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Corporate Governance, Board Independence and Financial Distress: A Critical Review of Literature

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Abstract:

This paper purposes to critically review existing literature on the relationship between corporate governance aspect of board independence, and its influence on financial distress. Specifically, the study reviews the theoretical and empirical literature related to board independence and financial distress with the objective of establishing research gaps for further research. In this context, the study identifies some of the most important theoretical, contextual and methodical shortcomings in prior studies and literature. Review of literature shows that the results of empirical studies on the relationship between board independence and financial distress are not only contradicting but also inconclusive. Further, the agency, stewardship and resource dependence theories give contradicting propositions on the relevance of board independence as a corporate governance mechanism.

Keywords: Corporate governance, board independence, financial distress

1. Introduction

Corporate governance is an issue that has attracted the attention of stakeholders because of the continued collapse of corporations across the world. Over the past two decades, the world economy has witnessed numerous cases of corporate failures among some of the globally reputed firms such as the Pacific Gas and Electric Ltd in 2001, Delta Airlines in 2005, Parmalat in 2003, Enron in 2001, Worldcom Ltd in 2002, among others. These corporate and systemic failures have been the dominant driver of corporate governance, (Martin, 2017). The Cadbury Committee (1992) defined corporate governance as the mechanism through which firms are directed and controlled. The Organization for Economic Co-operation and Development (2004) define corporate governance as not only a set of relations between management, the board of directors, capital providers and other interested groups but also the basis through which a corporation sets objectives and the necessary means to achieve them. The Capital Markets Authority (2016) define corporate governance as the process and structure used to direct and manage the business and affairs of a firm towards enhancing prosperity and corporate accountability with the ultimate objective of realizing the long term value of shareholders while taking into account the interest of other stakeholders. From these definitions corporate governance generally includes the framework for monitoring, regulating and controlling of corporations with the ultimate purpose of safeguarding the welfare of shareholders and other stakeholders.

The board of directors is the main corporate governance mechanism, (Xavier, 2014; Thomsen and Conyon, 2012). The board of directors has been conceptualized in several ways in literature including the proportion of independent directors, board tenure, board size, diversity of the board and board activities, (Wagana and Nzulwa, 2016). Thus, board independence is an aspect of board composition as well as an indicator of corporate governance. The Capital Markets Act (2016) defines an independent director as a member of the board who does not have pecuniary relationship with the company or related parties, is compensated through sitting allowances, does not own shares in the company and after nine years of service, a continuing independent director ceases to be one and assumes the position of non-executive director. Board independence refers to the proportion of the number of independent non-executive directors to the total number of directors, (Prabowo and Simpson, 2011). The level of board independence is determined by the degree to which the board consists of members who are not affiliated with the company through employment or economic exchange relations, (Gordon, 2007). A board is considered to have high level of independence if it has more outside members and if the chair of the board is not the same as the chief executive officer, (Gaur, Bathula and Singh, 2015).

Financial distress refers to a situation when the company is experiencing failure and in which the rate of return is less than the cost of capital, (Lakshan and Wijekoon, 2012). Financial distress occurs when company's cash flows are not sufficient to repay the principal and interest of debt and occurs when the firm's equity becomes negative, (Lee and Yeh, 2004). Agrawal (2015) describe financial distress as the inability of an entity to meet its financial obligations as and when they fall due or do so with difficulties. The most common term used to describe this continuum of financial difficulty includes failure, insolvency, default and bankruptcy, (Thakor (2014). According to Balcsen and Ooghe (2006) the concept of financial distress has been conceptualized using several accounting and financial measures. These include the suspension of payment of dividends, negative net operating income, negative earnings before interest and tax, negative shareholders' funds, major restructuring or retrenchment, inability to settle financial obligations and low interest coverage ratio, (Sri, 2017; Manzaneque, Priego and Merino, 2016; Khalida *et. al.*, 2018).

2. Theoretical Review

This section explores the theoretical perspectives on the relationship between board independence and financial distress on the basis of the agency, stewardship and the resource dependence theories.

