IMPACT OF SELECTED CORPORATE GOVERNANCE CHARACTERISTICS ON FINANCIAL DISTRESS: EVIDENCE FROM LISTED COMPANIES IN SRI LANKA

Priyanka, S[1] and Tharsika, K[2*]

[12] Department of Accounting, Faculty of Management Studies and Commerce, University of Jaffna, Sri Lanka

[1] santhanpriyanka@gmail.com, [2]tharsik@univ.jfn.ac.lk

https://orcid.org/0000-0001-5917-3457

ABSTRACT

This paper examines how corporate governance mechanisms impact financial distress of listed non-financial companies in Sri Lanka, which is an emerging market typified by a concentrated ownership structure, a dynamic regulatory framework, and a relatively weak institutional enforcement. The study adopts a quantitative research design and utilizes panel data collected from the annual reports of 74 non-financial companies listed on the Colombo Stock Exchange (CSE) over the period from 2019 to 2023. The companies were selected using a simple random sampling method to make sure that the sample of the population was not biased in terms of sector. Financial distress was measured using the popular Altman Z-score model, and corporate governance was assessed based on four board-specific variables: board size, number of board meetings, board independence, and CEO duality. A panel regression model of fixed effects was to be used to test the hypothesized relationships with the control of unobservable characteristics of the firms. The results suggest that the financial distress is negatively affected by board size and board meeting frequency in a significant negative way, which implies that the bigger the boards and the more frequent the board meetings, the greater the ability of the companies to sustain themselves in case of financial difficulties. These findings confirm the resource dependence theory, which argues the relevance of board diversification and proactive participation in enhancing organizational resilience. Contrastingly, CEO duality shows that the agency theory that the concentration of managerial and supervisory power undermines board oversight and leads to an increase in governance risks is supported by a strong positive correlation with financial distress. However, board independence was statistically negligible, which means that formal independence is not necessarily an effective measure of monitoring in the Sri Lankan corporate setting. The study adds to the literature on corporate governance with empirical evidence in Sri Lanka in the period of 2019-2023 that has encompassed the devastating economic crisis of 2022 in the country. The study contributes to a fresh understanding of the operations of governance systems to prevent corporate financial weaknesses in emerging economies through the application of financial distress instead of firm performance.

Keywords: ***Altman Z-score, Corporate Governance, Financial Distress, Emerging Market, Panel Data, Sri Lanka***

1 INTRODUCTION

In the aftermath of global financial crises and the collapse of high-profile corporations such as Enron, WorldCom, and Lehman Brothers, the role of corporate governance in prevention financial distress has gained increased academic and regulatory attention (Agrawal & Chadha, 2005; Kirkpatrick, 2009). These failures exposed systemic weaknesses, including inadequate board oversight, poor ethical conduct, and ineffective internal controls, all of which added to systemic instability and business collapse. As a result, corporate governance is now widely recognized as a fundamental component of both financial sustainability and organizational resilience, particularly in times of economic turbulence (Daily, Dalton, & Cannella, 2003).

Corporate governance broadly refers to the structures, processes, and mechanisms through which corporations are directed and controlled (OECD, 2015). The agency theory is focused on the reduction of agency conflicts that appear in the form of the separation of ownership and managerial power in contemporary corporations (Jensen and Meckling, 1976). Effective governance balances the interests of the shareholders with the managerial action, through increased accountability, transparency, and decision making. This is particularly important when faced with a case of financial distress, which is considered to be the declining ability of a firm to fulfill its financial commitments, and when left unattended, can result in bankruptcy or liquidation (Altman, 1968).

Existing literature shows that sound governance mechanisms can serve as protection in financial distress. These mechanisms promote monitoring, reduce managerial opportunism, and facilitate strategic interventions in times of crisis (Bhagat and Bolton, 2008; Fich and Slezak, 2008). Nonetheless, the findings of the traditional models of financial distress prediction such as the regularly used Altman Z-score (Altman et al., 2017) are largely based on financial ratios and often disregard the variables based on governance. This is especially significant in the emerging economies where the institutional frameworks, monitoring, and enforcement of the governing regulations can be relatively weak, which makes firms more susceptible to governance failure (Claessens and Yurtoglu, 2013).

