

PREDICTION OF FINANCIAL DISTRESS OF LISTED ENTITIES IN SRI LANKA USING FINANCIAL RATIOS

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Abstract

In the current nature and context in Sri Lanka, it is far more evident that the entities do suffer financial distress. Subsequently, they fail which in terms referred to as corporate failure. Corporate failure is the worst case that an entity or a business could come through; lasting financial distress does lead to such briefed corporate failure; hence predicting the forthcoming financial distress is significant in avoiding corporate failures and shakeouts. With standing with that, the purpose of this study is to develop a model using the devised financial ratios to predict the financial distress of listed entities in Sri Lanka. As a result of the model, built upon the financial ratios could be applied in any context in predicting financial distress at any given time. The study utilizes publicly available data from the corporate annual reports of a total sample of 70 firms which are clustered into two as 35 distressed firms and 35 un-distressed firms which are of similar capacities, listed on the Colombo Stock Exchange spanning 6 years from 2016 to 2021. A total of ten devised financial ratios were used in determining the model and analyzed using Logistic Regression Analysis. Analysis of the statistical testing results indicated that the prediction accuracy of the model consistent with the financial ratios is 77.86% one year before distress. Furthermore, the predictive accuracy of the model in all three years before distress is above 72%. Hence the model is robust in obtaining accurate results for up to three years before failure. The final model includes three financial ratios: working capital to total assets, debt ratio and cash flow from operating activities to total assets as these variables have more explanatory power in predicting financial distress. Therefore, pertaining to the need and the current context, the businesses, investors, employees, suppliers, financial institutions, regulatory agents and auditors can be used from the developed model in Predicting the Financial Distress of Listed Entities in Sri Lanka.

Keywords: *Financial Distress, Corporate Failure, Financial Ratios,*