CHAPTER II
LITERATURE REVIEW

2.1 Financial Distress

Company's major goal is to generate profit in order to keep the company operates their business in the future and meet the assumption of going concern. Yet, often the condition of the company is not in accordance with the plan which may lead to the occurrence of financial distress (Anggraini, 2015).

Financial distress is a condition where a firm cannot pay its financial obligations as they fall due (Moghaddam, 2016; Ombaba & Kosgei, 2017; Karugu, Kiriri, & Achoki, 2018). Elloumi and Gueyié (2001) referred financial distress as firms with negative earnings per share. Rafique (2018) stated that the first signal of financial distress is when firm has no enough current assets to cover current liabilities, when this happen creditor will not take the risk to give long term loan to firm. According to Pranowo et al. (2010), the symptom of corporate financial distress begins when revenue and profit decreased to more than 20% and operational cash flow is negative. Ufo (2015) stated financial distress affects negatively on firm's performance and debt coverage ratio resulting in revenue reduction, decrease in profitability and liquidity due to high leverage of the firm. Financial distress which lead to bankruptcy may cause economic, social and political impacts such as resignation, employee's layoff, dividend reduction.

The economic costs and emergence of social impacts caused by company in financial distress phase leads to the need of proper identification which will help

the company in providing early warning system so that the corrective action can be performed before the company go bankrupt (Kristanti, Effendi, Herwany, & Febrian, 2016). According to Abubakar, Astuti and Oktapiani (2018), some criteria must be met to be categorized as an early warning system which is appropriate to predict corporate financial distress:

1. Indicators can detect the presence of imbalances in corporations less than 1 year before the peak period of financial distress.
2. The used indicators can minimize various statistical errors when predicting the corporate financial distress.

2.2 Previous Research

The effect of independent commissioner on financial distress was researched by several studies **(**Fich & Slezak, 2008; Fadhilah & Syafruddin, 2013; Isnalita, 2013; Juniarti & Ellen, 2013; Siahaan, 2013; Hanani & Dharmastuti, 2015; Kristanti et al., 2016; Abdullah, Ma'aji & Khaw, 2016; Witiastuti & Suryandari, 2016; Pramudena, 2017; Luqman, Hassan, Tabasum, Khakwani & Irshad, 2018). Based on previous studies, the effect of firm size on financial was explained by (Wijantini, 2007; Chancharat, Tian, Davy, Mccrae & Lodh, 2010; Thim et al., 2011; Isnalita, 2013; Putri & Merkusiwati, 2014; Kristanti et al., 2016; Rianti & Yadiati, 2018).

Literature studies showed that the effect of maturity on financial distress has been conducted in various of countries (Thornhill & Amit, 2003; Altman, Sabato,

& Wilson, 2010; Chancharat et al., 2010; Abdullah et al., 2016; Altman, Drozdowska, Laitinen & Suvas, 2016; Coad, Segarra & Teruel, 2016; Leite & Carvalhal, 2016; Pervan, Pervan & Ćurak, 2017; Chmielewska & Matuszyk, 2018; Haykir & Çelik, 2018; Ma'aji, Abdullah & Khaw, 2018; Männasoo, Maripuu & Hazak, 2018). Dividend payment was used by reseachers as one of influential factors affecting financial distress (Bebczuk, 2005; Cohen & Yagil, 2009; Murekefu & Ouma, 2012; Abdulkadir, Abdullah & Chyuan, 2015; Kajola, Adewumi & Oworu, 2015; Giang & Tuan, 2016; Kanwal & Hameed, 2017; Charalambakis & Garrett, 2019; Gandhi, Loughran & Mcdonald, 2018)

Firm performance variable had been used as one of the indicators to predict financial distress (Defranco & Schmidgall, 2008; Thim et al., 2011; Alifiah, Salamudin & Ahmad, 2013; Ufo, 2015; Yadiati, 2017; Fredrick & Osazemen, 2018; Masdupi, Tasman & Davista, 2018; Waqas & Rus, 2018). Literature studies also showed that liquidity has been used to predict financial distress (Cho, Hong & Ha, 2010; Pranowo et al., 2010; Thim et al., 2011; Tan, Yong & Tay, 2012; Putri & Merkusiwati, 2014; Ufo, 2015; Kristanti et al., 2016; Karugu et al., 2018; Masdupi et al., 2018; Rahmawati & Handriyana, 2018; Restianti & Agustina, 2018).

