

Surviving Financial Distress: The Case of Too Many Herbs and Spices

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Abstract

Over 120 years ago Sir James Burns founded an organisation that is today, the international business group of Burns Philp and Company Ltd. The Group is widely known as a leading producer of yeast products and manufacturer of other bakery ingredients. Its ability to adapt to the ever-changing demands of business is widely recognised. During the late 1980's however, after the group expanded into the herbs and spices industry its financial state deteriorated. Yet, arguably the Group had entered a market that complimented its then existing core-activities. This paper examines circumstances surrounding that venture into herbs and spices. It argues that the Group's financial predicament, at that time, was exacerbated by the use of conventional accounting procedures. It illustrates that up-to-date market related financial details, in lieu of accounting book constructs, more aptly assist directors, managers, all stakeholders to conduct business and make informed economic decisions. This paper suggests that it is an entity's current financial state of affairs, with regard to tangible market referents, that enables a firm's strategic progress and facilitates proactive management; and in turn, assists in the sustainable development of business throughout the world.

Keywords

**Conventional Accounting
Accounting Misinformation
Financial Distress
Burns Philp
Free Cash Flow
Financial Statement Analysis**

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Introduction

'Sustainability is a philosophy that weighs the current economic benefits of activities against the effects of those activities on future generations' (Clikeman, 2004, p.24). Similarly the current activities of a business will result in an economic benefit or economic disaster for that business which, in turn, will either benefit or disadvantage its future business activities and the financial results of those activities. Although the future economic state of any business is by and large unknown; it is contestable whether conventional financial accounting data (generated by generally accepted accounting procedures) provides *any* relevant information in projecting any business' likely future financial results. By way of example, 'distress prediction modellers have been uneasy [for some time] regarding the variability and unreliability of [financial] accounting data' (Dean and Clarke, 2001, p.169). Such data, is however, frequently used to determine an entity's financial capacity to be in business and to continue to conduct its business.

This paper examines the serviceability of generally accepted accounting data as a *bona fide* indicator of an entity's financial state. This is important to all corporate stakeholders to enable them to determine an entity's financial capacity to sustain, diversify and expand its business activities.

Consider the comment by Clarke and Dean (2001, p.72) that:

[O]ver the past 50 years, Australia has witnessed the sudden collapse of major corporates. Companies with clean audit reports, frequently with strong market support, have suddenly announced their financial distress. Disturbingly, this has occurred in a setting in which corporate

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regulation has supposedly been beefed up in response to successive waves of collapses

Burns Philp and Company Limited

With the above in mind and taking Burns Philp and Company Limited as the main study context, this paper examines Burns Philp's publicly reported economic circumstances during the period from 1991 to 2004 inclusive. The period under review is of particular interest as it incorporates the Group's expansion into (and its exit from), the herbs and spices industry.¹ The financial distress experienced by Burns Philp during that period is informative not least because the Group's misfortune was seemingly *unexpected* by many. As with other corporate entities, diversified business activities and expansion policies were, and still are, an inherent part of Burns Philp's business strategies and its move into herbs and spices during the nineties signalled an extension of its core activities.

Recently (in 2004), the Group emphasised its continued potential for growth amid changing financial circumstances. It announced the sale of Tone Brothers, with transactions of its herbs and spices division completed by September 3 and yeast and bakery ingredients completed by September 30 (*Managing Director's Review, Annual Report, 2004*). Stakeholders were told:

[I]nitiatives ... transformed the Group into a position where future earnings will be significantly higher than they might otherwise have been, the portfolio of businesses enhanced and the Group's financial position strengthened, leaving us well placed to continue to grow as opportunities are identified.

The previous year (in 2003), Burns Philp increased its range of businesses including 'the integration of the Fleischmann yeast

1 Consider that the sustainable economic viability of business affects its future and that of other businesses, society and the economic environment. 'Economic performance is a company's total economic impact [on itself and] on the community' (Clikeman, 2004, p.24).

and bakery ingredients business in Latin America.² Around the same time the Group reduced their investments in non-core bulk liquid storage in Australia and industrial vinegar businesses in North America. Following a late 1990s restructure, they adapted their operating activities to meet the challenges of the then *current* economic climate; an example being the acquisition of Goodman Fielder in 2003.

Much earlier during 1988, Burns Philp moved into the herbs and spices industry at a time when consumer demand for herbs and spices heightened as public tastes changed from products heavily laden with salt and saturated fats to what was perceived to be a healthier style of cooking. Burns Philp entered a market that complimented their existing and thriving long-standing involvement in other food products and services like yeast and bakery, arguably staying in the realm of their core-activities.

The company quickly moved to establish a niche in the foods industry as a single source supplier for food ingredient products³ and well-respected brand names were an important consideration in their marketing and growth strategy. The Group continued to expand as it acquired active herbs and spices businesses in North America and Europe. It focussed on the acquisition of quality trade names and its ability to develop business opportunities taking advantage of economies of scale.

At that time the Group concentrated on the consumer sector of the herbs and spices business, leaving the industrial sector to others. This occurred as consumer preferences again altered and individuals, social groups and families more frequently visited restaurants and take-away food outlets. Altering consumer preferences are,

2 Further details contained in the managing director's review in the Burns Philp Annual Report, 2003.

3 Details in Alan McGregor's speech presented at the Burns Philp AGM, Nov.5, 1997. Also, the ASIC Report of the Investigation into Burns Philp & Company Limited, 1998, p.3.

seemingly, a quintessential feature of a market economy. As might be expected, the change in customer tastes did not adversely affect the industrial sector as much as it did the retail market; and that, for Burns Philp, was a problem. The Group had to contend with increasing capital costs, escalating operating expenses and rising competition. Eventually its conglomerate activities in herbs and spices were not sustainable, especially in financial terms.

