Available on: https://jefrr.ep-journals.org/ E-: 3051-3650, P-ISSN: 3051-3642

Journal of Economic Finance Research and Review

Volume: 02 Issue: 04 April 2026

The Role of Corporate Governance Mechanisms in Financial Distress: Evidence from Indonesian Manufacturing Firms

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Published Date: April 30, 2026 **Article DOI: 10.65150/EP-jefrr/V2E4/2026-08**

ABSTRACT: This study examines the role of corporate governance mechanisms—namely the audit committee, the proportion of independent commissioners, and institutional ownership—in explaining financial distress among manufacturing firms in Indonesia during the 2020–2023 period, a time characterized by significant economic pressure. Using a quantitative approach with panel data analysis, the study analyzes 51 manufacturing firms (204 firm-year observations) selected through purposive sampling. Financial distress is measured using the Altman Z-score model, while the Random Effects Model with robust standard errors is employed to ensure reliable estimation. The findings reveal that the audit committee and the proportion of independent commissioners do not have a significant effect on financial distress, suggesting that structural proxies such as committee size and board composition may not adequately capture the effectiveness of monitoring functions. In contrast, institutional ownership is found to have a significant effect, indicating that institutional investors play a more substantive role in influencing firms' financial conditions through monitoring, reducing information asymmetry, and disciplining managerial behavior. Overall, the results highlight that the effectiveness of corporate governance mechanisms in mitigating financial distress is highly dependent on their functional quality and level of active engagement rather than their mere formal existence. These findings contribute to the corporate governance literature in emerging markets and provide practical implications for managers, investors, and regulators in strengthening governance practices to enhance financial resilience.

KEYWORDS: Financial Distress, Corporate Governance, Audit Committee, Independent Commissioners, Institutional Ownership

INTRODUCTION

Research on financial distress in manufacturing firms is of critical importance, as the consequences of financial difficulties extend beyond individual companies and may generate cascading effects across supply chains, labor markets, and regional economic stability. In the literature, financial distress is commonly defined as a condition of financial deterioration that precedes bankruptcy, thereby serving as an early warning signal for managers and stakeholders to undertake preventive actions (Anggraeni et al., 2024). Given the high degree of operational interdependence within the manufacturing sector, disruptions in one firm can rapidly propagate to others, amplifying systemic risk. Consequently, early detection of financial distress becomes essential to minimize operational disruptions and sustain industrial continuity (Abbas & Frihatni, 2023; Salsabilla et al., 2023). In this regard, predictive models such as the Altman Z-score remain relevant and widely applied in assessing bankruptcy risk in manufacturing firms, particularly due to the sector's distinct risk characteristics (Hoque et al., 2022; Vacher et al., 2022). Therefore, research in this area contributes not only to academic discourse but also offers practical implications for economic decision-making (Abbas & Frihatni, 2023; Sareen & Sharma, 2021).

The decline in manufacturing firms' performance, which may heighten the risk of financial distress, underscores the importance of investigating financial distress within this sector. This condition is evident from the significant contraction in the manufacturing industry, as reflected by the decline in the Prompt Manufacturing Index (PMI), which fell from 51.50% in the fourth quarter of 2019 to 45.64% in the first quarter of 2020, indicating a shift into a contraction phase driven by reduced demand and supply chain disruptions (Suheriadi, 2020). The situation further deteriorated in the second quarter of 2020, when the PMI dropped sharply to approximately 28.55%, signaling a substantial decline in production activity (Lidwina, 2020). These developments reflect the intense financial pressures experienced by manufacturing firms, thereby increasing the potential for financial distress. Therefore, the 2020–2023 period represents a highly relevant context for examining the dynamics of financial distress in manufacturing companies.

