Corporate Governance Practices and Financial Distress: Empirical Evidence from Listed Companies in Sri Lanka

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Abstract

The study aims to investigate the impact of corporate governance on financial distress of listed companies in Sri Lanka. Board size, board composition, CEO duality, board meeting, director ownership, and audit committee size are proxies for corporate governance while financial distress is measured by the Altman Z-score. Altman Z-score measures financial distress inversely and bigger the Z-score indicates the smaller the risk of financial distress. Using hundred and eight individual observations of firms listed in Sri Lanka for the period of 2019 to 2021 and employing fixed effects model, the effect of corporate governance practices on financial distress is evaluated. The results from panel data regression analysis reveal that firms having large number of directors on the board have a low likelihood of financial distress of listed companies in Sri Lanka. Furthermore, when a chief executive officer serves as the chairman of the board at a company, the more likely it is that the company will experience financial distress. But, board composition, audit committee size, board meeting and director ownership have not shown any significant impact on financial distress. The current study also provides evidence that firm-specific characteristics such as firm size, leverage and profitability, could be useful as to determining the likelihood of financial distress. The findings may be of prominence to the academic researchers, practitioners, and regulators who are interested in discovering the quality of corporate governance practices in a developing market and its impact on financial distress.

Keywords: *Board size, CEO duality, Corporate governance, Financial distress*

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Introduction

The prediction of financial distress (FDIS) in recent years has been a major problem for businesses all over the world. Due to the COVID-19 pandemic as well as an increasing number of companies in FDIS, companies face a serious threat to their operations. Corporate governance (CG) is used as a controlling mechanism for a company's operations. In recent years, FDIS has piqued the interest of investors, policymakers, and researchers, prompting them to conduct extensive research on the implementation of CG practices. There is a conflict in current CG implementation on whether it is an effective mechanism to prevent organizations from FDIS (Alabede, 2016). According to Bilal et al. (2013), the probabilistic perspective defines FDIS. The possibility of FDIS is evaluated due to the inadequate liquidity of assets and the higher level of debt of a firm. Financial distressed companies need to face difficulties in paying their financial obligations to creditors.

Several situations cause FDIS to companies, such as being unable to forecast the development of operations, being unable to predict the company's cash flows, and making effective financial decisions. Some studies found that CG significantly increased the strength of bankruptcy forecasts (Lajili & Zéghal, 2010; Platt & Platt, 2012). Wruck (1990) stated that economic distress, poor management, and a decrease of performance led companies to fall into a FDIS situation. In addition, in the OECD, poor CG mechanisms plunge companies into FDIS situations. Another study by Manzaneque et al. (2016) on influence of good CG on FDIS reports a conflict between management and stakeholders during crisis time because managers prefer a short-term strategy not to lose their jobs.

COVID – 19 has generated distinctive and very profound challenges for almost all listed firms in Sri Lanka. The board of the directors, who is charged with overseeing the short-term and long-term health of the firms and its business prospects, navigating the COVID-19 crisis requires careful consideration of a range of concerns under these unprecedented situations. The board of directors should consider several CG issues as their corporations have to respond to the challenges and uncertainty caused by the COVID-19 pandemic.

Several researches have been conducted in developed nations, but in the emerging markets like Sri Lanka, insufficient studies have been conducted on CG and FDIS. Hence, this paper examines the impact of CG on FDIS of listed companies in Sri Lanka. This research is mainly focused on consumer services companies to obtain a deeper understanding of the hotel industry regarding FDIS. Although COVID-19 has affected every sector across the globe, and the hotel industry is among the hardest hit (Roshan et al., 2020; Arachchi & Gnanapala, 2020). Almost all of the hotel rooms were empty and more than half of the hotel employees have been thrown off from their jobs. Nearly 50% of revenue was declined during the first half of 2020 (Roshan et al., 2020). According to United Nation World Tourism Organization (UNWTO), international tourist arrivals are dropped by 20% to 30% in 2020 compared with 2019, which implies a loss of 290 million to 440 million tourists during a single year (UNWTO, 2020).

