

# **The Effect of Good Corporate Governance, Leverage and Firm Size on Financial Distress**

**(Empirical Study of Manufacturing Companies for the 2019-2021 Period)**

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**Abstract:** The aim of this study is to examine the impact caused by Good Corporate Governance, Leverage, and Firm Size as independent variables on Financial Distress as a dependent variable in manufacturing enterprises. This study employs a linear method using several linear regression analysis models in the form of panel data for a total of 579 observations from 193 organizations from 2019 to 2021. SPSS software version 25 was utilized in this investigation. The findings of this research reveal that the variables of board independence and block holder ownership have no effect on the potential of financial trouble in the company, however, leverage and firm size have an effect.

**Keywords:** Board independence, blockholder ownership, leverage, firm size, financial distress.

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## **1. Introduction**

The advancement of technology and information nowadays stimulates growth and increasingly fierce business competition; organizations that want to thrive and be more sophisticated must continue to improve while enhancing all parts of their business. In such a circumstance, no one market is immune to local and global rivalry. This happened to companies listed on the Indonesia Stock Exchange (IDX), which has over a hundred companies listed and will continue to grow in the future.

This progression has resulted in increased pressure on businesses to innovate and expand in order to compete. Economic growth grew to 7.07% in the second quarter of 2021, as demonstrated by the contribution of the manufacturing industry. This industry has the highest rate of growth, at 1.35%. Despite the fact that the manufacturing sector experienced pressure from the Covid-19 pandemic, which invaded Indonesia in 2020, a number of industrial subsectors grew significantly in the second quarter of 2021. The transportation equipment industry accounts for 45.70% of this total, followed by the basic metal industry (18.03%), the machinery and equipment industry (16.35%), the rubber industry and rubber and plastic goods (11.72%), and the chemical, pharmaceutical, and traditional medicine industries (9.15%). The manufacturing sector's export performance was USD81.06 billion from January to June 2021, accounting for 78.80% of total national exports of USD102.87 billion. For the period, the export-import balance showed a USD 8.22 billion surplus. (<https://kemenperin.go.id/>, 21 August 2021).

Companies that are unable to compete, on the other side, will experience bankruptcy; prior to bankruptcy, the company will endure financial distress (financial torments). When several companies are delisted, a financial hardship situation emerges. Delisting is the withdrawal of a company's shares from the Stock Exchange so that the shares can no longer be traded on the Stock Exchange. Delisting can also occur if the firm declares bankruptcy or wishes to become a closed company following a merger or acquisition.

As stated by Almilia and Kristijadi (2003), the model in assessing the forecast of bankruptcy symptoms of a company is required in the decision-making process by many parties such as management, shareholders, creditors, investors, government, and auditors. Bankruptcy (failure) is governed in Indonesia by the Bankruptcy Law No.1 of 1998, which states that debtors who have two or more creditors and are unable to pay at least one or more debts by the due date and cannot be acquired are deemed bankrupt by a decision of the competent court, either on their own application or at the request of five or more creditors.

## **2. Literature Review**

### **2.1 Agency Theory**

This theory describes relationships of agency as a contract between one or more people (principal), namely shareholders, who delegate authority on behalf of the principal to management (agent) as the party accountable for all decision-making (Jensen & Meckling, 1976).

Furthermore, there is a conflict of interest caused by an information gap, which results in management knowing more than shareholders (Panjitan & Muslih, 2019). According to the preceding description, the agent has the authority to control and make all decisions in the company. However, there is a conflict of interest in its

implementation because the agent prioritizes his own interests, resulting in agency expenses.

### 2.2 Good Corporate Governance

Good Corporate Governance (GCG) is unquestionably a system that regulates and supervises a firm while adding benefit to all stakeholders. The inadequate quality of Good Corporate Governance implementation will have an effect on the continuing decline in the performance of business entities, as well as the company's worsening finances or financial difficulty.

### 2.3 Board Independence

Individual investors, governments, and corporate institutions can all be part of ownership arrangements. Domestic institutions, foreign institutions, governments, employees, and domestic individuals are all included in the category of ownership arrangements. Different objectives will drive the ownership structure's supervision of the company, as well as its management and board of directors. At the end of the year, institutional ownership includes the government, financial institutions, incorporated institutions, foreign institutions, trust funds, and other institutions.

