



29833
‡

Impact of Corporate Governance Practices on Probability and Resolution of Financial Distress of Listed Companies in Sri Lanka

Thesis submitted to Master of Business Administration
(MBA) of Faculty of Management Studies,
Rajarata University of Sri Lanka, Mihintale



TKG Sameera
RJT/MBA/2010/043

ACC NO	29833
CALL NO.	658.15 SAM.

Abstract

The attention on corporate governance issues have been inspired among academics, regulatory bodies and investors mainly caused by questionable business practices and scandals which happened in many countries over the world. In recent past, Sri Lanka has also experienced a number of corporate failures. Reasons for such failures were also connected with the poor governance practices and misused of power of the responsible authorities. Cost of failure of a single corporate has a fatal effect over the economy as a whole than in the past. Therefore, identification of financial distress of organization prior to its collapse and implementing remedial actions could avoid the costs entailed with such corporate failures. In this context this study examined firm specific corporate governance structures of the financially distressed companies and investigate whether that structure have consequently affected on the firm's financial distress and resolution in the Sri Lankan context. The objectives of the study were to examine the changes in compliance level of corporate governance practices of distress and non-distress companies, identifying whether there was a significant difference of compliance level of corporate governance practices of the financial distress companies compared to the non-distress companies and examine the impact of corporate governance practices on probability and resolution of financial distress of the companies. 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 good governance practices was assessed by governance index prepared based on the Code of Best Practice on Corporate Governance. The analysis addressed that whether there was a negative association between compliance with corporate governance practices and probability of financial distress of the firm. The t-test was employed in order to test that, whether there was a statistically significant difference between the Corporate Governance compliance level of distress and non-distress companies. The relationship between Corporate Governance compliance level and firm distress was tested using correlation analysis and a binary logistic regression analysis by employing two models. The overall results and findings statistically confirmed that the level of compliance of corporate governance practices of distress and non-distress companies were significantly improved over the period concerned. Further, the level of compliance with corporate

governance practices of distress companies was significantly lower than that of non-distress companies. And also a significant impact existed in corporate governance practices on probability and resolution of financial distress. In addition it was found that board independence, board procedures, relation with shareholders and internal control procedures have significantly impacted over the probability and resolution of the financial distress of the company.

Table of Contents

	Page No.
Certification of Supervisor	I
Declaration of Student	II
Abstract	III
Acknowledgement	V
Table of Contents	VI
List of Tables	XI
List of Figures	XII
List of Abbreviations	XIII
CHAPTER ONE - Introduction	
1.1 Background of the Study	01
1.2 Statement of the Problem	03
1.3 Research Questions	05
1.4 Objectives of the Study	05
1.5 Significance of the Study	06
1.6 Scope of the Study	07
1.7 Research Design and Methods	08
1.7.1 Hypothesis	09
1.8 Organization of the Thesis	10
CHAPTER TWO- Literature Review	
2.1 Introduction	12
2.2 Bankruptcy Prediction Models	12
2.2.1 Application of Altman Z-score Model in Predicting Bankruptcy	14
2.3 Financial Distress	16
2.4 Theoretical Foundation of Corporate Governance	18
2.4.1 Agency Theory	18
2.4.2 Stewardship Theory	19
2.4.3 Stakeholder Theory	19
2.5 Corporate Governance	20
2.6 Corporate Governance Practice in Sri Lanka	21
2.7 Corporate Governance and Firm Performance	23

	Page No.
2.8 Corporate Governance and Financial Distress	24
2.8.1 Board Structure	27
2.8.2 Board Independence	29
2.8.3 Board Procedure	30
2.8.4 Directors' Remuneration Procedure	31
2.8.5 Relation with Share Holders	32
2.8.6 Audit Committee Procedure	33
2.8.6 Internal Control Mechanism	34
2.9 Summary	35
CHAPTER THREE - Methodology	
3.1 Introduction	36
3.2 Research Approach	36
3.3 Conceptualization	36
3.4 Hypotheses Development	41
3.4.1 Compliance Level of Corporate Governance Practices	41
3.4.2 Impact of Corporate Governance Practices over the Probability and Resolution of Financial Distress of the Firm	42
3.4.1.1 Board Structure	43
3.4.1.2 Board Independence	44
3.4.1.3 Board Procedure	45
3.4.1.4 Directors' Remuneration Procedure	46
3.4.1.5 Relation with Shareholders	47
3.4.1.6 Audit Committee Procedure	48
3.4.1.7 Internal Control Procedure	49
3.5 Operationalization	49
3.5.1 Financial Distress	50
3.5.1.1 Altman Z-score Model	50
3.5.1.1.1 Working Capital/Total Assets (X1)	51
3.5.1.1.2 Retained Earnings/Total Assets (X2)	51
3.5.1.1.3 Earnings before Interest and Taxes/Total Assets (X3)	52
3.5.1.1.4 Market Value Equity/Book Value of Total Debt (X4)	52
3.5.1.1.5 Sales/Total Assets (X5)	53