2.1. Agency Theory

The agency theory, formulated by Jensen and Meckling (1976), is based on the notion that in a modern corporation there is separation of ownership and control, resulting in agency costs associated with resolving the conflict between the owners and agents. A principal agent relationship arises when a principal (shareholders) contracts an agent (management) to perform some tasks on behalf of the principal and involves delegating some decision making authority to the agent. In executing the tasks, the agent chooses an action, which in turn has certain consequences, that is, an outcome that affects the welfare of both the principal and the agent, (Trond, 1993). Jensen and Meckling (1976) explain that if both parties to the relationship intend to maximize their utility, then it's more likely that the agent will not endeavor to uphold the interest of the principal. Managers are likely to engage in sub-optimal management behavior such as excessive consumption of perquisites, reluctant to undertake new profitable projects, investing of free cash flow in sub-optimal projects and organizational inefficiencies. Nevertheless, the principal can decide to control divergences from his interest by incurring agency costs which are the sum of monitoring, bonding costs and residual loss, (Williamson 1988)

Underlying the agency theory is the hypothesis that board independence is fundamental in safeguarding the interest of shareholders. The theory advocates that outside directors who are independent from management can best represent the shareholders' welfare, (Carter, Simkins and Simpson, 2003). The inclusion of more independent directors in corporate boards may diligently watch over management and help in aligning the interest of owners and managers, (Jensen, 1993) and are able to alleviate agency problems and limit self-interest of managers, (Abdullah, 2006). According to Chang (2009) the presence of independent directors results in the development of efficient activities that will detect and monitor the possibility of emergence of opportunistic behaviors by corporate managers. Outside directors reduce possibility of existence of information asymmetry and agency costs between management and shareholders, and on this basis they represent the interest of shareholders better than inside directors, (Fich and Slezak, 2008). The responsibility of independent directors is to control against opportunism and control the selfishness of managers so that the decisions they implement are consistent with the expectations of shareholders, (Eloumi and Gueyie, 2001). Lack of adequate board independence creates a power imbalance between the executive and non-executive members that can potentially lead to collapse of board effectiveness, (Muranda, 2016). Gordon (2007) assert that independent directors bring value to the company by providing better expertise but caution that increasing the number of outsiders could generate free-rider problems; their importance of contribution may be reduced and they will contribute less and put in less effort.

Though the agency theory is still a dominant theory in explaining issues of corporate governance it suffers from various limitations. Beyond the classical conflict between the shareholders and managers, the agency theory today is challenged by many conflicts; majority shareholders versus minority shareholders, managing shareholders versus minority shareholders, shareholders versus the creditors (Panda and Leepsa, 2017). It has also been criticized by the sociologists who argue that the theory assumes that the actors in the corporate world are self-interested and invisible and that markets are in no ways influenced by social relations. It further assumes that behavior is motivated by solely by personal financial interests. However, the scholars argue that some of the actions of the managers could be rooted in the social structures and is not entirely determined by economic incentives and information asymmetry, (Zogning, 2017). The agency theory is revolutionary, powerful foundation but predominantly it does not address any clear problem, is restrictive and hence lacks the practicality, (Abid, Khan, Rafiq and Ahmad, 2014). Nevertheless, in spite of the shortcomings, the agency theory is a very pragmatic and applied theory with many roots in many different academic fields and its usefulness is very extensive and prominent, (Panda and Leepsa, 2017).

2.2. Stewardship Theory

Unlike the agency theory, the steward theory describes a convergent relationship between the shareholders and corporate managers, (Donaldson and Davis, 1991). The theory, developed by Freeman (1984), hypothesizes that there is no conflict of interest between shareholders and corporate managers. It argues that managers are not opportunistic agents, but good stewards, who will act in the good faith and in best interest of the owners. The theory is based on a model of man where a steward perceives greater utility in cooperative, pro-organizational behavior than is self-serving behavior. It assumes a strong relationship between organizational success and a principal's satisfaction and hence, a steward overcomes the trade-off by believing that working towards organizational collective ends meet personal needs.

Contrary to the agency theory which focuses on control and conflict, the stewardship theory focuses on cooperation and collaboration, (Sundaramuthy and Lewis, 2003). The directors acting as stewards are concerned with acting honorably and doing the right things and thus the motivation for managers is not self-interest but service for others, (Stout, 2003). It holds that managers, if left on their own, will act as responsible stewards of the assets of the firm they control. In theory, the model of the agent is grounded on a steward whose behavior is pro-organizational and collectivistic. The reasoning behind is that the stewards' main goal is to achieve the objectives of the organization. This behavior ultimately benefits the principal in terms of increased share prices and return on shares, (Davis, Schoorman and Donaldson, 1997). The proponents of the theory argue that the board and management are a single, collective stewardship team. The board (stewards) basically supports management. Unlike the agency theory where the agent focuses on self-interest, the agent in the steward theory is self-actualizing and focused on higher needs. They place the organization ahead of their personal needs and are trustworthy, (Keay, 2017).

