

SCORING AS AN INDICATOR OF FINANCIAL STABILITY

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This article presents a financial scoring model estimated on Czech corporate accounting data. Seven financial indicators capable of explaining business failure at a 1-year prediction horizon are identified. Using the model estimated in this way, an aggregate indicator of the creditworthiness of the Czech corporate sector is then constructed and its evolution over time is shown. This indicator aids the estimation of the risks of this sector going forward and broadens the existing analytical set-up used by the Czech National Bank for its financial stability analyses. The results suggest that the creditworthiness of the Czech corporate sector steadily improved between 2004 and 2006.

1. INTRODUCTION

Credit scoring methods are a standard part of financial institutions' risk management processes. They allow lenders to rate the creditworthiness of their potential debtors by estimating the probability of default,¹¹⁸ with the aim of maintaining a high-quality loan portfolio. The most common type of credit scoring used in banks for the legal entities segment is financial scoring. In this case, companies are rated using financial indicators based on their accounting statements. The financial scoring process generates a score expressing the company's creditworthiness. This type of model can be applied analogously to aggregate economic data to construct a financial stability indicator based on the creditworthiness of the non-financial sector. From the credit risk assessment perspective, the indicator can be used to complement the sectoral macroeconomic models that have been estimated for the Czech economy and incorporated into the banking sector stress tests (Jakubík, 2007a).

This article begins by looking briefly at the definition and estimation of scoring models (section 2). Section 3 discusses the corporate financial indicators that can be used as explanatory variables for business failure. Section 4 contains a description of the data used to estimate the model. The resulting estimated model is presented in section 5, and section 6 then applies the model to data for the entire sector to estimate a creditworthiness indicator for the non-financial corporations sector. The final section summarises the results.

2. SCORING FUNCTION

Scoring models play a role in the decision whether or not to provide a loan.¹¹⁹ In practice, this is done by comparing information available on the client (obtained, for instance, from the client's loan application form or track record) against information on clients to whom loans have been granted in the past and whose quality is known. A predictive scoring model is estimated from the historical information on clients. By applying the model to known information on a potential obligor, one obtains the probability that the obligor will default. The decision is made by comparing the estimated probability of default against some threshold. A survey of these methods in the context of credit scoring can be found, for example, in Hand and Henley (1997) and Rosenberg and Gleit (1994).

A whole range of statistical methods can be used to construct scoring functions, among them linear regression, decision trees, neural networks and expert systems. In practice, however, logistic regression is the most commonly used method. In this case, it is assumed that the explanatory variables multiplied by the relevant coefficients are linearly related to the natural logarithm of the default rate (referred to as the logit – Mays, 2001).

¹¹⁸ Default is generally defined as the failure of an obligor to meet its obligations arising under a loan agreement. The Basel Committee on Banking Supervision (2006) defines default as a situation where at least one of the following events has taken place. The first is the situation where the bank finds that the obligor is unlikely to pay its credit obligations in full, without recourse by the bank to actions such as realising security. The second is the situation where the obligor is past due more than 90 days on any of its obligations. In this article, default will mean the failure of the firm.

¹¹⁹ Altman (1968) and Beaver (1966) studied the prediction of corporate bankruptcy as early as the 1960s. These methods were refined in the 1980s and, in particular, the 1990s by, for example, Dimitras, Slowinski, Susmaga and Zopounidis (1999). In the Czech literature, credit scoring has been studied by, for example, Jakubík (2003).

$$\ln \frac{s}{1-s} = b_0 + \sum_{i=1}^N b_i x_i, \quad (1)$$

where

s - denotes the probability of default of the firm at the one-year forecast horizon,

x_i - denotes the financial indicators of the firm,

b_i - denotes the coefficients of the relevant scoring function indicators.

