

Board Diversity in Financial Distress Companies in Malaysia

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ABSTRACT

Declining financial performance is often associated with weak board functioning. The number of publicly listed companies categorized as Practice Note 17 (PN17) by Bursa Malaysia has increased due to financial distress. This study examines the relationship between board diversity and financial distress among companies categorized as PN17 by Bursa Malaysia. The study employs a quantitative approach using secondary data obtained through content analysis of five years of annual reports. Board diversity is examined through two dimensions: board professionalism and politically connected boards. Financial distress, as the dependent variable, is measured using the Altman Z-score. Multiple regression analysis is employed to examine the relationship between board professionalism, politically connected boards, and financial distress. The study also considers the implementation of the Malaysian Code on Corporate Governance (MCCG) 2021 in examining board governance practices among financially distressed companies. The findings are expected to provide evidence on whether board professionalism and politically connected boards are significantly associated with financial distress. Overall, the study may provide useful insights for investors, practitioners, and regulators in evaluating the role of board diversity in mitigating financial distress among publicly listed companies in Malaysia.

Keywords: Board Diversity, Financial Distress, PN17 Companies, MCCG

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INTRODUCTION

1.1 Background

Nowadays, many researchers have found that financial distress analysis has become a field of growing interest, driven by the economic crisis caused by the COVID-19 pandemic. According to Nugroho et al. (2021), investors found it difficult to invest during the pandemic because the challenging situation in the second quarter of 2020 was driven by global economic uncertainty. In early 2020, lockdown orders in many countries severely affected major economies worldwide. 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). Chan & Chen (1991) defined financially distressed corporations as organizations with poor performance, inefficient production, and significant financial debt and cash flow concerns, and whose market value has declined. They are marginal because their prices are more vulnerable to economic fluctuations, and they are less likely to withstand adverse economic conditions. According to Edward I. Altman and Hotchkiss (2006), four generic terms commonly used in financial distress research are failure, insolvency, bankruptcy, and default.

Bursa Malaysia, formerly known as the Stock Exchange of Malaysia, is Malaysia's stock market regulator and deals with firms in financial crisis. On February 15, 2001, Bursa Malaysia issued Practice Note No. 4/2001 (PN4), later revised to Practice Note No. 17/2005 (PN17) on January 3, 2005 (Ashrofie Hanafi & Ahmed Shahimi, 2020). PN17 was further amended on May 5, 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 requires close monitoring and specific measures to prevent it from harming stakeholders such as shareholders and creditors.

On April 28, 2021, the Securities Commission (SC) released the Malaysian Code on Corporate Governance (MCCG 2021), which requires the board and directors to act as effective stewards and guardians of the company. Although compliance with the MCCG 2021 is voluntary, all publicly listed companies must, under the Listing Requirements of Bursa Malaysia Securities Berhad, report in their annual reports as recommended by the MCCG 2021. Ng et al. (2021) found that greater board diversity provides greater depth and breadth than non-diverse boards, with reference to the previous MCCG 2017. Distressed firms' governance characteristics significantly affect the bankruptcy probability (Fich & Slezak, 2008).

On the other hand, the board of directors plays a vital role in monitoring the company's activities. The supervisory function can warn managers about wrongdoing and improve organizational sustainability (Medina-Borja & Triantis, 2011). Few studies, such as Hsu & Wu (2014) and Salloum et al. (2013), examine financial distress and systemic issues through the board of directors' role. The role of independent or outside directors has received much attention in recent years, as panels are thought to improve a company's financial performance and reduce bankruptcy risk amid external upheaval. The board's role and function must align with the company's ultimate organizational objective.

This study examines the relationship between board diversity and financial performance among financially distressed companies under PN17. Two specific goals on board diversity regarding board professionalism and politically connected boards are examined in relation to PN17 companies' performance. The study will focus on board diversity attributes such as board professionalism in terms of qualifications and boards that may be active in politics that may impact financially distressed companies' performance.

