A CONCEPTUAL PERSPECTIVE ON CORPORATE GOVERNANCE AND FINANCIAL DISTRESS IN MALAYSIA

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ABSTRACT

This study aims to provide the conceptual framework on how corporate governance, specifically on the characteristics of the board of directors, has an impact on the financial well-being of the company. This study also employs a corporate governance perspective to examine the composition of the board and its influence on the financial well-being of the companies. The results of this study will provide practical insights for corporate management, boards of directors, and regulatory bodies. Gaining insight into how corporate governance practices can either alleviate or amplify financial distress which can guide decision-making processes, resulting in the development of more effective risk management strategies, enhancements to corporate governance structures, and ultimately, the improvement of corporate performance and stability.

Keywords: Corporate Governance; Board of Directors; Financial Distress

1.0 INTRODUCTION

Financial distress arises when a company struggles or fails to meet financial obligations to creditors or lenders (Suranta et al., 2023). Contributing factors encompass high leverage, illiquid assets, a substantial break-even point, and heightened sensitivity to economic downturns, all amplifying the risk of financial distress. The phenomenon occurs when a company confronts severe financial challenges, often stemming from overwhelming debt, managerial misjudgements, or external economic pressures, imperilling its financial well-being (Ikpesu et al. 2020).

The issue of financial distress among companies is intricate and carries implications for stakeholders, economies, and corporate viability. Companies experiencing financial distress grapple with an inability to satisfy their financial commitments, exposing vulnerabilities in their financial structure. If a company is identified as being in financial distress and no corrective measures are implemented to enhance its performance, there is a risk of the company entering into bankruptcy or undergoing liquidation (Khaliq et al., 2014; Ikpesu et al., 2020). In such an event, the business could lose its reputation and face the potential of losing existing or prospective investors.

Companies facing financial distress encounter economic challenges such as insufficient capital or equity. In Malaysia, a financially distressed company is classified as a PN17 Company (Manaf et al., 2020). The PN17 refers to Practice Note 17, which is a regulatory framework employed by Bursa Malaysia, the Malaysian Stock Exchange (Manaf et al., 2020). It classifies financially distressed companies failing to meet minimum capital, equity, or core business criteria. Companies under PN17 must submit a comprehensive plan for regularization to address financial challenges (Manaf et al., 2020). Bursa Malaysia, as the country's primary stock exchange, enforces these guidelines to maintain market integrity. Non-compliance may lead to delisting, emphasizing Bursa Malaysia's commitment to ensuring financial stability and safeguarding investor interests.

Corporate governance is one of the reasons for financial distress (Farooq et al., 2020). Corporate governance involves a system of rules, practices, and processes by which a company is directed and controlled. It encompasses the relationships among various stakeholders involved in a company and the goals for which the corporation is governed. The board of directors is responsible for providing oversight and guidance to management. Weak corporate governance may result in boards that lack independence, competence, or accountability. This can lead to a failure to adequately monitor management actions, allowing risky or unethical behaviour to go unchecked and contributing to financial distress. Inadequate corporate governance may exacerbate financial distress through the cultivation of a climate conducive to risk-taking, conflicts of interest, poor decision-making, and non-adherence to legal requirements. Conversely, robust corporate governance measures can serve to alleviate these vulnerabilities and foster enduring financial stability and success for a firm.

The relationship between certain corporate governance factors and financial distress can be complex and context-dependent. For instance, a larger board size may lead to challenges in decision-making efficiency and communication among board members. Additionally, a higher degree of board independence, where most directors are external and free from conflicts of interest, is generally associated with stronger oversight and accountability. Boards with a greater proportion of independent directors are more likely to provide effective checks and balances on management decisions, reducing the likelihood of financial distress resulting from poor governance practices or managerial misconduct. The frequency of board meetings can also impact the board's ability to stay informed about the company's operations, performance, and potential risks. Other than that, CEO duality refers to the situation where the CEO also serves as the chairperson of the board of directors. In cases where CEO duality exists without sufficient checks and balances, there may be a higher risk of managerial entrenchment, poor decision-making, and lack of accountability, all of which can contribute to financial distress. Thus, this study outlines the conceptual framework on the relationship between board size, board independence, board meeting frequency, and CEO duality with financially distressed companies.

