

Evaluating Firms in Financial Failure in Malaysia: A Case of Shariah Compliant Stocks

Norashikin Ismail

Faculty of Business Administration
University of Technology MARA Johor
Jalan Muar, 85009 Segamat
Johor
noras479@johor.uitm.edu.my

Assoc. Prof. Dr. Omar Samat

Faculty of Business Administration
University of Technology MARA Johor
Jalan Muar, 85009 Segamat
Johor

ABSTRACT

A recent issue on financial failure is an essential focus of attention in ensuring the wealth of investors being protected. It is important to examine financial failure in early stage before firms go bankrupt. This study is empirically examined the behaviour and causes of financial distress in Islamic capital market focusing on Shariah compliant firms. In order to maintain the efficiency of the Islamic stock market, a study on the corporate financial failure is required. A sample of 78 distressed firms is found from Shariah compliant firms between 2000 and 2003. An analysis of operating, liquidity and financial performance is the main indicator to financial distress firms. The evaluation of financial distress is conducted before and during the first two years of distress. A logistic regression models have been employed to investigate the contributory factors of financial distress. The findings reveal that poor operating performance and liquidity has significant effect on financial distress one year prior to distress year. In addition, poor operating performance seems to exist in the first year of shortfall and became better in the second year of distress. A leverage effect is not play a greater role in the year prior to distress, during and after distress year in such that only INTEXPAS shown a significant effect.

Keyword: Financial Failure, Operating, Leverage effect, Logistic Regression; Shariah Compliant Firms

1.0 Introduction

Generally, all public listed companies are exposed to financial failure. Financial failure is a crucial issue in company business operation that normally arose when economy is in recession. For example, the Asian crisis, which in year 1997-1998 had brought pressure on performance of major companies in Asian economies. Specifically, the Malaysia financial crisis started to begin in early 1998 with devaluation of Ringgit. A depreciation of Malaysia ringgit had triggered a concern to corporate world whereby few companies are facing financial failure. This Asian economic crisis and currency issue had forced unstable Malaysian companies to collapse particularly companies listed on the Bursa Malaysia, formerly known as Kuala Lumpur Stock Exchange (KLSE).

In addition, there is a downward slide in the performance of stock market when the Kuala Lumpur Stock Exchange Composite Index (KLSE CI) recorded its lowest level at 262.70 points on September 1, 1998. Due to this, it has created awareness to investors on financial failure issue matter known as corporate failure. Corporate failure is a process, which starts with management defects, leading to poor decisions that cause financial deterioration which eventually resulting in corporate collapse. Prior studies showed that financial failure were mainly from economic distress rather than financial distress. Argument of financial failure is still being discussed at present.

According to Steim (1984) defined failure as a non-performance of something due, required or expected. Firms are found to be in financial failure when they are facing a default on payments of massive loans or deficit in their shareholders' fund due to accumulated losses. The losses suffered by firms came mainly from poor operating performance. Meanwhile, Altman (1993) described failure is a situation when the company does not earn an adequate return on risk capital and can go on doing this for years without closing down. Nevertheless, a financial failure could turn into insolvency condition when firms are facing liquidity constraint, as firm liabilities exceed a fair valuation of its assets. Consequently, firms would have to forgo a positive NPV investment and financial distress will occur.

On the other hand, the evolution of Islamic financial system began in early 1980. Being the first Islamic bank, Bank Islam Malaysia had offered Islamic banking products and services. This is a pioneering stage the Islamic financial system took place as the financial market transactions, operations and services must comply with Islamic rules, principles and code of practices known as Shariah principles. The Malaysian Islamic financial system runs parallel with its mainstream counterpart and claims Shariah legitimacy by virtue of contracts (aqd) employed in financial transaction. As the industry grew, numerous products and services in insurance and capital market sectors were adapted to incorporate Shariah compliant aspects.

Importantly, in 1997 the Securities Commission had created a list of Shariah compliant stocks with nearly 65% of total stock listed in Bursa Malaysia. Hence, new Islamic capital market came into existence in Malaysia. In tandem with development of Islamic capital market, Bursa Malaysia has launched the Kuala Lumpur Shariah Index in April 1999. This

meant to keep track with the performance of Shariah compliant stocks. A rapid growth of Shariah compliant stocks proved that investors are aware and interested to participate in Islamic capital market. Recently, the number of Shariah compliant stocks had increased from 65% in 1997 to 86% at the end of 2006.

