JURNAL BISNIS DAN AKUNTANSI
Vol. 24, No. 2, Des 2022, Hlm. 205-214
Akreditasi Sinta3 SK No. 23/E/KPT/2019

P-ISSN: 1410 – 9875
E-ISSN: 2656 – 9124
http://jurnaltsm.id/index.php/JBA

EFFECT OF CORPORATE GOVERNANCE MECHANISM AND OPERATING CASH FLOW ON FINANCIAL DISTRESS

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Received: December 9, 2021; Revised: September 10, 2022: Accepted: September 12, 2022

***Abstract*:** *This study aims to examine the effect of corporate governance mechanisms and operating cash flows on financial distress. The variable of corporate governance mechanism is measured through managerial ownership, institutional ownership, and audit committee. Managerial ownership can reduce conflicts of interest between principals and agents, while institutional ownership and audit committees are related to increasing supervision over company management. So, a good corporate governance mechanism can avoid financial distress. The adequacy of operating cash flow also greatly affects the efficiency and effectiveness of the company's operational activities. If the company has a negative operating cash flow, it will greatly hamper the company's operational activities. Companies can experience financial distress. This study uses data from manufacturing companies that have negative EBIT values for two years from three years of observation in 2017-2019 as the research sample. This study uses the SEM-PLS analysis tool to answer the proposed hypothesis. The results showed that managerial ownership, institutional ownership, and audit committee had no significant effect on financial distress while operating cash flow negatively significantly effect of financial distress. The greater the operating cash flow value, the smaller the possibility of the company experiencing financial distress. Conversely, the smaller the operating cash flow value, the greater possibility of the company experiencing financial distress.*

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***Keywords*:** managerial ownership, institutional ownership, audit committee, operating cash flow, financial distress

Abstrak: *Penelitian ini bertujuan untuk menguji pengaruh mekanisme corporate governance dan arus kas operasi terhadap financial distress. Variabel mekanisme corporate governance diukur melalui kepemilikan manajerial, kepemilikan institusional dan komite audit. Kepemilikan manajerial dapat mengurangi konflik kepentingan antara principal dan agen, sedangkan kepemilikan institusional dan komite audit berkaitan dengan peningkatan pengawasan terhadap pengelolaan perusahaan sehingga diharapkan dengan adanya mekanisme corporate governance yang baik maka financial distress dapat dihindari. Penelitian ini menggunakan data perusahaan manufaktur yang memiliki nilai EBIT negatif selama dua tahun dari tiga tahun pengamatan yaitu tahun 2017-2019 sebagai sampel penelitian. Penelitian ini menggunakan alat analisis SEM-PLS untuk menjawab hipotesis yang diajukan. Hasil penelitian menunjukkan kepemilikan manajerial, kepemilikan institusional maupun komite audit tidak berpengaruh secara signifikan terhadap financial distress sedangkan arus kas operasi berpengaruh negatif secara signifikan terhadap financial distress. Semakin besar nilai arus kas operasi maka kemungkinan perusahaan mengalami financial distress semakin kecil dan sebaliknya semakin kecil nilai arus kas operasi maka kemungkinan perusahaan mengalami financial distress semakin besar.*

Kata kunci: kepemilikan manajerial, kepemilikan institusional, komite audit, arus kas operasi, financial distress

INTRODUCTION

Information about the company's health is important for both external and internal parties of the company. This information helps them decide their respective interests. For internal company parties, company health information helps provide signals for management to determine strategies for improvement, prevention, or solutions to conditions that occur in the company. One condition that is of concern to management is when the company's health is in the stage of financial distress. Bae (2012) states that when a company is in financial difficulty, the market value of the company drops, suppliers demand cash payments on terms of delivery of goods or services and large customers cancel their orders in anticipation of late deliveries. Financial difficulties also result from more expensive financing due to additional capital loans. In addition, the company only focuses on projects that provide short-term benefits and skips projects that have long-term benefits. Financial difficulties can result in a decrease in management efficiency. Management must be able to control and find solutions to these conditions before the company's condition becomes no better, namely bankruptcy. The stage of finding the factors that cause financial distress to be able to find a solution is the first step that must be done. There are several causes of companies experiencing financial distress, including poor corporate governance mechanisms and the inability of the company's cash flows to fund company operations and pay maturing debts. Previous studies on the effect of corporate governance mechanisms on the occurrence of financial distress still show inconsistent results. Some research results show that corporate governance mechanisms reduce or avoid the occurrence of financial distress (Kristanti et al., 2016; Manzaneque et al., 2016) but the results of other studies have found no effect of corporate governance mechanisms on financial distress (Shahwan, 2015).

