The Influence of Good Corporate Governance Mechanism on the Possibility of Financial Distress

Review of Integrative Business & Economics Research

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ABSTRACT

This study aimed to determine the effect of good corporate governance mechanism (managerial ownership, institutional ownership and independent commissioner) on the possibility of financial distress. The sample of this study contains 121 manufacturing companies listed on the Indonesia Stock Exchange in 2011-2013. The sample was selected using purposive sampling method for 22 companies, so that the unit of analysis was 66. The method of data analysis used descriptive statistics and logistic regression. The results of this study indicate that managerial ownership, institutional ownership and independent commissioner do not influence significantly on the possibility of financial distress. Suggestions for further research should extend the period of observation, so that the results can describe the actual condition. In addition to use financial indicators and corporate governance mechanism more diverse.

Keywords: good corporate governance mechanism, financial distress, managerial ownership

1. INTRODUCTION

Platt and Platt (2002) define the financial distress as a stage of decline in financial condition before bankruptcy or liquidation. The condition of financial distress is very important to find out by the firm, in order to perform actions to anticipate the occurrence of the level of *financial distress,* the conditions that lead to the occurrence of bankruptcy or delisting from the stock exchange. Delisting is the act, committed by the stock exchange authority, which causes the issuer securities is no longer traded on the stock exchange floor. Pranowo (2010) stated the cause of the occurrence of delisting happened to several public companies in the Indonesia Stock Exchange due to financial difficulties or be on condition of financial distress.

In Indonesia, since the *Global Financial Crisis* which occurred in 2008, as many as 8 (eight) companies were *delisted* from the Stock Exchange. In the banking sector, the monetary crisis in 1997, as many as 16 national private commercial banks were liquidated and simultaneously revoked their business permit by the government, and 45 other were declared as troubled banks. In 1999, a total of 38 banks closed, in 2004 the Bank Dagang Bali and Aspac Bank liquidated. 2005, Global Bank was closed, in 2008 the Bank Century case and the closure of Indover Bank, and in 2009 the business license of Bank IFI had been revoked by the government (Silaban, 2013).

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Financial distress could have been avoided if the firm applied the right strategy, such as implementing good corporate governance strategy. Al-Haddad et al. (2011) explains the purpose of good corporate governance is to ensure the firm's managers always take appropriate actions and selfless, as well as to protect the firm's stakeholders. The mechanism of good corporate governance in this research are the managerial ownership, the institutional ownership, and the presence of the independent Board of Commissioner. The implementation of good corporate governance mechanism will minimize the risk of firms suffering financial distress conditions.

This study will elaborate the influence of good corporate governance mechanism to the possibility of the occurrence of financial distress. Categories of firms suffering financial distress on this research in accordance with Elloumi and Gueyie (2001), i.e.firms that have negative earnings per share. Meanwhile the indicators of good corporate governance mechanism consists of managerial ownership, institutional ownership, and the independent Commissioner. Those factors were used as the independent variables in this study.

2. LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

Agency theory underlying the relationship between good corporate governance mechanism with the possibility of financial distress. Jensen and Meckling (1976) stated the agency relationship arises as a contract in which one or more persons (principal) involving another person (Agent) to perform acts according to the wishes principal. Where the principal desires are often different from the desire of management, so that it appears the conflict of interest between them. The principal party or the shareholders provide instructions to the agent or the management to manage the firm in accordance what was required to achieve the prosperity of the firm. While on the other hand, often the management as the agent will perform actions that do not comply with the instructions ordered by the principal. Agency conflict which arises between the various parties that have diverse interests can complicate and hinder the firm in achieving positive performance in order to generate value for the firm itself and for the shareholders (Agusti, 2013).