Sri Lanka represents a pertinent case for examining the governance and financial distress nexus in an emerging market. The issue's significance was particularly evident during Sri Lanka's harsh macroeconomic crisis in 2022, as the country experienced a sovereign debt default, acute foreign exchange deficits, and widespread economic instability. These macroeconomic shocks impose uncommon pressure on business sectors and determine the efficiency of those governance frameworks that can ensure financial and organizational stability. Corporate crashes, particularly in the finance companies, have been registered in the country, which was mostly contributed by the presence of governance failures, regulatory loopholes, and concentration of ownership (Balagobei & Keerthana, 2023). Although Sri Lanka has been implementing several governance reforms, including the establishment of a Corporate Governance Code and regulatory supervision by the SEC Sri Lanka and Colombo Stock Exchange (CSE), the implementation and enforcement of such reforms is not consistent (SEC Sri Lanka, 2020). Moreover, the ownership structure of the country, political involvement, low board independence, and poor investor protection are some of the structural features of a governance environment in Sri Lanka (Balagobei and Keerthana, 2023).

Though there has been a significant amount of research done in the developed economies where the issue of corporate governance to financial distress is analyzed, there is limited empirical evidence on this issue in the Sri Lankan context. The existing literature on the topic has focused more on the relationship between governance and firm performance and financial disclosure (Lakshan and Wijekoon, 2012), and little has been done on the forecast capacity within the financial distress case. Besides, the majority of the studies are limited to the financial sector, refusing the extended group of non-financial firms that make up a substantial number of listed companies in Sri Lanka. This poses a research vacuum on whether the corporate governance mechanisms can be used as an early warning sign of financial distress in non-financial listed firms that operate in the environment of institutional and economic volatility.

This research seeks to examine how the chosen corporate governance practices affect financial distress in the listed non-financial companies in Sri Lanka. The study is based on the agency theory, and it examines four major variables of governance, namely board size, the frequency of the board meeting, board independence, and CEO duality. These will be measured together with conventional financial measures to determine whether the governance structures can not only act as performance boosters, but also act as obstacles to financial decline. The research employs the data of companies that include the 2019 - 2023 period of time that provides data on the performance of the corporations before, during and after the peak of the 2022 economic crisis experienced in Sri Lanka. This time offers a special empirical atmosphere to assess the abilities of the governance structures to support the firms to resist extreme macroeconomic shocks.

Theoretically, the research study provides a contribution to the literature in offering contextual validation of the agency theory in an emerging market context that is relatively concentrated in terms of ownership and governance structures that are undergoing change. Moreover, the results can be viewed as informative to the resource dependence theory because they imply that the board structure can grant companies access to various expertise and strategic resources that are capable of cushioning financial vulnerability in times of economic uncertainties. Practically speaking, the results can have some useful suggestions to the policy-makers and regulatory authorities, namely, the Securities and Exchange Commission (SEC) of Sri Lanka and the Colombo Stock Exchange (CSE). The findings may assist in upgrading the Code of Best Practice on Corporate Governance by stressing on the enhanced supervision of the board, the distinct role division between the board chair and the CEO, and the enhanced involvement of the board members by organizing meetings frequently. These policy improvements can increase the effectiveness of governance structures to see warning signals of financial stress and increase corporate resilience during economic turmoil.

2 LITERATURE REVIEW

2.1 Theoretical review

Agency theory is a cornerstone of the literature on corporate governance that relates to the nature of conflict of interests that can occur as a result of the distance between ownership and control inherent by contemporary corporations (Jensen and Meckling, 1976). The main assumption of the theory is that the managers (agents) who are responsible in running the firm, do not always work in the interest of the shareholders (principals), especially when their interests do not coincide with those of the owners. This agency may cause agency costs, which may be inefficient resource allocation, risk-averse behaviour, or opportunistic decision-making (Chen et al., 2012).

Corporate governance comes into the limelight as yet another important tool to alleviate such agency conflicts by instituting systems and measures to bring the managerial behavior to be in line with the shareholder interests. The board of directors, the representatives of the shareholders towards the management team, has a key monitoring role on the accountability of the managerial and safeguarding the interests of the shareholders (Panda & Leepsa, 2017). Nevertheless, it does not ensure the effectiveness of the board. Nicholson and Kiel (2007) postulate that boards that are captured by the management or lack independence might not protect the interest of the shareholders appropriately, thus worsening agency problems.

