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Corporate governance effect on financial distress likelihood: Evidence from Spain

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ABSTRACT

The paper explores some mechanisms of corporate governance (ownership and board characteristics) in Spanish listed companies and their impact on the likelihood of financial distress. An empirical study was conducted between 2007 and 2012 using a matched-pairs research design with 308 observations, with half of them classified as distressed and non-distressed. Based on the previous study by Pindado, Rodrigues, and De la Torre (2008), a broader concept of bankruptcy is used to define business failure. Employing several conditional logistic models, as well as to other previous studies on bankruptcy, the results confirm that in difficult situations prior to bankruptcy, the impact of board ownership and proportion of independent directors on business failure likelihood are similar to those exerted in more extreme situations. These results go one step further, to offer a negative relationship between board size and the likelihood of financial distress. This result is interpreted as a form of creating diversity and to improve the access to the information and resources, especially in contexts where the ownership is highly concentrated and large shareholders have a great power to influence the board structure. However, the results confirm that ownership concentration does not have a significant impact on financial distress likelihood in the Spanish context. It is argued that large shareholders are passive as regards an enhanced monitoring of management and, alternatively, they do not have enough incentives to hold back the financial distress. These findings have important implications in the Spanish context, where several changes in the regulatory listing requirements have been carried out with respect to corporate governance, and where there is no empirical evidence regarding this respect.

Efecto del gobierno corporativo en la probabilidad de fracaso empresarial: evidencia española

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RESUMEN

Este trabajo analiza algunos mecanismos de gobierno corporativo (propiedad y características del Consejo de Administración) en las empresas cotizadas españolas y su impacto sobre las probabilidades de fracaso empresarial. Usando la técnica del emparejamiento, se lleva a cabo un estudio empírico con 308 observaciones, la mitad de ellas fracasadas y la otra mitad no fracasadas entre 2007 y 2012. Sobre la base del estudio de Pindado et al. (2008), se ha usado un concepto amplio de fracaso empresarial. Empleando modelos logísticos condicionales, y adicionalmente a otros estudios previos sobre fracaso empresarial, nuestros resultados confirman que en situaciones de dificultad previas a la quiebra, la propiedad de los consejeros y la proporción de consejeros independientes ejercen un impacto similar sobre la probabilidad de fracaso empresarial a otras situaciones de fracaso más extremas. Nuestros resultados van más allá al evidenciar una relación negativa entre el tamaño del consejo y la probabilidad de fracaso empresarial. Interpretamos estos resultados como una forma de creación de diversidad y mejorar el acceso a la información y a los recursos, especialmente en contextos donde la propiedad está altamente concentrada y los grandes accionistas tienen un gran poder de influencia en la composición de la estructura

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del consejo. Sin embargo, los resultados confirman que la concentración de la propiedad no tiene un efecto significativo sobre la probabilidad de fracaso empresarial en el contexto español. Interpretamos que los accionistas mayoritarios son pasivos con respecto a una mayor vigilancia de la gestión y alterativamente, no tiene suficientes incentivos para frenar las dificultades financieras. Estos resultados tienen importantes implicaciones en el contexto español donde se han propuesto cambios en los requerimientos relativos al gobierno corporativo y donde no hay evidencia empírica a este respecto.

Introduction

A retrospective analysis of the economic and financial crisis during 2007–2013 period highlights the important consequences of businesses' financial distress on stakeholders (i.e. financial creditors, managers, shareholders, investors, employees, government regulators and society in general). So, more than ever, the revision of financial distress prediction models and the development of models adapted to particular characteristics of countries have an important role in order to prevent and manage these situations. In this regard, the crisis has highlighted two important issues: (a) the inability of the agencies credit ratings, governments and financial creditors to anticipate and prevent firms' financial distress situations (Enron 2001 or Lehman Brothers 2008, among others); and (b) the importance of effectiveness of corporate governance mechanisms in crisis contexts (Husson-Traore, 2009).

