The Effect of Corporate Governance on Financial Distress of Concentrated Ownership of Manufacturing Firms on Indonesia Stock Exchange

1st Taufik
Economics Faculty
University of Sriwijaya
Palembang, Indonesia
taufik4saggaff@gmail.com

2nd Yuliani
Economics Faculty
University of Sriwijaya
Palembang, Indonesia
yuliani_syapril@unsri.ac.id

3rd Mohamad Adam
Economics Faculty
University of Sriwijaya
Palembang, Indonesia
mr_adam2406@yahoo.com

Abstract: This study aimed to determine the effect of corporate governance, return on asset, market prices to book value, firm size and leverage on financial distress of concentrated ownership of manufacturing firms in Indonesia stock exchange period 2016-2018. The population was 73 of the concentrated ownership of manufacturing firms. The sampling technique used was purposive sampling. Based on the sampling criteria, the number of samples selected was 16 companies. Analysis of the data used was multiple regression analysis. The findings of the study were that corporate governance and market prices to book value did not affect financial distress while return on assets, firm size and leverage affect the financial difficulties of concentrated ownership of manufacturing firms. For further research, it is recommended to add other related variables to financial difficulties.

Keywords: financial distress, concentrated ownership, corporate governance, return on asset, market price to book value, firm size and leverage

I. INTRODUCTION

The results of [1] put Indonesia in the last rank in the practice of corporate governance among Asian countries. This condition indicates that the principles of corporate governance relating to transparency, accountability, responsibility, independence and fairness of companies in Indonesia are still very poor compared to other Asian countries. The results of a financial services authority / OJK (2017) also revealed that the implementation of corporate governance in Indonesia is currently far behind compared to countries in the ASEAN region. If this condition continues it can have a negative impact on the company in the form of financial distress.

The issue of the relationship of corporate governance to financial distress is an important concern for researchers and practitioners globally [27]. Cases of leading companies in Amarike and Europe such as, Global Crossing, Merrill Lynch, and Enron Vivendi, Swissair, and Metallgesellschaft are silent witnesses to corporate governance scandals [24], [29], [19], [11] proved [2] proved that good corporate governance provided the right corporate decision making and improved the company's financial performance so as to avoid financial distress.

According to [15] majority ownership (concentrated ownership) and asymmetric information are indicated as one of the causes of financial distress. The majority owner controls the company so that the external party cannot control the company. This condition indicated that the practice of corporate governance in companies with concentrated ownership often ignores the principles of good corporate governance consisting of transparency, accountability, responsibility, independence) and fairness that are guidance for the company.

The role of good corporate governance is a guide that must be done by companies. According to [25]; [16]; [7] that good corporate governance will reduce agency costs, protect shareholder rights, increase company profitability, increase company value, increase stock returns, build trust in investors and stakeholders, reduce costs of capital, improve company performance, minimize asymmetric information and reduce the risk of financial distress. Empirical research on the effect of corporate governance on financial distress has been conducted by previous researchers, but there are still differences in research results. [20] proved that companies that experience financial distress were companies that practiced bad corporate governance. [5] revealed that there was a negative relationship between Malaysian companies that distress their status of ownership structure as measured by the percentage of shares held by executive directors, non-executive directors and blockholders. Meanwhile, [3] found a positive and significant relationship between financial distress and the practice of corporate governance.

Considering the lowest position of companies in Indonesia in the implementation of corporate governance in Asian countries, the strength of concentrated ownership interventions for companies is thus indicated to affect corporate governance practices and there are still differences in the results of previous research on the impact of corporate governance on financial distress, then this study tries to look at the impact of corporate governance implementation on...
companies that have concentrated ownership structures on financial distress. Analysis of the impact of corporate governance on financial distress of Indonesia public companies is a relatively new area of research. This study tries to prove how corporate governance influence on financial distress in concentrated ownership companies in the Indonesian stock exchange for the period of 2016-2018.