Furthermore, the selection of corporate governance variables—namely the audit committee, the proportion of independent commissioners, and institutional ownership—is motivated by inconsistencies in prior empirical findings. Some studies report that the audit committee has a significant effect on financial distress (Khalid et al., 2020), while others find no significant relationship (Indrati & Handayani, 2022; Maulani & Nugroho, 2024). Similar inconsistencies are observed for the proportion of independent commissioners, where certain studies document a significant effect (Ibrahim, 2019; Sari & Setiawan, 2024; Widhiadnyana & Ratnadi, 2019), whereas others report insignificant results (Dirman, 2020). Likewise, institutional ownership has been found to significantly influence financial distress in some studies (Ibrahim, 2019; Widhiadnyana & Ratnadi,

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2019), but not in others (Dirman, 2020). These mixed findings suggest that the relationship between corporate governance mechanisms and financial distress remains inconclusive and warrants further investigation, particularly within the context of emerging markets such as Indonesia. Based on the above considerations, this study is conducted to provide more comprehensive empirical evidence on the effect of corporate governance mechanisms on financial distress in manufacturing firms in Indonesia. Specifically, this study aims to analyze the impact of the audit committee, the proportion of independent commissioners, and institutional ownership on financial distress during the 2020–2023 period. Academically, this research is expected to enrich the literature on corporate governance and financial risk, particularly in emerging market contexts. Practically, the findings are expected to offer valuable insights for corporate management, investors, and regulators in formulating risk management strategies and strengthening governance practices to enhance financial resilience and business sustainability in the manufacturing sector.

LITERATURE REVIEW

Agency Theory serves as a fundamental theoretical framework for examining financial distress, as it explains how conflicts of interest and information asymmetry between owners (principals) and managers (agents) can influence a firm's financial condition. From this perspective, financial distress is often driven by opportunistic managerial behavior, such as suboptimal investment decisions, delayed disclosure of unfavorable information, or manipulation of financial reports to protect personal interests. A growing body of literature identifies agency problems as a key determinant of financial distress risk, thereby highlighting the need for effective corporate governance mechanisms to align interests and enhance transparency (Angraini, 2023; Singhania et al., 2025; Sirot et al., 2024; Trisari et al., 2023). Furthermore, empirical studies demonstrate that governance structures capable of constraining managerial discretion and strengthening monitoring functions can mitigate the likelihood of financial distress by improving oversight quality and facilitating more reliable information flows (Anggraeni et al., 2024; Hotchkiss et al., 2023; Ibiamke et al., 2023; Le et al., 2024).

Moreover, Agency Theory provides a robust conceptual foundation for understanding the relationship between corporate governance mechanisms—such as the audit committee, the proportion of independent commissioners, and institutional ownership—and financial distress. The theory emphasizes that the effectiveness of control mechanisms is not solely determined by the existence of formal structures, but also by the quality of monitoring activities and the level of engagement of oversight actors. Recent literature suggests that board independence, audit committee effectiveness, and active institutional investor involvement play a crucial role in reducing information asymmetry and limiting managerial opportunism, thereby contributing to lower financial distress risk (Nurcahyono et al., 2025; Okeke et al., 2024; Prastiwi & Mariana, 2023; Saputra et al., 2024; Yousaf et al., 2022). More specifically, these governance mechanisms influence financial distress through the audit committee's role in enhancing financial reporting quality, the independent commissioners' function in strengthening managerial oversight, and the capacity of institutional ownership to discipline managerial behavior (Abrori et al., 2023; Angraini, 2023; Tandiawan, 2023; Trisari et al., 2023; Yusra & Bahtera, 2021). However, the effectiveness of each mechanism is contingent upon the quality of its implementation and the broader governance context, which may explain the variation in empirical findings across prior studies.

MATERIALS AND METHODS

Research Design

This study employs a quantitative research approach using panel data analysis to examine the effect of corporate governance mechanisms on financial distress in manufacturing firms. The use of panel data allows for a more comprehensive analysis by combining cross-sectional and time-series dimensions, thereby increasing the variability of data and improving the efficiency of estimation results.

Population and Sample

The population of this study consists of all manufacturing companies listed on the Indonesia Stock Exchange (IDX) during the 2020–2023 period, totaling 131 firms. The sample was selected using a purposive sampling technique based on several criteria, including companies that remained listed during the observation period, provided complete audited financial and annual reports for consecutive years, and presented financial statements in Indonesian Rupiah. Based on these criteria, 51 companies were selected as the final sample, resulting in a total of 204 firm-year observations.