The existing body of literature has placed corporate governance in the framework of the agency theory. To illustrate, Fama and Jensen (1983) pointed out that agency problem arises as a result of the separation of ownership and control that creates a conflict of interest whereby managers act in their own selfish interests and not in the best interest of the firm. This breach differs with the premise that top management will always act in the best interest of the shareholders.

The agency theory is also transferred to financial decision making especially on capital structure. Jensen and Meckling (1976) suggested that leverage would be a disciplining mechanism to align the interests of managers with the shareholders. Increased debt levels subject managers to financial limitations so that they need to run the operations effectively to meet the debt costs.

Agency-related behaviours are also affected by the competitive forces of the product market. Solomon (2007) adds that an increased market competition can be used as an external governing mechanism where managers are compelled to improve the performance of operations thus, indirectly lowering the cost of agency. However, extreme competition may lead to firms making risky or unsustainable decisions that put them at greater risk of being put into financial distress.

The agency theory offers a powerful prism through which the role of the governance framework in affecting managerial actions and, eventually, the performance of a firm can be viewed. Besides the agency theory, there is the resource dependence theory (Pfeffer and Salancik, 1978) which also provides a useful understanding of corporate governance given that it focuses on how boards can avail firms access to external knowledge, expertise, and strategy resources. In new markets where institutions can be less well-developed, boards can also serve primarily as monitoring systems but also as sources of strategic resources that enable companies to deal with uncertainty in the economic environment. It highlights the significance of good board oversight, sound financial policies and the greater institutional environment in the development of the governance-financial distress nexus. Consequently, it continues to be a theoretical basis point of studying the interconnection between corporate governance and financial health in both the developed markets and the emerging markets.

2.2 Empirical review

2.2.1 Board size and financial distress

Though academic debate on the relationship between board size and financial distress has been quite high, it has not yet reached a consensus. In theory, it is a polarizing debate. The agency theory cautions that bigger boards will hinder efficiency, as coordinating them becomes challenging, free-riding is more likely, and they will be more susceptible to financial distress (Jensen, 1993; Cardoso, Peixoto, and Barboza, 2019). Resource dependence theory, in its turn, claims that bigger boards help the organization increase its capacity due to the pooling of different knowledge, provision of more strategic advice, and resource acquisition through bigger boards, particularly, in the periods of financial crises (Pfeffer and Salancik, 1978; Chang, Merino and Banegas, 2015).

The empirical studies in the developing markets in recent past have given inconsistent but informative evidence on the correlation between the size of the board and financial distress. According to the research carried out in Kenya (Kamau et al., 2023) and in Pakistan (Ud-Din et al., 2020), larger boards have a significant benefit of minimizing the chances of financial distress, which supports the resource dependence perspective, according to which a variety of expertise enhances decision-making and oversight of strategic decisions. Other researchers in Indonesia also made similar findings during the COVID-19 crisis, with Vargas-Cuentas and Rudiawarni (2022) stating that larger boards were able to enhance monitoring and organizational resilience when faced with economic uncertainty.

This argument is further supported by the evidence in Sri Lanka. Balagobei and Keerthana (2023) discovered that the size of the board was found to have a negative relationship with financial distress of listed companies, which indicates that board size can help to make better decisions and raise resources in the institutional weak environment.

Nonetheless, the opposite results have shown that the correlation between board size and financial distress is not always useful but depend on the context. In the study by Gerged et al. (2022) and Budiningsih et al. (2022), respectively, the board size did not have statistical significance in the explanation of financial distress in the UK and Indonesia. Most recently, Altass (2024) found a positive relationship between the board size and financial distress in Saudi Arabia, which could be explained by the presence of too large boards that might in turn impede prompt decision-making and heighten coordination issues. Combined, these divergent results indicate that board size effectiveness is heavily reliant on institutional setting, ownership structure, and the quality of board activities and not board size itself.

H_1: There is significant impact of Board size on financial distress.

