Financial Distress Prediction: The Ownership Structure and Management Agency Cost

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Submission date: 05-Mar-2020 09:08AM (UTC+0800)

Submission ID: 1269489805

File name: ID_69_Maya.docx (43.39K)

Word count: 3064

Character count: 17956

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Abstract. This research aimed to predict the financial distress through ownership structure and management agency cost. The ownership structure was tested by managerial ownership and institutional ownership. Meanwhile, the management agency cost was tested by administrative cost ratio. The population of this research were all companies listed in Indonesia Sharia Stock Index year 2016-2018 by using purposive sampling technique. Based on the criteria that have been determined, the total samples were 129 companies. The analysis of the data in this research used logistic regression analysis. The results showed that institutional ownership has a significant negative effect towards the financial distress. Despite, the managerial ownership and management agency cost have a insignificant negative effect toward the financial distress.

Keywords: ownership structure, management agency cost, financial distress, Indonesia Sharia Stock Index, logistic regression analysis.

1 Introduction

Financial distress is a stage where the financial conditions experience a decrease. It occurs in companies before bankruptcy or liquidation (Platt and Platt, 2002; Wruck, 1990). A company is categorized as experiencing financial distress if the company shows a negative number on the operating income, net income and equity book value also the company that make a merge (Al-Khatib, et al., 2012). Another phenomenon of financial distress is companies tend to experience liquidity difficulties as indicated by the company's failure to fulfill its obligations to creditors (Hanifah & Purwanto, 2013). Brigham & Daves (2003) stated that financial distress occurs over a number of errors, such as improper decision making, interconnected weaknesses that can affect directly or indirectly to management, and the lack of efforts to control the company's financial condition. So that the implementation is not as needed. This gives the conclusion that there is no guarantee for large companies can avoid this problem. It is because financial distress is related to the company financial condition where every company will surely deal with finance in order to achieve profit targets and company sustainability.

Companies that have experienced financial distress, need to be able to do predictive analysis and early detection before going bankrupt (Azwar, 2015). Agus (2011) added that this analysis is also needed by interested parties such as investors, policy makers, auditors and competitor companies and the general public. Specifically for investors, the results of the analysis will be used to choose the attitude towards the securities owned by the company where it will invest. Bhunia, et al., (2011); Haddad, et al., (2011) stated that financial distress in companies can cause problems that can reduce management efficiency. Therefore, we need a strong corporate governance structure and agency cost management in the company.

Elloumi, et al., (2001); Li, et al., (2008); Parulian (2007) stated that corporate governance affects financial distress. Ariean (2012) stated that the problem of financial distress arises because of the weak supervision from shareholders, board of commissioners and bank creditor. Otherwise, the better implementation of corporate governance in a company, the lower probability of financial distress in that company. This is in line with the opinion of Porter (1999); Classens (1999), the reason for a company's success or failure is caused by the strategy adopted by the company. This means that the success of a majority company is determined by the strategic and managerial characteristics of the company, including the strategy of implementing corporate governance system (Sutedi, 2011). The implementation of good corporate governance will foster a harmonious relationship between the board of directors and company management (Arief, 2009).

Indriastuti & Ifada (2011); Indriastuti (2012); Miglani, et al., (2014); Muranda (2006) stated that corporate governance is needed to ensure that the strategic direction and management of the company do not shift from existing plans and also to reduce the practice of fraud from the company's internal environment. However, managing a company can cause a conflict of interest between shareholders and agents. Conflicts of interest due to the possibility that agents do not always act in accordance with principals' interests trigger management agency costs (Jensen and Meckling, 1976). Li, et al., (2008) suggested that management agency costs affect financial distress. This is because, administrative costs incurred as management agency costs can adversely affect the company's financial condition. Ayuningtias., (2013) added that management agency cost has an influence on financial distress. Based on the description above, this study analyzes and empirically tests the factors that can predict financial distress in Indonesia Islamic stock index companies.