### 2.4 Blockholder Ownership

Individual investors, governments, and corporate institutions can all be part of ownership arrangements. Domestic institutions, foreign institutions, governments, employees, and domestic individuals are all included in the category of ownership arrangements. Different objectives will drive the ownership structure's supervision of the company, as well as its management and board of directors. At the end of the year, institutional ownership includes the government, financial institutions, incorporated institutions, foreign institutions, trust funds, and other institutions.

### 2.5 Leverage

Leverage is a ratio used to figure out a company's ability to meet all of its short and long-term obligations. How well the company uses its resources, such as receivables, capital, and assets.

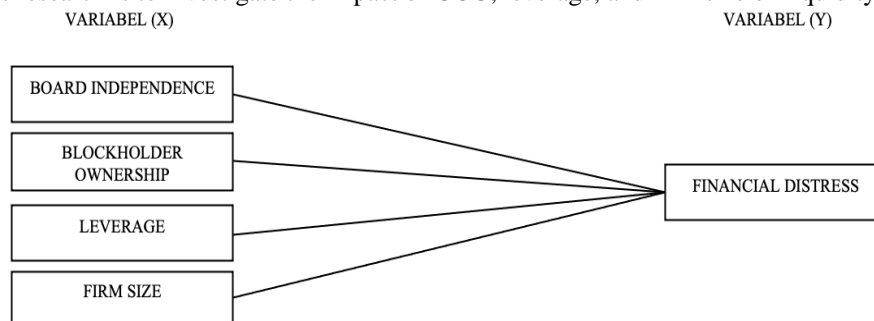
### 2.6 Financial Distress

Financial distress is a stage of deterioration in a company's financial status that occurs before it goes bankrupt or liquidates (Platt and Platt, 2002). It is a liquidity problem if the company is experiencing financial issues. And if the company experiences financial difficulties, it will be unable to meet all of its obligations, and if this is not addressed immediately, the company will become bankrupt.

## 3. Methodology and Procedures

### 3.1. Research Design

This is basic research, which is a study that builds on earlier research. According to his pastor, he is adopting a quantitative technique to prove his theory, which includes quantitative data. This study is causal in nature and was conducted to assess what has been done to examine the effect of Good Corporate Governance, Leverage, and Firm Size on Financial Distress in Manufacturing Companies for the 2019-2021 period. The objective of this research is to investigate the impact of GCG, leverage, and firm size on liquidity issues.



### 3.2. Population and Sample

This study's population comprises all manufacturing companies registered on the Indonesia Stock Exchange between 2019 and 2021. The following criteria were utilized to choose the research sample:

1. Manufacturing firms presented on the Indonesia Stock Exchange (IDX) from 2019 to 2021.

2. Companies that provide audited yearly financial statements in rupiah, supplemented by rupiah-denominated notes to the financial statements.
3. During 2019-2021, a manufacturing company listed on the Indonesia Stock Exchange has entire information on excellent corporate governance, Leverage, Firm Size, and Financial Distress.

### 3.3. Data and Data Resources

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### 3.4. Variable Operational Definition and Variable Measurement

#### 4.2.1. Dependent Variable

The dependent variable, often known as the dependent variable, is a variable that is affected or results from the presence of an independent variable (Sugiyono, 2009). The dependent variable in this study was financial distress. The ZFS (Zmijewski Financial Score) model use ratio analysis to assess a company's performance, leverage, and liquidity. This is to identify firms that are in financial hardship and companies that are not in financial distress using criteria such as companies that are healthy with ZFS less than zero and companies that are in financial distress with ZFS greater than zero. The following is the ZFS formula:

$$ZFS = -4.336 - 4.513(X_1)_{i,t} + 5.679(X_2)_{i,t} - 0.004(X_3)_{i,t}$$

Description:

- $X_1$  = Net Income/Total Assets (Profitability Measure)
- $X_2$  = Total Debt/Total Assets (Leverage Measure)
- $X_3$  = Current Asset/Current Liabilities (Liquidity Measure)

#### 4.2.2. Independent Variable

##### a. Board Independence

Board Independence is the proportion of independent outside directors to the total number of board executives in manufacturing companies for the period 2019-2021. The proportion of independent board members is calculated by taking the percentage of board members who originate from outside the company from all sizes of the company's board of commissioners (Miglani, 2015; Manzanque, 2016). The formula for determining board independence is as follows:

$$BI_{i,t} = \frac{\text{Number of Independent Board of Commissioners Members}}{\text{Total number of Board of Commissioners members}}$$