Drawing mainly on Dean and Clarke (2001), Clarke and Dean (2001) and Clarke *et al* (2003) with reference to Altman (1971, 1983, 1993), Argenti (1976, 1983), Ohlson (1980), Zmijewski (1984), Miller (1990), Loftus and Miller (2000) and others; this paper critically analyses financial accounting data generally available to assist stakeholders in their economic decision-making. An analysis of this data shows that the process used by Burns Philp to record its accounting transaction information during the period examined arguably contributed to the business' reported financial distress. The ASIC Report on Burns Philp⁴ and the Group's annual reports from 1991 to 2004 inclusive, are the primary source of financial data herein used.

Five sections follow. The next section briefly examines conventional financial accounting procedures that likely contributed to the Burns Philp dilemma. This is followed by a discussion of the Group's expanding and diversified business interests. Then an analysis of the various anomalies of financial accounting numbers with regard to the reported financials of Burns Philp during the period are examined.⁵ The penultimate section elucidates concerns reported by ASIC, and this is followed with some concluding remarks.

⁴ ASIC (1998, pp.1-52).

⁵ The concept of risk and risk management has forcefully re-surfaced with the collapse of HIH in Australia. Refer Sarre (2001, p.292).

Diverse Things

Debatably, the problem of Burns Philp's diminishing financial state was exacerbated by its use of conventional financial accounting procedures. Sharma (1996, p.37) with reference to several earlier studies asserted 'it is widely known that the income statement [statement of financial performance] and balance sheet [statement of financial position] may be flawed because of accrual allocations and creative accounting'. Essentially for Burns Philp generally accepted accounting practices allowably reduced the Groups reported costs at a time when its business expenses were actually rising. When the Group capitalised its costs of restructuring and rationalization and its slotting fees expenses for instance, its total assets figure increased and its' reported operating expenses decreased. Due to the capitalisation procedure the Group's assets and reported profits (for some time) were inflated. Thus its published financials did not necessarily tell the full story.⁶

The Australian Securities and Investments Commission (ASIC) questioned the amounts attributed to its intangibles, for example tradenames.⁷ In 1996 three independent parties were commissioned to assess the Burns Philp tradename values that were later determined, generally, to be over-valued in the accounts.⁸ The total amount reported for 1994, 1995 and 1996 [that included tradenames, trademarks and brand names] fluctuated from \$792.7 million, to \$1,121.4 million, to \$1,014.6 million respectively.⁹ At the same time, Burns Philp's total assets fluctuated accordingly but its operating profits continually decreased, and its free cash

⁶ Discussed later, is the awkwardness of capitalising costs as assets. Recently exemplified with the demise of (among others) Enron in the US and HIH in Australia.

⁷ Refer to the ASIC Report on Burns Philp (1998, pp.12-15) for details of its separate tradename valuation methods.

⁸ *Ibid.*

⁹ Refer Burns Philp Annual Report (1996, note 13a – Independent valuations)

flow¹⁰ (as dividends) although stable from 1994-95 decreased substantially from 1995-96 sending negative signals to the market as evidenced by the sliding share price from 1994-96, as shown in Table One.

The fall in share price reflects partly the market's unenthusiastic reaction to the Group's decline from a reported \$123m profit in 1994 to a \$61.8m operating loss in 1996, especially as its dividends decreased substantially (over 50%) from 1995 – 96. In addition to covering its interest costs on its borrowings, a business that historically pays dividends is mindful that 'investor confidence must be maintained or increased, so dividend payouts are necessary' (Sharma, 1996, p.40). The latter point is revisited later in this paper. Turning now to the figures in Table One, although revealing limited information, they serve to highlight discrepancies that likely occur in the information content of an entity's published financials.

Table One: An Abridged Three Year Financial Summary

	1994 \$m	1995 \$m	1996 \$m
Total Assets	3,062.1	3,380.9	2,978.5
Operating Profits (Loss) - after income tax	123.0m	115.1	(61.8)
Net Cash – Op. Activities	101.1	113.9	80.1
Free Cash Flow (dividends) cents*	19.0	19.0	8.0
Reported Share Price \$	3.50	2.94	2.40

Source: *Burns Philp Annual Report 1996 – Note: Reported share price is the "last" adjusted price as reported in the Group's Historical Summary in that Annual Report.*

* Here, "Free Cash Flow" is denoted with regard to dividends per share. Refer Bishop et al (2004, pp. 76,77).

¹⁰ Jensen (1986, p.323) defined free cash flow as 'cash flow in excess of that required to fund all projects that have positive net present values when discounted at the relevant cost of capital'. Bishop et al. (2004, pp76,77) elaborated that, as 'cash that is not reinvested in the firm is paid out as dividends, then dividends are the same as free cash flow ...'.

This is especially so when financial amounts attributed to assets are based on historical costs and the calculated profit numbers include accounting constructs such as allocated amounts for depreciation – the latter, only by chance having any external market referent. This is of concern, as business stakeholders arguably require astute and *current* financial details on the results of a business' operating activities. Unfortunately, conventional financial accounting statements do not provide such details as they are essentially based on historical costs and capitalisation methods and as Clarke and Dean (2001, p.75) proffered:

Capitalising expenses, deferring taking them into the calculation of profits, has featured in many collapses over the years. [For instance] Reid Murray did so with mortgage interest charges ... [and] Rolls Royce's capitalising of its research and developments costs masked its drive into bankruptcy in the 1970s.

