

# The Structure of Good Corporate Governance and Financial Indicators as Predictor of Financial Distress in Mining Sector Company in Indonesia

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## Abstract

The purpose of the paper are: (1) to examine financial indicators, including: current ratio, return on assets, debt to assets ratio, and total asset turn over as a predictor of financial distress in mining sector companies in Indonesia; (2) to examine the structure of Good Corporate Governance including: independent commissioner, audit committee, board of directors, independent audit committee ratios with non-independent, and institutional ownership ratio with managerial ownership as predictor of financial distress in mining sector company in Indonesia. Type of research is quantitative explanatory research. Sampling technique is used purposive sampling method, as many as 20 companies in the mining sector in Indonesia. Analytical techniques in this study uses logistic regression. The results of the research show that: current ratio, debt to asset ratio, total asset turnover, and institutional ownership ratio with managerial ownership are not predictors of financial distress in mining sector in Indonesia. However, return on Assets, independent commissioners, audit committees, boards of directors and independent audit committee ratios with non-independent are predictors of financial distress in mining companies in Indonesia.

**Keywords:** Good Governance Corporate Structure, Financial Indicator, Financial Distress

## 1. Introduction

The global economic condition for a powerful company is an opportunity, but for a weak company it is a threat. One of the weaknesses of the company indicated the existence of financial difficulties (financial distress), so this condition will threat the survival of the company to survive.

Financial distress is a condition where the company is experiencing financial pressure, so if it is not properly anticipated will have an impact on bankruptcy. This phenomenon is reflected when the company suffers from a lack of working capital to manage its assets, and it is also shown by the inability of the company to pay its obligations that are due soon. Thus, financial

distress needs to be detected early on so that companies can take preventive action before the company actually goes bankrupt. According to Platt and Platt (2006), financial distress is a condition in which a company experiences deviations and financial pressures so that it will gradually go bankrupt.

In the past several years, mining commodity production has contributed substantially to the country's revenues, but in recent years the production of mining commodities has declined significantly. The decline is due to the decline in mining commodity prices and the growing use of alternative energy sources.

In addition, coal exports have declined due to enforcement of environmental regulations in importing countries. Global awareness to reduce carbon emissions began to be encouraged. Two of Indonesia's coal export destination countries, namely India and China have begun to implement carbon emissions reductions. Particularly China, based on the results of research ever conducted, the Chinese people died about 1.6 million people due to air pollution, so the Chinese people reduce global warming by reducing the burning of coal that can cause air pollution. India is also more optimizing the domestic coal so that the country's coal exports are also reduced. ([www.minerba.esdm.go.id](http://www.minerba.esdm.go.id))

Production of coal only for domestic purposes, such as power plants, cement plants and so on. This causes coal companies to decline due to declining production demand while operating costs remain. High operational costs while reducing production demand and selling prices drastically lead to some mining companies will experience financial difficulties (financial distress).

Financial Distress in a more comprehensive manner can be predicted by using the ratio of finance and good corporate governance (GCG), where the financial ratios show the company's financial position over a certain period that reflects the company's performance. Furthermore, GCG is needed to encourage efficient, transparent and consistent market with laws and regulations. Therefore, the implementation of GCG needs to be supported by three interconnected pillars, those are the state and its instruments as regulator, business world as market participants, and users as users of business products and services (National Committee on Governance Policy, 2006).

According to Kurniasari (2013), that the financial statements are sources of information that can be used as a predictor in assessing the bank's health condition and financial difficulties bank. Therefore, it is needed a system to analyze financial performance through financial report to know existence of possibility of bank that have difficulties finance or financial distress which result in bankruptcy.

In order to realize Corporate Governance properly, support from several parties including from the Board of Commissioners, the Board of Directors, the Audit Committee, and the Independent Commissioner are required. It means that the Board of Commissioners, the Board of Directors, the Audit Committee, and the Independent Commissioner must have the same vision and mission to realize Corporate Governance well. Board of commissioners and board of directors have responsibility for the long-term sustainability of the company. Board of directors is an organ that knows about the performance of the company, while the commissioner has responsibility for supervision in a company. Board of commissioners consists of two commissioners who come from the parties and the undisliated commissioner of the unaffiliated party that is independent commissioner. The audit committee is a commissioner support committee that is responsible for ensuring that the company reports its finances properly.