1.2 Problem Statement and Objectives

A concern appeared when the 1997 Asian financial crisis occurred in line with the existence of Islamic capital market. A central question whether the financial crisis may threaten new journey of Islamic capital market in Malaysia. There is a possibility that drives firms into financial failure from Shariah compliant firms. Here, a financial failure refers to financial distress. Financially distress firms may cause investors to lose their invested money and distract supplier of funds specifically Muslim investors to make investment in the Shariah compliant stocks. Furthermore, investors feel fear to contribute more funds in supporting the growth of Islamic capital market. Therefore, the integrity and efficiency of Islamic capital market should be maintained through protecting Shariah compliant firms from financial distress.

In preventing bad reputation to the Islamic capital market, it is important to preserve investors' wealth by ensuring security to their investment. Due to this circumstance, it is essential to evaluate the performance of financial failure among Shariah compliant firms before they are in peril. In regard to this, there is a need to investigate nature of financial failure either coming from financial distress or economic distress. Therefore, this study aims to examine the determinants of financial distress in Islamic capital market context. Specifically, the study is to determine whether poor operating performance or leverage effect is the main contributor of financial distress.

2.0 Literature Review

A wider research has done on the corporate financial failure covering financial distress and bankruptcy issues for the last four decades. This corporate failure problem exists in the modern economies, having significant on economic and social implications. The impact of the economic downturn related to business cycle fluctuations and financial distress had increasingly interest and attention in finance. However, nothing much studies have done on Islamic capital market compare to modern capital market.

A study by Fazzari, Hubbard and Petersen (1988) indicate firms fall in financial difficulty when the net income less than or equal to zero in the previous year or by negative sales growth rate. Similarly, Platt, D (2002) state firms are classified as financial failure if the operating income is negative for several years, suspensions of dividend payments and major restructuring layoff.

Kahl (2001) indicates financial distress is when a firm cannot meet its debt obligation or has to structure its debt to avoid a default. Due to inability to pay debt payments, it leads to acquisition or liquidation of a firm.

Based on Sanjai, Nathalie, and Inchul (2005) studies, they identified financially distressed firms using five alternative proxies by identifying firms with negative net income for the previous years, negative real sales growth, low payout ratio and tangibility ratio. Also, they state firm experiences financial distress when its cash inflow is insufficient to meet its contractual obligation. A situation appears as the firm is in financial trouble by looking at the operating performance in terms of operating losses. Thus, lacks of immediate profitable opportunities and only opt to size down its' operation. The impact of these financial distress firms is trying to reduce its investment from previous year since lack of internal funds.

In Islamic perspective, any financial failure could lead to bankruptcy which known as Al Iflas or Al Taflis. Based on Kamal Latiff, he described Al Iflas as situation where a person is insolvent, which means become reduce from the state of ease or competent or richness to a state of difficulty or poverty. The impact on a company that faces a difficulty in financial is negative in the sense that growth of the company is not possible in the future.

The existing bankruptcy and distress literature cites two main causes of financial distress: debt overhang and economic distress. However, a study by Whitaker (1989) found that more firms enter financial distress as the result of poor management than as the result of economic distress. Similarly, Barker and Mone (1994), Hambrick and Schecter (1983), Hofer (1980), Hoffman (1989), indicated that corporate failure due to the decline in the performance, which was due to managerial inaction, poor timing and lack of intensity and poor implementation of turnaround strategies.

A further study has been done by Kam, Citron, and Muradaoglu (2005) on the nature and cause of financial distress in an emerging market context. The study investigates the characteristics of a sample of 100 distressed firms in China between 1999 and 2003. The finding reveals the corporate distress in China is caused by firm level poor operating performance and not by leverage.

3.0 Research Methodology

3.1 Sample and Data

Initially, there were 357 Shariah compliant firms listed in Main Board of Bursa Malaysia stated in the year 2000. Firstly, a sample selection procedure is designed to identify firms in financial failure known as financial distress. Few of definitions of financial distress have been used. Following literature used by Kahl (2001) and Kam, Citron and Muradaoglu (2005), this study attempts to define financial distress based on interest coverage.