Cash flow has an important role in the company's financial management. High profits or profits do not necessarily indicate that the company has sufficient cash to pay off maturing debts so that insufficient cash can lead to financial distress in the company (Blanc & Setzer, 2015). Adequate cash availability is very helpful for management in carrying out the company's operational activities, facilitating the achievement of the company's strategy, and making profitable investments both in the short and long term. Adequacy of cash helps management in managing the company to reduce the potential for financial distress.

This study examines the effect of corporate governance mechanisms and operating cash flows on financial distress. Previous studies used dummy data to measure financial distress, while this study used the company’s EBIT value. This study uses manufacturing companies that have negative EBIT values for two years as research samples. This proxy is taken from one form of financial distress namely economic failure. This research is important because research about the factors that influence financial distress is still inconsistent. This is supporte the result of research by Amri & Aryani (2021). They reviewed twenty eight articles on financial distress from eight national journals indexed by Sinta 2.

The corporate governance mechanism used consists of three variables, namely managerial ownership, institutional ownership, and audit committee. Managerial ownership reduces the conflict of interest between the principal and agent to reduce agency costs. Institutional ownership and audit committee variables are related to increased supervision of company management so that financial distress

is expected to be avoided. This study uses the company's EBIT value as a proxy for the financial distress variable. This study uses manufacturing companies that have negative EBIT values for two years from three years of observation as research samples. This proxy is taken from one form of financial distress, namely economic failure. Economic failure is a condition where the company's income cannot cover the total cost of the company, including the cost of capital.

1. *Financial Distress*

Financial distress is a condition at the stage where the company experiences financial difficulties before going bankrupt (Platt & Platt, 2008). A company can be categorized as experiencing financial distress if the company has a performance that shows a negative operating profit, negative net income, the negative book value of equity (Brahmana, 2007). Companies experiencing financial distress take responsive actions such as reducing investment, reducing dividends, and carrying out restructuring strategies. The restructuring strategy can be carried out by considering the company's life cycle (Koh et al., 2015). Lifecycle theory states that growth strategy and capital capacity depend on the company's life cycle.

2. Corporate Governance Mechanism

The agency relationship perspective is the basis used to understand corporate governance. The essence of the agency relationship is the separation between ownership (principal/investor) and controller (agent/manager) as well as differences in interests between principal and agent. This difference in interests requires a mechanism to bring the two relationships closer so that the difference in interests will also be reduced. The existence of a corporate governance mechanism can create good corporate governance to prevent the occurrence of financial distress in the company. The results of research by Kristanti et al. (2016), Manzaneque et al. (2016), and Ria Murhadi et al. (2018) show that corporate governance mechanisms affect financial distress, but the results of Shahwan's (2015) research show that there is no significant relationship between corporate governance and the possibility of financial distress. The following is the relationship between the dimensions of the corporate governance mechanism on financial distress:

Managerial ownership on financial distress

Managerial ownership is a situation where the manager owns the company's shares or in other words, the manager is also the owner or shareholder of the company. Agency theory describes the company as the meeting point of the agency relationship between the company owner (principal) and company management as an agent. In agency theory, it is stated that there are differences in interests between the principal and the agent, but if the manager acts as an agent as well as the principal, the difference in interests can be minimized. Mandala et al. (2017) state that share ownership by managers can improve the quality of decisions, increase the actual harmonization of cash flows with profits, reduce the desire to manipulate profits because every manipulation action they take on the interests of the company ends up hurting them. Managers who own shares in the company try to prevent financial distress. Research results Manzaneque et al. (2016), Yuyetta Etna. (2019) and Hanifah & Purwanto (2013) show that managerial ownership has a significant negative effect on financial distress. The hypotheses are formulated:

H_1: Managerial ownership has a significant negative effect on financial distress.