Platt and Platt Research (2002) shows that EBITDA to sales, current assets to current liabilities and cash flow growth have a negative effect on financial distress, while net fix assets to total assets, long term debt to equity, payable to total assets positive to financial distress. Furthermore, according to Ratna's research results (2007), that the board of commissioner has a significant effect on financial distress, but the board of independent commissioner and ownership structure has no significant effect on financial distress. Selfi (2014) indicates that institutional ownership, managerial ownership, board of directors, liquidity and leverage have no effect on financial distress. Board of commissioner and operating capacity have a positive effect on financial distress.

## **2. Problem Statement, Literature Review, and Hypotheses**

### *2.1 Problem Statement*

The objectives of the research are: (1) to analyze the financial structure, including: current ratio, return on assets, debt to assets ratio, and total asset turn over as predictors of financial distress in mining sector companies in Indonesia; (2) analyze the structure of Good Corporate Governance, including: independent commissioner, audit committee, board of directors, independent audit committee ratios with non-independent, and institutional ownership ratio with managerial ownership as a predictor of financial distress in mining company in Indonesia.

### *2.2 Literature Review*

#### *2.1.1 Financial Distress*

According to Platt and Platt (2006) financial distress is a condition in which the company suffers irregularities and financial pressures that will gradually lead to bankruptcy. Luciana (2003), asserted that financial distress occurred prior to bankruptcy. Furthermore, according to Ahmad and Herni (2014: 102) financial distress occurred due to factors of insufficient capital, the amount of debt and interest burden, and suffered losses. Furthermore Beaver (2006), and several years later continued by Altman (2008), that the measurement of financial distress used accounting data from the balance sheet and income statement of the company, in the form of financial ratios so that is used as a financial predictor variable distress.

Several studies have explained that the indication of the company is experiencing financial distress, including: (a) Whitaker (1999), if the company in a few years experienced negative net operating profit; (b) Tirapat and Nittayagasetwat (1999), if the company discharged its operations over the authority of the government and the company should undertake restructuring planning; (c) Almilia (2003), the company has for several years experienced negative net operating income and for more than one year did not pay dividends.

According to Baker et al. (2006: 512), there are several ways to overcome financial distress, those are: (a) Non-judicial action, namely by debt restructuring agreement and voluntary asset delivery; (b) Judicial action, namely by reorganization and liquidation.

#### *2.1.2 Financial Indicator*

The ratio of liquidity or often also called as working capital ratio is the ratio that is used to measure how liquid the condition of a company (Cashmere, 2010: 130). Furthermore, Brigham and Houston (2014: 134) mentions, the ratio of liquidity is a ratio that shows the relationship between cash and current assets with lancer liability. The ratio of liquidity commonly used current ratio and quick ratio.

Profitability ratios represent ratios that show a combination of liquidity effects, asset management and debt on operating results (Brigham and Houston, 2014: 146). Further

Kasmir (2010: 196) shows that the ratio of profitability is the ratio to assess the ability of companies in the search for profit. This ratio provides a measure of the effectiveness of a company's management level as shown by the profits generated from sales and investment income. Return on Assets (ROA) is a ratio that is used to measure a company's ability to generate net income based on the level of assets owned. High ROA indicates good asset effectiveness, it means that the management efficiency is good. (Mamduh Hanafi and Abdul Halim, 1996: 84)

Leverage/solvency ratio is the ratio that is used to measure the extent to which the company's assets are financed by debt (Cashmere, 2010: 150). This is in accordance with Brigham and Houston (2014: 140), that the leverage ratio is a ratio that measures how large the company uses debt financing. The leverage ratio consists of the ratio of total debt to total assets, interest rate multiplication ratio and earning before interest, taxes, depreciation, and amortization (EBITDA) ratio.

