

FINANCIAL DISTRESS FORECASTING OF NON-FINANCIAL FIRMS: A CASE OF PAKISTAN

Agha Jahanzeb^{1*}, Seyedhossein Naslmosavi², Pervaiz Ahmed Memon¹

¹ Sukkur Institute of Business Administration, Sukkur, Sindh, Pakistan

²Qaemshahr Branch, Islamic Azad University, Qaemshahr, Iran

*Corresponding author's email: agha.jahanzeb@iba-suk.edu.pk

ABSTRACT: *This study objects to classify the monetary ratios to forecast bankruptcy in Pakistan, centered between 2001-2010 the data turn out to be the data of companies of non-financial firms. Forecasting financial distress is the vital area of finance, an extensive amount of academic and experiential work to be done to calculate financial distress. This study has a Zmijewski (1984) applicability that scrutinize on the forecasting model of financial disaster. The study was carried out in Pakistan from 2001 during which all departments, in 2010, from sampling of Karachi Stock Exchange. Study displays that the model comprises of the variables equity, net income and cash flow basis, the financial problems of predicting and businesses deprived of crisis had a decent performance. The consequences of this study advised that the outdated model of Zmijewski is beneficial for Pakistan market, and by using representatives concerning cash flow of monetary distress exhibited better predictability. This model can be used for business organization, financing verdicts, managers and picking securities portfolio manager.*

Keywords: liquidity, leverage, EBIT and total debt

1. INTRODUCTION

Financial catastrophe has remained a mere nightmare for creditors and depositors for years. It is the absence of capability of a successful apprehension of business to encounter its existing debt requirements. As a substance of fact all corporations have countless debts to herald its prevailing maneuvers or to broaden its business. Well-planned strategies frequently entail a corporation to fund its operations for total debt activities. To what extent the worth of the assets of a business is less than the debt that might lead to his agreement, which might involve financial restructuring between companies. Monetary hardship is clear in different situations reliant on their room and justification. Rendering to the business "when the financial crisis is the term used to refer to a condition of financial commitment, the company's creditors were damaged or possesses difficulties". Union Financial crisis, bankruptcy is defined as: "You cannot pay your debt and non-payment of the debt securities of a person, as the condition of assets and liabilities of a company is not sufficient to relieving farmers." [1]describes monetary suffering by way of wherever disposable cash-flows stand insufficient to pay off its existing obligations for example interest cost or accretions. Due to non-availability of liquidation figures in Pakistan the term "financial distress" symbolize financial solidity of corporation i.e. prosperity, effectiveness and liquidness. Bankruptcy is distinct as the disaster of a firm to transmit on its prevailing processes owing of having extraordinary debt compulsions [2]. After the working cash flow of the corporation is scarce to encounter up-to-date responsibilities then it is incompetent to pay its arrears or the adverse net wealth of the business [3]. As there are missing classifications, numerous studies as [4] and [5] require outlining insolvency rendering to the basis and choice of their study. Consequently, this study also contemplates the notion described in numerous studies that the bankruptcy of a company in Pakistan by any of the subsequent activities has been carried out. Companies of Karachi Stock Exchange (KSE) for judgments settlement / liquidation of the regulation do not disrupt to be delisting from the list. Winding up a business by Securities and

Exchange Organization of Tehran (SEO). Pakistan is an emerging industry in different countries. In the past two decades, a lot has occurred in the incidence of bankruptcy in Pakistan. Therefore, this study recommends that there is a necessity to develop an exclusive business atmosphere in Pakistan so that it can deal with Pakistan's bankruptcy prediction model, the business's incompetence to defend the other. Furthermore, research has not been carried out in Pakistan, which goes insolvent, and did some research around the world has made it vibrant that the priorities of Pakistan. Therefore, this training is considered as a major point to seal the void of bankruptcy prediction in Pakistan. The values will deliver provision and timely monitoring the business sector in Pakistan and reinforce the monetary site of the business. The central points are:

1. To find out the variables those are not stressed.
2. To improve a model that can predict financial strength and differentiate among insolvent and non-insolvent businesses.

2. LITERATURE REVIEW

Insolvency prediction model has significant high praise, regulators, academics and practitioners. This is because regulators frequently apply predictive models to scrutinize the monetary health of the business. Researchers use bankruptcy to attempt to forecast the several propositions. Forecasting financial distress is very necessary because it has become a serious loss and high costs of investors. When a business goes insolvent, its stockholders, creditors, depositors, managers, entrepreneurs and dealers can experience enormous losses. A lot of effort has already stood through in the turf of risk management, but there is a want for the monetary disaster in order to discover the best forecasting model for Pakistanian businesses to re-evaluate. These studies emphasize on the applicability of model scrutiny in Pakistan, and find the finest illustrative distress prediction. Univariate investigation embodies the most modest [6], and at the same time other procedures weaker, there is a proposition that an effective scrutiny can evaluate univariate model [4,7,8,9]. A lot of studies implemented bankruptcy prediction through multivariate analysis; [10-16] can be cited