In Sri Lanka, some companies have failed due to a lack of consistency in policies, control procedures, guidelines, and mechanisms to ensure accountability and fiduciary duty (Jayasooriya et al., 2018). Moreover, in recent years, some listed companies faced difficulties in earning a profit as well as bankruptcy situations due to the COVID-19 pandemic and, new policies and regulations implemented by the government. Several studies have been conducted and concluded that there is a

significant association between CG and FDIS (Mariano et al., 2021; Younas et al., 2021; Luqman et al., 2018). Some other scholars have proved that there is no significant relationship between them (Li et al., 2021; Uduwalage, 2021). Therefore, there is an indecisive finding on CG and FDIS. Hence, the issue remains unsolved, giving scope for additional research.

Literature Review and Hypothesis Development

Theoretical Review

CG is significant in cutting-edge groups because of the separation of control and possession manipulated within the organizations. The pursuits of shareholders conflict with the pursuits of managers. The most important agent hassle is reflected within the control and route associated troubles because of the differential pursuits of the firm's stakeholders.

CG is defined as "the gadget with the aid of which commercial enterprise groups are directed and controlled" (OECD, 1999). The company's governance shape specifies the distribution of rights and obligations amongst unique individuals within the corporation such as the board, managers, shareholders, and other stakeholders, and spells out the regulations and techniques for making selections in company affairs. By doing this, it additionally offers the shape through which the organization's targets are set and the method of achieving the targets and tracking performance. Shleifer and Vishny (1997) define CG "the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment". A similar concept is suggested by Caramanolis Cötelli (1995), who regards "CG as being determined by the equity allocation among insiders (including executives, CEOs, directors, or other individual, corporate, or institutional investors who are affiliated with management) and outside investors".

Ehab, Rahim and Ananth (2011) define FDIS as "a borrower is unable to meet payment obligation to lenders and creditors due to reputation, leverage, volatility of earnings, collateral, economic condition or interest rates". As stated by Andrade and Kaplan (1998), FDIS is a circumstance in which a firm cannot fulfill its debt obligations to the creditors, which in return leads to either restructuring or bankruptcy. According to Ray (2011) a firm experience FDIS where there is a violation of loan contracts and when organization incur constant losses and fails to honor obligation when it is due. Wesa and Otinga (2018) noted that financially distressed firms are generally faced with two possible major problems; they are experiencing cash shortage on the asset side or overdue obligation on the liabilities sides of the statement of financial position. The adverse effect of FDIS in an organization threatens the survival of firms.

In Sri Lanka, Samarakoon and Hasan (2003) assess the Altman's Z-score models and reveal that third version of score model (Z"-score model) provides the highest overall success rate. Z-score models have a good potential in predicting FDIS of firms in emerging markets, but with a declining overall accuracy at the two consecutive years prior to distress. The current study provides evidence that Altman's Z-score model is an appropriate analytical tool for Sri Lankan corporations in predicting FDIS.

Empirical Review

CG researches have inconclusive evidences on the association between CG and FDIS of the firms. After many businesses have collapsed, the relationship between CG and FDIS has been the most researched topic in both developed and developing countries (Udin, Khan, & Javid, 2017). Some previous

studies show that CG practices have an impact on FDIS.

Cardoso et al. (2019) revealed that board size and FDIS has U shaped relationship, indicating an optimal number of directors of six during the period. Even so, board characteristics are insufficient to reducing the FDIS of firm and not enough to align shareholders interest when other factors are neglected. Mariano et al. (2021) suggested that low level of ownership concentration and a low degree-independence are more likely to experience FDIS. Even a large number of directors on board reduce the possibility of FDIS. Similarly, Younas et al. (2021) investigated the influence of the CG index on performance of non-financial firms listed on the Pakistan Stock Exchange and indicate a direct association between the CG index and the firm's FDIS. Even though Li et al. (2021) stated that CG alone is inadequate to predict FDIS, it can add to the predictive power of financial indicators and macroeconomic variables.

