

CORPORATE GOVERNANCE AND THE INSOLVENCY RISK: A STUDY OF LICENSED FINANCE COMPANIES IN SRI LANKA

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INTRODUCTION

Every business manager in an agency relationship is faced with balancing riskier policies and adopting less risky ones to increase the shareholders' wealth while safeguarding their self-interest and human capital invested in the company. Then, it may create agency problems within organizations. According to Ali et al. (2021) fundamental role of corporate governance (CG) is to overcome the agency problems between managers and shareholders by aligning their interests. The 2008 global financial crisis affected international credit and asset markets. It has exposed some control and risk management flaws, primarily in the financial sector. Ali et al. (2021) stated that the issue of risk-taking as an agency problem is more pronounced in the financial industry. A company may face several potential financial risks. One of these is the risk of insolvency, commonly known as bankruptcy. Failing to pay debts is called insolvency (Aguilar & Maciel, 2019). Insolvency risk-taking (IR) is an agency issue in a country's financial sector. Financial institutions in a country play a vital role in ensuring financial stability in the financial system.

This study is essential to the current context of the financial industry and economy in Sri Lanka because it investigates the impact of CG on the IR of Licensed Finance Companies (LFCs) in Sri Lanka. Indeed, the study primarily contributes to the literature on agency theory. Further, this study contributes to the scientific research and practices of the Sri Lankan financial sector because there is a dearth of studies in the literature concerning CG and the IR of the LFCs in Sri Lanka. Over recent years, the Sri Lankan LFC sector has deteriorated due to uncertainties in the country.

According to the Central Bank of Sri Lanka (CBSL) (2020), during the period from January to August 2020, the LFCs sector has become vulnerable due to a decrease in asset base, credit, and deposits, as well as an increase in nonperforming loans (NPLs) and declining profitability and the sector's capital and liquidity levels remained above the minimum regulatory requirements. However, a few individual LFCs did not meet the minimum capital requirements. Moreover, the return on assets (ROA) ratio and return on equity (ROE) ratio of the LFCs have declined continuously over the last few years. It was identified that the NPL ratio is a determinant of IR, and asset deterioration is one of the significant reasons for insolvency risk. Concerning these contexts, the solvency of the companies belonging to the LFC sector is questionable. In addition to the deteriorated performance of the LFCs in Sri Lanka, the CG of this sector shows a lack of good governance.

It has been repeatedly observed that a reason for the failure of LFCs is the lack of good governance, where ownership and decision-making are concentrated with the main shareholder or a few shareholders linked to the main shareholder (CBSL, 2020). These contexts raise a researchable problem in studying the impact of CG on the IR of LFCs in Sri Lanka. According to the Sri Lankan context, using a sample of 13 listed banks on the Colombo Stock Exchange (CSE), Sameera and Wijesena (2018) studied the impact of CG on credit risk. They found that board size and independence significantly and negatively impact credit risk. Moreover, Sameera and Wijesena (2020) examined the impact of CG on corporate risk using a sample of 64 listed companies on the CSE. The findings suggest that board independence significantly and negatively impacts corporate risk. Farwis et al. (2020) recently examined the relationship between CG and firm risk of CSE-listed companies. When reviewing past studies in Sri Lanka, there is a dearth of prior studies about the impact of CG on the IR of LFCs in Sri Lanka. Accordingly, this study aims to identify the impact of CG on the IR of the LFCs listed in Sri Lanka.

METHODOLOGY

LFCs listed in the CSE in Sri Lanka were selected as the target population of this study. The 29 LFCs listed in the CSE have been selected as the sample of this study for five years, starting in 2016 and ending in 2020. The final sample consists of 125 firm-year observations. The study comprises six variables: board independence (BI), women on the board (WIB), audit committee independence (ACI), board meetings (BMs), and audit committee meetings (ACMs) as independent variables, and insolvency risk-taking (IR) as a dependent variable. The study conceptualized its dependent and independent variables according to the empirical evidence. Nodeh et al. (2018) provide evidence of a negative and statistically significant association between BI and IR. Wilson and Altanlar (2012) and Maier and Yurtoglu (2022) found that WIB has a significant and negative impact on IR. Appiah and Amon (2017) reveal that ACI negatively impacts IR. Elamer et al. (2018) and Ayadi et al. (2019) explored a negative and significant relationship between BMs and IR. Moreover, Appiah and Amon (2017) and Al Haddad and Juhmani (2020) demonstrate that ACMs significantly and negatively impact IR. The conceptual framework for the current study is shown in Figure 1.