There is a limited study in Malaysia that specifically looks into, corporate governance area, thus this study explores the corporate governance characteristics of the active companies with financial distress indications listed on the main market of Bursa Malaysia. Companies that triggered any of the criteria according to Practice Note 17 of the Main Market Listing Requirements of Malaysian Stock Exchange are said to be reprimanded under the PN17 list as financial distress companies. However, there are companies traded normally in the official Bursa Malaysia Securities Berhad or the Malaysian Stock Exchange market but facing financial distress. A study conducted by Kim-Soon et al. (2013) found that not all the PN17 companies listed are in financial failure and there are financial difficulties companies listed among the non-PN17 companies.

The result of this study is to assist the companies in developing a more effective and efficient corporate governance framework and mechanisms, which would contribute to better management of the companies, thus minimizing the risk of being distressed. Potential investors would normally follow the market sentiment when deciding to invest in their money and hardly conducted in-depth financial analysis of the potential investment portfolios. Finally, this study is conducted with anticipation to assist the policymaker in evaluating the current practice of corporate governance, thus such improvement could be taken towards better governance of public listed firms.

2.0 LITERATURE REVIEW

2.1 Financial Distress definition and concept

Predictions of corporate financial distress and bankruptcy have received an overwhelming interest from researchers around the world since the 1960s and it has been the object of study of corporate financial literature to date. The encouragement from the American Institute of Certified Public Accountants and the Securities and Exchange auditor's role in early warning of the incidence of bankruptcy initiated the researchers' attention in analysing the financial health of companies in the United States. Beaver completed the first study of financial failure prediction in 1966 by using statistical analysis on financial ratios. He established a dichotomous classification assessment grounded on a simple t-test in a univariate context. His study used six types of financial ratios from the group of Cash Flow Ratio, Net-Income Ratio, Debt to Total Asset Ratio, Liquid Asset to Total Asset Ratio, Liquid Asset to Current Debt Ratio, and Turnover Ratio towards seventy-nine failure and non-failure companies that were harmonized by industry and assets size for a period of ten years (1954 – 1964). Beaver (1967) concluded that not all ratios predict equally well and Cash Flow to Total Debt Ratio has excellent discriminatory power throughout the five years while the predictive power of the Liquid Asset Ratio is much weaker. He further concluded that the ratio analysis can be useful in the prediction of failure for at least five years prior although the ratios do not predict the failure and non-failure companies with the same degree.

Further to the study completed by Beaver, Edward Altman later developed a bankruptcy prediction model through his study in 1968. Altman's study identified the working capital, total assets, retained earnings, earnings before interest and tax (EBIT), market value of equity, book value of total debt, and sales as an important set of financial and economic ratios in a bankruptcy prediction by employing a multiple discriminant statistical methodology. A sample of 33 bankrupt companies and 33 non-bankrupt companies for the period from 1946 to 1964 were selected for his study. Altman found that there is 95% accuracy one year prior to bankruptcy and 72% accuracy two years prior to bankruptcy. The study came out with a model, the Z-score, which has received overwhelming endorsement across the globe (Mahama, 2015). Altman's model is considered the most common bankruptcy prediction model among researchers (Mohammed, 2016).

The study on financial distress employing Altman's model is never outdated and has always been a topic of interest among researchers around the world. Rajkumar (2015) uses Edward Altman's financial distress detection model and current ratio to assess the financial situation of companies listed in the default board of Colombo Stock Exchange (CSE). He examined eight selected listed companies of CSE by assessing the secondary data obtained from the financial report of the companies and found that there are financially distressed companies listed in the CSE. He concluded that Altman's model and current ratio are reliable tools for investors to predict the financial failure of companies.

Another study carried out by Mahama (2015) found that there were distressed companies listed on the Ghana Stock Exchange (GSE) for the period between 2007 to 2013. This study applied Altman's Z-score to the financial statements of ten companies listed on GSE to determine the level of their financial soundness. He agreed with Gharaibeh et al. (2013), that the Altman model should be used along with non-financial models and proxies that reflect the firm's operating environment. He further suggested that in applying the Altman model, care is to be taken to rationalize the defects of ratios in detecting distress in projects and companies.

In the context of the Malaysia study, Kim-Soon et al. (2013) examine the applicability of the Altman Z-score in determining the financial failure of companies. He also used the Altman Z-score to examine whether there is a successful company between PN17 companies listed on the Stock Exchange of Malaysia. Kim-Soon et al. (2013) used a sample of 52 companies where the financial data were collected from the records over the period from 2003 to 2010 and they concluded that not all the PN17 companies are financial failure companies.