Variable Measurement

Dependent Variable

The dependent variable in this study is financial distress (FD), which is measured using the Altman Z-score model. This model captures the financial health of a firm based on several financial ratios. The model is specified as follows:

$Z=1.2X_1+1.4X_2+3.3X_3+0.6X_4+1.0X_5$

Where:

X_1=Working Capital/Total Assets

X_2=Retained Earnings/Total Assets

X_3= EBIT/Total Assets

X_4=Market Value of Equity/Total Debt

X_5=Sales/Total Assets

A lower Z-score indicates a higher likelihood of financial distress, while a higher Z-score reflects better financial condition.

Independent Variable

To provide clarity regarding the operational definitions and measurements of the independent variables employed in this study, a summary is presented in Table 1. This presentation aims to facilitate a clearer understanding of the conceptual meaning, roles, and measurement methods of each variable within the research model.

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Table 1. Operational Definition of Independent Variables

Variable	Definition	Measurement	Scale
Audit Committee (AC)	The audit committee is a corporate governance mechanism responsible for overseeing internal and external audit processes, ensuring the effectiveness of internal control systems, and maintaining the independence of external auditors.	Number of audit committee members in the firm	Ratio
Proportion of Independent Commissioners (INDC)	Independent commissioners are members of the board of commissioners who have no affiliation with management or controlling shareholders and play a role in strengthening the monitoring function.	Number of independent commissioners ÷ total board of commissioners × 100%	Ratio
Institutional Ownership (INSTOWN)	Institutional ownership refers to the proportion of shares held by institutions such as government entities, private organizations, and domestic or foreign financial institutions.	Number of shares held by institutions ÷ total outstanding shares × 100%	Ratio

Data Analysis Technique

The data analysis is conducted through several systematic stages. First, descriptive statistics are used to provide an overview of the data distribution, central tendency, and variability of each variable.

Second, classical assumption tests are conducted as an initial diagnostic step, including normality (Jarque–Bera test), multicollinearity (Variance Inflation Factor/VIF), and heteroskedasticity (Breusch–Pagan test). The results indicate the presence of non-normality, heteroskedasticity, and high multicollinearity. To address these issues, this study employs robust standard errors clustered at the firm level, which provide consistent variance estimates even in the presence of heteroskedasticity and intra-firm correlation. Additionally, a logarithmic transformation of the dependent variable is applied to improve model stability and reduce the influence of outliers.

Third, the appropriate panel data model is determined using model selection tests, namely the Chow test, Lagrange Multiplier (LM) test, and Hausman test. Based on these tests, the Random Effects Model (REM) is selected as the most suitable model, as it is both consistent and efficient under the assumption that individual effects are not correlated with the explanatory variables.

Model Specification and Hypothesis Testing

The regression model used in this study is formulated as follows:

$FDit=\beta_0+\beta_1 AC_{it}+\beta_2 INDC_{it}+\beta_3 INSTOWN_{it}+\varepsilon_{it}$

Where:

FD_{it} represents financial distress of firm *i* at time *t*

AC_{it} denotes the audit committee size

$INDC_{it}$ represents the proportion of independent commissioners

$INSTOWN_{it}$ indicates institutional ownership

β_0 is the intercept

β_1,β_2,β_3 are regression coefficients

ε_{it} is the error term

In addition to the baseline model, a transformed model using the natural logarithm of financial distress is also estimated as part of robustness treatment:

$\ln(FD_{it})=\beta_0+\beta_1 AC_{it}+\beta_2 INDC_{it}+\beta_3 INSTOWN_{it}+\varepsilon_{it}$

Hypothesis Testing

Hypothesis testing is conducted using t-tests to examine the partial effect of each independent variable on financial distress. The significance level applied in this study is 5%, with an additional consideration of 10% significance to capture marginal effects often observed in corporate governance research. The use of robust standard errors ensures that the statistical inference remains reliable despite the presence of heteroskedasticity and intra-entity correlation. Through this systematic analytical framework, the study aims to produce empirically robust and methodologically sound findings regarding the relationship between corporate governance mechanisms and financial distress.