The theory contends that managers are good stewards and therefore supports the view that the board should have a significant proportion of inside directors to ensure more efficient and effective decision making. This is because inside directors understand the business of the firm better than outside directors, (Schooley, Renner and Allen, 2010). Therefore, with such inside experience they are likely to align their interest with the interest of the shareholders, (Li, Wang and Deng, 2008). Contrary to the agency theory that advocates for majority of outside directors, the stewardship opines that the interest of the owners is best safeguarded by board dominated by inside directors. Harris and Raviv (2008) argue that corporations may prefer insider-controlled boards because of the information that is available to insiders relative to outsiders. If the cost of losing information is higher than the agency costs associated with inside control, the insider-controlled board is preferred. Schooley *et al.*, (2010) support the idea of inside controlled boards because independent directors may not have enough knowledge about the business of the company and this leads to poor decision making.

2.3. Resource Dependency Theory

The resource dependency theory, formulated by advanced by Pfeffer (1972), explains how the external resources affect the behavior of the firm and takes the strategic view of corporate governance. According to the theory, the acquisition of external resources is vital for strategic management of the firm. The theory postulates that organizations have a varying degree of dependence on the environment, especially for the resources they need to operate. Uncertainty and dependence propel an organization to proactively manage its environment. The theory views the board of directors as the means to manage external dependency (Pfeffer and Salancik, 1978), reduce external uncertainty, (Pfeffer, 1972) and reduce the transactional costs associated with environmental interdependency (William, 1984). The theory concentrates on the external role and linkages of each member of the board, who come from diverse independent organizations and is supposed to play a critical role in securing essential resources for a firm, (Abdullah and Valentine, 2009).

The theory strongly emphasizes the role of the board of directors in providing the much needed resources relevant for the survival of the firm, (Tricker, 2012). These resources emanate from the environment that consists of other firms and actually the resources are in the hands of other firms. Therefore, firms depend on each other and exchange resources. This is why resources are the power of firms because they are valuable, costly to imitate, rare and cannot be substituted. Resources and power are thus interlinked and firms with more resources are considered more powerful, (Hitt, Ireland and Hoskisson, 2012). The scarcity of resources leads to uncertainty for firms and therefore organizations seeks to exploit resources for the safeguard of its own long term survival, (Pfeffer and Salancik, 1978). Within the perspective of this theory, corporations are viewed as coalitions aligning their structure and pattern of behavior to acquire and maintain requisite external resources. (Pfeffer, 1972). The implication of this theory is that corporate boards will reflect the environment of the firm and that corporate directors will be chosen to maximize the provision of critical resources needed by the firm. Each director is expected to bring in different linkages and resources to the entity, (Hillman, Canella and Partzold, 2000).

Like the agency theory, the resource dependency theory support corporate boards dominated by independent directors. This is because independent directors bring knowledge and expertise which minimizes the uncertainty of the external environment, (Pfeffer, 1972). Additionally, they increase external linkages which can help in gaining access to resources important to the firm, (Pfeffer and Salancik, 1978). Further, such board is more likely to act in the best interest of the shareholders as compared to an inside dominated board, (Bilal, Faudziah and Syed, 2014).

From the foregoing analysis, it's clear that the three theories propose varying recommendations on board independence. Although both the agency and resource dependence theories support high levels of board independence; the reasons for this support are different. The agency theory views board independence as tool for monitoring management, whereas the resource dependency theory views board independence as conduit for accessing external resources. On the other hand, the stewardship theory supports board independence on the premise of inside knowledge. The applicability of each theory thus depends on the context, as none is applicable in all situations.

3. Empirical Review

Board independence is a critical area of corporate governance and has been widely researched in literature. However, the influence of board independence on financial distress has been inconclusive and therefore open to further empirical review. There is plenty of evidence that board independence has a direct influence on the likelihood of financial distress. Bilal, Faudziah and Syed (2014) in their study of firms listed on the Amman Stock Exchange for the period 2000 to 2011 reported a direct and significant influence of board independence on financial distress. On the same note, Ayoola and Obokoh (2018) explored the effect of corporate governance on financial distress in the Nigerian banking industry for the period 2005 to 2015. The result of analysis of secondary data using generalized quantile regression model shows that board independence is directly and significantly related with the likelihood of financial distress. In their examination of the association between board independence and financial distress for a group of 350 Indian listed companies for the period of 2010-2014, Shridev, Suprabha and Krishnaprasad (2016) established that the relationship between board independence and financial distress is direct and significant. Similar findings were reported by Abdullah (2006) who carried out a study on sample of Malaysian companies over the period 1999-2001. The results showed that board independence was directly associated with the possibility of financial distress. Khalida, Muhammad, Sadaf, Umar and Imtiaz (2018) compared financially health and financially distressed companies on the basis of board independence for a sample of manufacturing companies in Pakistan over the period 2006-2010 and concluded that board independence is directly related with financial distress.