Based on Kam, Citron and Muradaoglu literature, firms are classified as financial distress when the interest cover ratio is below one. A sample of financially distress firms are collected from the year 2000 till 2002.. In order to include in the sample, Shariah compliant firms have fulfilled the criteria of financially distress if the interest coverage less than one

in at least one year between from year 2000 till 2002. For the first three years starting from year 2000 when firm meets interest coverage criteria is denoted as year 0. So, year -1 is the year prior to onset of distress and year 1 is the second year after the ending sample year, 2002.

Certainly, only 257 Shariah complaint firms are found in the Worldscope DataStream. Due to incomplete and unavailability data, the final sample consist of 179 failure firm and 78 healthy firms. The healthy firms are randomly matched with failure firms. The financial data are collected from World Scope Data Stream focusing on financial ratio as well as accounting data on Profit and Loss account and Balance Sheet.

3.2 Method

The primary objective is to test the causes of financially distress stems from Shariah Compliant firms. In order to achieve this, a range of accounting ratios specifically interest coverage have been applied to examine the characteristics of our sample of distressed firms. Then, a logistic regression was employed as the appropriate statistical technique to estimate the probability of an event occurring. Under logistic regression, backward stepwise methods are used to analyse the variable one by one. This study is to evaluate the operating and financial performance from the onset to resolution of financial distress.

The first step in the process is to classify the group into two. In this case, firms are coded as 0 for financial distress and 1 for healthy firms. Subsequent to the identification of groups, collection of group element data follows.

The logistic regression approach model can be written as follows:

$$\text{Log} [P_i / I - P_i] = B_0 + B_1X_{i,1} + B_2X_{i,2} + \dots + B_kX_{i,k}$$

3.3 Variables selection

The dependent variable is a dummy variable representing the value of zero if the firm is in distress and one otherwise. This study expect leverage, operating performance, investment behaviour and other firm characteristic have significant effect on the causes of financial distress.. Hence, the independent is a vector of performance ratio prior to the onset of distress across the following categories: operating performance, financial performance and liquidity.

In determining financial distress firms, the interest coverage is a key measurement. The interest coverage is defined as earnings before interest tax depreciation and amortization divided by interest expenses. Four ratios are used as a proxy of operational performance that includes SALAS denotes the ratio of sales over total assets; EBITDAAS denotes the ratio of earnings before interest tax depreciation and amortization over assets; EBITDASAL denotes the ratio of earnings before interest tax depreciation and amortization over sales and OPM denotes the ratio of operating profit over sales. From

operating performance, it measures the firm's viability. The efficiency of utilizing assets in generating sales and return also play an important role in operational activities looking at SALAS and EBITDAAS.

For financial performance, there are four indicators applied in this study. The first indicator is leverage measured by the ratio of total debt over by total assets as a proxy for bank lending. The tendency to firms fall in distress can be explained by higher leverage ratio. Another two indicators are CLIABAS denotes the ratio of current liabilities over assets and INTEXPAS denotes the ratio of interest expenses over assets. Both ratio concerns with financing activities of firms measuring the capability of distressed firms used to support investment in assets and cover its debt obligation. Finally, the CASCLIAB denotes the ratio of current assets over current liabilities as a proxy for liquidity. A firm is said to be in liquidity constraint when there is insufficient of current assets to cover debt obligations.

Previous studies have shown that the operational, leverage and the liquidity have significant effect on financial distress. The expected sign for operating performance is negative indicate that poor operating performance could lead to financially distress. This is because of inefficiency of firm in generating sales and return. For leverage, the expected sign is positive whereby a large of debt structure could easily drives firms into distress condition. However, a negative sign of liquidity is expected representing the higher the liquidity ratio, the lesser for firms enter to financial distress

4.0 Findings

It seems that 78 Shariah compliant firms are found to be in distress condition, whereby 29 firms have interest coverage below one for one year. While, another 36 firms have interest coverage less than 1 for two years and the remaining are facing interest coverage problem in three consecutive years.

