Comparison Between Two Financial Distress Models:

A Case of PN4 Companies in Malaysia

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Lastly, the author would like to emphasis that errors (if any), remain the full responsibility of the author.

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ABSTRACTS

The study of financial distress has gain wide interest since the 1960s due to the severity of its impact on society and economy of a country. The early warning signs derived from distress prediction models allow preventive measures be drawn up to minimize the expected losses incurred.

This study applies both Ratio Model and Market Return Model in analyzing financial distress, by using a single group of sample comprising companies listed on the Main Board and Second Board of KLSE, in a unifying context over a period of 36 months prior to the occurrence of distress event. With the PN4 companies as proxy for financially distressed sample and non-PN4 companies representing viable group, this research aims to characterize the differences between financially distressed and viable companies prior to the actual occurrence of the event. Under an empirical framework, an objective comparison between the two models could be drawn.

Consistent with the outcomes from past research studies on Ratio Analysis, the findings revealed that Z-Score Model was effective in detecting signs of financial distress with an accuracy rate of 90 percent and 75 percent for the Main Board and Second Board respectively for the period one year prior to distress classification. The findings for year-2 and year-3 prior to distress classification, however, were not statistically significant. Nonetheless, compared to the viable group, the sampled financial distressed companies exhibited a deteriorating trend in the financial ratios as the distress period approaches.

As for the Market Return Model, the findings were not consistent with expectation on risk-return profile. Nevertheless, the anomalous findings were reflective of the outcomes on the earlier studies by Dichev's (1998) and Taffler (1999). The sampled PN4 companies under-performed as compared to viable group over the period under review. The findings were however, not statistically significant over the research period.

The lack of significant in this research could be attributed to several reasons. The shortcomings on disclosure and anomalies, attributed to non-compliance of corporate disclosure policy, undermine the competency of financial statement analysis. In addition, the country's state of economy from the period 1998 to 2001 could have affected the premium attached to financially distressed companies. Other plausible explanations could be attributed to the behavioral pattern of investors on the KLSE and the relatively low level of efficiency of the KLSE which could have affected the outcome of this research.

The findings in this study may assist the stakeholders in detecting financially distressed companies prior to the occurrence of the event. The Z-Score is a useful risk indicator. The lower the Z-Score, the higher is the risk of distress. The Z-Score Model has been widely applied in credit analysis.

Depending on the state of the country's economy, the signs of financial distress may be observed from the CAR of a firm as compared to its competitors. During the economic downturn and early economic recovery stages, the distress companies under-performed vis-à-vis the viable group. The financial distress companies are expected to out-performed viable companies during the economic boom.