Institutional ownership of financial distress

Institutional ownership is the percentage of voting rights owned by institutions (institutional investors). Institutional investors have an effective ability to control the management through a supervisory process. Supervision actions are carried out through

various rights that are obtained from the large percentage of shares owned. A certain percentage of shares owned by an institution can affect the process of preparing financial statements made by management which in turn can limit the behavior of management. The higher the institutional ownership, the higher the level of supervision so that financial distress can be avoided. The results of the research by Widhiadnyana & Dwi Ratnadi (2019) showed that institutional ownership had a significant negative effect on financial distress. The hypotheses are formulated:

H_2: Institutional ownership has a significant negative effect on financial distress

Audit committee on financial distress

The audit committee has a role in the process of supervising management in carrying out sound business management. The audit committee is tasked with assisting the board of commissioners to monitor the financial reporting process by management to increase the credibility of the financial statements of Suaryana (2005). The duties of the audit committee include reviewing the accounting policies applied by the company, assessing internal control, reviewing external reporting systems, and compliance with regulations so that the establishment of an audit committee within the company can prevent the company from experiencing financial distress. The audit committee has the power to examine reports from the company's internal auditors. This makes the audit committee have the opportunity to conduct a review of the organizational structure and internal control system that is owned by the company Chrisdianto (2013). The results of the research by Salloum & Gebrayel (2014) show that the frequency of audit committee meetings has a significant negative relationship to financial distress. The hypotheses are formulated:

H_3: The audit committee has a significant negative effect on financial distress

Operating Cash Flow on financial distress

The availability of cash in financing and paying the company's maturing debts is an important thing that must be considered by management. Leonie (2005) states that the ability to generate cash flows in the future is very important because it reflects the company's financial success to cover operations, current debt, interest, and dividend payments, and reinvest assets. Zaki & Rao (2011) stated that a positive net cash flow indicates the entity is in a healthy condition and can fulfill its obligations through net cash flow, and reduce leverage. An increase in cash flow can reduce the possibility of financial distress. Fawzi & Sanusi (2015), Kamaluddin, A, et.al (2019) and Veronica, Ida & Winata (2020) state that the cash flow ratio is a significant variable for predicting financial distress. Kordestani & Bakhtiari (2011) stated that financial distress can be predicted by the content and composition of the cash flow report. The results study of Safiq et al. (2020) show that future cash flows can provide a signal about financial distress. Karas & Reznakova (2020) examines the ability of cash flow to predict financial distress because insufficient cash flow has a close relationship with business difficulties. In addition, the cash flow approach has also been widely recognized in estimating business value and meeting the going concern assumption of the company, namely financial viability. The results showed that the operating cash flow ratio had an important role in financial distress, especially when combined with short-term debt. The hypotheses are formulated:

H_4: Operating cash flow has a significant negative effect on financial distress

RESEARCH METHODS

This study uses secondary data with documentation data collection techniques. The population of this research is manufacturing companies listed on the Indonesia Stock Exchange for the period 2017-2019. The sampling technique used is purposive sampling with the criteria of the company being sampled is a manufacturing company that has a negative EBIT value for two years out of three years of observation (2017-2019). This is the difference between this research and previous research. This research focuses on manufacturing companies experiencing financial distress. Here variable operational definition:

a. Managerial ownership
Managerial ownership is the number of shares by the management of the total share capital of the company being managed. The measurement used is based on the percentage of the number of shares owned by the management of the total outstanding share capital
b. Institutional ownership
Institutional ownership is the percentage of voting rights owned by institutions (institutional investors). The measurement used is based on the percentage of the number of shares owned by the institution from the total outstanding share capital.
c. Audit committee
The audit committee is a committee formed by and responsible to the board of commissioners in helping carry out the duties and functions of the board of commissioners. The measurement used is based on the number of audit committees in the company
d. Operating cash flow
Operating cash flow is cash flow from the company's operational activities. The measurement used is based on the value of the company's operational cash flow
e. Financial distress
Financial distress is a stage of declining financial conditions that occur in companies that previously experienced liquidation or bankruptcy. The measurement used is based on the company's EBIT value

This research uses the SEM-PLS analysis tool. SEM-PLS is a causal modeling approach that aims to maximize the variance of the latent criterion variable that can be explained by the latent predictor variable. Hypothesis testing using SEM-PLS analysis does not require the fulfillment of data normality assumptions because SEM PLS is seen as a nonparametric approach (Sholihin & Ratmono, 2021).

