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IMPACT OF CORPORATE GOVERNANCE PRACTICES ON FINANCIAL DISTRESS: EVIDENCE FROM LISTED COMMERCIAL BANKS IN SRI LANKA

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Abstract: The study investigates the influence of corporate governance (CG) practices on financial distress among listed commercial banks in Sri Lanka from 2019 to 2024. The research addresses a critical gap in emerging market contexts, where regulatory frameworks are evolving and economic challenges, such as the COVID-19 pandemic, have heightened risks of financial instability. The study employs board size, board independence, board activity, audit committee size, and audit committee independence as CG indicators, and Altman Z-score as a proxy for financial distress. Using data from listed commercial banks and conducting regression and correlation analyses, the study reveals that board independence and board activity significantly reduce financial distress, while larger board size increases it. The findings affirm that governance mechanisms related to board composition and engagement are pivotal in mitigating financial distress in Sri Lankan banks. Specifically, smaller, more independent, and actively meeting boards promote better oversight and risk management, reducing insolvency risk. These results support agency theory predictions that independent directors enhance the effectiveness of monitoring and reduce agency conflicts. The lack of significant influence from audit committee size and independence contrasts with some international studies, indicating potential contextual constraints such as inadequate enforcement, political interference, or lack of expertise within Sri Lankan audit committees. This gap highlights the need to strengthen audit functions beyond formal compliance. Acknowledging limitations such as sample size and data constraints, this study proposes a roadmap for strengthening CG practices in the Sri Lankan banking sector

Keywords: Corporate Governance, Financial Distress, Altman Z-Score, Commercial Banks, Sri Lanka

1. INTRODUCTION

CG has become increasingly central to discussions on financial stability and organizational resilience, especially in the banking sector. The collapse of several high-profile institutions and global financial disruptions underscore the need for robust CG frameworks. In Sri Lanka, where the banking sector plays a pivotal role in channeling capital and maintaining macroeconomic stability, understanding the link between CG practices and financial distress is critical. Research on corporate governance mechanisms and financial distress in Sri Lankan commercial banks has emerged as a critical area of inquiry due to the sector's pivotal role in economic stability and growth (Edirisinghe & Lanka, 2015; Liyanagamage, 2021). The evolution of corporate governance in Sri Lanka reflects a transition from colonial legal frameworks to contemporary regulatory reforms, including the adoption of Anglo-American governance structures and Basel principles (Edirisinghe & Lanka, 2015; Nanayakkara, 2024). This progression underscores the practical significance of governance in safeguarding financial institutions, especially given the banking sector's substantial share of national financial assets and its influence on public trust (Nanayakkara, 2024; Liyanagamage, 2021).

The agency theory (Jensen & Meckling, 1976) provides the foundational lens for understanding CG mechanisms, highlighting conflicts between principals (shareholders) and agents (management) and the role governance plays in aligning their interests to reduce agency costs. Stakeholder theory (Freeman, 1984) broadens the governance responsibility to all stakeholders, emphasising ethical and social considerations beyond financial metrics. Stewardship theory (Davis et al., 1997) offers an alternative view, positing that managers act as stewards motivated to enhance firm value rather than pursue self-interest.

Financial distress theories, such as the pecking order theory (Myers & Majluf, 1984), describe firms' financing behaviour when under distress, prioritising internal funds before external debt. Trade-off theory and bankruptcy cost theory further elucidate the balancing act between debt benefits and financial distress costs, providing a financial backdrop for governance interventions aimed at reducing insolvency risk.

Studies from developed economies (Manzaneque et al., 2016; Li et al., 2015) have found that board independence and audit quality are negatively associated with financial distress, highlighting the protective role of sound governance practices. In the Sri Lankan context, Sameera and Senaratne (2015) observed that compliance with CG codes significantly reduces the probability of financial distress. Similar patterns are evident in other developing economies; for instance, Hussein and Hassan (2016) report that governance variables have a positive contribution to firm stability among UAE banks. Brett and Chris (2017) caution, however, that the role of CG is often context-dependent, noting that uniform, 'one-size-fits-all' approaches may not be effective across varying institutional and cultural settings. Empirical evidence from Sri Lanka further supports the influence of board characteristics on financial distress. Multiple studies have identified board size, board independence, and gender diversity as governance attributes significantly and negatively associated with distress risk (Perera & Munasinghe, 2024; Balagobei & Keerthana, 2023; Pradeep, 2023). Moreover, variables such as board meeting frequency, CEO duality, and board members' educational qualifications have been employed to deepen the analysis of governance effectiveness (Perera & Munasinghe, 2024; Balagobei & Keerthana, 2023). Nevertheless, the literature is not without contradictions. For instance, while some studies associate CEO duality and larger board size with increased distress risk, others report no statistically significant effects, suggesting that findings are sensitive to variable definitions, sectoral focus, and methodological choices. This heterogeneity in measurements and sampling strategies complicates the formation of consistent conclusions.

Another critical dimension addressed in the literature is the socio-political context of Sri Lanka, which significantly shapes governance outcomes. Issues such as family ownership, political influence, and entrenched cultural norms have been shown to influence both governance practices and financial distress levels (Edirisinghe & Lanka, 2015; Weingart, 2023; Nazliben et al., 2023). These contextual factors underscore the limitations of applying formal governance frameworks without adapting them to local institutional realities. Although several studies acknowledge these socio-political influences, most discussions remain descriptive, lacking rigorous empirical modelling or longitudinal analysis. This gap constrains the development of nuanced, context-specific governance reforms. Furthermore, a growing body of research links governance quality to financial performance, with several studies reporting positive associations between governance mechanisms and indicators such as return on assets (ROA) and return on equity (ROE) (Pradeep, 2023; Kumara & Walakumbura, 2023). Identifying the specific governance attributes that drive profitability and resilience provides valuable insights for policymakers and regulators aiming to strengthen the financial sector through improved governance practices.