Luqman et al. (2018) analyzed that good CG attributes mitigate the likelihood of FDIS and found an inverse relationship between FDIS, director ownership, block-holder ownership, and audit committee. Elloumi and Gueyle (2001) examined the association between CG attributes and FDIS in Canadian firms and revealed that the board composition describes FDIS beyond exclusive reliance on financial indicators. Furthermore, segmenting financially distressed firms based on CEO change as a proxy for turnaround strategies provides useful insights into CG attributes in FDIS. Hambrick and D'Aveni (1992) found that having a leading CEO as a weak CG practice is more likely to be related with business insolvency. Daily and Dalton (1994) also confirmed that a direct relationship between the possibility of impoverishment and poor CG attributes as measured by CEO duality and low degree of independence among the directors.

Wang and Deng (2006) showed the inverse association between FDIS status and CG attributes such as ownership concentration, government ownership and the independent directors whereas CEO duality, board size, managerial ownership and degree of balanced ownership do not affect the possibility of FDIS in China. Likewise, Abdullah (2006) confirmed an inverse relationship between the FDIS and ownership, as measured by the proportion of shares held by executive directors, non-executive directors and outside block-holders. Furthermore, Li et al. (2008) found that ownership concentration, state ownership, ultimate owner, independent directors and auditors' opinion are adversely linked with the possibility of FDIS. Furthermore, managerial ownership doesn't influence FDIS. Ciampi (2015) identified that CEO duality, concentration of ownership and control and reduced independent directors are inversely related to small corporations' default, and that CG attributes improve the default possibility of small corporations.

However, Al-Tamimi (2012) indicated a direct association between FDIS and the CG attributes of national banks in UAE. Moreover, Pramudena (2017) investigated the impact of good CG on FDIS using a sample of 10 corporations in Sri Lanka and concludes a direct association between board size and FDIS as measured by Altman Z score. Accordingly, the following hypotheses have been developed to investigate the impact of CG on FDIS:

$H_{1:}$ Board size has a significant impact on FDIS.
$H_{2:}$ Board composition has a significant impact on FDIS.
$H_{3:}$ CEO duality has a significant impact on FDIS.
$H_{4:}$ Audit committee size has a significant impact on FDIS.
$H_{5:}$ Board meeting has a significant impact on FDIS.

H_6: Director ownership has a significant impact on FDIS.

Methodology

This section describes the research methodology and methods adopted in this study. Deductive approach and quantitative method are adopted as this study intends to analyse the association between CG practices and FDIS.

Population and Data collection

Consumer service companies play a key role in the Sri Lankan economy by creating jobs, generating revenue, and improving the quality of life for citizens. Therefore, the study of CG and FDIS in Sri Lanka takes a population of 36 consumer service corporations listed in Sri Lanka. The audited annual reports and the websites of the selected corporations are used as the main secondary sources of data. In order to enhance the quality of data, information for the period of three years from 2019 to 2021 has been considered. This study consists of 108 individual observations and employs panel data extracted from the annual reports of consumer service firms listed in Sri Lanka.

Measurement of Variables

Corporate Governance Practices

The CG is the very crucial element in the emerging economy. In this study, six proxies are used to measure the CG: board size, board composition, CEO duality, board meeting, director ownership, and audit committee size. Board composition is the proportion of independent non-executive directors to the total number of directors on the board while board size is measured by number of directors on the board. When the chief executive officer is functioning as board chairperson in the board, CEO duality is equal to one; otherwise, zero. Audit committee size denotes the number of members in audit committee. Board meeting is evaluated that number of meetings held per year. Director ownership is the number of shares held by directors in the firm.

Financial Distress

To evaluate the impact of CG on FDIS, the Altman *Z*-score is employed as a proxy of the converse of FDIS, where the *Z*-score model becomes one of the most frequently used early warning models of the risk of FDIS (Yi, 2012). Altman (1968) introduced the Z-score model as a good predictor of bankruptcy and the score is computed as follows:

$$\text{Z-Score} = 1.2X_1 + 1.4\,X_2 + 3.3\,X_3 + 0.6\,X_4 + 1.0\,X_5 \quad (1)$$

where,

X_1 - Working capital/total assets
X_2 - Retained earnings/total assets
X_3 - Earnings before interest and taxes/total assets
X_4 - Market value equity/book value of total debt
X_5 – Sales/total assets

If the Z-Score value is 1.81 or above, then it can be regarded that the firm is financially sound, and if the Z-Score value is less than 1.81, then it can be regarded that the firm is in financially distressed (Udin et al., 2017).

