CHAPTER 1: INTRODUCTION

1.1 Purpose and Significance of the Study
Financial distress may be defined as the inability of a corporation to meet its scheduled financial obligations. The financial distress, if left unattended, could lead to bankruptcy. Corporate failure represents a drain on the external value of the assets underlying an investor’s claim. It is an indication of resource misallocation which leads to undesirable social implications.

The study on financial distress has drawn considerable interest since 1960s, focusing mainly on the ability to predict the occurrence of such an event. Distress prediction models provide useful information to the stakeholders such as management and investors. The early warning signs derived from these models allow the stakeholders to take preventive measures in order to minimize the expected losses incurred.

As pointed out by Lev (1974), “An early warning signal of probable failure will enable both management and investors to take preventive measures: operating policy change, reorganization of financial structure and even voluntary liquidation will usually shorten the length of time losses incurred, thereby improve both private and social resource allocation”.

Based on observations made on business failure in the United States over the period from 1950 to 1971, the major causes of failure appear to be management incompetence and lack of experience (Lev, 1974). Other probable causes of failure identified are rapid expansion which was financed mainly by debt and preferred stock, company size, industry as well as economic factors.

The financial crisis which swept through the Asian region in the 1997/1998 has deeply affected the survival of a large number of corporations in Malaysia. The severity of the economic downturn in 1997/1998 led by a sharp currency depreciation and followed by the collapse of the stock market had left many
companies facing financial distress even until today. The main source of the financial distress was attributed to the indiscriminate expansion undertaken during the earlier economic boom. These expansions were funded mainly by short-term borrowings (Rajandram, 1999).

Malaysia was not spared from the Asian Financial Crisis. In 1996, there were 50 bankruptcy cases per month. The numbers soared to 350 cases in 1998. By 2001, the Official Assignee was handling more than 91,000 bankruptcies (The Star, 2001). The non-performing loans ("NPLs") ratio at its height rose to 18.0 percent, much lower than 40.0 percent as estimated by the international rating agencies. This was largely due to the Government’s preventive measure of carving out large NPL loans by Pengurusan Danaharta Nasional Berhad ("Danaharta"). Danaharta is the state-owned asset management company set-up in 1998 with a capital allocation of RM20 billion to acquire and manage NPLs for recovery.

Distressed companies continue to drag on the country’s investment and growth until the financial claims on these companies are resolved through restructuring of their debt obligations and their operations return to adequate profitability or the assets are redeployed. The Malaysian economy with an average growth rate of more than 9.0 percent per annum during the period from 1988 to 1997, suffered its most severe contraction in 1998. The gross domestic product ("GDP") recorded a negative growth rate of 7.4 percent in 1998. While the economy had turned-around in 1999, it has been a bumpy ride over the past five years.

The gravity of the financial crisis has resulted in investors demanding for greater disclosure and transparency. The last five years have been a challenging period for the Malaysia’s economy as businesses strive to adapt to the new economic landscape in the aftermath of the crisis. Arising from the investors’ concerns, the Kuala Lumpur Stock Exchange ("KLSE") has issued a set of guidelines under Practice Notes since January 2001 for compliance of companies listed on the bourse.
Among them is Practice Note 4/2001- Criteria & Obligations Pursuant to Paragraph 8.14 of the Listing Requirements (PN4/2001) which sets out the criteria and obligations of public listed companies that have failed to meet the KLSE’s requirement for a minimum financial condition. Pursuant to Practice Note 4, the listed issuers are required to conduct a self-assessment on its financial position. The Practice Note 4 came into effect on 15 February 2001.

In order to maintain and enhance market integrity and to protect the interests of investors who provide the capital to the companies listed on the KLSE, it is necessary that these companies comply with the minimum financial condition requirement. The Practice Note 4 is meant to alert the investors while compelling the financially distressed companies to pull their act together to regularize their financial condition within the stipulated deadline or face the prospect of being de-listed.

