Qualitative models of corporate failure:

Argenti and Z scope are the example of qualitative models

Argenti	**Score 25 or above** is symptom of failure within next two years	**Subjective model/scoring** based on qualitative analysis and analyst's personal opinion
Z Score	**Score 1.8 or below** is symptom of failure within next two years. Score GE 3 is good	Based on absolute public's available information **used to calculate the score.** Hence **Based on Objective score.**

- **Both the models include a score** and scores are given based on **qualitative factors/variables.**
- **Qualitative factors include:** defects, mistakes and symptoms of corporate failure.
- **Advantage of this Z model is:** it is easy to calculate and they provide an objective measure of failure. Other advantage is: **they contain both financial and non-financial measure**, which makes the information complete. It is also advantageous **as it includes judgement of the investigator** but it is disadvantageous at the same time, as the **investigator may include judgement always in line with the findings from financial ratios** or initial findings without considering changes.
- **Disadvantage of this model is:** it can be manipulated with creative accounting. If that happens, it will appear as a sign of corporate failure anyways.

ARGENTI MODEL

It is divided into three main areas, which are then subdivided into multiple subareas. Each of the subareas is scored and if the **addition of all scores is more than 25**, then the company is likely to fail. However most of the companies, which are failing or likely to fail; score very high, around 60 or more. In addition to the total score; scores of the three main areas are also checked and reviewed for the purpose of them to reveal something. **For example a high score in Mistakes made**, will reveal poor management. Company should do all it can to avoid insolvency.

- **Defects are:** Defects are divided **into management defects and accounting defects**.
  - **Management defects** are about character or strength of senior management. Fault in organization structure. CEO & MD positions are held by same person, an autocratic CEO, a passive board of directors, top management leaving the company, poor skills and experiences in management team and a poor record of responding to external/internal changes by the organization.
  - **Accounting defects:** lack of budgetary control system, lack of cash flow planning or a proper costing system in place. These generic topics need to be then applied to the specifics of the question.
- **Mistakes are:** Mistakes happen because there were defects at the first place. They are interconnected. If the management and accounting system is weak then mistakes are bound to happen**. High gearing** (Debt/Equity ratio goes beyond previous gearing ratio), **Overtrading** (Rise in revenue with the help of debt funding**), failure of large and important projects**. These areas are under direct control of the managers and failures in these areas happen due to poor management of the top management. These generic topics need to be then applied to the specifics of the question.

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- **Symptoms of corporate failure are:** Once there are defects found and mistakes made – there will be visible symptoms of failure be shown in lot of different areas; **such as:** qualified audit opinion in a row for many years, high staff turn-over, low interest cover ratio **(more the value, it is better) (PBIT / Interest Charged),** high operational gearing (fixed cost / total cost), police investigation of theft, director's resignation, extended overdraft, senior management leaving the company, share price dropping, dependence on a single or few customers or suppliers, poor ratios in the financial statement, use of creative accounting, frozen salary, delayed investment projects, falling market share, and there are a lot of bad press about the company in the media. These generic topics need to be then applied to the specifics of the question.

Z SCORE:

Z = 1.2 X1 + 1.4 X2 + 3.3 X3 + 0.6 X4 + X5

- = 1.2 (**X1 =** Working capital / Total Assets) + 1.4(**X2 =** Retained Earning / Total Assets) + 3.3 (**X3 =** Profit before Tax and Interest / Total Assets) + 0.6 (**X4 =** Market value of equity / Total long term debt) + 1 (**X5 =** Revenue / Total Asset)
- Qualitative models such as Z score use publicly available financial information and predict whether a company is likely to fall within two year period.
- The model uses a financial model equation, into which various financial data is input and a score is obtained.
- Advantage of this model is: it is easy to calculate and they provide an objective measure of failure. Other advantage is:
- Disadvantage of this model is: it can be manipulated with creative accounting. If that happens, it will appear as a sign of corporate failure anyways.
- Qualitative models actually fulfil the shortfalls/ complete the limitation in the financial ratio measures. Financial measures are limited in describing actual status of a company.
- Prediction of failure for companies with score below 1.8 is just a probabilistic one, not a guarantee. There is no detail analysis for the companies with performance score within the grey area 1.8 – 3.0.
- The model or equation was developed with statistical data of some companies analysing their historical financial data. Hence the model should not be applicable to any other company unless they are of same size, operating in the same market condition, economic condition and with same resources.
- A score below 1.8 is dangerous and indicates bad performance or corporate failure WITHIN NEXT TWO YEARS and a scope above 3 is generally good.
- Each component of the Z score formula is a variable for the Z score and they can individually explain their contribution to the rise/fall of the Z score.
- Then the information from the question can explain why the variable is falling. For example: debt level has been building up due to investment programmes and share prices and market value has fallen by 14% due to that.
- Once the reason for the performance has been figured out, we need to validate the relative performance by comparing our results with that of the competitors or market standard or

benchmark data. This will confirm whether the problem is with the company itself or with the current economic climate or general market condition.

- There could be issue with more than one variable components of the Z score formula. One such variable is profit derived from the asset invested. It may so happen that the profit will be realized from secondly year onwards, not from the year of investment and it will increase gradually but the asset value will increase immediately as soon as investment is made.

CONCLUSION FROM QUALITATIVE MEASURES:

- The qualitative models may imply or relay only bad points. However company may do well at the same time with its financial results (Rise in revenue, rise in profit etc). Increase in revenue and profit means that the product of the company is being liked by the customer. But that does not mean it is going to continue like this. Once the product is out of production and is adopted by the customer, the financial ratios may change and it will tally up with the opinion of the qualitative model measures.
- In order to confirm that the initial bleak results of financial measure are only temporary; further data will be required; which are:

Issue	Why	Solution
Interest Coverage Ratio going down. **Gearing Ratio is going up.**	No money available in the bank. Current Ratio is less than 1.	Cash-flow projection To confirm that the product will pay for investment with its maturity
Decline in Operating Martin need explanation	This is purely because of management control. Operating expenses are in control of the department managers. (Gross Profit – Operating Expenses = Operating Profit). Operating Profit / Revenue = Operating Margin.	**Detailed Analysis of Cost; costing system** – or using models such as Activity Based Costing or Kaizen model of costing; will analyse the cost at a detailed level, improve the cost continuously and help in improving the margin.
Share Prices going down	It is concerning as it affects consumer impression or external impression, shareholder values and Equity position of the company	Share price of the company's share need to be compared with market standard, competitor's share price and reviewed in light of general market condition. This is confirm whether there is a generic market condition or economic condition, which affects all companies in the market or it is something specific to the company being analysed.
In the early stages of the product/project life-cycle; when capital spending is high and returns are yet to be		**NPV (Net Present Value) & IRR (Internal Rate of Return).** NPV returns an absolute profit figure, whereas IRR returns a

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realized various financial ratios may appear bleak.		profit percentage. In the NPV method, revenue and cost of the project are calculated, discounted to present value – and then they are compared to the initial investment over the entire life cycle of the project or product. Projects/Products with negative NPV should be rejected, as these means s that the projects/product cannot recover its initial cost of project.
Revenue going down		