Kim-Soon et al. (2013) completed another study of financial distress companies listed on the Malaysian Stock Exchange using financial liquidity ratios and Altman's model with four objectives; to examine whether financial liquidity ratios (cash ratio, current ratio, quick ratio) and Altman Z-score used in determining the financial soundness of companies yield a significant difference; to examine whether PN17 companies and non-PN17 companies shown any significant difference in their financial status; to determine whether all the PN17 companies listed are financial failure companies; and to determine whether there is financial distress company listed as non-PN17 companies. They used seven years data (year 2003 to year 2009) collected from the library of the Malaysian Stock Exchange to analyze a total of 104 companies from nine sectors of industry listed in the main board (fifty-two PN17 companies and fifty-two non-PN17 companies). The result of the study shows that financial liquidity ratio and Altman Z-score are reliable tools in assessing the financial health of companies. Also, not all the PN17 companies listed are financial failures and there are financial difficulties companies listed among non-PN17 companies.

2.2 Financial Distress in Malaysia

In the case of Malaysia, AirAsia X, the long-haul arm of the AirAsia Group, faced financial challenges due to the COVID-19 pandemic's severe impact on the aviation industry (Rahman, 2023). The airline experienced a significant decline in passenger demand, leading to grounded flights, revenue loss, and increased financial pressure. AirAsia X had been categorized under PN17 (Practice Note 17) status in Malaysia (Rahman, 2023). PN17 is a regulatory status given to companies that do not meet certain financial criteria, indicating financial distress or potential financial difficulty. It imposes requirements and obligations on these companies to address their financial issues and regain compliance with regulatory standards.

To address its financial challenges and exit PN17 status, AirAsia X implemented various restructuring measures, including debt restructuring, cost-cutting initiatives, route optimization, and fleet rationalization (Rahman, 2023). Additionally, the airline engaged in negotiations with creditors and stakeholders to secure support for its restructuring efforts. One significant development in AirAsia X's journey out of financial distress was the approval of its debt restructuring scheme by the Malaysian Court in October 2021. The scheme allowed the airline to restructure its debts and liabilities, providing a path toward financial recovery. Exiting PN17 status typically requires companies to demonstrate improved financial performance, compliance with regulatory requirements, and a sustainable business plan. AirAsia X's successful implementation of its restructuring initiatives, coupled with the approval of its debt restructuring scheme, likely contributed to its ability to exit PN17 status.

Other than that, Perisai Petroleum Teknologi Berhad: Perisai Petroleum Teknologi Berhad is an offshore oilfield services provider that was classified under PN17 status due to its financial difficulties, including significant debt levels and declining revenues. Moreover, KNM Group Berhad, a global engineering, procurement, construction, and commissioning (EPCC) company in the oil and gas sector, was placed under PN17 status due to its financial challenges, including high debts and losses.

2.3 Agency Theory

The agency theory is an idea that explains the relationship between principals (shareholders) and agents (corporate managers) in business. Agency theory is concerned with resolving problems that can exist in agency relationships due to interest diversion. The agency relationship is a contract under which one party (the principal) engages another party (the agent) to perform some service on their behalf. As part of this, the principal will delegate some decision-making authority to the agent. The model of man underlying agency theory is that of a rational actor who seeks to maximize his or her individual utility (Jensen & Meckling, 1976). In agency theory, both agents and principals seek to receive as much possible utility with the least possible expenditure, thus they will choose the option that increases their individual utility (Hufford, 1997).

The advent of the modern corporation created a separation between ownership and control of wealth (Berle & Means, 1932). Even though owners would prefer to manage their own companies and acquire the maximum utility for themselves, this is impossible because of the capital requirements of the modern corporation (Berle & Means, 1932 as cited in Hufford, 1997). The modern corporation typically has multiple owners where each intends on maximizing their own investment in the organizations.

Owners' contracts with executives in managing their firms made them principals to their agents. Both agents and principals are motivated by opportunities for their own personal benefits. Principals invest their wealth and design governance systems in ways that maximize their utility, while agents accept the responsibility of managing a principal's investment as they perceive the possibility of gaining more utility with this opportunity than by accepting other opportunities (Hufford, 1997).

The principal-agent problem occurs when the interests of both parties are diverged, thus it will lead to the rise of the agency costs. The objective in agency theory then is to reduce the agency costs incurred by principals by imposing internal controls to keep the agent's self-serving behavior in check (Jensen & Meckling, 1976).