Given the massive impact of the corporate failure from both the economic and social point of view, this study attempts to compare the statistical and behavioral aspects of financially distressed vis-à-vis the financially viable companies. By applying the two distress prediction models, this study endeavours to characterize the differences between financially distressed and viable companies prior to actual failure happening. It seeks to determine whether early warning signs could be formulated before the occurrence of distress. Such information could be incorporated as a monitoring tool to reduce the impact on economic and social disruptions.

1.2 Scope of the Study
The scope of this study covers the companies listed on the Main Board and Second Board of the KLSE. As of 8 October 2002, there were a total of 850 companies listed on the KLSE comprising 556 and 294 companies on the Main Board and Second Board respectively.
A company is defined as facing financial distress if it has been classified as an affected listed issuer of Practice Note 4. On the other hand, the financially viable companies are listed companies which comply with the minimum financial condition. Since the Practice Note 4 came into effect in February 2001 and until the end of 2002, there have been 115 companies classified as the affected listed issuers as detailed under Table 1.2.1

Table 1.2.1: Total PN4 Companies as at 31 December 2002

<table>
<thead>
<tr>
<th>Total PN4 Companies</th>
<th>Total</th>
<th>Main Board</th>
<th>Second Board</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total number of PN4 companies since 15 February 2001</td>
<td>115</td>
<td>58</td>
<td>57</td>
</tr>
<tr>
<td>Number of companies that have regularised their financial condition</td>
<td>21</td>
<td>9</td>
<td>12</td>
</tr>
<tr>
<td>Total number of PN4 companies as at 31 December 2002</td>
<td>94</td>
<td>49</td>
<td>45</td>
</tr>
<tr>
<td>Number of Non-Specified PN4 companies</td>
<td>13</td>
<td>4</td>
<td>9</td>
</tr>
<tr>
<td>Number of Specified PN4 companies</td>
<td>81</td>
<td>45</td>
<td>36</td>
</tr>
</tbody>
</table>

*Source: KLSE Website*

With an aggregate market capitalization of around RM4.42 billion as at 3 January 2003, the PN4 companies represent around 0.9 percent and 11.11 percent in terms of total market capitalization and numbers of companies listed on the KLSE respectively. As of 3 January 2003, there were 94 PN4’s companies of which the trading of 67 companies have been suspended. Trading for 23 companies are under restriction while for the remaining 4 companies, trading is not restricted.

A company is deemed to be the affected listed issuer of Practice Note 4 if it fulfils one or more of the following criteria:

a) Deficit in the adjusted shareholders' equity of the listed issuer on a consolidated basis;
b) Receivers and/or managers have been appointed over the company's property, or over the property of its major subsidiary or major associated company. The property should account for at least 70 percent of company's total assets employed on a consolidated basis;

c) In the latest audited accounts of the company, the auditors have expressed adverse or disclaimer opinion in respect of the company's going concern;

d) Special administrators have been appointed over the company or a major subsidiary or a major associated company of the listed company pursuant to the provisions of the Pengurusan Danaharta Nasional Berhad 1998.

An affected listed issuer of the Practice Note 4 must comply with the following disclosure requirements:

a) within seven (7) market days make the first announcement of its PN4 status, its obligations under this practice note and the consequences of non-compliance with such obligations as well as its plan to regularize the financial condition;

b) submit monthly reports to the KLSE in a prescribed format and make announcement on the status of its plan to regularize its financial condition;

c) make requisite announcement within a period of six (6) months from the date of first announcement, a detailed plan to regularize its financial condition. Prior to making the requisite announcement, all agreements with third parties as part of the plan have been duly executed. It must also ensure that reasonable steps have been taken to procure creditors' agreement in-principle of the plan.

d) After the requisite announcement, the company has two (2) months to submit the plan to the relevant authorities for approval;

e) Approvals for implementation of the plan must be obtained within four (4) months from the date of submission.
An affected issuer is granted a maximum timeframe of between six (6) to twelve (12) months to implement its plans to regularize its financial condition. Failure to comply with the obligations set out under Practice Note 4 may result in the affected issuer being suspended and/or de-listed. Prior to being de-listed, the affected issuer will be accorded due process. For a more transparent and effective monitoring, KLSE has grouped the PN4 companies under one classification since March 2002.