This equation can then be used to derive the relationship for the probability of default. This relationship can be expressed using a logit curve.

$$s = \frac{1}{1 + e^{-b_0 - \sum_{i=1}^N b_i x_i}} \quad (2)$$

In the case of financial scoring, financial indicators based on accounting data are considered as the explanatory variables. The coefficients of the function can be estimated using the maximum likelihood method (Baltagi, 2002). Owing to the large number of indicators that can be included in the model, stepwise regression is used to select the variables. This method involves testing various combinations of variables maximising the quality of the model. The model works with a binary dependent variable (0/1) and can be constructed for computation of either the probability of default or the probability of non-default, depending on the definition of the independent variable in the regression. If we denote a "bad firm"¹²⁰ with the value 1, the resulting score obtained from the model corresponds to the probability that the firm will default.¹²¹

If we assume that a large number of firms are used in order to estimate model (1), then according to the law of large numbers the variable s in equations (1) and (2) corresponds to the proportion of firms that default at the one-year forecast horizon. Assuming that model (2) is estimated on the set of firms to which the function will later be applied, the outcome of the model truly represents the probability of default. As the ratio of good to bad firms in the sample does not usually match the real situation, and given also that accounting data from various moments in time are taken into consideration, the outcome of the model cannot be interpreted as the probability of default. In this context, variable s is usually referred to as the score expressing the riskiness or creditworthiness of the firm.¹²²

3. FINANCIAL INDICATORS

The financial indicators used as the explanatory variables in model (2) can be broken down according to several perspectives – for example the perspectives of lenders, shareholders or state authorities. It is important to emphasise that there is no clear consensus either in theory or in practice on the ideal method for analysing the financial indicators. In the Czech literature, various authors present various breakdowns of relative indicators – see, for example, Blaha and Jindřichovská (2006) and Kislíngrová (2007). There is a similar lack of unity in the foreign literature – see, for example, Damodaran (2002) and McKinsey et al. (2005).

Given the primary aim of our research, namely to construct a financial stability indicator based on the prediction of business failure, we chose 22 indicators and divided them into four main groups: liquidity indicators, solvency indicators, profitability indicators and activity indicators. The individual financial indicators are given in Table 1. For each indicator we also indicate its theoretical influence on business failure (positive or negative).

¹²⁰ A bad firm is defined here as a firm that defaults during the period under review but was a good firm prior to defaulting. A good firm means a firm that does not default during the period under review.

¹²¹ Some studies, conversely, denote "good firms" with the number 1. In this case, the resulting score represents the probability that the firm will not default.

¹²² The figure obtained can be converted to the probability of default with the aid of a suitable transformation. Either parametric or non-parametric estimates can be used for this purpose.

The liquidity indicators explore the firm's ability to meet its short-term liabilities (r1, r2, r15 and r19) or to cover its long-term liabilities with long-term assets (r10). Generally, higher liquidity implies a lower probability of default. Persisting problems with low liquidity usually indicate problems ahead with meeting long-term liabilities (i.e. declining solvency¹²³), which in the extreme case can result in company failure.

The solvency indicators describe the firm's ability to meet its long-term liabilities. Generally, a higher debt ratio (r3, r4 and r14) and a longer debt repayment period (r9) result in a higher probability of default. By contrast, an ability of the company to generate sufficient funds for debt repayment (r5, r6, r13 and r16) and a higher proportion of internal funds (r17) reduce this probability.

The profitability indicators explain how the company generates profit and the quantity of inputs it uses to do so. Generally, higher profitability implies a lower probability of default (r7, r8, r20 and r21).

The activity indicators measure the efficiency of use of various inputs by the company. From the financial point of view, it would be ideal if the company generated sales/profit by using the minimum amount of resources. Generally, the lower the company's efficiency, the higher its probability of default (r11, r12 and r22). The *sales turnover ratio* (r18) is constructed so that the value of the indicator rises – and the probability of default falls – as the volume of sales rises.

The potential influence of the individual indicators on corporate bankruptcy can be demonstrated on the following simplified example.¹²⁴ One classic symptom of declining solvency is when a company fails to make efficient use of inputs (its activity indicators deteriorate). Cash flows into the firm consequently shrink, leading to a decline in the firm's ability to meet its short-term liabilities (its liquidity indicators deteriorate). Over time, the company proves to be incapable of generating a profit (its profitability indicators deteriorate) to cover its short-term and long-term liabilities (its solvency indicators deteriorate). The firm's liabilities exceed its assets and it goes bankrupt.