A solid corporate policy could help in aligning the interests of both agents and principals. Thus, corporate governance can be used to change the rules under which the agent operates and restore the principal's interests. Incentives may be used to redirect the behavior of the agent to realign these interests with the principal.

2.4 Stewardship Theory

Stewardship theory defines situations in which managers are not motivated by individual objectives, yet rather are Stewards whose intentions are parallel with the principals' objectives (Davis et al., 1997). Stewardship theory argues that shareholder interests take priority with a joint leadership structure. In contrast to the implicit assumption of agency theory that boards are inherently opportunistic, Stewardship theory contends that non-financial factors such as intrinsic satisfaction from achievement, recognition, respect, and reputation will motivate boards to enhance firm value by using the unity of command to manage the firm's resources as good stewards.

According to this theory, Steward behavior is pro-organizational and collectivist, where it will not depart from the interests of his or her organization. A Steward will not trade self-serving behaviors for cooperative behaviors. The Steward put a high value on cooperation even when their interests diverged from the principals. A Steward's behavior is rational since he or she perceives greater utility in cooperative behavior and behaves accordingly.

Stewards are normal human beings, and they also have their survival needs to satisfy. Obviously, they must have an income in order to fulfill their survival needs. Because the Stewards will not trade self-serving behaviors for cooperative behaviors, they believe that their personal needs are met by working towards organizational, collective ends. Thus, the Steward's opportunistic behavior is guarded by the view that the utility gained from pro-organizational behavior is higher than individualistic, self-serving behavior. Pfeffer and Salancik (1978) emphasize that the increased discretion afforded by dual leadership enhances the board's ability to more quickly react and respond in a dynamic business environment and to secure resources critical to the firm's success.

2.5 Corporate Governance Attributes

2.5.1 Board size and financial distress

The board size refers to the number of board members in the company's organizational structure who act as representatives of the shareholders and other stakeholders. The ideal board size varies by country. The Malaysian Code on Corporate Governance does not prescribe the required size of the board. Instead, each board should evaluate its size to determine the impact on its functioning. There is no perfect and ideal board size, but the optimal size for a board should allow the board to operate cohesively as a team.

Previous studies indicated mixed results about the relationship between board size and firm's performance. The influence depends on how the board can reach consensus and to what extent the knowledge and expertise of the individual members are being utilized. There are two contradicting perspectives derived from the previous studies. Various researchers concluded the larger the board will lead to better performance (Alabdullah et al., 2018; Tulung & Ramdani, 2018; Shukeri et al., 2012). A large board provides greater monitoring, increases the independence of the board, and counteract the managerial entrenchment, hence increasing firm performance (Fauzi & Locke, 2012).

In contrast, some studies anticipated that the small size of the board is more effective. Keerthana et al. (2022) stated that board size positively impacts financial distress in which the findings suggest that having a small number of directors on board correlates with a decreased probability of experiencing financial distress. This is supported by a study conducted by Adnan et al., (2011) found that smaller board size and higher percentage of block ownership led to better efficiency of Malaysian banks. Their study investigates the impact of corporate governance on efficiency of Malaysian listed banks by using a panel data analysis. This study employed corporate governance variables represented by board leadership structure, board composition, board size, director ownership, institutional ownership, and block ownership. Thus, the first hypothesis is written as:
H1: There is a negative relationship between board size and financially distress company.

2.5.2 Board independence and financial distress

In line with the Malaysian Code on Corporate Governance, Principal A – Board Leadership and Effectiveness, emphasizes an ideal group of people who possess a well-balanced blend of skills, knowledge, experience and independent perspectives aligned with the company's objectives and strategic goals will secure the board effectiveness. The proper composition of the board will not only ensure sufficient diversity and independence but also serve as a deterrent against 'groupthink' or 'blind spots' in the decision-making process. This strategic composition also enables the board to effectively address challenges and contribute value to the company.

The board comprises executives and non-executives who are either independent or non-independent directors. The non-executive directors (NEDs) play a role in monitoring the actions of the CEO and executive directors to ensure that the shareholders' interests are well cared for. According to Nahar et al. (2023) independent directors play an important role in supervising management activities to enhance firm performance. Beasley (1996) explained that independent directors hold better judgment and fair representation of shareholders' interest, suitability as a reliable governing mechanism and their potential ability to concentrate on ensuring the maximization of shareholder value. In the study conducted by Nahar et al. (2022) board independence and board gender diversity support the initiatives taken by the Securities Commission. Hence, increasing the number of independent directors to make up at least half of the board size is important in enhancing board independence. The non-executive directors are also considered to be a guarantee of the integrity and accountability of company boards, thus by having independent non-executive directors on the board, these directors would help to monitor and control the opportunistic behavior of management and assist in evaluating the management more objectively (Alhaji et al., 2013). A study conducted by Li et al. (2008) indicates that ownership concentration, state ownership, ultimate owner, independent directors, and auditors' opinion turn out to be negatively associated with the probability of financial distress. Shukeri et al. (2012) also documented that board independence has a significant negative relationship with firm performance. Their empirical result provides no evidence that companies having more independent directors can increase firm value because there is no personal interest being exercised. Thus, the second hypothesis is as follows:
H2: There is a negative relationship between board independence and financially distress company.

