

Determinant of financial restructuring of financially distress firms in Indonesia

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Abstract:

This study aims to test the effect of monitoring agency variable : leverage, ownership structure and corporate governance on the probability of the firm choose a financial restructuring using dividend cut and debt increase as proxies. This study focuses on the restructuring strategy on manufacturing firms that experience declining performance, using the proxy of decreasing Return on Assets for two consecutive years, in the period of 2007 until 2017. Data analysis techniques using panel logistic regression through Eviews Program. The result shows that leverage, managerial ownership, and size board of director and capital intensity (as control variable) have significant impact on the probability of choosing a financial restructuring strategy through dividend cut, and the second panel data shows that institutional ownership, size board of director and liquidity have significant impact on the probability of choosing a financial restructuring through debt increase. This study provides strengthening empirical evidence about the impact of agency monitoring variables on the probability of financial restructuring choices in distress firms. This study is appropriate to carried out in Indonesia, which has a high leveraged firm on average 43%.

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I. INTRODUCTION

The global economic crisis in 2008 affects the performance of firms listed in Indonesian Capital Stock Exchange (IDX). There are several manufacturing firms that have to delisting as the result of crisis. A firm can be classified as facing financial distress if the firm shows negative operational performance, negative net profit, negative book value of equity, and firms that perform merger. It is also indicated by the decrease in the financial performance, insolvability and stock price. This can be detected through firm policies in solving this situation, such as merger and acquisition, dividend cut, delisting, and the shift in Z-score.

Domestic and global crisis has affected the condition of firms in all sectors such as the manufacturing sector. Manufacturing industry grew 4.7% in 2007 has dropped to 2.1% in 2009, suggesting slowing global demand were feared

declining performance of the manufacturing firm. (www.kompas.com; July 2016). Manufacturing firms also experience the decrease in term of financial performance, in this case Return On Assets (ROA), during the period of 2003-2009 or prior to and after the global crisis. The decrease in financial performance is the indication of financial distress. Firms in emerging countries are characterized by the high growth, leverage, ineffective corporate governance, and different legal and institutional context compared to the firms in the developed countries, thus we may argue that they may developed difference restructuring strategy to solve different situation (Lai & Sudarsanam, 1997). Firm performs restructuring to restore firm's performance through various strategies, asset restructuring, financial restructuring, or managerial restructuring (Lai & Sudarsanam, 2001). This article focused on financial restructuring because the problem in

capital structure becomes relevant in Indonesian firms as these firms share the characteristic of firms in emerging country, experiencing high leverage and financial distress. Previous research on determinants variables of probability of choosing financial restructuring has been done and as a references (Pandey, et al. 2015; Koh, et al. 2015; Ofek, 1993; Lai & Sudarsanam, 1997; Astha, 2004). Pandey, et al. (2015) findings were restructuring strategy choice is affected by monitoring agency variables. This empirical finding is supported by Lai & Sudarsanam, (1997); Ofek (1993); Jun Zao, (2009); Astha, (2004).

This article focused in financial restructuring because most of the firms that experience distress in Indonesia experience the difficulties in payment their debt and usually has high leverage ratio (Lai & Sudarsanam, 1997; Ofek, 1993). Indonesia an emerging country needs high leverage or high external funds, have ineffective corporate governance, low protection of minority investors, and still experience agency conflict, thus the restructuring is usually implemented by dividend payout reduction or debt restructuring. (Koh et al., 2015, La Porta, et al., 2000).

II. Literature Review and Hypothesis Development

Distress Firm and Restructuring Strategy

Restructuring is a popular term in the last 25 years in America and Europe (Hoskisson et al., 2005). Restructuring is divided into three forms, assets, financial, and management restructuring (Astha, 2004; Johnson, 1996). The structure used in this economic context indicates a specific and stable relationship between the key elements of a function or certain process. This structure defines the constraints in which the institution in daily operation tries to reach better economic performance. Thus, restructuring can be defined as an effort to change the institution structure in order to solve several or all short term obstacles. Restructuring is related with the change in the