To estimate model (1), the financial indicators obtained using the relationships given in Table 1 were further transformed into their relative order vis-à-vis the data sample used. In this way, each indicator value was transformed into a number lying in the range 0–1. This simple transformation makes the model estimate more robust to outlying values of the indicators considered.

Table 1 – Financial indicators

Ratio	Definition	Notation	Expected impact
Liquidity ratios			
Current ratio	$\frac{\text{current assets}}{\text{current liabilities}}$	r1	-
Quick ratio	$\frac{\text{cash} + \text{ST}^{\text{I}} \text{ receivables}}{\text{current liabilities}}$	r2	-
Cash ratio	$\frac{\text{working capital}}{\text{assets}}$	r19	-
Working capital	$\frac{\text{financial assets}}{\text{current liabilities}}$	r15	-
Capitalisation ratio	$\frac{\text{fixed assets}}{\text{long-term liabilities}}$	r10	-
Solvency ratios			
Leverage I	$\frac{\text{debt}}{\text{equity}}$	r3	+
Leverage II	$\frac{\text{LT}^{\text{II}} \text{ debt} + \text{LT}^{\text{II}} \text{ bonds}}{\text{equity}}$	r4	+
Leverage III	$\frac{\text{debt}}{\text{assets}}$	r14	+

¹²³ Liquidity is sometimes referred to as the short-term solvency of a company.

¹²⁴ In this simplified example we ignore alternative ways of restoring the firm to health (e.g. corporate restructuring, debt capitalisation and so on).

Table 1 – Financial indicators – continued

Ratio	Definition	Notation	Expected impact
Solvency ratios			
Debt payback period	$\frac{LT^i \text{ debt} + ST^I \text{ debt}}{\text{operating profit} + \text{interest expenses} + \text{depreciation}}$	r9	+
Interest coverage	$\frac{\text{operating profit} + \text{interest expenses}}{\text{interest expenses}}$	r5	-
Cash-flow I	$\frac{\text{net profit} + \text{depreciation}}{(\text{debt-reserves})/365}$	r6	-
Cash-flow II	$\frac{\text{net profit} + \text{depreciation}}{\text{debt}/365}$	r13	-
No credit interval	$\frac{\text{money} + ST^I \text{ payables} + LT^i \text{ payables}}{\text{operating expenses}}$	r16	-
Retained earnings	$\frac{\text{retained earnings}}{\text{assets}}$	r17	-
Profitability ratios			
Gross profit margin	$\frac{\text{operating profit}}{\text{sales}}$	r7	-
Return on assets	$\frac{\text{operating profit}}{\text{assets}}$	r8	-
Return on equity	$\frac{\text{net profit}}{\text{equity}}$	r20	-
Net profit margin	$\frac{\text{net profit}}{\text{sales}}$	r21	-
Activity ratios			
Average receivable collection period	$\frac{\text{receivables}}{\text{sales}/365}$	r11	+
Inventory ratio	$\frac{\text{inventories}}{\text{sales}/365}$	r12	+
Sales turnover	$\frac{\text{sales}}{\text{assets}}$	r18	-
Payables ratio	$\frac{ST^I \text{ payables}}{\text{sales}/365}$	r22	+

ⁱ Short-termⁱⁱ Long-term

4. DATA USED

For our research we used the large database of the Czech Capital Information Agency (Česká kapitálová informační agentura, ČEKIA), which contains the accounting statements (balance sheets and profit-and-loss accounts) of selected Czech firms for the period 1993–2005. Of the total of 31,612 firms in the database, 932 went bankrupt. Since some of the accounting statements had been completed very sparsely, we focused on the records of firms whose main economic activity (NACE) was filled in, because for these firms most of the accounting items were filled in as well. In order to estimate the scoring function, from the firms that went bankrupt we initially selected only those for which there was accounting data one year prior to the declaration of bankruptcy. There were 151 such firms.¹²⁵ Then, for the sample of firms that did not fail in the period under review we selected only those for which we had accounting statements for at least two consecutive years.¹²⁶ The data sample for the

¹²⁵ We excluded from our analyses those firms which underwent composition. There were only nine such cases in the database. Unlike bankruptcy, composition is not associated with the dissolution of the legal entity (Jakubík, 2007b).

