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BOARD DIVERSITY IN FINANCIAL DISTRESS COMPANIES IN MALAYSIA

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ABSTRACT

The declining financial performance is often associated with the weak function of the board's role in the companies. The number of publicly listed companies categorised as Practice Note (PN17) by Bursa Malaysia shows an increase due to financial distress. This study examines the effectiveness of board diversity in financially distressed companies categorised as PN17 by Bursa Malaysia using content analysis of annual reports for five years as secondary data. The characteristics of board diversity include board professionalism and a politically connected board. In contrast, the proxy of financial distress will be measured using Altman Z Score for multiple regressions in evaluating financial performance ratios. Implementing the Malaysian Code of Corporate Governance (MCCG) in 2021 also assessed the effectiveness of board diversity and its interaction with financial distress. The findings from this study are expected to provide evidence that board diversity may have a significant relationship with financially distressed companies. Overall, this study may assist investors, practitioners, and external regulators in monitoring the company by assessing the effectiveness of board diversity from being classified as a financially distressed company.

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Keywords:

Board Diversity,
Financial Distress,
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MCCG

INTRODUCTION

1.1 Background

Nowadays, many researchers found that financial distress analysis has become a study field of growing interest resulting from the economic crisis driven by the COVID-19 pandemic. According to Nugroho et al. (2021), investors found it difficult to invest during the pandemic due to the challenging situation in the second quarter of 2020 created by global economic uncertainty. In early 2020, significant economies were gravely influenced worldwide due to the primary cause of lockdown orders throughout many countries. The Malaysian economic crisis also hurt significant corporations, mainly publicly traded companies, increasing the number of financially challenged companies listed under Bursa Malaysia Practice Note 17.

Financial distress is described as a situation in which a company's financial obligations are either not met or are met only with difficulty (Wu et al., 2008). While Chan & Chen (1991) defined financially distressed corporations as organisations with poor performance, inefficient production, and significant financial debt and cash flow concerns, the firms' market value has declined. They are marginal because their prices are more vulnerable to economic fluctuations and less likely to resist adverse economic conditions. According to Edward I. Altman and Hotchkiss (2006), four generic terms commonly used which can be attributed to financial distress research are failure, insolvency, bankruptcy and default.

Bursa Malaysia, formerly known as the Stock Exchange of Malaysia, is the stock market regulator in Malaysia, and it deals with firms in financial crisis. On 15 February 2001, Bursa Malaysia issued Practice Note No. 4/2001 (PN4), which was later changed to Practice Note No. 17/2005 (PN17) on 3 January 2005 (Ashrofie Hanafi & Ahmed Shahimi, 2020). PN17 was further amended on 5 May 2006 concerning financial conditions and level of operation to enhance Bursa Malaysia's handling of listed financial distress firms. Financial distress has become a global concern that needs close monitoring and particular ways to prevent it from harming various stakeholders such as shareholders and creditors.

On 28 April 2021, the Malaysian Code on Corporate Governance (MCCG 2021) was released by the Securities Commission (SC), which requires the board and directors to be effective stewards and guardians of the company. Even though compliance with the MCCG 2021 is voluntary, all publicly listed companies are compulsory under the Listing Requirements of Bursa Malaysia Securities Berhad to report in the annual reports as recommended by MCCG 2021. Studies by Ng et al. (2021) state that more board diversity will result in better depth and breadth that the board can give compared to non-diverse boards with reference to previous MCCG 2017. Distressed firms' governance characteristics significantly affect the bankruptcy probability (Fich & Slezak, 2008).

On the other hand, the board of directors has a vital role as a more excellent supervisory function in monitoring the company's activities. The supervisory function is one technique of warning managers about management wrongdoing and improving organisational sustainability (Medina-Borja & Triantis, 2011). Few studies from Hsu & Wu (2014) and Salloum et al. (2013) on financial distress to systemic issues via the role of the board of directors. The function of independent or outside directors has received much attention in recent years since panels are thought to improve the company's financial performance and lower the danger of bankruptcy due to external upheaval. It is the board's roles and functions to be effective in line with the ultimate organisational objective of the company.

