Volume II ISSUE IV ISSN NO: 2582-6034

LEGALFOXES LAW TIMES

CORPORATE GOVERNANCE & BANKRUPTCY

BY

SHIVAM

ABSTRACT

This paper is aimed to study the controversy about the effect of corporate governance structure on the probability of bankruptcy. This paper especially focusses on proportion of independent board of directors, the effect of board size and the proportion of femaleboard of directors in the exposure of bankruptcy. The result of this paper shows that having larger boards just decreases the risk of bankruptcy for large firms, but having smaller boards reduces the probability of bankruptcy for both small and large firms.

CHAPTER 1: INTRODUCTION

Corporate Governance consists of a series of relationships between shareholders, managers and auditors of a business that ensures the establishment of a control mechanism to protect the interests of retail shareholders and to enforce the assembly resolutions effectively and to avoid possible abuses. This rule, which is based on the principle of accountability and social responsibility, is a collection of duties and obligations that the organization shall perform in order to ensure accountability and transparency. Whereas, Bankruptcy is an impactful occurrence no organization will ever want to undergo. Bankruptcy happens when a company cannot meet its obligations and attempts to reorganize its debts or liquidate its properties for a period of relief.Bankruptcies may have negative consequences for the firm. According to some studies conducted, the shareholders lost their share interest after bankruptcy, the bondholder got just a small portion of their investment, and the health benefits of retired workers were cut. Some units were closed with the result that work was cut off. From the consequences of the bankruptcy, it is important to determine the cause of the bankruptcy. Bankruptcy has been discussed and examined frequently in recent years.While this trend has already been identified in recent high-profile bankruptcy cases, there is only a limited amount of research that examines the corporate governance relationship to the risk of bankruptcy.[1]

Corporate governance basically focusses on the connection between boards, stockholder, top management, regulators, auditors, and other stakeholders.[2] Corporate governance has two possible effects on the probability of bankruptcy, the first one is that after the scandal of Enron and WorldCom, it is clear that financial and accounting details can be used to hide bad performance and the second one is that, since the firm’s governance structure is a nexus of incentive contracts, the effectiveness of the management response to distress would depend on the characteristics of the firm’s governance structure. Therefore, the probability of avoiding bankruptcy would also rely on the management's response to a level of distress that is likely to depend on the firm's governance structure.[3]

1.1.<u>Objectives of the study:</u>

The objective of this study is to find out-

- how the risk of bankruptcy is related to board characteristics, as a proxy for the corporate governance process.
- the effect of board size in the exposure of Bankruptcy.
- the proportion of female board of directors in the exposure of Bankruptcy.
- proportion of independent board of directors in the exposure of Bankruptcy.

---

[1] e.g. Daily and Dalton in 1994, Fich and Slezak in 2008
[2] Study conducted by Cochran & Wartick in 1998
[3] Study conducted by Fich and Slezak in 2008

1.2. Significance of the study:

The results of this study would be of interest to financial analysts, creditors, and accountants. The positive correlation between board size and risk of bankruptcy and the likelihood of bankruptcy will help both internal and external parties determine the risk of bankruptcy. In addition, the outcome can also provide guidance to the company to restore its board of directors to reduce its chance of bankruptcy.

1.3. Scope of the study:

This study refers to the insolvency source that is still limited but increasing in number.This research offers more details on the risk of bankruptcy associated with the corporate governance. In addition, this study also contributes to the corporate governance source, in particular the literature on board characteristics, by presenting evidence that board size is correlated with the risk of bankruptcy and confirms the findings of prior literature.[4]

1.4. Research methodology:

This paper has been completed under explanatory and analytical methodology of research. Explanatory, because this topic is not well researched before and it also focusses on explaining all the aspects of the study in a detailed manner. And, analytical because this study uses the facts or information which ae already available. Sources like articles and websites have been referred for the completion of this research paper.

1.5. Research questions:

The Research questions are as follows: -

1. Is the risk of bankruptcy related to the board size?
2. Is the risk of bankruptcy related to the independent director's proportion?
3. Is the risk of bankruptcy related to the proportion of female director?

[4]Darrat, Gray, Park, and Wu in 2016; Fich and Slezak in 2008; Platt and Platt in 2012

CHAPTER 2: LITERATURE REVIEW

2.1. Bankruptcy:

Beaver[5] defines failure as the inability of a company to pay its financial obligation.A company is deemed to have failed when faced by bankruptcy, bond default, overdrawn bank account or a preferred stock dividend not being paid. Bankruptcy has become an important topic for scholars to study, because it is an unexpected event that can have far-reaching implications for both the firm and its stakeholders.The effects of bankruptcy can be described as a reorganization of the management team or a decrease in market share, and a loss of confidence among various stakeholders.Employees even face different costs when their firm experiences bankruptcy; they may be fired from reorganization; their salaries are likely to drop and their pensions lose out.Concluding from these consequences and costs, it is important to understand the causes of bankruptcy.

Several researchers have developed models for evaluating the risk of bankruptcy over the last decades. These studies usually tend to form a model by analyzing match samples of non-bankrupt and bankrupt firms, using publicly accessible financial statements information to estimate the probability of those firms filing for bankruptcy at some stage.

