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The Role of Corporate Governance in Managing Insolvency Risk in the Post-Pandemic Era: An Empirical Study of Licensed Finance Companies in Sri Lanka

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Abstract

This study aims to identify the specific corporate governance (CG) factors that influence the probability of insolvency of the Licensed Finance Companies (LFCs) listed on the Colombo Stock Exchange (CSE) in Sri Lanka. The study is grounded in the evidence that CG is critical in managing insolvency risk, especially during the pandemic. The increasing financial instability among Finance Companies (FCs) highlights the crucial need for a comprehensive analysis of CG mechanisms and their impact on insolvency risk (IR). Specifically, the economic instability caused by the recent pandemic underscores the urgent need for such analysis. The sample comprised 25 LFCs listed on the CSE from 2019 to 2023. IR was measured using Altman's emerging-market Z-score (EMZ score). Panel regression and multinomial logistic regression analysis were employed to explore the impact of CG on the likelihood of insolvency risk. Key findings reveal that board gender diversity and the frequency of board meetings are significantly and inversely related to insolvency risk. Specifically, women on boards and the active engagement of audit committees contribute substantially to reducing insolvency risk. These findings highlight that organizations prioritizing gender diversity, ensuring regular board meetings, and fostering active audit committee engagement are more likely to enhance organizational stability and reduce excessive risk-taking behaviours. The study suggests that fostering diversity, inclusivity in leadership, and strong CG mechanisms contribute to long-term organizational sustainability and success in managing insolvency risk.

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

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Introduction

Every business management in an agency relationship needs to find a balance between riskier policies and less risky alternatives to generate shareholder wealth. This balance aims to protect their self-interest and capital investment in the company. According to Ali et al. (2021), the fundamental role of corporate governance is to overcome agency problems between managers and shareholders by aligning their interests. The 2008 global financial crisis affected international credit and asset markets. It has exposed some control and risk management flaws, primarily in the financial sector. Ali et al. (2021) further stated that the issue of risk-taking as an agency problem is more pronounced in the financial industry. Financial institutions are particularly vulnerable to insolvency risk, more frequently referred to as bankruptcy, which arises when an entity fails to meet its debt obligations (Aguilar & Maciel, 2019). The financial institutions in a country play a vital role in ensuring the financial stability of the entire financial system of that country. Thus, the resilience of financial institutions is critical for sustaining the country's economic and financial stability. Hence, insolvency risk-taking (IR) remains a significant concern, underscoring the need for improved governance mechanisms to ensure financial stability.

Over recent years, the Sri Lankan LFC sector has deteriorated due to uncertainties in the country. According to the Central Bank of Sri Lanka (2020b), during the period from January to August 2020, the LFCs sector has become vulnerable due to a decrease in asset base, credit, and deposits, as well as an increase in NPLs and declining profitability, the sector's capital and liquidity levels remained above the minimum regulatory requirements. Furthermore, a few individual LFCs did not meet the minimum capital requirements. As stated by CBSL (2020), the bank has issued a notice of cancellation of the license of a few LFCs. Moreover, CBSL (2020) also highlighted that LFCs' financial performance metrics have declined consistently over the past five years. Concurrently, the return on equity (ROE) dropped from 20.23% in December 2019 to just 12.09% in December 2023. As stated by the Central Bank of Sri Lanka (2023), the sector's asset quality declined, in addition to increasing its exposure to sovereign risk by making more investments in government securities. The sector's Capital Adequacy Ratio (CAR) improved as regulatory capital growth increased relative to risk-weighted assets. However, to ensure resilience, the sector requires further consolidation. Overall, the sector faced challenges, and its ability to adapt its business model will be critical in navigating economic turbulence.

These declining figures indicate a reduction in the profitability of the LFCs over the observed period. Conversely, some LFCs have registered capital adequacy ratios falling below the mandated threshold. Among these non-compliant LFCs, a subset characterized by frail financial standings has even exhibited negative capital adequacy ratios. These uncertainties in the LFCs operating in Sri Lanka raise concerns over the solvency of enterprises within this sector. According to Islam et al. (2020), the NPL ratio is a determinant of IR, and asset deterioration is one of the significant reasons for insolvency risk. Concerning these contexts, the solvency of the companies belonging to the LFC sector needs to be investigated. In addition to the deteriorated performance of the LFCs in Sri Lanka, it has been repeatedly observed that a reason for the failure of LFCs is the lack of good governance, where ownership and decision-making are concentrated with the main shareholder or a few shareholders linked to the main shareholder (Central Bank of Sri Lanka, 2020a).

