Essay on Distress

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Abstract

This paper describes the state of distress, outlines major signs of distress, creates hypothesis about the potential sources of distress plausible for the project and the environment mentioned, and describes ways of eliminating the distress factors. Financial statements are the best source as selected financial ratios are used to calculate the distress level of the firms. Factors like the economic cycle, macroeconomic factors, and mismanagement of cash flows cause distress financially to the firms. To avoid distress, the best strategies are to restructure business operations, debt, financing and to maintain cash outflow and inflow using simple procedures.

Keywords: Financial ratios; Distress factors; Financial distress; Debt financing; Stakeholders

Introduction to the State of Distress

Financial distress occurs when a firm cannot meet contractual obligations on its debt financing [1,2]. It can occur due to illiquidity, lack of equity, non-payment of debts, and shortage of current assets [3]. This refers to a weakening in a company’s financial condition caused by excessive financial leverage. The costs of financial distress involve incentives for stakeholders to make decisions that is not beneficial to the firm. In the extreme scenario, this can lead to bankruptcy where it will bear various expenses and be forced to sell assets to meet creditor’s claims [2]. Fiscal Distress can occur in an economy by assessing the relationship between the population distribution and the present value of a government’s future expenditure and government debt. Both financial and fiscal distresses are cyclical in nature [3]. The greatest challenge in financial distress is to recognize the main cause for such occurrence and rectify it immediately. The late discovery of financial distressed creates more time pressure and more questionable is the success of counter measures [4].

Major Signs of Distress

Jantadej says if a company reports loss for three months continuously, then it is financially distressed. Non payment of preferred dividends and reduction in common stock dividends are indicators of financial distress [1]. Difficulties in measuring financial distress very often lead to an identification problem of whether an individual factor is a trigger of financial distress or rather its consequence [4]. Financial economists believe that firms in distress share certain characteristics and they are:

- Default on payments occurs when a project in operation is unable to meet its debt service payments [3].
- Negative changes in financial ratios occur when return on equity(ROE) and return on assets (ROA) show distress. The cash flow coverage ratio is a better indicator for distress in project finance [3].
- The Efficient Market Hypothesis says that stock prices provide the most vital information that is not available anywhere else, e.g. a decline in stock price can cause financial distress leading to economic distress incase the stock exchange index declines [3].

- If a firm’s credit rating declines, then financial distress occurs, e.g. if a bank’s rating drops, the reputation is affected and causes a negative air around the investors [3].

- Firms producing highly specialized products or products requiring repairs make the costs of financial distress very costly, e.g. electronic companies [2].
- Similarly firms producing goods or providing services whose quality is important but difficult to assess in advance [2], e.g. Kingfisher Airlines in India is financially distressed and has not paid employees many months’ salaries.
- Firms having high growth opportunities, e.g. investors would not like to finance projects of distressed companies [2].
- Firms having intangible assets like human capital, brand name, etc. if distressed will lose customers and reputation in the market [2].

Potential Sources of Distress and Elimination of Distress Factors

Debt enforcement risk: Returns to distressed stocks are likely to be higher in countries with higher probability of renegotiation failure, higher debt priority, greater creditor recovery, stronger creditor rights, and lower insider ownership [5]. For Example, a U.S. exporter of electrical equipment for the trade has to contend with non-payment by a Brazilian reseller. Unless this issue was resolved, this would have affected the economic relations between two countries. They approached a third party that was an expert in debt collection services. This third party helped the exporter reach an amicable agreement with the reseller and come up with a solution consisting of a ten-month repayment plan.

Limits to arbitrage risk: Returns to distressed stocks are likely to be higher in countries with lower institutional ownership, higher market illiquidity, and higher Amihud’s illiquidity [5]. For Example, There is no way to go short housing. One can go short the bank issuing mortgages, but if the bank has two internal businesses i.e., jumbo sub prime loans and boring small business loans, then its not sensible for them to turn down the loan division in response to the market shorting? The sub prime loans on mortgages were the reason

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why market crashed in 2008. Exert price pressure directly to drive the
prices down. There’s speculation about how derivatives contracts will
be traded in the future on each other’s neighborhoods; depending on
how that’s implemented [6].

Takeover legislation risk: Returns to distressed stocks are likely to be
lower in countries with higher takeover index, takeover law, and
rule of law [5]. For Example, Louisiana is an example of a state enacting
anti-takeover laws since 1996. Since then, it has enacted five separate
anti take over provisions such as a control share acquisition statute,
a foreign corporation share acquisition statute, a fair price statute, a
foreign corporation control share acquisition statute, an expanded
fiduciary duty statute and a poison pill statute to protect domestic
corporation’s shareholders and retain existing businesses [7].

Informational transparency risk: Returns on distressed stocks are
likely to be higher in countries with greater information uncertainty
and lower quality of accounting/ disclosure standards [5]. For
Example, Banks are a significant source of financing around the world,
playing an important role in mobilizing savings, allocating resources,
and monitoring firms. An unresolved issue in bank regulation involves
the importance of informational transparency of banks in promoting
market disciplining of banks by outside investors as a fundamental
lever of bank regulation that can both supplement and enhance the
effectiveness of more traditional bank regulatory practices [8]. Banks
exhibit more risk-shifting behavior in countries where accounting
regimes are characterized by higher levels of earnings smoothing
[8]. This suggests that earnings smoothing by banks leads to less
informative earnings in the sense that such accounting information
appear to be less effective in facilitating the ability of outside investors
and regulators to monitor and discipline bank risk-taking [8].

Refinancing risk: Returns to distressed stocks are likely to be lower
in countries with greater availability of private credit [5]. For example,
if a bank has a ten-year fixed-rate loan funded by a 2-year time deposit,
the bank faces a risk of borrowing new deposits, or refinancing, at a
higher rate in two years. Thus, interest rate increases would reduce net
interest income. The bank would benefit if the rates fall as the cost
of renewing the deposits would decrease, while the earning rate on
the assets would not change. In this case, net interest income would
increase.

Investor preferences: Returns on distressed stocks are higher in
countries with greater average stock return skewness. Returns to
distressed stocks are expected to be higher due to demand for leverage
in countries with the availability of private credit [5]. For example,
recent research on Value at Risk (VaR) indicates that investors may
be strongly concerned about the likely maximum loss, i.e., the left side
of the distribution of a portfolio’s expected returns. The investors have
a stronger preference for a lower expected extreme loss for a higher
skewness. This relationship adds another dimension to the portfolio
selection process [9].

Conclusion

Financial Distress can be avoided using techniques/strategies by
restructuring business operations, restructuring debt, loan
modifications, extension of payment terms, debt settlement, etc. to
increase the company’s performance, eliminate waste and inefficiencies,
maximize customer value, and improve liquidity. To conclude,
managing cash flow helps avoid financial distress by increasing upfront
deposits and timely invoicing will increase the level of cash. Avoid
late fees, take early payment discounts, choose good vendors to avoid
cost increases, and adjust to balance the income and outflow of cash.
Researchers use quantitative analysis to predict financial distress based
on financial ratios that are derived from financial statements i.e., balance
sheet, income statement, and the statement of cash flows [1]. Small
changes incorporated can make a huge difference in a firm’s financial
status and prevent distress [10]. High fixed cost, illiquid assets, and
cash flows are sensitive to economic turns, and are all potential reasons
of entering a financial distress. Price index inflation and changes in the
interest rates are the prominent macroeconomic factors that hugely
influence the finances of a corporation or a project [1].

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