RESULTS AND DISCUSSION

The following are companies that in accordance characteristics to be the research sample. The characteristics are manufacturing companies that have negative EBIT values for two years out of three years of observation as the research sample. Companies that have a negative EBIT value indicate the company is experiencing financial distress

Table 1 Research Sample

	Company code	EBIT Negative 2017	2018	2019
1	ADMG	V	V	V
2	AISA	V	V	X
3	AKKU	V	V	V
4	ALTO	V	V	V
5	BAJA	V	V	X
6	BRNA	V	V	V
7	CCSI	X	V	V
8	CNTB	V	X	V
9	CTBN	V	V	X
10	ETWA	V	V	V
11	FPNI	V	X	V
12	GDYR	V	X	V
13	HDTX	V	V	V

14	KIAS	V	V	V
15	KICI	X	V	V
16	LMPI	V	V	V
17	MBTO	V	V	V
18	MASA	V	V	V
19	PCAR	V	V	V
20	POLY	V	X	V
21	RMBA	V	V	X
22	SMCB	V	V	X
23	SSTM	V	X	V
24	TIRT	X	V	V

Source: Data processed, 2021

The result of descriptive statistical test described in this table

Table 2 Descriptive Statistics

Variable	Min	Max	Mean
Mgt Owner	0,0	0,68	0,0556
Inst Owner	0,0	1,00	0,6
Audit committee	2,0	3,00	2,9
Operating cashflow (in trillion rupiah)	(94816)	81846	35231
Financial Distress (in trillion rupiah)	(521033)	13644	(19163)

Source: Data processed, 2021

Based on the table above, it can be seen that the minimum value for the managerial ownership variable is 0.00, the maximum value is 0.68 and the average value is 0.0556. The average value of only 0.0556 shows that the majority of the companies that are sampled in the study have very small managerial share ownership values. The average value does not even reach the value of 0.1 even though the maximum value is 0.68. The minimum value for the institutional ownership variable is 0.00, the maximum value is 1.00 and the average value is 0.6. The average value of 0.6 shows that the majority of the companies that are the sample of the study have a fairly large institutional ownership value.

The minimum value for the audit committee variable is 2.00, the maximum value is 3.00 and the average value is 2.9. The average value of 2.9 indicates that the majority of the companies that are the sample of this study have three audit committees. This shows the company's compliance with the Financial Services Authority (OJK) regulation No.55/POJK.04/2015 article 4 states that the audit committee must have at least three people from independent commissioners and from parties outside the issuer or public company.

The minimum value for the operating cash flow variable is -94816, the maximum value is 81846 and the average value is 35231. Although the minimum value of operating cash flow is negative, the average value of the sample company's operational cash flow is positive. This shows that although the research sample taken has a negative EBIT value, it still has sufficient cash flow for operational activities.

The minimum value for the financial distress variable is -521033, the maximum value is 13644 and the average value is -19163. The average value of the financial distress variable is negative because the proxy used for the financial distress variable is the EBIT value, which is mostly negative.

The goodness of Fit Model

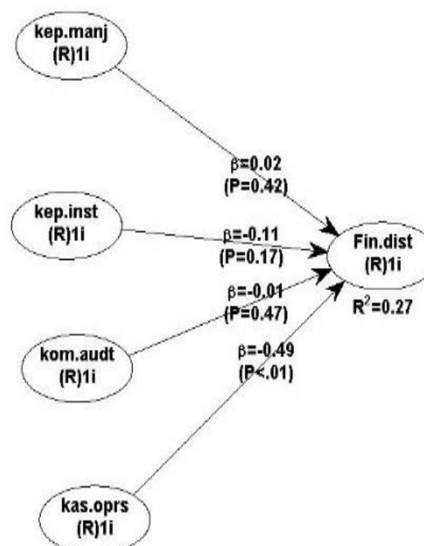
To test the proposed model, we use the goodness of fit model test. The goodness of fit model is a measure that states whether the model form can be used to test the proposed hypothesis. The model is said to be fit if the value of each criterion meets the existing threshold value. Table 3 shows that the tested model meets the goodnes of fit model. It can be

concluded that all models can be used for further analysis.