According to Kashmir (2010: 172), the ratio of activity is the ratio that is used to measure the effectiveness of companies in using assets owned. This ratio is also used to measure the efficiency of resource utilization. Brigham and Houston (2014: 136), explain that the ratio of asset/activity management is the ratio that is used to measure how effective a company regulates its assets. The asset management ratio consists of inventory turnover ratio, total uncollectible sales revenue, asset turnover ratio, and asset turnover ratio.

### 2.1.3 Good Corporate Governance (GCG)

The main theories associated with GCG are stewardship and agency theory. Stewardship theory builds on the philosophical assault of human nature, that man is intrinsically believable, capable of acting with full responsibility, having integrity and honesty with others. Meanwhile, agency theory sees that corporate management as an agent for shareholders will act with full awareness for its own interests (Chin, 2002).

Good Corporate Governance (GCG) is defined as the structure, system, and process used by company organs to provide long-term sustainable value added. In good corporate governance, GCG is a structure that stakeholders, shareholders, commissioners and managers use to set company goals and mean to achieve those goals and oversee performance (Bonazzi, 2007) and Abbasi (2012). The definition is also briefly confirmed by Cornett (2009) and Romano (2012), that GCG is as a participant relationship in determining direction and performance. Porter (2004) in Wardani (2006), states that the reason why a company succeeds or fails is likely to be more due to the strategy set by the company. Such strategies may include strategies for implementing GCG systems within a company.

Corporate governance is a rule, regulation, principles and practices that set the company's direction. Every company has a vision and mission, even if it is not written. Every company also has a long-term goal of corporate strategy (Bramantyo Djohanputro, 2006: 222).

In the National Committee on Governance Policy (2006), GCG principles include: transparency, accountability, responsibility, fairness and equity. It furthermore affirms that corporate organs consisting of general meetings of shareholders, board of commissioners and board of directors have an important role in the effective formation of GCG.

### 2.1.4 Financial Indicator, Good Corporate Governance and Financial Distress

Luciana (2004), that book value of shareholder of equity / total assets and debt ratio and Return on Asset (ROA) have significant effect, but industry ratio has better classification compared to financial ratio. Price trends and macro variables can also predict financial distress. Emrinaldi's (2007) study, that managerial ownership, institutional ownership,

independent commissioner, and board of directors have an effect on financial distress, while audit committee is insignificant. Furthermore, Tri Bodroastuti (2009), that the public ownership, the number of outside directors, institutional ownership and ownership of directors is not significant, while the number of boards of directors and the number of boards of commissioners is significant as a prediction of financial distress.

The results of Ellen and Juniarti's (2013) studies show that current ratio and inventory turnover can predict financial distress, while audit committee, board of commissioners and ownership structure are not able to predict. Furthermore, Selfi Anggraini (2014), shows that institutional ownership, managerial ownership, board of directors, liquidity and leverage have no significant effect on financial distress. Board of commissioners has a significant negative effect and operating capacity has a significant positive effect on financial distress. Furthermore, Haziro and Negoro's research results (2017), those are: the number of audit committee and audit committee meeting frequency have a significant positive effect on financial distress, while independent audit committee ratios with non-independent and financial expertise have no significant effect.

### 2.3 Hypotheses

Using the significance level of  $\alpha = 5\%$  and the partial significance test using the Wald test, where: if p-value of Wald test  $> 0.05$  then  $H_0$  is accepted, but if p-value of Wald test  $< 0.05$  then  $H_0$  is rejected. (Imam Ghozali, 2006: 150).

## 3. Research Methodology

This type of research is quantitative explanatory research. Explanatory research aims to test the theory or research hypothesis to reinforce or reject the theory or hypothesis of existing research. The analytical tool used is logistic regression, where the scale of data measurement for dependent variable with nominal scale and independent variable uses scale ratio. Dependent variable in this research is dummy variable, that is mining company that has and has not financial distress. Logistic regression model, adapted from Imam Ghozali (2006; 149), with formulation:

$$Y = \text{Ln} [p/(1 - p)] = b_0 + b_1X_1 + b_2X_2 + b_3X_3 + b_4X_4 + b_5X_5 + b_6X_6 + b_7X_7 + b_8X_8 + b_9X_9 + e$$

Where:

Y = The probability of mining companies experiencing financial distress

$b_0$  = Constants

$b_1, \dots, b_9$  = Logistic regression coefficient

X1 = Current ratio (CR);

X2 = Return on Assets (ROA);

X3 = Debt to Asset Ratio (DAR);

X4 = Total Asset Turn Over (TATO);

X5 = Independent Committee (KM-IND);

X6 = Audit Committee (KM-AUDIT);

X7 = Board of Directors (DW\_DIREKSI);

X8 = Independent Audit Committee Ratios with Non-Independent (KAI-NONI);

X9 = Institutional Ownership with Managerial Ownership Ratio (KI-KM).



