Global Scientific JOURNALS

GSJ: Volume 5, Issue 5, May 2017, Online: ISSN 2320-9186
www.globalscientificjournal.com

BOARD CONFIGURATION ON FINANCIAL DISTRESS

TDSH Dissanayake[1], HMDN Somathilake[2], KJS Madushanka[3], DMJ Wickramasinghe[4] and NHK Cooray[5]
Faculty of Management Studies, Rajarata University of Sri Lanka[1,2,3,4,5]
Corresponding Author: sulo.hiranthi@gmail.com

ABSTRACT

Board configuration is discussed in the context of the perceived need of the board as a strategic resource in the organization. This is one of highlighted area in the corporate governance. According to the practical scenarios corporate governance caused for the financial distress and most of distressed company reasons are emerging lack of good governance. This study is examined is there significant impact of board configuration on financial distress of manufacturing firms listed on Colombo Stock Exchange during the period of 2012 to 2016. The study identify there is only significant impact on distress is CEO duality and other board size. Both control variables of Return on Equity (ROE) and solvency are show significant impact on financial distress and there is a significant negative relationship in between the both independent variables of CEO duality and solvency.

Key Words: Corporate Governance, Board Configuration & Financial Distress

1. INTRODUCTION

1.1 Background of the Study

The latest governance failures show that the necessity of the examining the causes which are affected for poor financial health and the aspects of which can be influencing to the survival of the firm. Though there are inadequate studies done in relation to the effect of corporate governance failure on financial distress, it has being become a crucial factor of the long lasting of this era. This study is attempted to identify the impact of corporate governance on financial distress. Last few decades there are arising company collapses because of the lack of good governance in the organizations. So it affect not only for company but for the overall growth of economy. This is the reason the corporate governance become as a trend. In modern world

corporate governance become crucial for the sustainable of the organization. United Kingdom combined code (2010) states that the purpose of corporate governance is to facilitate effective entrepreneurial and prudent management that can deliver the long term success of the company. Survival of this competitive business world is depending on the financial strength and the corporate level of the organization has more responsibility on this duty. To eliminate the agency cost of the organization it is needed to aligned with the code of best practice. The survival is depending on the financial position and it may be affect for the operating activities, non-operating activities and goodwill. When company is distressed all the activities will be restricted. High debt level, bankruptcy and governance failures can be prominent reasons for the financial failures. According to the Farooq, Nazir and Nawaz (2012) who are identified different appearance in relation to the financial distress and financial distress is defined as the inability of a firm to pay its financial obligations. Hill, Perry and Andes (1996) highlight the reason for the bankruptcy, is the aggressive financial conditions and if the firm is well performed there is an opportunity to restrain the unfavorable situation and recover without failures. However according to Bilal (2013) financial distress is defined with a probabilistic perspective and possibility of financial distress is determined due to inadequate of liquidity asset and higher level of debt level of organization. In view of Purnanandam (2005) is defined the financial distress in terms of financial structure and security valuation. Further Purnanandam (2005) defined financial distress in terms of solvency. According to the (Fernando, 2016) identifies the high influence to the firm risk on the financial performance of the organization.

1.2 Problem Statement

Corporate governance caused for the financial distress and according to the practical scenarios most of distressed company reasons are emerging because of the lack of good governance. This study is related to the effect of board configuration on financial distress. So this study is examined that whether there is a significant impact of corporate governance on financial distress of firms listed on Colombo Stock Exchange.

1.4 Research Question

Based on the above objective of this study it is identify; is there impact of corporate governance failure on financial distress in companies listed in Colombo Stock Exchange ?

1.3 Research Objective

To examine the impact of corporate governance failure on financial distress of companies listed on Colombo Stock Exchange.