Table One show Burns Philp's operating profits diminishing from 1994 and substantially so from 1995 to the reported loss in 1996. The reported profit and loss figures however are calculated numbers and not necessarily indicative of real money - cash and access to cash. Yet, those decreasing profit figures most probably contributed to the Group's diminishing reported share price along with its stakeholder dissatisfaction in the sudden downward spiral of dividends per share from 1995-96. The latter possibly indicating a longer-term change in dividend policy or an ever-diminishing level of the business' access to cash, or both. Differently, Burns Philp's reported net cash from its operating activities fluctuated between the years, a point that needs to be further investigated.

Returning to the decreasing share price; notwithstanding the effect of declining profit figures and that numerous market forces impinge on share price behaviour many stakeholders at that time, (however well-informed), were likely unaware of the extent of the Group's inflated asset figures and that its operating profits/losses were

likely to have been far worse than depicted in its dated financial statements.

Following this in 1997, the Group resolved to sell its investments in herbs and spices and decided that as at 30 June 'all herb and spice intangible assets [were to be] ... written off as an abnormal item'.¹¹ In addition they reduced other reported intangibles related to their continuing businesses. The accounts remained, nonetheless, in accord with the professional accounting standard – AASB1040: *Statement of Financial Position* and were also in keeping with the requirements of SAC4, para.14 - essentially based on capitalised costs. The effect of those accounting procedures hid, from many, the Group's somewhat deteriorating financial circumstances.

Interestingly, with the release of International Accounting Standards, seemingly little has changed. In 2005 the Australian equivalent to IAS1; AASB101: *Presentation of Financial Statements* remains complex. In addition it refers to a Statement of Financial Position (AASB1040) as a Balance Sheet – back to the past! With regard to balance sheet assets, AASB *Framework*: para.100 provides four possible choices of measurement; historical costs and current costs, realisable value and present value that may be used under varying circumstances to represent assets in the financial statements. On the other hand, at para.101 historical cost is emphasised as the usual, 'commonly adopted' approach to measurement.

AASB *Framework*: para.100 states that a 'number of different measurement bases are employed to different degrees and in varying combinations in financial reports' hence, the output is most likely to reflect a confused mismatch of unlike numbers. It also identifies anomalies with the ever-changing market environment in that 'some entities use the current cost basis as a response to the inability of the historical cost accounting model to deal with the

effects of changing prices of non-monetary assets' (para.101). Here disparities are evident, especially with the interchangeable reference to costs and prices. After all costs represent an *outflow* of cash from a business; whereas prices are indicative of an *inflow* of cash.

On that basis, whether a business represents its assets by current costs or historical costs, both are costs and indicative of an outflow of cash albeit at different time zones. On the other hand, for a business to continue its activities and be able to pay its debts when due, requires certain constancy with regard to an inflow of cash to enable flexibility of operations. Similarly, SAC2 (2005, para.32) mandates that '[d]isclosure of information about the financial position of the reporting entity involves disclosure of information about its control over resources, financial structure, capacity for adaptation and solvency'. Adaptive behaviour is flexible behaviour.

Loftus and Miller (2000, p.41) generally have explained:

Traditionally financial reporting has not reported explicitly the risks and uncertainties associated with an entity's activities and financial position ... there has been little emphasis on communicating financial flexibility [adaptive behaviour].¹² These omissions are major weaknesses [especially] if one of the purposes of financial reports is to flag entities that are so exposed that they could easily suffer a major financial reversal and, lacking financial flexibility, collapse into insolvency.¹³

¹² Chambers (1966) spoke of adaptive behaviour in and by business; the idea of financial flexibility is in line with this concept.

¹³ The monograph of Loftus and Miller (2000) *Reporting on Solvency and Cash Condition* is particularly acknowledged for its significant (especially in timeliness) contribution to continued debate on financial reporting.

¹¹ See Burns Philp Annual Report (1997, note 13).

Accounting for Diversified Business Interests

SAC2 (2005, para.36) proffers '[i]nformation about the solvency of the entity, that is, information about the availability of assets to meet financial commitments as they fall due, is relevant for making and evaluating [economic] decisions ...'. It also reveals that information about 'the liquidity of the entity's assets and the availability of cash from sources external to the entity, is useful in predicting the ability of the entity to meet its financial commitments as they fall due ...'. In 2000, the wording in SAC2, para.36 was the same as was the case in 1997 and before. The focus, over time, centres on assets and cash: The availability and liquidity of assets to enable the entity to pay its debts and continue its business.

It follows that the definition of an asset is important. And the practice of capitalising a cost to call it an asset is of great concern. During the 1990s a major problem for Burns Philp manifested in the form of its slotting fees and the method used to report those and other costs. Slotting fees were an operating cost that ensured shelf space in supermarkets for the Groups' herbs and spices. These expenses were capitalized by the Group as "Other Assets", being paid to the supermarkets as a prepaid expense, recorded by the Group as an asset, and then amortized over time. Although the procedure is technically correct it can misinform stakeholders by inflating assets. Additionally, at each acquisition date the Group created a provision for rationalization and restructuring costs that resulted in an increase in intangible assets like, goodwill and tradenames. Subsequently any related expenditure was, until provisions were exhausted, written off against the provision instead of being charged against profit – effectively inflating reported profits.

