



Good corporate governance and financial distress in Indonesian state-owned enterprises

Muhammad Fadli Hanafi^{a*}, Rumanintya Lisaria Putri^b, Irwanda Wisnu Wardhana^c

^aFaculty of Economics and Business, Universitas Indonesia, Depok, Indonesia

^bFaculty of Economics, Universitas Islam Blitar, Blitar, Indonesia

^cResearch Center for Cooperative, Corporation, and People's Economy, National Research and Innovation Agency (BRIN), Central Jakarta, Indonesia

Corresponding author: fadli.hanafi@ui.ac.id

Abstract

Purpose — This study examines the effect of good corporate governance on financial distress in Indonesian listed firms and investigates whether the effectiveness of board independence differs between state-owned enterprises (BUMN) and private firms.

Method — The study employs panel data from Indonesian listed firms over 2015–2021, comprising 966 firm-year observations. Financial distress is measured using the Altman Z-Score, while governance is proxied by the proportions of independent commissioners and independent directors. The relationships are estimated using Generalized Least Squares (GLS).

Findings — Profitability significantly reduces financial distress, while higher leverage increases it. Independent commissioners and independent directors are associated with stronger financial conditions across the overall sample. However, BUMN status has no significant direct effect. More importantly, the interaction between independent directors and BUMN status is significantly negative, indicating that the beneficial role of board independence does not translate effectively into state-owned enterprises. The interaction involving independent commissioners is not significant.

Implications — Strengthening corporate governance in Indonesian state-owned enterprises requires more than formal compliance with board independence requirements. Policymakers, government shareholders, and corporate boards should emphasize the competence, integrity, accountability, and supervisory capacity of independent board members, particularly independent directors. Governance reforms should focus not only on-board composition, but also on appointment quality and monitoring effectiveness, while prudent leverage management and sustained profitability remain essential for reducing financial distress.

Originality — This study provides evidence that the effectiveness of board independence is ownership-specific, showing that governance mechanisms associated with stronger financial resilience in listed firms may operate differently within state-owned enterprises.

Keywords: Financial Distress, Corporate Governance, Board Independence, State-Owned Enterprises, Empirical Analysis.

JEL Classification: G33; G34; L32

Recommended Citation

Hanafi, M. F., Putri, R. L., and Wardhana, I. W. (2026). Good corporate governance and financial distress in Indonesian state-owned enterprises. *Jurnal Ekonomi Indonesia*. 15(2) 2026, 183-193

DOI: <https://doi.org/10.52813/jei.v18i2.433>

Submitted: 7 August 2023 – Revised: 31 August 2026 – Accepted: 31 August 2026

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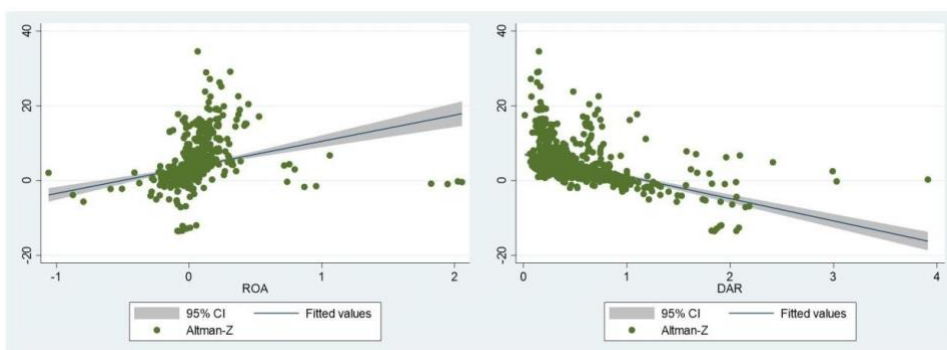
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Introduction

Good corporate governance (GCG) plays an important role in enhancing corporate performance and mitigating risk (Ammari et al., 2016). Since the 2008 global financial crisis, firms have increasingly strengthened governance practices to improve resilience against uncertainty (Daily et al., 1994). This has become increasingly important given that even companies with strong capital positions and sound financial performance cannot entirely avoid exposure to various risks. Furthermore, risks arising from uncertainty may occur under various circumstances, and stronger financial resilience can help firms mitigate such risks more effectively and reduce the likelihood of bankruptcy (Darrat et al., 2016). According to Pramudena (2017), bankruptcy is generally preceded or indicated by a certain level of financial distress.