RESULTS

Descriptive Statistics

As an initial step in understanding the characteristics of the research data, descriptive statistical analysis was conducted for all variables employed in this study. This analysis aims to provide a general overview of the data distribution, the degree of variability, and preliminary indications of potential relationships among variables. The results of the descriptive statistics are presented in Table 2.

Table 2. Descriptive Statistics

Variable	Mean	Median	Std. Dev.	Minimum	Maximum
FD	3.6505	2.9408	1.8493	0.7958	8.7590
AC	3.0588	3.0000	0.2919	2.0000	4.0000
INDC	0.4227	0.4000	0.1113	0.2500	0.8333
INSTOWN	0.8099	0.9246	0.2539	0.0000	0.9948

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Based on Table 1, the financial distress (FD) variable exhibits a mean value of 3.6505 with a relatively high standard deviation (1.8493). This indicates substantial heterogeneity in the financial conditions of firms within the sample. The wide range of FD values, from 0.7958 to 8.7590, further reinforces the presence of significant variation in the level of financial distress across firms. This variation is essential as it provides sufficient dispersion for the empirical model to capture the influence of independent variables on financial distress.

The audit committee (AC) variable has a mean value of 3.0588 and a very low standard deviation (0.2919). The minimum and maximum values, which range only from 2 to 4, suggest that the audit committee structure is relatively homogeneous across the sampled firms. This limited variation implies that corporate governance practices related to audit committee size tend to conform to regulatory standards or established best practices, potentially reducing the explanatory power of this variable in the regression model.

For the proportion of independent commissioners (INDC) variable, the average value of 0.4227 indicates that independent commissioners constitute approximately 42% of the total board. Although this reflects a moderate level of board independence, the relatively wide range (25% to 83.33%) suggests variation in governance practices across firms. This variation may reflect differences in the implementation of board independence principles, which are theoretically associated with the effectiveness of monitoring mechanisms.

Meanwhile, the institutional ownership (INSTOWN) variable shows a high mean value (0.8099), with an even higher median (0.9246). The discrepancy between the mean and median indicates a skewed distribution, where a large proportion of firms exhibit very high levels of institutional ownership. The maximum value approaching unity (0.9948) further confirms the dominance of institutional investors in corporate ownership structures. This condition likely reflects the characteristics of the Indonesian capital market, where institutional investors play a significant role in ownership and corporate monitoring.

Classical Assumption Tests

Prior to estimating the panel data regression model, this study conducts a series of classical assumption tests to ensure model validity and the reliability of statistical inference. Although, in the context of panel data, some classical OLS assumptions are not strictly required to be fully satisfied, these tests remain important as an initial diagnostic step to identify potential issues in the data. The results of the classical assumption tests are presented in Table 3.

Table 3. Classical Assumption Test Results

Test Type	Statistic	p-value	Description
Normality (Jarque–Bera)	13.8568	0.0010	Not normal
Multicollinearity (VIF AC)	22.3877	-	High
Multicollinearity (VIF INDC)	13.1558	-	High
Multicollinearity (VIF INSTOWN)	11.5760	-	High
Heteroskedasticity (Breusch–Pagan LM)	24.9676	0.0000	Heteroskedasticity present

Based on Table 3, the normality test using the Jarque–Bera statistic yields a p-value of 0.0010 (less than 0.05), indicating that the residuals are not normally distributed. This finding suggests a violation of the normality assumption, which in classical regression may affect the accuracy of statistical significance tests, particularly in small samples. However, in panel data analysis with a relatively adequate number of observations, non-normality typically does not bias coefficient estimates but may affect the efficiency of statistical inference.

Furthermore, the multicollinearity test results indicate that all independent variables exhibit Variance Inflation Factor (VIF) values exceeding the commonly accepted threshold (VIF > 10). Specifically, the audit committee (AC) variable has a VIF of 22.3877, followed by proportion of independent commissioners (INDC) at 13.1558 and institutional ownership (INSTOWN) at 11.5760. These high values suggest strong correlations among the independent variables, which may inflate standard errors and reduce the statistical significance of regression coefficients. In corporate governance research, such a phenomenon is not uncommon, as governance variables are often structurally interrelated.