2.2.2 Board independence and financial distress

The board of directors influences the financial distress of the firm. It is the responsibility of independent directors to evaluate management and assess their performance (Jensen & Meckling, 1976). According to managerial control theory, the capacity of non-executive directors to make strategic decisions is constrained (Westphal & Fredrickson, 2001). Agency theorists describe managerial independence as a crucial component of the board's monitoring function (Fama, 1980). The board's independence is not always meaningless due to a cause-and-effect relationship. This is in line with the theory that internal governance practices in a firm such as board independence are internally based and effective in responding to the operations and external environment of a firm (Arora, 2018; Kalyani et al., 2019). Independent directors play an important role in promoting good corporate governance by giving honest control and minimizing agency issues between the management and shareholders. It has been shown that boards that have more independent directors are in a better position to keep a check on the management, thereby resulting in financial stability and decreased chances of financial distress (Gerged et al., 2022). The independent directors have a wide range of skills and experiences which tend to be more effective in the overall management risks related to financial distress in the board. They will be useful in crisis and recovery implementation strategies. Independent directors are linked with reduced laxity in controlling financial performance and regulation adherence, and this may reduce risks that result in financial distress (Hatane et al., 2019).

H_2: There is significant impact of independent directors on financial distress.

2.2.3 Board meeting and financial distress

Some research indicates that more frequent board meetings are associated with a lower likelihood of financial distress. K. C. Chan,and J.Li (2008) argue that frequent meetings provide opportunities for the board to assess financial health, discuss risk management, and implement strategic adjustments, thus helping to mitigate financial distress. Similarly, Balagobei and Keerthana (2023) highlight that regular meetings enable boards to address pressing issues related to financial performance and operational challenges, potentially reducing distress risks. Frequency and quality of board meetings have been considered as some of the most important indicators of effective corporate governance. Research has indicated that companies that practice good governance, including frequent, meaningful board meetings have better chances of not going through financial turmoil (Jensen, 1993). There are however also opposing opinions. According to Adams and Ferreira (2009), regular meetings are not necessarily more effective. Rather, they can be indicators of problems under the hood of the company, where more frequent meetings by boards are done in reaction to current financial or operational challenges. This view suggests that frequency of meeting may at times be used as an indication of a reactive and not proactive governance style.

> H_3: There is significant impact of the number of meetings held per year on financial distress.

2.2.4 CEO duality and financial distress

The role of the chairman and the role of the chief executive officer are usually differentiated in order to maintain the independence of the board. Many studies have revealed that the separation of CEO and chairman is necessary to achieve the independence of the board, enhance board effectiveness and enhance the oversight (Fama, 1980; Jensen, 1993). In a study by Chaganti et al. (1985), the board composition and size compared between 21 distressed and non-distressed firms showed negative relationship between financial crisis and the CEO duality. Nevertheless, the evidence on whether CEO duality can contribute to financial distress is not consistent. There is some evidence that indicates a positive correlation between CEO duality and financial distress, which means that the accumulation of power in the hands of one person can lead to governance failures and increased risk exposure (Gerged et al., 2022). Duality among the CEOs might also impact internal control systems; e.g., the dual CEOs of a company might invest less resources in independent control, becoming more vulnerable to financial hardships. On the other hand, boards having more independent directors tend to have fewer instances of financial distress, serving as evidence of the need to have a balance in governance structure (Balagobei & Keerthana, 2023). According to the hypothesis of monitoring, we put forward the following hypothesis:

> H_4: There is significant impact of CEO Duality on financial distress.

3. METHODOLOGY

The research is based on the positivist research paradigm that assumes that reality is objective, observable, and quantifiable. In line with this philosophical approach, the research study will assume a quantitative approach to research in which measurable indicators are used to test how corporate governance mechanisms relate to the occurrence of financial distress. The study adopted the secondary data, which was collected from audited financial reports of listed non-financial companies in Sri Lanka, between the years 2019 and 2023. The selected study period is especially relevant as it includes the performance of firms in the country prior to the major macroeconomic disruptions in Sri Lanka, the COVID-19 pandemic and the serious economic crisis of 2022. These incidents caused a lot of financial strain to the companies and thus give a suitable background for analyzing whether corporate governance systems can alleviate financial distresses in times of economic turbulence.

Although there is a lot of literature regarding corporate governance and financial distress in developed economies, there are few empirical studies about it in emerging economies, especially in the Sri Lankan context. Since Sri Lanka has a distinct economic situation at the time of the study (with negative implications of the COVID-19 pandemic and a long history of macroeconomic instability), the study will provide timely and context-related information. It seeks to increase the knowledge on how the political establishments can act as compensating mechanisms amid financial strains in less robust economic set-ups.

