“THE IMPACT OF CORPORATE GOVERNANCE ON FINANCIAL DISTRESS OF LISTED FINANCE COMPANIES IN SRI LANKA ".

Content

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ABSTRACT

Empirical studies done on the impact of corporate governance on financial distress of finance companies have identified that well governed finance companies show the best financial performance and low effect of financial distress. Even though foreign researchers have conducted a multitude of studies concerning this area, it is not a trending research area in the Sri Lankan context. Due to the lack of studies in Sri Lanka and the incapability of generalizing the results of foreign studies to Sri Lankan context, a research gap can be identified to discover the impact of corporate governance practices on the financial distress of listed finance companies in Sri Lanka. Therefore the objective of the research is to investigate the level of impact of corporate governance on the financial distress of listed financial companies in Sri Lanka.

Corporate governance information and financial data are collected through Annual reports of listed finance companies in Sri Lanka. To evaluate the degree of good corporate governance practices based on collected data, a scoring scheme has been developed.

Financial Distress is measured using Altman *Z Score* which measures the probability of a company being insolvent, by considering profitability, leverage, liquidity and solvency. By performing a regression analysis, the predictability of independent variables on dependent variables is identified in order to verify whether Corporate Governance practices have an impact over financial distress of listed finance companies in Sri Lanka.

According to many research articles referred, corporate governance practices have an impact on financial distress of the finance sector. As there is a gap which we have identified above regarding this area, there is significant requirement to explore such a gap.

To address the identified research gap, this research explored the impact of corporate governance on financial distress the experience of listed finance companies in Sri Lanka. Our primary findings imply that listed finance companies in Sri Lanka, as a whole, recorded high level of CG practices, especially in practicing different attributes related to audit and control structures, BOD characteristics, disclosure and transparency and shareholder rights and investor relations. Moreover the results of the correlation show a positive significant relationship between two sub-components of CG level; namely the Board

of directors’ characteristics and the Audit and control structure with financial distress. Therefore there is a negative significant association between the investigated practices CG and the likelihood of finance distress in listed finance companies in Sri Lanka.

Key Words

Corporate governance, Financial Distress, Listed Finance Companies in Sri Lanka

1. Introduction

The modern business world is very complicated, and stakeholders require more information regarding business activities since they would like to know the return on their investment. However, many malpractices have taken place in the recent past. (eg.Danat Bank-Germany, Medici Bank-Florence, HIH Insurance- Australia, Ceylinco, Pramukha Bank and more recently, ETI Finance Limited in Sri Lanka). As a controlling mechanism, the corporate governance has risen over the recent period. These malpractices take place due to the financial distress of companies. Corporate Governance has a direct impact on a company's financial distress. The purpose of this study is to examine the impact of corporate governance on financial distress of listed finance companies in Sri Lanka.

“Corporate Governance is the system by which companies are directed and controlled.”(Cadbury Committee 1992). It is a set of relationships between company’s management, BOD, shareholders and other stakeholders, and it provides the guidance for achieving the organizations’ objectives while monitoring their performance. Financial distress refers to a period when a borrower (either individual or institutional) is unable to meet a payment obligation to lenders and other creditors. (Zaki,Bah and Rao 2011). This distress may be due to borrower specific factors like reputation, leverage, volatility of earnings, collateral or may be due to market specific factors like the economic condition and level of interest rates.

The relationships among these variables have been analysed through this study, to determine whether corporate governance has an impact on financial distress of corporations.

According to Parker et al. (2002) there is a negative association between CG practices and financial distress. In contrast, another study says that there is a positive association between bad CG practices and bankruptcy of firms. (Daily and Dalton 1994). For analysing the relationship among these two variables, different variable measures such as, *Altman* Z -Core to measure financial distress and developed an index with *Likert* scale to measure corporate governance level are used. Moreover, to analyse the relationship, regression analysis is performed.

There are some evidences from the prior studies regarding the relationship among CG and financial distress. However most of these studies were conducted in foreign countries in both the financial and non-financial sectors. As there is insufficient evidence from Sri Lankan context, this research paper will analyse how corporate governance impacts Sri Lankan Listed Finance Companies by considering their importance to the financial services sector and their contribution to the GDP. As the finance companies are very crucial in finance sector and they are governed by set of rules and regulations implemented by the government bodies, the results shown here accurately represent the relationships among the above variables. Compliance to the corporate governance directives issued by CBSL is used for analysing how the finance companies are adhering to the code of best practice. In order to obtain deeper understanding of the finance sector regarding the above relationship, this research is focused only on listed finance companies.

The Section 2 presents the literature review. It is followed by the research methodology in Section 3. The Section 4 presents the analysis of findings of the study. The final section provides a summary and conclusions of the study.

2. Literature Review

2.1 Corporate governance

Corporate Governance could be defined as “The system by which companies are directed and controlled.” (Cadbury Report 1992, cited in Handley-Schachler, Juleff and Paton 2007). It is concerned with structures, allocation of responsibilities and being accountable.

