THE IMPACT OF CORPORATE GOVERNANCE ON FINANCIAL DISTRESS: SPECIAL REFERENCE TO LISTED FINANCE COMPANIES IN COLOMBO STOCK EXCHANGE IN SRI LANKA

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INTRODUCTION

Corporate governance has emerged as a critical and multifaceted concept in today's dynamic and highly competitive global business environment. It plays a pivotal role in guiding and controlling the direction of companies, ensuring that they operate responsibly, transparently, and in the best interests of their stakeholders (Rathnayake & Samarakoon, 2020). As businesses continue to navigate increasing complexities and interact within the global economy, the importance of corporate governance has grown exponentially.

Financial distress, characterized by a company's inability to meet its obligations and trade liabilities through operating cash flows or when its total assets' aggregate value falls below that of its total liabilities and equity, poses a significant concern in today's business landscape (Balagobei & Keerthana, 2022). Given the mounting economic uncertainties worldwide, it has become imperative to address financial distress proactively to avert dire consequences such as bankruptcy, delisting, or organizational restructuring. Indeed, research has shown that robust corporate governance practices can effectively mitigate financial distress (Murhadi et al., 2018). Various models, including the well-known Altman's Z-score model, have been employed to predict financial distress (Rathnayake & Samarakoon, 2020).

This research holds substantial significance for many stakeholders, including investors, policymakers, and regulators, who are deeply engaged in these topics. A comprehensive understanding of the impact of corporate governance on financial distress can inform the development and implementation of evidence-based regulations and policies, ultimately enhancing financial stability and reducing risks and uncertainties within the corporate sector. Furthermore, given that financial distress can arise from various factors, such as poor management, weak market conditions, excessive debt levels, or unforeseen events (Chen et al., 2019), this study seeks to provide specific insights into how corporate governance can help mitigate these risks.

In addition, the heightened interest in corporate governance issues globally, triggered by corporate scandals and questionable business practices in numerous countries, underscores the importance of exploring its effects on financial distress (Sameera & Weerathunga, 2016). Some studies have already indicated a potential negative relationship between audit committee composition and financial distress, emphasizing the significance of corporate governance structures in safeguarding financial stability (Sameera & Weerathunga, 2016).

In conclusion, this research provides valuable insights into the intricate relationship between corporate governance and financial distress within today's multifaceted business environment. By examining the influence of corporate governance on financial distress in listed financial companies in Sri Lanka, this study aims to contribute evidence-based recommendations for policymakers and regulators. These recommendations can strengthen corporate governance practices and empower financial stability within the broader business sector in Sri Lanka and as part of the global discourse on corporate governance and financial resilience.

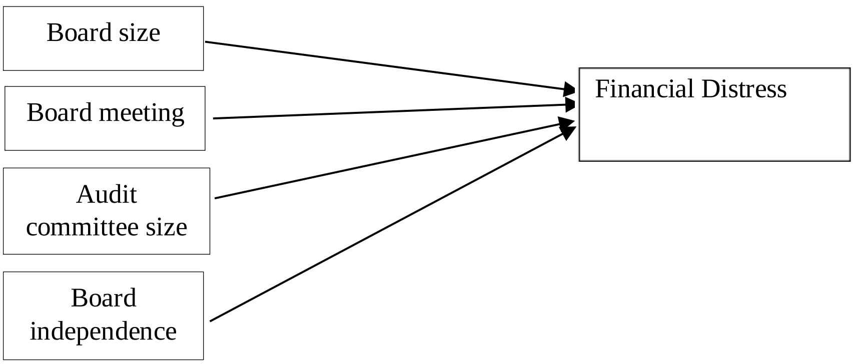
METHODOLOGY

The CSE is a vital platform for companies to raise capital and investors to trade securities in Sri Lanka. As of October 7th, 2022, the CSE listed 294 companies. Among these, the present research focuses on the population of listed finance companies, comprising 37 entities, to investigate the relationship between specific corporate governance variables and financial distress. The target sample for this study was derived through a combination of methods. Out of the 37 finance companies, 20 were selected using a convenience sampling method. However, five companies were exempted from the study due to the unavailability of annual reports spanning 2018 to 2022. Hence, the final sample includes 100 observations from listed finance companies in the CSE. The study relies on secondary sources, with the annual reports of these finance companies being obtained from the online database of the CSE. These annual reports encompass five years, from 2018 to 2022, providing comprehensive financial and governance-related information.

The research focuses on four primary variables related to corporate governance: Board Size (BSIZ), Audit Committee Size (ACSIZ), Board Meeting Frequency (BMEE), and Board Independence (BI). Each variable is crucial in shaping finance companies' decision-making processes and oversight. The main objective of this research is to examine the relationship between the identified corporate governance variables and financial distress in listed finance companies. Specifically, the study aims to test four hypotheses, which consider the potential impacts of each governance variable on the occurrence of financial distress.

Figure 1

Conceptual framework



The researchers' attention was drawn to the following hypotheses based on theoretical and empirical evidence.