The main objective of this study is to examine the relationship between board diversity and financial performance among financially distressed companies under PN17 companies. Two specific goals on board diversity regarding board professionalism and politically connected board are examined towards PN17 companies' performance. The study will focus on board diversity attributes such as board professionalism in terms of qualification and board that may be active in political t that may impact financially distressed companies' performance.

1.2 Problem Statement

Most of the companies in Malaysia have experienced a downturn which negatively impacted their financial position during the COVID-19 pandemic. The best indicators of financial distress are leverage indicators because they evaluate the external and internal financing mix and, most all, the foundation of the economic pyramid, or how many asset units are funded by one capital unit. Profitability and company performance are crucial indicators of a financial crisis. Khurshid (2013) found that current data ratio, profitability, solvency and leverage negatively correlate with financially distressed companies in Pakistan. However, the studies were only taken in Pakistan and may not indicate the same indicators in other countries. Besides various corporate finance and governance challenges, dividend policy is gaining much attention, especially from regulators and investors.

The high-profile firms facing a downturn need to strengthen governance to recover from the crisis of Covid-19. According to Lo Pucki and Whitford (1993), although many scholars acknowledged the importance of corporate governance in safeguarding shareholders' wealth, it is still questionable whether corporate governance may affect the likelihood of bankruptcy. Many previous works of literature examined the relation between governance and firm value without conditioning on distress (Eliezer M Fich & Shivdasani, 2006 (Morck et al., 1988; Yermack, 1996). Although to the extent that distress measurements reflect market values, governance features are not explicitly integrated into the financial distress model. They may also represent predictions about the influence of governance in the future, making corporate governance indirectly reflect the financial distress level.

On the other hand, the emergence of board governance studies such as board effectiveness and board member diversity encourages the concept of empirically investigating the relationship between board governance and the risk of financial fragility. In reality, there is limited research on the most recent implementation of the MCCG 2021. Previous research described excellent board governance as the ability of the board to turn the organisation's purpose into desired goals while successfully monitoring resource allocation to ensure that it is under the organisation's objectives (Miller-Millesen, 2003). If the boards practise and adhere to good governance, the organisation's performance will improve, lowering the risk of financial vulnerability. As a result, this study aims to link the features of board member diversity to the success of PN17 companies and contributes to the literature on board governance.

1.3 Relevance and Importance of the Research

This study presents various key outcomes concerning financially challenged enterprises classified as Bursa Malaysia Practice Note (PN17). First, this research provides a brief overview of the newest Malaysian Code on Corporate Governance (MCCG) implementation in 2021 to assist practitioners and other stakeholders in

understanding the operations of Malaysian publicly traded firms. Second, this study investigates the features of board diversity and the performance of financially distressed firms under PN17 by Bursa Malaysia.

In general, the effectiveness of corporate governance standards positioned board members as a key body in gaining public trust, particularly among investors in publicly traded firms. Understanding the influence of board members on the performance of PN17 companies can therefore be a method of assessing board effectiveness. This study enables academics to thoroughly understand the characteristics of the financially susceptible PN17 due to poor corporate governance standards.

Besides, information on financial ratios is useful to enlighten the practitioners, investors and other stakeholders on the risk of financial vulnerability among companies becoming PN17. Investors and creditors, for example, rely on a company's financial conditions to ensure the safety and profitability of their investments. This study may provide important financial information to future investors to know whether the company has a healthy financial statement.

Identification of financial indicators using financial ratios with Altman Z score analysis reflects the firm characteristics that significantly influence the magnitude of corporate governance practice and may help financial statement users identify and curtail future financial vulnerability. In conclusion, this study looks forward to adding to the body of knowledge on corporate governance in financially distressed companies based on the latest implementation of MCCG 2021 and the current list of PN17 companies.