John (2001) elaborates the significance of corporate governance, which explores the central role that private information on corporate intangibles plays in the private corporate governance role of financial institutions. The present debate on corporate governance expect that the financial institutions have a corporate governance part yet the verbal encounter and research have not clarified what this part is. This study examines the central part that private information on corporate intangibles has in the private corporate governance impact of financial Institutions (FIs). The institutional fund managers' (FMs) private cognizance of various qualitative or intellectual capital factors driving corporate performance was the explanation behind wide-ranging corporate governance influence concerning financial performance and conventional Cadbury-style corporate governance issues. Furthermore it reveals the possibility of FM corporate governance affect ended up being more interventionist with unfavourable changes in corporate performance factors, in FI-side effect factors and in regular conditions. The qualitative intangible factors, especially board and top management qualities were essential to this more proactive kind of intercession.

Moreover the study on (Handley-Schachler, Juleff and Paton 2007) has focused on reviewing the aims of corporate governance in financial services sector which takes more theoretical perspective. According to the study, it has been found that UK issued standards on corporate governance have been sector wide and do not address specific issues regarding to the financial services sector. They highlight more on single agency relationship between company directors and shareholders rather than accounting from broad range of principles. The distinctive characteristics of financial services companies imply the need for distinctive corporate governance arrangements for this sector. This research embraces the case study method which mostly highlight financial services sector in UK. First they have identified major components that drive the corporate governance and built their parameters based on the cotemporary academic or policy related studies. The key finding of this research is, there is a high leverage and a mismatch in their assets and liabilities of financial sector companies' balance sheet that implies that they keep lenders confidence and wider duty of care for bank directors. They have identified list of principals involved in financial services sector not only just shareholders but also Holder of irredeemable bonds or debentures, Depositors, Current account holders, Contributors to a managed fund, Defined contribution pension scheme members, Defined benefit pension scheme members, Insurance policyholders and Stock broking clients. Hence there is a wide verity of organizational structures rather than single agency relationship between Shareholders and directors.

Salim and Assem (2008) further examined the importance and ability of providing information to their corporate clients by Lebanese banks.

In spite of the fact that the present corporate governance structure relates more to a societal-internal-committee framework, a substantial number of activities have been embraced in Lebanon to enhance liquidity and the part of the Beirut Stock Exchange. Today, an investor outer market approach can be set up under Lebanese law. But the monetary circumstance has disheartened investors from taking an interest in such a move. For instance, the disappointment of the Lebanese experts to set up a market-based framework might be clarified by the high interest paid by government bonds. This makes speculators hesitant to put resources into a more dangerous, less fluid, and not really more gainful value advertise. Without a more quickly developing economy and an expansion in rivalry from new market contestants there will be little strain to enhance the administration of family-run organizations or to locate the minimum costly methods for fund. Unless these conditions are enhanced it is far-fetched that numerous families will chance giving up their control.

Moreover Habib and Azim (2008) focused on the association between corporate governance characteristics and quality of accounting information. Researchers have evaluated corporate governance under three dimensions representing; Board and Audit Committee structure, independence and audit quality dimensions based on corporate governance best practice code. Relationship between accounting numbers and share price was used to measure the quality of accounting information. Based on the results of regression and correlation analysis, reveals that there is a significant positive relationship among two of the governance variables and value-relevant of accounting information. This reflects that better corporate governance structures enhance the value-relevant of accounting information and restricts on earnings management activities. However the study has identified that firm-specific economic factors also have an influence over the quality of accounting information. Nonetheless corporate governance variables still considered to be significant in the model.

According to a recent study conducted based on the concept of Latour's notion of action at a distance (Ekanayake2018) examines the role of accounting inscription enabling action at distance ensure good corporate governance in public sector bank. Further this study, is by incorporating both financial and non-financial information about four main areas in accounting, namely external auditing, external reporting, management accounting and internal auditing have broadened the definition of accounting inscriptions. By this study, it found out that four areas in accounting have capacity to enable action at distance and lead good corporate governance in organizations. In conclusion the study suggests that actors should operate independently and without political intervention and undue influence from pressure groups. It will ensure the effective utilization of accounting inscriptions and good corporate governance in public sector banks.

2.2 Financial distress

Ehab, Rahim and Ananth (2011) defined financial distress 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. Researcher analysed the financial distress of banks using the 5 C’s framework and quantifies this 5 C’s to make decisions regarding the creditworthiness of banks based on a sample of 16 financial institutions in UAE. The first C, capital is measured by cost to income ratio variable was positive and statistically significant. The second C, capital is measured by equity to total assets has a positive and significant relationship with the probability of financial distress. The 3rd C is collateral is measured by total assets growth variable which indicates increased assets lead to increased loan default. The 4th C which is measured by credit risk variable, the impact on financial distress is highest and statistically significant. Results indicate that higher perceived credit risk in the previous year at a financial institution will result in an increased probability of financial distress in the current year.