structure to achieve long term strategy (Astha, 2004). Financial restructuring is defined as the change in financial structure or capital structure to solve financial difficulties, especially interest payment, is divided into two strategies: equity based strategy such as dividend cut, right issue, and SEO; and debt-based restructuring such as Net Debt and Debt extension (Lai & Sudarsanam, 2001). Firm with high leverage tends to choose strategy to reduce or eliminate dividend because of liquidity constraints, maturity of loans, or the consideration of bargaining position (DeAngelo and DeAngelo, 1990). Empirical evidence suggests that large firm tends to respond toward financial difficulties with rapid and aggressive dividend cut (DeAngelo and DeAngelo, 1990; John, Lang, and Netter, 1992). Most of the large firms take dividend cut to respond into the decline in performance (John et al., 1992)

Pandey (2015) differentiate restructuring into three main restructuring strategies, and then divides it into 16 different strategies: 1). business (assets) restructuring including assets reduction (cost rationalization-CR), Assets divestment-AD), Assets expansion (assets acquisition-AA), New market (NM), and change business (CB); 2). Financial restructuring including Debt restructuring (Debt to equity swap-DES), Debenture (DB), Convertible (CB), Debt extension (DE), Debt haircut (DH), equity based (equity issue-EI), and Dividend cut (DC); 3). Management Restructuring including Creditor presence (CP), changing board of director (CBM), ESOP, and Management turnover (MT). The differences in the classification of restructuring among researchers are related and complementary. Pandey (2015), for example, summarizes the classifications into three main groups, assets, financial, and management restructuring.

Koh et al. (2015) test the implication of lifecycle that affect the selection of restructuring strategy of firms that experience decline in performance, and find empirical evidence that

strategy selection can be affected by corporate life cycle: birth, grow, maturity, and decline, this effect will direct firms to financial restructuring choices such as dividend cut or changing capital structure. Related research is also done by Pandey (2015) by entering the agency variables and characteristics of the firm as a control as a determinant of restructuring options strategy in developing countries of Thailand. His findings were restructuring strategy choice is affected by both the agency and the control variable factors, this finding has similarities with the findings of similar studies in developed countries such as Lai & Sudarsanam, (1997); Ofek (1993); June Zao, (2009); Astha, (2004). The equation is on the behavior of the agency that is leverage, have a tendency to choose choosing a strategy of debt restructuring than acquisitions. Selection restructuring strategies can be tested in the context of inter-agency conflict stakeholders to explain the agency variables influence the probability of selecting or avoiding certain restructuring strategy. (Pandey, 2015)

Leverage

Firm with high leverage will receive careful monitoring from investors because there is small room for mistakes (Lai & Sudarsanam, 1997). Firms with high leveraged are relatively dominant in influencing the decision-making process in choosing the strategy of a firm restructuring. Ofek (1993) examined the effect of leverage on a restructuring strategy and stated that the high leverage may increase the probability of firms choose a strategy of financial and operational restructuring. (Ruud et al., 2003). Leverage determines how firm will react toward the decline in performance and how to turnaround (Lai & Sudarsanam, 1997; Ofek, 1993; Kang & Shivdasani, 1997). Jensen (1989) argues that the leverage effect on the probability of the firm in choosing a financial restructuring / debt is expected to have a positive direction, meaning that the higher the leverage, the trend of firms

choosing a financial restructuring / debt higher. Lai and Sudarsanam (1997) also found a positive relationship between leverage and all of its restructuring strategy. Leverage of large firm is found to affect the choice of restructuring of firms that experience decline in performance in Korea (Kang et al., 2013). Pandey (2015) state firms with high debt proved statistically significant has high tendency to select all of the financial restructuring strategies such as Convertible Debenture, Haircut Debt and Equity Issues (CB, DB, DH, EI). Koh et al. (2015) states that leverage does not affect financial restructuring in Thailand, both in equity based through dividend cut or debt restructuring through net debt. Based on the varied result of studies, the proposed hypothesis is as follows:

Hypothesis 1: Leverage impacts on the probabilities of financial restructuring strategy choices