For those companies which were classified prior to 31 December 2001, the KLSE had on 24 November 2001 agreed to extend the timeframe up to 31 December 2002 for them to implement their regularization plan. To meet the year-end deadline, the Securities Commission ("SC") had earlier advised the PN4 companies to submit their proposals by 31 August 2002. Should the submission be made after the 31 August 2001's timeline, the PN4 companies face the potential of de-listing if approvals are not obtained by 31 December 2002.

The status of regularization of the PN4 companies as of 31 December 2002, may be depicted on Table 1.2.2 below.

As at 3 January 2003, the KLSE has commenced procedures to delist 16 PN4 companies which have not submit any application to SC by 31 December 2002 while Rekapacific Berhad, has applied for a judicial review to the High Court of Malaysia on KLSE's intention to delist its securities.

Table 1.2.2: Status of Regularisation of PN4 Companies as at 31 December 2002

<table>
<thead>
<tr>
<th>Stage Event</th>
<th>Classified as PN4 on or before 31.12.2001</th>
<th>Classified as PN4 after 31.12.2001</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Pending Requisite Announcement</td>
<td>0</td>
<td>7</td>
<td>7</td>
</tr>
<tr>
<td>2 Pending submission</td>
<td>17</td>
<td>0</td>
<td>17</td>
</tr>
<tr>
<td>to authorities</td>
<td>17</td>
<td>2</td>
<td>19</td>
</tr>
<tr>
<td>----------------</td>
<td>----</td>
<td>---</td>
<td>----</td>
</tr>
<tr>
<td>Pending approval by authorities</td>
<td>47</td>
<td>4</td>
<td>51</td>
</tr>
<tr>
<td>Pending implementation</td>
<td>81</td>
<td>13</td>
<td>94</td>
</tr>
<tr>
<td>Total as at 31.12.2002</td>
<td>19</td>
<td>2</td>
<td>21</td>
</tr>
<tr>
<td>Already implemented (thus, out of PN4 category)</td>
<td>100</td>
<td>15</td>
<td>115</td>
</tr>
<tr>
<td>Total from 15.2.2001 to 31.12.2002</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Source: KLSE Website*

The procedures to delist the affected PN4 companies covers:

a) Upon receipt of the notice from KLSE, the affected companies shall make representation to KLSE within a period of 14 days from the date of receipt of the notice as to why its securities should not be delisted from the Official List of the KLSE;

b) After due consideration and the conclusion of the relevant due processes accorded, the KLSE will decide whether to delist these companies;

c) The affected companies will be notified once the decision to delist has been reached;

d) Upon receipt of the notification, the affected companies will be required to make an immediate announcement. The securities will then be removed from the Official List of the KLSE on a date specified by KLSE.

Once de-listed, the company remains a public company with its business and commercial affairs continue to operate. The investors and the shareholders of the affected PN4 companies, however, will not be able to trade their shares on the KLSE. If the KLSE decides not to de-list these companies, it can reprimand or impose a fine of up to RM1.0 million on these companies.
The KLSE has also clarified that despite being de-listed, these companies can still continue to regularize its financial position and at an appropriate time, to re-apply for a listing provided that the company satisfies the relevant conditions for listing and guidelines imposed by the SC on the offer of issue.

The move by KLSE signals the seriousness of the authorities in applying the whip of enforcement to reinforce investors confidence in the market.

This study applies two approaches in analysing financial distress. These models are compared in a unifying context over a period of 36 months preceding the date when an issuer becomes an affected issuer of Practice Note 4. Using a single sample of companies over an identical period, the empirical framework allows an objective comparison to be made from the models.

1.3 Limitation of the Study

The study examines corporate failure from two approaches using statistical techniques and behavioral reactions and compares the difference between them.

The ratio model, based on Altman’s Z-Score (1968), is formulated using multiple discriminant analysis (“MDA”) to weigh the relative value of information provided by a combination of financial ratios. The ratio model is premised on the argument that a substantial change in the ratio is the likely evidence of a destabilising event which may precipitate the collapse of a company. The market return model on the other hand, is hypothesized on the behavior of stock prices. Assuming the market is efficient, the return of the company’s stock will reflect the financial condition of the company.

