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The Impact of Corporate Governance on Financial Distress: Evidence from Listed Financial Institutions in Sri Lanka

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Abstract

This study focuses on the role of corporate governance in predicting financial distress of companies in the finance sector in Sri Lanka. Over the past two decades, several finance sector companies collapsed in Sri Lanka affecting numerous victims with no proper compensation payments. The study aims to unveil the impact of corporate governance on financial distress of companies in the financial sector. A number of key variables included to measure the corporate governance such as board size, board gender diversification, frequency of board meetings, audit quality, board member remuneration, CEO duality, education level of the board members, and board independence. As control variables firm size, profitability, and financial leverage are considered. Financial distress is operationalized through the measures of institutions negative profit, cash flow, or worth for three consecutive years. Data from 54 listed financial institutions in Sri Lanka were collected from 2017 to 2022. Descriptive analysis, Pearson correlation analysis, corporate governance comparison model, and regression analysis were employed for data analysis. The findings indicate that board size, board gender diversification, frequency of board meetings, higher audit quality, education level of the board, board independence, and return on equity have a significant negative impact on financial distress. These findings can help identify at-risk financial institutions, support decision-making for investors and stakeholders, guide the implementation of corporate governance policies, and inform policymakers in developing new governance policies.

Keywords: *Corporate governance, Code of best practice, Financial distress*

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Background to the Study

The financial sector is a critical component of any economy, influencing all other industries and the economic cycle. However, despite being the most regulated and monitored sector in the country, any crises within this sector can have severe and wide-ranging consequences. Sri Lanka has experienced several corporate failures in the financial sector over the past two decades, which have been attributed to poor corporate governance practices (Seylan Bank PLC, 2009). Some examples of corporate failures in the financial sector in Sri Lanka include the Golden Key Credit Card Co. Limited and ETI Finance. Golden Key accepted deposits like a bank without the necessary license, leading to a collapse when investors withdrew funds after the exposure of the Sakvithi scam. In the case of ETI Finance, the board of directors committed multiple offenses, leaving the company financially distressed and thousands of savings account holders unable to recover their funds (Seylan Bank PLC, 2009). The bankruptcy of these corporations has significant repercussions on fund providers, related businesses, and the overall economy. For example, the Golden Key collapse caused depositors to lose their money, while the ETI Finance debacle damaged the reputation of the financial sector and led to a loss of confidence among investors.

Corporate governance practices have come under scrutiny due to these scandals and the need for improved direction and control in organizations, driven by globalization and cultural changes. Financial distress, a prevalent issue globally, has led to the collapse and legal troubles of organizations. Therefore, studying and understanding the corporate governance factors that contribute to financial distress is crucial to prevent future debacles (Sameera & Senaratne, 2015).

Predicting and addressing financial distress plays a vital role in the long-term survival and growth of firms in a dynamic business environment. By identifying and addressing weaknesses in corporate governance, similar crises can be avoided in the future.

Discussion

This particular study was motivated by the observation that firms experiencing financial distress often exhibit weaknesses in their corporate governance structures. This study used secondary data from 54 licensed financial institutions between 2017 and 2022. Corporate governance variables such as board size, gender diversification, board meetings frequency, audit quality, board member remuneration, C.E.O duality, board independence, and education level of the board were incorporated as independent variables, with financial distress as the dependent variable. A comparative analysis between distressed and non-distressed firms revealed significant differences in several corporate governance variables. Notably, board size, gender diversification, board meetings frequency, board independence, audit quality, education level of the board, and return on equity showed significant impacts on financial distress. The study also confirmed the effectiveness of new directives issued by the central bank of Sri Lanka regarding specific corporate governance aspects.

One of the objectives of this study was to establish whether corporate governance has an impact on the financial distress of listed financial institutions in Sri Lanka which the study concluded that there is in fact a noticeable impact on financial distress caused by the corporate government structure of the financial institutions. Moreover, this study also had the objective to establish the nature of this impact which the study established as both negative and positive across the variety of corporate governance variables that was employed. And the final objective was to identify different corporate governance factors that influence financial distress as well as to identify whether some of these corporate governance factors are more significant than others. To achieve this objective, a binary logistic regression analysis was carried out, which indicated that all corporate governance variables had a negative impact on financial distress. Among these variables, board size, gender diversification, board meetings frequency, audit quality, education level of the board, and board independence were identified to be statistically significant.

Based on these findings, the study concluded that financial institutions with specific characteristics, such as higher board members, gender diversification, qualified board members, independent directors, and being audited by big four firms, are better equipped to avoid financial distress. The study recommends financial institutions to align their corporate governance practices accordingly, and regulatory bodies, like the central bank, should promote these characteristics through corporate governance policies. The study's findings have important implications for policymakers, regulators, investors, listed financial institutions, and other stakeholders in the Sri Lankan financial sector. Policymakers and regulators can promote good corporate governance practices among listed financial institutions through legislation, regulations, and other incentives. Investors can use corporate governance information to assess the risk of financial distress when making investment decisions. Listed financial institutions can adopt and implement good corporate governance practices to reduce the risk of financial distress and improve their overall performance. Other stakeholders, such as academics, researchers, financial analysts, rating agencies, and the media, can play a role in promoting awareness of the importance of corporate governance and encouraging listed financial institutions to adopt good corporate governance practices.

However, the study's limitations include its focus solely on listed financial institutions in Sri Lanka, limiting the generalizability of the findings. Future research is suggested to include data from non-financial institutions and compare corporate governance practices between financial and non-financial firms to expand the framework's applicability.

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