2 LITERATURE REVIEW

2.1 Financial Distress

Financial distress is "a firm's inability to meet its financial commitments as they mature" (Beaver, 2010). He stated that financial distress could manifest in various ways, including bankruptcy, bond default, an overdrawn bank account, and failure to pay preferred stock dividends. Financial hardship is a critical event that distinguishes the era of good financial health from the period of bad financial health and necessitates corrective efforts to resolve the issue (Andrade & Kaplan, 1998; Brown et al., 1993).

Financial distress is a firm that suffered negative net worth and default payment of the loan and operates continuously under court protection according to Section 176 of the Companies Act 1965. According to Altman and Hotchkiss (2006), corporate financial distress can be explained in four terms, failure, insolvency, default and bankruptcy. Insolvency means a firm cannot meet its short-term obligation due to a liquidity problem. Default shows that a business's performance is failing, whereas bankruptcy indicates the firm is in a financial crisis, and most jurisdictions require a formal declaration.

Financial distress may have a significant influence on businesses as well as many stakeholders, especially during a financial crisis. Financial hardship occurs when a corporation cannot pay or complete its financial obligations to creditors, and its revenues are overly sensitive to economic downturns. Investors will see that company as incompetent in generating good profit. The company's market value will drop, and this will distract the potential and current investors from buying the company's shares. And the worst-case scenario, if there is no action taken, they will call out any potential buyers to buy and replace their names on the company.

According to Edward I Altman (1968), financial statement analysis is used to determine the financial position, assess creditworthiness, and avoid bankruptcy risks. The financial analysis becomes more critical because it can help users make their decision about a company. Sori and Hasbullah (2009) stated that financial analysis is a tool used in decision making in planning and control processes. It has been used to determine the factors and reasons why the firm is unable to fulfil its obligation.

2.2 Board Diversity

Board diversity is supposed to improve decision-making and company performance (Van Der Walt et al., 2006). Milliken & Martins (1996) discussed the various types of board diversity, including age, gender, culture, religion, ethnicity, knowledge, technical skills and expertise, constituency representation, independence, career and life experience, professional background, and commercial and industry experience. According to Yousaf et al. (2021), board diversity features such as relational diversity (age and gender), task-oriented diversity (expertise and education), and structural diversity (independence) may reliably anticipate a firm's financial issues.

2.2.1 Board Professionalism

The research identified board professionalism as a result of professional experience or education. According to Carpenter & Westphal (2001), an effective board with diverse competencies and capabilities brings value to the board governance function. Furthermore, panels with a professional profile contribute to new ideas, are more creative in problem-solving, and widen knowledge in specialised areas, as mentioned by Hwang & Powell (2004) and Westphal & Milton (2000) and have a favourable influence on inventive performance (Wincent et al., 2010). It was also revealed that the proportion of board members with professional credentials and outsider representation significantly impacted corporate strategy revisions (Goodstein et al., 1994).

Much research on board professionalism has been undertaken in the business sector regarding organisational performance. For example, Kim & Lim (2010) observed that board diversity in terms of educational background positively impacted business value. However, Rose & Rose (2007) failed to relate board academics to firm performance. Chen, Fan, and Wong (2004) discovered that the number of directors with professional backgrounds, such as those in accounting, law, finance, and academics, is positively connected to the firm's market-to-book equity value. They went on to say that high-growth companies prefer to choose directors with professional, financial, and intellectual backgrounds rather than those with political connections.

From the above discussion, it can conclude that according to the study, having a more significant number of professional board members will help financially distressed companies perform better. Thus, the hypothesis can be drawn as:

H1: There is a positive relationship between board professionalism and financially distressed companies' performance.

2.2.2 Politically Connected Board

One of the director's social interactions is a politically connected board, which occasionally comes under social capital study. Social capital generally is characterised as a director's links to other businesses, personal contacts with firm management, or social position (S. G. Johnson et al., 2013). Boards of directors with high social

standing and prestige are more likely to retain their reputation by actively participating in decision-making (Oh et al., 2006).

