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An Empirical Investigation into Board Effectiveness and Financial Distress The Case of Indonesia

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ABSTRACT

This study analyses the effectiveness of the two board system mechanism implemented in Indonesia in condition of financial distress. The governance system of Indonesian companies with family business characteristics separates management functions, namely the board of directors (BD) and supervisory functions run by the board of commissioners. Since the members of the board of commissioners are partly not independent of the board of directors, the role of independent commissioners (IND) is critical important, especially in conditions of financial distress. The sample of this research is companies listed in Indonesia Stock Exchange in the period of 2014-2017. The logistic regression model was employed for 1,168 observations to analyze the influence of the BD and IND on financial distress. The results showed that the BD has a significant effect in reducing the likelihood of financial distress. Although IND have shown independency, it has not been significant in reducing the likelihood of financial distress.

1. Introduction

Financial distress is a condition of financial difficulties that has an impact on bankruptcy (Wruck, 1990). In general, the main cause of financial distress is caused by a poor corporate governance (Cabalu, 2005; Zhuang, Edwards, Webb & Capulong, 2000). Crow and Lockhart (2015) proves that board plays an important role in corporate governance. Weak corporate governance in many companies in Indonesia is caused by failure of board in managing the company.

To mitigate the agency problem that occurs in Indonesian companies, the Law of the Republic of Indonesia Number 40 of 2007 concerning Limited

Liability Companies (LLC) separates management and supervision functions (two-tier system). Indonesia has a family business characteristic, thus there is no separation between control and ownership. The party that has control over the company, namely the management board called the BD generally comes from the majority shareholders. Therefore, Financial Services Authority (FSA) which is known as Otoritas Jasa Keuangan (OJK) requires a supervisory board called the board of commissioners. The BD and board of commissioners are chosen by shareholders. Therefore, there is a potential that the board of commissioners is more oriented towards the interest of majority shareholders. To overcome this problem, FSA (OJK) requires that the board of commissioners filled with an IND members of at least 30% of the total board of commissioners. IND members are believed to be more objective in supervising and giving advice to the BD, hence decisions taken should be in line with the company's vision and mission (Elloumi & Gueyie, 2001; Li, Wang & Deng, 2008; Wagner, Stimpert & Fubara, 1998).

The size of board of directors in a company provides various perspectives regarding the efficiency of directors' performance (Chaganti, Mahajan & Sharma, 1985). Pfeffer (1972) and Zahra and Pearce (1992) stated that a large size of BD would make it easier for companies to have more access both in terms of resources and information to be maximally utilized, in order to reduce the likelihood of financial distress condition in a company. The CEO (Chief Executive Officer) is the leader of the BD, who is trusted in leading the entire line of operations of a company. The CEO is in-charge of making decisions and managing the company (Jensen, 1998; Lubinski; Lubinski & Humphreys, 1997; Kristanti, Rahayu & Huda, 2016). CEO's decisions will determine the performance of a company (Miller, Xu & Mehrota, 2014). CEO quality plays a role when companies face financial distress (Kristanti et al., 2016).

The purpose of this research is to analyze the effectiveness of the two-tier board system mechanism in conditions of financial distress in Indonesia, namely the BD and board of commissioners. Although the board of commissioners functions as a supervisor of the BD, some members of the board of commissioners are not independent with the BD. Therefore, the focus of this study will only refer to the IND. This research would like to illustrate a more precise condition of governance in Indonesia, where most Indonesia's companies are family companies, where no separate control and ownership are involved. The sample used in this study is all companies incorporated in the Indonesia Stock Exchange within a period of four years (2014-2017), except the financial industry.