2. LITERATURE REVIEW

There are several researches has identified the impact of board configuration on financial distress of the organization. Bredart (2014) has been conducted the study of financial distress and corporate governance: the impact of board configuration, point out that the board size is negatively affected for the distress and the existence of large board is favorably affected for the diversification of expertise. The study concludes the result as the board activity, board independence and CEO duality is not significantly affected for the financial health of the organization. And the study suggests that the board practices are highly influence on the financial level of the firm. Consistent the findings with the study of corporate governance and financial distress getting evidence from Australian listed firms conducted by Henry, Ahmed and Miglani (2010) examine the relationship of these two terms using the board size, board composition, CEO duality and audit committee as measurements and find out that board independence is not significantly affected for the financial health and CEO duality and board size is not significantly explain the distress level of firm. Approving these findings the study of board structure and ownership conducted by Abdullah (2006) using Malaysian distress firms as sample conclude that the board independence and CEO duality are not associated with financial distress though many previous studies advocate for the separation of role of CEO and chairman.

In the study examine the relationship between corporate governance characteristics and financial distress using sample of Canadian firms conducted by Elloumi and Gueyie (2001) highlighted that the board independence is affected significantly to financial level and surprising this study shows that CEO duality not significantly affect for financial distress. However the study of corporate governance and firms in financial distress argues and conclude the result using 178 Lebanese non listed firm, that there is negative relationship between board independence and financial distress and further, board size is positive affects financial distress is conducted by

Salloum and Azoury (2012) is consistently with findings of Li, Wang and Deng (2008) point out that high proportion of independent directors affect for less likelihood of financial distress in the study of ownership, independent directors, agency costs and financial distress.

In the study of corporate governance, cost of capital and financial distress conducted by Shibakawa (1994) and used United States and Japanese manufacturing sectors as a sample. This study, financial distress measured by the investing share prices and functions of security market and they concern ROE, ROI and Cost of Capital in between Japan and United State firms. According to the results of the study there is a huge different in Japan and United State firms when meeting the financial distress, but study is not recommended a system have capabilities to maintain continuously. Shibakawa (1994) suggest that distressed firms in United State can be mitigate by an exchange offers and in Japan, should not follow aggressive financing system and should restructure the lending activities. Further study find out that the changes in capital market, structure of corporate governance and cost of capital are mostly influence for the distress of Japan firms.

Shahwan (2015) study about the effect of corporate governance on both firm performance and financial distress and the findings are consistent with the Thorburn (2000) and shows inverse relationship in between Z score and risk of distress. Further this study use governance score to measure the corporate governance practices consisting of independent directors, 50% composition of board with non-executive director's state that that do not find any positive relationship between corporate governance practices and financial performance. In addition, shows insignificant negative association between corporate governance practices and probability of financial distress.

According to Thorburn (2000), conduct the study corporate governance and Financial Distress using evidence on Sweden firms and found that corporate fraud mostly occurred in financially distress firms. Moreover, strong and effective governance systems are essential to reduce risk of expropriation. Governance systems should be enforcement of regulation and contracts further dentify improvement of characteristics of governance system is help to monitor the fraudulent asset transfers. According to the study which examine the Lehman brothers' case conducted by Tothova (2010) and this study reflect that the reason for the failure of the fourth largest

investment bank in United States in 2007 is the corporate governance failure and technical failures. Based on the above literature review in below it is develop methodology of this study.