When reviewing past studies in Sri Lanka, there is a dearth of prior studies about the impact of CG on the IR of LFCs in Sri Lanka. Sameera and Wijesena (2018) investigated the impact of board structure on the credit risk of listed banks from the Colombo Stock Exchange (CSE). It revealed that both board size and board independence exerted a significant negative influence on credit risk. Moreover, Sameera (2020) examined the impact of CG on corporate risk using a sample of 64 listed companies on the CSE. The findings suggest that board independence significantly and negatively impacts corporate risk. Farwis et al. (2020) examined the relationship between CG and the firm risk of CSE-listed companies. They found that board size, women on board, non-executive directors, CEO duality, and director interlock significantly impact firm risk. These limited empirical studies highlight the fundamental importance of corporate governance structures in mitigating financial vulnerabilities. These studies have predominantly examined governance and risk relationships, while the present investigation uniquely addresses the role of corporate governance in mitigating insolvency risk, specifically within LFCs. It creates a pressing need for this investigation. In Addition, as explained above, the Sri Lankan LFC sector has faced substantial financial challenges in recent years, such as declining profitability, rising non-performing loans (NPLs), weakened asset quality, and falling short of maintaining minimum regulatory capital and liquidity requirements. Concurrently, the return on equity also decreased considerably, highlighting its vulnerability. Moreover, the increased exposure to sovereign risk in this sector due to investments in government securities highlights the need for urgent structural reforms. Given the evidence indicating governance deficiencies as a contributing factor to the financial instability of LFCs, it becomes critical to examine the role of governance attributes that may resolve insolvency vulnerabilities. However, despite the extensive body of literature examining the relationship between corporate governance and various dimensions of financial risk, there remains a dearth of studies focusing specifically on the relationship between CG and IR (Al Haddad & Juhmani, 2020; Ali et al., 2021; Younas et al., 2021). Given the prevailing circumstances, this study aims to bridge the research gap by investigating the role of corporate governance mechanisms in managing insolvency risk among LFCs. Furthermore, this research is significant to Sri Lanka's financial sector and economy as it was conducted during and after the COVID-19 pandemic. The economic disruptions caused by COVID-19 have underscored existing financial vulnerabilities and the need to adjust and prioritize specific dynamics in corporate governance practices.

The outcomes of this study make several significant contributions to the existing literature and offer practical implications for stakeholders within the financial sector. First, our study extends the current body of research on the effects of corporate governance on insolvency risk in financial institutions by demonstrating specific governance mechanisms. It highlights the critical role of gender diversity and active board engagement in mitigating financial vulnerabilities, particularly during periods of economic crisis. Second, our research contributes to the literature by underscoring the importance of robust audit committee oversight in enhancing risk management practices and ensuring the financial stability of financial institutions. Third, this study contributes to the empirical research and practices of the Sri Lankan financial sector because there is an absence of studies concerning CG and the IR of the LFCs in Sri Lanka. It offers empirical evidence regarding governance practices in mitigating insolvency risks, specifically within an emerging market context. From a theoretical standpoint, this research contributes to agency theory by empirically demonstrating how specific governance mechanisms can align the interests of managers and shareholders to reduce insolvency risks. The findings suggest that governance elements are crucial in monitoring managerial actions and mitigating opportunistic behaviors that could affect financial stability.

When the finding is positioned within the international discourse on corporate governance and insolvency risk, this study draws similarities and contrasts with the findings. For instance, similar research by Ali et al. (2021) found that stronger and shareholder-friendly corporate governance mechanisms in financial institutions are associated with increased insolvency risk. Al Haddad and Juhmani (2020) found that corporate governance mechanisms, particularly board size, audit committee size, and audit committee meetings, play a significant role in influencing firms' insolvency risk. By contrasting these conflicting international perspectives on CG and IR, the current study highlights its importance in outcomes in various contexts, such as emerging economies. The findings also provide considerable pragmatic implications for diverse stakeholders, including policymakers, regulatory bodies, industry practitioners, and investors, to strengthen regulatory frameworks and provide LFCs with governance guidelines to improve resilience. Investors and stakeholders can also utilize these insights to assess risk exposure and make informed decisions. Furthermore, the research provides a foundation for future studies, enabling a broader exploration of governance practices across different financial institutions.

Theoretical Framework, Literature Review, and Hypotheses

Corporate Governance and Economic Uncertainty

The recent pandemic, similar to the global financial crisis of 2008, has caused a considerable increase in research efforts within corporate governance. The main focus has been on exploring the relationship between corporate governance practices and the risk-taking behaviours of organizations during periods of economic uncertainty. Mathew (2013) noted that the 2008 financial crisis provoked a worldwide interest in corporate governance among academics and policymakers. Aguilar and Maciel (2019) highlighted the relevance of corporate governance in response to recent financial scandals across the United States, Europe, and Latin America. Their findings underscore how corporate governance has evolved into a critical international concern due to its implications for financial stability.

Furthermore, empirical studies by Al Haddad and Juhmani (2020) and Gariba et al. (2018) highlight the importance of corporate governance systems in preventing financial crises. These studies conclude that failures in governance mechanisms were a significant factor contributing to the global financial crisis and emphasize the role of CG in sustaining institutional integrity, particularly within financial sectors. Nodeh et al. (2018) build upon this by highlighting that excessive risk-taking and weak corporate governance were pivotal elements leading to the financial collapse and further reinforcing the necessity of robust CG frameworks to mitigate such risks. This existing body of literature reinforces the view that corporate governance is fundamental in promoting stability and resilience within financial institutions, particularly in times of crisis. Considering the current economic instability in Sri Lanka, it becomes crucial to investigate the influence of corporate governance on the insolvency risk of Licensed Finance

Companies (LFCs) in Sri Lanka. As the Sri Lankan economy faces ongoing challenges, such as economic fluctuations and market uncertainties, exploring how effective corporate governance practices can help LFCs mitigate the risk of insolvency becomes imperative.