	Page No.
3.5.2 Corporate Governance Variables	53
3.5.2.1 Basis of Preparation of the Corporate Governance Index	53
3.5.2.2 Variables of Corporate Governance Index	55
3.5.3 Control Variable	58
3.5.3.1 Size	58
3.5.3.2 Financial Risk	58
3.6 Data Collection	58
3.6.1 Data Collection Methodology	58
3.7 Method of Data Analysis	59
3.7.1 Descriptive Statistics	59
3.7.2 Pearson Correlation	60
3.7.3 Independent Sample T-Test	60
3.7.4 Regression Analysis	60
3.7.4.1 Model I	61
3.7.4.2 Model II	61
3.8 Summary	62
CHAPTER FOUR - Results and Data Presentation	
4.1 Introduction	63
4.2 Sample Profile	63
4.3 Compliance Levels of Corporate Governance Practices of Distress and Non-Distress Companies	65
4.3.1 Compliance Change of Corporate Governance Practices of Distress and Non-Distress Companies during the Period of 2008 and 2012	65
4.4 Comparative Analysis of Governance Scores	67
4.4.1 Analysis of Governance Scores of the Distress Companies	67
4.4.2 Analysis of Governance Scores of the Non -Distress Companies	69
4.4.3 Comparative Analysis of Corporate Governance Dimensions across Distress and Non-Distress Companies	70
4.4.3.1 Board Structure	72
4.4.3.2 Board Independence	72

	Page No.
4.4.3.3 Board Procedure	73
4.4.3.4 Directors' Remuneration Procedure	75
4.4.3.5 Relations with Shareholders	75
4.4.3.6 Audit Committee Procedure	77
4.4.3.7 Internal Control Procedure	78
4.5 Impact of Corporate Governance Practices on Financial Distress of the Companies	79
4.5.1 Correlation between Corporate Governance Variables and Firm Distress	79
4.5.2 Multivariate Analysis	81
4.5.2.1 Impact of Overall Corporate Governance Compliance level on Probability and Resolution of Financial Distress of the Companies - Model I	82
4.5.2.2 Impact of Individual Corporate Governance Practices on Probability and Resolution of Financial Distress of the Companies -Model II	84
4.6 Discussion	86
4.6.1 Compliance Levels of Corporate Governance Practices of Distress and Non-Distress Companies for the Period of 2008 and 2012	86
4.6.2 Compliance Differences of Corporate Governance Practices of Distress and Non-Distress Companies	88
4.6.3 Impact of Corporate Governance Practices on Probability of Finance Distress of the Firm	91
4.6.4 Relationship between Compliance of Board Structure and Probability of Finance Distress of the Firm	92
4.6.5 Relationship between Compliance of Board Independence and Probability of Finance Distress of the Firm	93
4.6.6 Relationship between Compliance of Board Procedures and Probability of Finance Distress of the Firm	95
4.6.7 Relationship between Compliance of Directors' Remuneration Procedure and Probability of Finance Distress of the Firm	96

	Page No.
4.6.8 Relationship between Compliance of Relations with Shareholders and Probability of Finance Distress of the Firm	99
4.6.9 Relationship between Compliance of Audit Committee Procedures and Probability of Finance Distress of the Firm	101
4.6.10 Relationship between Compliance of Internal Control Procedure and Probability of Finance Distress of the Firm	102
4.6.11 Impact of Control Variables on Probability of Finance Distress of the Firm	104
4.7 Summary	104
 CHAPTER FIVE- Summary, Conclusions and Implications	
5.1 Introduction	106
5.2 Summary of Findings	107
5.2.1 Compliance to Corporate Governance Best Practices	107
5.2.2 Impact of Corporate Governance Compliance on Probability of Finance Distress of the Firm	110
5.2.2.1 Overall Corporate Governance Compliance Level and Financial Distress	110
5.2.2.2 Board Structure and Financial Distress	111
5.2.2.3 Board Independence and Financial Distress	111
5.2.2.4 Board Procedures and Finance Distress	112
5.2.2.5 Directors' Remuneration Procedure and Finance Distress	112
5.2.2.6 Relations with Shareholders and Finance Distress	113
5.2.2.7 Audit Committee Procedures and Finance Distress	113
5.2.2.8 Internal Control Procedure and Finance Distress	114
5.2.3 Impact of Firm Size on Probability of Finance Distress of the Firm	114
5.2.4 Impact of Financial Risk on Probability of Finance Distress of the Firm	115
5.2.5 Summary of the Findings	115
5.3 Conclusions and Implications of the Study	116
5.3.1 Implications of the Study	120
5.4 Limitations of the Study and Recommendations for Future Research	121
References	123
Annexures	134