Control Variables

In most of the previous literature, certain firm-specific variables namely firm size, firm age, leverage and profitability were derived as control variables to eliminate any specification errors in the estimated model (Wang & Deng, 2006; Coles et al., 2008; Ehikioya, 2009). Firm size is the natural logarithm of total assets in a firm. Leverage refers to the long-term debt to total assets. Profitability is measured by net income to

total assets. Firm age is indicated by the natural logarithm of firm age since incorporation.

Model Specification

The panel regression model is employed to estimate the association between CG practices and FDIS. It is applied to overcome the limitations of the ordinary least squares (OLS) parameters. The following econometric model is specified to examine the impact of CG on FDIS.

$$FDIS=\beta_0+\beta_1 BSIZ+\beta_2 BCOM+\beta_3 CEOD+\beta_4 ACSIZ+\beta_5 BMEE+\beta_6 DOWN+\beta_7 FSIZ+\beta_8 LEV+\beta_9 PROF+\beta_{10} FAGE+\varepsilon \quad (2)$$

Where: β_0, β_1,β_2,β_3 ,β_4,β_5,β_6,β_7,β_8,β_9 and β_{10} - Regression coefficient; BSIZ- Board size; BCOM- Board composition; CEOD- CEO duality; ACSIZ- Audit committee size; BMEE- Board meeting; DOWN- Director ownership; FSIZ- Firm size; LEVE- Leverage; PROF-Profitability; FAGE- Firm Age; FDIS- FDIS.

Findings and Discussions

Descriptive Statistics

Descriptive statistics which is presented in Table 01 evaluate the selected CG practices and the FDIS of listed companies in the consumer service sector in Sri Lanka. As seen in Table 01, on average, the mean value of BSIZ is eight and the standard deviation is 2.06 which show that there is a substantial variation. Furthermore, 40.2% of the directors on the board are independent non-executive directors. Accordingly, it could be claimed that the proportion of outside directors is to the standard recommended by the best CG practices. CEOD is observed in 38.9 percent of the organizations in the target population. The firms in this study have conducted average four BMEEs which are in line with the stipulated baseline requirements of the code of best practice. On average, audit committee consists of three members in consumer service firms. Directors averagely hold 2.796% of organization shares during the sample period. The mean value of FDIS is 1.963 with the standard deviation of 3.006. The results show that there is a substantial variation in FDIS status among consumer service firms.

Table 01: Descriptive Statistics

Variables	Mean	Maximum	Minimum	St. deviation
BSIZ	8.194	14.000	4.000	2.062
BCOM	0.402	0.667	0.222	0.010
CEOD	0.389	1.000	0.00	0.490
ACSIZ	3.287	5.000	2.000	0.762
BMEE	4.056	13.000	1.000	1.918
DOWN	2.796	15.137	0.000	4.436
FDIS	1.963	16.650	-1.340	3.006
FAGE	1.398	2.000	0.000	0.579
FSIZ	9.000	10.000	6.000	1.144
LEVE	0.142	0.817	0.000	0.158
PROF	-0.012	0.137	-0.278	0.066

Source: Survey data

Multicollinearity

Table 02: Variance Inflation Factor (VIF)

Variable	Coefficient Variance	Centered VIF
C	12.076	NA
BSIZ	0.021	1.234
BCOM	9.753	1.293
CEOD	0.380	1.261
ACSIZ	0.218	1.750
BMEE	0.0317	1.613
DOWN	0.005	1.533
FAGE	0.291	1.351
FSIZ	0.068	1.243
LEVE	4.334	1.486
PROF	23.838	1.412

Table 02 represents the summary of the variance inflation factor for the explanatory and control variables of this study. In order to detect the multicollinearity problems in the regressive model, VIF test is carried out in the set of regressors with the dependent variable. If the VIF is greater than 10, there is a multicollinearity problem (Hair et al., 1995). In this study, there was the absence of multicollinearity problem among the CG and control variables as all VIFs are less than 10.

