
THE EFFECT OF CORPORATE GOVERNANCE ON FINANCIAL DISTRESS WITH FINANCIAL RATIO AS CONTROL VARIABLE

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Abstract

Purpose - This research aims to examine the effect corporate governance mechanisms, encompassing board independence, CEO tenure, ownership concentration, board size, board diversity, and audit committee size influence corporate financial distress, while incorporating financial ratio control mechanisms that encompass leverage, profitability, and liquidity metrics in companies with the availability of corporate governance data and financial ratios for five years (2019-2023).

Design/Methodology/Approach - This study applies a quantitative paradigm in its implementation. The total population that is the object of the study reaches 938 corporate entities, while the sample resulting in 153 companies as the unit of analysis, determination is carried out through a purposive sampling technique.

Findings - Panel data regression methodology serves as the analytical approach employed in this study, utilizing EViews software as the computational instrument for data processing and statistical estimation. This investigation seeks to address research gaps identified in prior scholarly work examining the corporate governance-financial distress relationship by integrating financial metrics, specifically leverage, liquidity, and profitability indicators as control mechanisms within the analytical framework. Furthermore, this study integrates a comprehensive spectrum of corporate governance dimensions, including board independence, CEO tenure, ownership concentration, board size, board diversity, and audit committee size.

Practical Implications - This research has implications for company management, not only to establish a structural corporate governance framework but also to ensure that decision-making and oversight functions are carried out effectively.

Originality/Value - This study integrates a comprehensive spectrum of corporate governance dimensions, including board size, CEO tenure, board independence, ownership concentration, board diversity, and audit committee size.

Keywords: Corporate Governance, Financial Distress, and Financial Ratio

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INTRODUCTION

Corporate governance is a concept that regulates the relationships between various parties within a company that play a role of the company in determining the direction, control, and performance (Abbas & Frihatni, 2023). In Indonesia, attention to corporate governance has intensified since the Asian financial crisis, which led to the establishment of the National Committee for Governance Policy (KNKG) in 1999 as an effort to improve the company's perceived weakness (Tasman & Ulfanora, 2024). However, various international reports indicate that serious challenges in Indonesia the implementation of corporate governance still faces, characterized by weak policy reforms and the low quality of corporate oversight mechanisms (Wardani et al., 2023).

Financial distress can be identified in which a business entity faces a significant decline in its financial capacity. Primary manifestation of which is the failure to fulfill various contractual obligations previously agreed upon with creditors and other stakeholders (Edi & Eilyn, 2023). It is important to understand that the implications of such a situation are not limited to short-term disruptions to a company's operational processes, but also have the potential to trigger ongoing threats in the form of bankruptcy or liquidation if the situation is not immediately mitigated through the implementation of appropriate and comprehensive financial management strategies (Kebede et al., 2024). Financial distress is often triggered by weak corporate governance, inappropriate financial decisions, and suboptimal managerial oversight (Yuliani & Rahmatiasari, 2021). Corporate governance should ensure that company managers act appropriately and selflessly and protect all stakeholders (Krisyadi & Kelly, 2021). The impact of this situation raises significant concerns for various parties, including investors, creditors, regulators, and the government (Lau, 2021).

Corporate governance mechanisms, including CEO tenure, board independence, ownership concentration, board size, board diversity, and audit committee size, play in maintaining a crucial role a balance of interests between principals and agents (Krisyadi & Anastasya, 2023). An independent board serves as a supervisor of management policies to guarantee they align with the company's interests (Mettana et al., 2021). CEO tenure reflects managerial experience, which can influence the quality of a company's strategic decision- (Saputri, 2021). Ownership concentration indicates a company's control structure, which can strengthen or weaken oversight mechanisms (Amalia & Matusin, 2016). Board size and board diversity are related to decision-making monitoring effectiveness and supervisory quality are influenced by governance structures, whereas audit committee size serves as a critical determinant in sustaining internal control systems and financial reporting integrity (Sinaga, 2023). When these governance mechanisms operate suboptimally, they may elevate the probability of encountering financial distress conditions (Farooque, 2021).