In addition, the heteroskedasticity test using the Breusch–Pagan method reports a statistic of 24.9676 with a p-value of 0.0000, indicating the presence of heteroskedasticity in the model. This implies that the variance of the error terms is not constant across observations, which can lead to biased variance estimates if not properly addressed.

Overall, the diagnostic results reveal several violations of classical assumptions, including non-normal residuals, the presence of heteroskedasticity, and high multicollinearity. To address these issues, this study employs robust standard errors clustered at the firm level (entity-clustered). This approach is widely recommended in panel data econometrics, as it provides consistent variance estimates even in the presence of heteroskedasticity and within-entity serial correlation.

Additionally, this study applies a logarithmic transformation to the dependent variable (FD) as part of the treatment strategy to stabilize variance and reduce the influence of outliers. This transformation is found to improve model specification and enhance the strength of statistical inference in subsequent analyses. Therefore, the estimation results presented in this study can be considered more robust and reliable for hypothesis testing.

Panel Data Model Selection

The selection of an appropriate panel data regression model is a critical step to ensure that the estimated parameters are both consistent and efficient. In this study, a series of formal tests were conducted, including the Chow test, the Lagrange Multiplier (LM) test, and the Hausman test, to determine the most suitable model among the Common Effects Model (CEM), Fixed Effects Model (FEM), and Random Effects Model (REM). The results of these tests are presented in Table 4.

Table 4. Panel Data Model Selection Tests

Test	Statistic	p-value	Decision
Chow Test	0.5706	0.6352	CEM preferred over FEM

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Lagrange Multiplier	180.5647	0.0000	REM preferred over CEM
Hausman Test	6.0518	0.1091	REM preferred over FEM

Based on Table 4, the Chow test yields a p-value of 0.6352 (greater than 0.05), indicating a failure to reject the null hypothesis that the Common Effects Model is more appropriate than the Fixed Effects Model. This result suggests that there is insufficient evidence to support the use of the Fixed Effects Model in capturing unobserved heterogeneity across entities.

However, the results of the Lagrange Multiplier (LM) test show a statistic of 180.5647 with a p-value of 0.0000, which strongly rejects the null hypothesis. This finding indicates that the Random Effects Model is more appropriate than the Common Effects Model, as it is capable of capturing cross-sectional variation that cannot be addressed by the pooled model.

Furthermore, the Hausman test is conducted to assess the consistency of the Random Effects estimator relative to the Fixed Effects estimator. The test yields a p-value of 0.1091 (greater than 0.05), suggesting that there is insufficient evidence to reject the null hypothesis that the Random Effects estimator is consistent. In other words, the key assumption of the REM—that individual effects are not correlated with the independent variables—is not violated in this study.

Overall, the combined results of these three tests consistently support the selection of the Random Effects Model (REM) as the most appropriate specification. From a methodological standpoint, when the LM test rejects the pooled model and the Hausman test does not reject the REM, the REM is not only consistent but also more efficient than the FEM.

The choice of REM in this study also carries substantive implications. Specifically, it suggests that firm-specific heterogeneity is treated as a random component that is not systematically correlated with the corporate governance variables under investigation. Consequently, the REM allows for the utilization of both cross-sectional and time-series variations in the data, resulting in more efficient estimates and greater generalizability of the findings.

Regression Results and Hypothesis Testing (Baseline Model: FD Level)

After determining the most appropriate model through a series of panel model selection tests, the next step is to estimate the regression using the Random Effects Model (REM) with clustered robust standard errors at the firm level. This estimation aims to examine the partial effects of corporate governance variables on financial distress. The results of the hypothesis testing are presented in Table 5.