In another study of the relationship between board independence and financial distress for sample of 171 financially distressed and 106 non-financially distressed Australian companies over period of 5 years between 2010- 2014, Miglan, Ahmed and Henry, (2015) reveals that board independence does not lead to lower levels of financial distress. Equally, Muhammad *et al.* (2018) examined the influence of board independence on financial distress using a sample of Pakistan listed firms over the period 2009 to 2016 and revealed a direct role of board independence in influencing the likelihood of financial distress. Hana (2018) examined the relationship between board independence and the likelihood of financial distress for a sample of 8774 USA firms over the period 2007 to 2016. Using logistic regression analysis the study established that firms with a higher proportion of independent members of the board are likely to experience financial distress. Amira and Tulia (2014) explored the relationship between board independence and financial distress for sample of 118 companies drawn from Denmark and Sweden. The multiple and binary regression results showed that board independence has a significant and positive relationship with the probability of financial distress. Similarly, Joseph (2019) examined the relationship between board independence and financial distress for sample of 100 financially distressed and 100 non-financially distress firms listed on the London Stock Exchange for the period 2009-2016. The results of the study indicate that board independence is positively and significantly related to the degree of financial distress. Based on an analysis of 82 companies listed on the Tehran Stock Exchange during the period 2010-2014, Reza and Mahdi (2016) found out that board independence has a positive and significant influence on financial distress.

The direct relationship between board independence and financial distress suggest that high levels of board independence increase the probability of financial distress. Nevertheless, some studies support an inverse association between board independence and financial distress. Fathi and Jean-Pierre (2001) assert that the influence of financial distress and outside directors is inverse and statistically significant. The study utilized a pooled cross sectional logit regression to analyze sample of 92 Canadian listed firms, 46 of which were in financial distress because they had experienced a negative earnings per share during the years 1994-1998. Similarly, Manzanque *et al.* (2016) conducted an empirical study on the effect of independent directors on financial distress for sample of firms drawn from Spain for the period 2007 to 2012. The study used a matched –pairs research design consisting of 308 observations. Results of the study show that board independence decreases the chances of financial distress. Moreover, Luqman, Masood, Tabasum, Maria and Irshad (2018) examined the link between board independence and the likelihood of financial distress. The sample of the study consisted of 52 firms listed on the Karachi Stock Exchange during the period 2006 to 2015. The logistic regression results indicated that board independence was inversely and significantly related to financial distress.

Ahmed and Syed (2017) sought to assess how board independence affects the likelihood of financial distress using a sample of 53 non-financial companies listed on the Karachi Stock Exchange over the period 2010 to 2014. Based on a regression analysis, the study revealed that board independence was inversely related to the level of financial distress. In another similar study, Li, Wang and Deng (2008) analyzed the relationship between board independence and financial distress for a sample of 404 Chinese listed companies for the period 1998 to 2008 and found out that independent boards have a negative influence on the probability of financial distress. Mwengei and Kosgei (2017) examined the influence board independence on financial distress on sample of 39 firms listed at the Nairobi Securities Exchange over the period 2004-2013. Guided by an exploratory design and using panel regression analysis, the study established that independence of the board is inversely and significantly related with financial distress. Correspondingly, Lakshan and Wijekoon (2012) in their study of firms listed on the Colombo Stock Market reported that the outside director ratio, representing independence of the board, was inversely associated with the probability of corporate failure.

Charbel and Nehme (2012) analyzed the relationship between corporate governance and financial distress for a sample of 276 Lebanese non-listed and family owned firms. The study carried over the period 2007-2010 established that board independence is inversely associated with financial distress. On the same token, Qasim, Javid and Rahimi (2011) studied the effect of board independence on financial distress of companies listed on the Tehran Stock Exchange. The results indicated a negative and significant association between the percentage of independent board members and financial distress. Wang and Deng (2006) conducted a study on the relationship between corporate governance characteristics and the risk of financial distress for a sample of Chinese companies that experienced financial distress in the year 2002 and 2003. Using binary logistic regression, the study established that the proportion of independent directors are negatively related with the probability of financial distress. Chang (2009) evaluated the relationship between board independence and financial distress in Taiwan and concluded that companies with a high proportion of non-executive board members are less affected by financial distress as compared to companies with low percentage of board independence. Ahmadu, Aminu and Tukur, (2005) conducted a study on the effect of board independence on financial performance of a sample of 93 firms quoted on the Nigerian Stock Exchange over the period 1996-1999. Using pooled regression analysis, the study found no evidence to show that corporate boards with high proportion of outside directors outperform others.