II. LITERATURE REVIEW

A. Agency Theory

The concept of separation of ownership and control in corporations popularized by [13] as a starting point for the development of the modern corporate world has consequences for the creation of agency problems. Agency problems have two sides, namely the classic agency problem between principals and agents (between shareholders and managers) and agency problems between controlling shareholders and non-controlling shareholders. Agency problems between principals and agents arise because of the separation of ownership and control, while agency problems between the controlling shareholder and non-controlling shareholder arise because of the separation between control rights and cash flow rights.

B. Alignment Effect

Theory Alignment effect [22] stated that the majority shareholder (concentrated ownership) is highly motivated to maximize the values of the company. They are able to gather information and supervise managers, but must pay attention to the potential for problems to the agency. Controlling shareholders have sufficient cash flow rights to prevent their desire to take over non-controlling shareholders and companies. The higher the concentration of cash flow rights, the higher the incentives for controlling shareholders to manage their companies appropriately.

C. Entrenchment Effect

Entrenchment is the act of controlling shareholders who are protected by their control rights, so that they are involved in the abuse of power such as expropriation. According to the entrenchment effect, large shareholders can represent their own interests, which need not take into account the interests of minority shareholders, employees, and managers. Under this theory, the company’s financial status influences the behavior of large shareholders. Tunneling and propping behavior are usually observed in companies with concentrated ownership [8].

D. Corporate Governance of Concentrated Ownership Firms and Financial Distress.

Concentrated ownership is the majority shareholder who has a significant financial investment in a company that is measured by the largest shareholding (in percent). Based on alignment effect theory which stated that concentrated ownership is highly motivated to maximize the values of their company. They are able to gather information and supervise managers. Concentrated ownership tends to have enough power to protect their interests and actively monitor company performance and management behavior. These shareholders can use the voting power of shareholders in dispersed ownership companies. A concentrated ownership companies usually have active shareholders and the high quality of monitoring. This condition can inhibit the selfish behavior of management. In such companies, managers may be hesitant to adopt their own interests for fear of losing their jobs. Thus, concentrated ownership helps increase the value of the company by preventing managers from behaving opportunistically so as to reduce the risk of financial distress. [17] proved that concentrated ownership reduces asset risk and insolvency risk. However, it is different from the findings [21] proved that concentrated ownership has a U-shaped relationship with risk. Stewardship theory states that managers as stewards focus more on shared interests or organizational goals rather than on personal desires. Theoretically, concentrated ownership gives a good contribution to the implementation of corporate governance in the company in improving the company’s financial performance in order to avoid financial distress. Research on the effect of corporate governance on finance has been conducted by previous researchers.[8] proved that there is an insignificant negative relationship between corporate governance practices and the likelihood of financial distress. The research result of [6] and [10] stated that corporate governance practices strengthen firm performance. The results of research conducted by [23]; [30] also stated that these practices protect firms against the risk of financial distress. The hypothesis of this research

H1: Corporate governance of concentrated ownership of manufacturing firms in Indonesia stock exchange period 2016-2018 effect on financial distress.

III. METHOD

A. Data and Sample

The data used in this study is secondary data of manufacture firms adopted from the Indonesian capital market directory. The population of this research is 73 concentrated ownership companies of manufacturing companies in Indonesia stock exchanges for the 2016–2018 period. The sampling technique applied is purposive sampling method. The sample selected was 16 companies having Z-score < 1.23 (distress zone).

B. Financial Distress Measurement

The company's financial distress is divided into three stages, namely financial distress incubation, deficit flow of funds, and financial distress. The Altman Z-score can be used to predict the financial health of a company [4]. The Z-score formula for manufacturing companies uses a formula that consists of 5 coefficients, namely:

\[ Z = 0,717X_1 + 0,847X_2 + 3,107X_3 + 0,420X_4 + 0,998X_5 \]

Information:

\[ Z \] = Altman Z-score  
\[ X_1 \] = net working capital / total assets  
\[ X_2 \] = retained earnings / total assets  
\[ X_3 \] = EBIT / total assets  
\[ X_4 \] = market value of equity / book value of total liabilities
If \( Z \geq 2.9 \) = safe zone, If \( 1.23 < Z < 2.9 \) = gray zone, If \( Z < 1.23 \) = distress zone.

