UNIVERSITI TEKNOLOGI MARA

TRADITIONAL FINANCIAL RATIOS AND CASH FLOW RATIOS: TOOLS FOR FINANCIAL DISTRESS PREDICTION

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Candidate's Declaration

I declare that the work in this dissertation was carried out in accordance with the regulations of Universiti Teknologi MARA. It is original and is the results of my own work, unless otherwise indicated or acknowledged as referenced work. This topic has not been submitted to any other academic institution or non-academic institution for any degree or qualification.

In the event that my dissertation be found to violate the conditions mentioned above, I voluntarily waive the right of conferment of my degree and agree be subjected to the disciplinary rules and regulations of Universiti Teknologi MARA.

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ABSTRACT

Financial distress is a well-known problem among businesses. Such situation is a concern to many stakeholders and therefore, there is a need to have a suitable tool and technique in predicting the likelihood of financial distress. Undeniably, it has a substantial impact on firm performance, capital structure and investment decision. This study aims to examine further into this issue. Specifically, this study examine whether ratio analysis is associated with financially distressed firms. This study investigates the differences in the mean score of ratios between financially distressed firms and non-financially distressed firms. This study also attempts to identify the components of ratios that can become the most significant predictor of financial distress. The total sample of the study is 210 firms consisting of 105 financially distressed firms and 105 non-financially distressed firms from various industries. Financially distressed firms were selected based on PN17 list updated by Bursa Malaysia. The financially distressed firms were then matched paired with the non-financially distressed firms of similar industry and size. The data was obtained from the financial statements of the firms over five years prior to the financial distress year. The independent sample t-test and logistic regression analysis were used to analyse the data. The result shows that there is a significant difference in the mean score of ratios between the two groups. Significant relationship between financial distress and predictor variables were also examined. The results show that RCACL, RWCTA, RCFTA and RCFTFA were found to be significantly associated with the probability of financial distress. Such results indicate that liquidity and efficiency were the most significant predictors of financial distress. This study is significant not only from the theoretical perspective but also from the perspectives of the practitioners and regulators in determining the causes of financial distress.

Keywords: Financial distress, financial ratios, cash flow ratios, PN17 companies, logistic regression.

CHAPTER 1

INTRODUCTION

1.1 Introduction

Financial distress is undeniably has a substantial impact on firm performance, capital structure and investment decision. A firm is having a financial distress when it is unable to meet its obligation when fall due. Firm performance is generally measured by firm's ability to make profit. A financially distressed firm normally suffers continuous losses over a period of time that requires the firm to revisit and decide on its capital structure, debt and equity financing (Ugurlu & Aksoy, 2006). In such situation, the distress firm has insufficient equity capital that subsequently left the firm with no option but to use external financing. Of consequence, the reliance on external financing causes the firm to incur higher cost and led to higher financial distress. In worst scenario, the financially distressed firm would face financial failure resulting to bankruptcy if no remedial action is taken.

A body of the literature has examined predictors of firms' financial distress by employing financial ratios. Financial ratios are calculated using information derived from the income statement and balance sheet that were prepared based on accrual-based accounting. It is remarkably proven that financial ratio analysis do provide users with useful and valuable information. Interpretation of financial ratios extends beyond its calculation since it demands users' knowledge on interpreting the results.

Another body of the literature has utilised cash flow ratios in predicting financial distress (Bhandari & Iyer, 2013; Ibarra, 2009; Jooste, 2006; Jooste, 2007; Kirkham, 2012; Kordestani et al., 2011). These studies adopt cash flow from operations as a basis for predicting firm's financial distress. They found cash flow from operations useful in evaluating firm's financial distress. Findings from earlier studies shows that the prediction model based on cash flow statement components provide better results (Jooste,