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Corporate Governance Effect on Financial Distress in Indonesian FMCG Companies

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ABSTRACT: Financial Distress is the alerted and feared by all of companies, both local and international companies and also become a main cause of companies to bankrupt. The main cause of financial distress is an ineffective corporate governance to solve the financial problem which lead the financial distress. The aim of this study is to investigate the effect of corporate governance that cause financial distress at FMCG companies in Indonesia. The examined variable in this study were Board Size, Board Independence, CEO Tenure and CEO Duality. This study used secondary data from 48 FMCG companies with 288 total sample in purposive sampling method. The statistical method used logistic regression for analyzed the data. The result of this study reveal that Board Size has significant effect on financial distress meanwhile Board Independence, CEO Tenure and CEO Duality has no significant effect on the cause of financial distress at FMCG companies in Indonesia during 2016-2021 period.

KEYWORDS: Corporate Governance. Financial Distress, Board Size, Board Independence, CEO Tenure, CEO Duality

1. INTRODUCTION

In all sector of business, profit is the most important things to increase the financial report so the activities can continue to produce the all of things that society needs and also attract the investor to investing a money to the firm in all sector, especially in FMCG companies. In order to achieveing this the good corporate governance must needed to make investor attracted to them and also clean from all the activities that harm firm like corruption or etc (Setiawan , 2021).

FMCG firms want to earn a profit for their sustainability operating activities e.g maximize advertising for sales, buy a new equipment for manufacturing or etc. Earn a profit is the most important for them to measure their firm performance in the future. So the firm must maximize the financial performance to continue it's operations.Also in FMCG companies has complex manufacturing operation (Letizia and Pandu, 2022). Financial distress make FMCG firm lead to bankruptcy, fail to pay debt to bank and etc. The cause of financial distress can from external or internal factor like corporate governance in FMCG firms.

Financial distress become a bad news for FMCG company according to Wruck (1990) when firm's operating cash flow insufficient to pay current liabilities and Saleh (2004) also stated that to find this must compare the long term liabilities to total asset, especially in FMCG (Fast Moving Consumer Goods) companies. This event according Cruz et.al (2014) is interesting in academia and industry views. Also Bayrakdaroglu et.al (2012) stated that the effect of financial distress are doubt and worst financial event for bank, firm, stakeholders , national regulator (In Indonesia is OJK (otoritas Jasa Keuangan)) and etc. Ross et.al (2020) described the cause of financial distress are layoff , decline of stock price, closing the factory, loss of profit , the resignation CEO who is competent, the decline of dividends. And in this case the main problem of financial distress is the ineffective corporate goverance at FMCG companies in Indonesia. The ineffective corporate governance lead by the mismanagement and bad financial decision (Andersen et.al 2013; Saunders & Cornett 2016;Wong 2006). Various causes that lead the ineffective governance are from the institutional ownership, CEO Duality, CEO Tenure, Board Independence. Financial reporting , etc (Pascual & Fuster, 2014).

Corporate governance make the worst financial distress is because the bad financial decision or fraud in serving the financial report in. it can be the independency, transparency accountability, fairness, and responsibility value of corporate governance become ineffective and inefficient , and society also review that there are many scandals or bad case in FMCG companies which lead the issue of financial distress in FMCG companies (Iqbal et.al , 2015).

The first cause of ineffective corporate governance is Board Size, it said that the big size of board size not support the firm because it can make the separation from firm vision and mission of their purpose to generate revenue (Gill & Mathur, 2011). The second is Board Independence , Board Independence that lead by board in company like CEO and their subordinates make the independency not free to operate the company because the nepotism in the company that prelude the downfall of company. M.U.F. Khan et.al (2019) described that board of directors contribute most to financial performance in the company. The third cause is CEO Tenure, the short or long period of tenure can make profit loss / gain significantly for company. It can caused many confusion and dissarray in company career path and CEO whose tenure longer than shorter is well known to market and company condition, and also auditted financial report (Xie 2015; Ali & Zhang 2014). The fourth cause is CEO Duality. CEO Duality is the condition where the same person holds more than 1 title in company. It can break the rule of company whereas loss or gain in company and cause the nepotism and corruption in company which lead financial distress. CEO Duality also become the hot topics and controversy in academia and industry and interesting for 25 years in all of countries in world (Dalton et.al 2007; G.Kolias et.al 2019).

