The Impact of Corporate Governance on Insolvency Risk: Evidence from Licensed Finance Companies in Sri Lanka

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ABSTRACT

Purpose: This study examines the relationship between corporate governance (CG) and insolvency risk (IR). It is grounded in the argument that corporate governance is essential for reducing excessive risk-taking behaviors that often lead to insolvency. The research addresses the increasing financial vulnerability of Licensed Finance Companies (LFCs) in Sri Lanka and highlights the significance of board independence, gender diversity, audit committee independence, and meeting frequency as determinants of financial stability and insolvency mitigation.
Design/methodology/approach: The sample comprised 25 LFCs listed on the CSE from 2019 to 2023. The insolvency risk was measured with Altman's emerging-market Z-score, and a panel regression analysis was employed to evaluate the impact of CG factors. Additionally, multinomial logistic regression analysis was used to explore the impact of corporate governance on the likelihood of insolvency risk.
Findings: The results reveal a statistically significant and inverse relationship between the presence of women on boards and the frequency of board meetings with insolvency risk. The inclusion of women's representation on the board is particularly influential in achieving low insolvency risk, while active audit committee engagement further reinforces a negative impact on the probability of insolvency. This indicates that increased gender diversity and consistent board engagement are associated with a lower likelihood of insolvency.
Practical implications: This research suggests that companies that prioritize gender diversity, ensure regular board meetings, and foster active audit committee engagement are more likely to enhance organizational stability and reduce excessive risk-taking behaviors.
Originality value: This study contributes to the existing body of knowledge on the role of corporate governance in managing financial risk within emerging markets. It explains the mechanisms through which governance structures influence insolvency risk, offering a critical basis for future research and policy initiatives to strengthen the resilience of financial institutions within developing economies.

Keywords: ***Corporate Governance, Insolvency Risk, Licensed Finance Companies, Z-score, Sri Lanka***.

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