Agency problem can also occur due to *asymmetric information* between the firm owners and management. *Asymmetric information* occurs when not all circumstances known by both sides, between *principal* and *agent. Asymmetric information* according to Agusti (2013) is a condition in which one party has information that is not owned by the other party, so that some of the consequences of the election decision cannot be considered done by one of the parties. The existence of *asymmetric information* can cause problems due to the difficulty of the *principal* to monitor and control the *agent's* actions. Thus we required a mechanism for controlling which can reduce the occurrence of agency conflict. In this case, the application of *good corporate governance mechanism* is expected to reduce the agency conflicts between owners and managers. Triwahyuningtias (2012) says *corporate governance* needed to reduce the *agency problem* between owners and managers so that the harmony of interests arise between firm owners and managers.

2.1 Influence of Managerial Ownership on the Possibility of Financial Distress

Managerial ownership is the proportion of shares owned by the management in the firm, in this case the Board of Directors and Commissioners. The existence of stock ownership by management to make the position between shareholders and managers

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can be accommodated. Thus the conditions of the firm's *financial distress* not only become dependents of shareholders, but managers also bear them. Widhianningrum (2012) stated the existence of managers and shareholders of course will align its importance as a manager with his interests as a shareholder. Management will try their best not to make mistakes in decision-making that leads to bad for the firm, because it would be detrimental to the management itself.

The existence of stock ownership by firm managers can improve the performance of the firm, as well as management could be made control over management in managing the firm. Agusti (2013) said in relation to the firm's performance, the higher managerial ownership would further add to the efforts of management to take the firm into a better direction which is more profitable for the owner, where the management is the owner of the firm concerned. So it can be concluded that managerial ownership influence negatively on the occurrence of *financial distress.* Previous research conducted by Fadhilah (2013) also showed the negative influence of managerial ownership on the occurrence of *financial distress.* The first hypothesis in this study is:
H1: Managerial Ownership influence negatively on the possibility of financial distress

2.2 The Influence of Institutional Ownership on the Possibility of Financial Distress

Institutional ownership according to Ellen and Juniarti (2013) are the ownership of shares by firms or other institutions (insurance companies, banks, investment companies, *asset management* and other institutional ownership). Institutional parties can do a better supervision than managerial parties because it has more advantages to obtain information and analyze all matters related to the Policy Manager. Based on the perspective of agency theory, the existence of institutional ownership will improve the firm's performance, because monitoring will continue to be exercised by the shareholders against the performance of the firm.

When institutional ownership in the firm is large, then the situation would encourage more effective oversight, because the institution is a professional who has the ability to evaluate the firm's performance. The greater ownership by financial institutions will be more power of voice and urge financial institutions to supervise management and consequently will give greater impetus to optimize the value of the firm so that the firm's performance will also be improved (Agusti, 2013). Triwahyuningtias (2013) reveals the existence of ownership by institutional investors such as securities companies, insurance companies, banks, investment companies, pension funds, and other institutional ownership will encourage increased scrutiny be optimized towards firms performance management, so that the potential occurrence of potential *financial distress* can be minimized. Fadhilah (2013) and Cinantya (2015) showed that institutional ownership influence negatively on the possibility of *financial distress.* The second hypothesis in this study is:
H2: Institutional Ownership influence negatively to the possibility of financial distress

2.3 The Influence of Independent Commissioner Board on the Possibility of Financial Distress

The Independent Commissioner is a party that serves as the overseer of the management in carrying out the *corporate governance* system (Fadhilah, *2013).* The independent commissioner is expected to put *fairness* as the main principle in

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considering the interests of the parties who may often be overlooked, such as minority shareholders and other *stakeholders.* Independent commissioner should be free of interests of the business and Affairs of any kind can be considered as intervention to act in the interest of a profitable firm *(Forum for Corporate Governance in Indonesia,* 2000).