Altman's[6] further research attempts to use the efficiency of the ratio analysis as an analytical tool for forecasting bankruptcy, known as Altman Z-score. He claims that traditional ratio analysis is no longer an effective analytical method, since it was presented in an unsophisticated manner. He also explains that his model proved to be accurate in predicting bankruptcy by 94% of the initial sample. In addition to prior literature on bankruptcy, Daily and Dalton[7] add the impact of corporate governance on the probability of bankruptcy of the company. They find that the composition of the board and the leadership system have an impact on bankruptcy incidence. The result shows that corporate governance, especially the board of directors, serves as the company's internal control tool.

---

[5] 1966
[6] 1968
[7] 1994

2.2. <u>The role of Board of Directors:</u>

According to Cochran and Wartick[8], Corporate governance is an umbrella concept containing many aspects relevant to the theories and activities of the board of directors and their executives and non-executive directors.They illustrate that corporate governance is a contractual connection between boards, stockholders, top management, regulators, auditors and other stakeholders.Maassen[9] explains that boards of directors are essential in most definition of corporate governance. Hillman and Dalziel[10] state that board of directors have two roles. First one is monitoring roles that refers to the responsibility of directors to monitor managers on behalf of shareholders and second one is the provision of resource role which refers to the ability of the board to bring resource to the firm.

An early research conducted by Baysinger and Butler[11] analyzes the relationship between board directors and firm value. They analyze the relation between the percentage of independent directors and a relative return on equity measure. They found that boards with more outsiders outperformed other firms but that it was not essential to ensure a majority of independent directors above average values.Study from Yermack[12] shows that small board of director is more effective.Smaller board firms also have more favorable financial ratio values, and better CEO performance incentives from compensation and the risk of dismissal. He states that the smaller board has a stronger method of communication, coordination and decision-making than the larger board, the study of Eisenberg, Sundgren and Wells[13] also support this result.

In addition to numerous studies examining the relationship between board of directors and firm performance, there is also a study discovering the correlation between board director and the possibility of corporate fraud. Study from Beasley[14] shows that the proportion of independent or external directors substantially decreases the risk of fraud, it was found that the risk of corporate fraud has a negative relation to the percentage of independent directors on board.

[8] 1998
[9] 1999
[10] 2003
[11] 1985
[12] 1996
[13] 1998
[14] 1996

This all together again highlights the significant role of a company's board of directors and that they do have an impact on a company's well-being.

2.3. <u>Board of Directors and Bankruptcy:</u>

According to Walsh and Seward[15], the boards of directors serve as a firm's internal monitoring mechanism in a corporate governance process. Mizruchi[16] claims that the board of director is the ultimate center of control of a firm.However, Louden and Zusman[17] argue that the Board is responsible for maintaining the firm's long-term stability and sustainability as the highest decision-making body in the firms. According to Hambrick and D'Aveni[18], the connection between corporate governance structure and financial distress that leads to bankruptcy exists because financial distress is not a discrete event, but rather a late stage of a "prolonged decline process" and a "downward spiral". Fich and Slezak[19] argue that smaller and more independent boards are contributing to more effective monitoring. They analyze the relationship between corporate governance and bankruptcy by calculating the hazard model with and without corporate governance based upon accounting details for both terms. They indicate that, firms in poor governance are less able to make necessary adjustment to avoid bankruptcy.

Study from Darrat, Gray, Park, and Wu[20] says that larger board reduces the likelihood of bankruptcy on complex firm. It implies that larger board provides more networks, knowledge, more experience and expertise. According to Burt[21] another perspective that explains the association of board directors on bankruptcy risk is resource dependency that sees board directors, specifically outside director as provider of external resource.

Therefore, these outside directors are required to play active roles in ensuring the company does not face the possibility of bankruptcy

---

[15] 1990
[16] 1983
[17] 1982
[18] 1988
[19] 2008
[20] 2016
[21] 1983

CHAPTER 3: BOARD SIZE AND BANKRUPTCY

Is the risk of bankruptcy related to the board size?

The size of the board relates to the number of Board members. Board size is a characteristic of board structure that has been covered in many literatures. It is seen as having a major effect on the board's results. Recent research indicates that large boards are of benefit to their firms.Firstly, the more the company's board of directors, the closer the organization is to vital resources.[22] Second, larger board is likely to reduce the probability of bankruptcy. They believe that larger board brings wider knowledge and better expertise to the company.[23] Other analysts argue that the size of a board may have consequences for the level of board independence, because the CEO may more effectively control a smaller group of directors as a result of social cohesion. In comparison, the CEO is less likely to control a larger board, because it can take more time and energy on the CEO's part to create consensus.[24] Other studies, however, claim that smaller boards are more effective than larger boards. The first reason is that, due to decreased coordination, communication and free-rider problems, smaller board of directors associated with better firm performance.[25]Secondly, smaller boards are more competent at improving value of company in the time of distress.[26]Large boards can also build coalitions which lead to group conflicts, making it harder to reach consensus.[27]During a crisis, a tendency to react indecisively might threaten the existence of firms.[28]Another implication of large boards is concerned with social loafing. Social loafing refers to a decrease in efforts exerted by directors as board size increases.[29]Therefore, it's hard to say whether and how the board size is correlated with the probability of bankruptcy.