2. Literature Review

2.1. Agency Problem and Corporate Governance in Indonesia

About 67 percent of companies in Indonesia are family business (Claessens, Djankov & Lang, 1999). Family business is a company which is owned and controlled by the majority of family members (Anderson & Reeb, 2003; Mori & Charles, 2018). In countries where the majority of controls and ownership held by the same individuals/groups, agency problems between majority and minority shareholders tend to happen (Dalziel, White & Arthurs, 2011; Calabro, Compopiano & Basco, 2017; Noodezh, Amiri & Moghimi, 2015) as happen in Indonesia. This conflict occurs when minority shareholders fail in giving opinions in a decision making process because of the smaller number of ownership. The BD generally comes from majority shareholders, hence it reflects the interests of the majority shareholders. Majority shareholders often act according to their own desires by utilizing their favorable position through their control of the corporate governance structure (Noodezh, Amiri & Moghimi, 2015; Shleifer & Vishny, 1997).

The majority of corporate governance's organs in Indonesia are characterized by family business consisting of GMS (General Meeting of Shareholders), BD, and board of commissioners (Republic of Indonesia Law Number 40 of 2007). Appointment and dismissal of members of the BD and members of the board of commissioners are held at the GMS.

BD is responsible managing the company to achieve the corporate's goals and strategies in accordance with government regulations. Republic of Indonesia Law Number 40 of 2007 article 97 emphasizes that in managing the company, BD must have good intentions and full responsibility. If a company faces bankruptcy due to the negligence of BD, and the company's assets are not enough to pay all of the company's liabilities, each director must be responsible for the unpaid liability.

The BD has the authority to run the management of the company, whose effectiveness will affect the overall performance of the company. Republic of Indonesia Law Number 40 of 2007 chapter VII and FSA (OJK) Regulation Number 33 of 2014 state that the number of directors in public companies in Indonesia must consist of at least two people, one of whom will be the CEO. The board of commissioners aims to supervise the regulations/ management policies of the company, and advise the BD on the decisions taken. To minimize the occurrence of agency problems for Indonesia's companies, the FSA (OJK) requires the involvement of independent parties in the composition of the board of commissioners. Republic of Indonesia Law Number 40 of 2007 states that the minimum number of board of commissioners is two people, one of whom is an independent commissioner (a party that is not affiliated with a major shareholder, member of the BD or other board of commissioners). FSA (OJK) Regulation Number 33 of 2014 more specifically states that the number of IND must be at least 30 percent of the total board of commissioners. The objective of the IND is to minimize conflict of interests between stakeholders (government, creditors, investors) and be more transparent. The board of commissioners must form audit committees and other committees (remuneration and nomination committee) to support the effectiveness of supervisory activities for the company (FSA Regulation Number 33 of 2014). The presence of the board of commissioners in the company contributes to quality decision making, thus the company is expected to avoid financial distress.

2.2. Financial Distress

Financial distress occurs due to a lack of the company's capacity to fulfill its financial obligations (Grice & Dugan, 2001; Grice & Ingram, 2001, Pindado, Rodrigues & Torre, 2008). Financial distress ultimately resulted in the bankruptcy of the company (Wruck, 1990). Platt and Platt (2002) proved that companies which have low or even minus operating cash flow to sales, low current ratio, high net fixed assets to total assets ratio, high long-term debt to equity ratio, and declining cash growth from the previous period, tend to be indicated to experience financial distress.

Pindado et al. (2008) identified two conditions that indicate the occurrence of financial distress, first, the company's operating income is lower than its financial negative for two consecutive years, and second, the decline in the company's market capitalization for two consecutive periods. Elloumi and Gueyie (2001) argue that if the company has negative earnings per share (earnings per share) then the company experiences financial distress. The decision taken in dealing with financial distress is the responsibility of BD. According to Whitaker (1999), if in good condition the company experiences financial distress, it can be said that the main cause is the weakness of the company's board.

2.3. Hypotheses Development

The BD plays a critical role in performing company's management activities as stated in the company's articles of association. Cossi and Caballero (2014) state that board effectiveness can be measured from the composition of the board itself. The composition will provide various perspectives regarding the efficiency of the directors' performance, who can be identified through the size of BD (Chaganti et al., 1985).