Kristanti et al. (2016) conducted a research on "The Determinant of Financial Distress on Indonesian Family Firm" with 7 sample of family companies during 2010-2014 period that were selected through purposive random sampling method. There is evidence that gender diversity, independent board, leverage, current ratio, location of director and quality of CEO have significant influence to the financial distress of Indonesian family firm. However, there are no significant

effect among operational risk, size, profitability risk, market risk and quality of auditor to financial distress.

Hanani and Dharmastuti (2015) conducted a study on "How do Corporate Governance Mechanism Affect A Firm's Potential for Bankruptcy?" with 30 samples of consumer goods sector firms listed in Indonesia Stock Exchange during 2010-2012 period. The result of the study indicates that independent commissioner, commissioner's board size, audit committee, the presence of nomination and remuneration committee have significant effect on bankruptcy prediction. This study failed to prove the effect of institutional ownership and managerial ownership to financial distress.

Rahmawati and Handriyana (2018) conducted a study on "Corporate Governance to Prevent Financial Distress Evidence from Corporate Governance Perceptions Index of Indonesia Companies" with 59 samples of company in Indonesia during 2013-2016 period which were selected through purposive sampling method. The result shows that company size, liquidity and rentability have significant influence to the financial distress in Indonesia companies whereas good corporate governance has no significant influence to financial distress.

2.3 Findings for The Relation between The Variables

2.3.1 Effect of Independent Commissioner on Financial Distress

Independent commissioner is defined as individual that serves as the overseer of the management in carrying out the corporate governance mechanism.

Hanani and Dharmastuti (2015) and Pramudena (2017) stated that independent commissioner has significant positive effect on financial distress. Fich and Slezak (2008) explained that non-independent commissioner may be better in overcoming financial distress since they have higher risk of being laid off when bankruptcy occurs. This means increasing independent commissioner proportion will also increase the possibility of financial distress. Hanani and Dharmastuti (2015) speculated that Indonesian companies tend to ignore the knowledge, experience and expertise of an independent commissioner to fulfill the regulations thus leading to ineffectiveness of independent commissioner's employment. Furthermore, poorly performed firms might try to employ more independent commissioner to attract investors. Puspita and Rinaldo (2015) stated that Indonesia companies usually appoint a former or active government official as a member of board of commissioners in order to have access to the relevant government agencies which may lead to the lack of integrity and ability of independent commissioner. Siahaan (2013) claimed that independent commissioner may slowing down or decrease firm's value if there are different opinions between board of commissioners and the company's internal.

Fadhilah and Syafruddin (2013), Kristanti et al. (2016), Luqman, Hassan, Tabasum, Khakwani, and Irshad (2018) argued that independent commissioner has significant negative effect on financial distress. Higher percentage of independent commissioner significantly decrease the possibility of company falls into financial distress since they would improve supervision on the companies and decrease

agency costs which will increase firm performance and the possibility of financial distress could be prevented.

Some prior research found no influence between independent commissioner and financial distress. Particularly, the small proportion of independent commissioner in Indonesian firms cause independent commissioner incapable to supervise management activities. Their duties as part of firm's decision makers has not been able to influence the decision made by management (Isnalita, 2013; Juniarti & Ellen, 2013; Witiastuti & Suryandari, 2016; Muhammad et al., 2018)

2.3.2 Effect of Firm Size on Financial Distress

Firm size illustrates the size of the company measured by the size of total assets owned by a company (Rianti & Yadiati, 2018). Based on Wijantini (2007), firm size is proved to have positive influence to financial distress in Indonesian companies since large firms tend to have more complicated internal organization structure which may be difficult to manage during financial difficulties period. Large firms have higher level and more complex conflicts of interest and positively related to bigger bank loans. Furthermore, Chancharat et al. (2010) concluded that larger companies may have inflexible management, problems in monitoring managers and employees thus leading to inefficient communication, decrease firm performance and increase the probability of financial distress. The bigger the size of a company, the more likely it will fall into bankruptcy.