3. METHODOLOGY

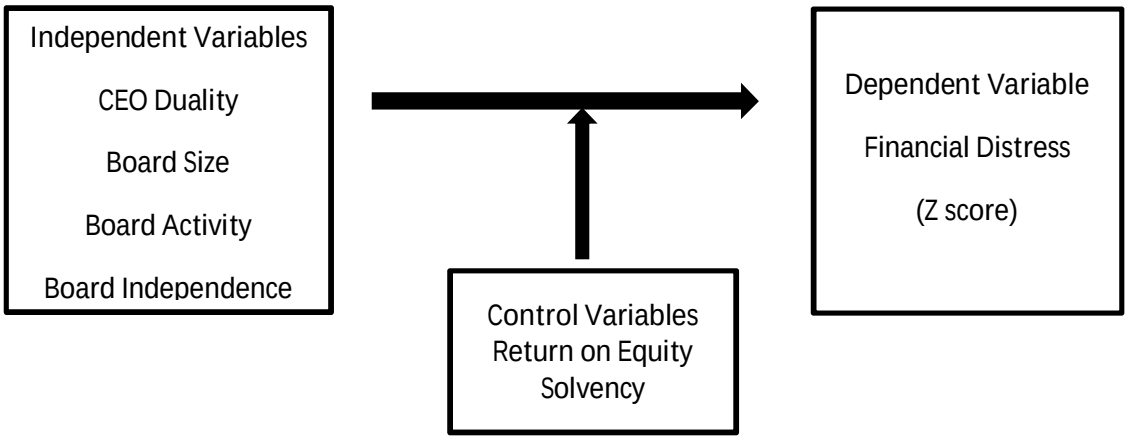
This chapter reviews the measurements which are identifying after examining the literature and conceptualizes these measurements. Further examine the previous studies in relation to the hypothesis, data analysis and methodology. This study examines the effect of corporate governance failure on the financial distress of the firm using firms listed on Colombo Stock Exchange. The total number of companies taken to study which do not reflect details related to the board practices as given in table 3.1. The required data for the study is obtained from the Annual Reports issued by the selected listed companies.

Table 3.1: Sample of the Study

Industry Sector	Total Number of firms	Number of firms excluded	Number of firms included
Manufacturing	40	10	30

Conceptual framework is constructed as follows.

Figure 3.1: Conceptual Framework



Then the study has analyzed the data and it has given interpretation board configuration on financial distress.

4. RESULTS AND DISCUSSION

In below table of the study is discuss the descriptive analysis.

4.1 Descriptive Analysis

Table 4.1: Overall Descriptive Statistics

Measurements	Minimum	Maximum	Mean	Standard Error	Standard Deviation	Skewness
Z Score	0.0039	5.7064	0.9406	0.119788	0.888374	3.095
CEO Duality	0	1	0.05	0.031	0.229	4.034
Board Size	5	9	7.44	0.176	1.302	-0.456
Board Independence	0	1	0.36	0.014	0.1	0.435
Board Activity	3	12	5.51	0.375	2.781	1.453
Return on Equity	-0.7923	2.2108	0.1171	0.044997	0.333709	4.356
Solvency	0.2519	0.9775	0.5732	0.026861	0.199208	0.270

Skewness value is 3.095 in the Z score and this is an indication of the pattern of distribution and due to this value reflect that there is an positive significant asymmetric distribution of the dependent variable and when considering other independent variables, CEO duality has 4.034 value relating to the skewness and this value is not represent symmetric distribution and it has also positive significant right tail. The Board size shows that symmetric distribution according to the value of skewness which is -0.456 and it has negative short tail. There is a normal distribution in relation to the board independence that denoted by the value of 0.435 in skewness. Due to the variable of board activity, the skewness value is 1.453 and it does reflect that there is

a symmetric distribution. There is a positive significant asymmetric distribution of return on investment that show the value of skewness is 4.356. The variable of solvency is reflecting 0.270 of skewness value and it denotes that there is a symmetric distribution.

4.2 Correlation Analysis

According to the table 4.2 shows that Z score is negative correlated with CEO duality, Board size, Board activity and Solvency. And both board independence and ROE are positively correlated with the dependent variable. All independent variables which are CEO duality, board size, board activity and board independence insignificantly affected for the dependent variable individually and only other two control variables are affected for the dependent variable significantly.

Table 4.2: Pearson's Correlations Matrix

Independent Variables	CEO Duality	Board Size	Board Independence	Board Activity	ROE	Solvency
Pearson Correlation	-0.162	-0.072	0.174	-0.026	0.641**	-0.321*
Sig.(2-tailed)	0.237	0.600	0.204	0.853	0.000	0.017

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

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

4.3 Regression Analysis

According to this study only concern the Analysis of Variance (ANOVA) and regression analysis to test the hypothesis.