Unit Root Test

Table 03 shows Augmented Dickey-Fuller (ADF) test used to check the stationary nature of data. The figures of P-value are less than 0.05 for all the variables. All the variables are stationary which shows that variables are not dependent over time. It is also concluded that data does not have any unit root at zero lag with no time and no drift trend.

Table 03: Augmented Dickey-Fuller (ADF) Test

Variables	ADF (t statistic)	Probability
BSIZ	-4.214002	0.0010
BCOM	-4.156391	0.0012
CEOD	-3.247950	0.0200
ACSIZ	-4.052831	0.0017
BMEE	-6.727305	0.0000
DOWN	-5.876038	0.0000
FAGE	-7.852103	0.0000
FSIZ	-2.945821	0.0437
LEVE	-7.306993	0.0000
PROF	-5.678620	0.0000
FDIS	-4.805351	0.0001

Panel Data Regression Analysis

Table 04: Panel Regression Analysis

	Pooled Least Squares			Random effects model			Fixed effects model		
	Coefficient	t-Statistic	Prob.	Coefficient	t-Statistic	Prob.	Coefficient	t-Statistic	Prob.
C	3.60	0.57	0.56	3.60	0.57	0.56	2.92	0.72	0.47
BSIZ	0.95	3.33	0.00	0.95	3.33	0.00	0.38	2.19	0.03
BCOM	4.84	1.07	0.28	4.84	1.07	0.28	5.94	1.85	0.06
CEOD	-2.11	-3.42	0.00	-1.65	-2.64	0.00	-1.88	-1.91	0.05
ACSIZ	0.59	0.70	0.48	0.59	0.70	0.48	-0.14	-0.28	0.77
BMEE	-0.17	-1.84	0.07	-0.17	-1.84	0.07	-0.15	-1.74	0.08
DOWN	0.08	0.84	0.40	0.08	0.84	0.40	0.00	0.12	0.89
FAGE	4.96	3.93	0.00	4.96	3.93	0.00	0.64	0.93	0.35
FSIZ	-2.23	-3.87	0.00	-2.23	-3.87	0.00	-0.65	-2.00	0.04
LEVE	2.83	1.78	0.07	2.83	1.78	0.07	2.79	2.08	0.03
PROF	9.59	3.88	0.00	9.59	3.88	0.00	8.53	3.77	0.00
R-squared			0.9367			0.9367			0.2073
Adjusted R-squared			0.8925			0.8925			0.1256
F-statistic			21.2071 (0.000)			21.2071 (0.000)			2.5375 (0.0092)
Durbin-Watson			2.6013			2.6013			1.8908
Hausman Test - Chi-Sq. Statistic									39.9817 (0.000)

As seen in Table 04, the results of the panel regression demonstrate that the Altman Z-score, the measure of distress status, is regressed on CG practices as measured by CG indicators. An absolute value of Altman Z-score which is used to measure the possibility of FDIS determines the FDIS inversely. A higher value of the Altman Z-score means a lower level of risk of FDIS.

Table 04 represents the Pooled Least Squares (PLS) and panel regression with fixed effects and random effects models to estimate unbiased results. Hausman test is applied to determine the best method between fixed effects or random effects. In this study, the fixed effects model is more appropriate as the p-value is less than 0.05 (Chi-Sq. Statistic 39.9817, $p < 0.05$). Accordingly, adjusted R squared value of 0.1256 indicates that 12.56% of the variance in FDIS of listed consumer service companies is demonstrated by CG variables and the remaining 87.44% of the variance is explained by other factors not shown in this model.