in this repute. Multivariate analysis agrees to speedy negotiation of plentiful variables in forecasting of indebtedness. Altman prolonged the efforts of Beaver by introducing discriminant function that syndicates ratios in multivariate analysis to get the desired results. Beaver differs from different researchers that univariate scrutiny forecast failure on the vile of some important and picky business proportion and non-business on the base of an extra proportion which makes puzzling and contradictory outcomes. To interpret this disaster Altman developed a model that syndicates proportions in multivariate structure. The study initiates that customary proportions can forecast insolvency then it delivers improper for probing the intensity of liquidation models. Deakin castoff proportions to broaden an insolvency forecasting model and concluded that arithmetical system mainly discriminant analysis can envisage commercial disappointment built on monetary facts initially as 3 years previous with high flat of accuracy.. Blum [17,18] erected a "Deteriorating Business Model" by combining a trial of 115 unsuccessful companies by 115 non solvent companies by discriminant scrutiny. The replica has a correctness proportion of around 94% single year prior to insolvency. Altman, Haldeman, and Narayanan prolonged his efforts of 1968 and prolonged his model to cuddle proportions. The fresh model has the capability to exactly forecast 70 percent of the insolvent companies 5 years earlier to insolvency. Authors in [19,20] used monetary proportions and discriminant study to place together a business catastrophe forecasting model. Steadiness is the main attribute of their model. The discriminant analysis used descriptive aspects at random. This procedure is critically evaluated due to its limitations as the assumptions are violated in present realm. Ohlson projected [21] a logit analysis to contract through the query of familiarity that displays complex accuracy amount than the multivariate discriminant analysis. A lot of studies approved logit scrutiny that aimed to forecast the insolvency after growth of O-score analysis [21,22,23,24].

3. METHODOLOGY

Data

This study used secondary facts that is composed from yearly reports of 123 listed businesses in the phase from 2001 to 2010 in Tehran Stock Exchange. The study with accessibility and eminence of data. The facts did not cover any monetary institutions as they have diverse strength and obligation structures.

The criteria tailored by this study for the range of the sample are as under:

1. The stocks of the corporation must be operated at Karachi Stock Exchange (KSE) in the illustration period.
2. The firm must belong to non-financial sector. It is because monetary sector has different insolvency condition.
3. The company must comprise at least ten years of monetary data.

The dependent variable that forecast bankruptcy probability of the company for ten years. The ratio that should be needed to figure out bankruptcy is total debt. While estimation Zmijewski [25] used bankruptcy statistics to analyze chance

of bankruptcy. Chance of bankruptcy is calculated by taking log of total debt. As insolvency numbers is not accessible in Pakistan thus the chances of insolvency cannot be predicted as used by Zmijewski (1984)?. There are a lot of ways to contrast the presentation of financial distress forecasting models but the best comparable and pertinent technique is to assess the ordinal skill of the model to mark a distinction among distressed and non-distressed corporations. So the main base of contrast is the complete correctness of the models. On the whole accurateness is built on the entire quantity of correct forecasting of distressed and non-distressed companies.

Hypotheses

H₁: Keeping large amounts of debt, the greater the probability of bankruptcy.

H₂: Higher liquidity ratios, reducing the probability of bankruptcy

H₃: Lower EBIT higher will be the probability of bankruptcy.

METHODOLOGY

Including business and sample population in Karachi Stock Exchange (KSE) listed covers all companies of Karachi Stock Exchange 2001-2010. The following four statistical approaches that need to evaluate the liquidation is: (i) Logit, (ii) Probit (iii) linear probability, and (iv) Multivariate discriminant analysis (MDA). Though, Altman and Saunders (1998) study looks MDA as central method amid all the four statistical approaches. This study employs MDA as it has moderately great prognostic capability in insolvency prediction. Over the last four eras wide exertion has been arranged in the portion of monetary distress prediction and there are a lot of models predictable by numerous studies for bankruptcy prediction. Presentation of Zmijewski (1984) probit model is calculated in this study. We can relate MDA as well as Logit model to compare the differences and accuracy among the models.

$$\text{Logit}(\pi) = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 \dots + \beta_k X_k$$

Where Z is the overall index, $\beta_1, \beta_2, \dots, \beta_n$ stand discriminant factors, X_1, X_2, \dots, X_n are sovereign/independent variables. The discriminant Score (Z) is in use to conjecture the insolvency temperament of the business. Inferior the value of Z, superior is the firm's bankruptcy likelihood and vice versa. However MDA technique has frequently used due to its far above the ground predictive skill, it has definite limitations. This technique does not have a distinctive control for non-financial actions and industry must be recognized by the Z-score model [27]. In calculating, the predictable model based on 3, 4 ... and n years craft. it is hard to make a choice that the insolvency variation in exact year[28]. Further, MDA move to and paired trial equally likely[29,30,31,32].