Financial distress can therefore serve as an early warning signal of potential bankruptcy resulting from poor operating performance (Jensen & Meckling, 1976). A high level of financial distress indicates weak financial performance, particularly in components associated with operating activities, which may eventually lead a company into severe financial difficulties. Therefore, improvements in corporate governance are required to mitigate the potential risks associated with financial distress. By employing the Altman Z-Score as a measure of financial distress, the relationship between financial performance and financial distress can be identified through the trends.

Figure 1. Relationship between Altman Z-Score, Profitability, and Leverage

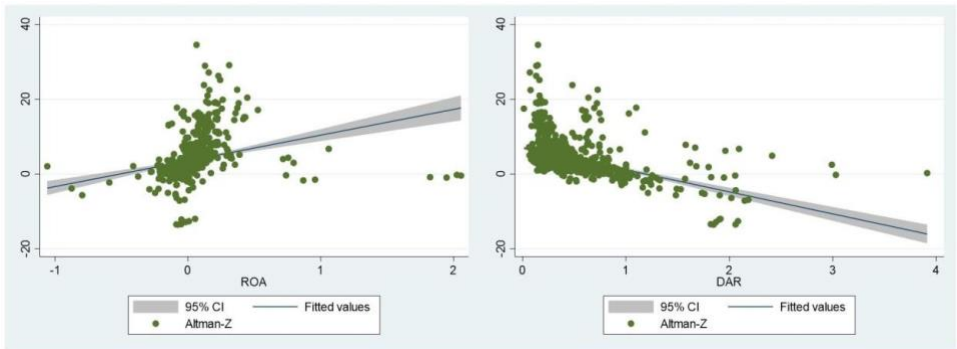


Source: Annual Financial Report (2023)

It can be identified that both profitability and leverage perform the expected sign. A higher level of profitability, which is indicated by Return on Asset (ROA), performs a positive trend with the Altman Z-Score meaning higher profitability would potentially drive the company away from financial distress. On the other hand, a higher level of leverage, indicated by higher Debt to Asset Ratio (DAR), performs a negative trend with Altman Z-Score meaning a higher level of leverage would threaten the company to financial distress. These trends are relevant to the notion that a company should always maintain its optimum level of leverage to avoid financial distress by improving the level of profitability (Sewpersadh, 2019; 2020). Financial stability is crucial for state-owned enterprises (SOEs) due to their role as government-backed entities. Their performance is important not only for generating government dividends but also for supporting sustainable development (Christiansen, 2013).

In Indonesia, recent policy reforms highlight the need for stronger corporate governance, as poor SOE performance and potential financial distress may affect both government finances and public confidence (Shleifer and Vishny, 1997).

Figure 2. Relationship between Altman Z-Score, Profitability, and Leverage in Private Firms

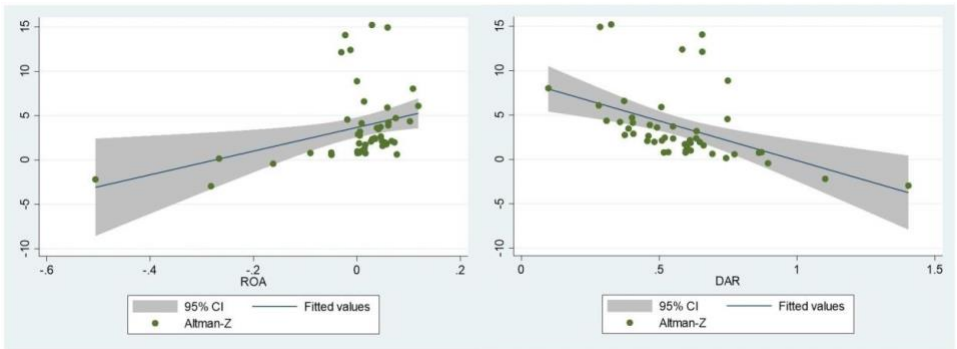


Source: Annual Financial Report (2023)