When considering the relationship between the macro economic variables and financial distress the results show that macro-economic variables didn’t impact on financial distress in financial institutions in UAE during 2000-2008 when the global financial crisis occurred. In this study said factors will be set as controlled variables and evaluate the effect of corporate governance on financial distress.

2.3 Relationship between Corporate Governance and Financial Distress

Fathi and Jean-Pierre (2001) examined the relationship between corporate governance characteristics and financial distress status based on a sample of Canadian firms. EPS, liquidity and leverage were utilized to measure financial distress of companies. Results led to conclude that board composition does, in fact, contribute to explain financial distress beyond financial indicators.

In a recent investigation, the level of corporate governance was measured by using ownership structure, board chairmanship, corporate ethics, board decision-making processes, regulatory authority responses and organisational systems adequacy. The study exhibits that where there is adequate board monitoring, senior management oversight follows. One of the main sources of board inadequacies observed in this study appears to be power imbalance in the board where the board chairman in the case is executive and power tends to be skewed in his favour. In circumstance when the institution shifted too far from its core, board inadequacies tend to show through poor oversight. In all the cases in the study, lack of a proactive approach by the regulatory authorities seems to have encouraged poor corporate governance practices. To a huge degree on some boards appear to have sanctioned regulatory arbitraging where the powerful board members gave themselves insider loans, which were never repaid (Zororo 2006).

As reported by Li, Wang and Deng (2008) the focus is given on to investigate the impact of ownership structure, independent directors, managerial agency costs and audit’s opinion on financial distress based on a sample of listed companies in Chinese stock exchange. According to the results of the research; large shareholders’ ownership, state ownership, higher proportion of independent directors and Auditors opinion reflect a negative association with the probability of being financially distressed. This indicates that Audit Committee can be considered as an important external governance mechanism. However the study declares that managerial agency cost is positively related with financial distress. It implies that managerial agency problems impair the financial condition of the firm. Further it appears that financial distress is not associated with the managerial ownership.

Furthermore, Hussein and Hassan (2012) evaluate the corporate governance practices of UAE National Banks and the effect of corporate governance on performance and financial distress based on a sample of 23 UAE National banks. The questionnaire was consisting of two sections. Former concerned on disclosure and transparency, executive compensation, relationship with shareholders, governance structure, policies and compliance, relationship with stakeholders and board of directors as corporate governance variables and later deals with performance and financial distress. The outcome reveals that UAE the National Banks are aware of the significance of mentioned corporate governance factors. It reveals that there is a significant positive relationship with the above factors and the corporate governance practices and the level of corporate governance of UAE National Banks are at an acceptable level. Further the results indicate that there could be identified a significant positive association between financial distress and corporate governance practices.

An examination carried on to analyse the connection between corporate governance and accruals quality during a crisis based on an example comprises of 340 companies listed on the ASX amid 2007-2009 (Husam and Keith 2016) demonstrates that companies receive at any rate required governance mechanisms due to drastically changes in the part of corporate governance and with those progressions directions changed to guarantee that. According to this examination it demonstrates that good CG is positively related to accruals quality during the period of financial crisis. All the more critically, the effect of good governance heightens amid the Global financial crisis (GFC), where the relieving role of governance is apparently under pressure.

Parkinson (2016) further focused on studying the impact of financial distress on corporate governance in UK public companies. Using multiple case studies enable researchers to developed more confident in overall results and can be driven a broader base from which reference can be drawn. Study was conducted for five large public companies in UK. By undertaking a detailed analysis of decisions made by shareholders, directors, creditors, the researcher was able to find out the governance issues in financially distressed period and identify the methodologies to analyse the area.

Brett and Chris (2017) in their study emphasis that good corporate Governance attributes may differ crosswise over firms, and governance ought not to be seen through a "one size fits all" focal point. Generally speaking, the outcomes support Kahl’s observations in 2002 (cited in Brett and Chris2017), proposing that organizations continue through the liquidation procedure with the opinion that creditors are uncertain if the firm can or will be successful. Firms roll out improvements that ought to enhance their odds for progress after rise; however in the event that they fall flat, it isn't entirely a direct result of the corporate governance structure. At last, the outcomes question the task of corporate governance instrument amounts considered as "effective" normally among all organizations. Facing financial distress and potential liquidation gives an opportunity to the company's governance structure to display its value and effectiveness. This conviction may help clarify huge numbers of the clashing discoveries in the governance literature. Analysing the eccentric idea of corporate governance in future investigations is an intelligent following stage in facilitating the comprehension around there. Analyse these empirical studies reveal that there is a space for further investigation on effect of corporate governance on financial performance and financial distress simultaneously and broad investigation of above variables.