Larger size directors can build broader external connections (Goodstein, Gastom & Boeker, 1994; Lamberto & Rath, 2008) as well as build better relationships with stakeholders (Goodstein et al., 1994). The company's stakeholders cover shareholders, employees, creditors, management, government and various other parties involved in the operationalization of the company. Zahra and Pearce (1992), Pfeffer (1972) and Ahmad and Adhariani (2017) argue that companies will find it easier to obtain resources and information if they have larger number of directors. The information obtained by the company certainly can also be well distributed along with the positive relationships between the company and stakeholders. Therefore, conflicts of interest between various stakeholders can be mitigated and reduce the occurrence of financial distress. The large the number of directors the more the opportunity available for company to utilize director's expertise (Tricker, 1984). Diverse expertise of BD provide perspectives which make a decision-making process to be more qualified, thus helping the company to avoid financial distress. However, the problem of coordination among directors will arise during strategic decision making process, when a company is faced to a financial distress condition (Forbes & Miliken, 1999). Nevertheless Chaganti et al. (1985), Chan, Chou, Lin and Liu (2016) highlighted a problem raised as the number of BD increased which is balancing each director's interests in decision made. When a company is faced to a financial distress condition, the problem of coordination will arise during strategic decision making process. The hypothesis proposed is:

H1: *The size of directors is negatively related to the possibility of financial distress.*

The CEO is a main figure on the BD. When a company is in a healthy condition, the CEO will be appraised as the most outstanding performer. However, when the company is facing a difficult situation, CEO is a first figure to be highlighted (Bernstein, 2006). CEO has responsibilities to harmonize the interests of shareholders, as well as to overcome conflicts of interest between shareholders and other stakeholder.

Cossin and Caballeror (2014) state that one of the crucial components in the board is the quality of the CEO. There are many factors that can describe the quality of the CEO. Jensen (1998) has proven that IQ (Intelligence Quotient) of a CEO determines results that will influence the decision making process (Lubinski & Humphreys, 1997).

According to Bhagat, Bolton and Subramanian (2010) and King, Srivastav and William (2016), the CEO's education level can influence his perspective, ability, persistence in facing challenging business conditions, and connections obtained by the CEO. The better education owned by a CEO is expected to improve the decision making mechanism, in order to dismiss any stakeholders being disadvantaged, including creditors and the government. Miller et al. (2014), King et al. (2016) and Chevalier and Ellison (1999) proved that CEO who studied at top universities or universities have a higher intelligence and motivation than others (Miller et al., 2014).

Rotemberg and Saloner (2000) stated that the company's success in performing its operational activities was determined by the quality of CEO. Research from Kristanti et al. (2016) proved that a qualified CEO make the right decisions to mitigate the complexity of the problems suffered by the company. Good decisions derived from the CEO can prevent companies from facing a financial distress condition. However, research from Bhagat et al. (2010) and Gottesman and Morey (2010) states that CEO's quality is not a significant factor because the quality does not affect the company's performance, hence it does not affect financial distress condition. The hypothesis proposed is:

H2: *The quality of the CEO is negatively related to the possibility of financial distress.*

Cossin and Caballero (2014) state that board independence is an important component that can be measured by the existence of IND. FSA (OJK) Regulation Number 33 of 2014 states that an IND is a member of the commissioner who is not affiliated and comes from outside the company, and has an obligation to monitor the activities of the company. Baysinger and Hoskisson's (1990) research states that independent parties usually have a very independent attitude, thus they tend to disclose the company's condition to stakeholders and can increase the likelihood of financial distress.

Ahmad and Adhariani (2017), Elloumi and Gueyie (2001), Ombaba and Kosgei (2017) and Wang and Deng (2006) showed that companies with a higher proportion of IND has a lower likelihood of financial distress because they can be more efficient in providing advice to help overcome possible failures (Fich & Slezak, 2008). This advice will certainly not only benefit one party, but will consider the interests of both the majority and minority shareholders. Arifin and Rachmawati (2006) stated that the presence of IND in the company is one of the effective mechanism to reduce conflicts of interest between majority and minority shareholders.