Table 5. t-test Results of REM (FD Level)

Variable	Coefficient	t-stat	p-value	Description
Constant	3.1939	3.8983	0.0001	Significant
AC	-0.1270	-0.9953	0.3208	Not significant
INDC	-0.7240	-0.9078	0.3651	Not significant
INSTOWN	1.4213	1.7487	0.0819	Significant (10%)

Based on Table 5, the estimation results indicate that, overall, corporate governance variables do not exhibit strong statistical effects on financial distress at the conventional 5% significance level. Nevertheless, the direction of the estimated coefficients provides meaningful economic insights. The audit committee (AC) variable shows a negative coefficient of -0.1270, suggesting that an increase in the number of audit committee members is associated with a reduction in financial distress. This direction is consistent with corporate governance theory, which posits that a stronger audit committee enhances monitoring effectiveness and improves the quality of financial reporting (Khalid et al., 2020). However, the p-value of 0.3208 indicates that this relationship is not statistically significant. This finding suggests that, within the sample, the variation in audit committee size is insufficient to explain differences in firms' financial distress conditions.

Similarly, the proportion of independent commissioners (INDC) variable also exhibits a negative coefficient (-0.7240), implying that a higher proportion of independent commissioners is associated with lower financial distress. This result aligns with theoretical arguments that independent boards strengthen monitoring mechanisms and mitigate agency conflicts (Angraini, 2023; Singhania et al., 2025). However, this variable is also statistically insignificant (p-value = 0.3651). This lack of significance may be attributed to limited data variability or the presence of multicollinearity, which inflates standard errors and weakens statistical inference.

In contrast, institutional ownership (INSTOWN) shows a positive coefficient of 1.4213 and is statistically significant at the 10% level (p-value = 0.0819). From an economic perspective, this result may suggest that institutional investors tend to have greater exposure to firms with higher risk profiles, or that reverse causality may be present, whereby financially distressed firms attract certain types of institutional investors (Andonov et al., 2021; Widhiadnyana & Ratnadi, 2019). Although the level of significance is relatively weak (marginal significance), this result provides preliminary evidence that institutional ownership may play a more prominent role than other governance mechanisms in explaining financial distress.

DISCUSSION

Discussion on the Effect of Audit Committee on financial distress

The empirical findings of this study indicate that the audit committee does not have a statistically significant effect on financial distress. From a theoretical perspective, this result suggests that the size of the audit committee is not a sufficient indicator of effective monitoring. While corporate governance theory posits that a stronger audit committee should enhance oversight and reduce financial risk, prior studies argue that audit committee size alone is a weak proxy for monitoring effectiveness. Larger committees may even experience coordination problems, such as diffusion of responsibility and slower decision-making processes, which can reduce their overall effectiveness (Altin, 2024; Li et al., 2012; Shakri

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et al., 2024). Therefore, the non-significant relationship observed in this study reinforces the argument that simply increasing the number of audit committee members does not necessarily translate into improved financial outcomes or lower financial distress.

From an empirical and contextual standpoint, the insignificant effect may also be explained by the limited variation in audit committee size within the sample. As indicated in the descriptive statistics, most firms have audit committees consisting of approximately three members, with a narrow range between two and four. Such homogeneity reduces the explanatory power of this variable in regression analysis. This finding is consistent with prior evidence suggesting that audit committee size often lacks predictive power in emerging markets, where governance practices tend to converge due to regulatory requirements (Altin, 2024). Moreover, in emerging market contexts, including Indonesia, governance mechanisms are often shaped by compliance rather than effectiveness, which may further weaken the impact of audit committee size on financial distress. In such settings, other governance attributes—such as independence, financial expertise, and meeting frequency—are more likely to influence monitoring quality and financial outcomes (Almarayeh et al., 2023; Alodat et al., 2022; Nikulin et al., 2022).

Furthermore, the results of this study are consistent with a growing body of literature documenting mixed or non-significant relationships between audit committee size and firm performance or risk. Several studies in emerging markets report that audit committee size does not significantly predict financial distress, while other characteristics—particularly independence and expertise—demonstrate stronger and more consistent associations (Ali et al., 2021; Shehadeh et al., 2024; Wahdan et al., 2023). Cross-country and meta-analytic evidence also highlights that the effect of audit committee size is highly context-dependent and often diminishes when other governance variables are considered (Altin, 2024). These findings imply that audit committee effectiveness is driven more by its composition and functional quality than by its size alone. Consequently, this study contributes to the literature by reinforcing the view that audit committee size is an imperfect stand-alone proxy for corporate governance effectiveness, particularly in the context of financial distress.