A recent research was carried on to examine the quality of corporate governance and their impact on firm performance and financial distress of Egyptian listed companies conducted based on a sample of 86 non-financial firms listed on Egyptian exchange in 2008 (Shahwan 2015). Financial companies were excluded from the sample as financial companies were subject to many rules and regulations. This sample consists of six different industries. Financial distress of the Egyptian companies was assessed on the basis of Altman Z score. Here the manufacturing firms and non-manufacturing firms are likely to be classified as distressed firms when their Z score is less than 2.9 and 2.6 respectively. From 86 companies 45 firms were defined as distressed firms based on their Z score. Further level of corporate governance was measured utilizing an index which focused on four dimensions; disclosure and transparency, composition of the board of directors, shareholders’ rights and investor relations and ownership and control structure. Both internal and external validity was there and the sample was representative. According to this study there is a little variation of corporate governance practices among Egyptian firms. However practicing corporate governance within the firms in Egypt is clearly weak despite the efforts taken by authorities. A Kruskal Wallis test carried out to investigate the significant variations among the industrial sectors.

Results of this investigation indicates that there are no significant variations regarding the size of the firm, firm's financial leverage, firm's current ratio, institutional ownership and the corporate governance indicators. As per the results indicates capital structure of the Egyptian firms tends to rely on debt as a major source of financing. The range of aggregate corporate governance indicators is between 0 and 0.667 with a SD of 0.155. In this sample mean value is 0.147 which indicates practicing corporate governance attributes in Egyptian firms are clearly weak even though Egyptian authorities had taken many efforts to improve corporate governance practices.

The results of the Wilcoxon test shows significant evidence of the low level of corporate governance practices in terms of board of directors compared to other variables. Moreover, this study indicates that according to a logistic regression there is an insignificant negative association between corporate governance practices and a firm's financial distress.

2.4 Prior Studies in Sri Lankan context

When considering the Sri Lankan context, Sameera and Senaratne (2015) in their study on "Impact of CG Practices on probability and resolution of financial distress of listed companies in Sri Lanka" analyzed the effect of compliance to corporate governance practices on probability and resolution of financial distress of the company. Distressed and non-distressed companies were identified through Altman Z-score while an index was prepared based on the Code of Best Practice on Corporate Governance in order to measure corporate governance practices of those companies. It recommends that a higher level of compliance will resolve the financial distress. In regard of the individual governance factors in particular board independence, board procedures, relations with shareholders and internal control system are essentially affect over the resolution of financial distress of the firm. The other governance factors specifically board structure, directors' compensation procedure and audit committee procedure have discovered negative however not critical effect over financial distress of the firm of the firm.

There have been former studies evidencing the relationship between financial distress and corporate governance in financial institutions in the international context. In the absence of adequate research materials, associated with the Sri Lankan financial system setting, the task of defining such relationship has been of more challenging. In order to address the same, this research has been complied, as Sri Lankan financial system is decidedly monitored for compliance in corporate governance, by the regulatory bodies. Based on the above research gap, the following research questions are developed in the context of listed finance companies in Sri Lanka.

- Does the level of corporate governance of Listed Finance Companies impact on the Financial Distress?

3. Methodology

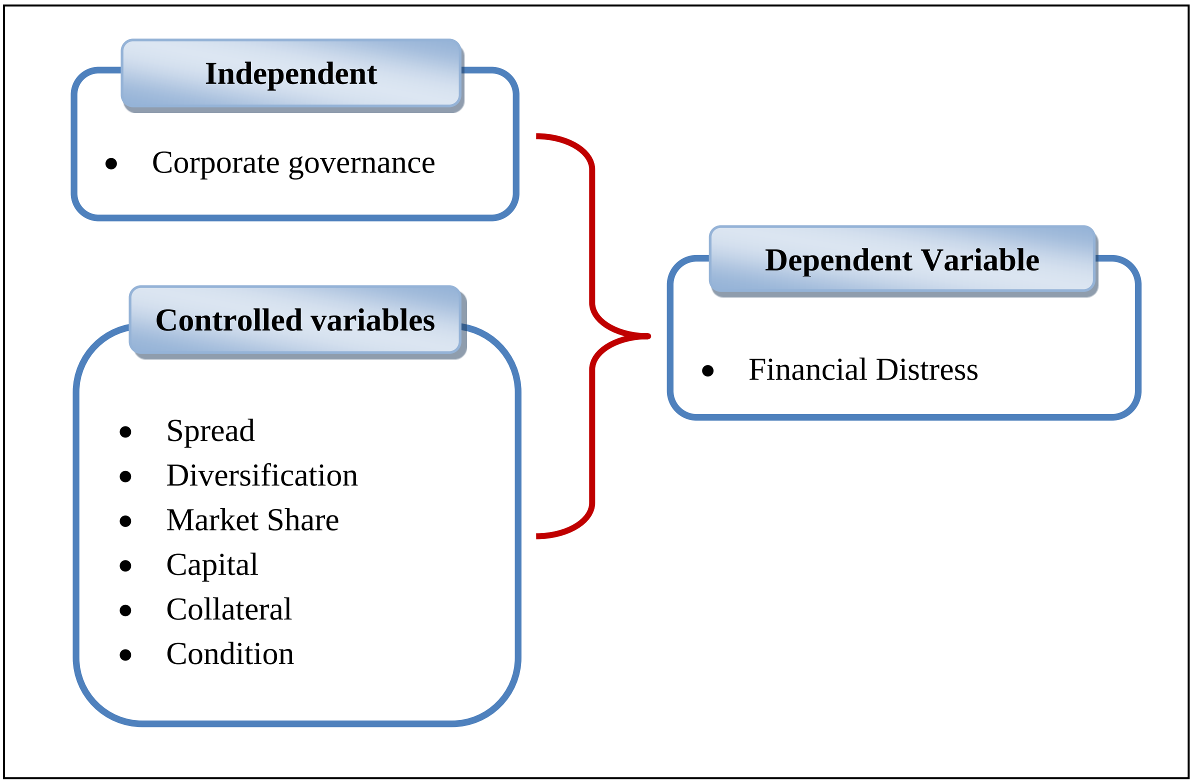
This section explains the research approach, sample, data and data collection methods and data analysis techniques of the study.