The study analyzed multiple regression analysis to examine the dependent variable with the independent variables, so the outcome of the study estimates the following regression model.

$$y_{cp} = \beta_0 + aLEV_{cp} + bLIQ_{cp} + dLEBIT_{cp} + \varepsilon_{cp}$$

Where y_{cp} is the log of total debt (LTD) response for company C in year P, with financial covariates are effective leverage (LEV), liquidity (LIQ) and log of earning before

interest tax (LEBIT).The disturbance term denoted as ϵ_{cp} was assumed to be serially uncorrelated with mean zero.

4. RESULTS AND DISCUSSION

To obtain an overview of the nature of data set, descriptive statistics analyses (minimum, maximum, mean, standard deviation) were employed for the dependent and independent variables.

Table 1 Descriptive Statistics

Variables	Minimum	Maximum	Mean	Std. Deviation	Skewness	Kurtosis
LTD	.00	7.93	5.296	0.888	-0.790	1.766
LEV	-1.14	2.52	0.807	0.696	-0.075	-0.188
LIQ	0.00	3.95	1.491	0.540	0.732	3.497
LEBIT	.00	6.25	4.345	1.232	-0.151	0.389

Table 1 indicates that the highest mean value of log of total debt 5.296 whereas the leverage has 0.807 the lowest value. It syndicates that higher the value low will be the chances of insolvency, lower the value it will be vice versa. However, the log of earning before interest tax has highest standard deviation of 1.232 whereas the liquidity has the last standard deviation of 0.540.

The degree of association and mode of joining the independent and dependent characteristics of bankruptcy prediction choice, the spearman’s correlation is run using:

Table 3 presents the influences of independent variables on total debt. Firm leverage is positively influencing the total debt with coefficient value of 0.459 which is significant. Firms tends to be differentiated in its business and has a superior parting of possession from management, thus more debt is preferred. Positive the value of the variables it has the ability to pay off its debt as it does not fall into the bracket of insolvency. All the variables in the statistics table are significant as it has positive relation with the total debt.

Table 2 Correlation Coefficient Analysis

Variables	LTD	Liquidity	Leverage	LEBIT
LTD	1.000			
LIQ	0.032*	1.000		
LEV	0.114**	-0.754	1.000	
LEBIT	0.305**	0.199*	-0.202*	1.000

** are significant at p < 0.01

* are significant at p < 0.05

Table 2 indicates that the correlation coefficients among total debt and all the independent variables are significant. Total debt has positive significant relationship with the leverage (r = 0.114), liquidity (r = 0.032) and the earnings before interest tax (r = 0.305) respectively. This means that firms which high in leverage, liquidity and with high of earnings before interest tax tend to have more debt.

Table 3 Regression Analysis

Variables	Coefficients	Sig.
Intercept	3.307	0.000**
LIQ	0.391	0.000**
LEV	0.459	0.000**
LEBIT	0.238	0.000**
Adjusted R Square		0.148
R Square		0.150
F-Value (Sig.F)	71.913	0.000

** are significant at p < 0.01

** are significant at p < 0.01

Liquidity is positively influencing the total debt with coefficient value of 0.391 which is significant at 1% confidence level. Companies with high liquidity usually seek for debt financing, whereas companies with low profitability are disposed to upsurge debt level. Because of higher profitability, firms may prefer to keep their profits in the company as an internal funding source. This research has exhibited a positive effect between the earning before interest tax and debt coefficient value of 0.238. Thus, these findings suggest that higher the value of earning before interest and taxes higher will be the benefits and investment opportunities for the company. Earning before interest and taxes shows positive relationship as positive it will be liquidation chances will be less for the company to go bankrupt.

5. CONCLUSION

Categorizing that the monetary ratios are the most important in insolvency forecasting for the non-financial area of Pakistan using a sample of corporations from 2001 to 2010 period. Liquidity, leverage, EBIT and total debt were observed. The regression scrutiny formed a parsimonious model of three variables. Further, our study added in the existing works by discovering three important financial variables namely liquidity, log of EBIT, leverage ratio that can be castoff to discover the insolvency hazard in Pakistan. These three monetary variables are amongst prevalent monetary ratios backing corporate letdown in insolvency works (Eljelly et al., 2001). In comprehensive, it is proposed that the supervisory specialists in Pakistan would retain these three important monetary variables in assessing the monetary wellbeing of the firm. Lastly, it can be contended that our model delivers vision into measuring the multifaceted monetary situation of a firm and could propose avenues for upcoming investigation amongst academia and practitioner for emerging better insolvency forecasting model for Pakistan.

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