The research examines 284 listed companies of Colombo Stock Exchange (CSE) as of September 30, 2024 that comprises 20 GICS industrial groups and a market capitalization of Rs. 4,381.83 billion. A sample including 74 non-financial companies was chosen randomly to have an equal representation of sectors, except the financial companies, since they have a different regulatory framework. The sample of listed companies is also a way of accessing reliable and audited data and a wide sample of the Sri Lankan corporate environment.

Table 1 :Sample selection

Industrial sector	**Number of companies**
Energy	3
Materials	12
Capital Goods	3
Commercial and Professional Services	2
Transportation	2
Automobiles and Components	5
Consumer Durables and Apparel	8
Consumer Services	4
Retailing	2
Food and Staples Retailing	8
Food, Beverage, and Tobacco	6
Household and Personal Products	5
Health Care Equipment and Services	3
Pharmaceuticals, Biotechnology, and Life Sciences	2
Telecommunication Services	2
Utilities	3
Real Estate	4
Total	74

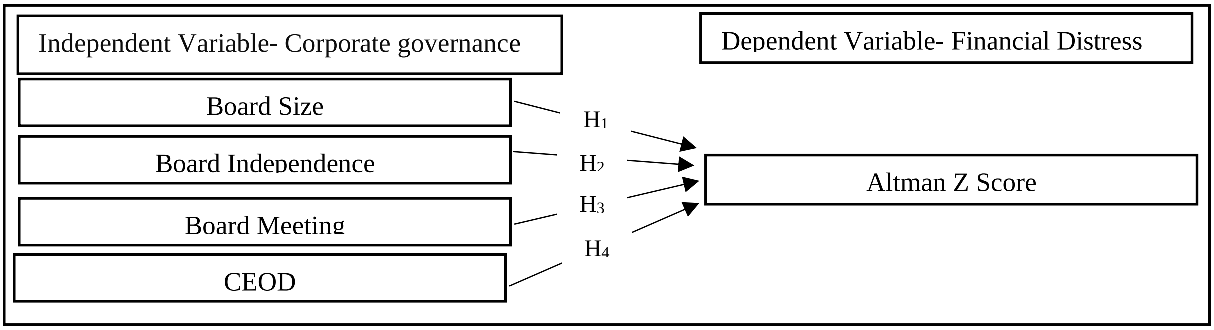
Source: Developed by the researcher

Simple random sampling technique was used to sample to reduce bias in the process of selection. To begin with, the entire sample of non-financial firms listed in the Colombo Stock Exchange was selected with the exclusion of those in the financial sector because of the special regulatory and capital structure needs. The eligible firms were given a numerical identifier and a random number generation process was used to select the companies at random until the desired sample size of 74 firms was settled. This was done to ensure that every qualified firm was given an equal chance of being represented in the sample, which gave more representativeness to the dataset.

Table 2 : Operationalization

Concept	Variable	Indicator	Measurement
Dependent Variable	Financial Distress	Altman Z Score	Z' = (0.717 X1) + (0.847 X2) + (3.107 X3) + (0.420 X4) + (0.998 X5) X1 = working capital/total assets, X2 = retained earnings/total assets, X3 = earnings before interest and taxes/total assets, X4 = market value equity/book value of total liabilities, X5 = sales/total assets, Z =overall index
Independent Variable	Board Size	The total number of members serving on a firm's board	Number of directors on the board.
	Board Meeting	Number of the board meetings held per year.	Number of board meetings per year.
	Board Independence	Ratio of number of Independent directors to total number of directors.	Independent Directors/Total Number of Directors
	CEO Duality	An indicator variable taking the value of 1 when the CEO and the chairman of the board is the same person 0 otherwise	A dummy variable where "1" denotes CEO duality (same individual holds both CEO and Chairman positions) and "0" denotes separation of roles.

Source: Developed by the researcher



Source: Developed by the researcher

Figure 1: Conceptual framework

This study investigates the impact of key corporate governance variables on the likelihood of financial distress in firms, conceptualized in Figure 1: Conceptual Framework. The independent variables, Board Size, Board Meeting Frequency, Board Independence, and CEO Duality, are hypothesized to significantly influence financial distress, which is the dependent variable capturing a firm's financial vulnerability. The dependent variable, financial distress, is operationalized using the widely accepted Altman Z-score, which aggregates five financial ratios into a single index that predicts the probability of distress. Even though the Altman Z-score model has been initially applied in the context of the US manufacturing firms, the model has been proved to be applicable to different international and emerging market settings as well. The Altman Z-score is one of the most common and empirically tested financial distress predictors compared to other prediction models (i.e. the Springate model or the Ohlson O-score model) when it comes to corporate financial distress (Altman et al., 2017). The model is also applicable in this study, since it uses financial ratios based on publicly traded financial statements, thus is consistent and comparable between the Sri Lankan listed companies. Moreover, Altman Z-score has been utilized as an effective measure as far as financial distress is concerned and the previous research studies carried out in the developing markets have managed to reach their desired conclusion.