Financial Distress is a situation where a mining company experiences a negative profit for two consecutive years. Furthermore, This study uses following ratios for measuring financial distress: (a) Current ratio is a measurement of the ability of a mining company to pay its short-term liabilities; (b) Return On Assets is the ability of a mining company to use all of its assets to generate profits; (c) Debt to Assets Ratio is how much the proportion of funding assets of mining companies derived from debt; (d) Total asset turnover is to measure how effective a company uses all its assets to increase sales of a mining company.

This study uses following ratios for measuring GCG: (a) an independent Board of Commissioners is the number of boards of commissioners that are assigned and responsible for supervising and advising the board of directors to ensure mining companies conduct GCG; (b) The audit committee is the number of audit committees to assist the commissioners in terms of financial reporting to mining companies; (c) Board of directors is the number of boards that are assigned and responsible for managing the mining company; (d) The ratio of independent and non-independent audit committees is the proportion between independent and non-independent audits of mining sector companies; (e) Institutional Ownership Ratio with Managerial Ownership, is the proportion between institutional ownership and managerial ownership of mining company stocks.

### 3.1 Data Set

This research population is all mining sector companies listed on Indonesia Stock Exchange from 2011 - 2016, consisting of coal sub sector, oil and gas sub sector, metal and other mineral and rock sub sector. This research is using purposive sampling method, resulted as many as 20 mining companies.

## 4. Empirical Results and Discussion

Based on logistic regression result, the equation model obtained is:

$$Y = \text{Ln} [p/(1 - p)]$$

$$Y = - 1,156 + 0,103\text{CR} - 0,172 \text{ROA} - 1,783 \text{DAR} - 0,236 \text{TATO} - 1,784 \text{KM-IND} + 0,701 \text{KM-AUDIT} + 0,241 \text{DW- DIREKSI} + 0,327 \text{KAI-NONI} + 0,813 \text{KI} - \text{KM} + e$$

Further assessing the fit model in logistic regression is done by using -2 log likelihood, Cox and Snell R Square, Hosmer and Lemeshow Goodness of FIT Test and 2 x 2 classification table.

From -2 log Likelihood's test results, obtained value of 69.317 in block 0 before independent variable entered in the model, after the included independent variables to 51,852 in block 1. Decrease - 2 log Likelihood's test showed better model and fit model suitable with the data so that the model is feasible to use.

From Cox and Snall R Square obtained values Nagelkerke R Square 0, 472 or 47.2% which means the proportion of variability dependent variable (financial distress) which can be explained independent variable is equal to 47.2%, while the remaining 52.8% is explained by other variables which is not included in this model.

Hosmer and Lemeshow Goodness of FIT's test value is 7,853 with significance level 0,497 so it can be said fit model match with observation data because it is bigger than 0,05.

The 2 X 2 classification table is used to calculate the correct and false estimates. The columns show two predictive values of the dependent variable, (0) for no financial distress and (1) for financial distress, whereas the rows indicate the actual observation value of the dependent variable which are (0) for not financial distress and (1) for financial distress. The prediction

of companies that was not experiencing financial distress is 45 companies, while the number of observation is only 43 companies so that the accuracy of classification in this model is 95.6%. The prediction of companies that was experiencing financial distress using financial ratios, GCG, independent audit committee ratios with non-independent, and institutional ownership ratio with managerial ownership is 15, while the result of observation is just 6 companies, so that the classification in this model is 40%. The overall percentage accuracy of the model based on financial ratios, GCG, independent audit committee ratios with non-independent, and institutional ownership with managerial ownership ratios is 81.7%.