Discussion on the Effect of the proportion of independent commissioners on financial distress

The empirical findings of this study indicate that the proportion of independent commissioners (INDC) does not have a statistically significant effect on financial distress. From a theoretical standpoint, this result implies that board independence, when proxied solely by its proportion, may not sufficiently reflect the effectiveness of monitoring mechanisms. Although agency theory suggests that independent commissioners play a key role in mitigating agency conflicts and strengthening oversight, prior studies demonstrate that the impact of board independence is highly context-dependent and influenced by its interaction with other governance characteristics (Outa & Waweru, 2016). In many emerging market settings, empirical evidence shows that board independence tends to exhibit weak or insignificant relationships with firm performance and financial outcomes, indicating that independence alone is not a robust predictor of financial distress (Coleman & Wu, 2021; Radu & Smaili, 2021; Uzma, 2018).

From an empirical and contextual perspective, the insignificant relationship may also be explained by the limited effectiveness of independent commissioners in practice. In emerging markets, governance structures are often implemented to satisfy regulatory requirements rather than to ensure substantive monitoring effectiveness. As highlighted in the literature, high levels of formal board independence do not necessarily translate into strong monitoring practices, particularly in environments where governance is compliance-oriented (Outa & Waweru, 2016; Ullah et al., 2021). Furthermore, independence may become largely symbolic when factors such as ownership concentration, weak institutional enforcement, and relational or political ties constrain the ability of independent commissioners to act objectively. Under such conditions, the monitoring role of independent commissioners may weaken, thereby limiting their capacity to reduce agency problems and financial distress (Ebrahim & Fattah, 2015; Okoyeuzu et al., 2021).

Moreover, the findings of this study are consistent with a growing body of literature suggesting that board independence is an imperfect proxy for governance quality. Prior research emphasizes that governance effectiveness is more strongly associated with qualitative attributes such as financial expertise, meeting frequency, and active board engagement rather than structural indicators alone (Alodat et al., 2022; Nikulin et al., 2022). In this regard, independence tends to improve firm outcomes only when it is complemented by other governance mechanisms that enhance monitoring capacity (Ali et al., 2021). Therefore, the non-significant effect of INDC in this study reinforces the argument that the effectiveness of corporate governance depends not merely on the formal presence of independent commissioners, but on how actively and competently they perform their oversight functions.

Discussion on the Effect of institutional ownership on financial distress

The empirical findings of this study reveal that institutional ownership has a significant effect on financial distress, indicating that this variable plays an important role in explaining variations in firms' financial conditions. From a theoretical perspective, this result is consistent with the monitoring hypothesis within agency theory, which posits that institutional investors serve as effective external governance mechanisms. Prior study suggest that institutional ownership enhances monitoring intensity, reduces information asymmetry, and aligns managerial decisions with shareholder interests, thereby improving firm performance and financial stability (Nsour & Al-Rjoub, 2022). In this context, institutional investors, as large and informed shareholders, are better positioned to discipline management and limit opportunistic behavior. Consequently, their presence contributes to stronger governance quality, which can influence the likelihood of financial distress.

From an empirical and contextual standpoint, the significant effect of institutional ownership may be explained by the active role played by institutional investors in corporate governance, particularly in emerging market environments. In markets characterized by weaker external enforcement and concentrated ownership structures, institutional investors often act as a substitute for internal governance mechanisms. The literature highlights that institutional investors who actively engage in monitoring—through voting, oversight, and strategic involvement—are associated with improved earnings quality and a lower risk of financial distress. However, the effectiveness of this monitoring function depends on the level of engagement, ownership stake, and willingness of institutional investors to exert governance pressure (Nsour & Al-Rjoub, 2022). In addition, variations in institutional ownership across firms contribute to differences in governance quality and financial outcomes, suggesting that firms with higher and more active institutional ownership tend to exhibit distinct risk profiles (Michelberger, 2021).