To evaluate the relationship between corporate governance and financial distress, this study employs a multiple regression model using EViews software. The model investigates the impact of board independence (BI), CEO duality (CEOD), board size (BS), and board meetings (BM) on financial distress, measured by the Altman Z-Score. The regression equation estimated in EViews is:

$FDt = \beta 0 + \beta_1 BSi, t\text{-}1 + \beta_2 BIi, t\text{-}1 + \beta_3 BMi, t\text{-}1 + \beta_4 CEODi, t\text{-}1 + \varepsilon$------------------(1)

Where,

FDt = Financial distress firms
BI=Board Independence
CEOD=CEO Duality
BS=Board Size
BM=Board Meeting

4. RESULTS AND DISCUSSION

4.1Descriptive statistics

Descriptive statistics are useful to make general observation which provides simple summaries about the sample and the measures about the data collected. The main purpose of the descriptive statistic is to summarize the data which includes the mean, maximum, minimum, standard deviation. Data have been analyzed in respect of how corporate governance practices and FD changes among non-financial companies over the five years' period.

Table 3 illustrates the descriptive statistics for corporate governance practice proxies such as BS, BI, CEOD, and BM, and dependent variable that is denoted by FD. The data containing 370 observations which have been collected from last five years' annual reports for non-financial companies that include 74 companies.

Table 3: Descriptive Analysis

	FD	**CEOD**	**BS**	**BM**	**BI**
Mean	2.22	0.67	7.17	4.95	0.69
Median	1.90	1.00	7.00	4.00	0.70
Maximum	7.66	1.00	10.00	14.00	1.00
Minimum	-1.23	0.00	3.00	1.00	0.28
Std. Dev.	1.72	0.47	1.78	2.26	0.18
Sum	818.18	246.00	2646.00	1827.00	256.50
Sum Sq. Dev.	1089.44	82.00	1164.24	1887.12	12.88
Observations	370	370	370	370	370

Source: Results from data analysis

As shown in the above table 3, The value of financial distress of sample companies lies between -1.23 to 7.65, whereas the standard deviation is 1.72, suggests considerable variation in the financial health of the firms. The mean FD (Altman Z-score) is 2.21, indicating that on average, the companies in the sample are in the "grey zone" bordering on financial distress (Altman, 1968).

CEOD lies within the range of 0 to 1, with standard deviation is 0.472. Mean value of CEOD 0.666. The board size of the selected companies for the period, mean is 7.17 and ranged from 3 to 10 members. The standard deviation of the board size is 1.77%. The average board independence is 0.69, which lies within the range of 0.28 to 1.00 with a standard deviation of 0.187. Board meetings have an average value of 4.95 with a range from 1 to 14.

4.2Multicollinearity test

Table 4: Variance Inflation Factor (VIF) Results

Variable	VIF
BS	1.02
BI	1.08
BM	1.05
CEOD	1.04

Source: Results from data analysis

Diagnostic tests were carried out before the regression analysis to determine the possible existence of multicollinearity between the independent variables. Multicollinearity may give inaccurate regression estimates and undermine the precision of the interpretation of coefficient estimates. In order to evaluate this problem, the Variance Inflation Factor (VIF) was estimated on each independent variable. The VIF statistics of all the independent variables lie between 1.02 and 1.08, which are far much smaller than the standard value of 5 (Hair et al., 2019).