Putri and Merkusiwati (2014) found that firm size has significant negative effect to financial distress. Since firm size is measured by total assets of the

company thus bigger company assets will lead to higher ability of the firm to pay off their debts which can prevent the firm to fall into financial difficulties. Larger firms show better chance of survivability since they have better control of market condition so they are able to face economic competition (Siahaan, 2013) and larger firms tend to have sufficient assets which can be liquidate to cash when needed (Situm, 2014).

Based on Isnalita (2013), Ufo (2015), Kristanti et al. (2016), Rianti and Yadiati (2018), they found that firm size does not have significant relationship with financial distress. Kristanti et al. (2016) stated that either large or small firms may survive as long as they have good firm performance. Since the firm size is measured by total assets, Rianti and Yadiati (2018) argued that it is also important to consider whether those assets have been effectively used to improve the firm's financial condition.

2.3.3 Effect of Maturity on Financial Distress

Maturity or referred as firm age is measured by the age in years since the company starts their operation (Männasoo et al., 2018). Older firms have better performance than younger firms. Older firms have higher probabilities to survive and grow because they have gone through longer period of learning process resulting to more experience rather than younger firms (Altman et al., 2010). Older firms show higher value, better return on investment and better governance practices (Leite & Carvalhal, 2016). Young firms seems to be more likely to fail compare to longer existence companies due to the experience and growth

development (Coad et al., 2016; Ma'aji et al., 2018). These researches are supported by (Abdullah, Ma'aji, & Khaw, 2016; Altman, Drozdowska, Laitinen, & Suvas, 2016).

According to Pervan, Pervan and Ćurak (2017), younger firms have higher possibility to avoid financial distress since younger firms tend to be more flexible in adapting to new business circumstances than older firms. Younger firms failure were caused by lack of knowledge and management abilities while older firms failure were caused by inability to adapt to new environment (Thornhill & Amit, 2003). Haykir and Çelik (2018) stated that young companies have higher profits until they reach certain age. When they pass the threshold age, older firms perform better than younger firms. Some previous research also found that firms age has no effect on financial distress (Chancharat et al., 2010; Chmielewska & Matuszyk, 2018).

2.3.4 Effect of Dividend Payment on Financial Distress

Dividend payment does not only explain or provide information about the firm's future performance but also act as a source of cash flow to shareholder (Kanwal & Hameed, 2017). Dividend plays a vital role to show the earning which is generated by the company to the shareholder and potential investor (Murekefu & Ouma, 2012).

Based on Cohen and Yagil (2009), financial distress firms tend to have higher pay out rate than financially stable firms in order to attract investors. Firms will be more attractive in the stock exchange if they paid dividend (Giang & Tuan,

2016). Kajola, Adewumi and Oworu (2015) found that most shareholders do not only prefer to invest in firms that pay dividend promptly, they are likely to react negatively to firms that are either reduce dividend or no dividend payment for some time.

Bebczuk (2005), Charalambakis et al. (2019), Gandhi, Loughran and Mcdonald (2018) proved that dividend payment is negatively associated with financial distress. Bigger and more profitable firms pay more dividends. Conversely, riskier and more indebted firms prefer to pay lower dividends (Bebczuk, 2005). Abdulkadir, Abdullah and Chyuan (2015) indicated that firms make adjustment to dividend consistently to decrease bankruptcy risk in financial crisis.

2.3.5 Effect of Firm Performance on Financial Distress

Firm performance or referred as profitability shows the health of the company (Alifiah et al., 2013) and measures on the effectiveness of management in generating financial return (Defranco & Schmidgall, 2008). According to Thim et al. (2011), Ufo (2015), Masdupi, Tasman and Davista (2018), Waqas and Rus (2018), profitability has significant negative effect on financial distress. Firms with lower profitability will lead to higher probability of financial distress. This implies that firms are not generating enough profit and increase the chance to fall into bankruptcy (Thim et al., 2011). Ufo (2015) concluded that financial distress influence firms' profitability through decline in cash flow and revenue constantly which will lead to short-term insolvency, inhibit working capital and increase

company debts. Firm with high profit will less likely to have loans and debts since they have enough internal funds.

Yadiati (2017) found that profitability has influence but not significant to financial distress. Although firm has the ability to generate profit well, company still has to concern whether the profit has been able to cover all company's needs and liabilities. Different result was conducted by Fredrick & Osazemen (2018) which stated that probability affects financial distress positively.