Insolvency Risk in Financial Institutions

According to Hussain et al. (2020), insolvency is a state in which a firm cannot meet its financial obligations. The risk of insolvency is unavoidable. It is the primary source of losses and instability. Furthermore, insolvency risk is the most serious risk borne by financial institutions (Djebali & Zaghdoudi, 2017). Based on that, insolvency risk is a significant risk in any financial company in any country. According to the current context within the Sri Lankan financial system, it is more important to study whether LFCs in Sri Lanka face an insolvency risk. According to Aguilar and Maciel (2019), inefficient stakeholder contracts expose the company to various risks, and there is a close relationship between CG and the risk of insolvency. Rodica et al. (2020) stated that insolvency risk management is essential in financial institutions because failures are very costly at the micro- and macroeconomic levels. Because of the global financial crisis in 2008 and the Asian financial crisis in 1997, the insolvency risk of organizations became an interesting area among researchers worldwide, especially in developed countries.

Measuring Insolvency Risk in Emerging Economies

Previous studies on corporate governance and insolvency risk have stated that the Altman model is the best method to define insolvency risk, especially in emerging countries. According to Rodica et al. (2020), the revised Altman Z-score model is one of the most effective multiple discriminant analyses explored throughout the last 40 years. Aguilar and Maciel (2019) stated that Altman’s Z score model is widely known and used in numerous studies to establish whether a company is financially sound, with a medium probability of bankruptcy, or in a situation of insolvency or potential failure. Hussain et al. (2020) indicated that the EMZ score is appropriate for defining insolvency risk in emerging countries. Al Haddad and Juhmani (2020) investigated the impact of corporate governance mechanisms on the insolvency risk of non-financial institutions listed in Bahrain Bourse from 2015 to 2019, and it used Altman’s Z-score model to measure the firms' insolvency risk to identify discrimination zones. Further, Garba and Mohamed (2018) investigated the interactive role of the audit committee size on the link between ownership structure and bankruptcy of listed Nigerian financial firms using Altman’s Z-Score model. According to the empirical review of Altman’s model, Altman’s EMZ score is the most appropriate model to predict the insolvency risk of companies in developing countries like Sri Lanka. Based on that, the researcher used Altman’s EMZ score to define the insolvency risk of the LFCs in Sri Lanka.

Agency Theory and Insolvency Risk

This study is grounded in agency theory, which provides a foundational framework for understanding the relationship between corporate governance and insolvency risk. Nodeh et al. (2018) stated that the agency theoretic model can explain the connection between corporate governance and risk-taking. Specifically, agency theory highlights how the divergence of interests between managers and shareholders can result in managerial decisions that do not align with shareholder value maximization. Consequently, the insolvency risk of a particular entity is increasing (Ali et al., 2021). Agency theory further explains that the interests pursued by principals and agents, intensified by information asymmetry, lead to the generation of agency costs. These costs manifest in various forms, including undertaking excessive risk that does not necessarily contribute to shareholder wealth (Aguilar & Maciel, 2019). The LFCs sector has exhibited deteriorating performance, which can be attributed to poor corporate governance practices and increased insolvency risk. Then, the interest pursued by the managers and shareholders of the LFCs can result in excessive insolvency risk-taking. Based on the theoretical background of the agency theory, there is a conflict between the interests of the shareholders and managers of the companies, leading to agency problems through taking excessive risks. The theoretical foundations of agency theory argue that corporate governance mechanisms are essential for resolving these agency conflicts. By aligning shareholders' and managers' interests, corporate governance might reduce excessive risk-taking and improve financial stability. Thus, agency theory serves as the theoretical framework for this study, highlighting the inherent agency problems between shareholders and managers and their implications for corporate governance and insolvency risk within Licensed Finance Companies in Sri Lanka.

Stewardship Theory and Insolvency Risk

Stewardship theory suggests that managers are inherently motivated to act in the organization's and its shareholders' best interests (Deshani & Ajward, 2021; Rahman & Ali, 2022). According to this theory, governance mechanisms should empower managers to fulfill their stewardship roles, promoting long-term stability and reducing the likelihood of insolvency through supportive and collaborative governance practices. For the present study, stewardship theory provides a robust theoretical justification for hypothesizing that governance practices fostering trust, empowerment, and ethical leadership can significantly reduce insolvency risk (Madison, 2014). Specifically, the presence of women on boards, the independence of audit committees, and the frequency of board meetings are governance attributes that align with stewardship principles, promoting a governance environment that supports long-term financial stability.

Hypotheses Development

Board Independence

Board independence refers to the composition and structure of a company's board of directors, where many board members are considered independent. Independent directors are expected to provide objective and impartial judgment, oversee management actions, protect the interests of shareholders, and enhance the overall transparency and accountability of the organization.

They bring diverse perspectives, expertise, and experience from outside the company, promoting effective oversight and decision-making processes. Hussain et al. (2020) argued that non-executive directors play a vital role in establishing a supervision system to mitigate agency conflicts between agents and principals. Their study highlighted an important finding: a significant and negative relationship exists between the independence of the board and the probability of a company experiencing bankruptcy. Further, Sameera (2020) investigated the impact of corporate governance, including board structure, procedure, and independence, on corporate risk. This study found a significant negative correlation between board independence and corporate risk. As Djebali and Zaghdoudi (2017), independent directors on a company's board play a crucial role in mitigating the risk of insolvency. Independent directors significantly reduce financial risks that could lead to the company's insolvency by providing unbiased oversight and making decisions that prioritize the long-term stability of the organization. Nodeh et al. (2018) A previous study further reinforced this idea, revealing a robust and inverse association between board independence and the likelihood of a company going bankrupt. This suggests that the level of independence demonstrated by the board of directors impacts the likelihood of a company facing financial distress and potential insolvency. Given these compelling findings, the researcher's working hypothesis is as follows.

H_1: There is a significant relationship between the independence of the board of directors and the firm's insolvency risk.