Differences in the relationship between financial performance and financial distress are observed between private companies and state-owned enterprises (SOEs). The results indicate that higher profitability and prudent leverage management are important in reducing financial distress. Moreover, Indonesia's SOEs appear to be more responsive to changes in financial performance than private companies. The correlation between Return on Assets (ROA) and the Altman Z-Score is 0.3465 for SOEs, compared with 0.2619 for private companies.

Similarly, the correlation between the Debt-to-Asset Ratio (DAR) and the Altman Z-Score is -0.4744 for SOEs and -0.4608 for private companies. These findings suggest that higher profitability is more strongly associated with improved financial health in SOEs, while excessive leverage may increase their exposure to financial distress (Ross et al., 2017).

Figure 3. Relationship between Altman Z-Score, Profitability, and Leverage in Indonesian State-Owned Enterprises



Source: Annual Financial Report (2023)

Improving a company's financial performance is closely related to the quality of corporate governance (Hart, 1995a). According to Williamson (1985), corporate governance refers to a set of rules that regulates the relationship between shareholders and management. It serves as an important mechanism for aligning corporate objectives and strategies with overall business operations (Ross et al., 2017). Previous studies have highlighted the importance of corporate governance in relation to financial distress. Darmawan et al. (2016), for example, used the proportion of independent commissioners as a proxy for corporate governance and found that their presence had a significant effect on financial distress. However, Hanani and Dharmastuti (2015) found that a higher proportion of independent commissioners may also be associated with greater financial distress in Indonesia, particularly when appointments do not sufficiently consider the competencies required to perform board responsibilities effectively.

Therefore, this study examines the impact of good corporate governance (GCG) on financial distress, with a particular focus on Indonesian state-owned enterprises. This study draws on the theoretical foundations of good corporate governance (GCG), financial distress, and state-owned enterprises. Good corporate governance has become an important topic in corporate finance, particularly because governance mechanisms emerge in response to two fundamental conditions: agency problems and transaction costs that cannot be fully resolved through contracts (Hart, 1995). In the absence of agency problems, individuals within an organization could simply be directed to maximize profits or firm value, or to minimize costs, without requiring additional incentive mechanisms. However, in practice, differences in interests among organizational actors create agency problems that require appropriate governance mechanisms.

Agency problems alone, however, do not fully explain the need for GCG. Principal-agent theory assumes that some information and costs are privately held by different parties (Hart, 1995), making contracts essential for defining rights and obligations. Nevertheless, contracts are rarely complete because contracting itself involves substantial costs. These include the costs of anticipating possible contingencies, negotiating contractual terms, and drafting enforceable agreements that can be interpreted by third parties in the event of disputes (Coase, 1937; Williamson, 1985; Klein et al., 1978). Consequently, contracts may contain gaps or unspecified provisions, which may require renegotiation when new information emerges and can potentially generate additional costs or legal disputes.

Good corporate governance can therefore be understood as a mechanism for addressing decisions and contingencies that are not fully specified in the original contract. More specifically, GCG allocates residual control rights over a firm's non-human assets, referring to the authority to determine how assets are used when such decisions have not been explicitly specified in advance (Grossman & Hart, 1986; Hart & Moore, 1990; Hart, 1995). One important element of corporate governance is the structure of the corporate board. The board is responsible for overseeing top management and making important strategic decisions. In practice, however, questions remain regarding its effectiveness. Corporate boards generally consist of executive directors, who are directly involved in management, and non-executive directors, who primarily perform monitoring and oversight functions. Under a two-tier governance system, these functions are separated between the Board of Directors and the Board of Commissioners, whereas under a one-tier system they are combined within a single board.

When management and oversight functions are combined, executive directors may face limitations in objectively monitoring their own decisions. Even under a two-tier system, however, non-executive directors or commissioners may not always perform their monitoring role effectively. They may have limited financial interests in the company, insufficient time to devote to corporate affairs, or close relationships with the shareholders or management responsible for their appointment. To strengthen board oversight, the Cadbury Committee emphasized the importance of appointing independent members to corporate boards.