In this section, evaluation of operating and financial performance for financial distress firms is discussed in detail. Firstly, Table 1 illustrates the descriptive results of 78 distressed firms during distress period between year 2000 and 2002. It shows that the operation of financial distressed firms are not performing well during distress years as the mean of EBITDAAS and OPM are recorded at -0.405 and -37.753 respectively. A negative value of EBITDAAS and OPM indicates the firms have obtained a negative operating income. Besides that the gap between minimum and maximum for operating variables are large as indicated by EBITDAAS, OPM, EBITDASAL and SALAS.

Table 1: Descriptive Statistics for 78 Distressed Firms Between Year 2000 and 2002

Variables	Mean	Min.	Max.	Std Dev
EBITDAAS	-0.405	-42.209	2.864	3.259
OPM	-37.753	-1382.58	25.57	156.156
EBITDASAL	0.186	-38.93	48.784	5.422
SALAS	0.145	-81.715	25.367	8.265
INTEXPAS	0.079	-1.274	9.446	0.678
CLIABAS	-0.002	-87.974	31.082	9.822
LEV	0.157	-86.732	637.02	9.654
CASCLIAB	2.122	0.034	61.586	6.737

Notes: This table provides the descriptive statistics of the variables for financial distress firms and healthy firms during selected distress years. The EBITDAAS represents the operational performance indicator as measured by the ratio of earnings before interest tax depreciation and amortization over assets. The second operational performance is OPM calculated as operation profit over sales. The EBITASAL represents the third operational performance indicator and given by the ratio of earnings before interest tax depreciation and amortization over sales. SALAS represents fourth operating performance indicator and is calculated by sales over assets. INTEXPAS represents financial performance indicator as measured by the ratio of interest expenses over assets. Another financial indicator is CLIABAS calculated as by the ratio of current liabilities over assets. LEV is a proxy for bank lending and is given by the ratio of total debt over assets. CASCLIAB represents liquidity indicator and measured by the ratio of total current assets over current liabilities.

In addition, Table 2 reveals the summary of descriptive statistics of 78 distressed firms for pre and after distress year.

Looking at above Table 1, it presents the mean for INTEXPAS and LEV is positive. This means firms still facing with debt burden including the interest obligation during distress years. However, only CLIABAS has negative mean of -0.002. It proves that most of assets are financed in long run rather than short run. A small proportion of current liabilities have used to invest assets in financially distressed firms. The mean for liquidity ratio is 2.122 indicates firm have sufficient current assets to cover current debt obligations. There is big gap between minimum and maximum of financial indicators and liquidity during distress years.

A descriptive statistics at the onset of financial distress until the second year are presented in Table 2. The onset of financial distress begins in year 1999 and year 2003 as the second financial distress year.

Table 2: A summary statistics of 78 distressed firms for year 1999 and 2003.

Variables	Prior to Distress Year Year 1999				Second Distress Years Year 2003			
	Mean	Min.	Max.	Std Dev	Mean	Min.	Max.	Std Dev
EBITDAAS	-0.1250	-4.308	0.3473	0.643	0.106	-2.673	4.084	0.677
OPM	-23.054	-843.620	40.950	108.198	-34.068	-733.48	45.980	100.816
EBITDASAL	-0.088	-2.498	1.3497	0.612	0.145	-6.519	8.228	1.426
SALAS	0.140	-55.530	10.164	7.116	0.764	-11.337	16.237	2.746
INTEXPAS	0.0004	-4.995	0.883	0.640	0.057	0.231	1.049	0.175
CLIABAS	0.081	-52.969	12.697	7.211	0.386	-30.048	17.085	4.638
LEV	0.455	-46.338	6.801	5.987	0.391	-16.199	13.773	2.775
CASCLIAB	1.158	0.160	4.729	0.869	2.602	0.087	71.372	8.790

Notes: This table provides the descriptive statistics of the variables for financial distress firms one year before and after the distress years. The EBITDAAS represents the operational performance indicator as measured by the ratio of earnings before interest tax depreciation and amortization over assets. The second operational performance is OPM calculated as operation profit over sales. The EBITASAL represents the third operational performance indicator and given by the ratio of earnings before interest tax depreciation and amortization over sales. SALAS represents fourth operating performance indicator and is calculated by sales over assets. INTEXPAS represents financial performance indicator as measured by the ratio of interest expenses over assets. Another financial indicator is CLIABAS calculated as by the ratio of current liabilities over assets. LEV is a proxy for bank lending and is given by the ratio of total debt over assets. CASCLIAB represents liquidity indicator and measured by the ratio of total current assets over current liabilities.