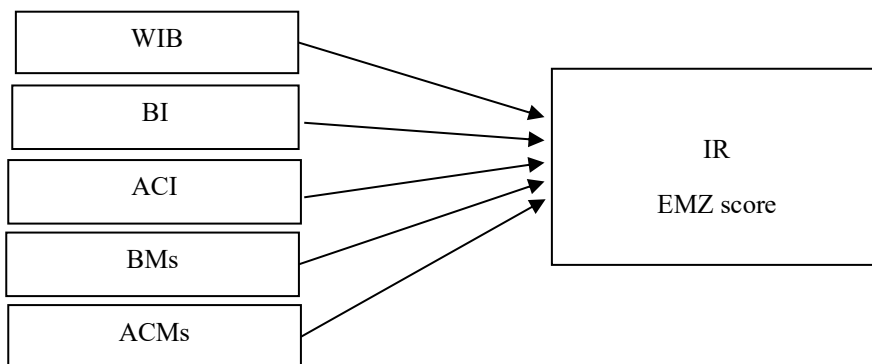


Figure 1 Conceptual Framework

The researchers' attention was drawn to the following hypotheses.

H₁: BI has an impact on firms' insolvency risk.

H₂: WIB have an impact on a firm's insolvency risk.

H₃: ACI has an impact on a firm's insolvency risk.

H₄: BMs have an impact on a firm's insolvency risk.

H₅: ACMs have an impact on a firm's insolvency risk.

According to Hussain et al. (2020) the EMZ score is the appropriate model to define IR in underdeveloped countries. The operationalization of the study is constructed in the following manner.

Table 1 Operationalization

Variable	Operationalization
Dependent Variable	
IR	$Z = 3.25 + 6.56X_1 + 3.26X_2 + 6.72X_3 + 1.05X_4$
	$X_1 = \text{Working Capital/Total Assets}$
	$X_2 = \text{Retained Earnings/Total Assets}$
	$X_3 = \text{Operating Income/Total assets}$
	$X_4 = \text{Book value of equity/ Total liabilities}$
	$Z < 1.21 = \text{High IR (Distress Zone)} = 2$
	$1.21 < Z < 2.90 = \text{Moderate IR (Grey Zone)} = 1$
	$Z > 2.90 = \text{Low IR (Safe Zone)} = 0$
Independent Variable	
BI	Independent Directors / Total directors
WIB	Female Directors / Total directors
ACI	Independent directors in Audit Committee / Total Directors in Audit Committee
BMs	Board of Director meetings per year
ACMs	Audit Committee meetings per year

$$IR = \alpha + \beta_1 (BI_{i,t}) + \beta_2 (WIB_{i,t}) + \beta_3 (ACI_{i,t}) + \beta_4 (BM_{i,t}) + \beta_5 (ACM_{i,t}) + \varepsilon_i \dots (1)$$

The researchers used descriptive statistics, correlation analysis, and panel regression analysis to test the hypotheses. Multinomial logistic regression analysis was employed as secondary data analysis. The regression model of the study is formulated as follows.

RESULTS AND DISCUSSION

To interpret the empirical results and findings of the study, the researchers tested the descriptive statistics. The results are demonstrated in Table 2.

Table 2 Descriptive Statistics

Variables	Min	Max	Mean	Std. Deviation
IR	0.04	2.37	1.41	0.54
BI	0.11	0.71	0.40	0.13
WIB	0.00	0.60	0.18	0.14
ACI	0.33	1.00	0.70	0.18
BMs	6.00	18.00	12.43	1.74
ACMs	1.00	13.00	6.64	2.88

According to the mean value of IR, the sample LFCs have a moderate probability of IR. There is no vast difference between the minimum, maximum, and mean of BI, reflecting that the BI of the LFCs is stable. There is no vast difference between ACI's minimum, maximum, and mean. The mean value of BMs indicates that the sample LFCs comply with the CG requirements. There is a high spread between the ACMs of the LFCs in the study. Pearson's correlation analysis was employed to examine the correlation between the variables, as illustrated in Table 3.

Table 3 Pearson Correlation Analysis

	IR	BI	WIB	ACI	BMs	ACMs
IR	1.000					
BI	-0.129	1.000				
WIB	-0.247**	0.210*	1.000			
ACI	-0.255**	0.378**	0.378**	1.000		
BMs	-0.127	0.471**	-0.101	0.176*	1.000	
ACMs	0.079	-0.096	0.178*	0.210*	0.004	1.000

Note: $N=125$, **, * Correlation is significant at the 0.01 level and at the 0.05 level (2-tailed) respectively.

WIB and ACI correlate negatively and significantly with IR. BI and BMs correlate negatively but insignificantly with the IR. The ACMs indicate an insignificant positive correlation of 0.079 with the IR. Since the p-value of the Hausman test is more significant than 0.05 ($\text{Prob} > \chi^2 = 0.9930$), the study's results were discussed through the random-effects model. Results are demonstrated in Table 3.

Table 3 presents the results of the panel regression analysis. Since the *p-value* of the analysis results is greater than 0.05, BI does not exert a significant impact on the IR. Therefore, H_1 was not empirically proven, and H_1 was not supported. Complying with the empirical findings of Wilson and Altanlar (2012) and Maier and Yurtoglu (2022), WIB exerts a negative and significant impact on IR. Concerning the empirical results and findings, H_2 was supported.