The analysis of the causes of financial distress and the development of robust and stable models of financial distress prediction are far from a new issue. In fact, from 1960s the numerous financial distress or bankruptcy prediction models developed are an extension to seminal works of Beaver (1966, 1968), Altman (1968, 1982) or Ohlson (1980), among others. The empirical debate about financial distress has focused on explanation power of financial and accounting information (Altman, 1968, 1982; Beaver, 1966, 1968; Ohlson, 1980; Zmijewski, 1984) applying diverse statistical methods (linear discriminant analysis, logistic analysis, probit analysis). However, several researchers argue that economic and financial data alone do not provide sufficient predictive power of future insolvency, being therefore necessary to include variables representative of ownership and/or corporate governance characteristics in order to improve the predictive power of models (Chang, 2009; Chen, 2008; Deng & Wang, 2006; Fich & Slezak, 2008; Lee & Yeh, 2004; Simpson & Gleason, 1999; Wang & Deng, 2006).

In fact, from 1980s there is a large body of literature that highlights the importance of corporate governance and its influence on the likelihood of financial distress or bankruptcy (Chang, 2009; Chaganti, Mahajan, & Sharma, 1985; Daily & Dalton, 1994a,b; Deng & Wang, 2006; Donker, Santen, & Zahir, 2009; Fich & Slezak, 2008; Lajili & Zéghal, 2010). This is explained, according to the postulates of Agency Theory, by the fact that conflict of interests on the relationship between management and other stakeholders, by delegating roles, is more severe in crisis because managers will choose a short-term strategy that results in higher private benefits, at the prospect of losing their jobs (Donker et al., 2009). This managers' behavior leads to an ethical conflict with shareholders because they prioritize their personal aims against the overall company objective, which is to maximize the value of shares and ensure the company survival in the future. Despite the extension of previous literature, it has been limited to certain context (U.S., Taiwan and China) and on bankruptcy or legal processes of financial distress (ex-post models). However, the corporate governance mechanisms, ethics codes and legal systems to control financial distress situations differ from one country to another, reasons why the extension of analysis to other geographic context and to other financial distress situations different to bankruptcy contributes to complement the existing literature. Particularly, the special characteristics of corporate governance in Spain (ownership concentration, unitary board system and voluntary good governance practices) likely raise serious agency conflicts in financial distress situations. In this sense, the analysis of relationship between corporate governance and companies' financial distress for Spain provides evidence for this type of contexts, where overall analysis of this issue is still lacking.

Accordingly, the development of corporate financial distress' explanation and forecast models, based on ownership, corporate governance and accounting variables, would make a significant contribution to financial and corporate governance literature. In this sense, the questions answered by this research are: Are the ownership concentration and directors' ownership affecting the likelihood of financial distress in Spain? Which of the board characteristics affect the financial distress likelihood in the Spanish market?

In order to answer these questions, the general objective of this work is to validate the relationship between corporate governance mechanisms (ownership and board characteristics) and the likelihood of financial distress for Spanish listed companies where overall analysis of this issue is still lacking. To this end, we used companies' data between 2007 and 2012, and applied conditional logistic regression analysis. Using an approximation to Pindado, Rodrigues, and De la Torre's (2008) study, we considered a company as "distressed" when it meets some of the following conditions: (a) its earnings before interest and taxes, depreciation and amortization (EBITDA) are lower than its financial expenses for two consecutive years; and/or, (b) a fall in its market value occurs between two consecutive periods. So, we used a broad concept of business failure beyond the bankruptcy, previously recognized as indicators of business failure (see Manzaneque (2006) for a major revision), in order to overcome previous literature limitations on this question (Mora, 1994).

Our study contributes to the literature in different ways. Previous literature analyzes the effect of corporate governance on firms' bankruptcy (Deng & Wang, 2006; Lajili & Zéghal, 2010; Mangena & Chamisa, 2008) and the obtained results document a negative and significant effect between board ownership and a strong corporate governance system on business failure likelihood. In the same line of the above studies, our results confirm that in difficult situation previous to bankruptcy, the roles of board ownership and board independence are similar to those exerted in more extreme situations as is the bankruptcy case. That is, following the Agency Theory assumptions, the ownership of directors and independence of board members, as factors that reduce principal-principal conflict of interests that arises between majority and minority shareholders and are common in concentrated contexts as the Spanish market, are important to reduce the likelihood of failure. Our results go one step further to offer a negative relationship between board size and the likelihood of financial distress. We interpret this result as a form of creative diversity and improve the access to the information and resources, especially in contexts where the ownership is highly concentrated and large shareholders have a great power to influence in the board structure. Moreover, regarding ownership structure, the results show that neither non-institutional nor institutional shareholders' ownership has any effect to reduce the