Managerial Ownership

According to Jun Zhao (2009), owners tend to have strong influence on the diversification types/restructuring strategy related with the implementation of firm organizational structure, the different ownership structure may affect the nature of restructuring activities selected by certain business group. Studies have found that in American and other developed countries, types of ownership affect corporate strategy. Dominant stockholders will use their influence to redirect firm that experiences a decline in performance. Restructuring measures depend on stockholder's preference. Stockholders seem to unfavorable views on Dividend Cut (DC), Equity Issues (EI), or sales of assets to pay debts (Lai and Sudarsanam, 1997; Lang et al., 1995). On the other hand, they will support the debt restructuring, as the lender (creditor) will make some concession or agreement between the creditor and the debtor. The deal could be a lighter debt repayment before the debt restructuring (Ruud, et.al, 2003).

However, the influence of dominant stockholders may create another conflict. The exploitation for stockholder's interest and supervision may cause the change in the member of previous BOD, influence decision making for risky projects, and causes the collaboration with creditors to take over minority stockholder's capital. The moral hazard do the controlling shareholder (blockholder) increase the agency cost of debt due to excessive dividend payments or through substitution of assets for high-risk projects that benefit shareholders (Jensen and Meckling, 1976). Demsetz and Lehn (1985), Crutchley and Hansen (1989), conclude that the high level of managerial ownership can be used to reduce agency problems. Based on this assumption, it is hypothesized that:

Hypothesis 2: Managerial ownership impacts on the probability of financial restructuring strategy choices

Institutional Ownership

Institutional ownership shows positive relationship with assets and management restructuring strategy (Cost rationalization-CR and Creditor presence). Firms with controlling shareholders showed a significant negative correlation statistically Creditor strategy Presence in the shareholder structure This due to new stockholders tends to compete with the stockholders who are currently in the ownership structure (Pandey, 2015). Their researchers show that institutional ownership significantly affects financial restructuring through debt restructuring. If institutional ownership is greater, firms have stronger bargaining power to get lending from lenders (Koh et al., 2015). Kohh et al. (2015) finding is straying from agency cost theory, control mechanism in firm with institutional ownership will be stronger in controlling manager

behavior, resulting in the greater trust from external party. Effective monitoring may reduce the use of liabilities (Crutchley et al., 1999). Based on this assumption, it is hypothesized that:
Hypothesis 3: Institutional ownership impacts on the probability of financial restructuring strategy choices

Boards of Director

The size of BOD shows positive relationship with CBM strategy and the issuance of bonds (DB). This may be caused by the large size of BOD affects the CBM. However, the size of BOD shows negative and significant relationship with Dividend Cut strategy, when the dividend payout policy as a mechanism for reducing the agency conflict between management and shareholders (Pandey, 2015) (Pandey, 2015). Jun Zhao (2009) finding shows that compared to another type of ownership, government owned enterprise tends to increase their business coverage through assets restructuring strategy, while private business groups tend decrease the scope of their business through financial restructuring strategies such as divestitures and spin-offs. Based on this assumption, it is hypothesized that:

Hypothesis 4: Boards of director impacts on the probability of financial restructuring strategy choices

The selection of restructuring strategy is also affected by non-agency variables (Lai and Sudarsanam, 1997) and this method can become the internal and external factors. The additional factors added into logistics regression analysis as control variables including capital intensity, liquidity, and firm size. But not hypothesized in this study.

Figure 1 shows the conceptual model assumed in this study (see [Figure1](#)).

