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Prediction of Financial Distress:

An Empirical Assessment

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ABSTRACT:

Predictive value of accounting information and the forecasting process have become very important in the accounting profession because only relevant accounting information can help accounting users predict the ultimate outcome of past, present, and future events (Kieso 2007). In many previous studies, there has been substantial movement toward articulating the

importance of accounting data, especially cash flows and net income, in the predictive process. In this study, we empirically re-examined the ability of cash flows from operating activities and accrual-based net income in predicting corporate failure as evidenced by bankruptcy. In the past, the results of this type of research were mixed. Differently from previous research, we focus on the timing of predictive ability, i.e., which data, cash flows or net income, is faster in predicting a firm's bankruptcy. We also investigate the timing of auditors' issuance of a going-concern opinion.

In addition to cash flows, net income and audit opinions, we tested the prediction ability of Altman's (1968) Z-score model. Although the model is a simple linear combination of financial data, cash flows and net income, and is not based on any rigorously-derived foundations, it has performed very well in predicting bankruptcies. The results of this study would help investors and creditors evaluate the usefulness of financial data and audit opinions in predicting firms' failure.

In line with these studies, we looked into the ability of NI and CFO to predict firms' bankruptcy using 41 firms that went bankrupt beween1995 and 2012.

The preliminary results show that NI is more accurate and faster than either CFO or audit opinion in predicting firms' failures. On average, NI signals a firm's bankruptcy 2.41 years before the bankruptcy filing while CFO signals 1.48 years before filing. Auditors issued a going-concern opinion, another signal for firms' failure, to only 16 out of 41 bankrupt firms one year before bankruptcy, and no auditors issued the going-concern opinion two years before bankruptcy.

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