2 Hypothesis Development

2.1 Managerial Ownership and Financial Distress

Managerial ownership is assumed to be able to reduce agency problems in a company. If the problems occur continuously, it can cause financial distress in the company. This is caused by managerial ownership, the decision making related to the company will be carried out with full responsibility because it is in accordance with the interests of shareholders in this case including the interests of management as one of the components of the company owner (Emrinaldi, 2007). Ownership by management will also increase management supervision of the company itself (Triwahyuningtias & Muharam, 2012). Agency theory suggests an incentive mechanism to encourage management to act in the interests of stakeholders. Management cannot think like stakeholders if they are not stakeholders. In the previous study conducted by Arieany (2012), the results showed that there was a significant and negative relationship between managerial ownership and companies that experienced financial distress. The first hypothesis is as follows:

H1: Managerial ownership negatively affects financial distress.

2.2 Institutional Ownership and Financial Distress

Institutional ownership is one of the corporate governance mechanisms that can reduce problems in agency theory between owners and managers so that there is an alignment of interests between company owners and managers. Therefore it does not create a management agency cost that can lead to a financial distress of a company. If the institutional ownership is greater, the more efficient utilization of company assets. As the result, the potential for financial distress can be minimized. It is because, a company with institutional ownership greater than 5 percent indicates its ability to supervise the management (Bodroastuti, 2009). Based on Abdullah's research (2006) in Malaysia, stated that institutional ownership has a significant negative relationship in companies that experience financial distress. The second hypothesis is as follows:
H2: Institutional ownership negatively influences financial distress.

2.3 Management Agency Cost and Financial Distress

The company will try to reduce management agency costs. Beside external conflicts, there are also internal conflicts within the agents and principals (people tend to be inconsistent). Management agency cost is the provision of appropriate incentives to managers, as well as supervise the costs in order to prevent the desire of managers who may take actions in contrary to the objectives of the company's shareholders (Fachrudin, 2011). Research on the effect of management agency cost on financial distress by Ayuningtias (20[illegible]) and Li, et al., (2008) stated that management agency cost has a positive influence on the possibility of financial distress. Third hypothesis is as follows:
H3: Management agency cost has a positive impact toward financial distress.

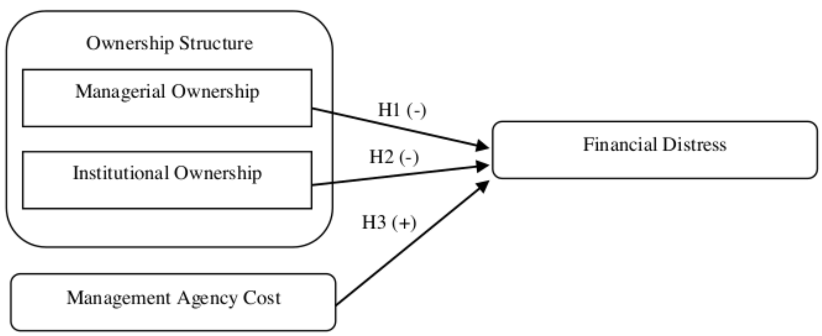

Fig. 1. Research Model.

3 Methodology

The population in this study were companies listed on the Indonesia Sharia Stock Index year 2016-2018. The sampling method used a purposive sampling method with the following criteria: (1) listed as a company registered since 2016-2018; (2) companies that report financial statements using Rupiah exchange rate; (3) companies that submit complete data related to the research variables; (4) companies that experience financial distress. Based on theose criteria, the total sample used in this were 129 companies (43 companies x 3 years). All data will be analyzed using logistic regression (Ghozali, 2016).

Financial distress is measured using an Interest Coverage Ratio (ICR), which is the ratio between earnings before interest tax and interest expense. If the interest coverage ratio shows a number of more than 1, then it is classified as a company that does not experience financial distress and given the code 1. Whereas if the interest coverage ratio shows a number less than 1, then the company can be said to be a company that experiences financial distress and given the code 0 (Hidayat & Meiranto, 2014). Managerial ownership is measured using a percentage of share ownership by managers, directors, and commissioners in the company. Institutional ownership is measured through the proportion calculation of company share ownership by institutions of all outstanding shares (Indriastuti, 2012). Management agency cost is measured using administrative cost ratio, which is a comparison between administrative costs and sales Li, et al., (2008).

4 Result and Discussion

4.1 Result

The results of hypothesis testing in this research used the logistic regression test model. It is used to test the effect of managerial ownership, institutional ownership and management agency costs in predicting the possibilities for financial distress in a company.