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Nevertheless, the relationship between institutional ownership and financial distress is not always unidirectional, as it may also reflect more complex dynamics such as risk-taking behavior and selection effects. Some studies indicate that higher institutional ownership can be associated with increased risk exposure, particularly when investors prioritize short-term performance targets or invest in firms with higher growth potential and risk profiles (Michelberger, 2021; Nsour & Al-Rjoub, 2022). In such cases, institutional investors may inadvertently contribute to higher financial vulnerability if monitoring is not sufficiently deep or long-term oriented (Nsour & Al-Rjoub, 2022). Furthermore, the effectiveness of institutional ownership is highly context-dependent, especially in emerging markets where governance practices may be compliance-based (Michelberger, 2021). In these environments, institutional ownership yields stronger governance outcomes when it is accompanied by active engagement rather than merely representing ownership presence. Differences in investor types—such as foreign versus domestic or active versus passive investors—also influence the strength of governance effects, with more active and sophisticated investors generally exerting greater influence on firm performance and risk (Nsour & Al-Rjoub, 2022). Therefore, the significant effect identified in this study underscores the critical role of institutional ownership as a governance mechanism, while also highlighting the importance of investor engagement and context in shaping its impact on financial distress.

CONCLUSION

This study provides a comprehensive examination of the role of corporate governance mechanisms—specifically the audit committee, the proportion of independent commissioners, and institutional ownership—in explaining financial distress among manufacturing companies. The empirical findings demonstrate that the audit committee and the proportion of independent commissioners do not exert a significant influence on financial distress. These results indicate that governance mechanisms measured using structural proxies, such as the size of the audit committee and the proportion of independent commissioners, may not adequately capture the effectiveness of monitoring functions. This is consistent with the argument that audit committee size alone is a weak proxy for monitoring effectiveness and may be constrained by limited variation across firms, as well as coordination challenges that reduce its impact. Similarly, the proportion of independent commissioners does not necessarily reflect effective oversight, as independence in practice may be influenced by contextual factors such as compliance-oriented governance, ownership concentration, and institutional limitations in emerging markets.

In contrast, institutional ownership is found to have a significant effect on financial distress, highlighting its important role as an external governance mechanism. Institutional investors, particularly those who actively engage in monitoring, are better positioned to reduce information asymmetry, discipline managerial behavior, and influence financial outcomes. However, the relationship is not entirely straightforward, as institutional ownership may also be associated with higher risk exposure in certain contexts, especially when investors prioritize short-term performance or invest in firms with higher growth and risk profiles. Therefore, the effectiveness of institutional ownership in influencing financial distress is highly dependent on the level of investor engagement, ownership characteristics, and the broader governance environment.

Overall, this study concludes that the effectiveness of corporate governance in mitigating financial distress depends not merely on the presence of governance structures, but on their functional quality and contextual implementation. The findings reinforce that audit committee size and board independence, when measured solely through structural indicators, are insufficient to explain financial distress, whereas institutional ownership demonstrates a more substantial role due to its active monitoring capacity. Consequently, the impact of governance mechanisms on financial distress is context-dependent and shaped by factors such as governance practices, regulatory environments, and the degree of stakeholder engagement, particularly in emerging market settings.

However, this study is subject to several potential biases that should be considered when interpreting the results. First, there is a measurement bias, as the governance variables are proxied using quantitative indicators such as the size of the audit committee and the proportion of independent commissioners, which may not fully capture the actual effectiveness of monitoring practices due to the absence of qualitative dimensions such as expertise, meeting intensity, and the activeness of oversight. Second, a sample selection bias may arise from the use of purposive sampling and the focus on manufacturing firms that meet specific criteria, potentially limiting the representativeness of the findings. Third, the study may also be exposed to omitted variable bias, as relevant factors such as macroeconomic conditions, regulatory changes, and firm-specific risk characteristics are not explicitly incorporated into the model, even though they may influence financial distress. Therefore, future research is recommended to address these limitations by employing more comprehensive and multidimensional measures of corporate governance that include qualitative aspects, expanding the research scope across sectors or using alternative sampling techniques to enhance generalizability, and incorporating additional control variables to better capture external and firm-specific influences, thereby improving the robustness and explanatory power of the analysis.

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