Description:

- $BI_{i,t}$  = Board Independence
- $i$  = company (i)
- $t$  = for year to (t)

##### b. Blockholder Ownership

A block holder is a firm's dominant shareholder who has the authority to influence corporate managers' actions and decision-making (Miglani et al., 2015). Employees, directors and their families, trusts, other firms, and individuals are a variety of block holders. The following formula can be used to determine block-holder ownership:

$$BO_{i,t} = \sum \text{Shareholder}_{i,i} (> 5\%)$$

Description:

- $BO_{i,t}$  = Share ownership above 5%
- $i$  = firm (i)
- $t$  = for year to (t)

##### c. Leverage

As explained by Ardiyos (2013), leverage is used to compare the magnitude of a company's debt to its entire capitalization. The higher this ratio, the greater the likelihood of the corporation failing to pay its

obligations. The following formula can be used to calculate leverage:

$$\text{Debt Asset Ratio} = \frac{\text{Total Debt}}{\text{Total Asset}} \times 100\%$$

Information:

Debt Asset Ratio= Rasio Hutang Perusahaan

Total Debt= Total Hutang

Total Asset= Total Asset

#### d. Firm Size

Firm size refers to the entire amount of assets possessed by a corporation. The following formula can be used to calculate firm size (Yazdanfar & Ohman, 2020):

$$Fsize = \ln \text{Total Asset}$$

Description:

FSize = Company size

Ln = Natural logarithms

i = company (i)

t = for year to (t)

### 3.5. Data Analysis Method

Multiple regression analysis with the SPSS 25 program was employed in this investigation. Multiple linear regression (multiple regression analysis) is a statistical technique for determining the effect of the independent variable on the dependent variable, i.e., the dependent variable with the independent variable. Board Independence (BI), block holder ownership (BO), leverage (Lev), and firm size (Fsize) are the independent variables in this study. While financial distress is the dependent variable. The formula for multiple linear regression is as follows:

$$Y_t = \alpha + \beta_1.X_1 + \beta_2.X_2 + \beta_3.X_3 + \beta_4.X_4 + \beta_n.X_n + e$$

Description:

$Y_t$  = financial distress

$\alpha$  = constant coefficient

$\beta$  = Regression coefficient

$X_1$  = board independence.

$X_2$  = blockholder ownership

$X_3$  = leverage

$X_4$  = size

E = Constant

## 4. Result Analysis

### 4.1. Descriptive Analysis

Tabel 1: Statistic Analysis Result

	N	Minimum	Maximum	Mean	Std.Deviation
Board Independence	379	.0000	2.0000	.441393	.1958480
Blockholder Ownership	379	.0000	9.0000	2.530343	.5139572
Leverage	379	.0020	1.3080	.454372	.2203382
Firm Size	379	22.4160	33.4950	28.291697	1.6370148
Financial Distress	379	-4.6520	3.2620	-1.986847	1.4188279
Valid N (Listwise)	379				

DataSource:Secondarydatamanaged byresearchers,2023

The following can be deduced from the table above:

- This study has 379 observations in manufacturing enterprises with four independent variables: board independence, block holder ownership, leverage, and firm size.
- Board Independence has a score of 0.0 and a maximum of 2.00. The standard deviation is 0.5139572, while the mean is 2.530343.
- The value of Blockholder Ownership ranges between 0.00 and 9.00. The standard deviation is 0.1958480, with a mean of 0.441393.
- Leverage values range from 0.0020 to 1.3080, with minimum values. Despite the fact that the average is 0.454372 and the standard deviation is 0.2203382.

e. Minimum Firm Size values range from 22.4160 to 33.4950. In comparison to the standard deviation of 1.6370148 and the average value of 28.291697.

#### 4.2.1. Normality Test

Tabel 2: Normality Test Result

	Unstandardized Residual
N	379
Test Statistic	,030
Asymp. Sig. (2-tailed)	,200

Data source: researchers' secondary data processing, 2023

The previous table's Kolmogorov-Smirnov test results reveal that the data are normally distributed. As can be observed from asym sig. (2-tailed) If Financial Distress is the dependent variable and the number is 0.200, the value is greater than the 5% or 0.05 significant threshold. These findings imply that the leftover data from the study were provided on a regular basis.