There were several limitations however based on the underlying assumptions of the two approaches. The MDA approach has been sharply criticized because the validity of its results hinges on restrictive assumptions (Altman and Eisenbeis, 1978, Pinches, 1980, Zmijewski, 1984). It assumes that the
decisions between distressed and viable companies must be linearly separable and the ratios are completely independent from each other. In practice, the average ratios vary significantly between firms operating in different sectors. In addition, the distribution of ratios around the average will differ between industry, over time and usually the distribution will be skewed as well. These assumptions therefore make MDA incompatible with the complex nature, boundaries and inter-relationships of financial ratios. The power of MDA for financial analysis hence, is compromised and the results may be erroneous (Karels and Prakash, 1987).

The market return model meanwhile, assumes that the capital market agents in general use the financial statement information as though it were filtered through a multivariate bankruptcy prediction model. Despite the ability of the model to discriminate between bankrupt and non-bankrupt firms, most of the market-related studies find a weak association between bankruptcy model prediction and abnormal stock returns (Zavgren et. al, 1988).

This could be attributed to several factors. Firstly, for the market to reflect the fair market price of the stocks, it must be assumed that the market is semi-strong efficient. Past studies on the KLSE (Kok and Goh, 1994) has shown that the Malaysian stock market depicted weak form efficiency over the period of 1974 to 1993. The Malaysian stock market was earlier transformed from a generally weak form of inefficient market in the 1980s to a weak form efficient market by the late 1980s to early 1990s (Saw and Tan, 1989).

Even if assuming the stock market is semi-strong efficient, Dugan and Forsyth (1995) argued that the past findings suggested that the market agents were using other publicly available information not contained in the annual or quarterly financial statements. Thus, by not considering the role on the flow of these information may contribute to the lack of significant results in the outcome of the earlier studies.
Ramaswami (1987) found that because of the cross-sectional difference between the interval of market perception time and the date of bankruptcy, the imposition of a single event period for all sample firms to study abnormal stock returns surrounding the bankruptcy announcement date may not be realistic. The firm-specific characteristics may affect the stock market reaction to information about a given company beyond the uniform event window.

Despite the shortcomings identified above, both models are selected as the most appropriate approach for this study. The primary advantage of the MDA approach is its ability to analyze the entire variable profile of an object simultaneously rather than sequentially examining its individual statistics. Thus, eliminating the problem of dealing with classification. It has proven to be a fairly reliable tool in a wide variety of context and markets. By carefully devising the sample selection process to reduce the sampling bias, the MDA's shortcomings to a certain extent, can be mitigated. The Altman Z-Score has been tested in various contexts and the model has retained its robustness despite being developed more than 30 years ago.

The KLSE has come a long way since its inception. For the past 10 years, the local bourse has improved significantly in its efficiency largely due to the structural changes and developments over the capital market. In addition, the SC has in 1996 embarked on a three-phase shift from Merit-Based Regulation towards a Disclosure-Based Regulation. Full disclosure regime was enforced from 2001 onwards.

Given the shift in the regulation effective from 1996 onwards, it would be fair to assume that the capital market agents on the KLSE will be applying information on the financial statement in their assessment as this was part of the regulated disclosure. Prior to 2001, there was no obligation on the listed issuer to disclose further than the financial information although the listed issuer has been encouraged to do so since 1996. Hence, using the abnormal stocks returns in discriminating financial distress and viable
companies may appears appropriate in this aspect despite the inconclusive findings in the past studies.

1.4 Organisation of the Study

The study is organized in the following manner. In Section 1, the topic of financial distress is introduced and the significance of this study is discussed. In addition, this section covers the scope of the research together with limitations of the study. This section concludes with the organization of the study.

Section 2 presents reviews of the literature on financial distress models, in particular in the application of financial ratios and market returns in detecting financial distress.

This will be followed by the research methodology providing methods applicable in this study as outlined in Section 3. Sampling design, collection procedures and analysis techniques will also be examined in detail.

Findings of this study are presented in Section 4. Finally, Section 5 will conclude by summarizing the study and highlighting the implications thereto. It will also provide suggestions for future research area.