4.4Regression Analysis

Table 5: Regression Results on the Impact of Corporate Governance Variables on Financial Distress

	Coefficients	t Stat	P-value
c	4.31	7.56	0.00
BS	-0.19	-4.56	0.00
BI	0.28	0.51	0.61
BM	-0.22	-3.50	0.00
CEOD	0.97	3.53	0.00
R Square			0.57
F-statistic			6.23
Prob(F-statistic)			0.00
Hausman			
chi2			9.24
Prob > chi2			0.05
Breusch and Pagan Lagrangian multiplier test for random effects			
chibar2			287.8
Prob > chibar2			0.00

Source: Results from data analysis

Table 5 presents the regression results examining the impact of corporate governance variables on financial distress among listed non-financial companies in Sri Lanka. The analysis employed a fixed effects panel regression model to examine the impact of corporate governance variables on financial distress among listed non-financial companies in Sri Lanka between 2019 and 2023. Model selection was guided by a series of diagnostic tests. The Breusch and Pagan Lagrangian Multiplier test rejected the null hypothesis that variance across entities is zero (chibar^2 = 287.8, p = 0.00), confirming the presence of panel effects and validating the use of a panel regression model over pooled OLS. To determine whether fixed or random effects would be more appropriate, the Hausman test was performed. The chi-square statistic (χ^2 = 9.24, p = 0.05) indicated that fixed effects were preferable, as it account for unobserved heterogeneity and potential correlation between individual firm effects and regressors.

The model's explanatory power was substantial, with an R-squared value of 0.57, indicating that 57% of the variation in financial distress could be explained by the selected governance variables. The model was statistically significant overall (F-statistic = 6.23, p = 0.00), affirming the joint relevance of the independent variables in explaining financial distress within the sample.

Board size exhibited a negative and statistically significant relationship with financial distress (β = -0.19, t = -4.56, p = 0.00), supporting resource dependence theory. Resource dependence theory argues that larger boards enhance organizational capacity by pooling diverse expertise, offering greater strategic advice, and facilitating resource acquisition-factors especially valuable during financial downturns (Pfeffer & Salancik, 1978; Chang, Merino, & Banegas, 2015). In contrast, agency theory warns that larger boards may impair efficiency due to coordination difficulties, free-riding, and slower decision-making, potentially increasing a firm's vulnerability to financial distress (Jensen, 1993; Cardoso, Peixoto, & Barboza, 2019). However, the negative association found in this study contradicts the agency theory perspective, suggesting that the benefits of a larger board outweigh potential inefficiencies in this context.

The frequency of board meetings also showed a negative and significant relationship with financial distress (β = -0.22, t = -3.50, p = 0.00), highlighting the role of active board engagement. This result aligns with the view that governance is not solely structural but also behavioral. Boards that meet frequently are better positioned to monitor management, review financial performance, and take corrective action when needed.

Contrary to theoretical expectations, board independence exhibited a positive but statistically insignificant coefficient (β = 0.28, t = 0.51, p = 0.61). This challenges the core assumption of agency theory, which advocates for independent directors as mechanisms to enhance objectivity and shareholder protection. The insignificance of board independence may reflect several contextual issues within the Sri Lankan corporate landscape, such as nominal compliance, weak regulatory enforcement, or the limited influence of independent directors in practice. This result echoes concerns raised by Bhagat and Black (2002) and Ehikioya (2009), suggesting that formal independence does not necessarily translate into governance effectiveness unless supported by real authority, active participation, and institutional integrity. The result aligns with numerous studies carried out on emerging markets which claim that formal board independence cannot always be reflected into good governance. As an illustration, according to the study by Silva (2020), the independence of directors in Sri Lankan listed companies did not have a significant impact on the financial performance of the business as independent directors lacked power and influence. Comparatively, Bhagat and Black (2002) and Ehikioya (2009) believe that the independence of the board is still not sufficient to ensure that effective monitoring is provided, unless it is combined with good institutions and active board practice. The coefficient of board independence (0.28) is small and statistically insignificant, though, as an economic perspective, which indicates that increasing the percentage of independent directors is statistically insignificant in financial distress in the sampled firms. It means that the performance of governance can rely more on board activity and board leadership than on the composition of the board.

CEO duality displayed a strong positive and statistically significant effect on financial distress ($\beta = 0.97$, $t = 3.53$, $p = 0.00$). This finding supports the agency theory argument that the combination of CEO and board chair roles leads to a concentration of power, which compromises the board's ability to function as an effective oversight body. The result aligns with international governance best practices, including the OECD's Principles of Corporate Governance, which advocate for the separation of the two roles to promote accountability and reduce agency risks. In the Sri Lankan setting, where concentrated ownership and familial leadership structures are common, the risk associated with CEO duality may be even more pronounced, heightening the firm's vulnerability to financial distress through unchecked decision-making and strategic myopia.