Based on the output of the fixed effects model, BSIZ has a positive association with Z-Score model (ß=0.38, p=0.03) at 0.05 significant levels. This finding collaborates with prior studies such as Dissanayke et al. (2017), Elloumi et al. (2001), Din et al. (2020), and Handriani et al. (2021). Therefore, H_1 is supported by the finding. The significant positive association between BSIZ and FDIS indicator suggests that if a firm has a large number of directors on board, the likelihood of the FDIS will be low. It implies that having more directors on the board, it supports to the effective decision-making process. A diverse board with different skills, backgrounds and experiences is assumed to be able to approach problems from a greater range of perspectives, to raise challenging questions and to debate more vigorously within top management groups. But, BCOM has not

shown any significant impact on FDIS at 0.05 significant levels. Hence, Therefore, H_2 is not supported by the finding. This result is in line with prior studies namely Berthelot et al. (2012), Dal Vesco and Beuren (2016) and Acero Fraile and Alcalde Fradejas (2014). Furthermore, CEOD is negatively associated with FDIS indicator (ß=-1.88, p=0.05) at 0.05 significant levels. This finding collaborates with prior study such as Wang and Deng (2006). Therefore, H_3 is supported by the finding of the study. The negative association between CEOD and FDIS implies that firms having the practice of CEOD are likely to experience the possibility of FDIS. The practice of CEOD in firms may raise the risk of entrenchment and agency conflicts (Fama & Jensen, 1983; Jensen, 1993). This finding is consistent with the study of Ali and Nasir (2018). According to the Table 04, ACSIZ (ß=-0.14, p=0.77), BMEE (ß=-0.15, p=0.08) and DOWN (ß=0.00, p=0.89) have not shown any significant impact on FDIS of listed companies in the consumer service sector at 0.05 significant levels. Hence, H_4, H_5 and H_6 are not supported by findings of the study. Moreover, FAGE does not have a significant impact on FDIS. But, LEVE and PROF have a positive impact on FDIS whereas FSIZ has a negative impact on FDIS at 5% significant levels. Durbin Watson test is 1.8908, which is close to 2 indicating a very low level of autocorrelation.

Conclusion

The present study examines the impact of CG on FDIS of listed companies in consumer service sector in Sri Lanka for the period of three years from 2019 to 2021. Employing panel data regression analysis with fixed effects model, it is concluded that BSIZ has a positive association with the FDIS indicator. It suggests that if a company has a large number of directors on board, the possibility of the FDIS will be low. Furthermore, CEOD is negatively associated with FDIS of listed companies in consumer service sector in Sri Lanka. It indicates that companies having the practice of CEOD are likely to experience the possibility of FDIS. Other variables of CG such as ACSIZ, BMEE and DOWN do not affect the FDIS. Furthermore, LEVE and PROF have a positive impact on FDIS while FSIZ has a negative impact on FDIS. Furthermore, the results show that few CG practices are not much suitable to reduce FDIS when BSIZ is a more prominent factor to mitigate the FDIS. Thus, it is concluded that companies should position themselves by strengthening their governance structures to increase their attractiveness and, therefore, access to financial markets.

Recommendations and Future Direction

Based on the findings of the study, when appointing the directors on the board, their knowledge, skills, and experience should be considered for conducting the business of the board. Hence, the possibility of FDIS can be reduced in the firms. Moreover, it can be recommended that the chairman as well as chief executive officer should be different person in the companies. Therefore, the agency and other related issues would be mitigated, and it can help alleviate FDIS of the listed companies.

Overall, the empirical findings of the present study extend the understanding of CG and its effects on FDIS in Sri Lanka. Researchers, owners, and practitioners are more interested in the findings of the study for various reasons. This study provides the contribution to the existing body of knowledge on the impact of CG practices on FDIS. Furthermore, this study contributes to future research on FDIS and the understanding of distress prediction models. It highlights the need to establish other instruments to ensure the protection of the interests of minority shareholders since the independence and composition of the board members are shown to be insufficient.

The findings of the study are subjects to shortcomings. The sample size needs to be extended and more attributes of CG will be incorporated to increase the validity and generalizability of the results. The findings show that CG practices are not sufficient to align the shareholders' interests and unsuitable for mitigating FDIS in firms when other factors are neglected. In the future, researchers may incorporate other governance factors to assess the CG practices such as director remuneration, remuneration or other board committees, the presence of women directors on the board, qualifications and age of the directors. Furthermore, future investigators can be encouraged to explore the association between risk management and CG attributes. Another productive extension of this study would be to examine the influence of CG on firm intellectual capital performance.

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