Fama and Jensen (1983) and Zahra and Pearce (1989) have proven that the presence of IND in the company is a sufficient measure to monitor the directors' performance (which are controlled by majority shareholders), so that decisions taken are in line with the interests of all shareholders and reduce the possibility of financial distress. This study is in accordance with studies conducted by Lakshana and Wijekoon (2012) Li et al. (2008) Manzaneque, Priego and Merino (2016) and Wagner et al. (1998). However, Chaganti et al. (1985) and Simpson and Gleason (1999) have not been able to prove the relationship between the proportion of INDto financial distress. The hypothesis proposed is:

H3: *IND have a negative relationship with the possibility of financial distress.*

3. Method

This study examines the relationship of board effectiveness to financial distress with sample of companies listed on the Indonesia Stock Exchange (IDX) during 2014 until 2017. Data screening samples are presented in Table 1.

Table 1
Sample Data

Criteria	*Number of Company*	*Number of Observation*
The number of companies listed on the IDX	628	2.512
Less: Financial industry	(91)	(364)
Less: Companies conducting IPOs during 2012-2019	(140)	(560)
Less: Companies that do not have complete financial statements and annual reports for 2012-2017 period	(79)	(316)
Less: Companies that do not meet criteria (Positive Return on Equity due to negative net income and equity)	(26)	(104)
Total samples	292	1.168

Source: data processed

Research Variable

Dependent Variable

Financial Distress (DIS) is the dependent variable of this study, which is represented using dummy as follows:

0: the company's operating profit does not suffer for two consecutive years and there is no fall in its market capitalization occurs between two consecutive periods;

1: the company's operating profit suffers for two consecutive years and there is a fall in its market capitalization occurs between two consecutive periods

Independent Variable

There are three independent variables used in this study:

1. BDSIZE measured using the number of directors in the company.
2. CEO Quality (DQUALITY) which is represented using dummy, as follows:
   0: CEO's education level is under Bachelor or does not have an experience as a director/commissioner;
   1: CEO's education level is Bachelor or above, or have an experience as a director/commissioner.
3. IND measured using the percentage (%) of IND members who have served the company for less than 10 years, are divided into total company commissioners.

   This study uses as control company characteristics variables such as:

   1. Leverage (LEV) measured using a percentage (%) of debt compared to the total assets of the company.
   2. Company Size (TOTASS) measured using the nominal value of the company's total assets.
   3. Company Value (MCAP) measured using the market capitalization of the company.
   4. Corporate growth (GROWTH) measured using the company's average sales growth for two consecutive years.
   5. Profitability (ROE) measured using the percentage (%) of net income compared to the shareholders' equity.

The following logistic regression model is used to measure the relationship between board effectiveness and the possibility of financial distress:

$DISit = \alpha it + \beta 1\ BDSIZEit + \beta 2\ DQUALITYit + \beta 3\ INDit + \beta 4\ LEVit + \beta 5\ TOTASS\ it + \beta 6\ MCAPit + \beta 7\ GROWTHit + \beta 8\ ROEit + \varepsilon it$

Note:

DIS = financial distress; BDSIZE = board of director size; DQUALITY = CEO quality; IND = independent commissioner; LEV = leverage; TOTASS = company size; MCAP = company value; GROWTH = company growth; ROE = profitability

4. Result and Discussion

Result

Table 2 shows that Indonesia's companies that experienced financial distress (DIS) were relatively small at 89 observations (mean: 0.0761). This shows that Indonesia's economic condition during 2014-2017 was relatively good compared to global conditions which experienced a slowdown in those years. The sector that experienced highest financial distress was the trade, service and investment industry, which were 32 financial distress events, while there were almost no financial distress events in the agriculture industry.