It shows that the operating performance is weak with the mean for EBITDAAS, OPM and EBITDASAL are negative value prior to distress year. The operational performance became better in second distress years when the mean for EBITAAS had increased from -0.1250 in year 1999 to 0.106 in year 2003. Also, the EBITDASAL had improved its mean from -0.088 in year 1999 to 0.145 in year 2003. Again, the mean of SALAS is 0.140 before distress year and increased to 0.764 in post distress year. However, the operating profit margin (OPM) is not showing any improvements as the mean decreased to -34.068 in year 2003. Certainly, there is an improvement in operational performance from the onset of financial distress until the second year except for OPM indicator. Overall, the operational performance is getting better from the onset until the second financial year.

Prior to the distress years, the mean of INTEXPAS, CLIABAS, LEV and CASCLIAB are recorded in positive value. The financial position is quite stable when the mean of

INTEXPAS and CLIABAS is 0.0004 and 0.081 respectively. Then, mean for INTEXPAS and CLAIBAS increased to 0.057 and 0.386 in year 2003. The leverage had improved as the mean of 0.455 in year 1999 decreased to 0.391 in year 2003. In addition, more capability to cover current obligation are found when the CASCLIAB had recorded at 1.1581 in year 1999 to 2.602 in year 2003.

The main interest of this study is to examine the causes of financial distress. Before examine the determinants, it is essential to evaluate the nature of financial distress. Below is the Table 3 that evaluates the performance of financially distressed firms during the selected sample period, from year 2000 until 2002. The performance can describe into three main categories; operating, financial and liquidity. As been mentioned earlier, the definition of distress is based on interest coverage for any of three consecutive years between year 2000 and 2002.

There is conflict in operating performance results when the EBITDAAS and EBITDASAL shown a different sign. Supposedly, a low level of operational could contribute to financial distress as the coefficient of EBITDASAL is -0.511 at 1% significance level. Then, the coefficient of EBITDASAL changed to 3.942 at 5% significance level in year 2001. Alternatively, the coefficient of EBITDAAS is showing a positive value of 14.590 at 1% significance level and 13.835 at 5% significance level in year 200 and 2002 respectively.

Similarly, OPM and SALAS had a positive significant effect during the financial distress years with the coefficient of 0.180 and 0.628 at 1% significance level and 5% significance level. The poor performance was found during distress years, starting from year 2000 till 2002. Again, OPM has positive significant effect on distress with coefficient of 0.191 at 1% significance level in year 2002. Overall, there is a mix sign shown in the operational indicator shown during distress year with negative and positive sign as indicated by EBITDASAL, EBITDAAS, SALAS and OPM.

For financial performance indicator, only INTEXPAS has negative significant effect with the coefficient of -20.354 at 5% significance level as shown in year 2001. This indicates a low of INTEXPAS value tends to increase tendency of financial distress to occur. For liquidity, there is positive significant effect between CASCLIAB and financially distress firms with the coefficient of 0.375 at 5% significance level. Based on BASCLAIB, the ability to cover debt obligations plays an important role in financial distress matter.

Table 3: Operating and Financial Performance of Distressed Firms during Distress Years from Year 2000 till 2002

Variables	Year 2000		Year 2001		Year 2002	
	β	p-value	β	p-value	β	p-value
Constant	-1.122	0.039	-0.817	0.083	-0.757	0.079
EBITDAAS	14.590	0.000***	0.540	0.790	13.835	0.001**
OPM	0.007	0.182	0.180	0.000***	0.191	0.000***
EBITDASAL	-0.511	0.000***	3.942	0.027**	1.059	0.514
SALAS	-0.363	0.203	0.628	0.031**	-0.041	0.860
INTEXPAS	6.344	0.343	-20.354	0.020**	-6.215	0.035
CLIABAS	0.249	0.218	0.054	0.919	0.579	0.025
LEV	-0.810	0.301	0.423	0.594	-1.040	0.019
CASCLIAB	0.375	0.034**	0.007	0.893	0.106	0.013

Notes: This table illustrates the determinants of financial distress between year 2000 and 2002. The operating performance is explained by EBITDAAS, OPM, EBITDASAL and SALAS. For financial performance, the indicator is INTEXPAS, CLIABAS and LEV. The liquidity indicator is CASCLIAB.

