



Effect of Financial Distress Likelihood on Financial Performance of Firms Listed on the East African Community Exchange Markets

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Abstract

An effective listed firm's financial performance is vital to economic growth through employment creation, GDP growth, capital mobilization and other commitment policies. However, the current dynamic business environment is characterized by poor financial performance, a significant concern for listed firms, which leads to collapse, suspension, and delisting from exchange markets. This matter calls for immediate intervention, as its persistence may affect their capacity to contribute to economic development. Despite the numerous studies on this phenomenon, there has been inadequate attention to the impact of financial distress likelihood on financial performance of firms listed on the East African Community exchange markets. Thus, the study fills the knowledge gap by investigating this relationship. The study was anchored by positivist philosophy and guided by explanatory and longitudinal research designs. The study targeted 112 firms; after inclusion and exclusion criteria, the study focused on 48 firms. Moreover, it utilized secondary data extracted from financial reports that were audited for a 10-year period, from 2015 to 2024, yielding 480 observations. The study found that financial distress likelihood had a negative but significant link with financial performance ($\beta = -0.0253$, $p < 0.05$). This study revealed that the predictor significantly affects the outcome variable in the context of East African Community exchange markets, hence contributing significantly to the body of knowledge. The study thus concludes that safeguarding listed firms against conditions that elevate financial distress likelihood is critical in preserving financial performance. One of the study's recommendations is that the firms' management should establish sound financial distress monitoring systems that offer early warning signals and allow timely corrective measures before financial distress likelihood adversely affects the firm's financial performance. Additionally, policymakers need to streamline disclosure requirements for financial distress signals in financial reporting.

Keywords: *Financial Performance, Financial Distress Likelihood, East African Community Exchange Markets*

Introduction

Academicians and practitioners have continually explored the topic of financial performance for decades, owing to its importance to stakeholders such as investors, shareholders, creditors, management, and other interested parties. It has emerged as an urgent issue for stakeholders in the new global economy due to the multidisciplinary nature of the subject (Keter et al., 2023). The effective financial performance of listed enterprises is seen as integral to economic development, serving as conduits for capital mobilization, employment generation, contributing to Gross Domestic Product (GDP), corporate governance enhancement, sustainable development goals (SDGs), and many other commitment policies such as Vision 2030 (Muturi & Kalui, 2022). However, in the current dynamic business environment, ineffective financial performance is a major issue of concern among listed firms (Anton & Afloarei Nucu, 2020), resulting in a greater drop in support for key pillars of economic development (Kwarko et al., 2021; Muturi & Kalui, 2022; Zhang, 2024). The majority of these firms are experiencing a significant decline in their financial performance (Odhiambo et al., 2022). Kohlhase and Pierk (2021) noted that approximately 30% of listed firms experience poor financial performance in a normal year. This rate surge is further exacerbated in crises like the 2020-2021 COVID-19 crisis and 2008-2009 financial crisis. Robinson et al. (2025) further revealed that profit warnings, as an indicator of poor financial performance among the United Kingdom's (UK) listed firms, rose to 20% in 2025. Moreover, 19% of London-listed firms have shown poor financial performance (Kassin, 2025). In developing economies, especially, the partner states in East African Community, a large number of quoted firms have registered declines in financial performance (Odhiambo et al., 2022). In Kenya, some firms listed on the Nairobi Securities Exchange (NSE), such as Marshall East African, Hutching Biemer, and A. Baumann & Co Ltd, have been delisted, and others, like Deacon East African Limited and Atlas Africa Industries Ltd have been suspended due to poor

financial performance (CMA, 2020). Dar es salaam Stock Exchange (DSE) is not excluded from this phenomenon. For instance, firms such as Precision Air service and cross listed Kenya Airways have reported poor financial performance. In Uganda listed firms have also reported poor financial performance. For example, New Vision Printing and Publishing Company Limited recently released a profit warning (USE, 2023). Due to dominance in poor financial performance of firms many scholars (Akgün & Türkoğlu, 2024; Cheng et al., 2025; Kabir et al., 2021; Mutai et al., 2025) have focused on addressing the issue. However, the problem still persists. Therefore, due to the persistence of this phenomenon in emerging economies, it motivated researchers to carry out research on the effect of financial distress likelihood on the financial performance of firms listed on the East African Community exchange markets.

Notably, financial distress likelihood is a burning phenomenon for almost all firms worldwide (Madhushani & Kawshala, 2018a). It has become more popular in recent years, as shown by the booming theoretical and empirical literature focusing on the area (Walela et al., 2022). The attention of various studies calls for a deep analysis of why financial distress is a key phenomenon for firms and global economies. Moreover, the occurrence of financial distress has forced some large companies to file for bankruptcy (Madhushani & Kawshala, 2018). Thus, uncovering financial distress likelihood situations is crucial for the long-term survival of a firm. Further, the literature on credit risk is suggestive of borrowers' inability to meet their debt obligations, potentially leading to default. This literature inspired the invention of Altman's Z-score model, essential for predicting the financial distress likelihood (Altman, 2019; Tanjung, 2020). Thus, credit risk theory connects how financial distress likelihood affects the performance of the firm. Financial distress is often seen as a firm's inability to cover its expenses and liabilities due to inadequate income (Che et al., 2024). It is further viewed as a situation in which a firm faces greater financial constraints or risks being bankrupt (Suffian et al., 2023), which adversely impacts financial performance. Therefore, deriving from the foregoing debate, it is noted that the existing body of knowledge is limited in explaining how financial distress likelihood affects financial performance, importantly in EAC exchange markets. This research thus focuses on addressing existing knowledge gaps by employing advanced methodologies and constructs to explain the link between these variables.