3.1 Research Approach and Operationalization

This study is focused on listed finance companies in Sri Lanka (Appendix 1 -List of listed finance companies – Sri Lanka). They play a vital role in the monetary system as well as in the economic stability and are being closely monitored by the Central Bank of Sri Lanka. The conceptualization of variables and the measures used to quantify them are expressed below.

3.2 Conceptual diagram and variable measurement.

Based on the literature review, the following conceptual diagram has been developed to illustrate the impact of Corporate Governance on Financial Distress.



The following measurements have been identified for the variables of the study based on extant literature.

Variable Type	Variable	Measurement	Supportive literature
Independent	Corporate Governance	Corporate governance index which focused on four dimensions; disclosure and transparency, board of director's characteristics, Shareholder rights and investor relationships, audit and control structure. *(Appendix 2- Scoring Scheme)*	Shahwan(2015)
Dependent	Financial Distress	Altman Z score	Shahwan(2015) Sameera and Senaratne (2015)
Control	Spread	Spread= Net interest income-Net interest expenses / Total average assets	Karam and Shweta (2015)
	Diversification	Diversification= Non- Interest income/ Total average assets	Karam and Shweta (2015)
	Market share	Market share = Deposits of a bank/ Total deposits of all banks	Karam and Shweta (2015)
	Capital	Capital= cost to income ratio	Karam and Shweta (2015)
	Collateral	Collateral = total assets growth variable	Karam and Shweta (2015)
	Condition	Condition= Credit risk variable	Karam and Shweta (2015)

3.3 Hypotheses

According to the observations of the literature survey, several researchers have explored a negative association between CG characteristics of firms and probability of being distressed. (Fathi and Jean-Pierre 2001; Zororo 2006; Li, Wang and Deng 2008; Shahwan 2015; Hussein and Hassan 2012; Husam and Keith 2016; Brett and Chris 2017). Given this relationship between CG practices and financial distress, there is a need to clarify such associations with regard to the Sri Lankan context. The hypotheses are as follows:

H0 – There is no significant relationship between level of CG practices& FD

H1 – There is a negative relationship between level of CG practice & FD

3.4 Sample Size & Selection of Sample

The sample of the study consisted of all finance companies (32) listed on the Colombo Stock Exchange for a period of three years from 2014/15 to 2016/17. In order to increase the quality of data selected, information relating to a period of three years have been considered. *(Refer Appendix 1 – Listed finance companies)*

3.5 Sources of Data

To analyse the relationships specified in the above hypotheses, the data related to the dependent variable (financial distress) and the independent variable (corporate governance) have been collected over a period of past three years from secondary sources, which include published annual reports, websites of the listed finance companies and other publications of the listed finance companies.

3.6 Data Analysis Strategies

Correlation and regression analysis are performed to elaborate the characteristics of the variables and to explore the relationship. The SPSS statistical package has been used to calculate statistical measures. A regression model indicated below is developed to identify the relationship between the independent variable and dependent variable to test the hypotheses of the study.

$$\boldsymbol{FD = k + \beta_1 CG + \beta_2 SP + \beta_3 DIV + \beta_4 MS + \beta_5 CAP + \beta_6 COL + \beta_7 CON + \varepsilon}$$

Where,

FD = Financial Distress

CG = Corporate Governance

SP = Spread

DIV = Diversification

MS = Market Share

CAP = Capital

COL =Collateral

CON = Condition

The regression model is used to examine the relationship that exists between the Financial Distress (FD) and independent variables including controlled variables. However the main focus of this study is to examine the association between the level of corporate governance and Financial Distress which is measured using a scoring scheme (*Refer Appendix 2- Scoring Scheme)* developed based on Code of Best Practise for companies in Sri Lanka on corporate governance. Hence CG is considered as the testing independent variable which represents the total score of corporate governance index (CGI) for each company and other six variables namely; Spread, Diversification, Market Share, Capital, Collateral and Condition are considered being controlled variables. Moreover k denotes constant; β is the coefficient of independent variables and ε is the error term.