Similar stories on provision accounts, capitalised expenses and deferred costs pervade the past annals of finance in Australia – refer Clarke *et al.* (2003). For instance with Reid Murray and H.G. Palmer in the sixties; Associated Securities, Minsec

and Cambridge Credit in the seventies; Bond Corporation, Westmex and Adsteam in the eighties – then more recently Enron, WorldCom, HIH and One.Tel from the nineties into the new millennium. Technically such "creative" accounting procedures, as mentioned above, accord with generally accepted accounting practice. But for Burns Philp (and many others) the outcome erred – toward, even unintentionally, an inflated reported financial result.

It was around 1996 that the full financial effect of the accounting methods became evident to Burns Philp, when the provision accounts expired and restructuring and rationalization costs were actually charged against annual profit.¹⁴ Then and seemingly only then, did the accounting profit fiasco become somewhat apparent. As Clarke *et al.* (2003, p.279) remarked:

[T]he only kind of calculation that can determine the financial outcome of a business venture over its entire life – [is] a comparison between the sum of money with which it commenced and (in like terms) the sum of money or its equivalent with which it finishes – for that is all that periodic financial statements can reasonably achieve.

Table Two provides a fourteen-year summary of Burns Philp's assets, debts and its reported capacity to be able to financially cover its interest expense. Loftus and Miller (2000, p.105) asserted that 'not only is the extent of debt in the capital structure [of a business] important but the timing of debt's required payment (its

¹⁴ Recall that the ACA, s.297 states: 'the financial statements and notes for a financial year must give a true and fair view of: (a) the financial position and performance of the company ...' regardless of the intention of the Group, and complying with generally accepted accounting practice, it would seem this statute was overlooked. When assessing what to denote as an asset or an expense of a business, cases like Enron and WorldCom in the US, HIH and OneTel in Australia, exemplify that capitalizing costs as an asset is an ongoing problem for conventional accounting with regard to ascertaining an entity's actual financial state.

relative liquidity) is also important'. As such, the dated financial state of a business is important to ascertain its financial capacity to pay its debts when they are due. The fact that financial statements are dated infers that the financial content of the statements should directly relate to the date on the statement. It is contestable whether the details provided in Table Two concur.

The data indicate a fluctuating financial state for Burns Philp. The Group's assets show a relatively steady increase up to and including 1995 that basically decline to 2002 with slight movement between the years. Its liabilities are shown to continually vary during the period with net debt reportedly peaking for the Group in 1998 at \$1,364.8 million. But assets in financial accounting, currently, are defined with regard to *future economic benefits*; they are not necessarily tangible and marketable resources. Assets so defined are

fundamentally intangible, sometimes with no marketability. For a business to cover its debt requires that the business has money and/or access to money because its contracted debt obligations must be paid – if not forgiven. Hence its assets would need to be real, in the sense of being marketable, able to be expressed in current money terms, if they were to be useful (with regard to available money) in covering those debt commitments.

Burns Philp's increasing asset figures, as reported from 1999 to 2003 do not necessarily indicate an increasing financial capacity to cover its debt. If an entity's assets are not represented by current market monetary equivalents the reported figures are unlikely to indicate its dated financial capacity to access cash, in a timely manner, to cover its debt payments. This is the case (at least) in a factual, up-to-date monetary sense.

Table Two: Burns Philp, a Fourteen Year Financial Summary

YEAR	Net Debt \$M	Total Liabilities \$M	Total Assets \$M	Times Interest Covered
1991	256.9	978.8	2084.4	2.4
1992	319.1	1041.7	2275.3	4.5
1993	707.5	1479.2	2778.6	4.2
1994	996.6	1736.6	3062.1	3.4
1995	1108.8	2018.7	3380.9	3.2
1996	964.6	1737.3	2978.5	2.9
1997	1124.6	1894.0	2200.4	1.4
1998	1364.8	2209.0	2238.2	1.3
1999	1073.2	1384.3	1417.9	1.7
2000	1031.4	1467.1	1596.7	2.2
2001	1093.5	1582.9	1860.8	2.2
2002	731.9	1885.0	2364.5	2.8
2003	2812.1	3845.8	4604.1	2.2
2004	2634.8	3511.0	4400.8	1.6

Source: Financial data sourced from the Historical Financial Summaries in Burns Philp & Company Limited's Annual Reports for 1993, 1998, 2003 and 2004. Burns Philp reported its year-end net debt as borrowings less cash and short-term deposits (Annual Report, 1993).

Regard the *times interest-covered ratio* results shown above. This ratio is an indicator supposedly of the Group's ability to cover (to pay) its incurred debt obligation. The table shows the ratio sliding from 1992 to 1998 but the financial information content in that result is incomplete and largely dependent on the output of anomalies inherent in the calculation of accounting profits.¹⁵

Through diversification Burns Philp acted to expand its business opportunities, reduce its business risk and promote growth and that move created the potential for increased financial wealth. Unfortunately, '[a]cquisition brings growth, but it does not necessarily generate property, increase wealth or ensure ongoing profits' (Clarke *et al.*, 2003, p.173).

Nor do increasing accounting profit numbers indicate necessarily an increase in an entity's financial wealth. Loftus and Miller (2000) examined a number of studies that compared accrual-based data against cash flow data to investigate which data would most likely be of benefit to economic decision makers. Cash and current cash equivalent details are found generally to be more beneficial in informing stakeholders of an entity's financial state – as elaborated in the next section.

