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Corporate Governance and Financial Distress: evidence from Taiwan

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Abstract

Prior empirical evidence supports the wealth expropriation hypothesis that weak corporate governance induced by certain types of ownership structures and board composition tends to result in minority interest expropriation. This in turn reduces corporate value. However, it is still unclear whether corporate financial distress is related to these corporate governance characteristics. To answer this question, we adopt three variables to proxy for corporate governance risk, namely, the percentage of directors occupied by the controlling shareholder, the percentage the controlling shareholders shareholding pledged for bank loans (pledge ratio), and the deviation in control away from the cash flow rights. Binary logistic regressions are then fitted to generate dichotomous prediction models. Taiwanese listed firms, characterised by a high degree of ownership concentration, similar to that in most countries, are used as our empirical samples. The evidence suggests that the three variables mentioned above are positively related to the risk for financial distress in the following year. Generally speaking, firms with weak corporate governance are vulnerable to economic downturns and the probability of falling into financial distress increases.

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