CG=*f* (DT, BOD, SI, AC)

We have identified four broad areas affecting corporate governance; namely, disclosure and transparency (DC), board of director's characteristics (BOD), Shareholder rights and investor relationships (SI), audit and control structure (AC). Then we have divided afore mentioned four areas into sub categories and given them an equal weightage as all the practices are equally important.

$$\boldsymbol{Altman\ Z\ score = 6.567X_1 + 3.26X_2 + 6.72X_3 + 1.05X_4}$$

Where:

$$\boldsymbol{X_1 = Working\ Capita/Total\ Assets}$$

$$\boldsymbol{X_2 = Retained\ Earnings/total\ Assets}$$

$$\boldsymbol{X_3 = Earnings\ befor\ Interest\ and\ Tax/Total\ Assets}$$

$$\boldsymbol{X_4 = Book\ \ Value\ of\ Equity/Total\ liabilities}$$

Financial distress is measured using *Altman Z Score* which measures the probability of a company being insolvent by considering its profitability, leverage, liquidity and solvency. The revised *Altman Z Score* in 1993 for non-manufacturing firms was used to better reflect the distress position of financial institutions. There is a converse relationship between computed *Altman Z Score* value and companies' financial distress. Therefore a score below 1.10 represents a probability of bankruptcy for the company. On the other hand a score above 2.60 shows that the company is not likely to become insolvent while 1.10 – 2.60 represents grey area (Altman, 1993).

4. Findings& Discussion

4.1 Descriptive Statistics Variables

As shown in Table 1, the range of CG is in between 26.67% to 100%, with the standard deviation of 19.74%. It implies that there is a large variation in practicing CG mechanisms among these finance companies. However, the mean value of CG is 78.27%. This implies that practicing CG attributes within finance sector is, on average, acceptable, but some finance companies still do not take these practices into effect despite the significant effort taken by the authorities of Sri Lanka. The negative skewness is due to the mean is less than median. We should also notice that the average percentage of the CGI within finance companies in Sri Lanka is higher than previous studies in other emerging markets. For example, the mean score of CG in Brazil in 2008 is 67% (Lima and Sanvicente, 2013) and 14.7% in Egypt (Tamer, 2015).

Table 1	**Descriptive Statistics**				
		CG		Financial Distress	
		Statistic	Std. Error	Statistic	Std. Error
Mean		74.2784	2.01545	1.718161	.1811365
95% Confidence Interval for Mean	Lower Bound	70.2772		1.358560	
	Upper Bound	78.2796		2.077762	
5% Trimmed Mean		75.1469		1.871055	
Median		80.0000		2.274574	
Variance		389.957		3.150	
Std. Deviation		19.74732		1.7747678	
Minimum		26.67		-3.8358	
Maximum		100.00		3.7533	
Range		73.33		7.5891	
Interquartile Range		26.71		1.4713	
Skewness		-.483	.246	-1.375	.246
Kurtosis		-.723	.488	1.309	.488

As shown in Table 2 the mean values of the four sub categories of the aggregate CGI are; DT, BOD, SI and AC. The mean values range from 8.74% to 24.45% which almost show same behaviour of the aggregate CGI in terms of strong practices of CG. The most frequently complied with category among finance companies of Sri Lanka is the category of attributes relating to audit and control structures, followed by board of directors' characteristics, disclosure and transparency and shareholder rights and investor relations.

Financial Distress, the dependent variable is measured using Altman Z-score which is subsequently modified to suit non-manufacturing firms as mentioned in the previous Chapter. Based on prior literature, a company can be classified as bankrupt when the Z-Score is less than 1.10, and a Z-score that is greater than 2.60 indicates a healthy firm. However, a grey area exists for the firms that have a Z-score within the range of 1.10 – 2.60. Firms which fall under grey area are financially unstable. (Tamer, 2015)

Based on our data, the mean value of Z-score is 1.7. As per the above classification, it lies inside the grey area, which means that there is an unstable financial situation within the sector. However they are not more likely to be bankrupt.

Table 2	**Aggregate CGI and its components**			
	Mean	**SD**	**Minimum**	**Maximum**
Aggregate CGI	74.2784	19.74732	26.67	100.00
DT	19.1369	7.37121	.00	26.68
BOD	21.9439	7.97122	0.00	26.68
SI	8.7428	5.74352	0.00	13.34
AC	24.4548	7.21920	13.34	33.35

Table 3 implies that the collected data set has a deviation from the overall distribution in both variables. Some finance companies recorded a higher CG level such as 100% and some recorded 26.67% level of CG which is the lowest ever recorded. The minimum and maximum values of financial distress lie between -3.8358 to +3.7533 respectively. These values indicate that there are firms which are performing well (+3) while some are more likely to be bankrupt (-3). The mean value may be impacted by the extreme values which are the high bankruptcy situations as well as the high performing companies.

Table 3	**Deviation from overall distribution**				
		CG		Financial Distress	
		Case Number	Value	Case Number	Value
Highest	1	40	100.00	10	3.7533
	2	41	100.00	54	3.7160
	3	42	100.00	53	3.6890
	4	43	100.00	91	3.6027
	5	44	100.00[a]	11	3.5921
Lowest	1	18	26.67	16	-3.8358
	2	17	26.67	18	-3.7628
	3	16	26.67	17	-3.3150
	4	15	43.34	25	-1.9788
	5	14	43.34[b]	14	-1.8222

4.2 Relationship between CG and FD

The results obtained from the statistical analysis of correlation and regression are presented in the following table.

