PREDICTION OF CORPORATE FAILURE

THROUGH FINANCIAL STATEMENT ANALYSIS

A paper submitted to the

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PREFACE

Objectives

The main objective of this project paper is to
analyze the financial ratios of failed companies
as to its characteristics or attributes that
would best reflect or predict the possibility of
impending corporate failure of the companies.
Thus, whether financial ratios analysis can
predict corporate failure.

Methodology

Two failed companies were selected. Data for
these companies came from the records of the
Registrar of Companies and the Kuala Lumpur
Stock Exchange Handbook. The companies were of
various sizes according to asset values and
during the period under review were suspended
from the Kuala Lumpur Stock Exchange. One
company was involved in the processing of sawn
timber and other timber products while the other
was involved in the cultivation, processing of
sugar cane and refining sugar and its
byproducts. For comparisons with non-failed
companies, 2 companies were selected having
similar activities and capital structure.

The financial statement of the two failed companies were analyzed for 5 years before failure by using financial ratios analysis. The following key financial ratios were used;

(I)   Profitability Ratios

    (a) Profit Margin

    (b) Return on Assets

    (c) Return on Equity

    (d) Return on Capital Employed.

(II) Liquidity Ratios

    (a) Current Ratio

    (b) Acid-Test Ratio

(III) Gearing Ratios

    (a) Total Debt to Equity

    (b) Total Borrowings to Equity

    (c) Times Interest Earned

(IV) Efficiency Ratios

    (a) Stock Turnover

    (b) Total Assets Turnover

    (c) Average Collection Period.

Each ratio was then analyzed in two ways, by
(i)   a time-series analysis, in which the historical behaviour of the ratios was examined,

(ii)   a cross-sectional analysis, in which the
        ratio was evaluated in relation to a
        non-failed company in the same industry
        for the same time period.

For   comparative purposes,   the   financial
statements of the companies were summarized as
per   the "Malaysian Corporate   Performance"
method.   The definition of term and the
calculation of key ratios were also adapted from
the publication.

Besides using the financial statements as the
major source of data, the writer also relied on
library reseach such as accounting text books
and journals. Other reading materials were also
refered to with a view to obtaining an indepth
knowledge on the subject.

Scope and Limitations

This project paper is confined to the financial
ratio analysis of 2 failed companies for a 5
year period before their failure (as described
under   Methodology).   The financial ratio
analysis of the 2 failed companies were then
compared with a non-failed company respectively.

The financial ratio analysis of failed and
non-failed companies were then analyzed as to