¹²⁶ To estimate the scoring function we need to have corporate accounting data for two consecutive years. The first period is used for estimating the function and the second for identifying the quality of the firm (failed, healthy). If no accounting data are available for the following period, we are unable to determine the quality of the company in question.

estimation of the model was constructed so as to best capture the true data structure. Usually, however, a larger proportion of bad firms than exists in reality is included in the sample so that the good and bad firms can be distinguished using statistical methods. Sometimes a sample containing the same number of good and bad firms is used (Wezel, 2005). Generally, the good firms are chosen so as to be as similar as possible to the bad ones according to selected criteria, for example size as measured by assets, number of employees or sales.¹²⁷ We also randomly selected accounting periods for which statements were available for the immediately succeeding accounting period. In this way we made sure that the firm in question did not fail in the year following the period under review. In all, 606 good firms were ultimately selected using this procedure. The data sample thus contained a total of 757 firms, which were divided into two categories according to whether they went bankrupt in the period following the period for which the accounting data were selected for the company in question. According to the econometric literature, when the event of interest is rare, logistic regression underestimates the influence of the characteristics on the event, so an artificial sample is generated and the estimated values are further transformed so that they match the incidence in the population.¹²⁸

Table 2 shows the breakdown of the data in the database on the selected data sample by accounting period and firm quality (good/bad). In the total data sample, moreover, there exists a set of firms for which we are unable to determine the quality in the given year (indeterminate firms). These are firms for which accounting statements for the following year are not available. Although the database contained accounting data for the period 1993–2005, in the final year it is no longer possible to determine the firm's quality. For this reason, the selected data sample does not cover 2005.

Table 2 – Breakdown of data sample by accounting period and firm quality*

	Total data				Used data sample		
	Total	Undefined firms	Bad firms	Good firms	Total	Bad firms	Good firms
1993	980	89	1	890	1	1	0
1994	1.824	53	0	1.771	4	0	4
1995	5.606	147	0	5.459	13	0	13
1996	7.023	1.032	9	5.982	53	9	44
1997	7.056	1.261	15	5.780	50	15	35
1998	6.802	1.028	12	5.762	48	11	37
1999	7.541	1.307	25	6.209	69	25	44
2000	7.377	3.094	18	4.265	62	17	45
2001	5.660	1.536	5	4.119	40	5	35
2002	7.869	956	8	6.905	57	8	49
2003	22.264	4.420	25	17.819	110	25	85
2004	18.989	18.490	35	464	250	35	215
Total**	98.991	33.413	153	65.425	757	151	606

Source: ČEKIA and authors' calculations

* A bad firm means a firm that went bankrupt at the one-year horizon, whereas a good firm for the given period means a firm that did not go bankrupt the following year.

** The "Total" row contains the number of observations for the given set of firms. On the full data sample this figure does not equal the total number of firms, because in the selection each company is monitored for several accounting periods.

Table 3 shows the breakdown of firms by size in the data sample. This is based on corporate assets and conforms to the European Commission categorisation.¹²⁹ Nonetheless, we should mention that the European Commission also offers other enterprise size categorisations (according, for example, to number of employees or sales).¹³⁰ The

¹²⁷ A summary of the methods can be found, for example, in Heckman et al. (1997).

¹²⁸ For the estimation of the scoring function, an alternative sample constructed in the same way but with a new random selection for the good firms was used in the robustness tests – see section 5, where we discuss the results of the model.

¹²⁹ Commission Regulation (EC) No 70/2001 as amended by No 364/2004. The enterprise size boundaries were converted from EUR to CZK using the approximate exchange rate 1 EUR = 30 CZK.

¹³⁰ The Czech Statistical Office also uses a breakdown by number of employees.

enterprise size definition chosen by us and used in Table 3 was based on the available data, which were part of the data source used. The source contained corporate assets, and not numbers of employees. Sales information did form part of the database, but had been filled in for only some companies, so it could not be used. Under the definition we used, micro-enterprises with assets not exceeding CZK 60 million have the largest representation in the data sample, while large enterprises with assets exceeding CZK 1,290 million have the lowest representation. However, large enterprises account for more than 80% of the aggregate assets of the firms represented in the sample.