Accounting Numbers and Cash Flows

Following the lead of Sharma's (1996) case analysis of the failed Brash Holdings Ltd., the current ratio, return on assets (in this case, net operating profit/total assets) and leverage as long-term debt/total assets are here briefly discussed, with particular regard to Burns Philp. The findings emphasise 'evidence [from previous studies] that the financial data reported in conventional profit and loss accounts and balance sheets generally are not serviceable

¹⁵ Although the ratio result diminishes coincidentally with the adverse circumstances the Group suffered after it diversified into the herbs and spices industry, this is debatably coincidental. Myriad factors in the economic environment might (and possibly did) affect the result.

for showing the wealth and progress of companies or for deriving indicators of their financial characteristics' (Dean and Clarke, 2001, p.150).

In Sharma's study of Brash Holdings, accrual-based methods revealed the company as profitable and liquid up to 1992 after which its financial circumstances deteriorated, seemingly around 1993. Sharma's cash flow ratios indicated the company was likely in financial distress some years before it became apparent with conventional financial analyses using accrual-based number.¹⁶ Loftus and Miller (2000, p.282) concurred that 'cash flow ratios calculated by Sharma provided additional insights into, and earlier warning of, the financial difficulties faced by Brash'.

With particular regard to the food industry, Jones *et al* (1998) explored the relevance of cash reports as opposed accrual-based financial statements and suggested that the needs of users of financial reports would benefit from an increased expenditure of 'time and resources to developing and evaluating more rigorous systems of cashflow reporting, as well as continually refining *accrual measurement procedures*' [emphasis added] (1998, p.57).

Cash flow/total debt has long been advocated a significant factor in ascertaining the likelihood of financial failure.¹⁷ Jones and Ratnatunga (1997) re-emphasised the increasing international drift toward cash flow information as a significant factor in financial reports. Yet, little consensus appears generally on what represents the better indicators of a business' pending financial failure.

Consider; for decades distress prediction models have utilised a variety of financial ratios in the process of *univariate* and *multivariate* analyses of an entity's financial strength. Altman's Z-score model

¹⁶ 'For instance, only the conventional return ratios indicated any signs of distress, while all three categories of cashflow ratios indicated that Brash was facing a financial crisis' (Sharma, 1996, p.43).

¹⁷ See for instance Beaver (1966).

of 1968 further developed in his influential monograph (1971) were instrumental in establishing quantitative prediction analyses on possible business failures. Argenti (1976) examined various and seemingly frequent routes to failure. Argenti (1983) developed the A-score trajectory model, decisively to consider qualitative, non-financial, factors as indicators of company failure. Keasey and Watson (1987) tested the Argenti hypotheses with particular regard to small company failure. They noted that Argenti identified an “autocratic management style” as a key defect, generally, of business. Hence, variables Keasey and Watson (1987) examined included managerial structure, internal accounting systems, financial statement content, audit/auditors and gearing. They stated a major reason for their analysis was ‘because of the well-known problems associated with using financial ratios ... [and that a] further advantage of this non-financial information is that it is generally less open to manipulation’ (1987, p.351).

In the span of two decades debate on the relevance of including *financial* and/or *non-financial* factors in prediction modelling gained momentum. Contributors to the debate were many and included Ohlson (1980), Taffler (1982 and 1983), Zmijewski (1984), von Stein and Zeigler (1984), Keasey and Watson (1987), Miller (1990), McRobert and Hoffman (1997) and many more.

Ohlson (1980) for instance, explored financial ratios as predictors of corporate failure/bankruptcy and determined the size of the firm and measure/s of its financial structure; performance; current liquidity were significant factors. He stated as a major finding:

[P]revious studies appear[ed] to have overstated the predictive (in the sense of forecasting) power of models developed and tested. The point of concern ... if one employs predictors derived from statements which were released after the date of bankruptcy, then the evidence indicates that it will be easier to “predict” bankruptcy (1980, p.110).

Zmijewski (1984) examined two biases (choice-based and sample selection) that usually emerge with regard to data collection in financial distress/bankruptcy research studies. He defined financial distress ‘as the act of filing a petition for bankruptcy’ (1984, pp. 63,64). Dietrich (1984, p. 84) agreed ‘[m]any studies operationalize financial distress as bankruptcy ... [noting] that bankruptcy is a legal, rather than an economic, condition’. Importantly, Dietrich stressed that concentrating on whether a business is bankrupt or not bankrupt ‘may be an oversimplification of the economic condition of firms’ (1984, p.84). This paper accentuates the latter; and concentrates on factors that may determine the actual economic condition (dated financial position) of a business, in lieu of utilizing distress prediction models.

Dean and Clarke (2001, pp.147-183) provided a detailed synopsis of distress prediction models and highlighted areas of concern such as, the use of contemporary financial accounting data. They contested the ‘functionality of both the quantitative and qualitative distress prediction models currently in use’ (p.182) and emphasised that ‘[i]n examining these models one should contemplate the consequences of drawing upon the accounting data created through compliance with the Accounting Standards’ (p.163). Again, the latter is accentuated here acknowledging that:

In most studies liquidity and operating turnover ratios have exhibited limited differences between distressed and non-distressed firms. This is interesting. It invites further research. The lack of cash is the obvious ultimate cause of failure. And the ongoing concern of legislators with solvency suggests an indicator of this attribute would be critical in any distress prediction model (Dean and Clarke, 2001, p.182).

