Corporate Governance Impacts on Bankruptcy

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Corporate Governance and Bankruptcy Risk

Literature suggests a strong correlation between corporate governance and controlling bankruptcy risks. To understand the relationship, the theory suggests studying the impact of corporate governance on debt. Corporate governance and strict bankruptcy laws affect the level of debt.

Corporate governance negatively influences the cost of debt, while its impact on the amount of debt is positive. Bankruptcy laws influence firms with poor corporate governance standards more than companies with efficiency standards. The lower level of corporate governance causes firms to suffer the consequences of bankruptcy laws. Poor corporate governance involves high bankruptcy risks, while the study uncovers the role of corporate governance and bankruptcy in the variable of debt. The central factor that builds an association between the two variables is the borrowing power of the board members. The decisions of the members regarding borrowing and crediting have a direct impact on bankruptcy risks. The findings indicate that the cost of debt does not depend on the audit committees depicting an independent relationship between the two factors. Better corporate governance suggests lowering the cost of debt but increasing debt. Other findings depict that effective corporate governance with strict bankruptcy laws lowers the risks of debt default. Protecting creditors' interests also poses high risks in the case of weaker corporate governance. Ownership structures, the board of directors, and stakeholders have a significant influence on controlling bankruptcy risks (Funchal, Galdi, & Lopes, 2008).

Darrat, Gray, and Park (2014) identify different factors of corporate governance that impact bankruptcy risks. The study suggests that the variables of corporate governance are significant predictors of risks involved in bankruptcy. The findings reveal a strong relationship between corporate governance and bankruptcy risks. Firms with larger boards are capable of reducing risks of bankruptcy. The impact of corporate governance on bankruptcy risk increases with time. Changes in corporate governance increase the risks of debt default. However, a strong association exists between efficient corporate governance involving a large board, effective structure, and policies with low bankruptcy risk (Darrat, Gray, & Park, 2016).

Evidence on Governance and Debt Default

Wang and Ling (2010) explored the impact of corporate governance on risks of debt default. The assessment of previous studies depicted that corporate governance rules had significant non-linear impacts on bankruptcy risks. Negative association prevails between governance provisions and the likelihood of default as it provides opportunities for fending off the managers. Conservative policy choice was the selection of managers that increased the risk factor. Managerial benefits of control are more likely to reduce the value of a firm, which again contributes to an increased risk of debt default. Stronger corporate governance decreased the probability of risk while weak governance resulted in increased default risk. The regulatory response has a direct relationship with the bankruptcy risk. The firm's operational complexity increases due to an increase in monitoring of the optimal board, resulting in high marginal benefits for the firm. Optimization of stakeholders' value often results in high bankruptcy risks because they are more likely to change the board that fails to maximize their gains. In such a case, the risk of defaulting on debt will increase substantially. Effective corporate control policy manages internal conflicts through different tactics that minimize the risks of bankruptcy. Poor judgments of decision-makers and weak internal and external controls result in increased risks. A power-sharing relationship between corporate governance and stakeholders results in inefficient decisions. The rights of stakeholders have a correlation with equity value, and they demand high value. Reduction in stakeholders' rights acts in favor of efficient corporate governance that reduces risks of debt default. The results depend on 201 cases of bankruptcy, confirming a strong correlation between corporate governance and bankruptcy risks. Poor profitability of firms reflected weak corporate governance due to ineffective decision-making that resulted in increased default risks (Wang & Lin, 2010).

Board Ownership and Financial Distress

Manzaneque, Priego, and Merino (2016) study the role of corporate governance, including ownership and characteristics of the board, on bankruptcy risks. The research design emphasized 308 observations, classifying them as distressed and non-distressed findings. The study identifies bankruptcy risk as a business failure and explores its relationship with corporate governance. The size of the board has a negative correlation with financial distress, which depicts low bankruptcy risks. Large board size minimizes the risks of a debt default that a firm faces. An efficient audit committee is part of strong corporate governance, which results in improved access to information and resources. The relationship between efficient audit committees and corporate governance exhibits a positive impact on controlling bankruptcy risk. The results also depict the negative role of large stakeholders and their power on bankruptcy risk. The high power of stakeholders results in increased risks of debt default. High stakeholder power influences the decisions of the board and audit committee, resulting in weak corporate governance (Manzaneque, María, & Merino, 2016).

Corporate Governance and Firm Survival

Chancharat (2013) determined how corporate governance influences bankruptcy risks and their association with a company's survival. The survival of the firm depends on controlling default risk. Companies with efficient corporate governance are able to minimize risks associated with bankruptcy, thus improving their financial position. The prediction of financial distress and firms' ability to manage bankruptcy risks depends on the performance of corporate governance. Corporate governance with a large board lowers the threats of financial distress as the likelihood of efficient decision-making increases. The limited role of stakeholders in a firm's decisions also minimizes default risks that enhance the firm's survival opportunities. The findings also reveal the negative role of stakeholders' interest in controlling the decisions of the board and managers. Increased involvement of stakeholders increases the risks of debt default and declines the chances of a firm's survival (Chancharat & Chancharat, 2013).

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