DIRECTORS' REMUNERATION AND FINANCIAL DISTRESS: EVIDENCE FROM MATERIALS COMPANIES LISTED IN COLOMBO STOCK EXCHANGE

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ABSTRACT

Firms are endangered by various financial risks, specifically, financial distress. Financial distress provides an early warning signal for predicting future losses. Excessive remuneration for managers is believed to be a prominent cause for firms to fall into the trap of financial distress, leading to the risk of corporate failure. Extensive studies have been carried out on the effect of corporate governance attributes on financial distress, but there are only a few studies in Sri Lanka that investigate the relationship between directors' compensation and financial distress in Sri Lanka. Over the past few years, there has been a spotlight focusing on the overpayment of directors' compensation, especially for highly dignified organizations, due to the greater deviations identified in the salaries of executives and employees. Therefore, the core objective of this study is to investigate the effect of directors' remuneration on the financial distress of materials companies listed on the Colombo Stock Exchange. This study incorporates data collected from 17 entities in the materials industry from 2016 to 2022, where it mainly focuses on a quantitative approach and is purely based on secondary data analysis. Financial distress, measured using the Altman Z-score model, served as the dependent variable, while director remuneration was used as the independent variable. Further, the control variables incorporated in this study are return on assets and firm size, and the data were analyzed using the correlation, ordinary least squares regression, fixed effect, and random effect models employing the Eviews 12 software with the data extracted from the Colombo Stock Exchange website. The regression output revealed that the fixed-effect model is applicable in which the director's compensation has a significant negative impact on financial distress. However, control variables such as return on assets (ROA) and firm size (FS) do not have a significant impact on financial distress. Thus, the findings show that financial distress becomes healthier when directors are over pumped with compensation. The outcome of the study is supported by agency theory, which states that remuneration acts as a boosting agent for managers, resulting in no conflict of interest between shareholders and managers; both interests are aligned, ultimately leading to lower financial distress. This study is imperative for various stakeholders, such as investors, the government, and financial regulators, especially for investors to make decisions regarding compensation-based incentives. Moreover, this would strengthen the government's enforcement of regulations and policies.

Keywords: Agency theory, financial distress, remuneration