Financial statement analysis and the prediction of financial distress.

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Financial Statement Analysis and the Prediction of Financial Distress

William H. Beaver, Joan E. Horngren Professor of Accounting (Emeritus), Graduate School of Business, Stanford University, USA, fbeaver@stanford.edu Maria Correia, Assistant Professor of Accounting, London Business School, England, mcorreia@london.edu Maureen F. McNichols, Marriner S. Eccles Professor of Public and Private Management, Graduate School of Business, Stanford University, USA, fmcnich@stanford.edu

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Abstract

Financial statement analysis has been used to assess a company's likelihood of financial distress — the probability that it will not be able to repay its debts. Financial statement analysis was used by credit suppliers to assess the credit worthiness of its borrowers. Today, financial statement analysis is ubiquitous and involves a wide variety of ratios and a wide variety of users, including trade suppliers, banks, creditrating agencies, investors and management, among others. Financial distress refers to the inability of a company to pay its financial obligations as they mature. Empirically, academic research in accounting and finance has focused on either bond default or bankruptcy. The basic issue is whether the probability of distress varies in a significant manner conditional upon the magnitude of the financial statement ratios. This monograph discusses the evolution of three main streams within the financial distress prediction literature: The set of dependent and explanatory variables used, the statistical methods of estimation, and the modeling of financial distress.

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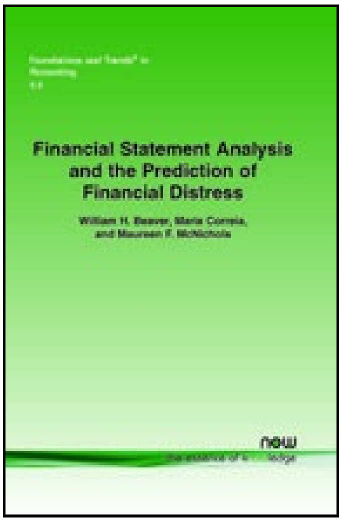
Financial Statement Analysis and the Prediction of Financial Distress discusses the evolution of three main streams within the financial distress prediction literature: the set of dependent and explanatory variables used, the statistical methods of estimation, and the modeling of financial distress.

Section 1 discusses concepts of financial distress. Section 2 discusses theories regarding the use of financial ratios as predictors of financial distress. Section 3 contains a brief review of the literature. Section 4 discusses the use of market price-based models of financial distress. Section 5 develops the statistical methods for empirical estimation of the probability of financial distress. Section 6 discusses the major empirical findings with respect to prediction of financial distress. Section 7 briefly summarizes some of the more relevant literature with respect to bond ratings. Section 8 presents some suggestions for future research and Section 9 presents concluding remarks.



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