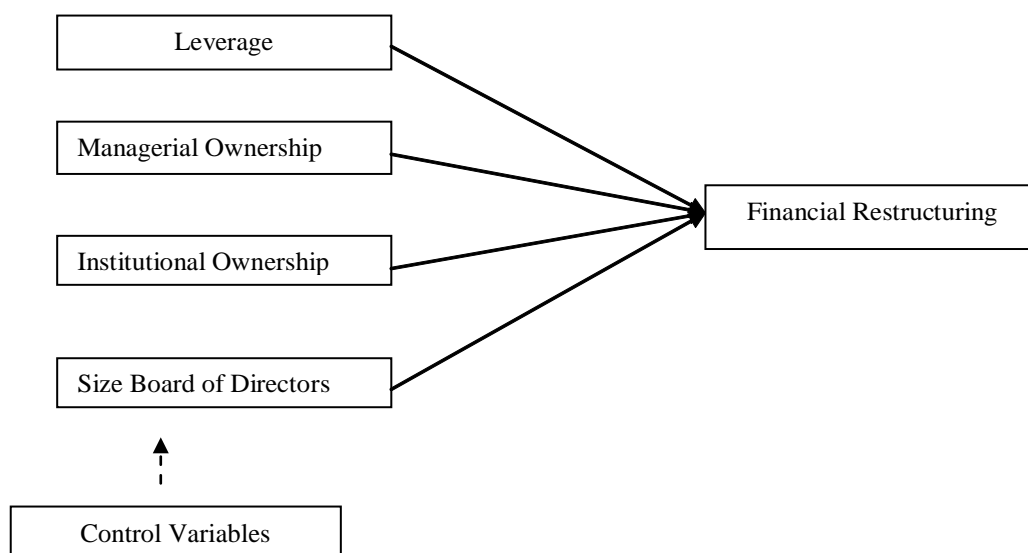


Fig.1. Research Model

III. Methodology

Sample and Data Collection

The sampling procedure conducted by defining the declining ROA for two consecutive years in 2007-2017. Two years provide sufficient number of firms to be analyzed and provide sufficient time for firms to deal with the declining performance. The population of this study is manufacturing firms listed in IDX in 2007-2017 with total number of 188 firms. The samples are manufacturing firms that experience declining ROA for two consecutive years with the total number of 81 firms and total observation of 810 observations. The firms that are delisted and bankrupt are excluded from the sample.

Measurement

The variables used in this study are independent variables, dependent variables, and control variables (Pandey, 2015). The independent variables are agency monitoring variables that consist of:

Leverage (Lev)

Leverage measured by dividing total debts to total assets.

$$\text{Lev} = (\text{Total debt} / \text{total assets}) \times 100\%$$

Managerial Ownership (Mgr)

Insider ownership measured using the percentage of stock ownership by commissioner, directors or managers.

$$\text{Mgr} = \% \text{ shareholding by commissioner, director or managers}$$

Institutional Ownership (Inst)

Institutional ownership measured using the percentage of stock ownership by foreign and domestic entities.

$$\text{Inst} = \% \text{ shareholding by domestic and foreign financial entities}$$

Size Board of Directors (Board)

Size Boards of director measured using the number of director owned by firm

$$\text{Board} = \text{total number of firm's directors}$$

The dependent variables consist of:

Dividend cut (DC)

Dividend Cut is the decrease in the dividend growth or dividend elimination, scored 1 if there is decline in dividend growth from t-1 until t during research period

Debt Increase(DI)

Debt increase is the level of debts that increases higher than the book value of total assets from t-1 until t during research period. Scored 1 if there is increases and 0 for the contrary.(Koh et al., 2015)

The control variables consist of:

Capital intensity (Int)

Capital Intensity measured by dividing sales revenue with fixed assets

$$\text{Int} = (\text{sales revenue}/\text{fixed assets})100\%$$

Liquidity (Liq)

Liquidity measured using current ratio computed by dividing current assets with current liabilities

$$\text{Liq} = (\text{currents assets}/\text{current liabilities})100\%$$

Firm size(Size)

Firm size measured using natural logarithm of total assets (Pandey, 2015, Koh et al., 2015)

$$\text{Size} = \ln \text{Total Assets}$$

Analysis Technique

The technique used to analyze the data is logistic regression using Eviews program. After the prediction variables are identified, the binary logistic regression is performed by entering the variables in the model one by one. The logistic regression model is:

$$L_i = \ln (p_i / 1 - P_i) = Z_i = \beta_1 + \beta_2 X_i \quad (1)$$

$$DC_i = \beta_1 + \beta_2 Lev_t + \beta_3 Mgr_t + \beta_4 Inst_t + \beta_5 Board_t + \beta_6 Int_t + \beta_7 Size_t + \beta_8 Liq_t + \mu \quad (2)$$

$$DI_i = \beta_1 + \beta_2 Lev_t + \beta_3 Mgr_t + \beta_4 Inst_t + \beta_5 Board_t + \beta_6 Int_t + \beta_7 Size_t + \beta_8 Liq_t + \mu \quad (3)$$