Guidelines for *Good Corporate Governance Indonesia* provides rules that the number of independent Commissioners should be able to ensure that the supervisory mechanism running effectively and in accordance with the legislation and one of the independent commisioners should have a background in accounting or finance. The existence of independent Commissioners is required within a firm to mediate or reducing the impact caused by the various interests that ignores the interests of the public shareholders (minority shareholders) as well as other *stakeholders,* particularly at companies in Indonesia who used the Community fund in business financing (NCG, 2006), The presence of the board of Commissioners are independent within the firm will reduce the probability of *financial distress,* so it can be concluded that the independent commissioner influence negatively on *financial distress.* Daughter and Lely (2014) and Ellen and Juniarti (2013) showed that the existence of independent board have no influence on the probability of *financial distress.* The different results are obtained by Fadhilah (2013) that the independent commissioner have negative influence on *financial distress.*

H3: Independent commissioner influence negatively on the possibility of financial distress

3. RESEARCH METHODS

3.1 Population and Sample

The population in this research is all the manufacturing companies listed on the Indonesia Stock Exchange (IDX) from January 1st 2011 until December 31st 2013 a number of 121 companies. The sample in this study is a number of 22 companies, with three years observation period in order to obtain a number analysis unit 66. The sample selection using a purposive sampling technique with the following criteria:

1. Registered as a manufacturing firm in Indonesia Stock Exchange during the period 2011-2013 continuously.
2. Firms that make financial reports with foreign currency unit were excluded from sample research.
3. The firm never received negative earnings over the period 2011-2013.
4. The Firm publishes the complete annual report that provides all the required data regarding the research variables, namely the managerial ownership, institutional ownership and independent Commissioners.

3.2 Research Variables

This research has four variables, consisting of one dependent variable and three independent variables. The dependent variable in this research is financial distress. While the independent variables of this study are the managerial ownership, institutional ownership, the proportion of independent Board of Commissioners, liquidity, and *leverage.*

1. Financial Distress

   Categories of firm experiencing financial distress in this research, is a firm that has negative earnings per share, according to Elloumi and Gueyie (2001).

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Financial distress in this study measured by dummy variables, with a given number 1 on the firms that have negative earnings per share and the number 0 on firms that have positive earnings per share.

2. Managerial Ownership
   Managerial ownership is the amount of the company shares which are owned by the management or the firm's manager, the form of ownership by the Board of Directors and Board of Commissioners. Measurement of managerial ownership is done by calculating the number of shares owned by management over the total number of outstanding share of the firm capital.
3. Institutional Ownership
   Institutional ownership is the amount of the firm's shares which are owned by institutional shareholders. Institutional ownership is measured by the proportion of the number of shares owned by the institution divided by the number of shares issued by the firm.
4. Independent Commissioner
   Independent commissioner is a member of the Board of Commissioners who is not affiliated with management, other members of the Board of Commissioners and the controlling shareholder, and free from the business relationship or other relationship which could affect its ability to act independently or act in the interests of the firm (NCG 2006). Measurement of the independent Commissioners is done by calculating the percentage of independent members of Board of Commissioners of the number of commissioners.

3.4 Data Analysis Techniques

The data are obtained by downloading and examining the annual financial statements of each firm listed on Indonesia Stock Exchange period 2011 to 2013. Data analysis in this study uses descriptive statistics and logistic regression.

4. RESULT AND DISCUSSION

4.1 Descriptive Statistics

Descriptive statistics describe the minimum value, maximum, mean, and standard deviation for each variable which is owned by the firm which is the object of this research. Following are the results of descriptive statistics:

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Table 1. Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
FN	66	0	1	, 64	, 485
KM	66	, 0000	9.6223	1.07410	2.48484
KI	66	, 0000	98.9583	70.08846	24.18658
DKI	66	, 0000	, 5000	, 30 301	, 16 552
Valid N (listwise)	66				

Table 1 shows the average value of managerial ownership and independent commissioner as low as 1.07410 and 0.30301. Mean while the average institutional ownership is high at 70.0884.

