2008). The figures used to calculate construct reliability and variance were extracted from the output of the standardised solution. The results are summarised in Table 2.

The results of running the program for the three indicators of BoC, five indicators of AC, and two indicators of QoA demonstrate construct reliability values above 0.70

(CR>0.70) and variance values above 0.5 (VE>0.50). This means that all indicators are reliable; no indicator needs to be discarded.

Structural Model Suitability

An analysis was performed on the coefficients of structural equations by specifying a certain level of significance. For a significance level of 0.05, the value t of structural equation must be greater than or equal to 1.96 or, for practical purposes, greater than or equal to 2 (Wijanto, 2008).

Structural Equation Modeling

ALTMANZ = 0.19*BoC + 1.20*AC + 0.040*QoA Errorvar.= 0.31 R^2 = 0.85

$$(0.091) \quad\quad (0.11) \quad\quad (0.038) \quad\quad\quad (0.044)$$
$$2.05 \quad\quad\quad 11.32 \quad\quad 1.05 \quad\quad\quad\quad 7.18$$

Table 3 lists the t-values corresponding to the three hypotheses. Figure 2 shows the path diagram identified. Note that all coefficients have values t significant except for the variable AC or Audit Quality that has a value t smaller or less than 2.00. It can be concluded that hypotheses H1 and H2 have proved to be significant. This means that there is a positive and significant influence between the variables and board of directors' audit committee of the possibility that companies may experience financial distress (proxy by Altman z-score). In other words, greater supervision by the board of commissioners and the expanding functions of an audit committee will affect the increase in the value of Altman z-score, which means that the company is in a very healthy state, i.e., the probability of bankruptcy is very small.

Consider now the coefficient of determination of the structural equation as determined by the corresponding R^2-value (Wijanto, 2006). The LISREL results can be seen in Equation Reduced Form R values obtained[2] for the structural equation. The model has a R^2 value of 0.85, which means the model is able to explain 85% of the changes in the latent variable financial distress. Therefore, it can be concluded the model is reasonably good. The overall t-values for each of the three hypotheses proposed in this research are summarised in Table 3.

Table 3
The value of the t-value for each hypothesis

Hypothesis	Path	Estimated	t-value	Results
H1	BoC → ALTMANZ	0:19	2:05	Significant
H2	AC → ALTMANZ	12:11	11:32	Significant
H3	QoA → ALTMANZ	1:05	1:05	No Significant

The resulting path diagram is shown in Figure 2 below. It refers to the structural model generated from the LISREL output.
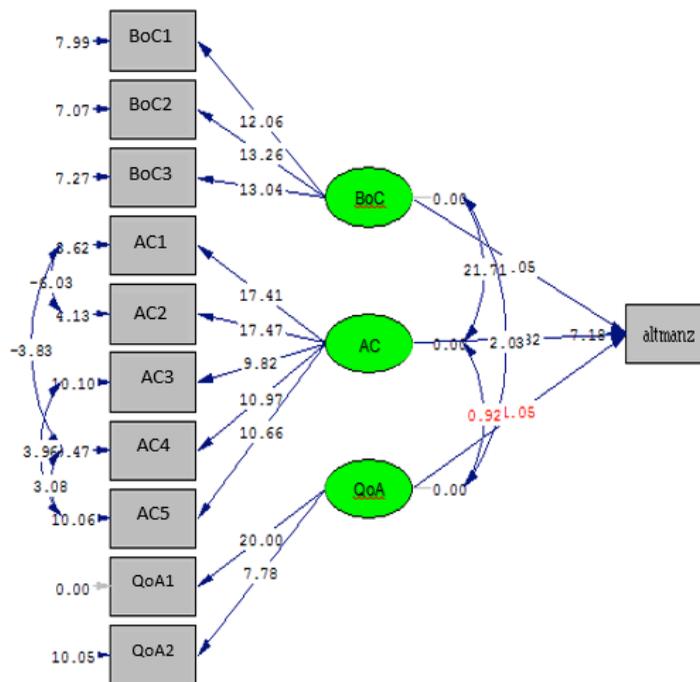
Figure 2. Path diagram

The structural equation model confirmed that the board size has a significantly positive effect on financial distress. This means the bigger the number of commissioners, the greater the likelihood of financial distress. These results contradict those of Wardhani (2006) that there is a negative influence between size of the board and financial distress. However, the results of the present study are consistent with Dalton, Dan and Catherine (2006); Jensen (1993); Lipton and Lorsch (1992); Yermack (1996) who observed a positive relationship between board size with the possibility of the

company going bankrupt and the company's performance. This means a company with bigger board size will not be able to do the coordination, communication, and decision making better than the one with a smaller board. In short, the value of increasing the board size unduly, is questionable.

The second hypothesis on the effect of audit committee on financial distress has also been proved to be positive and significant, at least in Indonesia. The is inconsistent with Pierce and Zahra (1992) who report the effectiveness of the audit committee will be increased if the committee size is increased, because the committee has better resources to tackle the issues being faced by the company. On the other hand, the findings of study support those of Rahmat et al. (2008), who examined the relationship between the audit committee characteristics and financial distress. One of the characteristics of the audit committee is its size. The results from the study indicate that the size of the audit committee has no significant effect on financial distress. The bigger the size of the audit committee, the less focused is the company on overseeing its operations.

The third hypothesis on the effect of the audit committee to financial distress was supported but not statistically significant. This suggests that the third hypothesis has not been successfully backed, which suggests that the quality of audit does not increase the likelihood of financial distress. Although audit quality has no significant effect, the sign of the coefficient value is in accordance with the hypothesis put forward. These results are not consistent with the findings of Mutchler et al. (1997) who showed that large-scale KAP (Big 6) are more likely to issue a 'going concern' audit opinion of financial companies that had difficulty compared with small-scale KAP (Non-Big 6). However, this study supports Ramadhany (2004) where the variable scale auditor (Big Four and Non-Big Four) had no significant effect on the possible issuance of audit opinion by the auditor or the possibility of the company's financial distress.

CONCLUSION

This research was an extension of previous studies to examine the effect of corporate governance on financial distress. The purpose of this study was to see how far the application of the principles of good corporate governance (GCG) can affect the likelihood of companies becoming bankrupt or get into financial distress. Findings confirmed Hypothesis 1 confirmed the size of board of commissioners affects financial distress positively. A larger board size can increase chances of company's bankruptcy. This is because a large board size can lead to poorer coordination, communication, monitoring or supervision, and decision making. Hypothesis 2 whether audit committees affect financial distress was supported by the findings at a significant level. Specifically, the output results from structural equations showed audit committees positively affect financial distress. However, a bigger audit committee could lead to lesser focus on overseeing the company's operations. Hypothesis 3,

namely effect of audit quality on financial distress, was not supported by this study, there is some effect but it is not statistically significant.

Although results of this study contribute to the literature on corporate governance and financial distress, there are some limitations. First, it did not take into account control mechanisms such as board training and professional experience, board diversity, or the design of compensation contracts of directors which can be tackled by future studies. Second, the sample period is not long enough to study issues such as causality of variables and endogeneity problems. Future research could focus on these issues to better understand the complexity of financial distress and its causes.

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