Board independence is widely recognized as an important attribute of good corporate governance (Kanapathippillai et al., 2019). Lu et al. (2022) found that independent board members play an important role in explaining variations in firm performance. Independent directors may enhance firm value through objective monitoring, broader expertise, and external networks (Coles et al., 2008). Their effectiveness also depends on their access to relevant corporate information, as emphasized in the Adams and Ferreira framework (Lu et al., 2022).

Previous studies further suggest that independent board members can provide higher-quality advice to management because they bring external experience and expertise that may not be available within the firm (Hermalin & Weisbach, 1988, as cited in Coles et al., 2008). Coles et al. (2008) also demonstrated that the presence of independent board members influences the relationship between board size and firm performance. These findings reinforce the importance of board independence as a governance mechanism for strengthening monitoring, improving decision-making, and ultimately supporting better corporate performance.

Methodology

The data used in this study were collected from the annual financial reports of publicly listed firms for the period 2015–2021. A total of 132 firms met the selection criteria, resulting in 966 firm-year observations. The sample distribution is presented in the following table.

Table 1. Definition and Measurement of Variables

Variables	Data	Descriptions
Dependent	Altman Z-Score	A measurement that indicates a company's likelihood of bankruptcy. It is indicated by the following score: - score < 1.81 = distress (bankruptcy range) - 1.81 ≤ score < 2.67 = relatively at risk, but still managed to avoid distress - 2.67 ≤ score = sustainable (sound performance)
Independent	Debt to Asset Ratio (DAR)	A leverage ratio indicates the level of debt a company possesses compared to its assets. Higher DAR indicates a higher degree of leverage, reflecting higher potential financial risks.
	Return on Asset (ROA)	A financial ratio that indicates the level of profitability of a company compared to its asset. Higher ROA indicates the ability of the company to efficiently utilize its asset to generate profit.
	Independent Commissioner	Member of the board of commissioners who do not have a direct relationship with the company or its business lines. Their existence is expected to improve the quality assurance of the company because they are demanded to strictly observe the company's operating activities.

Variables	Data	Descriptions
Dummy	Independent Director	Member of the board of directors who does not have a relationship with a company or related parties from the company. Their existence is expected to increase the company's performance, as they are considered to have the least potential conflict of interest in managing the company.
	Indonesia's State-owned Enterprises (BUMN)	Indicating the status of a firm as Indonesia's state-owned enterprise (BUMN), where 1 = BUMN; 0 = otherwise)

Source: Authors' compilation based on relevant literature and firms' annual financial reports.

The study comprises 966 firm-year observations from 132 publicly listed firms over the 2015–2021 period. The data were obtained from the firms' annual financial statements. The descriptive statistics for each variable are presented in the following table.

Table 2. Descriptive Statistics

Variables	Obs	Mean	Stdev	Max	Min
Altman	966	3.869	4.767	34.560	-13.511
DAR	966	0.535	0.369	3.912	0.013
ROA	966	0.046	0.180	2.056	-1.06
Independent Commissioners	966	0.408	0.108	1.000	0.167
Independent Directors	966	0.15	0.15	0.667	0.000

Source: Processed by Author

This study employs an empirical model to estimate the relationship between the dependent and independent variables. The model is mathematically specified as follows:

$$y_{it} = \alpha_{it} + \sum_{i=1}^n \beta_i x_{it} + \gamma_i d_{it} + \varepsilon_{it}$$

(1)

Where y_{it} represents financial distress as the dependent variable, proxied by the Altman Z-Score. x_{it} represents the independent variables, comprising both financial fundamentals—Debt-to-Asset Ratio (DAR) and Return on Assets (ROA)—and corporate governance indicators, namely independent commissioners and independent directors.