IV. Result and Discussion

Result

Hypotheses Testing

We analyze the determining variables of financial restructuring strategy using logistic regression on panel data. As expected, the agency variables: leverage, management ownership, and firm characteristics simultaneously affect the selection of financial restructuring strategy. Fit model is assessed from Hosmer-Lomesow value. Based on the result of analysis using Eviews, we find that the proposed models DC(2) and DI (3) achieved Hosmer-Lomesow value of DC 17.6726 and DI 8.5016 with Chi Square probability of 0.4774 dan 0.3861 or higher than alpha value tolerated at 5%, thus supporting H_0 which states that the model is fit or there is no significant difference between the observation and predicted value from the model. The power of independent variables can be accessed from the R^2 value of 3.7 (3.5) percent. While the result of logistic regression analysis shows the determinant influence of financial restructuring as follows: see Table 1 and 2.

Table1
Logistic Regression Summary Dividend Cut (DC)

Variable	Z statistics	Odd ratio	Sig.
Leverage	1.782377	1.012457	.0477
Managerial Ownership	-1.680527	0.331877	.0535

Institutional ownership	-0.905462	0.444861	.0365
Size Board of Director	2.745821	1.132740	.0060
Capital intensity	-1.638036	1.000000	.0612
Size of firm	-2.817390	0.871941	.0048
Liquidity	-0.024013	0.998774	.0609

χ^2	.477
LR Statistics	26.8988
Adjusted R Square	.037

Table 2
Logistic Regression Summary Debt Increase (DI)

Variable	Z statistics	Odd ratio	Sig.
Leverage	-1.037161	0.770657	.2997
Managerial Ownership	1.383809	2.461244	.1664
Institutional ownership	1.757214	4.871031	.0589
Size Board of Director	3.053308	1.161640	.0023
Capital intensity	1.263324	1.000000	.2065
Size of firm	-0.454724	0.977051	.6493
Liquidity	-1.892811	0.890312	.0509

χ^2	.386
LR Statistics	25.08594
R Square	.035

V. DISCUSSION

Table 1, we can see that the z value of dividend cut for Leverage is 1.782377 (p. 0.0477), which means that partially, leverage affects the decision of financial restructuring through Dividend Cut strategy but not prefer Debt Increase strategy. Thus, the hypothesis is supported with the positive direction as predicted. If we consider the odd ratio value of 1.012457, it shows that firms tend to

select dividend cut strategy to perform financial restructuring when they experience distress. Firms with high leverage have a tendency to select financial restructuring such as dividend cut and debt restructuring strategy (Ofek, 1993; Lai & Sudarsanam, 1997; Pandey, 2015). However, this result is not supported by Koh et al. (2015) and Hillier & Patric (2005) who find empirical evidence that leverage does not affect firm which

is choosing financial restructuring strategy especially through dividend cut. Table 2, we can see that there is z value of debt increase strategy of Leverage is -1.037161 (p. 0.2997) and odd ratio of 0.770653; less than 1, which indicates that debt addition is unfavorable or the higher leverage has lower tendency of taking debt strategy. This finding does not support the finding from previous studies.