2.3.6 Effect of Liquidity on Financial Distress

Liquidity represents the extent to which a firm can quickly liquidate assets to cover short-term liabilities (Cho et al., 2010) and identify the company's general effectiveness in debt control (Tan et al., 2012). Liquidity is generally considered as a backing funds against financial difficulties or as the source to fund project and investment.

Pranowo et al. (2010) and Kristanti et al. (2016) stated that liquidity has significantly positive effect on financial distress. Kristanti et al. (2016) stated that if a company is liquid, the profitability will also reduce so it will lead to higher probability of bankruptcy occurrence.

Thim et al. (2011), Ufo (2015), Masdupi et al. (2018), Rahmawati and Handriyana (2018) argued that liquidity has negative and significant influence in financial distress. Higher liquidity shows higher proportion of current asset rather than current liabilities in accordance with lower possibility of corporate financial distress (Ufo, 2015). Firms with low liquidity ratios may not own enough liquid

assets to finance their short-term debt obligations. Current assets can be liquidate quickly if the company have insufficient fund to pay interest or loans (Thim et al., 2011). A company will be said to be close to financial distress if the company has many obligations due. If the company is able to finance and pay off its short term liabilities well then the company's potential to experience financial distress will be smaller (Rahmawati & Handriyana, 2018).

Putri and Merkusiwati (2014), Restianti and Agustina (2018), Karugu et al. (2018) proved that liquidity has no effect on financial distress. Liquidity which is measured by current ratio also consist of account receivable and inventory inside current asset. Company needs time to generate the account receivable and inventory into cash to pay off company's debt (Restianti & Agustina, 2018).

2.4 Research Framework

Financial distress predictions provide early warning system regarding a firm's future financial health which are useful for firms and outside stakeholders to perform actions before a bankruptcy occur. The research framework conducted in this study is a combination of variables which have influence and huge impact on the prediction of financial distress. Independent variables used in this study are independent commissioner, firm size, maturity, dividend payment, firm performance and liquidity.

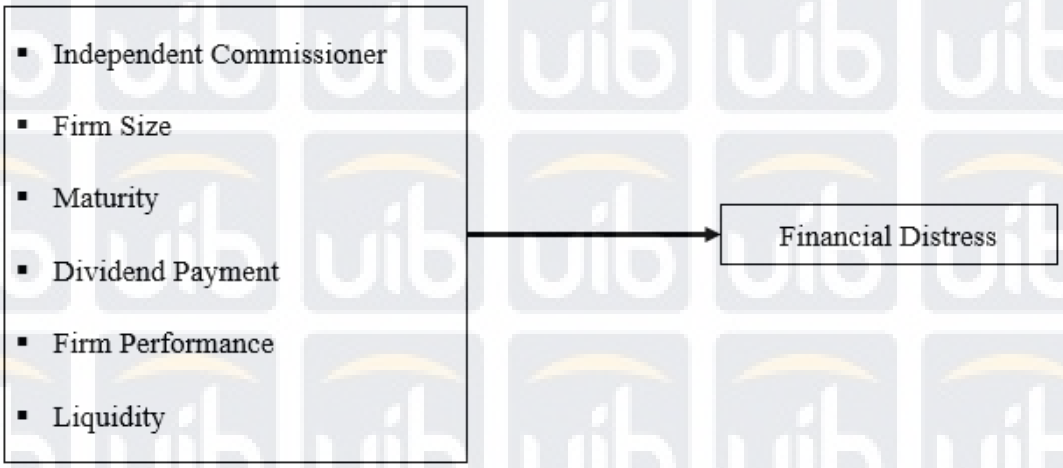

Figure 1 Research Framework, The Determinants of Financial Distress on Family Business in Indonesia.

2.5 Hypothesis Development

Based on the research framework above, hypothesis development of this research are as follows:

H1: There is a negative relationship between independent commissioner and financial distress.

H2: There is a negative relationship between firm size and financial distress.

H3: There is a negative relationship between maturity and financial distress.

H4: There is a negative relationship between dividend payment and financial distress.

H5: There is a negative relationship between firm performance and financial distress.

H6: There is a negative relationship between liquidity and financial distress.