On the other hand, the politically connected board is responsible for acting as a boundary spanner (Miller-Millesen, 2003). During particular times, a politically connected firm will have significant financial difficulties because political institutions (including political parties and politicians) expect it to be able to give financial assistance in achieving political aims (Kamaludin, 2010).

Several scholars found mixed results when exploring the link between a politically connected board and corporate success. Goldman et al. (2009) discovered a considerable effect of political connection among US corporations with the stock market, indicating favourable anomalous stock prices rose quickly after the nomination of a politically connected board member was announced. Niessen & Ruenzi (2010) discovered a similar outcome: the politically connected business considerably outperformed the stock market. This implies that politically connected boards impacted the firm's performance. (Raymond Fisman, 2001).

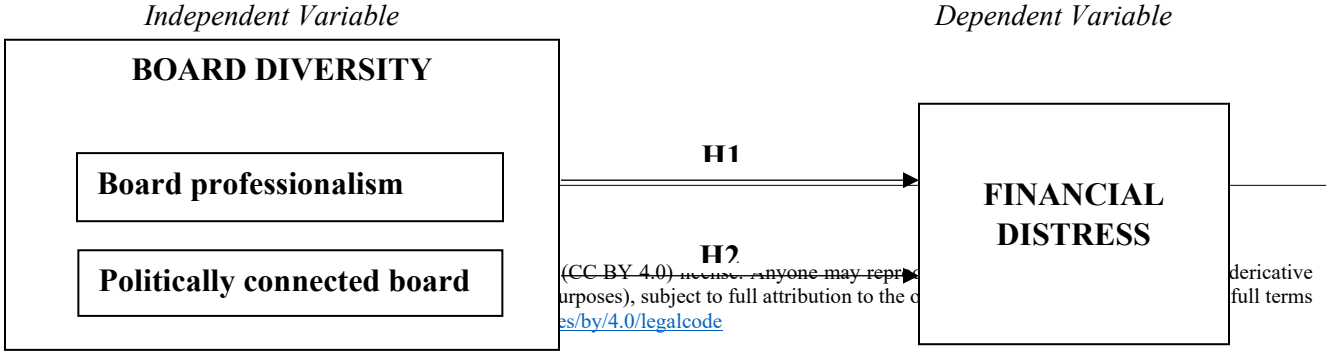
In contrast, Chen et al. (2004) discovered an undesirable finding in which stock returns lagged the market three years after the IPO due to the selection of politically connected CEOs. Furthermore, Chen et al. (2004) discovered that business leverage is positively associated with a politically connected board of directors. This suggests that CEOs with political connections are unsuccessful at increasing corporate efficiency. Gul (2006) and S. Johnson & Mitton (2003) discovered that firms with political connections performed poorly and worsened corporate performance throughout the financial crisis era.

In conclusion, positive findings on politically connected board and firm performance in Malaysia assert the importance of investigating this study in the context of financial distress. From above can be drawn the hypothesis that:

H2: There is a positive relationship between politically connected boards towards the performance of financially distressed companies.

2.3 Financial Ratios in Financial Distress Companies

Financial ratios are essential for evaluating the company's performance and determining the company's financial situation when studying financial statements. Financial ratios are useful indicators for assessing a company's performance and financial position (Kim-Soon et al., 2013). Profitability, liquidity, solvency, and management efficiency are critical in evaluating a company's financial distress and developing and implementing finance and investment programmes (Mohammed, 1997). This is also supported by the researcher's view that in addition to institutional and corporate governance factors, financial ratios assessing the size, liquidity, profitability, and leverage are likely to be major predictors of financial distress (Bhattacharjee & Han, 2014).