Hence, board size may or may not have anassociation with the probability of bankruptcy.

[22] Pfeffer and Salancik, 1978
[23]Darrat, Gray, Park, and Wu, 2016
[24] Muth and Donaldson, 1998; Zahra and Pearce, 1989
[25] Yermack, 1996
[26] Fich and Slezak, 2008
[27] Goodstein, Gautam, and Boeker, 1994
[28] Daily and Dalton, 1994
[29] Kidwell and Bennett, 1993

CHAPTER 4: PROPORTION OF INDEPENDENT BOARD AND BANKRUPTCY

Is the risk of bankruptcy related to the independent director's proportion?

Proportion of independent board refers to the percentage of independent directors in the board.The definition of independent director is: "one who has no need or inclination to stay in the good grace of management, and who will be able to speak out, inside and outside the boardroom, in the face of management's misdeeds in order to protect the interests of shareholder".[30]Independent director has two roles within the board, monitoring roles and providing resource roles according to their position, monitoring effectiveness and giving advice to the organization.[31]There are numbers of studies supporting the presence of independent directors, like Nguyen and Nielsen[32] investigating stock price reaction to sudden deaths and concluding that independent directors are often seen as useful to the firm.Byrd and Hickman[33] show that independent directors are more likely to remove CEO with bad performance. Independent director has negative association with bankruptcy, which means independent directors decrease the likelihood of corporate bankruptcy. A company with more independent directors has more effective business adjustment while under distress rather than a company with more inside directors.[34]

Independent directors may adversely affect the cohesiveness of the board, because they simultaneously play the roles of decision-makers and managers, which can lead to conflict of interest.[35] Chaganti & Sharma[36] and Abdullah[37] also find that there is no relation between the board independence and the likelihood of bankruptcy. Their results of the study appear as they deal only with one form of industry. They argue that the proportion of independent directors in the retail industry is not a main determinant of bankruptcy.[38]Despite prior research on the

[30] According to the definition of Clarke, 2007
[31] Hillman and Dalziel, 2003
[32] 2010
[33] 1992
[34] Fich and Slezak, 2008
[35] Perry, 1995
[36] 1985
[37] 2006
[38] Study of Chaganti & Sharma

association between board independence and bankruptcy likelihood, prior research is quite limited.Given the mixed evidence of the preceding study, I propose a hypothesis in a null-form.

Hence, proportion of independent director does not have association with the probability of bankruptcy.

CHAPTER 5: PROPORTION OF FEMALE DIRECTOR AND BANKRUPTCY

Is the risk of bankruptcy related to the proportion of female director?

Proportion of Female Director refers to percentage of female director in the board.There are growing studies exploring the notion of having a female director within the boards. The reasons behind the theory that board diversity increases a firm's competitive advantage are based on intuitive reasoning.[39]First, it is argued that by balancing the diversity of a firm's directors to the diversity of its potential customers and employees, the more diverse the board, the greater the perception that consumers prefer. Second, it is argued that diverse board increase creativity and innovation because these characteristics are not randomly distributed among the population but tend to vary systematically with demographic variables such as gender.Third, it is argued that diverse boards will boost problem-solving ability as the variety of perspectives arising from a more diverse board allows for more alternatives to be identified.

However, there are other research that point out that the female directors may not necessarily result in more effective monitoring if women directors are marginalized and conclude that there is no reason to expect greater female director enhance board monitoring.Lau and Murnighan[40] (1998) explain that when greater female director among board members generates more conflicting opinions, decision-making will be more time-consuming and less effective.

The above points address both positive and negative relationships between appointments of female directors and firm performance. The existing empirical evidence is still inconclusive due to the different methodologies and proxies. Prior studies show that it is difficult to predict the

[39] Explained by Robinson and Dechant in 1997
[40] 1998

relation between female director and firm performance. Nevertheless, these studies provide theories for this study as bankruptcy is an indication of firm performance. Since there is no adequate number of studies that examine the effect having female director inside the board on the probability of corporate bankruptcy, it is worthwhile to examine this association. I propose a hypothesis in a null-form.

Hence, proportion of female director does not have an association with the probability of bankruptcy.

From the argument that stated above, the mixed results regarding the effect of corporate governance proxies to the bankruptcy suggest that further study is necessary.

CONCLUSION

The purpose of this study is to provide evidence that board director's characteristics have impact on the probability of corporate bankruptcy. Board size, proportion of female directors and proportion of independent directors are used as the board of director characteristic indicators. The results show that overall, board director's characteristics have some influence on the probability of bankruptcy, board size is likely to be associated with probability of bankruptcy in the company, while proportion of female director and proportion of independent director is not.The significant correlation of board size is in line with study from Fich and Slezak (2008), which indicated smaller board are more effective at avoiding bankruptcy once the company becomes distressed. These results prove that the board director serve as internal control mechanism in the corporate governance, and that governance structures do partially contribute to the probability of bankruptcy.