4.2 Logistic Regression Test Results

Following are the results of logistic regression test:

Table 2. Logistic Regression Test Results

		B	SE	Wald	df	Sig.	Exp (B)
Step 1 [a]	KM	, 422	, 244	2.977	1	, 084	1,524
	KI	-, 009	, 019	, 246	1	, 620	, 991
	DKI	-2.630	2,264	1,349	1	, 245	, 072
	Constant	1,214	1,856	, 428	1	, 513	3.367

a. Variable (s) entered on step 1: KM, KI, Jakarta.

Managerial ownership variable as measured by comparing the ownership by managers of all outstanding shares shows the value significance of 0.084 greater than the significance level of 5% (0.05). This result means that the managerial ownership variable does not influence significantly on the possibility of *financial distress,* so that H1 is rejected. Institutional ownership variable as measured by comparing the institutional ownership of the entire outstanding shares shows the value significance of 0.620 greater than the significance level of 5% (0.05). This result means that institutional ownership variable does not influence significantly on the possibility of *financial distress,* so that H2 is rejected. Independent Commissioner as measured by comparing the number of independent Commissioner with the total number of Commissioner in the firm shows significance value of 0.245 greater than the significance level of 5% (0.05). This result means that the independent Commissioner variables does not influence significantly on the possibility of *financial distress,* so H3 is rejected.

4.3 Discussion

The managerial ownership variable in this study had no influence on the possibility of *financial distress,* and showed a positive coefficient for *financial distress.* The results of this research are not in accordance with the *agency theory,* that has been put forward previously. *Agency theory* suggests the existence of an incentive mechanism to encourage management to act in accordance with the interests of *stakeholders.* Managerial stock ownership creates a position between shareholders and

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managers can be aligned, the management will not think as *stakeholders* if they do not become *stakeholders.* With the managerial ownership, decision-making related to the firm will be carried out with full responsibility, because in accordance with the interests of shareholders, in this case, including the interests of management as one of the components of the owner of the firm (Fadhilah, 2013).

Shares ownership by the firm managers can improve the performance of the firm management and could be used as the control over management in managing the firm. This occurs, because management as manager of the firm is also the owner of the firm, so that management will try their best not to make mistakes in decision-making which was fatal for the firm, because it would be detrimental to the management itself. Agusti (2013) said in relation to the firm's performance, the higher managerial ownership would further increase to the efforts of management to take the firm into a better direction which is more profitable for the owner,

This research did not manage to prove the influence of managerial ownership on the possibility of *financial distress* at manufacturing firms listed in the Indonesia Stock Exchange period 2011-2013. This was due to the failure of firms in implementing *good corporate governance.* The small number of managerial ownership is indicated as a reason for the managerial ownership has no influence on the possibility of the *financial distress,* because the amount of managerial stock ownership incapable to influence the activity of management in managing the firm. Sense of belonging on the firm management which also as firm shareholders are not strong enough, so less able to motivate the management for preventing the firm from *financial distress.*

Stock ownership by the management in some firms was just as symbolic, used to attract the attention of investors. If investors know that some of firm's shares owned by management, then investors would assume that the value of the firm will increase along with existence of the shares owned by the firm management. This is indicated by the unit of samples in this study that showed the average of managerial stock ownership in firms experiencing *financial distress* of 1.197385, greater than the firms which did not experience on *financial distress* of 0.858363. It is also indicated as the cause of the results of the research showed a positive coefficient on the managerial ownership variable.

The results are consistent with Ellen and Juniarti (2013) and Cinantya (2015) which showed that managerial ownership has no influence on the possibility of *financial distress.* This is because the managerial ownership is only symbolic and the implementation of *good corporate governance* in a firm is only a formality which is not supported by an efficient performance.

Institutional ownership variable in this study had no influence on the possibility of *financial distress.* Based on the perspective of *agency theory* with the institutional ownership will reduce the divergence of interests between the shareholders with the firm manager due to the *monitoring* of institutional parties. *Monitoring* functions performed by institutional owners would make the firm more efficient in the use of firm assets as resources in its operations, although the supervision by investors as the owner of the firm is done from outside the firm (Agusti, 2013).