Beyond corporate governance considerations, the financial health of an organization constitutes another essential element in forecasting financial distress scenarios. Financial ratio assessment, encompassing leverage, profitability, and liquidity indicators functions as an evaluative tool for determining an enterprise's capability to fulfill immediate and extended

financial obligations while maintaining steady and viable profit generation (Sati & Prasetyo, 2019). Earlier scholarly substantially affect investigations demonstrate that leverage, profitability, and liquidity metrics the possibility of experiencing financial distress (Yoganata, 2023).

Considering the situation described, this research was designed with the objective of investigating the impact of corporate governance mechanisms on financial distress by incorporating financial ratios as control variables into the analytical framework. This research contributes to the gaps addressing in previous analysis by simultaneously examining all elements of corporate governance and comprehensively considering a company's financial condition. By utilizing empirical data from entities listed on the Indonesia Stock Exchange from 2019 to 2023, this study is projected to yield more comprehensive insights into the contribution of corporate governance and financial performance in preventing financial distress. Furthermore, these findings are also expected to provide significant theoretical contributions to the development of corporate governance and corporate finance literature.

LITERATURE REVIEW

Corporate governance can be interpreted and understood as an integrated series of various managerial processes as well as organizational structures that are systematically functioned and operationalized with the aim of orienting the company's strategic direction as well as regulating and controlling all operational and tactical aspects of the business entity (Kuswandi & Indriyani, 2020). The fundamental objective of implementing corporate governance is to maximize and increase the value received by shareholders in a sustainable long-term perspective, but at the same time, it must also ensure that the interests of other stakeholders (stakeholders) who have relationships with the company are not ignored or set aside in the strategic decision-making process (Bui & Krajcsák, 2024).

The most fundamental and primary conceptual foundation or basis in an effort to understand the importance dan significance of corporate governance implementation in the context of modern organizations is agency theory, or what is known as agency theory. Agency theory essentially describes and explains the existence of a contractual working relationship between the party granting authority which in the corporate context is the investor or shareholder with capital ownership, and the party receiving the authority or mandate to run the company (agent), in this case the managers or executive management (Jamal & Enre, 2023). Both parties are bound by an agreement or cooperation contract that regulates the rights and obligations of each party. In the previously described contractual relationship configuration, managers or executive management are delegated authority and broad powers to carry out management, regulation, and operational and strategic decision-making activities related to the company. All of these activities are carried out on behalf of and for the benefit of the capital owners or shareholders who have granted them the mandate.

However, agency theory also assumes to maximize their own interests that each individual acts (Manzaneque et al., 2016). Shareholders, as principals, are generally oriented towards increasing financial returns and investment value, while managers, as agents, tend to

pursue personal satisfaction in the form of financial compensation and other benefits inherent in the working relationship. These differing interests have the potential to give rise to agency conflicts and information asymmetry, particularly when oversight mechanisms are ineffective. If the working relationship between principal and agent is not managed effectively, the company's goals will be difficult to achieve, financial distress will increase, and the risk of declining financial performance.

Financial distress risk may escalate when corporate governance practices are inadequately executed. As articulated (Kebede et al., 2024), financial distress denotes an organizational fiscal state undergoing deterioration or transitioning into a crisis stage, marked by the organization's incapacity to honor diverse financial obligations within stipulated timeframes. This conceptual framework spans a wide continuum, extending from deteriorating fiscal outcomes and operational breakdowns through insolvency and obligation non-performance (Rahim et al., 2023). Predictive assessment of financial distress can be accomplished via financial ratio examination, exemplified by the Altman Z-Score methodology, which evaluates insolvency probability through the integration of designated financial metrics (Christian & Purba, 2023).

Multiple corporate governance instruments are theorized to shape the probability of encountering financial distress. Board independence, representing the ratio of independent commissioners within the board composition, is regarded as having the potential to enhance managerial monitoring efficacy and reduce agency-related (Manzaneque et al., 2016). Multiple investigations have revealed that board independence exerts an inverse relationship with financial distress (Wiranti & Andreas, 2024), though certain empirical evidence suggests the absence of a statistically meaningful impact (Deviacita & Achmad, 2015).

H1: Board independence has a significant negative effect on financial distress.

