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Impending Bankruptcy: Examining Cash Flow Pattern of Distress and Healthy Firms

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Abstract

Studies have proven that information on earnings has become less relevant to measure company performance during distressed situation. A relatively simple and convenient way to analyze a company's financial status is by using cash flow information. The present study examines eight types of cash flow patterns used as an alternative tool to predict financial distress incidence. The cash flow patterns derived from positive and negative signs of cash flow components which consist of operating, investing and financing activities. The data collected consists of 124 Malaysian public listed companies covering the period of 2006 until 2013. The main objective of the study is to find out whether there is any significant relationship between cash flow patterns and financial distress incidence. The results found that companies are more likely to experience financial distress situation when the company generates positive cash inflow from daily operation activities and use the cash generated to finance future investment and long term debt. Besides, the companies are also more likely in distressed situation when they are unable to cover its short term obligation due to insufficient cash inflows generated from the main operating activities. Distressed companies are more likely to acquire external financing since the excess of cash generated from operating activities is insufficient. When the company experienced outflows in all operating, investing and financing activities, there is high tendency for the company to go bankrupt. The results also revealed that there is a significant difference between distressed and healthy companies in incidence of different patterns of cash flow.

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Keywords: cash flow; cash flow patterns; financial distress; operating; investing and financing activities

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1. Introduction

Statement of cash flows is part of financial statement components other than statement of financial position, statement of comprehensive income, statement of changes in equity and notes to the financial statements. Statement of cash flows provides information on inflows and outflows of cash in a company within one completed financial accounting period (Ibarra, 2009). According to Gup, Samson, Dugan, Kim and Jittrapanun (1993), statement of financial position and statement of comprehensive income have become the primary sources of information since accrual accounting system was used for the purpose of recording and reporting daily business transactions. However, a statement of cash flows can be used as a complement to the two statements since it uses cash basis.

Jantadej (2006) claims that during distressed situation, information on earnings become less reliable to measure the company's performance and suggests that cash flows are more preferable. Financial distress, business failure and bankruptcy have quite a similar meaning in explaining the financial problems of the company. Only those companies who can quickly adapt with rapid changes in environment may survive successfully in the industry. Public listed companies which are classified by Bursa Malaysia under PN17 are given temporary recovery period and are required to restructure their financial affair so that they can exit from the declared status. When a company is declared under PN17 status, it reflects bad impact on the image and jeopardizes the reputation of the company. Based on Bursa Malaysia (2014), from 2008 to 2013, there is an increase in number of Malaysian public listed companies being classified under PN17 status. As on 31 December 2008, the number of companies listed as PN17 was 33. In between 2008 to 2013, there were numerous number of public listed companies listed entered and exited from the list. This number increased to 62 companies for the period ended 31 December 2013. This suggests that since the number of distressed company increases from time to time, it is crucial for the companies to be aware of any early signal of financial distressed.

The present study examines the cash flow information from different perspectives. The statement of cash flows is divided into three major sections which are operating, investing and financing activities. The cash flows from each activity may turn out to be either positive or negative. According to Tergesen (2001), the positive sign indicates that there is a cash inflow (excess in cash) to the company generated from operating, investing and financing activities whereby the negative sign indicates cash outflow from the respective activities. The positive and negative signs from each activity may result in many different cash flow patterns. For example, if a company is experiencing inflow from operation activities, but outflow from investment and financing activities, the combination pattern would be (+, -, -). The combination signs of cash flows from the three activities represent the composition of cash flow patterns (Bruwer and Hamman, 2005; Dickinson, 2011; Gup et al., 1993; Jantadej, 2006; Kordestani, Biglari, and Bakhtiari, 2011). Altogether there are eight (8) possible cash flow patterns. Therefore, the present study is conducted with the primary aim of determining whether there is any significant difference between distressed and healthy companies in incidence of different patterns of cash flows and examining any significant relationship between patterns of cash flows and companies which are in financial distress.

2. Literature Review and hypothesis development

According to Sharma (2001) cash flow is obviously not a new concept. Long time ago, most of the daily transactions was recorded using cash basis. Even until now, there are few organizations that are still practicing cash-basis accounting since they believed that the basis is still relevant (Ibarra, 2009). Over the time, the numbers of transactions in a company are getting higher and thus require the company to have detailed information of cash flows. Beside financial analysis, cash flow analysis provides relevant information which may act as a complementary to accrual information.

This present study examines types of patterns for cash flow statement as independent variable which is further categorised into eight possible patterns which are CFP1, CFP2, CFP3, CFP4, CFP5, CFP6, CFP7 and CFP8. These cash flow patterns were adopted from previous studies which found to be useful indicators of financial distress occasion (Bruwer and Hamman, 2005; Gup et al., 1993; Dickinson, 2011; Jantadej, 2006; Rodgers, 2011). The dependent variable of the current study is financial distress status which is further categorized into distressed and healthy companies. In the present study, the size of company has been set to be the control variables with two different types of measurement either by using total turnover or total assets.