Table 2
Descriptive Variable

	Variable	*N*	*Mean*	*Std Dev.*	*Min.*	*Max.*
Dependent	DIS	1168	0,0761	0,2654	0	1
Independent	BDSIZE	1168	4,8775	2,0058	2	16
	DQUALITY	1168	0,9417	0,2342	0	1
	IND	1168	0,3508	0,1354	0	0,8
Control	LEV	1168	0,2381	0,1985	0	2,8867
	TOTASS (in million Rupiah)	1168	10.100.000	23.200.000	7.650	296.000.000
	MCAP (in thousand Rupiah)	1168	12.000	44.100	20,5835	550.000
	GROWTH	1168	-2.509,611	51.556,95	-1.253.542	1.868,955
	ROE	1168	0,03851	0,5436	-13,82725	8,910532

DIS = financial distress; BDSIZE = board of director size; DQUALITY = CEO quality; IND = independent commissioner; LEV = leverage; TOTASS = company size; MCAP = company value; GROWTH = company growth; ROE = profitability

BD size (BDSIZE) with the mean 4.8775 shows that on average, Indonesia's company has four to five directors (including a president director). If the total observations are being quartiled, the result proves that BD' size will be proportional to the size of the company assets. The result of this descriptive statistic indicates the importance of the existence of BD in Indonesia. CEO Quality (DQUALITY) has a mean value of 0.9417, which indicates that most of CEO in Indonesia's company has a Bachelor degree or at least has an early experience as a director or commissioner.

Table 3
Quartile of BD' Size and Company Size

Quartile	*BDSIZE*	*TOTASS*
Quartile 1	2.790	2,675,860,879,273.580
Quartile 2	3.880	4,817,822,109,130.810
Quartile 3	5.295	10,047,103,448,973.400
Quartile 4	7.550	22,824,702,255,900.200

BDSIZE = board of director size; TOTASS = company size

The IND has an mean value of 0.3508, which indicates that the average of Indonesia's company has a composition of IND compared to the total commissioners by 35 percent. It can be concluded that the BD size and IND have already been in accordance with RI Law Number 40 of 2007, which requires a minimum of two BD and a minimum of 30 percent of IND in the company.

Table 4 presents the logistic regression result between BD and IND with financial distress. The result has been free from multicollinearity problem. The results show Prob>chiz value in the Pearson test of 0.0000, which means that the model is fit, appropriate and can be used to predict the occurrence of financial distress.

BD size (BDSIZE) has a negative relationship to financial distress (DIS) with a p-value of 0.084 as shown in Table 4. Therefore, the first hypothesis

Table 4
Logistic Regression Test Results

DIS	*Coef.*	*Std. Err.*	*Z*	*P>|z|*
BDSIZE	-0,1315	0,7605	-1,73	0,084*
DQUALITY	0,5934	0,6112	0,97	0,332
IND	0,6647	0,8364	0,79	0,427
LEV	1,1087	0,4914	2,26	0,024**
TOTASS	0,0000000000000374	0,0000000000000105	3,55	0,000***
MCAP	-0,000000111	0,0000000321	-3,46	0,001***
GROWTH	0,0000236	0,000043	0,55	0,583
ROE	-0,6765	0,3388	-2,00	0,046**
_cons	-2,8456	0,7076	-4,02	0,000
Number of observations		1168		
Prob>Chi2		0,0000		
Pseudo R2		0,0858		

Significant on: *** α = 1 percent, ** α = 5 percent, * α = 10 percent; DIS = financial distress; BDSIZE = board of director size; DQUALITY = CEO quality; IND = independent commissioner; LEV = leverage; TOTASS = company size; MCAP = company value; GROWTH = company growth; ROE = profitability

(H_1), which is the size of the BD, has a negative influence on financial distress. However, this logistic regression results have not been able to prove the influence of CEO quality (DQUALITY) and the role of independent board of commissioners (IND) in dealing with financial distress. CEO Quality (DQUALITY) in Table 4 with p-value of 0.332 is above alpha 10%, which indicates that DQUALITY does not have a significant relationship to DIS. Thus, the second hypothesis (H_2) which states that CEO quality has a negative effect on financial distress has not been proven. The supervisory function carried out by IND has also not been proven effective as shown in Table 4, with a p-value of 0.427, which is above alpha 10%. Thus, the third hypothesis (H_3), namely IND, has a negative influence on the possibility of financial distress also cannot be proven.