This paper is to describe financial distress which lead by corporate governance in FMCG companies. It interesting since the crisis can lead the untrusthworthy and inconfidence for investor to invest their money and stock to FMCG companies and also make the firm can bankrupt so the paper is to explain also the corporate governance practice that lead financial distress in FMCG companies.

This paper aim is to identify the ineffective corporate governance at FMCG industries in Indonesia for 2016-2021 or in 6 years. The ineffective corporate governance in FMCG industries make the product that they produce and sell not gain the profit and their planning for expansion can halted because financial distress. The benefit of this paper is :

1) To help FMCG industries identify the problem of their corporate governance.
2) To reduce the harmful activity that harm the firm like corruption or nepotism in board.
3) To improve the corporate governance in FMCG industries.

2. 2LITERATURE REVIEW AND THEORETICAL REVIEW

2.1.1 LITERATURE REVIEW

Many existing studies show the corporate governance effect on financial distress are caused by board independence, board size, CEO tenure, and CEO duality. Kalsie and Shrivastav (2016) stated that board size positive significantly cause the financial distress. Orozco et.al (2017) who research in Colombia and used k-Mean Cluster also stated that board size can cause the financial distress. Isik and Ince (2016) also stated that board size make a financial distress in Turkish firms during 2008-2012 period.

Board independence can reduce the financial distress in Pakistan and India Firms (Khurisd et.al 2019; Shetty & Vincent 2021). Munene et.al (2020) also stated that the result negatively in kenya. But in some instance that board independence can caused a financial distress in Canadian and Nigerian firms according to Ayodeji & Okunade (2019), and also according to Yousaf et.al (2020) significantly effected the financial distress in Chinese firms with data processing at machine learning model.

CEO tenure in 42 Pakistani Firms can reduced financial distress because not dominant CEO in Zahra et.al (2018). CEO tenure also increased the firm performance that prevent financial distress in Shanghai and Shenzhen listed firm during 2009-2015 (Khan et.al 2020). But Yahaya and Awen (2021) stated that CEO tenure can caused a financial distress in Nigerian firms, also Sewpersadh (2021) research show CEO tenure can caused financial distress in 116 South African firms.

CEO Duality can caused financial distress in 442 Vietnamese firms according to Pham and Pham (2020). Also Mei Yu (2020) stated that ceo duality make financial distress in companies around the world. But Mubeen et. al (2020) whose research in 442 Chinese firms showed that CEO duality can reduce financial distress in 442 Chinese firms.

2.1.2 Agency Theory

Simon Herbert (1959) stated that manager was a satisfier to firm than a capable person to maximalize the firm profit. This problem effected the agency theory. Agency Theory stated by Jensen and Meckling (1976) as shareholders of the firm can convinced themselves that their agents or CEO could decide the best decision to the firms , if they can satistfy the shareholders , they would get the incentive / bonus like option or the others. Fama and Jensen (1983) also stated that the board must contain the independent director, but CEO who dominated / ruled the firm make the decision, controlling and separation between CEO and shareholders make it difficult to shareholders so the make a profit decrease. Independent directors make a separation and decision effectively. Jensen (1993) argued that firm board which have many director can slow the firm performance and respond the decision that make it ineffective to implement that.

2.1.3 Resource Dependence Theory

Pfeffer and Salancik (1978) predicted in their theory that director can bring the benefit for firms like advice , access to information , and preference to legitimacy and resource. Pfeffer and Salancik (1978) also stated firm that already regulated needed a outsider who already experienced and also explained the CEO succession or CEO Tenure.

2.1.4 Stewardship Theory

Barney (1990) argued optimistic about managerial behaviour and stated that outsider didn't needed because agent or insider directors were best resource in firms and shouldn't needed to be motivate for individual target. Akin (2004) also argued that firm representatives can act as firm purpose and business owner to protect their interest in firm, and Sheikh and Wang (2012) stated CEO duality create a effective ease to CEO and increased firm performance.