Table 3 – Description of data sample used

Type	Assets (CZK millions)	Number of firms	Good firms		Number of firms	Bad firms	
			Share according to number of firms (%)	Share according to assets of firms (%)		Share according to number of firms (%)	Share according to assets of firms (%)
Micro firms	< 60	292	48.2%	0.8%	70	46.4%	1.0%
Small firms	61-300	138	22.8%	3.5%	36	23.8%	5.4%
Medium firms	301-1.290	90	14.9%	10.8%	24	15.9%	14.7%
Large firms	>1.291	86	14.2%	84.9%	21	13.9%	78.9%
Total	-	606	100.0%	100.0%	151	100.0%	100.0%

Source: ČEKIA and authors' calculations

5. RESULTS OF THE MODEL

The resulting model (3) confirmed the relationships between the liquidity, solvency, profitability and activity indicators and business failure. The best statistical properties were shown by the model containing seven statistically significant indicators (of the 22 considered in all). These included three solvency indicators (*leverage I* and *II* and *interest coverage*), two profitability indicators (*return on equity* and *gross profit margin*), one liquidity indicator (*cash ratio*) and one activity indicator (*inventory ratio*). The resulting model takes the following form:

$$score = \frac{1}{1 + e^{-(b_0 + b_1 r_3^* + b_2 r_4^* + b_3 r_5^* + b_4 r_7^* + b_5 r_{12}^* + b_6 r_{19}^* + b_7 r_{20}^*)}} \quad (3)$$

where

- score - expresses the risk of the firm, which is linked to the probability that the firm will go bankrupt at the one-year horizon,
 - r_i - denotes the individual financial indicators of the firm,
 - b_i - denotes the coefficients of the relevant scoring function indicators,
 - *
- denotes the relative order operator in per cent, which returns the relative order of the value of a given indicator for a given firm vis-à-vis the full data sample used to estimate the model.¹³¹

¹³¹ The relative order operator returns a number in the range of 0–1. It is analogous to seeking a quantile on the given data sample, except that the value for which we are seeking the position in the given sample is not part of the sample. In practice, we calculate the value of a given financial indicator, such as the *cash ratio*, and seek the two closest indicator values in the data sample between which the value sought lies. From the relative order of these two values we calculate the relative order for the sought value by linear interpolation. If, for example, the *cash ratio* takes the value 0.2, the relative order operator for it is calculated by linear interpolation of the relative order of the two closest values to 0.2 occurring in the data sample used for the estimation of the model, namely 0.1996 and 0.2015, whose relative orders are 0.5733 and 0.5746. We then obtain the resulting relative order value using the following relationship:

$$0.5733 \cdot \frac{0.2015 - 0.2}{0.2015 - 0.1996} + 0.5746 \cdot \frac{0.2 - 0.1996}{0.2015 - 0.1996} = 0.5736, \text{ i.e. } 0.2^* = 0.5736.$$

This means that in the original data sample on which the model was estimated, 57.36% of the values of this indicator are less than 0.2.

As the model is based on the relative order of the indicators in the sample, the estimated coefficients of the function express their relative importance. The larger is the indicator's coefficient (in absolute terms), the larger is its weight in the scoring function.¹³² From this perspective, *interest coverage*, *cash ratio* and *leverage I* appear to be the most important indicators (Table 4).

The estimated scoring model confirmed our expectations regarding the impact of the individual indicators on business failure. It is clear that a higher debt ratio increases the probability of default (see *leverage I* and *II*), whereas a higher ability to repay debts (see the *interest coverage*) reduces this probability. Likewise, higher profitability (see *gross profit margin* and *return on equity*) and higher liquidity (see *cash ratio*) increase the financial stability of the firm and reduce its probability of default. By contrast, lower efficiency (see *inventory ratio*) implies lower financial stability of the firm.