#### 4.2.2. Multicollinearity Test

Table 3: Multicollinearity Test Results

Model	Collinearity Statistics	
	Tolerance	VIF
Board Independence	,997	1,003
Blockholder Ownership	,959	1,043
Leverage	,976	1,025
Firm Size	,978	1,023

Data source: secondary data analyzed by researchers in 2023

According to the table's multicollinearity test findings, all variables have a tolerance value of 0.10 and a VIF value of 10. This condition was met, indicating that there was no multicollinearity between the independent variables in the regression model and Financial Distress as a dependent variable in the study.

#### 4.2.3. Heteroscedasticity Test

Table 4: Heteroskedasticity Test Results

		Board Independence	Blockholder Ownership	Leverage	Firm Size	Financial Distress
Board Independence	Correlation Coefficient	1	0.049	0.023	-0.055	0.023
	Sig. (2-tailed)	.	0.344	0.651	0.29	0.656
	N	379	379	379	379	379
Blockholder Ownership	Correlation Coefficient	0.049	1	.111*	.160**	.129*
	Sig. (2-tailed)	0.344	.	0.031	0.002	0.012
	N	379	379	379	379	379
Leverage	Correlation Coefficient	0.023	.111*	1	-0.012	.981**
	Sig. (2-tailed)	0.651	0.031	.	0.821	0
	N	379	379	379	379	379
Firm Size	Correlation Coefficient	-0.055	-.160**	-0.012	1	-0.063
	Sig. (2-tailed)	0.29	0.002	0.821	.	0.219
	N	379	379	379	379	379

Financial Distress	Correlation Coefficient	0.023	.129*	.981**	-0.063	1
	Sig. (2-tailed)	0.656	0.012	0	0.219	.
	N	379	379	379	379	379

\*Significant correlation at the level of 0.05 (2-tailed).

\*Significant correlation at the level of 0.01 (2-tailed).

Datasource:Secondary processing of information by authors, 2023.

Based on the results of the Spearman Rank evaluation, which was used to evaluate heteroscedasticity, it is possible to draw the conclusion that heteroscedasticity does not exist because all independent variables have a significance value of greater than 0.05.

#### 4.2.4. Autocorrelation Test

Table5: AutocorrelationTestResults

Model	R	Std.ErroroftheEstimate	Durbin-Watson
1	.982 <sup>a</sup>	.2677367	1.909

Datasource:supplementary datascrutinizedbyresearchers,2023

In accordance with the findings of the autocorrelation test, this yields a Durbin-Watson value of 1.909. According to Durbin-Watson, who evaluated the research data between -2 and 2, there is no autocorrelation in the regression equation of the model.

#### 4.2.5. Multiple Linear Analysis

Table 6:AutocorrelationTestResults

	Unstandardized B	Coefficients Std. Error	Standardized Coefficients Beta	T	Sig.
(Constant)	-3.605	0.25		-14.393	0
BI	-0.07	0.07	-0.01	-0.995	0.32
BO	0.008	0.009	0.009	0.888	0.375
LEV	6.295	0.063	0.978	99.493	0
FSize	-0.044	0.009	-0.05	-5.12	0

Datasource:additional data examined by researchers,2023

According to the coefficient table above, regression is described as follows:

$$Y_t = \alpha + \beta_1.X_1 + \beta_2.X_2 + \beta_3X_3 + \beta_4X_4 + \beta_n.X_n + e$$

$$Y_t = -3.605 - 0.07 BI + 0.008 BO + 6.295 LEV - 0.044 FS + e$$

SPSS 25 software was used to perform tests on the equation of a constant value of -3.605. This implies that if the independent variable in each regression model is 0 in each model, the firm's performance score based on financial distress is -3.605. The coefficient value of the BI variable is -0.07. This value explains why BI factors have a negative impact on the financial strain. If one unit of the BI variable increases or decreases, the financial distress variable moves in the opposite direction by -0.07. The coefficient value for the BO variable is 0.08. This number demonstrates that BO factors have an effect on financial distress. If the BO variable increases or decreases by a single unit, the financial distress variable moves in the same direction by 0.08. The coefficient for variable leverage is 6.295. This value explains why the variable Leverage has a favourable impact on financial distress. If one unit of the variable Lev increases or decreases, the financial distress variable moves in the same direction by 6.295. The coefficient value for the Firm Size variable is 0.044. This value explains why the Firm Size variable has a negative impact on financial distress. If the FSize variable increases or decreases by one unit, the financial distress variable moves in the opposite direction by -0.044.

