

THE EFFECT OF BOARD PRACTICES OF CORPORATE GOVERNANCE ON FIRMS' FINANCIAL DISTRESS LIKELIHOOD IN SRI LANKA

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Introduction

The relationship between corporate governance and financial distress is a matter of great interest nowadays. According to the Lee and Yeh (2004) corporate governance was regarded as one of the key factors which caused the Asian financial crisis in 1997. In the global context a high degree of business failures could be seen in 1930s in the aftermath of the stock market crash in 1929 and subsequent great depression. And also the great recession in 2007 led by which was the subprime mortgage crisis. Apart from macro-economic condition leading to corporate collapse, recent financial scandals too have been caused on the large firms like Enron, WorldCom, Parmalat and Satyam to collapse, questioning again the integrity of the governance of corporate. This suggests that governance especially in publically listed companies play a vital role in determining the survival and growth of business. Seen in this light, corporate collapses stemming from poor governance practices have been attracted much attention of many scholars. In this context, the said

association of governance attributes with the financially distressed companies of an emerging market like Sri Lanka is an area, which could yield grater deal of diversity from that of developed markets. Therefore the use of bankruptcy prediction model for assessing financial distress of Sri Lankan companies and relationship of attributes of governance practices on financial distress has not been completely addressed by previous studies. In this light the present study attempts to examine the board practices of the financially distressed companies and to investigate whether that structure have consequences for the firm's financial distress.

Methodology

Hypotheses Development

The findings of Gilson (1990) and Gilson and Vetsuypens (1993) clearly demonstrate that firms change elements of their governance structure after experiencing financial distress. Therefore empirical findings imply the question of whether more optimal board practices of governance structure could have prevented the onset of

distress. Based on this reasoning, it was hypothesized that:

- H1:** There is a negative relationship between compliance of Board Structure in corporate governance practices and probability of finance distress of the firm.
- H2:** There is a negative relationship between compliance of Board Independence in corporate governance practices and probability of finance distress of the firm.
- H3:** There is a negative relationship between compliance of Board Procedures in corporate governance practices and probability of finance distress of the firm

Sample and Data

The study was based on the secondary data. Altman Z-score model was employed to identify 32 distress and 32

non-distress companies during the period of 2008 to 2012. The level of adopting board practices was assessed by governance index prepared based on the Code of Best Practice on Corporate Governance

Model development

Based on the assumed causal relationships the binary logistic regression analysis was carried out to measure the effect of board practices of corporate governance on likelihood of financial distress of sample firms over a multiple-year time frame. The analysis was carried out on the premise of expected negative association between compliance of corporate governance practices and finance distress of the firm. To test the hypotheses, following binary logistic regression models were estimated by considering two control variables of firm size and financial risk.

$$\text{Probability Distress} = a_0 + \beta_1 BS_{it} + \beta_2 BI_{it} + \beta_3 BP_{it} + \beta_4 ALS_{it} + \beta_5 FR_{it} + \epsilon$$

(Where , for sample firm i and year t, *Distress* is 1, when firm is classified as being in financial distress, and 0 otherwise, *Independent Variables*-Board Structure (BS), Board Independence (BI), Board Procedure (BP), Size -log size of the Assets (ALS), Financial Risk- Total debt/Total Assets (Leverage) (FR), Error term(ϵ))

Results and Analysis

The findings (chi-square= 177.278 and p value= 0.000) of the omnibus test of model coefficients in table 01 indicate that the model is statistically significant because the p-value is less than 0.05. Nagelkerke R Square value of 0.567 reveals that the predictor variables have 56.7% ability to represent total variation of the financial distress probability of the sample firms. It means this estimated model has 56.7% of ability to predict the financial

distress probability of the firms and remain proportions is explained by the other factors which have not been considered in present model. Thus, 56.7% Nagelkerke R square shows the evidence for goodness of fit of the model. In addition to that 84.1% of Classification Performances indicates the number of observations in the sample that an estimated equation classified correctly and the model performs well in distinguishing between financially distressed and non-

distress firms. Furthermore p value of Hosmer and Lemeshow test is greater than 0.05 (0.127). Thus null hypothesis of “the model fits” is accepted. It implies that the model's estimates are in acceptable level. In other word this model predictions are not significantly different from observed values. A closer look at the individual coefficients in Table 01 reveals that two variables of board practices out of three, (BI, b = -4.444, BP, b = -9.336) are negative impact and statistically significant at

0.05. However coefficients of BS (-0.285), is negative as expected, but not significant either at 0.01 or 0.05 levels. In respect of control variables the size of the firm (ALS) is not statistically significant at any confidence (1% and 5%) level. On the other hand, Financial Risk (Leverage) is positive and statistically significant (p< 0.05), which suggests that higher leverage companies are more likely to experience financial distressed than lower firms.

Table 1 Regression Results for Model

Nagelkerke R Square				- 0.567	Classification Performances	- 84.1%
Omnibus Tests of Model Coefficients					Chi-square	177.278(Sig 0.000)
Hosmer and Lemeshow Test					Chi-square	17.343(Sig 0.127)
Variables	B	Std. Error	Wald	Sig.	Exp(B)	
BS	-0.285	0.943	0.091	0.762	1.330	
BI	-4.444	1.044	18.104	0.000**	.012	
BP	-9.336	1.520	37.708	0.000**	.000	
ALS	1.680	0.613	7.503	0.060	5.366	
FR	-0.775	0.331	5.492	0.019**	.461	
Constant	12.190	3.233	14.221	0.000	1.968E5	

Notes-** Statistically Significant at 0.05 level

BS-Board Structure, BI-Board Independence, BP-Board Procedure, ALS- Assets Log Size, FR –Financial Risk(Leverage).

Conclusion

The finding of the study revealed there was a significant impact existed in Board Independence and Board Procedure over the likelihood of financial distress of the firm. The other variable namely Board Structure, have found negative but not significant impact over financial distress of the firm. These findings are consistent with Lee and Yeh (2004) which suggesting

that poor corporate governance can increase the probability of financial distress even for firms with good financial performance. In this light, to resolve the financial distress, researcher recommends to increase the number of independent directors' representation in the board of the distress companies. As suggested by the Bathala and Rao (1995) and Rediker and Seth (1995) the

independent directors play an important role in effective corporate governance, especially in terms of decision-making and control function. Therefore, by improving the independent directors' representations as well as their participation in board activities, will reduce the uncertainty by taking effective decisions and improve the financial performance by monitoring the management activities. From the aspect of board procedures it is further recommended to establish, a nomination committee to make the recommendations on all new appointments, a system to evaluate the annual board performances and compositions and a system to evaluate CEO and other executive directors.

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