

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 as 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 distress 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 effected 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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