Current ratio, debt to asset ratio, total asset turnover, and institutional ownership with managerial ownership ratios are not predictors of financial distress. This is indicated by the magnitude of the value of sig. current ratio which is 0.643; value of sig. debt to asset ratio is 0.351; value of sig. total asset turnover is 0.779 and value of sig. ratio of institutional ownership to managerial ownership is 0,549. Based on these figures are all above  $\alpha$  5%, meaning that it is not a predictor of financial distress of mining companies in Indonesia.

Return on Assets, independent commissioners, audit committees, boards of directors and independent audit committee ratios with non-independent are predictors of financial distress in mining companies. Shown with value of sig. return on asset which is 0.0361; value of sig. an independent commissioner which is 0.041; value of sig. audit committee which is 0.027; value of board of directors and sig. ratio of independent audit committee with non-independent which is 0,015. Based on these figures, they are all under  $\alpha$  5%, it means that these variables are significantly predictors of financial distress in Indonesian mining companies.

The results show that the current ratio is not as a predictor of financial distress in the mining sector companies. This is not in accordance with the research of Platt and Platt (2002) and Ellen and Juniarti (2013) which suggest that current ratio has a significant negative effect on financial distress. But it supports the research of Wahyu and Doddy (2009) and Selfi Anggraini (2014), that the current ratio is not a predictor of financial distress. This condition is caused by because mining company is a primary sector. The high-value of current assets in mining companies are in the inventory section, while the inventory owned by mining companies are still available in nature, so to cash it into cash to fullfil the company's existing obligations is still requiring a long process. This condition causes whether or not current ratio is high, it is not as a predictor of financial distress. Thus, the decrease of mining commodity demand causes the revenue received by the company to decrease, but it does not mean the company has difficulty to fullfil its obligations because the company's inventory is still quite big.

The results showed that the Return on Asset (ROA) of mining companies is significant as a predictor of financial distress. This is in accordance with research by Luciana (2004), Wahyu and Doddy (2009), Yap (2012), Hanifah (2013) and Okta Kusanti (2015) that ROA can predict financial distress with negative direction, it means that if ROA increases, financial distress decreases, and vice versa. High ROA indicates that the company manages the owned assets to make a profit properly and vice versa.

Debt to asset ratio of mining companies is not significant as predictors of financial distress. The results of this test are not in accordance with the research of Luciana (2004), Oktita Yap (2012), and Agus (2013), which state that debt to asset ratio can predict the condition of financial distress in companies with significant positive effects. However, supporting the research of Wahyu and Doddy (2009), Ellen and Juniarti (2013), Selfi Anggraini (2014), and Okta Kusanti (2015), debt to asset ratiot is not significant as a predictor of financial distress.

This is because although the debt owned by mining companies is quite high but the guarantees on the debts of mining companies are quite safe and the prospects for the performance of mining companies are still promising despite some restrictions from some countries. In addition, the high debt, due to the funds needed for exploration and exploitation is very large, it means that if this stage has been done the wealth of mining companies will increase.

Total Asset Turn Over mining companies is not significant as a predictor of financial distress. The results of this test are not in accordance with the research Yap (2012), Oktita and Agus (2013) and Okta Kusanti (2015), which state the total asset turnover can predict the condition of financial distress in the company with a negative direction, it means that if total assets turnover is high, financial distress is going down, and vice versa. But it supports Selfi Anggraini's (2014) research. Total asset turnover is not significant as a predictor of financial distress, this is due to the decline in sales will not last long, it because the alternative materials with sufficient quantities is not yet found. This means that market participants are still optimistic that the company's performance will soon recover.

Independent commissioners of mining companies are significant as predictors of financial distress. This study does not support Oktita and Agus (2013), but it is consistent with Emrinaldi's (2007) research, that independent commissioners have a significant negative impact on the company's financial distress. The existence of an independent commissioner within a mining company can support better governance towards an increasingly competitive business competition. With an increasing number of independent commissioners within the company, it will reduce financial distress, as the supervision of an independent commissioner on the governance of the company will improve. The independent commissioner's activity is to have the authority and responsibility to plan, lead, control or supervise the activities of the issuer or public company in the last six months, except for re-appointment as independent commissioner of the issuer or public company in the next period.