The conceptual framework integrates corporate governance as a system of mechanisms involving board structure, ownership concentration, and regulatory oversight, which influence financial distress outcomes through the lenses of agency theory and institutional theory (Sameera, 2020; Ahmad et al., 2018). Corporate governance mechanisms are posited to reduce information asymmetry and agency costs, thereby lowering the likelihood of financial distress (Perera & Munasinghe, 2024; Sameera, 2020). This framework guides the examination of the impact of governance variables on distress prediction within the banking sector. Therefore, the present research aims to analyse the extent to which corporate governance mechanisms impact financial distress in Sri Lankan commercial banks.

2. METHODOLOGY

This quantitative study utilises secondary data sourced from the annual reports of 20 commercial banks listed on the Colombo Stock Exchange for the period 2019–2024. Due to incomplete data, four banks were excluded, leaving a sample of 16 banks for analysis.

2.1 Variables:

2.1.1 Independent Variables: Board Size (BS), Board Independence (BI), Board Activity (BA, proxied by meeting frequency), Audit Committee Size (ACS), and Audit Committee Independence (ACI).

2.1.2 Dependent Variable: Financial Distress, measured by the Altman Z-score, a well-established predictor of corporate insolvency risk.

2.1.3 Control Variable: Bank Size, measured as the natural logarithm of total assets, to account for scale effects.

2.2 Analytical Approach: Stationarity of time series data was verified using the Augmented Dickey-Fuller (ADF) test to ensure validity of regression assumptions. The primary empirical model employs pooled Ordinary Least Squares (OLS) regression to estimate the impact of governance variables on financial distress while controlling for bank size.

3. RESULTS AND DISCUSSION

The variables in the model were tested and confirmed to be stationary at the level, indicating stability in their statistical properties over the observed period.

In Table 1 below, the model explains approximately 52.98% of the variation in the Altman Z-score, as indicated by the R-squared value (0.5298). The adjusted R-squared value is 0.4995, suggesting a good model fit, particularly for cross-sectional data. The F-statistic (17.47, $p < 0.001$) confirms the overall significance of the model. The coefficient for BS is -0.1408, and the relationship is statistically significant at the 1% level ($t = -4.470$, $p < 0.001$). This implies that larger board sizes are associated with lower Altman Z-scores, indicating a negative impact on financial stability. The result supports the notion that overly large boards may hinder effective decision-making. Further BI shows a positive and statistically significant effect on the Altman Z-score ($\beta = 1.1589$, $t = 2.493$, $p = 0.014$), suggesting that a higher proportion of independent directors improves financial soundness. This finding aligns with agency theory, which emphasises the monitoring role of independent directors. The coefficient for BA is 0.0947, with a t-statistic of 4.699 and a p-value of 0.000, indicating a strong positive and significant relationship with financial health. Increased board meeting frequency may enhance oversight and strategic involvement. AC The coefficient of

-0.0490 and a t-statistic of -1.140 ($p = 0.257$) suggest that Audit Committee Size has a negative but statistically insignificant impact on the Altman Z-score. Therefore, the number of audit committee members alone may not directly affect financial stability. ACI also shows a negative relationship ($\beta = -0.717$, $t = -1.701$), but it is marginally insignificant at the 5% level ($p = 0.092$). This implies that while independence may be important, its effectiveness might depend on other contextual or operational factors. Research model is ;

Altman Z score=1.2042−0.1408(BS)+1.1589(BI)+0.0947(BA)−0.0490(AC)−0.7170(ACI)+0.0784(BANKSIZE)

Table 1. Regression analaysis

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	1.204223	0.756110	1.592656	0.1146
BS	-0.140818	0.031502	-4.470157	0.0000
BI	1.158896	0.464929	2.492631	0.0144
BA	0.094736	0.020161	4.698923	0.0000
AC	-0.049033	0.043025	-1.139634	0.2574
ACI	-0.716996	0.421474	-1.701166	0.0923
BANKSIZE	0.078416	0.027554	2.845905	0.0054

R-squared	0.529813	Mean dependent var	2.803100
Adjusted R-squared	0.499478	S.D. dependent var	1.023161
S.E. of regression	0.723861	Akaike info criterion	2.258996
Sum squared resid	48.72970	Schwarz criterion	2.441358
Log likelihood	-105.9498	Hannan-Quinn criter.	2.332801
F-statistic	17.46559	Durbin-Watson stat	1.172608
Prob(F-statistic)	0.000000		

4.0 CONCLUSION

The findings of this study align with existing literature in several key areas. Board size was found to have a significant negative impact on financial stability, consistent with studies such as Perera & Munasinghe (2024) and Balagobei & Keerthana (2023), which argue that excessively large boards may hinder effective governance. Similarly, board independence and board activity were positively associated with financial health, supporting previous research that emphasises the role of independent and actively engaged directors in reducing corporate risk and distress (Sameera, 2020)Additionally, the positive relationship between bank size and the Altman Z-score confirms prior findings that larger banks benefit from better resource access and operational resilience. However, the study's results diverge from some literature with respect to audit committee size and independence, which showed no significant effect on financial distress. This contradiction may stem from differences in institutional capacity and the practical functioning of audit committees in the Sri Lankan context, where formal governance structures may not always translate into effective oversight due to socio-political influences. The study also highlights that while some governance mechanisms consistently enhance financial health, others, such as audit-related variables, require deeper institutional reform and enforcement to become effective predictors of stability.

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