Some studies provide evidence that board independence does not statistically influence financial distress. For instance, Hafiz and Desi (2007) sought to determine whether the proportion of independent directors influence the likelihood of financial distress. The study based on a sample of 190 companies listed on the Indonesia Stock Exchange over the period 2011-2015 revealed that board independence has no effect on financial distress. Correspondingly, Atty, Moustafasoliman and Youssef (2018) examined the impact of board independence on financial performance, using a sample of 50 active companies listed on the Egyptian Stock Exchange covering the period 2012 to 2017. The study supported an insignificant effect of board independence on financial distress. Moreover, studies by Xavier (2014) based on a sample of 312 USA firms for the period 2007 to 2009 concluded that the association between board independence and financial distress is not significant. Equally, Dissanayake, Somathilake, Madushanka, Wickramasinghe and Cooray (2017) examined the impact of board independence on financial distress of manufacturing firms listed on the Colombo Stock

Exchange over the period 2012 to 2016. Based on a correlational analysis of secondary data, the study showed an insignificant relationship between board independence and financial distress.

4. Critical Review of Existing Literature

Existing literature strongly suggest that there is an association between corporate governance, in particular board independence, and financial distress. Nonetheless, several research issues have not been addressed. Most of the studies have been carried out on firms listed at the various security exchanges. Firms trading in the various securities exchanges are listed under stringent conditions and their operations are also monitored. To eliminate this sample bias, there is need to extend these studies to firms not listed. Besides, studies on the relationship between board independence and financial distress have largely been conducted in foreign countries which are characterized by unique regulatory, political, ethical and economic fronts. These results may not be applied and generalized in the Kenyan context, which calls for more studies for Kenyan firms, both listed and non-listed.

Additionally, most of the studies have assessed the risk of financial distress using a variety of accounting and financial methods such as the Altman Z score, the Ohlson's O-score, the Option to Default Methodology and the Hazard Model. Nevertheless, there are other non-financial measures of financial distress such satisfaction of stakeholders, upholding of rights of shareholders, corporate social responsibility and many others. More research could be carried out using the non-financial measures. Further, the empirical evidence on the relationship between board independence and financial distress is mixed and inconclusive. Prior studies posit a direct association (Bilal, Faudziah and Syed, 2014; Ayoola and Obokoh, 2018; Shridev, Suprabha and Krishnaprasad, 2016; Khalida, Muhammad, Sadaf, Umar and Imtiaz, 2018) or an inverse relationship, (Charbel and Nehme, 2012; Qasim, Javid and Rahimi, 2011; Chang, 2009); whereas others suggest no association, (Hafiz and Desi, 2007; Atty, Moustafasoliman and Youssef, 2018). Consequently, the influence of board independence on financial distress is inconclusive and still open for future empirical analysis.

5. Conclusions and Recommendations

The study reviews empirical literature on corporate governance from board independence perspective and discusses its influence on financial distress. The paper also highlights areas for further research. The result shows that the agency theory, resource and stewardship theories prescribe varying and often contradicting recommendations on the influence of board independence on financial distress. Since there is no single theory that can fully explain the association between board independence and financial distress, the paper calls for a holistic application of the provisions of the theories. Further, the study recommends for further studies through the lens of other theories such as the political, transactional and institutional theories.

Most of the studies have conceptualized financial distress in terms of the Altman Z score, which is accounting based and historical. Future studies may therefore consider using methodologies such as the distance to default and other non-financial measures of financial distress. Though there is a great deal of literature that explains the relationship between board independence and financial distress for foreign countries, this relationship has not been significantly explored in the Kenyan context. The Kenyan economy is unique in terms of the regulatory, legal and ethical perspectives and hence there is need for further empirical studies, especially for non-listed firms.

Though there is consensus that board independence influence financial distress, the results are not only contradicting but also inconclusive. This is because the concept of corporate is dynamic and what constitutes corporate in one locality may be different from another. Thus there is need for continuous empirical studies on the subject.

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