OPERATIONAL FRAMEWORK

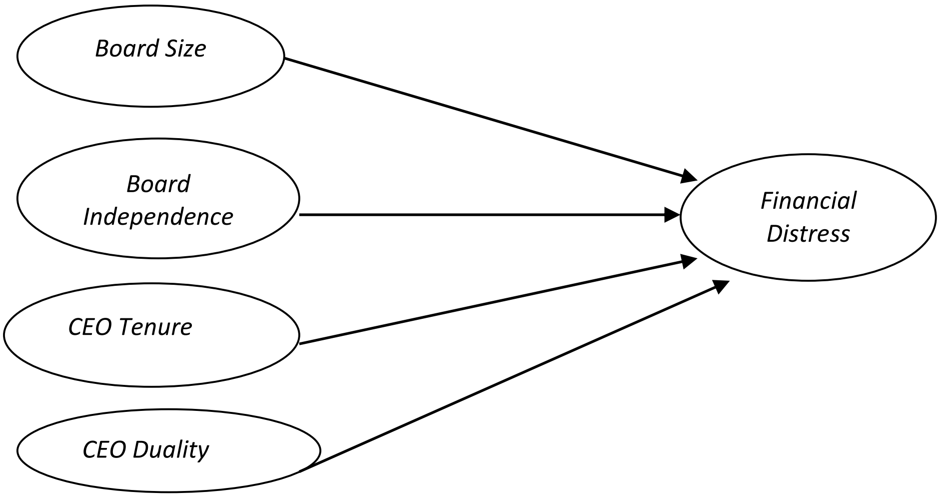

Figure 1. Operational Framework of corporate governance to Financial Distress
Sources : Isik and Ince 2016; Yousaf et.al 2020; Sewpersadh (2021) ; Mei Yu (2020)

3. RESEARCH METHODOLOGY

The research methodology is quantitative and used secondary data from FMCG companies website that contains board size, board independence , CEO tenure and CEO duality information and also financial information in their websites. The method of the analysis is 1). Descriptive statistics, 2) Corelation analysis, 3) Logistic Regression. The software in this papers used Python 3.10.6 in the form of Pandas and Statsmodels library on google colab application.

Model specification

The formulated model of Multinomial Logistic Regression used in this paper :

$$\pi 0(x) = \frac{1}{1 + expP1(x) + expP2(x)}$$

$$\pi 1(x) = \frac{expP1(x)}{1 + expP1(x) + expP2(x)}$$

$$\pi 2(x) = \frac{expP2(x)}{1 + expP1(x) + expP2(x)}$$

Operational Variables Definition :

Board Size (BS) : Total numbers of board of directors and commisioner in firms

Board Independence (BI) : Percentage of Independent director / commisioner to board of commisioner

CEO Tenure (CT) : Total years of CEO lead the firms

CEO Duality (CD) : The dummy variable which 1 is CEO has dual control and 0 otherwise

Financial Distress (FD) : Condition when the firms can’t fullfill their obligations. Mathematics model use Z Score Altman :
Z = 1.2(X1) + 1.4(X2) + 3.3(X3) + 0.6(X4) + 1.0(X5)

$$X1 = \frac{WORKING\ CAPITAL}{TOTAL\ ASSET}$$

$$X2 = \frac{RETAINED\ EARNINGS}{TOTAL\ ASSET}$$

$$X3 = \frac{EBIT\ (EARNINGS\ BEFORE\ INTEREST\ AND\ TAXES)}{TOTAL\ ASSET}$$

$$X4 = \frac{BOOK\ VALUE\ TO\ EQUITY}{TOTAL\ LIABILITIES}$$

$$X5 = \frac{SALES}{TOTAL\ ASSET}$$

And also calculate with dummy variable where :
2 = Distressed
1 = Grey Area
0 = Otherwise

STATISTICAL RESULT

Table 1. Descriptive Statistics

	BI	BS	CT	CD	FD
count	288.000000	288.000000	288.000000	288.000000	288.000000
mean	0.358333	8.437500	8.319444	0.437500	0.576389
std	0.180723	3.093702	10.685333	0.496942	0.818598
min	0.000000	4.000000	0.000000	0.000000	0.000000
25%	0.330000	6.000000	1.000000	0.000000	0.000000
50%	0.355000	8.000000	4.000000	0.000000	0.000000
75%	0.500000	10.000000	12.000000	1.000000	1.000000
max	0.750000	19.000000	50.000000	1.000000	2.000000

Source: Researcher's computation (2022) using Pandas

Note : BI = Board Independence; BS = Board Size; CT = CEO Tenure; CD = CEO Duality; FD = Financial Distress.
Table 1 show the mean, median standard deviation and range. The mean for Board independence is 0.358333 which show 1 independent commisioner / director for every FMCG firms, Board Size mean is 8, CEO Tenure mean is 8 years respectively, CEO Duality mean is 0 which no duality control from CEO and Financial Distress mean is 0 which no of FMCG companies distressed.