Table 1. Wald Test Result

Dependent Variable	Independent Variable	B	S.E.	Wald	df	Sig	Exp (B)
Financial Distress	Managerial Ownership	-1.954	2.119	1.987	1	.459	1.490
	Institutional Ownership	-5.139	2.461	9.118	1	.013	1.129
	Management Agency Cost	-1.291	2.983	1.120	1	.952	1.939
Chi-square	6.758					0.788	
Nagelkerke R Square	,186						

Table 1 shows the Chi-square value of 6.758 with a significance of 0.788. Based on these results, because the significance value is greater than 0.05, it can be concluded that the model able to predict the value of the observation. The magnitude of determination coefficient in the logistic regression model is shown by Nagelkerke's R Square value of 0.186. It means, the dependent variable is explained by the independent variable at 18.6% while the remaining 81.4% is explained by other variables outside the research model. The results of hypothesis testing show that (1) managerial ownership has a Wald value of 1.987 with a significance level of 0.459. Since the significance level above 5% and the value of coefficient b is negative, it can be said that managerial ownership does not have a significant negative effect on the prediction of financial distress in a company. This shows that in the logistic regression model the hypothesis 1 is rejected.

Institutional ownership has a Wald value of 9,118 with a significance level of 0.013. Since the significance level under 5% and the value of coefficient b is negative, it can be said that institutional ownership has a significant negative effect on the prediction of financial distress in a company. This shows that in the logistic regression model the hypothesis 2 is accepted. Management agency cost has a Wald value of 1.120 with a significance level of 0.952. Since the significance level above 5% and the value of coefficient b is negative, it can be said that the management agency cost has no significant negative effect on the prediction of financial distress in a company. This shows that in the logistic regression model, the hypothesis 3 is rejected.

4.2 Discussion

4.2.1 Managerial Ownership and Financial Distress

Managerial ownership does not have a significant negative effect on the prediction of financial distress. It means that the higher managerial ownership, it reduces the possibility for companies to be indicated having a financial distress. The ability of managerial ownership in predicting financial distress can be caused by the share ownership of the management will provide additional incentives to management in supervising the policies. This additional incentive will reduce opportunistic management behaviors and can align interests with other shareholders. The results of this study are in line with research conducted by Ayuningtias (2013); Xiaolan & Zongjun (2006) that managerial ownership variables have no effect toward financial distress.

4.2.2 Institutional Ownership and Financial Distress

Institutional ownership has a significant negative effect on the prediction of financial distress. The greater ownership of institutions will encourage a more optimal level of management performance supervision. It is because institutional ownership represents a source of power that can be used to support the existence of management. With the increasing supervision, institutional investors can help in reducing agency costs incurred by companies, so that the possibility of losses to companies that result in financial distress will be smaller Ayuningtias (2013). Companies with large institutional ownership (more than 5%) indicate their ability to influence management policies through voting. Through this institutional ownership, the winner of institutional shares can replace or strengthen the monitoring function in a company, in order to reduce the possibility of the company to experience financial distress (Laurenzia and Sufiyati, 2015). The results of this research are consistent with research conducted by Arieany (2012); Ayuningtias (2013); Laurenzia and Sufiyati (2015) that institutional ownership has a significant negative effect on financial distress.

4.2.3 Management Agency Cost and Financial Distress

Management agency cost has no significant negative effect in predicting financial distress. This is because the administrative costs component used in this research does not only cover managerial costs such as managerial salary costs, executive fees, travel costs, entertainment costs, conference expenses, and welfare payments (Li et al., 2008). Rather it also includes electricity costs, depreciation, building rent and other administrative costs that are not included in managerial costs. Therefore, this causes a large amount of administrative costs ratio (Ayuningtias., 2013). The results of this research are different with the research conducted by Li et al., (2008) and Ayuningtias (2013), suggested that the management agency costs proxied by administrative cost ratios have a positive impact on financial distress. This is because, administrative costs incurred as management agency costs can adversely affect the company's financial condition.

5 Conclusion

Managerial ownership and management agency cost do not have a significant negative effect on financial distress predictions. Institutional ownership has a significant negative effect on the prediction of financial distress. The limitation of this research is the low ability of independent variables in explaining the dependent variable, which is only 18.6%. Therefore, for future research, it would be better to add other independent variables such as financial ratios, audit committees and company size and extend the research time.

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PAGE 2

PAGE 3

PAGE 4

PAGE 5

PAGE 6

PAGE 7

PAGE 8