Table 3 Overall Model Fit

Item	Criteria	Result	Conclusion
Average path coefficient (APC)	P <0,05	P=0,041	Model fit
Average R-squared (ARS)	P<0,05	P=0,004	Model fit
Average adjusted R-squared (AARS)	P<0,05	P=0,01	Model fit
Average block VIF (AVIF)	acceptable if <= 5, ideally <= 3,3	1,120	Model fit
Average full collinearity VIF (AFVIF)	acceptable if <= 5, ideally <= 3,3	1,437	Model fit
Tenenhaus GoF (GoF)	small >= 0,1 medium >= 0,25 large >= 0,36	0,521	Large
Sympson's paradox ratio (SPR)	acceptable if >= 0,7, ideally = 1	1,000	Model fit
R-squared contribution ratio (RSCR)	acceptable if >= 0,9, ideally = 1	1,000	Model fit
Statistical suppression ratio (SSR)	acceptable if >= 0,7	1,000	Model fit
Nonlinear bivariate causality direction ratio (NLBCDR)	acceptable if >= 0,7	0,875	Model fit

Hypothesis test results



Based on the picture above, it can be seen that the variables of the corporate governance mechanism, namely managerial ownership, institutional ownership and audit committee have no significant effect on financial distress. This can be seen from p>0.05. These results indicate that hypotheses one, two and three are not supported. Managerial ownership has no significant effect on financial distress because the average number of shares owned by managers is very small. Ownership of very few shares does not make them a controller. The decisions they make are influenced by other parties, namely the controlling shareholder so that the existence of the shares they own does not affect the health condition of the company. The results of research by Shan, Y. G. (2019) show that managerial ownership actually has a negative effect on firm value. Arora & Sharma (2016) conducted a study by examining the effect of institutional ownership on company performance. The company's performance is measured using five ratios, namely Tobin's Q, stock return, net profit margin, return on assets and return on equity measured using stock return, net profit margin, return on assets and return on equity. The results of Udin et al (2017)

also show that institutional ownership does not significantly affect financial distress. This is because institutional investors tend to play a passive role. The audit committee has no significant effect on financial distress. The results of this study support the research results of Nuresa & Hadiprajitno (2013) which found that there was no effect of the size of the audit committee on financial distress. Most of the companies studied have a number of audit committees as many as three people and this is in accordance with the Financial Services Authority (OJK) regulation No.55/POJK.04/2015 article 4. The number of audit committees does not affect the company's financial condition but may be influenced by other aspects such as the understanding and experince of the audit committee, the independence of the audit committee and the active role of the audit committee. Meanwhile, the fourth hypothesis proposed can be supported. Operating cash flow has a significant negative effect on financial distress. The greater the value of operating cash flow, the smaller the possibility of the company experiencing financial distress and conversely the smaller the value of operating cash flow, the greater the possibility of the company experiencing financial distress. The results of this study support the research of Fawzi et al (2015), Kordestani & Bakhtiari (2011), Safiq & Kusumastati (2020), Kamaluddin, A, et.al (2019) and the research of Karas & Reznakova (2020).

CONCLUSIONS AND SUGGESTION

Based on the results of the discussion, the conclusion can be given is the corporate governance mechanism (managerial ownership, institutional ownership, audit committee) has no significant effect on financial distress. Managerial ownership of shares can make managers more careful in making decisions. However, if we view from data that shows the number of shares owned by managerial is very small, it can be concluded that managerial is not the controller. There is a possibility that important decisions made by managerial are influenced by controlling shareholders so that the impact of these decisions is financial distress experienced by the company. Institutional ownership does not significantly affect financial distress. The role of institutional ownership as the controller does not work as it should, this is because institutional investors tend to play a passive role. The audit committee has no significant effect on financial distress. When viewed from the number of audit committees, this is in accordance with the regulations issued by the OJK. However, this is not enough for the audit committee to carry out its role. There are several other factors that are needed such as the understanding and experience of the audit committee, the independence of the audit committee and the active role of the audit committee.

The operating cash flow statement has a significant negative effect on financial distress. This shows the company's ability to operational activities finance and the ability to pay maturing obligations are factors that affect companies experiencing financial distress. This study uses the number of audit committees to measure the audit committee because it is listed in OJK regulations. Further research can use other indicators in measuring the audit committee. The next researcher can use the frequency of audit committee meetings, the audit committee's understanding of the financial statements and the independence of the audit committee

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