The Audit Committee is a committee that established by and responsible to the board of commissioners in assisting the duties and functions of the board of commissioners. The results of this study indicate that the audit committee of mining companies is quite significant as a predictor of financial distress in a positive direction. If the number of audit committees increases, financial distress will also increase and vice versa. This condition indicates that mining companies with too large audit committees will cause inefficiency, because employees will feel influenced by their activities, so the opportunity to innovate and improvise feels very limited, and it will reduce the motivation of work. The results of this study are not in accordance with the research results of Oktita and Agus (2013) and Okta Kusanti (2015). But it supports Haziro and Negoro's research (2017).

The board of directors of mining companies is significant as a predictor of financial distress. The results of this study do not support Selfi Anggraini research (2014), but support the research of Emrinaldi (2007), Tri Bodroastuti (2009), Oktita and Agus (2013), Okta Kusanti (2015), which the existence of board of directors is a predictor of financial distress with direction negative. That means the higher the number of boards of directors will lower financial distress and vice versa.

The ratio of independent audit committees to non-independent is significant as a predictor of financial distress. This result is consistent with Haziro and Negoro's (2017) research result, independent audit committee ratios with non-independent significance as a predictor of financial distress, but does not support Emrinaldi's (2007) research. Based on the results of the study, if the ratio of the number of independent audit committee is more than the



non-independent audit committee, the financial distress of the mining company will decrease and vice versa. This means that the results of an objective performance assessment of mining companies will be a motivation of the company in performing.

The ratio of institutional ownership to managerial ownership is not significant as a predictor of financial distress. The results of this study are not in accordance with the research of Oktita and Agus (2013), that institutional ownership and managerial ownership have a significant effect on financial distress. But the research results are consistent with Javed (2007), Abbasi (2012), Romano (2012), Selfi Anggraini (2014) and Okta Kusanti (2015), which indicate that institutional ownership and managerial ownership is not significant as a predictor of financial distress in the mining sector in Indonesia. This condition is caused by the investors have the same commitment of how to make the mining company's performance better from year to year, so it will not experience any bankruptcy. Wahidahwati (2002) has also confirmed that the company's managerial ownership has no significant effect on debt policy. This is because the proportion of ownership by the managerial party tends to be small so the management feel reluctant to work as much as possible. Thus, due to the small managerial ownership, the management may act less cautiously towards the determination of the debt policy.

It's just that according to Gill and John's (2012) research results, that managerial ownership is the proportion of shareholders from the management who actively participate in corporate decisions (directors and commissioners). If the ownership of the company owned by the directors is lower, then the decision taken by the directors will be more likely to be weak. Overall, it will be disadvantageous for the company, so the possibility of corporate value will tend to decrease.

## **5. Conclusion**

Based on the results of the research that has been discussed, we can point out some conclusions as follows:

- 1) Current ratio is not significant as a predictor of financial distress for mining companies in Indonesia.
- 2) Debt to asset ratio is not significant as a predictor of financial distress for mining companies in Indonesia.
- 3) Total asset turnover is not significant as a predictor of financial distress for mining companies in Indonesia.
- 4) The ratio of institutional ownership to managerial ownership is not significant as a predictor of financial distress for mining companies in Indonesia.
- 5) Return on Assets is significant as a predictor of financial distress for mining companies in Indonesia.
- 6) Independent commissioner is significant as a predictor of financial distress for mining company in Indonesia.
- 7) Audit Committee is significant as a predictor of financial distress for mining company in Indonesia.
- 8) Board of directors is significant as a predictor of financial distress for mining company in Indonesia.
- 9) The ratio of independent and non-independent audit committees is significant as a predictor of financial distress for mining companies in Indonesia.

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## Appendix

Appendix 1. -2 log Likelihood's Test Results

Appendix 2. Cox and Snall R Square Results

Appendix 3. Hosmer and Lemeshow Goodness of FIT's Test Results

Appendix 4. 2 x 2 classification table

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