*** 1% significance level

**5% significance level

A further analysis of financial failure performance was explained in Table 4, focusing on pre and post financial distress years. Looking at Table 4 below, it depicts the causes of Shariah compliant firms that contribute to financial distress one year before and after distress years. A selected sample of financial distress firms was chosen between year 2000 till 2002 based on interest coverage.

Table 4: Determinants of Financial Distress for 78 Firms

Variables	Prior to Distress Year (t -1)			Second Year Financial Distress Year (t +1)		
	β	SE	p-value	β	SE	p-value
Constant	1.542	0.544	0.005	0.156	0.314	0.619
EBITDAAS	-4.361	1.041	0.000***	0.022	0.842	0.980
OPM	0.014	0.005	0.002***	0.119	0.022	0.000***
EBITDASAL	-7.295	1.541	0.000***	-0.547	0.528	0.299
SALAS	-0.529	0.267	0.048**	0.701	0.261	0.0074***
INTEXPAS	6.384	10.890	0.558	-11.646	5.801	0.045**
CLIABAS	0.867	0.885	0.327	-0.205	0.624	0.743
LEV	-0.851	0.891	0.340	0.055	0.892	0.950
CASCLIAB	-0.528	0.280	0.060*	0.047	0.033	0.146

Notes: This table illustrates the determinants of financial distress between year 2000 and 2002. The operating performance is explained by EBITDAAS, OPM, EBITDASAL and SALAS. For financial performance, the indicator is INTEXPAS, CLIABAS and LEV. The liquidity indicator is CASCLIAB.

*** Significance level at $\alpha = 0.01$

**Significance level at $\alpha = 0.05$

It is proven that poor level of operating performance is the main contributor to financial distress. This has been demonstrated through three of operational indicators; EBITAAS, EBITASAL and SALAS have a negative significant effect on financial failure known as financial distress. From Table 4, it shows that the coefficient for EBITDAAS is -4.361 at 1% significance level. There is an inverse relationship between EBITDAAS and financial distress. This means the more operating income denoted by EBITDA, the lesser tendency to fall in distress condition. Similarly, the coefficient for EBITDASAL is -7.295 at 1% significance level. It indicates the higher the ratio of EBITDASAL, low probability to enter into financial distress. But, OPM has a positive significant effect to financially distress firms with the coefficient of 0.014 at 5% significance level.

The efficiency of operating can explain in term of how firms utilize its assets in generating sales measured by SALAS. Based on Table 4, there is negative significant effect of SALAS to financially distressed firm with the coefficient of -0.529 at 5% significance level. Assets are said to be efficient if generate more revenue which eventually could prevent financial distress to occur. Besides that, liquidity is another contributor to financial distress with the

coefficient of CASCLIAB is -0.528 at 10 % significance level. A negative CASCLIAB indicates a high liquidity constraint could cause more firms to enter in financial distress. None of financial performance indicators show a significant effect on financial distress. In short, it concludes that the poor operating has a significant effect and not leverage effect.

In the second year of shortfall, OPM and SALAS show a positive significant effect toward financial distress. This can be seen in Table 4 when the coefficient of OPM and SALAS is 0.119 and 0.701 at 1% significance level respectively. A positive value of OPM and SALAS explained the more revenue generated from operating more tendency financial distress to exist. It is conflict with

However, there is leverage effect after the distress year when the coefficient of INTEXPAS is -11.646 at 5% significance level. This indicates the higher the value of INTEXPAS, more leverage effect to the distressed firms.