Table 4	Correlations					
	Disclosure and transparency	Board of directors' characteristic	Shareholder rights and investor relations	Audit and control structure	CG	Financial Distress
Disclosure and transparency	1					
Board of directors' characteristics	0.224*	1				
Shareholder rights and investor relations	0.120	0.247*	1			
Audit and control structure	0.196	0.621**	0.429**	1		
CG	0.570**	0.786**	0.592**	0.814**	1	
Financial Distress	0.448**	0.851**	0.477**	0.722**	0.913**	1

*. Correlation is significant at the 0.05 level (2-tailed).

**. Correlation is significant at the 0.01 level (2-tailed).

The results of Pearson's correlation based on 96 observations, shows a positive significant relationship between two sub-components of CG level; namely the Board of directors' characteristics and Audit and control structure with financial distress (0.851 and 0.722 respectively). However, it shows a correlation of 0.913 between overall CG level and FD. This indicates that there is a significant positive relationship between CG practices and the Altman Z-score. Furthermore, the higher the Altman Z-score represents, the lesser the probability of being bankrupt (Distressed) is. Hence, there is a statistically significant negative association between two variables; CG practices and Financial Distress at the significance level of 0.01. Thus based on the results *H1* is accepted; that there is a negative relationship between level of CG practices & FD with a significance level of 1%.

Further the regression analysis carried out on the relationship between CG practices and firm's financial distress finds the statistical relationship between variables. Table 5 predicts the value of the distress changes due to change of CG level.

Table 5	Overall validity of the Regression model					
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	F	Sig.
1	.913[a]	.834	.832	.7270063	472.148	.000b

a. Dependent Variable: Financial Distress

b. Predictors: (Constant), CG

According to Table 5 above, R square describe the explanatory power of the independent variables over the variance in the dependent variable. And the sig value indicates the overall validity of the relationship. Accordingly, the results of the regression demonstrates that the Altman Z-score, the measure of distress status, was regressed on CG practices as measured by CGI. The R square value of 0.834 indicates that, CG practices explain 83.4% of the variance in Financial Distress of listed Finance Companies in Sri Lanka and the overall model is considered to be valid as the P - value is less than 5%. Hence, it rejects the Null hypothesis that there is no significant relationship between the level of CG practices and Financial Distress.

Table 6 Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	-4.378	.290		-15.086	.000
	CG	.082	.004	.913	21.729	.000

a. Dependent Variable: Distress

According to the results, a simple regression line for Financial Distress could be developed based on level of CG practice using coefficient of the independent variable.

$$\boldsymbol{FD = -4.378 + 0.082\ CG}$$

Sig and *t* value are the t-statistics and their related 2-tailed p-values are used in testing whether a given coefficient is significantly different from zero. Using a confidence level of 95%, the coefficient for CG (0.082) is significantly different from 0 because its p-value is 0.000, which is less than 0.05.

5. Summery & Conclusion

This study examined the impact of corporate governance on financial distress of Sri Lankan Listed Finance companies. All finance companies listed on the Colombo Stock Exchange for a period of three years from 2014/15 to 2016/17 were considered in the study. Accordingly corporate governance was measured using an index developed based on the Code of Best Practice on Corporate Governance. Every finance company which is listed under the Central Bank of Sri Lanka adheres to set of rules and regulations. These rules and regulations include the code of best practice on corporate governance issued jointly by the Institute of Chartered Accountants of Sri Lanka and the Securities and Exchange Commission of Sri Lanka. The control variables used in the study were spread, diversification, market share, capital, collateral and condition.

Descriptive statistics are used to describe the characteristics of listed finance companies in terms of CG level and distress. And both correlation and regression analysis identify the relationship between corporate governance and financial distress of listed finance companies in Sri Lanka. As investigated in prior literature, it reveals that there is a negative association between corporate governance and financial distress (Fathi and Jean-Pierre 2001) and (Shahwan 2015) while there are variations in the level of corporate governance practices in different contexts. Hussein and Hassan (2012) identified that corporate governance practices of UAE National Banks are at an acceptable level. On the other hand Shahwan (2015) has investigated that Egyptian-listed firms, as a whole, recorded a low level of CG practices and identified a need for improvement in CG practices. Our primary findings imply that listed finance companies in Sri Lanka as a whole, recorded high level of CG practices, especially in practicing different attributes related to audit and control structure, BOD characteristics, disclosure and transparency and shareholder rights and investor relations. One implication of this study is that authorities of Sri Lanka should motivate all listed finance companies to invest in more comprehensive CG. Such investment is of significant importance to improve the company's overall competitiveness (Baek et al., 2009; Pae and Choi, 2010). Moreover the results of correlation shows a positive significant relationship between two sub-components of CG level; namely Board of directors' characteristics and Audit and control structure with financial distress. This indicates that there is a significant positive relationship between CG practices and the Altman Z-score. Therefore there is negative significant association between the investigated practices of CG and the likelihood of finance distress in listed finance companies in Sri Lanka.

