

**A STUDY OF BANKRUPTCY PREDICTION
IN SRI LANKA**

By

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**A research submitted to the
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of the requirements for the
Degree of Master of Business Administration (Finance)**

DECLARATION

“The work described in this research was carried out by me under supervision of Dr. P.D Nimal, Senior lecturer, and report on this has not been submitted in whole or in part to any university or any other institution for another degree or diploma.”



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CHAPTER 1

INTRODUCTION


1.1 Background of the Study

Almost all stake holders, Managers, stockholders, lenders and employees are concerned about their firm's financial status. If the financial status of the firm is not satisfactory the job security of managers and employees is not guaranteed, and stockholders' equity and lenders' privileges are at stake. The state, as a regulator in a market, has concerns about the occurrence of financial distress of corporations (Xu and Zhang, 2004). This creates a demand among executives, employees and stockholders for information on the financial status of the firm, to be sure of its future. Further, management makes frequent inquiries and regular efforts to react to a continuous demand on how financial distress is predicted.

The recent credit crunch in the US share market which was initially triggered by the sub-prime issue, resulted in the collapse of a large number of financial institutes viz., banks, corporations and stock markets. Most of Europe still faces financial difficulties and economic hardships, which do not seem to have feasible solutions. Similarly in 2006, the Saudi Arabian Stock market collapsed losing over 1300 points in the price index, 65% of it at the top level. This phenomenon had an adverse outcome on a large portion of the population and several deaths and cases of serious illnesses are recorded as a result (Al-Rawi, 2008). This was the first time such an event had occurred in the

SUPERVISOR APPROVAL

I approve the Research Paper titled “**Study of Bankruptcy Prediction in Sri Lanka**” by **K.A.K. GNANAWEERA**; Student Registration#: 5266FM2009029, for the submission to The Faculty of Management & Commerce, University of Sri Jayewardenepura, Sri Lanka in partial fulfillment of the requirement of the Master of Business Administration in Finance Degree.


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I look forward to an exciting and challenging future with success!

ABSTRACT

The most pervasive reason for a firm to be gone in distress and possible failure is some type of managerial incompetence. Many external stakeholders are not involved in the day-to-day business procedures of a company but need to know the financial health of a company they have interests in. Financial reporting has become an important module of communication between a corporates and stakeholders. The quest of finding a simple and accurate bankruptcy prediction system or model is in high demand by many stakeholders to detect the present and future health of a company. Many researchers depend on different kind of models but Altman's Z-score model is being used significantly in many organizations, worldwide, because of its level of accuracy and simplicity of calculation using freely available financial data. The purpose of the research is to determine the accuracy and predictability of Altman's Z-score model(s): Z'' and Z''^1 , in Sri Lankan context.

This research examines 33 de-listed companies and good companies (listed); 2 to 3 year periods prior de-listing by using their financial information to calculate Z-score value. Further, this study examines Z-score values for de-listed & bankrupted companies with good companies and de-listed & non-bankrupted companies with good companies 2 and 3 year periods prior de-listing to identify bankruptcy prediction accuracy of Altman's Z-score model(s).

This study identifies that the Z'' model achieved 92% prediction accuracy when it is applied to de-listed and bankrupted companies 3 years prior to de-list and 100%

prediction accuracy when it is applied to de-listed and bankrupted companies 2 years prior to de-list. Conversely the Z''^1 model achieved 83% prediction accuracy when it is applied to de-listed and bankrupted companies 3 years prior to de-list and 100% prediction accuracy when it is applied to de-listed and bankrupted companies 2 years prior to de-list. but the Z'' model predicted 13% of de-listed and non-bankrupted companies 3 years prior de-listing which may lead to insolvency and 19% of de-listed and non-bankrupted companies 2 years prior de-listing which may lead to insolvency. Further the Z''^1 model predicted 13% of de-listed and non-bankrupted companies 3 years prior de-listing which may lead to insolvency and 13% of de-listed and non-bankrupted companies 2 years prior de-listing which may lead to insolvency. Therefore according to evidence suggests the prediction accuracy of Z''^1 model slightly better than the Z'' model.

The results obtained in this study are subject to information restraints as availability of relevant information for de-listed companies was limited. Hence further research is needed to evaluate the soundness of the Z-score model(s) for bankruptcy prediction in Sri Lankan Context.

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ABBREVIATIONS

AMW	Associated Motorways
ANN	Artificial Neural Networks
ASPI	All Share Price Index
BE	Book value of Equity
CFA	Chartered Financial Analyst
CO.	Company
CSE	Colombo Stock Exchange
DEV.	Development
EBIT	Earnings Before Interest & Tax
FD	Financial Distress
GP	Gross Profit
LTD	Limited
M & A	Mergers & Acquisition
MDA	Multiple Discriminant Analysis
MN.	Million
MVE	Market Value Equity
NDB	National Development Bank
NO.	Number
PLC	Public Limited Company
PROP.	Property
PVT.	Private
ROC	Registrar of Companies
SLT	Sri Lanka Telecom
UK	United Kingdom
USA	United States of America

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