Another relevant aspect is CEO tenure, which represents the duration of a CEO's leadership. This construct is associated with accumulated competence and experience in formulating strategic decisions. CEOs with longer tenures generally demonstrate a superior understanding of the dynamics of the organization's internal conditions and the company's external landscape. This longitudinal experience facilitates more informed and contextually relevant decision-making, thus enabling more effective financial risk management and reducing the likelihood of financial distress (Mahardini, 2023). However, excessively long tenures also have the potential to weaken the oversight function and negatively impact financial performance (Hazzaa et al., 2024).

H2: CEO tenure has a significant negative effect on financial distress.

Ownership concentration also serves as a crucial mechanism in corporate governance structures. Concentrated share ownership among a few dominant shareholders has the potential to intensify the monitoring function of management performance and mitigate agency conflicts arising from the separation of control and ownership. This ownership concentration creates a stronger incentive for majority shareholders to actively supervise managerial decisions (Medioli et al., 2022). However, Sarker and Hossain, (2023) majority shareholder dominance

also has the potential to encourage abuse of power, which can harm the company and increase the risk of financial distress.

H3: Ownership concentration has a significant negative effect on financial distress.

Furthermore, board size, which reflects the number of board members within a company, influences the effectiveness of decision-making. An excessively large board can potentially reduce the effectiveness of coordination and oversight, thereby increasing the likelihood of financial distress (Listari & Karina, 2021). Several studies support the positive effect of board size on financial distress (Abbas & Frihatni, 2023; Darryl & Yusbardini, 2023) although there are contradictory findings (Manzaneque et al., 2016).

H4: Board size has a significant positive effect on financial distress.

Furthermore, board diversity is increasingly viewed as a crucial element of modern corporate governance. Diverse board member characteristics are believed to enrich perspectives in decision-making and improve a company's responsiveness to changes in the business environment (Sarhan et al., 2019). Diverse boards tend to be more adaptive in facing financial challenges, potentially reducing the likelihood of financial (Khan & Abdul Subhan, 2019). Empirical findings show that companies with higher levels of board diversity have a lower risk of financial distress (Khan & Abdul Subhan, 2019; Rosadi & Dillak, 2023; Prihatiningtias & Adiwicaksana, 2024).

H5: Board diversity has a significant negative effect on financial distress.

Another significant mechanism dimension is the existence of an audit committee, which serves as a supporting mechanism for the board of commissioners in safeguarding shareholder interests by accelerating the quality of financial reporting (Christian & Haryono, 2021). Although several empirical studies indicate a moderate correlation between audit committee dimensions and company performance (Fariha et al., 2022) (Salloum et al., 2015), other empirical evidence demonstrates that audit committees with a larger membership composition have the capability to reduce exposure to financial distress risk, mediated by the presence of members with adequate expertise and competence (Alqatamin, 2018).

H6: Audit committee size has a significant negative effect on financial distress.

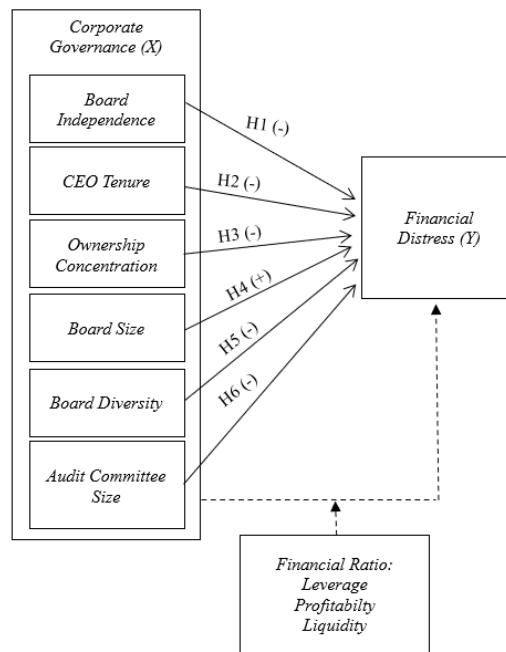


Figure 1. Conceptual Framework

RESEARCH METHODS

This study adopts and implements the causality research paradigm as an epistemological framework used to understand the causal relationship between variables, where the paradigm is operationalized through a quantitative approach that emphasizes the use of numerical data and statistical analysis. The method of data collection or technique implemented is the documentary method, where researchers utilize and extract information from secondary data that is already available in the form of annual financial reports of companies that have been published and can be accessed by the public. The analysis process of the collected research data begins with the descriptive statistical analysis stage, where the purpose of this stage is to provide a comprehensive picture or description of the characteristics and profiles of the research data through the calculation of various statistical measures including the average value (mean) as a measure of central tendency, the minimum value as the lower limit of the data, and the maximum value as the upper limit of the data. Following the descriptive stage, the research hypothesis testing process was carried out using multiple linear regression analysis techniques based on a panel data structure. The entire model estimation and data processing process utilized EViews statistical software as the primary computational (Sugiyono, 2022).