Table 4.3: Strength and Explanatory Power of the Model

R	R Square	Adjusted R square	Std. Error of the Estimates
.732	.536	.478	.6416995

The adjusted R square describes the strength of the relationship between the model and dependent variable. The adjusted R square is 47.8% relating to this study. It shows a 47.8% of

strength of relationship between the model and Z score related to this study. According to the R Square shows the explanatory power of the model and due to this study the R square is 53.6%. This indicate the all independent variable of CEO duality, Board size, board activity, board independence and other two control variables are accountable for dependent variable of financial distress in 53.6%. The remaining of 49.4% is explained by the variables which are not concerning in this study or else 53.6% of the variation in dependent variables which is Z score is explained by the CEO duality, board size, board independence and board activity. The multiple correlation coefficients (R) are 0.732. The standard error shows to what extent the independent variables were unable to predict the dependent variable and it is 0.641 and it reflects a higher estimation.

The acceptability of the model from statistical perspective represents by ANOVA of financial distress and F statistics shows that the model fitness or validity of estimated model. P value is indicate that the significance level of the F value if ($P<0.05$) and according to this results significance of F value is 0.000 and F value is 9.249.

Table 4.4: Coefficient of Overall Model

Model	Unstandardized Coefficients		P value
	Beta Value	Std. Error	
Constant	1.367	0.723	0.065
CEO	-0.823	0.398	0.044
Board Size	0.000	0.069	0.996
Board Independence	0.246	0.977	0.803
Board Activity	0.014	0.033	0.668
ROE	1.681	0.271	0.000
Solvency	-1.298	0.451	0.006

The P values of table 4.5 are indicated the significance level of the each variable when P value is less than 0.05 ($p<0.05$) and P value of CEO duality, return on equity and solvency are respectively 0.044, 0.000 and 0.006. According to this result only CEO duality, return on equity and solvency are significantly affected for the dependent variable. And other board size, board activity and board independence variables are insignificant to the Z score. Further both CEO

duality and solvency show negative relationship with financial distress and other variables as board size, board activity and board independence show positive relationship.

4.4 Hypothesis Testing

H1: According to the developed hypothesis H1 indicates that there is a positive relationship in between CEO duality and financial distress. With reference to the coefficient of CEO duality, it implies that there is a Negative relationship and it rejects the hypothesis 1.

H2: Based on the coefficient of board size, the developed hypothesis which is H2 is rejected due to the beta value of 0.000.

H3: The coefficient of Board Independence is 0.246 and shows positive relationship between board independence and financial distress. Therefore this result implies that H3 is rejected.

H4: The coefficient of Board Activity infers positive relationship between both Board Activity and Z score and the coefficient value is 0.014 and it implies that there is a positive relationship between financial distress and Board Activity though P value does exceed 0.05 and it accepted the H4.

5. CONCLUSION

The objective of this study is to examine the impact of governance failure on financial distress of listed companies and the study identify there is only significant impact on distress is CEO duality and other board size, board activity and board independence are not significantly impact on the financial distress. Both control variables of Return on Equity (ROE) and solvency are show significant impact on financial distress. According to the results of this study reflect that there is a significant negative relationship in between the both independent variables of CEO duality and solvency. And other board independence, board size, board activity and ROE variables are show insignificant positive relationship.

REFERENCES

Abdullah, S. N. (2004). Board composition, CEO duality and performance among Malaysian listed companies. The international journal of business in society, Vol 4, 47-61.

Abdullah, S. N. (2006). Board structure and ownership in Malaysia:the case of distressed listed companies. International Journal of Business in Society, Vol 6, 582-594.

Ahmed, E., & Hamdan , A. (2015). The Impact of Corporate Governance on Firm Performance: Evidence From Bahrain Bourse. International Management Review, Vol 11, 1-17.