1.2 Research Objectives

RO1: To examine the relationship between board professionalism and financial distress among PN17 companies in Malaysia.

RO2: To examine the relationship between politically connected boards and financial distress among PN17 companies in Malaysia.

1.3 Problem Statement

Most companies in Malaysia experienced a downturn that negatively affected their financial position during the COVID-19 pandemic. Leverage indicators are among the best indicators of financial distress because they assess the external and internal financing mix and, most importantly, the foundation of the economic pyramid: how many asset units are funded by one unit of capital. Profitability and company performance are also crucial indicators of financial distress. Khurshid (2013) found that the current data ratio, profitability, solvency, and leverage negatively correlate with financial distress in Pakistan. However, the studies were conducted only in Pakistan and may not reflect the same indicators in other countries. Beyond corporate finance and governance challenges, dividend policy is gaining significant attention, especially among regulators and investors.

High-profile firms facing a downturn need to strengthen governance to recover from the COVID-19 crisis. According to Lo Pucki and Whitford (1993), although many scholars acknowledge the importance of corporate governance in safeguarding shareholders' wealth, it remains unclear whether corporate governance affects the likelihood of bankruptcy. Much prior literature examined the relationship between governance and firm value without conditioning on distress (Fich & Shivdasani, 2006; Morck et al., 1988; Yermack, 1996). Although distress measures reflect market values, the financial distress model does not explicitly integrate governance features. They may also reflect predictions about governance's future influence, so corporate governance indirectly reflects financial distress levels.

Meanwhile, the emergence of board governance studies, such as board effectiveness and board member diversity, encourages empirical investigation of the relationship between board governance and the risk of financial fragility. In reality, research on the most recent implementation of the MCCG 2021 remains limited. Previous research described excellent board governance as the board's ability to turn the organization's purpose into desired goals while monitoring resource allocation to ensure alignment with the organization's objectives (Miller-Millesen, 2003). If the boards practice and adhere to good governance, the organization's performance will improve, lowering the risk of financial vulnerability. As a result, this study aims to link board member diversity features to the success of PN17 companies and contribute to the literature on board governance.

1.4 Relevance and Importance of the Research

This study presents key outcomes on financially challenged enterprises classified under 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 examines board diversity features and the performance of financially distressed firms under Bursa Malaysia's PN17.

In general, effective corporate governance standards position board members as a key body in gaining public trust, particularly among investors in publicly traded firms. Understanding how board members influence the performance of PN17 companies can therefore help assess board effectiveness. This study helps academics better understand the characteristics of financially vulnerable PN17 companies linked to poor corporate governance standards.

In addition, financial ratio information helps practitioners, investors, and other stakeholders understand 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 help future investors assess whether a company has a healthy financial statement.

Identifying financial indicators using financial ratios and Altman Z-score analysis reflects firm characteristics that significantly influence the magnitude of corporate governance practice and may help financial statement users identify and reduce future financial vulnerability. In conclusion, this study aims to contribute 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 a period of good financial health from one of poor financial health and requires corrective action to resolve the issue (Andrade & Kaplan, 1998; Brown et al., 1993).

Financial distress occurs when a firm has negative net worth, defaults on loan payments, and operates continuously under court protection under Section 176 of the Companies Act 1965. According to Altman (1968) 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 obligations 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 can significantly affect businesses and 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 at generating good profits. The company's market value will drop, discouraging potential and current investors from buying its shares. In the worst case, if no action is taken, they will call for potential buyers to step in and replace management.

According to Altman (1968), financial statement analysis helps determine financial position, assess creditworthiness, and avoid bankruptcy risks. Financial analysis becomes more critical because it helps users make decisions 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 fulfill its obligations.