With the focus on cash and returning to Burns Philp; financial details shown in Table Three indicate the current ratio although fluctuating with a noticeable drop in 1998, was likely not of much concern to

stakeholders. Whereas the times interest covered ratio, previously shown in Table Two signifies a steady decline from 1993 to 1999 that perhaps reflects the entity's move into herbs and spices. The two results however send conflicting messages to stakeholders. While, at that time, the current ratio might have indicated reasonable liquidity, of concern was the Group's continuing financial capacity to cover its interest charges on its debt – a longer-term consideration.

More recently the Group reported increasing financial strength, in comparison to the late 1990s, at least with the apparent decrease in its net debt. The Group's consolidated cash position, ostensibly provided by its operating activities, advanced from \$118.4 million in 2001 to \$213.1 million in 2002, although there was a slight dip in 2003 to \$201.5 million and a further decline in 2004 to \$175.1 million.

Table Three: Ratios of Liquidity, Return on Assets and Leverage

YEAR	CA/CL	NPAT/TA	L-TD/TA
1991	2.02	0.08	0.23
1992	1.93	0.04	0.24
1993	1.76	0.04	0.31
1994	1.32	0.04	0.27
1995	1.68	0.03	0.39
1996	1.98	-0.02	0.40
1997	1.25	-0.40	0.55
1998	0.97	-0.13	0.53
1999	1.46	0.05	0.79
2000	2.16	0.05	0.77
2001	1.20	0.05	0.58
2002	3.10	0.06	0.63
2003	1.03	0.04	0.64
2004	1.12	0.03	0.63

Source: Financial data from Burns Philp & Company Limited's Annual Reports (1991-2002).

From a ratio perspective only, Table Three provides a useful insight; emphasising differences between short-term liquidity levels and the longer-term solvency.¹⁸

¹⁸ "Solvency" is here defined in terms of the Australian *Corporations Act 2001* (ACA), s95A(1) that an entity is deemed solvent if it can pay its debts when they are due and payable.

On the probability of liquidity (the entity's capacity to pay its "immediate" debt obligations), the current ratio might be adjusted for inventories and any prepayments to provide a more precise measure but the unknown element of doubtful, or bad debts, in accounts receivable would remain.¹⁹ The result, in financial terms, is contestable primarily because the constituent parts of the ratio are not of "like kind" – and particularly so in terms of current money's worth; considering the changing value of money over time.

The return on assets points to problems in, or before, 1995 as the negative return up to 1998 implies. The profitability ratio might provide some confirmation of a downturn in economic events but with the benefit of hindsight, changes in accounting procedures actually contributed to a sizeable and negative influence on the calculation of profit. Recollect that when the provision accounts for restructuring costs were no longer available (following Clarke *et al.*, 2003, one might question whether they should have been used in the first place) and the capitalisation of slotting fees ceased, expenses were then charged against profits. If these were to be expensed in the years 1995–1998 for instance, then the reported profits for those years would have been, at least, reduced by prepaid slotting fees, reportedly as listed below:

Table Four: Slotting Fee Prepayments from 1995 to 1998

Slotting Fees	1995 \$000	1996 \$000	1997 \$000	1998 \$000
Current	54,200	35,300	Nil	6,800
Non-current	131,700	84,000	Nil	12,300

Source: Burns Philp Annual Reports: 1995-1998.

¹⁹ Furthermore, the problem of what debt should be taken into consideration when assessing an entity's financial state, in the short-term and in the long-term is important; the assessment ultimately affects the entity's financial capacity to operate as a *bona fide* going concern.

With regard to the “Nil” slotting fee prepayment in 1997; Burns Philp’s Annual Report explained that ‘total prepaid slotting allowances at 30 June 1996 of \$119.3m comprised gross expenditure of \$248.0m and accumulated amortisation of \$128.7m’ (1997, note 14 (a)). But, after ‘the decision to sell the herb and spice businesses, the unamortized balance of slotting allowances at 30 June 1997 of \$136.4m ... [were] written off as an abnormal item’ (1997, Note 4).

Leverage ratio shows debt as increasingly relied on up to 1999 except for two slight downward movements in 1994 and 1998. From 2002 the position appears stable with seemingly a higher risk orientation than the early 1990s, also indicated by the slightly declining return on assets from 2002 to 2004, but the degree of that risk is unknown. Alternating factors like: changing levels of competition in the food industry, expansion policies, increased operating and capital costs, improved technology and operating capacity, changing business plans and strategies of management - all combine to increase an entity’s risk position.²⁰ This may be good, it is not necessarily bad; risks are taken in business, as a dynamic ever-changing economic environment demand. The point is that in such a climate - surely, management and other stakeholders require factual up-to-date results of financial transactions that reflect their business decisions. That is how companies and investors in an efficient market should operate.

Table Five and Table Six provide an overview of Burns Philp’s accounting profits against its cash flows, including reference to its changing share prices and earnings per share across the period examined. Possible relationships between the data are discussed. Firstly, Table Five focussing on operating, investing and financing activities reveals a decline in *cash from operations* from 1995 to 1996, an improvement in 1997 that was quickly

²⁰ Risk factors of a more behavioural nature, likely to have financial consequences for a business entity, are not examined in this paper.

followed by a sharp drop from 1997 to 1998 although the year to date cash figure increased, supplemented by the investing and finance figures. The cash position from operating activities possibly reflects the Group’s financial results from its move into herbs and spices, shown earlier by the current ratio results in Table Three, albeit to a lesser extent. There, the Group’s liquidity position appeared to improve and its profitability seemed to increase and stabilise in 1999 and 2000, all during a time of increased cash received from operations.