2.5.3 Board meeting frequency and financial distress

Board meetings attended by the board members or their representatives to discuss and address important issues relating to their prior experiences, current problems, and forward-looking matters as it relates to the company's survival. The board of directors play a role as agents of the company and responsible in taking actions and making decisions on behalf of the company. Every decision documented in the board meeting is legal and becomes effective in the company. The Malaysian Code on Corporate Governance encouraged companies to have regular board meetings for discharging duties and responsibilities. Furthermore, it is compulsory for the board to reveal the frequency of board meetings they had in a year and details of the attendance of each individual director in respect to meetings held.

The agency theory of corporate governance lies on assumption that managers are opportunistic and individualistic, which they are prone to moral hazard. Thus, a frequent board meeting might expeditiously observe social control behaviour in order that it does align with shareholders' goals. It is anticipated to reduce the agency problems and enhance firm performance. Board meeting frequency is determined by the number of meetings held in a year and frequently held meetings are considered as a meaningful way of improving board effectiveness. Board meeting serves as a platform of synchronizing board members' opinion towards accomplishing firms' overall objectives. Also, it helps to increase board efficiency and bring the board members into collective mind by serving as a platform for circulating relevant information to all board members regarding the growth of the company.

Vafeas (1999) suggested that board activity, measured by board meeting frequency, is an important dimension of board operations as the frequency of board meetings are increased following the company's poor performance. It is supported by Ntim and Osei (2011) which also concluded boards that meet more frequently are likely to generate better financial performance. According to Francis et al. (2015) firms with low board attendance at meetings perform significantly worse than boards which have good attendance during a financial crisis. A recent study completed by Eluyela et al. (2018) also found a positive relationship between board meeting frequency and firm performance.

However, some studies consider board meetings to be less useful due to insufficient time non-executives spend with the company and consider such time could be better utilized for a more meaningful thoughts exchange with the management. Furthermore, frequent meetings require managerial time and raise travel expenses, administrative expenses, and directors' meeting fees. Johl et al. (2013) stated that board meetings are found to have an adverse effect on firm performance. Their study specifically tested the effects of board meeting, board independence, board size and directors accounting expertise on firm accounting performance. The study sample consisted of the 700 public listed firms in Malaysia and both financial and non-financial data were extracted from annual reports for the year 2009. The result is parallel with the earlier study conducted by Johl (2006), which found that there was a negative relationship between frequency of board meetings and entrepreneurial activities in firms. Therefore, the third hypothesis is written as:
H3: There is a positive relationship between board meeting frequency and financially distress company.

2.5.4 CEO Duality and financial distress

Numerous governance codes emphasized good governance principles by stressing on the fact that the roles of CEO and Chairman of the company should be held by separate individuals to remove unvested power over one individual and for better performance of the company. The Malaysian Code on Corporate Governance (MCCG) suggests that it's preferable to have a division between the roles of CEO and Chairman to maintain a fair distribution of power and authority, preventing any single individual from having unchecked decision-making authority. Role duality refers to a situation when one person holds the two most dominant posts in a corporation, the Chief Executive Officer (CEO) and Chairman. Though there is a broad body of literature on how CEO duality may influence the firm performance, the studies have produced mixed results. One school of thought points out the importance of roles separation between CEO and Chairman of the company, while the other school of thoughts supports the role duality.

A study conducted by Azeez (2015) suggests that role duality would infringe the separation of decision management from decision control. He further viewed that this would lead to unvested power on one individual leading decision biases over one individual leaving greater opportunity for him to act in accordance with his personal interest which would in turn be harmful for the shareholders of the company. The finding is consistent with the study conducted by Keerthana et al. (2022) and Duru et al. (2016), which found that CEO duality has statistically significant negative impacts on firm performance and is likely to experience financial distress. Separation of roles may produce information-sharing costs, conflicts between CEO and Chairman and inefficiency. It will be costly to communicate firm-specific information to others in a timely manner; the decision making process and execution may both be less efficient when there are two key leaders; as well as it may be more difficult to assign blame for bad company performance.