3

Independent Variable Dependent Variable

Figure 1 Conceptual Framework

3 RESEARCH METHODOLOGY

This research uses a quantitative approach to find the relationship between board diversity and PN17 companies' performance using panel data associated with 19 companies listed on the main board categorised as PN17 by Bursa Malaysia. This study collected data from 2016 to 2020 annual reports from Bursa Malaysia. All the data samples will be analysed using Statistical Package for the Social Science Version 22.0 software. It will present regression analysis, a technique used to measure linear relationships between more than two variables between dependent and independent variables. One of the regression analyses is Multiple regression analysis which allows several independent variables to be included in the same type of regression equation and thus can predict a single dependent variable.

To analyse the performance and to assess the results, the five years annual reports of the PN17 companies from 2016 to 2020 are reviewed. The reports provide financial information such as accounting ratios from the Statement of Profit or Loss and Statement of Financial Position, whilst non-financial information details on board from the Statement of Corporate Governance could strengthen this study's findings. Most research on financial ratios analysis employed data from annual reports, such as the statement of financial position and income statement (Greenlee et al., 2007; Ryan & Irvine, 2012). The dependent variable in this study, financial distress, is quantified using financial measures divided into three categories: liquidity, profitability, and leverage. These ratios are computed using a self-constructed ratio spreadsheet.

Non-financial information, on the other hand, is utilised to measure independent factors, such as board professionalism and political connections. The variables are calculated based on the percentage of board members that are professionally and politically connected (Bradshaw et al., 1992).

3.1 Board Professionalism

This study adopted the measurement of board professionalism from Bradshaw et al. (1992) and Hwang & Powell (2004). The investigation began by looking for a person with professional education and expertise from the list of office–bearers. Among the board members, the person with a professional background will be recognised for their relevant professionalism.

The index ranking will be used to measure the board's expertise and education. According to the Reeb and Zhao (2013) study, each education level was represented by a number ranging from 1 to 7. The higher the education level, the higher the index number. The categorical variables method was used to describe the level of education as follows: 1. Below Bachelor's degree; 2. Bachelor's degree; 3. MBA degree; 4. Master's degree; 5. Doctoral degree; 7. Top 200 bachelor degrees according to QS University ranking.

Board expertise will be measured based on the area in which the board has finance-related knowledge. The study from Guner et al. (2008) to measure financial expertise concerning the number of directors who possess knowledge and experience in finance-related areas will be preferred.

3.2 Politically Connected Board

The existence of the politically connected board among board members will be used to assess the politically connected board. This technique is comparable to research by Callen et al. (2003), in which the board members' backgrounds were classified into numerous groups, including well-known individuals.

This study defined a member as having a political connection if they have previously held roles such as Senator, Member of Parliament, or Director of an organisation. Aside from that, anybody with a title such as Tun, Dato' Seri, Puan Seri, Datuk, or Datin falls under this group.

3.3 Financial Distress

Altman Z-Score is the most often used measure for assessing a company's financial situation. Altman invented the Altman's Z-Score Method in 1968. Many studies have utilised it to assess financial distress (Kim-Soon et al., 2013). According to Edward (1968), the Altman model employs five financial analysis ratios: earnings before interest and tax / total assets, sales / total assets, the market value of equity / total liabilities, working capital/total asset ratio, and retained earnings / total assets. This is also supported by Brahmana et al. (2019) and Demirkan and Platt (2009). In the study, they categorised the firm's financial status that is being measured using the Z-score into three groups, as shown in the table below.

Table 1: Description of Z-score

No.	*Range of Z score*	*Interpretation*
1.	Above 2.99	The financial institution is in good position and safe from financial problem
2.	Between 2.99 and 1.81	It is considered as gray area as the financial institution have chances to faces bankruptcy problem
3.	Less than 1.81	The financial institution is most likely to be heading towards bankruptcy problem. Necessary actions are needed to avoid from the worst situation.

4 RESULTS

At the stage of conceptual paper, the study will be expected to provide result analysis as follows:

H1: There is a significantly positive result in board professionalism towards the performance of PN17 companies.

The board's professionalism shall influence the performance of the companies by having good direction for each other. However, lower professionalism among the board may lead to the company's performance falling.

H2: There is a positive with insignificant result politically connected board towards the performance of PN17 companies.