Table 2. Corelation Matrix

```
[13] ps.corr()
```

	BI	BS	CT	CD	FD
BI	1.000000	0.070484	-0.042342	0.024442	0.014760
BS	0.070484	1.000000	-0.154863	0.337408	-0.241632
CT	-0.042342	-0.154863	1.000000	0.401419	0.191593
CD	0.024442	0.337408	0.401419	1.000000	0.054604
FD	0.014760	-0.241632	0.191593	0.054604	1.000000

Source: Researcher's computation (2022) using Pandas

Table 2 show he corelation matrix which all of independent variables effect to Financial Distress, the dependent variable below 0.4 so the multicolinearity data no exists.

Table 3. Multinomial Logistic Regression Results

MNLogit Regression Results

Dep. Variable:	FD	No. Observations:	288
Model:	MNLogit	Df Residuals:	278
Method:	MLE	Df Model:	8
Date:	Thu, 19 Jan 2023	Pseudo R-squ.:	0.06410
Time:	07:29:05	Log-Likelihood:	-243.64
converged:	True	LL-Null:	-260.33
Covariance Type:	nonrobust	LLR p-value:	5.268e-05

FD=1	coef	std err	z	P>|z|	[0.05	0.95]
const	-0.6406	0.660	-0.971	0.332	-1.726	0.445
BI	-0.7015	0.915	-0.766	0.443	-2.207	0.804
BS	-0.0995	0.071	-1.398	0.162	-0.217	0.018
CT	0.0367	0.018	2.080	0.037	0.008	0.066
CD	-0.0698	0.432	-0.162	0.872	-0.780	0.641
FD=2	**coef**	**std err**	**z**	**P>|z|**	**[0.05**	**0.95]**
const	0.4991	0.668	0.748	0.455	-0.599	1.597
BI	0.6949	0.882	0.788	0.431	-0.755	2.145
BS	-0.2955	0.079	-3.756	0.000	-0.425	-0.166
CT	0.0195	0.016	1.245	0.213	-0.006	0.045
CD	0.7122	0.393	1.813	0.070	0.066	1.358

Source: Researcher's computation (2022) using statsmodels

Table 3 show the coefficient of multinomial logistic regression :

1) $p1(x) = -0.6406 – 0.7015BI – 0.0995BS + 0.0367CT – 0.0698CD$
2) $p2(x) = 0.4991 + 0.6949BI – 0.2955BS + 0.0195CT + 0.7122CD$

4. DISCUSSION

Following the result in Multinomial Logistic Regression in table 3 in the financial distress on grey area (marked by 1) the variable which significance is CEO Tenure which p-value is 0.037 and positive relationship , but in financial distress in distressed category (marked by 2) CEO Tenure is have positive relationship and no statistically significant. Board Independence both in grey area and distressed not statistically significant because p value > 0.05 and CEO duality also. Board size in grey area not statistcally significant and in distressed category is statistically significant. The CEO Tenure research is consistent to Yahaya and Awen's (2021) research and board size supported by kalsie and shrivastav (2016) . Board Independence also consistent with Munene et.al (2020) research. And CEO Duality consistently with Mubeen et.al (2020) research.

CONCLUSION

The FMCG firm must make a attention of size of the board because some big size of board doesn't effective to regulate the firm and have a interest conflict also nepotism in FMCG companies, CEO tenure not causing financial distress because the wise and competent CEO tenure lasting longer so make financial performance not distresses also CEO duality not make financial distress in FMCG companies. Board independence can prevent financial distress because the outsider can intervene the insider director to regulate the good decisions in FMCG companies. This paper supported the theory of agency, resource dependence theory and stewardship theory. The paper wish is make the board of director not become large in company so the all of FMCG companies become not distressed companies, and to society become trust the firms and also make the clean and effective corporate governance in FMCG companies.

RESEARCH RECOMMENDATION

This study formulate a machine learning model , in this paper is logistic regression using Python 3.10.6 in SPYDER software with Pandas and Statsmodels library, in modern digital era, the software used for this research can evolve using programming language to processing the data like R or Julia and etc, also the model can use Naive Bayes, confusion matrix etc, and for variable can expand to e.g CEO gender, CEO personality and etc.

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