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Voluntary corporate governance structure and financial distress: Evidence from Australia

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ABSTRACT

We examine the role of voluntary adoption of corporate governance mechanisms in mitigating the financial distress status of firms. Using a sample of 171 financially distressed and 106 healthy listed Australian firms over the 5-year period prior to the introduction of the ASX Corporate Governance Council Code in 2003, we find support for the argument that the adoption of certain corporate governance mechanisms is beneficial for firms, as reflected in a reduced likelihood of financial distress. In particular, greater levels of blockholder and director ownership and the existence of a separate audit committee are associated with lower financial distress likelihood. We also find causal evidence that the voluntary adoption of particular corporate governance structures leads to lower levels of financial distress, rather than financial distress recognition leading to corporate governance structural reform.

1. Introduction

In this paper we examine the association between the voluntary adoption of corporate governance mechanisms and the likelihood of financial distress of listed Australian firms from 1999 to 2003. In particular, we examine whether board composition, director and external ownership, CEO duality and the presence of an audit committee are associated with the likelihood of financial distress of listed Australian firms. The rationale for our choice of this particular period is that it precedes the introduction of the Australian Securities Exchange (ASX) Corporate Governance Council's 'Principles of Good Corporate Governance and Best Practice Recommendations' requirement in 2003. During 1999–2003, companies effectively voluntarily devised their own corporate governance practices and, since there were no recommended governance practices which companies could follow, Australian listed firms varied significantly in their corporate governance practices (Henry, 2008).

Focusing on a time period incorporating no formal corporate governance requirements provides an opportunity to directly assess: (i) whether companies that are closer to, or have a higher probability of financial distress, adopt corporate governance structures that differ compared to those employed by healthier firms; and (ii) whether there is a bi-causal relationship between financial distress and corporate governance. This approach differs from prior studies which examined the link between corporate governance and the probability of financial distress in environments where formal corporate governance codes exist. This latter setting introduces potential noise or bias resulting from firms adopting prescribed corporate governance platforms, including situations of non-mandatory compliance, rather than

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identifying voluntary corporate governance reform responses to firm-specific conditions.

Few prior studies have examined the direct association between various corporate governance attributes and financial distress of firms. Exceptions are Abdullah (2006) for Malaysian firms, Elloumi and Gueyle (2001) for Canadian firms, and Lee and Yeh (2004) for Taiwanese firms. Elloumi and Gueyle (2001) examined the relationship between various corporate governance attributes, such as the presence of outside directors on boards, equity ownership of outside directors and CEO–chair duality, with the likelihood of financial distress of Canadian firms. They found that the presence of outside directors and ownership of outside directors are negatively related to the likelihood of financial distress. However, the presence of CEO and duality fail to show any significant association with financial distress of firms. Abdullah (2006) found that non-executive director ownership and the presence of outside blockholders reduce the probability of financial distress in Malaysian firms. He found no association between board independence, duality and the likelihood of financial distress. For Taiwanese firms, Lee and Yeh (2004) found a higher stock pledge ratio, the largest shareholders exerting more control on supervisors and directors, and greater deviation of control rights from cash flow rights are associated with higher probability of firms experiencing distress the following year.

Our paper extends this literature by examining other governance attributes, including the existence of a board audit committee, which has not previously been considered. Board audit committee activity is expected to be closely aligned with the going concern status of firms. We also attempt, using a simultaneous equations framework, to disentangle the causality issue between corporate governance and financial distress, which has previously been ignored. This is also the first study to provide related evidence in a voluntary corporate governance setting, as we focus on a time period prior to the introduction of a formal corporate governance code in Australia in 2003. Thus, our findings may have important implications for corporate governance policy as set by the ASX Corporate Governance Council by identifying corporate governance attributes that are associated with a reduced level of financial distress likelihood.

Other contributions of our paper include assessing the influence of corporate governance on both binary and continuous variable representations for financial distress, whereas prior literature has only focused on analysing firms defined dichotomously as ‘distressed’ and ‘healthy’. We categorise financial distress based on earnings generation which allows us to examine the influence of corporate governance attributes on operating performance, whereas most previous studies focused on the effects of corporate governance on market-based valuation outcomes. Furthermore, by evaluating corporate governance attributes in an *ex ante* regulatory setting, our results will inform about the likely benefits of the adoption of Best Practice recommendations (or at least a number thereof) now in place.

During the early 2000s, a series of corporate collapses and frauds in Australia, most notably HIH Insurance, One Tel and Harris Scarfe, destroyed substantial amounts of shareholder wealth[1] and weakened investor trust. As a result of these events, concerns were expressed about the weakness or failure of existing corporate governance practices, which initiated considerable debate on corporate governance practices and led subsequently to the introduction of the ASX Corporate Governance Council Principles of Good Corporate Governance and Best Practice Recommendations reforms.

Prior studies have suggested that agency costs are higher for listed companies in Australia compared to other western countries such as the US and UK (Fleming et al., 2005; Henry, 2010). The existence of greater agency cost levels further raises concerns about the extent and effectiveness of traditional monitoring and incentive mechanisms. In light of this environment, it is our suggestion that firm corporate governance structure may play an increasingly important role as an effective monitoring mechanism and in reducing agency costs. Prior studies, including Ang et al. (2000), Fleming et al. (2005) and Singh and Davidson (2003), provide evidence that specific corporate governance attributes, including director ownership and board independence, reduce firm-level agency costs. Henry (2010) found that greater overall compliance with a corporate governance code is associated with a lower agency cost platform. There is also a wealth of literature examining the relation between corporate governance and firm performance (see Brown et al., 2011 for a recent literature review, including Australian-related evidence), with mixed evidence regarding the nature of any association between the strength of firm corporate governance and performance outcomes. For Australia, Henry (2008) documented that *ex ante* (or pre-introduction voluntary) compliance with the ASX Corporate Governance Council recommendations positively impacted on the market valuation of a sample of Australian listed companies.

We propose that firms maintaining a lower platform of agency costs are less likely to experience financial distress. If, as the earlier literature suggests, adherence to the recommended corporate governance regime is associated with lower underlying agency costs, stronger firm-level corporate governance should be negatively related to the likelihood of financial distress. We employ both a dichotomous variable indicating financial distress status, and a continuous variable representing financial distress using the Zmijewski (1984) model. The results of our study provide evidence that higher director and blockholder ownership and the existence of an audit committee are significantly negatively related to financial distress likelihood for our sample of Australian firms. Our findings suggest that these governance attributes may act as substitute agency and monitoring mechanisms. Robustness analysis using simultaneous equation system suggests that causality runs from corporate governance attributes impacting on financial distress, rather than vice versa.

The remainder of our paper is structured as follows. Section 2 develops the hypotheses. Data description and sample selection criteria are described in Section 3. The description of variables is provided in Section 4. The empirical

[1] The collapse of insurance giant HIH Insurance in Australia alone has cost shareholders more than $5.3 billion in losses (Clarke et al., 2003).