Ahmed, K., Henry, D., & Miglani, S. (2010). Corporate Governance and Financial Distress: Evidence from Australia. Journal of Contemporary Accounting and Economics, Vol 11, 18-30.

Altman, E. I. (1968). Financial Ratios, Discriminant Analysis and the Prediction of Corporate Bankruptcy. Journal of Finance, Vol 23, 1-21.

Altman, E. I. (1977). Predicting Financial Distress of Companies: Revisiting the Z score and ZETA Models. Journal of Banking and Finance, 1-30.

Amba, S. M. (2012). Corporate governance and firms' financial performance . Journal of Academic and Business Ethics , 1-11.

Anjum, S. (2012). Business bankruptcy prediction models: A significant study of the Altman's Z-score model . Asian Journal of Management Research, Vol 3, 1-8.

Bilal Nayef Zureigat, Fadzil, F. H., & Ismail , S. S. (2014). The Relationship between Corporate Governance Mechanisms and Going Concern Evaluation: Evidence from Firms Listed on Amman Stock Exchange. Journal of Public Administration and Governance, Vol 4, 1-11.

Bilal, Sehar, N. U., Khan, J., & Tufail, S. (2013). An Investigation of Costs of Financial Distress in Case of On-going Manufacturing Firms of Pakistan. Journal of Management and Administrative Sciences, Volume: 2, Issue: 4, 413-422 .

Brédart, X. (2014). Financial Distress and Corporate Governance: The Impact of Board Configuration . International Business Research, Vol 7, 1-9.

Brown, L. D., & Caylor , M. (2004). Corporate Governance and Firm Performance. Journal of Economics, 1-53.

Charalambakis, E. C. (2013). On the prediction of Corporate Fianacial Distress in the financial crisis: Empirical Evidence from Greek listed firms. Greece: Bank of Greece Printing Works.

Cheema, K. U., & Din , M. S. (2013). Impact of Corporate Governance on Performance of Firms: A Case Study of Cement Industry in Pakistan. Journal of Business and Management Sciences,Vol 1, 44-46.

Farooq, U., Nazir , M. S., & Nawaz , M. M. (2012). Operating or Financial Distress? How much Costly these are? American Journal of Scientific Research , 96-108.

Fernando, C.P.S.K., & Dissanayake, T. D. (2016). Determinants of Capital Structure. 3rd International Research Symposium . Sri Lanka: Rajarata University.

Gueyie, F. E.-P. (2001). Financial distress and corporate governance: Empirical Analusis. Interantional Journal of Business in Society, 15-23.

Guoa, Z., & Kumara, K. U. (2007). Corporate Governance and Firm Performance of Listed Firms in Sri Lanka. Journal of Social Behavioral Sciences, 664-667.

Habib, A., Bhuiyan, M. B., & Islam, A. (2013). Financial distress, earnings management and market pricing of accruals during the global financial crisis. The international journal of business in society, Vol 39, 155-180.

Haniffa, R., & Hudaib, M. (2006). Corporate Governance Structure and Performance of Malaysian Listed Companies. Journal of business finance and Accounting, 1034–1062.

Heenetigala, K., & Armstrong , A. (2011). The Impact of Corporate Governance on firm performance in an unstable economic and political environment: Evidence from Sri Lanka . Journal of Business Society, 1-17.

Hill, N. T., Perry, S. E., & Andes, S. (1996). Evaluating Firms in Financial Distress: An Event History Analysis. Journal of Appliied Business Research, Vol 12, 1-12.

John E. Core, H. R., & Larcker, D. F. (1999). Corporate governance, chief executive officer compensation, and firm performance. Journal of Financial Economics, 371-406.

Kahl, M. (2001). Financial Distress As A Selection Mechanism: Evidence From The United States. Journal of Business systems, 1-58.

Kajananthan, R. (2012). Corporate Governance Practices and Its Impact on firm Performance : Special Reference to Listed Banking Institutions in Sri Lanka . Global Journal of Management and Business Research, Vol 12, 1-8.