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 stemming from 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 new ideas, are more creative in problem-solving, and broaden knowledge in specialized areas, as noted by Hwang & Powell (2004) and Westphal & Milton (2000), and positively influence 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 examined its relationship to organizational performance in the business sector. For example, Kim & Lim (2010) found that board diversity in educational background positively affected business value. However, Rose & Rose (2007) failed to relate board academics to firm performance. Chen, Fan, and Wong (2004) found that the number of directors with professional backgrounds, such as accounting, law, finance, and academia, is positively connected to the firm's market-to-book equity value. They also found that high-growth companies prefer directors with professional, financial, and intellectual backgrounds over those with political connections.

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

H1: There is a significant relationship between board professionalism and financial distress among PN17 companies in Malaysia.

2.2.2 Politically Connected Board

One of the directors' social interactions is political connections, which occasionally falls under social capital studies. 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).

In contrast, the politically connected board acts as a boundary spanner (Miller-Millesen, 2003). At times, a politically connected firm faces significant financial difficulties because political institutions (including political parties and politicians) expect it to provide financial assistance to achieve 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 on the stock market, indicating that anomalous stock prices rose quickly after the nomination of a politically connected board member was announced. Niessen & Ruenzi (2010) found a similar outcome: politically connected firms outperformed the stock market. This suggests that politically connected boards affected firm performance. (Raymond Fisman, 2001).

In contrast, Chen et al. (2004) found an undesirable result: stock returns lagged the market three years after the IPO because of 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 politically connected CEOs are unsuccessful at increasing corporate efficiency. Gul (2006) and S. Johnson & Mitton (2003) found that firms with political connections performed poorly and worsened corporate performance during the financial crisis.

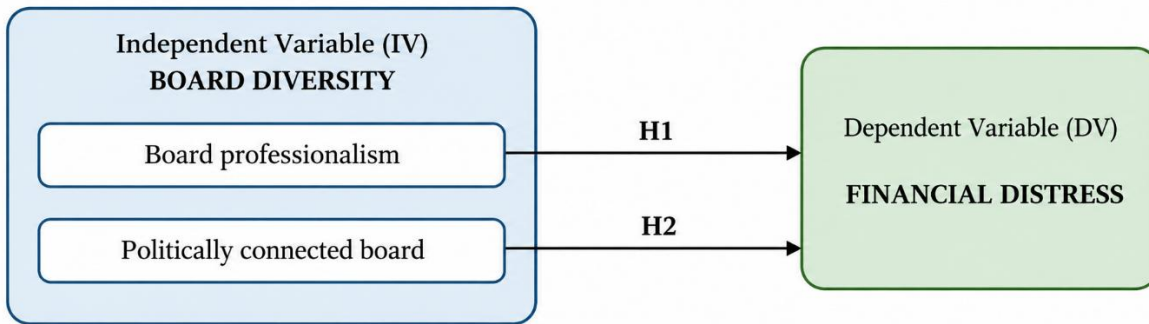
In conclusion, positive findings on politically connected board and firm performance in Malaysia assert the importance of investigating this study in the context of financial distress. From the above, the following hypothesis can be drawn:

H2: There is a significant relationship between politically connected boards and financial distress among PN17 companies in Malaysia.

2.3 Financial Ratios in Financially Distressed Companies

Financial ratios are essential for evaluating a company's performance and 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 programs (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).

Figure 1. Conceptual Framework



3 RESEARCH METHODOLOGY

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

To analyze performance and assess the results, this study reviews the five years' annual reports of the PN17 companies from 2016 to 2020. The reports provide financial information such as accounting ratios from the Statement of Profit or Loss and Statement of Financial Position, while non-financial information, such as board details from the Statement of Corporate Governance, could strengthen this study's findings. Most research on financial ratio analysis has used 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 recognized for their relevant professionalism. The index ranking will measure the board's expertise and education. According

to Reeb and Zhao (2013), each education level was represented by a number ranging from 1 to 7. Higher education levels correspond to higher index numbers. 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's 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 presence of politically connected 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 authors classified board members' backgrounds 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 organization. In addition, anyone 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 utilized it to assess financial distress (Kim-Soon et al., 2013). According to Altman (1968), the Altman model uses five financial ratios: earnings before interest and tax / total assets, sales / total assets, market value of equity / total liabilities, working capital / total assets, and retained earnings / total assets. This is also supported by Brahmana et al. (2019) and Platt (2009). In the study, they categorized the firm's financial status, measured using the Z-score, into three groups, as shown in the table below.