The dummy variable d_{it} indicates state-owned enterprise (BUMN) status, taking a value of 1 for BUMN and 0 otherwise, while ε_{it} represents the error term. Furthermore, α denotes the constant, while β and γ represent the coefficients of the independent variables and the BUMN dummy variable, respectively. The model is estimated using Generalized Least Squares (GLS) to account for potential heteroskedasticity and correlation across the error terms.

Results and Discussion

The first step is to conduct a correlation analysis among the variables to assess potential multicollinearity in the model. Correlation coefficients exceeding the threshold of 0.75–0.80 may indicate potential multicollinearity concerns. The results of the correlation analysis are presented in the following table.

Table 3. Correlation Analysis

	Altman Z Score	DAR	ROA	Independent Commissioner	Independent Director
Altman Z Score	1.000				
DAR	-0.460	1.000			
ROA	0.264	0.069	1.000		
Independent Commissioner	0.088	0.0582	0.216	1.000	
Independent Director	0.056	-0.004	-0.024	-0.027	1.000

Source: Processed by Author

The next step presents the results of the empirical analysis using the Generalized Least Squares (GLS) model. The estimation results are reported across three model specifications with different combinations of independent variables, as presented in the following table.

Table 4. Estimation Results

Variables	Model 1		Model 2		Model 3	
Debt to Asset Ratio (DAR)	-6.238 (0.347)	***	-6.252 (0.347)	***	-6.257 (0.346)	***
Return on Asset (ROA)	7.591 (0.728)	***	7.639 (0.729)	***	7.637 (0.727)	***
BUMN			0.726 (0.591)		2.015 (2.277)	
Independent Commissioner	2.456 (1.208)	**	2.522 (1.208)	**	2.747 (1.234)	**
Independent Commissioner X BUMN					-1.463 (5.867)	
Independent Director	1.982 (0.854)	**	2.157 (0.865)	**	2.403 (0.867)	***
Independent Director X BUMN					-15.559 (7.3559)	**
_cons	5.564 (0.546)	***	5.478 (0.55)	***	5.351 (0.559)	***
Log-likelihood	-2,702.0		-2,701.3		-2,698.7	
Prob > chi2	0.000		0.000		0.000	
AIC	5,414.1		5,414.6		5,413.4	
BIC	5,438.4		5,443.8		5,452.4	

Dependent: Altman Z-Score (higher score indicates the sound performance of the firms) Level of significance: * $p < 0.1$; ** $p < 0.05$; *** $p < 0.01$

Source: Processed by Author

The results confirm the importance of financial fundamentals in determining corporate financial health. Across all specifications, DAR has a negative and statistically significant coefficient, whereas ROA has a positive and statistically significant coefficient.

These results indicate that firms with greater leverage tend to exhibit lower Altman Z-Scores, while firms with stronger profitability exhibit better financial conditions. The stability of these coefficients across the three specifications also suggests that relationships are not materially altered by the inclusion of ownership and governance interaction terms. The governance variables provide a more nuanced result. In Model 1, both independent commissioners and independent directors are positively and significantly associated with the Altman Z-Score, consistent with the monitoring perspective of corporate governance. Independent board members may reduce agency problems by strengthening oversight, challenging managerial decisions, and improving the quality of strategic monitoring.

This result is broadly consistent with [Maier and Yurtoglu \(2022\)](#), who document a negative relationship between board independence and insolvency risk. However, recent studies emphasize that this relationship is highly dependent on institutional context. Model 3 reveals that state ownership changes the relationship between board independence and financial health. Because BUMN is coded as one and private firms as zero, the coefficient on Independent Director (2.4033) represents the association for private firms. The interaction coefficient between Independent Director and BUMN is -15.560 and statistically significant, indicating that this association is substantially weaker for state-owned enterprises. The implied marginal coefficient for BUMN firms is $2.403 - 15.56 = -13.156$.

However, the statistical significance of this combined marginal effect should be assessed using a post-estimation linear-combination or marginal-effects test before concluding that independent directors themselves have a statistically significant negative association with financial health within BUMN. Importantly, the significant interaction coefficient demonstrates a difference between ownership groups rather than automatically establishing that the within-BUMN marginal effect is statistically significant. This distinction strengthens the interpretation of the empirical findings and prevents overstatement of the result. The weaker effectiveness of board independence within state-owned enterprises may reflect the distinctive institutional environment surrounding SOEs. Unlike private firms, SOEs simultaneously face commercial objectives, government ownership, public accountability, and potentially multiple principals.