The more recent years reveal improvements in the Group’s financial details as it moves further away from its mid-nineties financial crisis. Cash used in investing activities substantially increased from 1999 to 2002, reportedly due to payments for property, plant and equipment as well as payments for businesses. In 2003, the major use of cash for investing activities was for the Goodman Fielder and Fleischmann acquisitions, predominantly the former and that was also the main contributor to the reduced year end cash figure from 2002 to 2004.

Although cash receipts (from operations) in 2002 somewhat outweighs the negative effects of borrowing costs and cash payments for operating activities, the main cash contributors to financial activities as reported in the 2002 annual report were a draw-down of borrowings and an issue of senior subordinated notes.²¹ Similarly in 2003, the draw-down of borrowings was the major contributor to financing activities whereas in 2004 the reduced figure reflects a much diminished draw-down to the previous two years to offset the repayment of borrowings.

²¹ For instance: ‘On 21 June 2002 the Group raised US \$400 million of new senior subordinated debt in the US. This debt has a term of 10 years, maturing in 2012 ... the Group’s debt being restructured ... its earliest maturity is now 2006 with the balance maturing in 2012’ (Burns Philp Annual Report, 2002, Managing Director’s Review of operations).

Table Five: Burns Philp's Cash Flows A\$ million - 1991 to 2004

YEAR	Cash (Op)	Cash (Inv)	Cash (Fin)	CashYD
1991	100265	196027	-9257	422756
1992	115430	-105513	-50371	397744
1993	119500	-451200	250800	311000
1994	101100	-432800	186600	154900
1995	113900	-200300	188200	254300
1996	80100	-75900	75500	319100
1997	126500	-193000	-27300	235100
1998	-154800	267500	119300	455400
1999	122400	120500	-640300	71600
2000	152100	-32900	-21400	187500
2001	118400	-89800	-17500	216000
2002	213100	-105800	607400	922700
2003	201500	-1,946700	1,033800	178000
2004	175100	-14500	-165600	170100

Source: Financial data from Burns Philp & Company Limited's Annual

Table Six shows Burns Philp's reported accounting profit figures attributable to shareholders, dividends per share, earnings per share and fluctuations in share prices during the period examined. Seemingly the Group's increased use of cash for investing opportunities from 2000 (particularly Goodman Fielder in 2003) aligns with the increased and positive reported accounting profit figures throughout the new millennium. Unfortunately the entity's reported share price for the past seven years has substantially fallen in comparison to the previous seven year period from 1991. That fall may reflect investor dissatisfaction with the "Nil" dividends per share policy, business acquisitions, dilution of shareholdings and such. As Jensen (1986, p.324) asserted '[m]anagers with substantial free cash flow can [maintain or] increase dividends ... [but] ... capital markets punish dividend cuts with large stock price reductions'; if so, it follows that managers are unlikely to report unwittingly, zero dividends per share.

In turn, escalating reported profit figures in published financial statements may serve to increase market confidence that may be expressed by upward moving share prices. Yet, from a financial perspective those

profit figures do not consider the time value of money and are not representative necessarily of a *bona fide* increase in monetary wealth. Ultimately the recorded profit figure does not, except by chance, have regard for the worth of money in terms of buying and selling goods and services and paying debt, in a current market. Clarke and Dean (2001, p.82) explained:

[I]n real terms – ... When the general purchasing power of the currency has changed, comparing the number of dollars lost [or gained] does not give any indication of the relative size of the financial fallout [or growth].

Essentially, monitoring the changing purchasing power of money over time is important for the continuity of any size of business, national or international. Further, knowing a business entity's level of liquidity and its state of solvency are crucial for stakeholders to enable them to evaluate the entity's changing financial capacity to sustain its business activities presently and into the future. The task is two-fold. Stakeholders require *up-to-date information* of an entity's cash position (and that includes its access to cash) with regard to *the due date of all debt* it has incurred in

conducting its business. This requires stakeholders have access to continuously updated information on the monetary equivalents of assets held and utilized by the entity to generate its continuing business. Loftus and Miller (2000, p.105)

warned the ‘proportion of [an entity’s] debt with a *near due date* [liquidity] may result in insolvency, particularly if the entity’s assets are relatively illiquid ...’.

Table Six: Burns Philp’s Reported Net Profit, Share Price and Calculated Earnings Per Share – from 1991 to 2004

YEAR	Net Profit/Loss A\$ million	Free Cash Flow - cents (Dividends)	Share Price (Last) A\$	Earnings Per Share - cents (Basic)
1991	162.4	15.5	3.08	14.9
1992	92.1	15.5	3.60	24.3
1993	110.1	17.0	3.96	27.7
1994	123.0	19.0	3.50	29.3
1995	115.1	19.0	2.94	25.5
1996	-61.8	8.0	2.40	-12.0
1997	-873.3	4.0	2.46	-164.6
1998	-285.4	Nil	0.13	-53.8
1999	65.9	Nil	0.29	12.4
2000	82.2	Nil	0.42	15.4
2001	88.5	Nil	0.46	13.6
2002	146.2	Nil	0.65	17.3
2003	170.0	Nil	0.75	14.4
2004	110.9	Nil	0.68	4.6

Source: Burns Philp’s Annual Reports – Statement of Financial Performance 1998, 1996, and 1993 plus Five (5) year summaries 2004, 2003, 1998, 1993.