Keasey, K., & Watson, R. (1991). Financial Distress Prediction Model: A Review of their Usefulness. British Journal of Management, Vol 2, 89-102.

Ko, L.J., Blocher, E., & Lin, P. P. (1990). Prediction of Corporate Financial Distress: An Application of the Composite Rule Induction System. The International Journal of Digital Accounting Research, Vol 1, 69-85.

Lakshana A.M.I., & Wijekoon, W. (2012). Corporate governance and corporate failure. Journal of Economics and Finance, 191-198.

Li, H.X., & Wang , Z.j. (2008). Ownership, independent directors, agency costs and financial distress: evidence from Chinese listed companies. The international journal of business in society, Vol 8, 622-636.

Makhlouf, M. H., Laili, N. B., & Basah, M. Y. (2014). Board Directors Characteristics and firms Performance among Jordanian Firms, Proposing conceptual Framework. International Journal of Technical Research and Applications, Vol 2, 18-23.

Mclntyre, M. L., Murphy, S., & Mitchell, P. (2007). The top team: examining board composition and firm performance. The international journal of business in society, Vol 7, 547-561.

Merton, R. C. (2012). On the pricing of Corporate debt: the risk structure of interest rates. Journal of Finance , 1-22.

Miller, W. (2009). Comparing Models of Corporate Bankruptcy Prediction: Distance to Default vs. Z-Score . Journal of Business systems, 1-21.

Nanayakkara, K. G., & Azeez, A. A. International Journal of Business and Social Research , Vol 5. Predicting Corporate Financial Distress in Sri Lanka: An Extension to Z-Score Model.

Outecheva, N. (2007). Corporate Financial Distress: An Empirical Analysis of Distress Risk . 1-200.

Perry, T., & Shivdasani, A. (2005). Do Boards Affect Performance? Evidence from Corporate Restructuring. The Journal of Business, Vol 78, 1403-1432.

Purnanandam, A. (2005). Financial Distress and Corporate Risk Management: Theory & Evidence. Journal of Financial Economics, 1-61.

Salloum, C., & Azoury, N. (2012). Corporate Governance and Firms in Financial Distress: Evidence from a Middle Eastern Country. International Journal of Business Governance and Ethics, Vol 7, 1-7.

Shahwan, T. M. (2015). The effects of corporate governance on financial performance and financial distress: evidence from. The international journal of business in society, Vol. 15 , 641 - 662.

Shibakawa, R. (1994). Corporate Governance, Cost of Capital and Fianacial Distress. Journa] of Commerce and Management , 1-14.

Shivanna, M. (2010). The Satyam Fiasco: A Corporate Governance Disaster! . India.

T, Velnampy, & Kanth, P. A. (2014). Corporate Governance Practices: A Study of Sri Lanka. European Journal of Applied Social Sciences Research, *Vol 2*, 1-5.

Teen, M. Y. (2012). Corporate Governance Case Studies. Singapore.

Tothova, S. (2010). Corporate Governance failure in the Lehman Brothers case. United State of America.

Velnampy, T. (2013). Corporate Governance and Firm Performance: A Study of Sri Lankan Manufacturing Companies . Journal of Economics and Sustainable Development, Vol 4, 1-10.

Vo, Duo., & Phan, T. (2013). Corporate Governance and Firm Performance: Empirical Evidence from Vietnam. journal of Economic Development, 1-19.

Wu, M.C, Lin, H. C, Lin , I. C, & Lai , C. F. (2009). The Effects of Corporate Governance on Firm Performance. Journal of Finance, 1-15.

Yasotharalingam, L. (2011). Effect of board size on Company Performance in the listed financial institutions in Sri Lanka. international Journal of Research in Commerce, Economics and Management , Vol 1.

Zheka, V. (2005). Does Corporate Governance Predict Firms' Performance? The Case of Ukraine . Journal of Business systems, 1-62.