The target population focused on in this empirical study totaling 938 companies operating across various industrial sectors. Encompasses all business entities officially listed on the Indonesia Stock Exchange (IDX). The selection process for determining the research sample was operationalized using purposive sampling, also known as judgment sampling. This is a non-probabilistic sampling technique or procedure where observation units are deliberately selected based on a set of specific criteria that are highly relevant to the predetermined research objectives and needs (Surahman et al., 2019). The sample criteria included the availability of

corporate governance data and financial ratios for the 2019–2023 period, the completeness of corporate governance information, and the consistency of audited financial statements. Based on the selection process and outlier testing, a final sample of 153 companies was obtained, which was analyzed using a panel method to examine trends and relationships between variables over the five years of observation.

RESULTS

Descriptive statistical analysis was conducted to provide an overview of the dataset. The results, computed using EViews software, are presented in this section in a structured manner. The analysis begins with descriptive statistics, followed by classical assumption tests to ensure the adequacy of the regression model. Subsequently, model selection procedures are applied to determine the most appropriate estimation approach, and regression results are reported to examine the relationships among the variables. All findings are presented objectively as the basis for further interpretation in the discussion section.

Table 1. Descriptive Analysis Results

Variable	Mean	Min	Max
Financial Distress	1.746	-1.43	7.49
Board Independence	0.804	-	-
CEO Tenure	9.097	-	-
Ownership Concentration	52.64	-	-
Board Size	5	-	-
Board Diversity	0.147	-	-
Audit Committee Size	3	-	-

Source: Processed Result (2025)

The descriptive statistics presented in Table 1 provide an overview of the characteristics of the variables included in the study. The mean value of Financial Distress is 1.746, indicating that, on average, firms are positioned in a moderate financial condition rather than in extreme states of financial health or distress. The observed range, from -1.43 to 7.49, reflects substantial variation in financial conditions across firms.

Board Independence shows a relatively high mean value of 0.804, suggesting that a large proportion of board members are independent. CEO Tenure averages 9.097 years, indicating relatively stable leadership within firms. Ownership Concentration, with a mean value of 52.64, reflects a considerable level of share ownership concentration among dominant shareholders. Board Size and Audit Committee Size, with average values of 5 and 3 members respectively, represent common governance structures across firms. In contrast, Board Diversity remains relatively low, as indicated by a mean value of 0.147, suggesting limited heterogeneity in board composition. Overall, these results indicate variability in both financial conditions and corporate governance structures, which provides a relevant basis for further analysis of the relationships among the variables.

Table 2. Classical Assumption Tests

Test	Indicator	Result
Normality	Prob > 0.05	Normal
Multicollinearity	Correlation < 0.8	No issue
Heteroskedasticity	Prob > 0.05	No issue
Autocorrelation	DW \approx 1.9	No issue

Source: Processed Result (2025)

The results of the classical assumption tests presented in Table 2 indicate that the regression model satisfies the required statistical assumptions. The normality test shows that the probability value exceeds the significance level, suggesting that the residuals are normally distributed. The multicollinearity test reveals that all correlation values among the independent variables are below the acceptable threshold, indicating the absence of strong linear relationships between variables.

Furthermore, the heteroskedasticity test confirms that the variance of the residuals is constant, as all probability values are above the significance level. The autocorrelation test, as indicated by the Durbin–Watson value of approximately 1.9, suggests that there is no autocorrelation in the model. Overall, these results imply that the regression model is statistically adequate and suitable for further analysis.