Women on the board

Women on the board refers to including women as board members, either executive or non-executive directors. The concept of increasing the presence of women on boards has gained attention due to the recognition of gender diversity as a crucial aspect of corporate governance and business performance. Empirical studies highlighted that gender diversity brings a variety of perspectives, skills, and experiences to the boardroom, leading to better decision-making, improved governance, and enhanced organizational performance. Maier and Yurtoglu (2022) argue that gender diversity in boards drives company values and firm success since it leads to greater diversity and less discrimination. It was found that including female directors on the board significantly reduces a firm's insolvency risk, indicating a negative relationship. Another study by Brogi and Lagasio (2021) stated that board diversity encourages a more diversified decision-making process and protects stakeholders' interests, enhancing the quality of corporate governance. Similarly, Wilson and Altanlar (2012) discovered that the presence of women on boards was inversely related to the likelihood of insolvency. Based on this reasoning, hypothesis 2 is proposed.

H_2: The presence of women on the board significantly influences the firm's insolvency risk.

Board Meetings

Al Haddad and Juhmani (2020) found that the directors held board meetings regularly to discuss the firm's current status and plans and to share prior experiences, all to make decisions that will shape the company's upcoming events and contribute to the company's continuity. The study found a significant negative relationship between board meetings and insolvency risk.

Elamer et al. (2018) suggest that the frequency of board meetings reflects the board's achievements and its ability to oversee managerial behaviour, particularly in identifying and addressing inappropriate risk-taking. This implies that a higher frequency of board meetings may enhance the board's oversight function and reduce the likelihood of insolvency by proactively addressing potential risks. Similarly, Alshirah et al. (2020) stated that regular board meetings are a commitment to exchange information between managers and shareholders regularly. This leads to the assumption that the frequency of board meetings can reduce agency conflicts between managers and shareholders and then reduce the insolvency risk-taking of the companies. Ayadi et al. (2019) found a significant and negative correlation between the number of board meetings and the risk of insolvency. Based on these findings, it is postulated that the following hypothesis can be formulated.

H_3 – The frequency of board meetings significantly impacts the firm's insolvency risk

Audit Committee Independence

Audit Committee Independence refers to the degree to which members of an audit committee are free from any conflicts of interest or undue influence that may impair their ability to carry out their responsibilities objectively. Rodica et al. (2020) noted that one of the s fundamental roles of the audit committee is identifying and controlling risks and assessing the effectiveness of operations in risk management, assuring the risk policies are being followed. The independence of the audit committee is ensured by having independent directors on the board. According to Appiah and Amon (2017), independent non-executive directors (NEDs) reduce the likelihood of fraud and earnings management by mandating superior audits from external auditors. Additionally, Al Haddad and Juhmani (2020) state that the absence of independent directors weakens the audit committee's effectiveness in controlling agency conflicts and reducing the firm's insolvency risk. These findings suggest a potential relationship between audit committee independence and insolvency risk. Considering the results, the researcher hypothesized the following.

H_4: The independence of the audit committee has a significant impact on the firm's insolvency risk.

Audit Committee meetings

According to agency theory, audit committees that meet more frequently are more likely to perform their oversight responsibilities (Appiah & Amon, 2017). They argue that more frequent audit committee meetings indicate a higher likelihood of fulfilling their oversight responsibilities. Their study reveals a negative relationship between audit committee meetings and insolvency risk, suggesting that regular meetings enable more effective monitoring of managerial activities and reduce agency conflicts. In contrast, Al Haddad and Juhmani (2020) found a positive relationship between audit committee meetings and insolvency risk. While this finding appears contradictory, it highlights the need for further investigation to understand the specific dynamics in different contexts and organizations. Based on the above facts, the following hypothesis was formulated for the present study.

H_5: The frequency of audit committee meetings significantly impacts the firm's insolvency risk.

The empirical justifications from this reviewed literature support the hypothesis that corporate governance practices, such as board independence, board diversity, the presence of independent directors, and the frequency of board and audit committee meetings, influence the insolvency risk of organizations. Specifically, independent directors have been found to mitigate agency conflicts and restrain managers from acting in their self-interest, thereby enhancing the firm's overall performance and reducing the likelihood of insolvency. Board independence and board diversity, including the presence of women on the board, have also been associated with reduced insolvency risk. The audit committee plays a crucial role in risk management and assessing the effectiveness of operations, with its independence strengthening the monitoring function and enhancing effectiveness. The frequency of board meetings and audit committee meetings has been linked to the ability to identify and control risks, as well as to monitor management and reduce the likelihood of false reporting. Regular board and audit committee meetings have contributed to financial stability by reducing agency conflicts and risk-taking behaviours. The findings of the reviewed literature highlight the importance of conducting in-depth studies on corporate governance in the context of insolvency risk within financial institutions, especially in emerging economies such as Sri Lanka.