Consequently, formal board independence may not necessarily translate into substantive autonomy or effective monitoring. Recent Indonesian evidence supports this interpretation. [Andreas \(2024\)](#) finds no significant direct effect of board independence on financial distress among listed SOEs and identifies political connections as relevant, while [Jahja et al. \(2024\)](#) show that governance effectiveness in Indonesian SOEs may be weakened when political affiliations affect board arrangements. More recent qualitative evidence also suggests that governance implementation in Indonesian SOEs may remain oriented toward formal compliance rather than substantive governance effectiveness ([Jahja et al., 2026](#)). In contrast, the interaction between BUMN status and independent commissioners is statistically insignificant.

This indicates that the relationship between independent commissioners and financial health does not differ statistically between SOEs and private firms in the present model. One possible interpretation is that the supervisory function of independent commissioners is more institutionally established within Indonesia's two-tier board structure than the role historically attached to independent directors. Nevertheless, this result should be interpreted cautiously and should not be taken as evidence that independent commissioners are equally effective in all ownership contexts without further marginal-effect tests and governance-quality measures.

Conclusion

This study examines the relationship between good corporate governance and financial distress in Indonesian listed firms, with particular emphasis on state-owned enterprises (BUMN). Using the Altman Z-Score as a measure of financial distress and Generalized Least Squares (GLS) estimation, the study evaluates the roles of financial fundamentals, board independence, and state ownership in shaping firms' financial resilience. The findings show that profitability and leverage are important determinants of financial distress.

Higher Return on Assets (ROA) is associated with stronger financial conditions, whereas a higher Debt-to-Asset Ratio (DAR) is associated with greater exposure to financial distress. Independent commissioners and independent directors are positively associated with financial health across the overall sample, while BUMN status itself has no statistically significant direct effect on the Altman Z-Score. The effectiveness of board independence, however, differs within state-owned enterprises. The interaction between independent commissioners and BUMN status is statistically insignificant, whereas the interaction between independent directors and BUMN status is negative and significant. This finding suggests that formal board independence alone may be insufficient to improve financial resilience in Indonesian SOEs, highlighting the potential importance of board competence, accountability, and effective supervisory capacity.

These findings imply that governance reform in Indonesian SOEs should extend beyond formal compliance with board independence requirements. Policymakers and shareholders should place greater emphasis on the quality and effectiveness of independent board oversight, while prudent leverage management and improved profitability remain essential for reducing financial distress. Overall, the study demonstrates that the effectiveness of corporate governance mechanisms varies across ownership contexts, underscoring the importance of governance arrangements that combine formal independence with substantive oversight capacity in Indonesian state-owned enterprises.

Several limitations should be acknowledged. First, the study relies primarily on formal board-composition measures and therefore cannot directly capture the competence, political connections, appointment processes, information access, or actual monitoring intensity of independent board members. Second, the sample period ends in 2021 and consequently does not capture subsequent changes in Indonesia's SOE governance framework. Third, the regulatory change concerning the Independent Director position during the observation period may affect the comparability of this governance measure across years, although additional robustness analyses are used to mitigate this concern. Future research may extend the analysis by incorporating board expertise, political connections, appointment mechanisms, governance quality indicators, and alternative measures of financial distress, as well as by examining Indonesian SOEs under the more recent institutional framework.

AI declaration

The authors declare that artificial intelligence (AI) tools were used solely to assist in language refinement, grammar checking, and improving the clarity of writing. The use of AI did not influence the research design, data collection, data analysis, interpretation of results, or the development of conclusions. All intellectual contributions, including conceptualization, methodology, analysis, and final content, remain the full responsibility of the authors.

Conflict Interest

The authors declare that there are no conflicts of interest regarding the publication of this paper. The research was conducted independently without any financial, commercial, or personal relationships that could be construed as a potential conflict of interest.

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