Financial Distress Likelihood and Financial Performance

Scholars have been lured to place greater emphasis, in a global context, on understanding how financial distress and financial performance relate following the high rate of enterprise failure resulting from poor financial performance, which is often explained by financial distress. For example, De Mel and Buddhika (2025) assessed how financial distress affects the financial performance of quoted non-bank financial institutions on the Colombo Stock Exchange in Sri Lanka between 2013 and 2022. The research applied Altman's Z-score model to quantify financial distress, and Return on Equity (ROE) and Return on Assets (ROA) as metrics of financial performance. It used multiple regression analysis, and the evidence shows that financial distress significantly but negatively affects financial performance, with companies at higher distress levels exhibiting weaker financial results. This research advocates that firms need to proactively monitor financial health, enhance liquidity, and optimize capital structures to improve stability. The evidence concurs with that of Kabishka and Vijayakumaran (2023) and Madhushani and Kawshala (2018), who examined the relationship between the aforementioned variables in Sri Lanka and found a significant impact. Similarly, Al Barrak et al. (2023), Mpora et al. (2025), and Wu et al. (2020) revealed that financial distress inhibits corporate financial performance. Financial performance is hampered when corporation in financial trouble reallocate resources from productive operations to debt servicing and restructuring (Nguyen Thi et al., 2025).

In addition, Ahmad et al. (2020) evaluated how financial distress affects performance of non-financial firms listed on the Pakistan Stock Exchange (PSX) from 2011 to 2016. Using a causal-effect research design, the study treated financial distress (quantified by Altman's Z-Score) as the independent variable, with firm performance as the dependent variable and leverage and firm size as control variables. Data from 161 non-financial companies were collected using a convenience sampling design from annual reports and analyzed in SPSS and Excel, with the performance of firms being evaluated by Tobin's Q. The results indicate a negative but significant relationship between financial distress and the performance of a firm. Furthermore, Jahan and Kabir (2019) studied how financial distress influences financial performance of non-bank financial institutions (NBFIs) that are quoted on the Dhaka Stock Exchange in Bangladesh. This study used data from 20 NBFIs over five years (2013–2017). Financial distress was evaluated by Altman's Z-score, whereas return on equity (ROE) and return on assets (ROA) were crucial for

measuring firm performance. The investigation was guided by corporate risk management theory. The findings reveal a rapid increase in distress of NBFIs, demonstrating the significant effect of financial distress on the financial performance of corporations.

Contradictory evidence based on different measures of financial distress was revealed in research by Wan et al. (2021) on the effect of financial distress on the performance of firms, focusing on 39 publicly listed Malaysian companies from 2018 to 2020. The research adopted a descriptive design, and an analysis of the relationship between variables was done using OLS. Moreover, the research was anchored by Modigliani and Miller's theorem and the static trade-off theory. The debt-to-equity ratio was critical in assessing financial distress, whereas return on assets measured the firms' performance. The findings indicate that debt-to-equity ratio negatively but significantly relates to firm performance. Therefore, higher debt-to-equity ratios are associated with a notable decline in return on assets. Conversely, debt ratio positively links with firm performance, demonstrating how higher debt ratios are closely linked with higher returns on assets. Similarly, Boachie (2025) reported that financial distress significantly and positively affects financial performance of specific rural banks in the Ashanti Region, Ghana. It employed system improvement, linear, and multiple regression in analyzing variable relationships. The research was informed by entropy theory, cash flow theory, and theories of liquidity and profitability. Additionally, it utilized a quasi-experimental study design and focused on 29 rural banks. The study also utilized secondary and primary data. Questionnaires were the primary tools for gathering data from a sample size of 126 management staff.

Moreover, Sporta (2018) investigated how factors of financial distress affect the financial performance of commercial banks regulated by the Central Bank of Kenya (CBK), prompted by the growing number of banks facing financial difficulties and declining returns. It focused on aspects like capital adequacy, asset quality, liquidity, operational efficiency, as well as leverage as measures of financial distress. The study conducted a census of 43 banks using secondary panel data from 2005 to 2015 and used Stata with panel-data regression models for data analysis. It was informed by trade-off theory, liquidity preference model, buffer theory of capital adequacy, Wrecker's theory of financial distress, Efficient Market Hypothesis theory and agency theory. The results showed that all five distress factors significantly impact financial performance. Reflecting on the empirical literature reviewed above, it is evident that there are limited studies focusing on how financial distress likelihood relates to financial performance in the context of the East African Community. Therefore, the current research fills these contextual and conceptual gaps by examining the effect of financial distress likelihood on financial performance among firms listed on the EAC exchange markets. Thus, we propose:

H₁: Financial distress likelihood has a negative and statistically significant effect on financial performance among firms listed on the EAC exchange markets.