Research Design, Sample, and Data

Data and Sample Selection

The methodology adopted for this study follows the deductive approach. The study focused on Licensed Finance Companies (LFCs) listed in the Colombo Stock Exchange (CSE) in Sri Lanka as the primary unit of analysis. The LFCs sector in Sri Lanka was selected due to its critical role in the financial system and its vulnerability to economic fluctuations. The Central Bank of Sri Lanka (2020b) reported a decline in profitability, rising non-performing loans, and regulatory challenges, highlighting its vulnerability. Ali et al. (2021) emphasized that managers in the financial industry must comply with regulations mandating the maintenance of adequate capital and liquidity. This compliance impacts the decision-making capabilities of financial institutions, which, in turn, influences the level of risk they pose to the market. Despite its significance, previous studies have mainly focused on non-financial companies, creating a gap in understanding the governance processes of LFCs (Al Haddad & Juhmani, 2020; Younas et al., 2021). Therefore, the LFCs were selected as the sample for the present study. The sample consisted of 25 LFCs listed in the CSE. The initial sample was 29 LFCs; four companies were excluded due to incomplete data. The data spanning the five years from 2019 to 2023 was gathered to ensure a comprehensive analysis. The final analysis was based on 125 firm-year observations. The variables selected for the present study are board independence, the presence of women on the board, audit committee independence, board meetings, and audit committee meetings. These factors were chosen because they are perceived to be significant with insolvency risk.

Measurement of Variables

The study employed Altman's Z-Score model, modified in 2005, to measure insolvency risk. Hussain et al. (2020) noted that Altman introduced the emerging-market Z-score distress prediction model in 2005 as a revised version of the original model applicable to developing countries. The study's operationalization comprises constructing and implementing the following measures and indicators.

Table 1: Operationalization

Category	Variable	Definition/Formula
Dependent Variable	Insolvency Risk (IR)	$Z=3.25+6.56X_1+3.26X_2+6.72X_3+1.05X_4$
		X_1: Working Capital ÷ Total Assets
		X_2: Retained Earnings ÷ Total Assets
		X_3: Operating Income ÷ Total Assets
		X_4: Book Value of Equity ÷ Total Liabilities
	IR Categories	$Z < 1.21$: High IR (Distress Zone) = 2
		$1.21 < Z < 2.90$: Moderate IR (Grey Zone) = 1
		$Z > 2.90$ Z : Low IR (Safe Zone) = 0
Independent Variables	Board Independence (BI)	Independent Directors ÷ Total Directors
	Women on Board (WIB)	Female Directors ÷ Total Directors
	Board Meetings (BM)	Number of Board of Director Meetings per Year
	Audit Committee Independence (ACI)	Independent Directors in Audit Committee ÷ Total Directors in Audit Committee
	Audit Committee Meetings (ACM)	Number of Audit Committee Meetings per Year

Source: Constructed by Researcher, 2023

Several statistical analyses were performed to examine the relationships between corporate governance and insolvency risk, including descriptive statistics, correlation analysis, a panel regression model, and multinomial logistic regression analysis. Each serves a distinct purpose aligned with the study's hypotheses and objectives. Descriptive statistics were first utilized to summarize the fundamental characteristics of the dataset, providing a clear overview of variables, which established the baseline for further analysis. Following this, correlation analysis was conducted to identify preliminary associations between corporate governance factors and insolvency risk, enabling the identification of potential relationships and assessing the strength and direction of these associations without implying causality. Panel regression analysis was employed, considering the longitudinal nature of the data with repeated observations over time. The panel regression model allowed for a more in-depth examination of the relationships between corporate governance and insolvency risk while accounting for individual firm-specific effects and time-related variations.

Additionally, multinomial logistic regression analysis was used as a secondary approach to explore the likelihood of firms falling into various insolvency risk categories of low, moderate, and high based on the presence and magnitude of the corporate governance variables. It provides insights into how specific governance variables affect the probability of experiencing different levels of insolvency risk. Collectively, these analytical techniques enabled a comprehensive assessment of the interplay between corporate governance structures and insolvency risk. Accordingly, the regression model of the study is formulated as follows.

$$IR = \alpha + \beta_1 (BI_{i,t}) + \beta_2 (WIB_{i,t}) + \beta_3 (ACI_{i,t}) + \beta_4 (BM_{i,t}) + \beta_5 (ACM_{i,t}) + \varepsilon_t$$

Data Analysis and Discussion

The researcher conducted a preliminary assessment to determine the normality of the sample data about the variables under consideration before reaching empirical outcomes and findings. This assessment aimed to determine whether the dataset had been sourced from a population that adheres to a normal distribution pattern. An analytical approach focusing on Skewness was employed to evaluate normality. Table 2 demonstrates the normal distribution of the sample data using a skewness analytical approach.

Table 2: Skewness

Variable	Skewness	Std Error of Skewness
BI	0.522	0.217
WIB	0.957	0.217
BM	0.065	0.217
ACI	0.136	0.217
ACM	0.780	0.217
IR	0.091	0.217

Source: Constructed by Researcher, 2023

Note (S): *n=125*, **BI** - Board Independence, **WIB** - Women in Board, **BM** - Board Meetings, **ACI** - Audit Committee Independence, **ACM** - Audit Committee Meetings, **IR** – Insolvency Risk

Moreover, the highest variance inflation factor (VIF) value of 1.581 suggests that collinearity among variables is very low, indicating no chance of a multicollinearity issue. This argument was reinforced by the tolerance values as well. The tolerance values of all the variables were greater than 0.633. Furthermore, when carrying out the regression analyses on the three dependent variables, the Breusch Pagan test was performed, and it was found that heteroscedasticity was not present in the data. Table 3 presents the perspective on the Variance Inflation Factor (VIF) and tolerance levels.

Table 3: VIF and Tolerance

Variable	VIF	Tolerance
BI	1.581	0.633
WIB	1.275	0.784
BM	1.379	0.725

ACI	1.377	0.726
ACM	1.114	0.898

Source: Constructed by Researcher, 2023

Note (S): *n=125* **BI** - Board Independence, **WIB** - Women in Board, **BM** - Board Meetings**,** **ACI** - Audit Committee Independence, **ACM** - Audit Committee Meetings

Descriptive Statistics

Table 4 shows the descriptive Measures for the variables, including IR, BI, WIB, ACI, BM, and ACM. The corresponding descriptive measures include the minimum, maximum, mean, and standard deviation of each variable.