The findings of this study will round to the benefits of theoretical implementations as well as practical implementations. When it comes to theoretical implications, this study addresses the gap of knowledge that exists regarding the impact of corporate governance on financial distress of listed Finance Companies in Sri Lanka. Furthermore, this study introduces a scoring scheme that would measure the various aspects of corporate governance practices and disclosures in listed Finance Companies in Sri Lanka, which can be developed up to a rating system that can be used to evaluate the level of corporate governance in Finance Companies as well as a company in future researches.

In the present, corporate governance has a major impact when investors make their investment decisions. This study will provide guidance for investors to make self-evaluations based on the developed scoring scheme before taking their investment decisions. Moreover, this research will help policy makers to make more consistent policies towards corporate governance. It is also a responsibility of finance companies to comply with terms of corporate governance and also engage in awareness campaign for corporate governance. This may facilitate bringing more transparency in the functioning of financial institutions and also increase the faith of investors in the management.

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Appendixes

Appendix 1 -List of listed finance companies – Sri Lanka

1. Abans Finance PLC
2. Alliance Finance Co. PLC
3. AMW Capital Leasing and Finance PLC
4. Arpico Finance Co.PLC
5. Asia Asset Finance PLC
6. Associated Motor Finance Co. PLC
7. Bimputh Finance PLC
8. BRAC Lanka Finance PLC
9. Central Finance Co.PLC
10. Citizens Development Business Finance PLC
11. Colombo Trust Finance PLC
12. Commercial Credit & Finance PLC
13. Commercial Leasing & Finance PLC
14. L B Finance PLC
15. LOLC Finance PLC
16. Mercantile Investments & Finance PLC
17. Merchant Bank of Sri Lanka & Finance PLC
18. Multi Finance PLC
19. Nation Lanka Finance PLC
20. Orient Finance PLC
21. People's Leasing & Finance PLC
22. People's Merchant Finance PLC
23. Prime Finance PLC
24. Senkadagala Finance PLC
25. Singer Finance (Lanka) PLC
26. Sinhaputhra Finance PLC
27. Siyapatha Finance PLC
28. Softlogic Finance PLC
29. Swarnamahal Financial Services PLC
30. The Finance Co PLC
31. Trade Finance & Investments PLC
32. Vallibel Finance PLC

Appendix 2- Scoring Scheme

#	Disclosure Requirement	Weighted Percentage according to relative significance	Section Reference
	Disclosure and transparency (DC)	**26.67%**	
01	A statement confirming that as at the date of the annual report they are in compliance with the Corporate Governance Rules and if not, set out the reasons for its inability to comply.	6.67%	7.10.a Section 7.10 of the SEC Listing Rules with regard to Corporate Governance requirements
02	Declaration of independent judgments of board of directors.	6.67%	A.1.5 Code of best practice 2017
03	Does the firm disclose the amount of executives' compensations?	6.67%	3(i)(B) Code of best Practice of 2017
04	Does the firm disclose its governance structures and policies?	6.66%	3(8)(ii)(g) Code of best practice
	Board of directors' characteristics (BOD)	**26.65%**	
05	Does the Board have more than 50 per cent external directors (non-executive Directors)?	6.66%	A.5.1 & A.5.2 of code of best practice 2017
06	Does the Board contain at least one-third of members as independent members?	6.66%	5.1 A & 5.5A of Code of best practice 2017

07	Are there two separate individuals for the roles of Chairman and CEO/MD?	6.67%	A.2 & 7.1 Code of best practice & CBSL rule 2017
08	Do Board committees consist of at least three non-executive board members the majority of whom are independent	6.67%	A.5.1 &A.5.5 &of Code of best practice 2017
	Shareholder rights and investor relations (SI)	13.33%	
09	Does bank disclose sufficient information to shareholders to carry out their own analysis or to seek independent advice?	6.66%	F.1 of Code of best practice 2017
10	Does the firm exercise the one-share one-vote rule indiscriminately?	6.66%	F.2 Code of best practice 2017
	Audit and control structure (AC)	33.35%	
11	Presence of a balanced understandable assessment of the Bank's Financial position, performance and prospects	6.67%	D.1.1 Code of best practice 2017
12	Maintain a sound system of internal control to safeguard Shareholders' investments and bank's assets	6.67%	D.2.1 Code of best practice 2017
13	Established agreements for selection and application of accounting policies, financial reporting and Internal control Principles.	6.67%	D.3 Code of best practice 2017
14	Is there a review of external audit function and relationship with external auditors.	6.67%	D.3.2 Code of best practice 2017
15	The Chief Executive Officer and Chief Financial Officer shall attend Audit Committee meetings	6.67%	7(10)6 CSE Rules 2017

	Total	100%	