5. Discussion

The results of the first hypothesis shows that BD as a team plays a role in dealing with financial distress. Bodroastuti (2009), Hanifah and Purwanto (2013), and Sastriana and Fuad (2013) also proved that the decisions taken by the BD will have a higher in quality if there is a large size of the directors. Zahra and Pearce (1992), Pfeffer (1972) and Ahmad and Adhariani (2017) state that the small in directors' size will make the company less optimal to operate due to limited access in resources and information. The variety of information that the company exposes will certainly add a new perspective to the BD. Large size directors can build broader connections including good relations with stakeholders (Lamberto & Rath, 2008; Goodstein et al., 1994). The variety of information obtained by company and good relationships intertwined between stakeholders will improve the quality of decision making that eventually impacts company's performance, especially financial performance (Nawangwulan, Ilat, & Warongan, 2018). The high profits produced by the company will certainly avoid financial distress.

Jensen (1993) states that a large size in BD can make the process of monitoring the financial reporting more effective. This will reduce the potential in financial reporting errors that can affect financial distress. The ability of directors can be optimalized according to their respective fields, thus the greater the number of directors, the more optimal utilization of the directors' capabilities (Tricker, 1984). Diverse expertise from the BD is expected to provide a new perspective in company's decision making process, in order to avoid financial distress.

This study has not succeeded in proving the influence of CEO quality in dealing with financial distress. The proxy used to measure the quality of

CEO in this study is the level of education and experiences that particular CEO has served both in the level BD/commissioners. Bhagat et al. (2010) and Gottesman and Morey (2010) state that the education of a CEO does not affect the performance of the company or financial distress. Bhagat et al., (2010) emphasized that there are many components that are hard to be quantified into CEO quality other than education and experience such as track records, ability to lead and interpersonal skills, which may have more impact on CEO's performance, company's performance and financial distress experienced by the company.

The result shows that the role of IND were not significant in dealing with financial distress. Empirical evidence in Indonesia tend to show the insignificant influence of IND on financial distress such as done by Ananto, Mustika & Handayani, (2017) and Deviacita & Achmad, (2012), Helena & Saifi, (2018), Sastriana & Fuad, (2013), Wardhani, (2007).

The interesting finding of the result is the positive relationship between IND and financial distress. Surya and Yustiavandana (2008) explains that the presence of IND in the company is expected to reduce conflict of interests between parties other than majority shareholders, namely: minority shareholders, BD, employees and other related parties. Therefore, IND must be independent and express the condition of the company honestly, thus stakeholders could become aware of the actual conditions of the company (Baysinger & Hoskisson, 1990). This finding proves that IND have shown independent behaviour by disclosing transparently the financial distress faced by the company with the purpose of seeking the possible solutions (given that mean of 0.3508). However, the relatively small number of IND members compare to other members of Board of Commisioner make it for IND to show an effective supervisory role. In fact, most Indonesian companies tend to only meet the minimum requirements for the number of IND, which is 30% of the total board of commissioners. In conditions that require voting among the Board of Commissioners, the number of IND is less effective because of their small number. This explains the insignificance influence of IND in Indonesia in dealing with financial distress.

6. Conclusion

This research proved that the BD as a team plays an important role in financial distress. The extent of connections, portfolios, access to resources and information obtained by the BD to avoid the company from financial distress. However, the influence of CEO's quality in dealing with financial distress cannot be proven by this study. Many other components that are difficult to quantify into the proxy of CEO quality make it less accurate in measuring CEO quality in Indonesia's companies.

IND as neutral parties who provide advice to the BD has not shown a significant role in financial distress. Supervision of the BD has not been optimal in facing financial distress, even though IND has shown an attitude of independence.

This research measures CEO quality using two components, namely CEO's education and experience. Future research is expected to expand the CEO quality assessment component such as: the perception of company members towards the CEO. Further research is also suggested to include the value weight in measuring CEO quality instead of using dummy.

This research is expected to have implications for several parties in Indonesia, including for company's management to increase the number of BD in order to reduce the possibility of financial distress. In addition, investors can reassess companies that they would likely to invest in, considering the size of the BD, thus companies chosen do not have a tendency to experience financial distress. This study can also enrich public's knowledge regarding various characteristics of the BD and commissioners and their influence on financial distress conditions.

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