THE RELATIONSHIP BETWEEN FINANCIAL DISTRESS RISK AND STOCK RETURNS: EVIDENCE FROM SRI LANKA

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If the financial foundation of the company is weak and appears to be in bankruptcy, it can adversely affect all people who are involved in business and financial partnerships with the company. Therefore, the main objective of this study is to identify whether there is any significant difference between stock returns of a financial distress company and a non-distress company. The Z-score model developed by Altman which is concluded by many researchers as a highly reliable measurement of capturing the distressed situation of a company operating in a country such as Sri Lanka has been used as a proxy for measuring the financial distress in the study. As a result of this study, 59 companies were determined as non-distressed because their Z scores were higher than 1.81, whereas 42 companies were categorized as distressed because of lower scores than 1.81. The analysis indicates that there is not any significant difference between the stock returns of the distressed company and the non-distressed company. It is also examined from empirical studies that the mathematical interpretation and earlier findings of the distress situation, the book-to-market effect, and the market capitalization on stock returns do not hold in the case of Sri Lankan companies on the Colombo stock exchange. Through looking individually and collectively at the return patterns of financially distressed and non-distressed companies, the study can be used effectively for successful decision-making for investors as well as corporate bodies when getting their investment decisions.

Keywords: *Bankruptcy; B/M ratio; Financial Distress; Stock Returns; Z-score*