H_1: Board size significantly influences the financial distress listed finance companies in Sri Lanka.

H_2: Board meeting significantly influences the financial distress listed finance companies in Sri Lanka.

H_3: Audit committee size significantly influences the financial distress listed finance companies in Sri Lanka.

H_4: Board independence significantly influences the financial distress listed finance companies in Sri Lanka.

RESULTS AND DISCUSSION

The descriptive statistic table summarizes descriptive statistics containing the mean, standard deviation, minimum, and maximum of the dependent variable (FDIS) and four independent variables (BSIZ, BMEE, ACSIZ, BI) from 2018-2022. The data comprise a sample of 20 listed finance companies in Sri Lanka. The total number of observations is 100.

Table 1

Descriptive statistics

	FDIS	BSIZ	BMEE	ACSIZ	BI
Mean	139.253	8.620	12.440	3.490	3.350
Median	5.488	9.000	12.000	3.000	3.000
Maximum	5139.033	13.000	25.000	6.000	7.000
Minimum	-10.789	5.000	5.000	2.000	1.000
SD	735.898	1.958	2.455	0.980	1.048
Skewness	5.901	0.038	2.522	0.385	0.745
Kurtosis	37.205	2.456	15.885	2.556	4.001
Observations	100	100	100	100	100

Note. **FDIS** – Finance distress, **BSIZ** – Board size, **BMEE** – Board meeting, **ACSIZ** – Audit committee size, **BI** – Board independence

Table 2

Correlation analysis

	FDIS	BSIZ	BMEE	ACSIZ	BI
FDIS	1				
BSIZ	0.398**	1			
BMEE	-0.311**	-0.158	1		
ACSIZ	-0.084*	0.219	-0.225	1	
BI	0.109	0.459	-0.131	-0.041	1

The researchers conducted a correlation analysis to examine the relationship between corporate governance variables and financial distress (FDIS). The results showed that Board Size (BSIZ) had a significant positive correlation of approximately 0.3975 with financial distress. Conversely, Board Meeting Frequency (BMEE) and Audit Committee Size (ACSIZ) exhibited significant negative correlations of 31.11% and 8.44%, respectively, with financial distress. However, the correlation between Board Independence (BI) and financial distress was insignificant, showing a positive correlation with the FDIS of sample companies.

The regression analysis indicates that the independent variables in the study collectively account for 19.64% of the variation in the dependent variable. The remaining 80.357% of the variation is influenced by other factors not considered in this research. Specifically, the study found that Board Size (BSIZ) has a significant positive impact on financial distress (FDIS) with a coefficient (β) of 132.788.

Table 3
Results of regression analysis

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	769.752	581.406	1.324	0.189
BSIZ	132.788	44.464	2.986	0.004
BMEE	-86.807	26.718	-3.249	0.002
ACSIZ	-154.071	71.595	-2.152	0.034
BI	-47.027	74.078	-0.635	0.527
R-squared	0.196			

In contrast, Board Meeting Frequency (BMEE) has a significant negative impact with a coefficient of -86.807. Audit Committee Size (ACSIZ) significantly negatively impacts financial distress with a coefficient of -154.071. However, Board Independence (BI) was found to have an insignificant and negative impact on financial distress, with a coefficient of -47.027.

CONCLUSION AND IMPLICATIONS

Financial distress in listed finance companies is a critical concern, especially for economies that rely heavily on their financial sectors to foster economic growth and stability. The present study investigates the factors influencing financial distress in listed finance companies within the Colombo Stock Exchange (CSE) in Sri Lanka. The primary objective of this study was to examine the intricate relationship between corporate governance and financial distress, which is paramount to academia and industry.

The study commenced by clearly outlining its initial objectives, aiming to bridge an existing gap in the literature regarding corporate governance's impact on financial distress in this context. However, upon reflection, it is acknowledged that the conclusions may need to fully encapsulate the depth and intricacies presented in the earlier sections. It recognizes the need for a more comprehensive wrap-up to revisit the initial problem statement and more explicitly tie it to the findings.

While this study offers valuable insights into the relationship between corporate governance and financial distress in Sri Lanka, it is acknowledged that it might not present groundbreaking or novel findings that significantly advance the field. This study relied on established variables and methods, which may have limited the paper's novelty. However, this study’s findings add to the existing body of knowledge and offer a valuable contribution to understanding corporate governance's role in mitigating financial distress within Sri Lanka's financial sector.

Overall, this study represents a significant endeavor in understanding the factors affecting financial distress in listed finance companies within the CSE in Sri Lanka. Further, this study sheds light on the intricate interactions between corporate governance and financial distress. By analyzing critical variables related to corporate governance, the study provides valuable knowledge to stakeholders in the financial sector and paves the way for informed decision-making and policy formulation. Additionally, its contribution to the existing literature and potential impact on future research make it a valuable resource for scholars and academics seeking to explore this area further.

Keywords: Colombo stock exchange, corporate governance, financial distress

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