5.0 Conclusion

The issue on financial distress has long been a subject of debate in finance. Financial distress is a situation where companies are unable to pay their debts or have negative shareholders fund arising from a huge losses and debt burden. In this study, firms are classified as financially distress if the interest coverage is below 1 in any of three consecutive years.

In real life investors concern on financial distress matter because it affects the firm's value as well as shareholders' wealth. An opportunity to explore the Islamic capital market specifically for Shariah compliant stocks regarding of the financial failures should be done. Hence, this paper is focused on the financial distress to Shariah Compliant firms listed in Main Board of Bursa Malaysia

This paper has analysed distressed firm's operating efficiency and financial performance starting from its onset to the first two years of distress for 78 firms that became distressed between 2000 and 2002. Therefore, this study aims to investigate the behaviour of financially distressed firm focusing on the operational, financing and liquidity performance.

The results confirm that poor operating performance is the main contributor of financial distress in the Islamic capital market proven by the EBITDAAS, SALAS and EBITDASAL has negative effect on financially distress. A good operating performance would prevent firms enter into financial distress. In the first year of shortfall, a slightly bad operating performance was found as measure by EBITDASAL. However, the operational had improved better in the second year of distress.

The leverage effect is not plays its essential role to financial distress because only INTEXPAS has negative significant effect on financial distress during and second year of distress. A high investment in assets through debt financing create interest obligation that

cause financial distress to occur. This result is in line with Kam, Citron and Muradoglu (2005) which states that corporate distress in China is caused predominantly by firm poor operating level, not by leverage.

As conclusion, the contribution of this study is useful of users such as investors, shareholders, financial institutions, creditors, bankers and managers in developing market efficiency in Islamic perspective. In order to achieve this, monitoring the operational, financing, liquidity and investment performance of distressed firms play greater role for evaluation purpose.

In examining the determinants of financial distress, it is recommended to include the investment behaviour, ownership structure for further research. A study of second board firms is suggested to investigate the size effect on financial distress.

References

- Altman, E. I. (1993) "Corporate Financial Distress and Bankruptcy", New York: John Wiley and Sons.
- Barker III, V. L. and M. A. Mone (1994) 'Retrenchment: Cause of Turnaround or Consequence of Decline', *Strategic Management Journal*, 15, 395-405.
- Fazzari, S. M., Hubbard, R.G., and Petersen, B.C., (1988) 'Financing Constraints and Corporate Investments', *Brookings Papers on Economic Activity* 1, 141-195.
- Hambrick, D. C. and S. M. Schecter (1983) 'Turnaround Strategies for Mature Industrial Product Business Units', *Academy of Management Journal*, 23: 2, 231-248.
- Hofer, C. W. (1980), 'Turnaround Strategies', *Journal of Business Strategy*, 1:1 Summer, 19-31.
- Hoffman, R. C. (1989), 'Strategies for Corporate Turnaround: What Do We Know About Them?', *Journal of General Management*, 46, 46-66.
- Kam A, Citron D, Muradoglu G. (2005) 'The Characteristics of Corporate Distress in an Emerging Market: The Case of China', Cass Business School Research.
- Kahl, M. (2001) 'Financial Distress as a Selection Mechanism: Evidence from the United States', *Journal of Finance*.
- Platt, H.D. and Platt M.B. (2002) "Predicting Corporate Financial Distress: Reflections on Choice-Based Sample Bias", *Journal of Economics and Finance*, 26:2, 184-199.
- Sanjai, B., Nathalie, M. and Inchul, S. (2005) 'Investment and Internal funds of Distressed Firms', *Journal of Corporate Finance*, 11, 449 - 472.
- Smith and Graves (2005) "Corporate Turnaround and Financial Distress", *Managerial Auditing Journal*, 29:3, 304-320.
- Sudarsanam S. and Lai J. (2001), 'Corporate Financial Distress and Turnaround Strategies: An Empirical Analysis', *British Journal of Management*, 12, 183-199.
- Taffler, R. J. (1982), ' Forecasting company failure in the UK using Discriminant Analysis and Financial ratio data', *Journal of the Royal Statistical Society, Series A*, pp .145, 3, 342-358
- Whitaker, R.B. (1999) "The Early Stages of Financial Distress", *Journal of Economics and Finance*, 23:2, 123-133.