An Overall View

It is incontestable that cash and ready access to cash is a critical factor in sustaining a business’ financial capacity to stay alive and to continue its business operations. Cash aligns liquidity and is accepted generally as a significant factor in any assessment of financial circumstance. On the other hand *liquidity* promotes a *short-term* view only, of an entity’s financial position, while the concept of *solvency* is more deeply rooted in concerns of continuity and genuinely profitable long-term business operations. Thus, the combination and structure of an entity’s assets in conjunction with its accumulated liabilities gains significance in any assessment of its dated financial state.

Back to Burns Philp: Still operating in the herbs and spices industry with a view to

increasing and improving its rationalisation and productivity programs to ensure cost reductions.²² Cost reductions among other things increase cash flow and provide further opportunities for product development or project expansion. In 2002 Burns Philp reportedly invested around \$82 million in profit improvement projects, at the same time initiating cost reduction programs and ultimately its reported profits increased. Tenuous though, is increasing the reported accounting profit number without determining, at the same time, whether a *bona fide* increase or decrease has occurred in the entity’s actual financial state.

Cash, access to cash and all related cash management issues, crucial to the ongoing

²² Refer: Burns Philp Annual Report (2002) Managing Director’s Review.

financial success of business, tend (sometimes) to be pushed aside to promote that habitual key to reported financial success – accounting profit.²³ Contemplate cash-crisis cases explored by Chambers (1973) and Clarke *et al.* (1997 and 2003). The circumstances of H.G. Palmer, Minsec, Cambridge Credit, Westmex, Adsteam and then more recently Ansett, One.Tel, HIH, Enron and WorldCom come to mind – and all were seemingly experienced businesses with experienced management teams and yet their subsequently *unexpected* financial failures were associated, in part, with insufficient cash flows and the outcome of accounting procedures that among other things, had capitalised costs.

Burns Philp survived, and during recent years re-focussed its operations splitting its activities - for instance, between: Yeast/Bakery 69%, Herbs and Spices 16%, Vinegar 6%, Technical and Corporate 5%, Terminals and Bulk Storage 4% (Annual Report, 2002, ‘Managing Director’s Review’). Although the Group managed to endure its 1990s venture of expanding herbs and spices it was not without comment and rejoinders, not least of all from the Australian Securities and Investments Commission (ASIC).

ASIC and Burns Philp

In 1998 the ASIC Report revealed that Burns Philp planned to obtain the necessary funds for its advance into herbs and spices from two main sources, the sale of its non-core business assets and debt. Subsequently two main issues arose. First, ASIC questioned the accounting treatment of assets in the Group’s reported financial statements. Second, ASIC expressed concerns with regard to corporate governance issues and the activities of the Burns Philp executive.²⁴ Although

²³ See Scheutze (1993 and 2001) for informed discussion on the significance of cash and the necessity to re-define accounting assets.

²⁴ Although the concept of corporate governance is not examined in depth in this paper related issues do have regard for the capacity of directors and other corporate officers to have access to financial details that provide the opportunity for them to be able to

corporate governance is not a new idea²⁵ it has, of late, gathered momentum. The perceived lack of governance nationally and internationally has for example, won public notoriety at least for some corporate entities and their directors during the past decade – as reported in the popular press. This is most likely due, in part, to the continued and *unexpected* array of corporate collapses throughout the twentieth and now into the twenty-first century.

Prior to the ASIC review on Burns Philp however, critical outcomes for the Group included a public solvency crisis that adversely affected its business operations and its market value in terms of a diminishing share price. Eventually the ASIC report (1998) included several questions concerning the responsibilities and duties of the Group’s corporate officers – in line with public focus on directors and their corporate governance responsibilities.

ASIC were particularly concerned with areas such as:

- Directors’ responsibility to ensure that the board functions effectively;
- Directors’ responsibility to ensure they are appropriately informed about business performance;
- Directors’ questioning and evaluating key features of intangible asset valuation reports;
- Directors’ responsibility to ensure that shareholders are appropriately informed.

Each point entails governance issues that in turn have regard for financial information and the *quality of financial information* provided to directors. This is an area for future academic research and discussion generally in the business environment.

For instance, to fulfil corporate governance responsibilities as described above, in

factually quantify an entity’s state of solvency.

²⁵ See for instance Shailer (2004, p.1) and Subramaniam and Ratnatunga (2003, p1).

addition to their legal and social duties²⁶ directors should know whether the entity they govern is solvent and whether it has the financial capacity to continue to conduct its business operations after it has paid its accumulated debts. It seems incontestable then that directors need continual, factual financial details about the ever-changing financial structure of the business they direct as well as up-to-date financial results of its operating activities.

Conclusion

Case studies such as this illustrate that directors, corporate officers and other stakeholders require, but do not necessarily have, access to continuously current financial information – and that equates to *quality* financial details about the entity they direct, manage or in which they otherwise invest.

The circumstances of other more recent cases for example One.Tel, HIH, Waterwheel in Australia; Enron and WorldCom in the U.S., as reported in the financial and popular press also serve to illustrate the essential nature of up-to-date financial information with regard to a business and its daily operations, its capital structure and financial performance, its inter-action with creditors, consumers and the ever-changing market environment. Stories of this nature focus particularly on the indispensable attributes of cash and ready access to cash for any entity intent on continuing and expanding its business activities in a dynamic market environment.

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²⁶ Refer for instance: ACA (s.95A, s.588).

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