Table 4: Descriptive Measures

Variables	Minimum Observation	Maximum Observation	Mean Value (μ)	Standard Deviation (σ)
BI	0.12	0.69	0.3870	0.1389
WIB	0.00	0.58	0.1773	0.1464
BM	5.00	17.00	12.43	1.8534
ACI	0.33	1.00	0.7035	0.1798
ACM	1.00	13.00	6.64	2.917
IR	0.06	2.98	1.5232	0.5657

Source: Constructed by Researcher, 2023

Note (S): *n=125*, **BI** - Board Independence, **WIB** - Women in Board, **BM** - Board Meetings, **ACI** - Audit Committee Independence, **ACM** - Audit Committee Meetings**, IR** – Insolvency Risk

Based on the insolvency risk mean value analysis, the sampled LFCs exhibit a moderate probability of facing insolvency. The range between the minimum and maximum values of board independence is relatively narrow, suggesting a stable level of independence within the LFCs. Similarly, the range between audit committee independence's minimum and maximum values is not significantly wide.

The mean value of board meetings indicates that the sampled LFCs comply with corporate governance requirements. However, the number of audit committee meetings among the LFCs included in the study is considerably dispersed. This variability in ACM highlights the varying levels of engagement and activity of audit committees within the sampled LFCs.

Correlation Matrix

Pearson's correlation analysis was employed to examine the association between the variables, as illustrated in Table 5.

Table 5: Pearson Correlation Analysis

	BI	WIB	BM	ACI	ACM	RI
BI	1.000					
WIB	0.214*	1.000				
BM	0.469**	-0.133	1.000			
ACI	0.369**	0.392**	0.181*	1.000		
ACM	-0.085	0.178*	0.004	0.221*	1.000	
IR	-0.129	-0.256**	-0.127	-0.263**	0.069	1.000

Source: Constructed by Researcher, 2023
*** Correlation is significant at the 0.01 level (2-tailed), * Correlation is significant at the 0.05 level (2-tailed)*
***Note (S):** n=125, **BI** - Board Independence, **WIB** - Women in Board, **BM** - Board Meetings, **ACI** - Audit Committee Independence, **ACM** - Audit Committee Meetings, **IR** – Insolvency Risk*

The results reveal an insignificant and weak negative correlation between IR and BI, suggesting that a higher level of board independence is associated with a lower likelihood of insolvency. A moderate negative correlation exists between IR and WIB, indicating that companies with a higher representation of women on the board tend to have a lower insolvency risk, and this correlation is statistically significant. Similarly, a moderate negative correlation is observed between IR and ACI, indicating that greater audit committee independence is associated with a reduced insolvency risk, and this correlation is statistically significant.

On the other hand, the correlation between IR and BM is weak and negative, implying that more frequent board meetings may be linked to lower insolvency risk, but this correlation is not statistically significant. Finally, a weak positive correlation between IR and ACM suggests that more audit committee meetings may slightly increase the insolvency risk. However, this correlation is not statistically significant.

Regression Analysis

The study employed panel and multinomial regression because panel regression captures the magnitude of the impact over time, while multinomial regression could be more insightful for risk stratification, which helps identify the firms most likely to experience varying levels of insolvency risk. The random and fixed-effects models were applied in the panel regression analysis, and the Hausman test was conducted to determine the most appropriate model. Since the p-value of the Hausman test is greater than 0.05 (Prob > chi2 = 0.9930), the results were discussed through the random-effects model. Results are demonstrated in Table 6.

Table 6: Random Effects Model

	Coefficient	Standard Error	Z Value	p>|z|	95% Confidence Interval	
BI	0.5275	0.4465	1.18	0.256	-0.3476	1.4028
WIB	-1.3404	0.4239	-3.07	0.002	-2.1314	-0.4694

BM	-0.0742	0.0293	-2.19	0.029	-0.1216	-0.0067
ACI	-0.5357	0.3041	-1.74	0.081	-1.1269	0.0654
ACM	0.0268	0.0184	1.45	0.146	-0.0093	0.0630
_Cons	2.4296	0.4174	5.82	0.000		
Prob > chi2 = 0.0008						
R – sq. = 0.1693						

Source: Constructed by Researcher, 2023
Note (S): *n=125 BI - Board Independence,* ***WIB*** *- Women in Board,* ***BM*** *- Board Meetings,* ***ACI*** *- Audit Committee Independence,* ***ACM*** *- Audit Committee Meeting*