On the other hand, Simpson & Gleason (1999) stated that the combination of the CEO and chairman of the board into one position may influence the internal control system in such a way as to reduce the probability of financial distress in the company. The result is consistent with the study done by Miglani et al., (2015a), which stated that the CEO duality leads to reducing the probability of financial distress in the company. As such, the fourth hypothesis is written as:
H4: There is a negative relationship between CEO duality and financially distress company.

2.6 Conceptual Framework

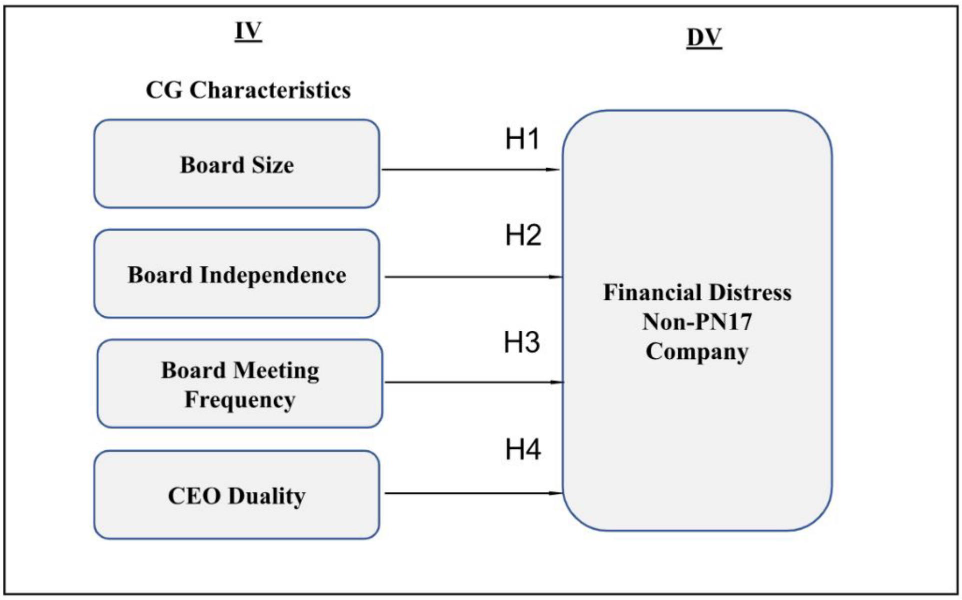

Fig 1 *Conceptual Framework*

3.0 CONCLUSION

This study outlines conceptual perspectives on the relationship between corporate governance characteristics such as board size, board independence, board meeting frequency, and CEO duality with financial distress of PN17 companies listed in the main market of Bursa Malaysia.

This study contributes to the adding body of literature on the relationship between corporate governance structures and distress company. Also, it helps to determine the corporate governance characteristics that give significant influence on the financial distress. An early detection of those factors could help companies to evaluate their current governance structure for any necessary improvement towards more effective and efficient corporate governance framework and mechanisms, thus avoiding the potential risk of being liquidated. Finally, this study is hoped to assist the policymaker in evaluating the current practice of corporate governance and formulating the more efficient framework. This study differs from prior research by offering specific, empirical insights into the relationship between corporate governance and financial distress, in advocating for more efficient risk management strategies, and addressing both company-level and policy-level considerations.

The limitation of this study, this study only access the relationship between corporate governance with companies listed as PN17 status. However, this study believed there are active companies in Bursa Malaysia listing that currently in unhealthy financial situations. Altman Z Score is proven to be one of the effective method in assessing the financial health of the companies based on the previous empirical studies. Thus, the researcher could employ Altman Z-score Model to identify the financial health of the companies. The Altman Z-score Model analysed a set of financial and economic ratios by employing a multiple discriminant statistical methodology. For future research, researchers might consider extending the timeframe to obtain more comprehensive findings. Additionally, it is recommended that researchers examine bankruptcy costs or financial distress costs within small firms, where the probability of business failure is higher compared to larger corporations.

CO-AUTHOR CONTRIBUTION.

The authors affirmed that there is no conflict of interest in this article. Authors 1 and 2 prepared the literature review and wrote the original version of the article. Author 3 and 4 prepared discussion and conclusion.

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