5. CONCLUSION

The main aim of the research was to test how the corporate governance mechanisms influence financial distress among the listed non-financial firms in Sri Lanka. The motivation behind this study was the problem statement that, although governance is a critical variable in the prevention of corporate failures, there is a lack of empirical data on the predictive potential of the operationalization of governance variables in financial distress in new markets, such as Sri Lanka. The current literature in the Sri Lankan setting has concentrated much on firm performance or quality of disclosure, and has not considered the nexus of governance and distress in the context of non-financial firms.

This study examined how financial distress measured by the Altman Z-score is determined by four important variables of governance, including board size, board independence, frequency of board meeting, and CEO duality using panel data comprised of 74 non-financial companies listed on the Colombo Stock Exchange between 2019 and 2023.

The empirical findings indicated that the financial distress was materially negatively impacted by the board size as well as the board meeting frequency, which implies that board size and the frequency of the board meetings are positively correlated with the financial well-being. The results confirm the assumptions of resource dependence theories, and it is observed that the organization of governance and diligence of board members increases the level of control and decision-making ability, especially in the time of financial decline.

On the other hand, the positive impact of the presence of the CEO duality on financial distress was considerable, which supports the argument of power concentration in case the CEO is the board chair. This is where role separation comes out as a necessity in order to have effective supervision and accountability of the boards. Surprisingly, the effect of board independence was found to be statistically **in**significant indicating that the availability of independent directors alone is not enough to mitigate financial distress, but this could be caused by poor enforcement, restricted independence of directors, or a token compliance in Sri Lankan corporate setting.

5.1Implications

The implications of this study to the corporate governance reform and financial stability in Sri Lanka are critical particularly in mitigation of financial distress. Financial distress is a great risk to the existence of corporations, stakeholder trust and the overall well-being of the entire economy especially in the emerging economies such as Sri Lanka where institutional protection is generally ineffective. The present research demonstrates that the financial distress levels are linked to the presence of certain governance practices, i.e., a larger board size and a high number of board meetings, which means that they can be considered as the protective mechanism in times of deteriorating financial results. On the other hand, CEO duality was also discovered to greatly heighten the risk of financial distress and therefore, unregulated executive power may result in inadequate decision-making and lack of accountability. These results imply that companies and authorities need to focus on governance frameworks not only to improve performance but also as a corporate shield against financial meltdown. Regular regulators like the Securities and Exchange Commission (SEC) and the Colombo Stock Exchange (CSE) ought to encourage the active implementation of governance codes and discourage the symbolic compliance. To the corporate leaders, it implies that they should engage in board habits that are really efficient in detecting the early warning signs of financial trouble and acting decisively before distress can progress into insolvency or collapse. Enhancing corporate governance is therefore not only a compliance issue but an essential move into instilling resilience and avoiding financial panic in the corporate world of Sri Lanka.

5.2Limitations and future research directions

This research offers valuable information about the connection between corporate governance and financial distress in Sri Lanka, but there are a number of limitations that should be considered. First, it focuses exclusively on a single-country context, which may restrict the generalizability of the findings to countries with different institutional, economic, or regulatory environments. Second, the analysis is limited to non-financial publicly listed companies, thereby excluding financial institutions, private firms, and small and medium-sized enterprises that may follow different governance practices and experience financial challenges differently. Third, the study is based solely on secondary quantitative data, which may not fully reflect qualitative dimensions such as leadership behavior, boardroom dynamics, ethical culture, or managerial competence. In addition, financial distress was measured through financial ratios, offering a useful but somewhat narrow lens that may overlook broader organizational and contextual factors. These limitations open several avenues for future research. Expanding the analysis to include multiple countries, particularly within South Asia or other emerging markets, would allow for comparative insights and enhance the applicability of the findings across diverse contexts. Including financial institutions and unlisted firms would offer a more comprehensive picture of corporate governance across different organizational types. Moreover, incorporating qualitative approaches such as interviews, surveys, or case studies could provide a deeper understanding of the human and cultural aspects of governance that influence financial health. Future studies may also benefit from using longitudinal data to observe how governance practices evolve over time and respond to periods of financial stress. Exploring external influences such as macroeconomic conditions, political stability, and regulatory shifts could further enrich understanding of how governance structures function as defences against financial distress.

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