Table 3. Model Selection

Category	Indicator	Value	Interpretation
Model Selection	Chow Test (Prob)	0.000	Fixed Effect preferred
Model Selection	Hausman Test (Prob)	0.000	Fixed Effect selected
Model Fit	F-statistic	17.671	Model is significant
Model Fit	Prob (F)	0.000	Statistically significant
Model Fit	Adjusted R ²	0.783	Strong explanatory power

Source: Processed Result (2025)

The results presented in Table 3 indicate that the appropriate panel data model for this study is the fixed effect model. The Chow test yields a probability value of 0.000, which is below the significance level, indicating that the fixed effect model is preferred over the pooled model. This result is further supported by the Hausman test, which also shows a probability value of 0.000, confirming that the fixed effect model is more suitable than the random effect model. In terms of model fit, the F-statistic value of 17.671 with a probability of 0.000 indicates that the independent variables jointly have a statistically significant effect on the dependent variable. Additionally, the adjusted R-squared value of 0.783 suggests that the model is able to explain a substantial proportion of the variation in financial distress. Overall, these results indicate that the selected model is both appropriate and statistically robust for further analysis.

Table 4. Regression Results (Summary)

Variable	Coefficient	Result
Board Independence	-1.516	Significant
CEO Tenure	-0.019	Significant
Ownership Concentration	-0.049	Not Significant
Board Size	0.470	Significant
Board Diversity	-0.436	Not Significant
Audit Committee Size	-0.340	Significant

Source: Processed Result (2025)

The regression results presented in Table 4 indicate that several corporate governance variables have statistically significant effects on financial distress. Board Independence shows a negative and significant coefficient, suggesting that a higher proportion of independent board members is associated with lower levels of financial distress. Similarly, CEO Tenure exhibits a negative and significant relationship, indicating that longer executive experience contributes to improved financial stability.

In contrast, Board Size displays a positive and significant coefficient, implying that larger boards are associated with higher levels of financial distress, which may reflect reduced coordination or monitoring efficiency. Audit Committee Size also shows a negative and significant effect, indicating that stronger oversight mechanisms are associated with a reduction in financial distress. Meanwhile, Ownership Concentration and Board Diversity do not demonstrate statistically significant effects, suggesting that their influence on financial distress is not supported within this model. Overall, the findings highlight the importance of specific governance mechanisms in explaining variations in financial distress among firms.

DISCUSSION

The empirical findings reveal that corporate governance mechanisms do not uniformly influence financial distress, indicating that their effectiveness depends on specific structural and contextual conditions. The results provide important insights into how governance attributes shape financial stability through both monitoring effectiveness and decision-making dynamics.

Board independence is found to have a significant negative effect on financial distress, suggesting that a higher proportion of independent directors strengthens oversight and reduces the likelihood of financial difficulties. This finding supports the perspective of agency theory, which emphasizes the role of independent boards in mitigating conflicts of interest between management and shareholders (Jensen & Meckling, 1976). Independent directors are more likely to provide objective evaluations and constrain opportunistic managerial behavior, thereby improving financial discipline. This result is consistent with prior empirical studies demonstrating that stronger board independence contributes to lower financial distress risk (Permana & Serly, 2021; Prasetya & Carolina, 2023).

CEO tenure also exhibits a significant negative relationship with financial distress. Longer tenure is associated with accumulated managerial experience and firm-specific knowledge, which enhance strategic decision-making and financial risk management. From the perspective of upper echelons theory, executive characteristics, including tenure, shape organizational outcomes (Hambrick & Mason, 1984). Experienced CEOs are better equipped to anticipate risks and implement adaptive strategies, thereby reducing financial vulnerability. This finding aligns with previous research indicating that longer CEO tenure contributes to organizational stability and lower distress probability (Mahardini, 2023).

In contrast, ownership concentration does not demonstrate a significant effect on financial distress. This finding suggests that the presence of dominant shareholders does not necessarily guarantee effective monitoring. Although concentrated ownership is often associated with stronger control, it may also lead to entrenchment, where controlling shareholders prioritize private benefits over firm performance (Shleifer & Vishny, 1997). The absence of a significant effect indicates that ownership structure alone is insufficient to influence financial outcomes without complementary governance mechanisms. Similar findings have been reported in prior studies showing that ownership concentration does not always reduce financial distress (Rosifah, 2023).