Table 1: Description of Z-score

<i>No.</i>	<i>Range of Z-score</i>	<i>Interpretation</i>
1.	Above 2.99	The financial institution is in a good position and safe from financial problems
2.	Between 2.99 and 1.81	It is considered a gray area, as the financial institution has a chance of facing bankruptcy problems
3.	Less than 1.81	The financial institution is most likely heading toward bankruptcy. Necessary actions are needed to avoid the worst situation.

4 RESULTS

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

H1: Board professionalism has a significant positive effect on the performance of PN17 companies.

The board's professionalism influences company performance by providing good direction. However, lower board professionalism may lead to lower company performance.

H2: Politically connected boards have a positive but insignificant effect on the performance of PN17 companies.

A board member with strong political connections is expected to drive better company performance. However, only a minority of political members may hold board positions in companies, resulting in insignificant results for Hypothesis 2.

For practical reasons, this study included data from only five years and may not accurately represent the overall view of financial distress among Malaysian publicly listed companies. A longer period may provide a better picture of financial distress in Malaysia. Because the study focused on small populations, industries with larger populations may offer better results, as different industries may have different levels of financial distress. This would provide more detailed and conclusive findings that might be useful to the users.

5 DISCUSSION

This study examines the relationship between board diversity and 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 categorized under PN17 by Bursa Malaysia.

Board professionalism covers the education and expertise of the board of directors. A strong connection between the company and other corporations and non-profit organizations would help support the 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), which studied board capital encompassing 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. Competence in corporate governance and extensive expertise help keep an organization's costs low. As a result, board capital helps alleviate financial difficulties in many ways.

A politically connected board may influence a company's corruption. The more corruption there is, the more likely it is that a company may have financial difficulties caused by stifled economic progress. If

If political boards are corrupt, the public will feel the consequences of their actions. Corruption can lead to the repeal of legislation, resulting in higher operational expenses. This situation reduces the company's ability to generate profit and can eventually lead 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) find evidence that the rate of corruption is positively associated with a company's growth, implying that as corruption increases, so does the company's growth. The likelihood of financial distress reduces as the company grows.

This variable suggests that low-performing businesses 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 shows that the poorer the company's performance, the greater the likelihood that the firm will enter financial hardship, 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 help users ensure firms are in good condition by measuring the extent of financial distress.

6 CONCLUSION

This study examines the association between board diversity and the performance of financially distressed companies. This study examines board diversity through two dimensions: board professionalism and politically connected boards. Board professionalism is assessed based on directors' education and expertise, while political connection is assessed based on the presence of politically connected board members.. Another component of board professionalism is politically connected boards, used to measure the impact on the performance of companies categorized under PN17 by Bursa Malaysia. The study uses five years of panel data and regression analysis to test the hypotheses.

The impact of board members on financial outcomes is of significant interest to both researchers and the general public, as this study seeks to understand the effect of board diversity on financially challenged organizations. Financial ratios are a useful tool for evaluating financial distress, and the profile of financially fragile PN17 enterprises provides a more detailed financial picture of the organization.

As the current study tries to appreciate the influence of board diversity on financially challenged organizations, the impact of board members on financial results is of considerable interest to scholars and the general public. Financial ratios have been shown 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 organization.

However, further consideration should be given to content analysis of annual reports for five years for PN17 companies, which could yield conclusive findings that cannot be generalized to provide a clear picture of overall performance using financial ratios to measure PN17 financial vulnerability. Beyond trend analysis of 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 organizations. Other independent factors for improved evaluation include board meetings, board independence, and member rotation.

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