Table 4 – Estimated scoring model

Variable	Type	Indicator Notation	Coefficient Notation	Coefficient	Standard Error	Significance
Constant	-	-	b ₀	2.4192	0.9289	0.009207
Leverage I	Solvency	r3	b ₁	2.5779	0.3788	0.000000
Leverage II	Solvency	r4	b ₂	1.7863	0.5727	0.001813
Cash-flow I	Solvency	r5	b ₃	-3.4902	1.0005	0.000486
Gross profit margin	Profitability	r7	b ₄	-2.4172	0.4802	0.000000
Inventory ratio	Activity	r12	b ₅	1.7679	0.4033	0.000012
Cash ratio	Liquidity	r19	b ₆	-3.3062	0.4246	0.000000
Return on equity	Profitability	r20	b ₇	-2.2491	0.5621	0.000063

Source: Authors' calculations

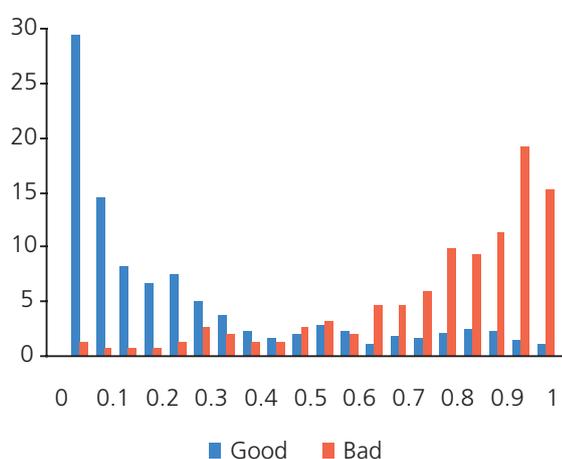
Although the model confirmed some of the expected results, for example that solvency and liquidity ratios are the most important for predicting corporate bankruptcy, one surprising result is the importance of inventories, as contained in the *inventory ratio* (i.e. the number of days a company has goods in stock in the form of inventories). The higher this indicator is, the longer goods lie in the company's store and the less saleable its inventories are.¹³³ One possible explanation for the importance of this indicator is the high stock of unsaleable inventories typical of businesses heading towards bankruptcy. This argument is supported by the fact that the *total liquidity* indicator, which includes inventories in current assets, proved to be insignificant. Conversely, the *cash ratio*, which does not include inventories in current assets at all, appears to be significant. This implies that the saleability of inventories – among other indicators – plays an important role in the prediction of corporate bankruptcy.

The aim of the scoring model is to correctly separate good and bad firms. This property expresses the quality of the estimated function. To measure it, one can use the Gini coefficient, for example. The value of this coefficient should be as close as possible to 1, which would mean a 100% ability to separate firms in terms of their quality using the scoring function. The quality of the model can be demonstrated graphically by means of a histogram (Chart 1) or a Lorenz curve (Chart 2).

¹³² The relative order operator applied to the individual financial indicators used in the scoring function ensures that the model is robust to extreme values.

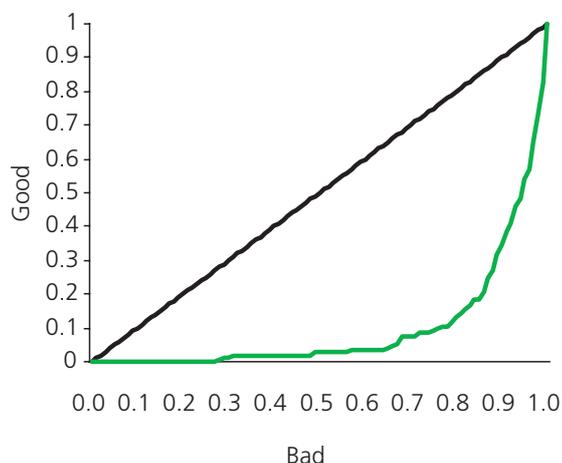
¹³³ Nevertheless, we should point out that different industries display different *inventory ratios*. For example, this indicator is high for ship manufacture, but very low for retail trade.