Table 4 Random-Effects Model

IR	Coef.	Std.Err.	Z	p> z	[95% Conf. Interval]	
BI	0.527	0.446	1.18	0.237	-0.348	1.402
WIB	-1.300	0.424	-3.07	0.002	-2.131	-0.469
ACI	-0.531	0.304	-1.74	0.081	-1.127	0.065
BMs	-0.064	0.029	-2.19	0.029	-0.121	-0.007
ACMs	0.027	0.018	1.45	0.146	-0.009	0.063
_Cons	2.430	0.417	5.82	0.000		
Prob > chi2	=	0.0008				
R – sq	=	0.1583				

n=125

There is no significant impact of ACI on the IR. Considering the insignificant impact of ACI on the IR, H₃ was not supported. BMs exert a significant and negative impact on the IR. These results are consistent with Ayadi et al. (2019). Based on that, H₄ was supported. ACMs do not exert a significant impact on the IR. Based on that, H₅ was not supported. Multinomial logistic regression analysis was employed to elaborate on the CG variables' significant impact on the IR categories, as illustrated in Table 5.

Table 5 Multinomial Logistic Regression Analysis

IR		Coef.	Std.Err.	Z	P> z	[95% Conf. Interval]	
0	BI	4.280	2.710	1.58	0.114	-1.031	9.591
	WIB	-7.236	1.987	-3.64	0.000	-11.131	-3.341
	ACI	4.058	1.678	2.42	0.056	0.770	7.346
	BMs	-0.031	0.172	-0.18	0.858	-0.369	0.307
	ACMs	-0.002	0.083	-0.03	0.973	-0.165	0.159
	_Cons	-1.828	1.910	-0.96	0.338	-5.571	1.915
1	(base outcome)						
2	BI	-5.890	3.276	-1.80	0.072	-12.310	0.530
	WIB	2.099	2.696	0.78	0.436	-3.185	7.382
	ACI	-1.640	2.017	-0.81	0.416	-5.593	2.312
	BMs	0.220	0.171	1.29	0.198	-0.114	0.554
	ACMs	-0.372	0.148	-2.50	0.012	-0.663	-0.080
	_Cons	0.970	2.090	0.46	0.642	-3.125	5.067

Note: *N*=125, 0 – Low Insolvency Risk, 1 – Moderate Insolvency Risk, 2 – High Insolvency Risk

Since the researcher assigned moderate IR as the baseline category, no coefficients or tests were provided for this level. According to the low IR category results, WIB exerts a negative and significant impact on the low IR, consistent with Maier and Yurtoglu (2022). The remaining CG variables do not significantly impact the low IR. According to the high IR

category results, ACMs show a significant and negative impact on high IR, consistent with the empirical studies of Al Haddad and Juhmani (2020) and Appiah and Amon (2017). The remaining CG variables do not significantly impact the high IR.

CONCLUSIONS AND IMPLICATIONS

This study aimed to examine the impact of CG on insolvency risk. The researcher used secondary data to gather data from 25 LFCs listed in CSE from 2016 to 2020. To achieve the objective of this study, the researcher employed descriptive statistics, correlation analysis, panel regression analysis, and multinomial logistic regression analysis. According to the correlation analysis results, WIB and ACI negatively correlate with the IR at significant levels. BI and BMs negatively correlate with the IR, but it is insignificant. According to the panel regression analysis, WIB and BMs have a significant and negative impact on the IR, reflecting that an increase in BMs and WIB can reduce the IR. The other remaining CG variables do not significantly impact the IR. Concerning the multinomial logistic regression analysis, the researcher found that WIB has a significant and negative impact on the low probability of IR. Moreover, ACMs significantly and negatively impact the high probability of IR. Other CG variables do not significantly impact the probabilities of IR. The findings of this study inspire senior executives and practitioners in LFCs in Sri Lanka to increase the appointment of women to the board to reduce insolvency risk and increase the frequency of board meetings and audit committee meetings to enhance the monitoring of risk-taking and ensure the financial stability of the companies. To ensure the financial stability of the LFCs in Sri Lanka, mitigate the weaknesses of the CG, and overcome the deteriorated performance of the LFCs in Sri Lanka, practitioners, regulatory bodies, policymakers, and decision-making bodies of the LFCs can pay closer attention to the relevant areas using the findings of this study. Moreover, this study's findings help investors make investment decisions while investing in the stock market and corporate debt market. The study's findings suggest various policy changes that can be incorporated into strategic and regulatory frameworks. The sample of this study was biased toward LFCs listed in Sri Lanka. The sample excludes all other companies listed in CSE in Sri Lanka and other LFCs not listed in CSE. The study's small sample size also inherited the findings' reliability. Future research works should align with the large sample sizes and non-financial companies in Sri Lanka. Further, comparative studies of financial and non-financial companies should be carried out. Moreover, using primary data, future studies should be conducted to find the impact of CG on the insolvency risk of small and medium enterprises (SMEs).

Keywords: Corporate governance, insolvency risk, licensed finance companies

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