While for the variable management/insider ownership in table 1, there is significant influence of this variable on firm decision in selecting financial restructuring through dividend cut with the coefficient of -1.680527* (p.0.0535). Thus, the proposed hypothesis is supported. If we consider the odd ratio value of 0.331877; which is lower than 1, it indicates that dividend cut strategy is unfavorable for firms with a larger managerial ownership structure. This result does not support Pandey (2015), Lai (1997), and De Angelo (1990). Managerial ownership affects the probability of firm to choose financial restructuring strategy, according to agency theory which states that ownership structure can reduce agency conflict through monitoring mechanism such as dividend cut policy. This is also support the residual theory of cash dividend, if the company has excess cash it should distributeto shareholders as dividend. (Chrutcley & Hansen, 1989). This finding supports Fan et al. (2013) who proves that ownership structure affects the behavior of firm that experience distress to restructure their capital structure through restructruing strategy. Xu-Dong Ji (2015) finds that management ownership affects the bankruptcy and relates it with its effect on restructuring strategy. But in table 2, we can see that managerial ownership doesn't significant affect probability of the firm to choose debt increase strategy. But if we see the value of odd ratio 2.4612 greater than one indicates firm tend to choose debt increase strategy.

The finding proves that institutional ownership affect financial restructuring decision through debt

increase with coefficient value of 1.757214 (p. 0.0789) (see table 2). From the odd ratio value of 4.87103; higher than 1, indicates that firms with higher institutional ownership tend to perform financial restructuring through debt increase. This finding is supported by Pandey (2015) and Koh et al. (2015), but not supported by Knyazera (2011) who states that institutional ownership is related with dividend policy. But in Dividend cut model (Table 1), institutional ownership has odd ratio value lower than 1, it indicates firm with higher institutional ownership doesn't like to choose dividend cut strategy.

Component of corporate governance, size board of director, has significant effect on the financial restructuring through dividend cut with z coefficient of 2.745812 (p. 0.006). From the odd ratio of 1.1327 (higher than 1), it indicates that firm with more members of BOD tend to select dividend cut as their financial restructuring strategy (see Table 1). Thus, the proposed hypothesis is supported, this result also supported by Pandey (2015), in which board size has significant effect on dividend cut strategy. Then, in table 2, we also see the significant effect of BOD size on debt restructuring, this means that boards affects the selection of debt increase strategy with z value of z 3.053308 (p. 0.0023) and odd ratio value of 1.1616 (higher than 1). This indicates that the larger the size of board of director, the most likely firm to perform debt restructuring strategy compared to the firms with small board of directors. This result contradicts Pandey (2015), Koh et al. (2015), and Susan et al. (2002) who proves that the size of board does not significantly affect the outcome of financial distress.

Firms that experience declining performance will try to restore their condition, manager as the one who responsible in managing the firm will choose restructuring strategy that will include stakeholders with the main objective of maximizing stockholders value. This study test the effect of corporate governance, leverage, and firm

characteristics on the selection of financial restructuring strategy measured using dividend cut and debt increase, whether or not these determinants significantly affect managerial decision. Based on the analysis result, we find empirical evidence that leverage, corporate governance, ownership, and firm characteristics affect the decision of financial restructuring in Indonesia simultaneously. However, partially, leverage, manager/insider ownership, board of directors, and the control variables of capital intensity and firm size affect the dividend cut strategy. Even though only leverage, board of directors, and capital intensity that actually affect the tendency of manufacturing firms in Indonesia to choose dividend cut strategy. Meanwhile, institutional ownership and board or directors affect the tendency to choose debt increase strategy. This finding is consistent with the finding in previous studies, which proves that the variables of agency and corporate governance (board of directors) have an effect on the tendency of firms to choose both for dividend cut and debt increase strategy.

The results of this study can prove empirically about the impact of agency monitoring variables and company characteristics as a control variable on the probability of choosing financial restructuring strategy and add references in financial management, especially corporate restructuring theory. The results of this study are expected to produce a mapping of restructuring strategy choices based on the determining variables so that they are able to make the decision to choose the most appropriate restructuring strategy.

VI. Limitation and Future Research

This study still contains the limitation is selecting the proxy that determine the decline in firm performance. This due to the database on the firms that experience declining performance is not available, thus we employ a proxy and the fit in selecting a proxy becomes a limitation. Besides

that, this study only focused on one restructuring strategy that is financial restructuring. Thus the finding cannot provide the alternative of restructuring strategies for decision maker. Future studies may focus on another strategy such as business and management restructuring. The implication of this study is providing empirical support on the influence of agency variables and corporate governance on the decision in firm financial restructuring strategy.

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