# Predicting Corporate Failure of Listed Companies in Sri Lanka

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***Abstract*- The purpose of this research is to develop a model to predict corporate failure of listed companies in Sri Lanka. This study utilized publicly available data from annual repots of a sample of 70 failed firms and a sample of matched 70 non failed firms listed on Colombo stock market for a period covering the 2002 to 2008 financial years with logistic regression analysis. A total of seven corporate governance variables were used as predictor variables of corporate failure.**

**Analysis of the statistical testing results indicated that Model consists with corporate governance variables improved the prediction accuracy to reach 82.86% one year prior to failure. Furthermore, predictive accuracy of the Model in all three years prior to failure is above 73%. Hence model is robust in obtaining accurate results for up to three years prior to failure. Final model includes four corporate governance variables, outside director ratio, CEO duality, remuneration of board of directors and company audit committee. These variables are having more explanatory power to predict corporate failure.**

**Therefore, model developed in this study can assist investors, managers, shareholders, financial institutions, auditors and regulatory agents in Sri Lanka to forecast corporate failure of listed companies.**

***Keywords: Corporate governance, logistic regression, corporate failure prediction***

## I. INTRODUCTION

Concept of corporate governance is most important for today business. Corporate governance refers to the rules, procedures, and administration of the firm's contracts with its shareholders, creditors, employees, suppliers, customers, and government. Governance is legally vested in a board of directors who have a fiduciary duty to serve the interests of the corporation rather than their own interests or those of the firm's management.

The substantial volume of researchers developing the corporate failure prediction models admits that the financial ratio is one of major predictors of the corporate failure. However, these models have been extensively criticized. Much of this criticism evolves from their sole reliance on ratios derived from the accounting information contained in financial statements. Recently many researches have cited bad corporate governance as one of the key factors leading to the corporate failures. Therefore, it can be evident that an early warning system cannot be developed without incorporating the corporate governance characteristics. To the authors' best knowledge, No research was found in Sri Lanka which incorporates corporate governance variables in predicting corporate failure.

Even though interest in corporate governance has grown rapidly in recent years with the global increase in the number of corporate failures such as Enron, WorldCom, HealthSouth and Arthur Anderson; the role of corporate governance in corporate failure prediction has been largely neglected. A study of above failed companies indicated that there was a lack of consistence policies, control procedures, guidelines and mechanisms to ensure accountability and fiduciary duty. Poor corporate governance can increase the probability of corporate failure even for firms with good financial performances.

## II. CORPORATE GOVERNANCE IN SRI LANKA

The Institute of Chartered Accountants of Sri Lanka (ICASL) and the Securities and Exchange Commission of Sri Lanka (SEC) in consultation with the Colombo Stock Exchange have spearheaded a joint initiative with a view to formulating standards on corporate governance for mandatory compliance by companies listed on the Colombo Stock Exchange. In 1997, The Institute of Chartered Accountants of Sri Lanka published a voluntary code of corporate governance conduct and financial management with the intention of promoting transparency in corporate earnings in order to facilitate socio – economic developments. This was primarily based on the Cadbury Committee Report. Thereafter certain revisions were made to the code by The Institute of Chartered Accountants of Sri Lanka and the Securities and Exchange Commission of Sri Lanka to include the latest global developments in corporate governance practices.

With effect from financial year commencing 1 April 2008, listed companies in Sri Lanka have been subject to rules on corporate governance as statutorily required by the Securities and Exchange Commission of Sri Lanka (Colombo Stock Exchange 2008). Section 7.10 of the Listing Rules (2009) states the corporate governance compliance. It has been evident that many companies were failed in Sri Lanka due to bad corporate governance mechanism. This led to study the

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