The existence of supervision carried out by the institutional parties will encourage management decisions are always getting better, more responsible, and more favors the interests of the owners. It can prevent the firm from choosing the wrong strategies which can result in losses for the firm itself. It also encourages a more optimal

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supervision improvement on performance of the firm's management, so that the potential possibility on *financial distress* can be minimized (Triwahyuningtias, 2013).

This research did not manage to prove the influence of institutional ownership on the possibility of the *financial distress* at manufacturing firms listed in the Indonesia Stock Exchange period 2011-2013. It was due to the institutional stock ownership is majority and centralized ownership. Centralized ownership can lead to a lack of transparency in the use of funds in the firm as well as an appropriate balance between interests that exist. For example: between the shareholders and the firm management, or between the controlling shareholder and the minority shareholder.

The existence of stock ownership by large and centralized institutions lead to institution as shareholders no longer perform its function to encourage the improvement of supervision on management. Institutional parties as shareholders indicated could easily control the management of the firm by the existence of such large shareholdings.

This research is in line with Ellen and Juniarti (2013), Princess and Lely (2014), and Juniarti (2013) which stated there is no influence of institutional ownership on the possibility of *financial distress.* That is because in a firm is often the institutional ownership is merely a formality and is not intended to meet *good corporate governance.* So the supervision on the management in carrying out its operational activities are not actually carried out by the institution.

The result of the third hypothesis testing shows that the independent commissioner variables had no influence on the possibility of the *financial distress.* A*gency theory* explains the existence of the independent commissioner is required within the firm to mediate or reduce the impact caused by the various interests that ignores the interests of the public shareholders (minority shareholders) as well as other *stakeholders,* particularly at firms in Indonesia that use a public funds in financing its business (NCG 2006). The presence of independent commissioner within the firm will reduce the possibility of *financial distress* due to the effective supervision of the firm management.

This study did not manage to prove the influence of independent commissioner on the possibility of *financial distress* at manufacturing firms listed in the Indonesia Stock Exchange period 2011-2013. This is caused by to the number of independent commissioner on the firm's relatively small. This small proportion of independent commissioner leads independent commissioner incapable to monitor the management activities. The independent commissioner functions and duties as the balance in the decision-making is not too strong, so it has not been able to influence the decisions made by management.

Other factors causing differences in the result is due to the existence of independent commissioner merely as a formality. The firms sampled in this study showed 77.27% of the firm has already fulfill the Law No. 40 Year 2007 regarding Limited Liability Company. According to the law, the minimum number of independent commissioner is about 30% of all commissioners, but the results showed that independent commissioner had no influence on the possibility of *financial distress.* It indicated that the existence of independent commissioner in the firm is only as a formality, to meet the regulation.

This research is in line with research conducted by the Women and Lely (2014) and Ellen and Juniarti (2013) which showed the independent commissioner had no influence on the possibility of *financial distress.* The existence of independent commissioner in the firm only as a formality, to meet the regulations and are not

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intended to fulfill the implementation of *good corporate governance*. Therefore the existence of the independent commissioner not to run the monitoring function well and did not use its independence in supervising the policy of the Board of Directors. Finally supervision function that should be the responsibility of the board of commissioner member becomes ineffective.

5. CONCLUSION

The implementation of good corporate governance mechanisms (managerial ownership, institutional ownership and independent commissioner) in this research did not manage to prove their influence on the possibility of financial distress. The implementation of good corporate governance mechanism in this research apparently is only a formality. A number of 77.27% of firms already meet the regulations, but in fact incapable of influencing the performance of the firm's management to avoid financial distress. Future research should extend the observation period, in order to obtain more sample unit and the results can illustrate the actual condition of the factors that influence the occurrence of *financial distress.* Future research are expected to use the *financial indicators* such as financial ratios - liquidity, profitability and other *corporate governance* mechanisms, such as the audit committee.

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