Board size is found to have a significant positive effect on financial distress, indicating that larger boards may reduce governance effectiveness. While larger boards are expected to provide diverse expertise, they may also suffer from coordination problems and slower decision-making processes (Lipton & Lorsch, 1992). Increased board size can lead to communication inefficiencies and weaker monitoring, which may negatively impact financial performance. This finding supports previous studies suggesting that excessively large boards may hinder effective governance and increase financial risk (Pratiwi & Venusita, 2020).

Board diversity does not show a significant effect on financial distress. This result suggests that diversity, particularly gender diversity, has not yet translated into measurable financial outcomes within the observed firms. One possible explanation is the relatively low level of diversity, which limits its influence on decision-making processes. From a theoretical perspective, diversity is expected to enhance cognitive perspectives and improve governance quality (Carter et al., 2003). However, its impact may depend on the extent to which diversity is meaningfully integrated into strategic decision-making. Similar findings have been reported in studies indicating that board diversity does not always have a direct impact on financial performance or distress (Nisa & Anshari, 2025).

Audit committee size demonstrates a significant negative effect on financial distress, highlighting the importance of effective oversight mechanisms. A larger audit committee enhances monitoring capacity, improves financial reporting quality, and reduces information asymmetry. From an agency perspective, the audit committee plays a critical role in minimizing opportunistic behavior and ensuring accountability (DeZoort et al., 2002). This finding supports prior research indicating that stronger audit committee structures contribute to reduced financial distress risk (Adityatama & Hermi, 2023).

Overall, the findings emphasize that governance effectiveness is not determined solely by structural attributes but also by how these mechanisms function in practice. Board independence, CEO tenure, and audit committee size emerge as critical factors in reducing financial distress, while ownership concentration and board diversity do not show direct effects. The positive relationship between board size and financial distress further suggests that governance complexity may undermine effectiveness if not properly managed.

These results contribute to the literature by highlighting the differentiated roles of governance mechanisms in emerging market contexts. The findings suggest that monitoring quality and managerial experience are more influential than ownership structure or diversity alone in shaping financial stability. This implies that corporate governance reforms should prioritize strengthening oversight functions and enhancing leadership quality to mitigate financial distress.

CONCLUSIONS AND RECOMMENDATIONS

The findings of this study demonstrate that corporate governance mechanisms do not exert a uniform influence on financial distress, but rather operate through differentiated roles depending on their functional effectiveness. Board independence, CEO tenure, and audit committee size are found to significantly reduce financial distress, indicating the importance of effective monitoring, leadership stability, and oversight quality in maintaining financial stability. In contrast, board size shows a positive relationship with financial distress, suggesting that larger governance structures may reduce coordination efficiency and weaken monitoring effectiveness. Meanwhile, ownership concentration and board diversity do not exhibit significant effects, indicating that structural presence alone is insufficient to influence financial outcomes without effective implementation.

These results contribute to the corporate governance literature by highlighting that governance effectiveness is contingent not merely on formal structures, but on how these mechanisms function in practice. The findings reinforce agency theory by demonstrating the importance of monitoring mechanisms in mitigating financial risk (Jensen & Meckling, 1976), while also supporting the perspective that managerial characteristics, such as CEO tenure, influence organizational outcomes (Hambrick & Mason, 1984). Furthermore, the results suggest that governance complexity, as reflected in larger board size, may introduce inefficiencies that counteract its intended benefits.

From a practical perspective, the study provides important implications for managers, investors, and regulators. Companies should prioritize strengthening governance quality by enhancing the effectiveness of independent boards and audit committees, rather than merely increasing the number of board members. Leadership continuity should also be considered as a strategic asset, given its role in reducing financial risk. For investors, the findings emphasize the need to evaluate firms comprehensively, not only based on governance structure but also on the effectiveness of its implementation, financial performance, and risk management practices.

Despite its contributions, this study has several limitations. The use of non-probability sampling may limit the generalizability of the findings. Additionally, the study focuses on selected governance variables and does not fully capture the complexity of corporate governance mechanisms. The cross-sectional nature of the data also restricts the ability to observe dynamic changes over time. Future research is encouraged to extend this model by incorporating additional variables such as managerial ownership, institutional ownership, or risk management practices. The use of longitudinal data may provide deeper insights into the dynamic relationship between governance and financial distress. Furthermore, qualitative approaches could be employed to explore how governance mechanisms operate in practice, particularly in emerging market contexts.

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