C. Corporate Governance Index Measurement

According to [1] The corporate governance disclosure index is an index that assesses the implementation of corporate corporate governance which is built based on the principles of good corporate governance which consists of the principles of transparency, responsibility, independence and fairness. The corporate governance disclosure index in this study refers to [26] study. The calculation of this index value refers to research that has been done by [18] The formula for the corporate governance disclosure index value is as follows:

\[
CGI_j = \frac{\sum_{i=1}^{n} X_{ij}}{\sum_{i=1}^{n} M_i}
\]

\( CGI_j \) = value of corporate governance index of each company
\( X_{ij} \) = value of all scores of the items of corporate governance principles practiced by the company.
\( M_i \) = The totality of items of corporate governance principles which amounted to 60 items.

D. Control Variable

This study also added return on assets, market to book Ratio, firm size and leverage as research control variables. This is done to avoid specification errors in the estimation model [9].

E. Analysis Techniques

Multiple regression was used to test the impact of corporate governance and control variables on financial distress. The regression equation model in research is as follows:

\[
Y_1 = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + e_1
\]

Information:
\( Y_1 = \) Financial Distress
\( \alpha = \) constant
\( \beta_1, \beta_2, \beta_3, \beta_4, \beta_5 = \) Coefficient of Corporate Governance, Return on Asset, Marketto Book Ratio, Firm Size, Leverage
\( X_1, X_2, X_3, X_4, X_5 = \) Corporate Governance, Return on Asset, Marketto Book Ratio, Firm Size, Leverage
\( e_1 = \) Error

IV. RESULT AND DISCUSSION

Table I showed descriptive statistics of the researcher. The implementation of the principles of corporate governance of concentrated ownership companies was on an average of 76.59%. Meanwhile, the return on assets, market price to book value, firm size and leverage of the company from 2016-2018 experienced quite high fluctuations.

| Minimum | Maximum | Mean | STSTD |
|---------|---------|------|-------|
| FD      | -1.27   | 1.26 | .6289 | .50537 |
| CG      | .60     | .92  | .7659 | .08728 |
| ROA     | -9.07   | 36.00| 2.3422| 7.38970 |
| MPBV    | -.45    | 41.00| 3.8796| 8.90040 |
| FIRM SIZE| 11.39   | 18.68| 15.1971| 1.80418 |
| LEVERAGE| -2.08   | 11.86| 1.7773| 2.19050 |

The results of an ANOVA on table II showed that the value of \( F = 4.298 \) with \( \text{sig} = 0.003 \), thus this regression can be used to predict financial distress or corporate governance, return on assets, market price to book value, firm size and leverage affect financial distress.

| Sum of Squares | df | Mean Square | F     | Sig. |
|----------------|----|-------------|-------|------|
| Regression     | 4.063 | 5 | 813 | 4.298 | .003 |
| Residual       | 7.941 | 42 | .189 |      |      |
| Total          | 12.004 | 47 |      |      |      |

The results of the regression coefficient on table III below mentioned that corporate governance did not affect financial distress, thus the research hypothesis was rejected. Meanwhile, the control variable consisting of return on assets, firm size and leverage had a positive effect on
financial distress while the market price to book value had no affect financial distress.

The study proved that the majority of shareholders (concentrated ownership) did not contribute to the financial distress of manufacturing companies in the Indonesian stock exchange for the period of 2016-2018. This condition indicated that the shareholders majority were not the cause of the company's financial distress. They had made a fairly good contribution in implementing the principles of corporate governance even though the implementation was only around 76.59%. The results of this study also implicitly proved that the majority of shareholders did not intervene enough on the company's management. This research result supported the theory of alignment effect which stated that the shareholder majority (concentrated ownership) was highly motivated to maximize the values of the company. Alignment was an act of controlling shareholder which was synchronous with the interests of non-controlling shareholders. Ownership of cash flow rights by controlling shareholders suppressed their desire to take over and increases their attractiveness to pay cash dividends [13]. However, this study results did not support the entrenchment effect which stated that the entrenchment effect was caused by the controlling shareholder. Entrenchment was the act of controlling shareholders who were protected by their control rights (control rights), so that they were involved in the abuse of power such as expropriation. The entrenchment effect consisted of expropriating corporate profits. According to the entrenchment effect, large shareholders can represent their own interests which need not take into account the interests of minority shareholders, employees, and managers. Under this theory, the company's financial status influences the behavior of large shareholders. Tunneling and propping behavior are usually observed in companies with concentrated ownership [8].