Chart 1 – Histogram of estimated scoring function



Source: Authors' calculations

Chart 2 – Lorenz curve of estimated scoring function



Source: Authors' calculations

Chart 1 shows the firm distribution of the data sample used according to score and according to whether bankruptcy occurred. The blue columns express the percentage of good firms and the red columns the percentage of bad firms for each score interval. The ideal situation would be if all the bankrupt firms were assigned a score of 1 and all the healthy ones a score of 0. This, however, does not happen in practice, as we are unable to observe the complete characteristics of the firm and so we are working with imperfect information. This implies that the function cannot fully separate the firms according to their quality. There is always a set of bad firms that are classified as good ones, and vice versa. The aim is to keep such cases to a minimum.

Chart 2 depicts the cumulative distribution of the scores of good and bad firms. In the ideal case, guaranteeing a 100% rate of separation, this curve would take the form of a right angle. From the Lorenz curve one can compute the "Gini coefficient" as the ratio of the area enclosed by the green curve and the black diagonal and the total area below that diagonal. The generally accepted Gini coefficient for this type of model fluctuates above 60% depending on the data used and the purpose of the scoring (Mays, 2001). With a Gini coefficient of 80.41%, our estimated model satisfies the requirement of a sufficient rate of separation of the firms on the data sample used.

The estimation of the model for the alternative data sample, constructed according to the same rules as the sample used, confirmed that our estimate is sufficiently robust. The robustness of the model was also tested on another alternative data sample consisting of good clients selected entirely at random, and their representation according to the breakdown by assets was different from both the alternative and original data samples. In this case, a slight change was made to the model (two of the seven indicators were replaced with others¹³⁴), but when the model was applied to aggregate data on financial corporations (discussed in section 6), similar results were obtained (the resulting score was different owing to a different ratio of good to bad clients in the sample, but the time profile of the score was similar). The quality of the model as measured by the Gini coefficient was also almost identical.

6. USE OF THE MODEL TO ASSESS THE FINANCIAL STABILITY OF THE ECONOMY

Financial scoring is routinely used to assess the creditworthiness of individual firms. If we have aggregated data for the whole non-financial sector, we can imagine this sector as one large hypothetical firm with an aggregated balance sheet. Alternatively, given the use of relative indicators only, we can view the aggregated indicators as characteristics of the average firm in the sector. Assuming a degree of homogeneity, the estimated model can be applied to the aggregated indicators of non-financial corporations. If the situation in the sector takes a turn for

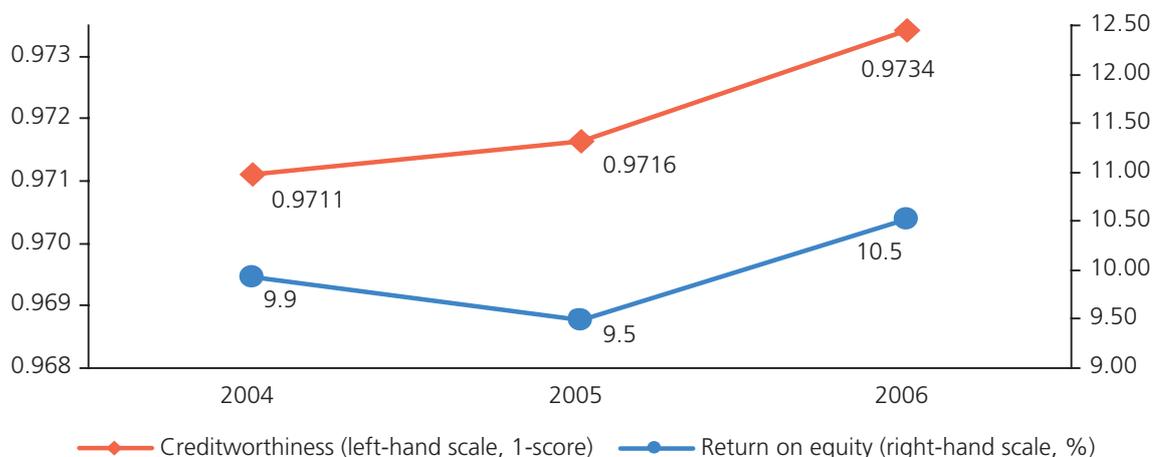
¹³⁴ Retained profit and cash flow I were replaced with gross profit margin and interest coverage.

