

Predicting default of a small business using different definitions of financial distress

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Abstract

The presentation introduces a number of risk-rating models for the U.K. small businesses using an accounting-based approach, which employs financial ratios to distinguish between defaulting and non-defaulting firms and to predict corporate bankruptcy. A common problem with default prediction consists in a small number of bankruptcies or real defaults available for analysis. The presentation contemplates adopting less strict definitions of default by considering different levels of financial distress and investigates the impact of different definitions on the choice of predictor variables and predictive accuracy of the model. The analysis demonstrates that each definition considered leads to a different model. The presentation describes the variable composition of these models, compares their predictive accuracy and comments on the suitability of each approach used.