Board member with good connection as a politician is expected to drive the company better. However, only minority political members may hold the board position in the companies, resulting in insignificant results to Hypothesis 2.

For practical considerations, this study has only includeed the data from five years and did not accurately represent the overall view of financial distress among Malaysian publicly listed companies. The extended period may provide a better idea of the financial distress in Malaysia. As the study focused on small populations, each industry at bigger populations may offer better results because different industries may have different financial distress levels. This would provide more detail and conclusive findings that might be useful to the users.

5 DISCUSSION

This study examines the relationship the board diversity in terms of board professionalism, focusing on the board's education and expertise. Whilst another component of board professionalism is a politically connected board, these two variables may impact the performance of companies categorised under PN17 by Bursa Malaysia.

Board professionalism covers the education and expertise of the board of directors. A solid connection between the company and other corporations and non-profit organisations would aid in support of a company in times of crisis. The association between board professionalism and financial distress was statistically significant with a positive relationship that aligned with research from Brahmana et al. (2019) that study on board capital encompassed network, education, and expertise. Similarly, a board of directors with an established track record and a strong educational background would guide a firm to greater heights. Competency in corporate governance and extensive expertise guarantee that an organisation's costs are minimal. As a result, board capital helps to alleviate financial difficulty in every manner.

A politically connected board may have influenced the corruption of the company. The more corruption there is, the more likely it is that a company may have financial difficulties caused to stifling economic progress. If

political boards can be corrupt, the public will feel the consequences of their actions. Corruption will result in the repeal of legislation, resulting in more extraordinary operational expenses. Such a situation decreases the company's capacity to produce a profit and eventually leads to its demise. According to Kristanti et al. (2017), corruption control has a considerable negative influence on the financial distress of Indonesian companies because increased corruption raises the cost of capital, causing it to go bankrupt. Ayaydin and Hayaloglu (2014) discover evidence that the rate of corruption has a positive association with the company's growth, implying that as corruption grows, so does the company's growth. The likelihood of financial distress reduces as the company grows.

This variable suggests that businesses with low performance are more likely to face financial difficulties. According to the regression analysis from the previous chapter, there is a substantial relationship between the company's performance (Tobin's Q) and the Altman Z score. It demonstrates that the poorer the company's performance, the greater the likelihood that the firm would enter financial hardship, which is consistent with research by (Delen et al., 2013 and Zeli, 2014). They discovered that poor company performance may raise the likelihood of insolvency and bankruptcy among US and Italian enterprises. This research may assist users in ensuring that the firms are in good condition by measuring the extent of financial distress situations.

6 CONCLUSION

This study examines the association between board diversity and the financially distressed companies' performance. Board professionalism focuses on two variables: education and expertise. Another component of board professionalism is politically connected board used to measure the impact of the performance of companies categorised under PN17 by Bursa Malaysia. Five years of panel data are used with regression analysis for findings as a quantitative approach.

The impact of board members on financial outcomes is of significant interest to both researchers and the general public, as the current study seeks to comprehend the effect of board diversity on financially challenged organisations. Financial ratios were found to be a useful tool in evaluating the financial distress condition, and the profile of financially fragile PN17 enterprises gives a more detailed financial picture of the organisation.

As the current study tries to appreciate the influence of board diversity on financially challenged organisations, the impact of board members on financial results is of considerable interest to scholars and the general public. Financial ratios were discovered to be an effective method for assessing financial distress, and the profile of financially vulnerable PN17 firms provides a more thorough financial picture of the organisation.

However, further consideration should be taken on content analysis from the annual reports for five years based of PN17 companies could lead to several conclusive findings that cannot be generalised to show a clear picture of overall performance using financial ratios to measure PN17 financial vulnerability. Aside from trend analysis on financial performance, other approaches such as in-depth interviews with the board of directors and surveys, might offer better insights into the performance of financially challenged organisations. Other independent factors for improved evaluation include board meetings, board independence, and member rotation.

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