**4.2.6. Determination Coefficient Test**

Table 7 Determination Coefficient Test

R	RSquare	Adusted Square	R	Std. Error of the Estimate
,982	,965	,964		,2677367

Datasource:secondarydataevaluatedbyresearchers,2023

The modified R2 results have been calculated and are appended in Table 7. The adjusted R2 value in Table 8 is 0.965, with the value increasing when the extra independent variable has a substantial effect on the dependent variable. While other variables not included in this study explained the remaining 3.5%.

**4.2.7. Model Feasibility Test (F-Test)**

Table 8:F-Test

Model	SumofSquares	F	Sig
1	734,132	2560,345	,000 <sup>b</sup>

Datasource:Additionaldatadealwith researchers,2023

Table 8 shows that a F value of 2560.345 was obtained with a significance level of 0.00. Because the significance is less than 0.05, the factors Board Independence, Block holder Ownership, Leverage, and Firm Size all affect Financial Distress at the same time.

**4.2.8. T-Test**

Table 9 : T Test

	Unstandardized B	Coefficients Std. Error	Standardized Coefficients Beta	T	Sig.
(Constant)	-3.605	0.25		-14.393	0
BI	-0.07	0.07	-0.01	-0.995	0.32
BO	0.008	0.009	0.009	0.888	0.375
LEV	6.295	0.063	0.978	99.493	0
FS	-0.044	0.009	-0.05	-5.12	0

Datasource:Additionaldatadealwith researchers,2023

The table above leads to the following conclusions:

1. The significance value for the Board Independence variable is 0.320, which is greater than 0.05 or 5%. As a result, H-1 was denied, demonstrating that Board Independence has no effect on Financial Distress.
2. The Block holder Ownership variable has a significance value of 0.375, which is higher than 0.05 or 5%. In this sense, hypothesis H is disregarded, demonstrating that Block holder Ownership has no effect on Financial Distress.
3. The significance value for variable leverage is 0.000, which is less than 0.05 or 5%. As an outcome, it is possible to conclude that the hypothesis is accepted, implying that Leverage is against Financial Distress.
4. The significance value for the Firm Size variable is 0.000, which is less than 0.05 or 5%. As a result, H-1. acceptable, implying that Firm Size Influences Financial Distress.

**5. Conclusion**

According to the Independence board, the detrimental impact on financial distress was insignificant. This is due to a lack of awareness of corporate responsibility, and occasionally an independent board has a lack of independence, which can result in insufficient oversight of firm performance. Another possibility is that an independent commissioner carries out his duties simply by following applicable provisions (for example, regulations established by law) in order to avoid the threat of sanctions for noncompliance with these regulations, which would put the company in financial jeopardy. Because if an independent commissioner is serious about carrying out his duties in accordance with the established vision, mission, and goals, the company

will avoid financial distress.

Block holder ownership has a negligible positive impact on economic distress. This is due to the fact that block holder ownership does not help to enhance the value of share ownership, which may result in financial difficulties for the company. Some board executives who do not own shares or have less than 5% ownership and work in the firm do not dare to make decisions and do not have full rights and power over problems that arise within the organization.

According to the findings of leverage study, excessive leverage means a company's obligation to pay off debts, both long-term and short-term debt, grows. The larger the debt, the more probable the company may default if earnings do not meet expectations. This potential causes the company to face financial difficulties.

Financial distress is negatively influenced by firm size. This is because the larger the company, the higher the total assets controlled by the company, which minimizes the chance of financial trouble, and vice versa. A company with tiny firm size is particularly exposed to the prospect of financial difficulty because companies with this small size also have little profits and a high probability of debt default.

### **Limitations**

Limitations in this study, there are numerous constraints that researcher must consider in addition, namely:

1. The year data in this study ranges from 2019 to 2021 since it was proposed at the time that researcher alter the research year to be more relevant to current situations.
2. There is a potential that the ZFS formula utilized for the variables analyzed is incompatible. It is predicted that future research will be conducted in order to be cautious in the selection of sectors connected to the factors analyzed so that the study's results are not biased.

### **Suggestion**

Suggestions for future researchers:

1. Update research by changing the year period to make it more relevant to current situations.
2. Other indicators to consider when determining financial distress factors in manufacturing companies include good corporate governance with board independence variables and block holder ownership in manufacturing companies. Meanwhile, leverage and firm size can indicate whether or not a company is in financial distress.

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