The results presented in Table 6 indicate that BI does not have a statistically significant impact on insolvency risk since the p-value for the analysis exceeds 0.05. Consequently, the findings suggest that the influence of board independence on the insolvency risk of firms is not significant within the context of this study. Thus, H1 was not empirically proven, and H1 was not supported. WIB exerts a negative and significant impact on IR, consistent with the empirical findings of Wilson and Altanlar (2012) and Maier and Yurtoglu (2022). Thus, H_2 was supported. As stated by Wilson and Altanlar (2012), the presence of women reduces the insolvency risk of companies because women are risk-averse and add more value to management. Maier and Yurtoglu (2022) highlight that newly appointed women can add new skills rather than newly appointed males in management. Women's new skills contribute to more effective decisions and lower the insolvency risk. The results indicate that BMs significantly and negatively impact IR. These results are consistent with Ayadi et al. (2019). Thus, H_3 was supported. Elamer et al. (2018) noted that the frequency at which board meetings are held can indicate the board's level of achievement and effectiveness in overseeing and identifying instances of managerial misconduct, such as excessive risk-taking. The present study evidenced that an increase in the frequency of board meetings would result in enhanced managerial oversight since it provides board members with more opportunities to deliberate on corporate strategy and risks. This engagement has the potential to impact a firm's performance positively. Consistent with the literature, increased board meetings can positively impact the company’s performance and lower insolvency risk-taking. ACI has no significant impact on IR. Considering the insignificant impact of ACI on the IR, H_4 was not supported. ACM also does not significantly impact the IR, and H_5 was not supported.

As illustrated in Table 7, Multinomial logistic regression analysis was employed to elaborate on the CG variables' significant impact on the IR categories. By utilizing multinomial logistic regression, the study could examine the associations between CG factors and different categories of IR while simultaneously considering the potential influence of corporate governance variables. This statistical technique assesses how CG variables contribute to the likelihood of falling into different risk categories.

Table 7: Multinomial Logistic Regression Analysis

IR category	Variable	Coefficient	Standard Error	Z Value	P>|z|	95% Confidence Interval	
0	BI	4.2799	2.7100	1.58	0.114	-1.0317	9.5915
	WIB	-7.2364	1.9874	-3.64	0.000	-11.1318	-3.3410
	BM	-0.0309	0.1724	-0.18	0.858	-0.3688	0.3069

	ACI	4.0576	1.6776	2.42	0.056	0.7695	7.3456
	ACM	-0.0027	0.0826	-0.03	0.973	-0.1648	0.1592
	_Cons	-1.8279	1.9097	-0.96	0.338	-5.5710	1.9150
1			(Base outcome)				
2	BI	-5.8897	3.2759	-1.80	0.072	-12.3105	0.5309
	WIB	2.0986	2.6959	0.78	0.436	-3.1853	7.3826
	BM	0.2198	0.1706	1.29	0.198	-0.1145	0.5542
	ACI	-1.6404	2.0167	-0.81	0.416	-5.5932	2.3123
	ACM	-0.3719	0.1485	-2.50	0.012	-0.6630	-0.0808
	_Cons	0.9704	2.0798	0.56	0.632	-4.1255	5.0665

Source: Constructed by Researcher, 2023

Note(S): *n=125*, **0 –** Low Insolvency Risk**, 1 –** Moderate Insolvency Risk**, 2** – High Insolvency Risk, **BI** - Board Independence, **WIB** - Women in Board, **BM** - Board Meetings**, ACI** - Audit Committee Independence, **ACM** - Audit Committee Meetings

The moderate insolvency risk category serves as the reference group in this analysis, meaning the low and high insolvency risk results are interpreted relative to this baseline. As the base outcome, it is assumed that firms with moderate insolvency risk lie between the extremes, and the coefficients for the other categories provide insight into deviations from this central point. According to the low IR category results, WIB exerts a negative and significant impact, consistent with Maier and Yurtoglu (2022). The remaining CG variables do not significantly impact the low IR. According to the high IR category results, ACM has a significant and negative impact on high IR, which is consistent with the empirical studies of Al Haddad and Juhmani (2020) and Appiah and Amon (2017). The remaining CG variables do not significantly impact the high IR. As demonstrated in Table 7, BI does not significantly impact the insolvency risk. Therefore, hypothesis H1 was not supported. In addition, multinomial logistic regression analysis shows that WIB exerts a negative and significant impact on the insolvency risk with a low probability of insolvency risk ($p>|z| = 0.000$, Coeff = -7.2364). These results are consistent with the findings of Maier and Yurtoglu (2022) and Wilson and Altanlar (2012). Thus, a higher presence of female directors on the board is associated with a reduced likelihood of insolvency. According to Maier and Yurtoglu (2022), if diverse teams outperform homogeneous teams, a more gender-diverse board of directors will likely boost firm performance and reduce the risk of insolvency. Concerning the empirical results and findings, Hypothesis H2 was supported.

The results obtained from panel regression analysis and multinomial regression analysis indicate that ACI does not significantly impact insolvency risk. These findings suggest that the level of independence within the audit committee plays a minor role in influencing the likelihood of insolvency for the companies. However, the analysis shows a negative association between audit committee independence and insolvency risk. Considering the insignificant impact of ACI on the insolvency risk, hypothesis H4 was not supported. In contrast, the random-effects model of the panel regression analysis shows that BM significantly and negatively impacts the insolvency risk ($p>|z| = 0.029$, Coef = 0.0742). These results are consistent with the empirical studies of Ayadi et al. (2019). Based on that, hypothesis H3 was supported.