the worse, the financial indicators of firms will deteriorate on average. This will be reflected in a falling score of the average representative firm. However, the scope and inhomogeneity of the sample of firms on which the model was estimated place some limitations on the model. We could get better results by decomposing the sample into several more homogeneous segments and then estimating the model for these groups of firms separately. In the ideal scenario, we would decompose the firms by size and area of economic activity. Owing to the small number of bad firms in the data source used, however, this is not possible.

An aggregated balance sheet can be obtained for Czech firms from the publicly available data of the Czech Statistical Office, which has data containing the economic results of non-financial corporations. This data is published in a sufficiently detailed structure (to enable the construction of the seven aforementioned indicators included in the model) only for corporations with 100 employees or more. The seven indicators obtained in this way (r_3 , r_4 , r_5 , r_7 , r_{12} , r_{19} and r_{20}) are substituted into equation (3) to give an aggregated score representing the level of risk of the entire sector.

The resulting score was computed for 2004–2006.¹³⁵ The value of the creditworthiness indicator (the 1-score) for 2004–2006 (see Chart 3) can be interpreted as the creditworthiness of the non-financial sector for the one-year forecast horizon. This indicator is related directly to the probability of default of the corporate sector. By contrast with the original data sample, the model is only applied to data on firms with 100 employees or more, but one can get some idea of the evolution of the corporate sector over time. Given the aforementioned limitation, the resulting score is probably underestimated and thus the creditworthiness is overestimated, owing to the higher level of risk of the small enterprises excluded from the aggregate data. For financial stability purposes, however, the dynamics of this indicator over time are more important than its absolute level. The results suggest a steady improvement in the creditworthiness of the non-financial sector between 2004 and 2006 in line with the positive macroeconomic trend. Although there was a slight decline in *return on equity* and the *gross profit margin* in 2005, the positive development of the other five indicators (a falling debt ratio, rising liquidity, increasing interest coverage and a decreasing inventory ratio) outweighed this effect and the resulting creditworthiness score increased slightly compared to 2004. A positive shift and a reduction in the risk of the sector occurred in particular in 2006, which saw improvements in five out of the seven financial indicators studied (the only deteriorations were recorded by *leverage I and II*). The biggest improvements were shown by *interest coverage* (a year-on-year improvement of 24.2% to 11.78), *cash ratio* (a year-on-year increase of 24.2% to 0.385) and *return on equity* (a year-on-year improvement of 10.7% to 0.105). The results of the model are consistent with the conclusions contained in the 2006 Financial Stability Report, according to which 2006 was an extraordinarily successful year for the large corporations sector and the outlook for 2007 was favourable (CNB, 2007). The constructed indicator offers a more comprehensive aggregate view of the riskiness of the sector as a whole going forward.

Chart 3 – Creditworthiness of the non-financial corporations sector



Source: Authors' calculations and CZSO

¹³⁵ Since some of the balance sheet items needed to calculate the necessary indicators were not monitored until after 2004, these values for 2004 were estimated from the available data for 2004 and 2005.

7. CONCLUSIONS

Financial scoring is a method used to assess the creditworthiness of obligors and thus is frequently used by lenders when deciding whether or not to provide credit products. This study showed that it is possible to use these traditional methods to monitor the financial stability of the corporate sector. Using accounting data on Czech firms, a scoring model based on seven financial indicators was estimated using logistic regression. By applying this model to the aggregate financial results of non-financial corporations, the scores of the Czech corporate sector as a whole – corresponding to its level of risk for the one-year forecast horizon – were calculated for 2004–2006. The results of our study suggest that the creditworthiness of the Czech non-financial corporate sector improved between 2004 and 2006. This indicator will be incorporated into the quantitative system used by the Czech National Bank to assess financial stability. The calculated score will be used each year as auxiliary information for evaluating the probability of the corporate sector running into difficulties at the one-year forecast horizon.

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