Return on assets, firm size and leverage had a positive and significant effect on the financial distress of concentrated ownership of manufacturing firms in Indonesia Stock Exchange in the period of 2016-2018. Company assets increased quite sharply from 2016-2018, but asset management could not increase greater profits. This condition indicates that the company's concentrated ownership of manufacturing firms in Indonesia Stock Exchange had not been able to optimize the assets to generate profits. On the other hand corporate debt also contributes to the company's financial distress. The capital structure policy carried out by the management raises the pressure on the company's financial distress. The role of management in carrying out asset management policies, capital structure policies and the efficiency of company operations can be a cause of corporate financial distress. This condition may occur due to a conflict of interest of concentrated ownership of manufacturing firms. According to the agency theory proposed by [13] that there was a conflict between shareholders as the owner of the company and management as the controller responsible for the daily activities of the company. Shareholders were more oriented towards long-term value creation (increasing the value of the company in the long term), whereas management was more oriented to the short-term horizon in accordance with the contract period as management. The form of conflict can be in the form of compensation (bonus) and excessive use of company facilities by management, as well as other forms of benefits that benefit management which is charged to the company. Market price to book value did not have an impact on financial distress. This is likely that the market price to book value was not directly related to the company's financial performance, so that its role in financial distress did not occur.

V. CONCLUSION

This research concluded that corporate governance and market price to book value did not effect financial distress of concentrated ownership firms in the Indonesia stock exchange. Meanwhile return on assets, firm size and leverage had an impact on financial distress. The implementation of corporate governance of concentrated ownership firms was already quite well. The result proved that majority shareholders did not intervene the management of the company. The management of concentrated ownership firms of manufacturing companies in the Indonesia Stock Exchange in the 2016-2018 period was indicated to contribute to the financial distress of concentrated ownership firms in the Indonesia stock exchange. For the future, management of firms should be deep attention to capital structure policy, optimizing the use of assets to generate profits and operating efficiency.