Regarding ACM, the panel regression analysis indicates no statistically significant impact on insolvency risk. However, the multinomial logistic regression analysis reveals a negative and significant relationship between ACM and the insolvency risk at the high probability of insolvency risk category. These results align with the empirical evidence Al Haddad and Juhmani (2020) and Appiah and Amon (2017) reported. Consequently, this finding indicates an assumption that an increase in the frequency of audit committee meetings can enhance the monitoring of risk-taking and ensure financial stability, resulting in a reduction in the high probability of insolvency risk. Al Haddad and Juhmani (2020) also noted that meeting frequency might improve the financial reporting process and internal control, improving financial performance and lowering the risk of insolvency. Consistent with the empirical studies, H2 and H3 were supported, and H1, H4, and H5 were not supported. Finally, the study underscores that specific corporate governance mechanisms, particularly the presence of women on boards, board meetings, and the frequency of audit committee meetings, significantly mitigate insolvency risk in LFCs. Women on boards are associated with a reduced likelihood of firms experiencing low insolvency risk, while more frequent board and committee meetings significantly reduce the probability of high insolvency risk. Other factors, such as board independence and audit committee independence, also show trends toward reducing risk but do not achieve conventional levels of statistical significance. These findings underscore the importance of gender diversity and active governance in enhancing financial stability within the firm.

Conclusion and Implications

This study examined the impact of corporate governance on insolvency risk. The researcher gathered data from 25 LFCs listed in CSE from 2019 to 2023 and employed descriptive statistics, correlation analysis, panel regression analysis, and multinomial logistic regression analysis to achieve this objective. The correlation analysis results show that WIB and ACI significantly negatively correlate with the IR. BI and BM negatively correlate with the IR, but they are insignificant. According to the panel regression analysis, WIB and BM significantly and negatively impact the IR, reflecting that an increase in BM and WIB can reduce the IR. The other remaining CG variables do not significantly impact the IR. Concerning the multinomial logistic regression analysis, the researcher found that WIB has a significant and negative impact on the low probability of IR. Moreover, ACM has a significant and negative impact on the high probability of IR. Other CG variables do not significantly impact the probabilities of IR.

The unsupported hypotheses H1, H4, and H5 highlight some significant practical implications for LFCs and stakeholders in the financial sector in Sri Lanka. Firstly, the insignificance of board independence (H1) suggests that merely increasing the proportion of independent directors may not enhance financial stability unless these directors are actively engaged and empowered to influence strategic decisions (Ashraf et al., 2021; Nkuutu et al., 2021). This underscores the need for LFCs to focus on the active participation of independent directors rather than just their quantity. Similarly, the insignificant impact of audit committee independence (H4) indicates that LFCs must prioritize the functionality and authority of these committees, ensuring they have the necessary resources and support to perform their oversight roles effectively. Hypothesis H5, the lack of a consistent impact of audit committee meeting frequency on insolvency risk, highlights that frequent meetings alone do not guarantee better risk management. It emphasizes the importance of these meetings' substantive content and outcomes, advocating for more meaningful and action-oriented discussions rather than merely increasing the number of meetings. Collectively, these findings encourage LFCs to adopt a more nuanced approach to corporate governance, focusing on enhancing the operational quality of governance mechanisms rather than relying solely on structural attributes (Nkuutu et al., 2021; Zhou et al., 2021). Additionally, regulators and policymakers should consider these insights to refine governance guidelines, promoting not just the presence of certain governance features but also their effective implementation and integration into the firms' strategic and operational frameworks. This may indicate that traditional metrics, such as independence and meeting frequency, are insufficient to address the complex risks financial institutions face in emerging markets like Sri Lanka. Instead, it may necessitate a reassessment of how these governance practices are implemented, monitored, and aligned with firm-specific needs and the broader economic environment.

The findings of this study offer critical insights for senior executives and practitioners in the financial sector in Sri Lanka, particularly in navigating the challenges posed by the post-pandemic economic environment. The research underscores the importance of strengthening corporate governance, including increasing the representation of women on boards, as a means to mitigate the elevated insolvency risks observed during this period of economic recovery. Women's participation in boardrooms brings diverse perspectives, which can enhance decision-making processes and contribute to more effective risk management strategies. Furthermore, the study emphasizes the importance of increasing the frequency of both board meetings and audit committee meetings to enhance the monitoring of risk-taking and ensure the financial stability of the company.

To enhance the financial stability of Licensed Finance Companies (LFCs) in Sri Lanka, it is essential to focus on the identified corporate governance areas and rectify the declining performance metrics. The insights derived from this study offer valuable guidance for practitioners, regulatory bodies, and policymakers, suggesting targeted interventions that can be embedded within strategic and regulatory frameworks. Furthermore, the study's findings serve as a crucial resource for investors, aiding in informed decision-making. The implications of this research underscore the necessity for comprehensive policy reforms, which can be strategically implemented to support the resilience and sustainability of the LFC sector in Sri Lanka, thereby contributing to the overall stability and growth of Sri Lanka's financial sector.
The sample of this study was primarily focused on LFCs listed in Sri Lanka, which presents a notable limitation due to its exclusion of other companies listed on the Colombo Stock Exchange (CSE). This limitation suggests a potential bias in the findings, as they may need to represent the broader financial landscape in Sri Lanka. To enhance the generalizability and robustness of future research, it is recommended that subsequent studies include a more diverse sample, encompassing both listed and unlisted LFCs, as well as non-financial companies within the Sri Lankan context.

Additionally, future research could benefit from comparative analyses between financial and non-financial companies, offering insights into the differential impacts of corporate governance practices across these sectors. Such studies could illuminate sector-specific governance challenges and provide a more precise understanding of corporate governance dynamics in Sri Lanka. Furthermore, it is essential to explore the implications of corporate governance on the insolvency risk of small and medium-sized enterprises (SMEs). Given SMEs' critical role in the economy, future research should employ primary data to assess the governance structures within these entities and their influence on financial stability. This would fill a significant gap in the literature and provide practical insights for policymakers and practitioners aiming to strengthen the resilience of SMEs in Sri Lanka.

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