REFERENCES

[1] Asian Corporate Governance Association / ACGA (2019), "Corporate Governance Watch Hard Decisions: Asia Faces Tough Choices in Corporate Governance Reform", Hongkong.
[2] Akshita Arora, Chandan Sharma, (2016) "Corporate governance and firm performance in developing countries: evidence from India", Corporate Governance, Vol. 16 Issue 2, pp.420-436, https://doi.org/10.1108/CG-01-2016-0018.
[3] Al-Tamimi, H. A. H. (2012), "The effects of corporate governance on performance and financial distress: The experience of UAE national banks", Journal of Financial Regulation and Compliance, Vol. 20 No. 2, pp. 169-181.
[4] Altman, E. I. (1968), “Financial ratios, discriminant analysis and the prediction of corporate bankruptcy”, The Journal of Finance, Vol. 23 No. 5, pp. 589-609.
[5] Abdullah, S.N. (2006), “Board structure and ownership in Malaysia: the case of distressed listed companies”, The International Journal of Business in Society, Vol. 6 No. 5, pp. 582-594.
[6] Black, B.S., Jung, H. and Kim, W. (2006), “Does corporate governance predict firm’s market values? Evidence from Korea”, Journal of Law, Economics and Organization, Vol. 22 No. 2, pp. 366-413.
[7] Claessens, S. and Yurtoglu, B. (2013), “Corporate governance in emerging markets: a survey”, Emerging Markets Review, Vol. 15, pp. 1-33.
[8] Cheung, W. A. and Wei, K. J. (2009), “Insider ownership and corporate performance: Evidence from the adjustment cost approach”, Journal of Corporate Finance, Vol. 12 No. 5, pp. 906-925.
[9] Ehikioya, B.I. (2009), “Corporate governance structure and firm performance in developing economies: evidence from Nigeria”, Corporate Governance: International Journal of Business in Society, Vol. 9 No. 3, pp. 231-243.
[10] Hodgson, A., Lhadoopahan, S., and Buakes, S. (2011), “How informative is the Thai corporate governance index? A financial approach”, International Journal of Accounting and Information Management, Vol. 19 No. 1, pp. 53-79.
[11] Hawtrey, K. (2009), “The global credit crisis: why have Australian banks been so remarkably resilient?”, Agenda, Vol. 16 No. 3, pp. 95-115.
[12] https://www.cnminonesia.com/ekonomi/2017/ojk-praktik-gcg-perusahaan-indonesia-masih-tertinggal/
[13] Jensen, M.C. and Meckling, W.H. (1976), “Theory of the firm: managerial behavior, agency cost and ownership structure”, Journal of Financial Economics, Vol. 3, pp. 305-60.
[14] Komite Nasional Kebijakan Governance /KNKG. (2006), “Pedoman UnnumGood Corporate Governance Indonesia.
[15] Kirkpatrick, G. (2009). “The corporate governance lesson from the financial crisis: OECD Report”, Financial Market Trends, 1, 2-55.
[16] Love, I. (2011), “Corporate governance and performance around the world: What we know and what we don’t” The World Bank Research Observer, 26, 42–70.
[17] Iannotta, G., Nocera, G. and Sironi, A. (2007), “Ownership structure, risk and performance in the European banking industry”, Journal of Banking & Finance, Vol. 31 No. 7, pp. 2127-2149.
[18] Kamel, H. and Shahwan, T. (2014), “The association between disclosure level and cost of capital in an emerging market: evidence from Egypt”, Afro-Asian Journal of Finance and Accounting, Vol. 4 No. 3, pp. 203-225.
[19] Li Liu, Wen Qu, Janto Haman, (2018) “Product market competition, state-ownership, corporate governance and firm performance”. Asian Review of Accounting, Vol. 26 Issue: 1, pp.62-83, https://doi.org/10.1108/ARA-05-2017-0080
[20] Manzaneque, M., Priego, A. M. and Merino, E. (2016), “Corporate governance effect on financial distress likelihood: evidence from Spain”, Revista De Contabilidad, Vol. 19, Issue. 1, pp. 111-121.
[21] Magalhaes, R., Gutiérrez, M. and Tribó, J.A. (2010), “Banks' ownership structure, risk and performance”, available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1102390
[22] Norman H. Chorn, (1991) The “Alignment” Theory: Creating Strategic Fit”, Management Decision, Vol. 29 Iss: 1
[23] Parker, S., Peters, G.F. and Turetsky, H.F. (2002), “Corporate governance and corporate failure: a survival analysis”, Corporate Governance: International Journal of Business in Society, Vol. 2 No. 2, pp. 4-12.
[24] Reinganum, M. R. (2009). Setting National Priorities: Financial challenges facing the Obama Administration.Financial Analysts Journal, 65(2), 32-48.
[25] Rajab, B. and Handley-Schachler, M. (2009), “Corporate risk disclosure by UK firms: trends and determinants”, World Review of Entrepreneurship, Management and Sustainable Development, Vol. 5, pp. 224-243.
[26] Surifah (2011), “Arranging The Index Of Corporate Governance”, Jurnal Dinamika Manajemen Vol. 2, No. 1, 2011, pp: 1-16. http://journal.unnes.ac.id/nju/index.php/jdm
[27] Subramaniam, S. and Reddy, V. N. (2012), “Corporate governance disclosures and international competitiveness: a study of Indian firms”, Asian Business and Management, Vol. 11, pp. 195-218.
[28] Shahwan, T. M. (2015), “The effects of corporate governance on financial performance and financial distress: evidence from Egypt”. The International Journal of Business In Society, Vol. 15, Iss. 5, pp. 641-662.
[29] Supriti Mishra, Pitabas Mohanty, (2014) "Corporate governance as a value draver for firm performance: evidence from India", Corporate Governance, Vol. 14 Issue: 2, pp.265-280, https://doi.org/10.1108/CG-12-2012-0089
[30] Wang, Z.-J. and Deng, X.-L. (2006), “Corporate governance and financial distress: Evidence from Chinese listed companies”, The Chinese Economy, Vol. 39 No. 5, PP.5-27.