Covariates

Control variables aid in avoiding misleading conclusions. Previous studies have substantiated that the size and age of a firm have significant effects on financial performance (Agoraki et al., 2023; Yusuf & Yahaya, 2023). Particularly, Ngumo et al. (2020) reported the criticality of the size of the firm in evaluating financial performance. Mutumanikam & Adelin (2024) further noted that large firms utilize stronger market positions, better financial resource access, and economies of scale, which, as a consequence, might affect performance. Moreover, the study by Rwakihembo et al. (2023) linking the age of the firm and the financial performance of private limited firms found a significant and positive effect between the variables. There has been an extensive investigation into the association across firm age, size, and financial performance in the existing literature; therefore, it is necessary to consider them as control variables in the current study. These attributes help the researchers ensure the accuracy and accountability of factors capable of influencing the connection between the core variables being researched (Memon et al., 2024). They are essential for this current research as they enhance the validity of the results by limiting the effect of adjustment, confounding, nuisance, and extraneous variables that might otherwise distort the observed relationships between the main variables of interest (Memon et al., 2024).

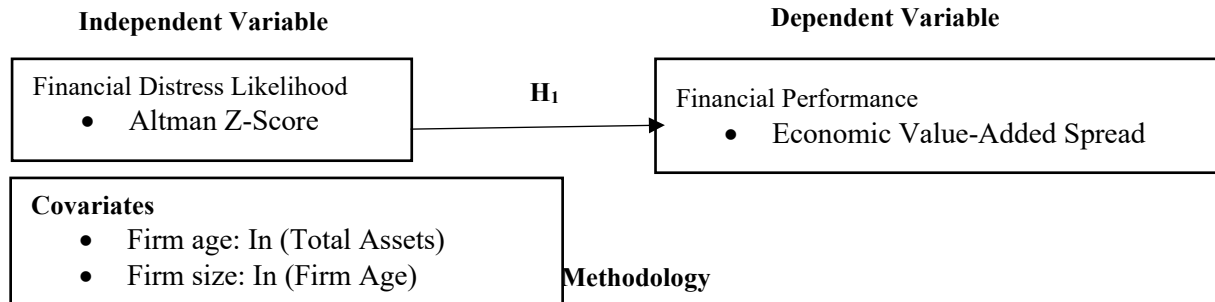


Figure 1: Conceptual Framework

like the Uganda Securities Exchange (USE) in Uganda, the Dar es Salaam Stock Exchange (DSE) in Tanzania, the Nairobi Securities Exchange (NSE) in Kenya, Somali Stock Exchange (SSE), and Rwanda Stock Exchange (RSE). The research adopted explanatory and longitudinal research designs, aligning with the positivist philosophy. It utilized secondary sources of data obtained from financial reports from 2015 to 2024 that have undergone a rigorous auditing process. The study targeted 112 firms however, after excluding firms with unbalanced panel data and those listed after 2015, the study focused on 48 firms for the analysis, yielding 480 observations. The study employed R software version 4.5.3 to analyze descriptive statistics comprising the mean, standard deviation, minimum, and maximum, while inferential statistics, including correlation analyses, were conducted to evaluate strength and direction, and hierarchical regression aimed to test the study's hypothesis.

Measurement of Variables

The current study used the Economic Value Added (EVA) spread as a proxy for financial performance. EVA spread is also seen as an economic return or value spread (De Wet, 2005; Fang & Guo, 2025; Huaman-Roque et al., 2025). EVA spread is a financial performance metric used to examine the excess value of economic profit over invested capital. It also directly captures true economic value creation by ensuring explicit accountability for the full cost of capital, thereby aligning performance measurement with shareholder wealth and long-term sustainability (Alsoboa, 2017). This is given as Return on Capital Invested (ROIC) minus Weighted Average Cost of Capital (WACC) (Huaman-Roque et al., 2025; Leitner & Olofsson, 2025). The latest Altman Z-score of 1995 was utilized in measuring the financial distress likelihood in selected firms, since it introduces a constant of +3.25 into the 1993 model to enhance model effectiveness within emerging economies (Rashid et al., 2023). The natural log of the number of years since the firm's actualization was used to measure the age of the firm, as reported in the literature (Ahinful et al., 2023; Iman et al., 2022). Also, the natural log of total assets was employed to measure the size of the firm (D'Amato & Falivena, 2020; Rahman & Yilun, 2021).

Results and Discussions

Descriptive Statistics and Correlation Analysis

Financial Performance (FP), measured by Economic Value Added (EVA) spread, recorded a mean of -0.0305 and a standard deviation of 0.1063, suggesting that, on average, firms generated returns below their cost of capital during the study period. This concurs with the argument of Huaman-Roque et al. (2025), who stated that a negative EVA spread indicates value destruction, particularly caused by inefficiencies in management and elevated costs of finance. Firm age (InFAge) recorded a mean of 4.0088 and a standard deviation of 0.5007. Firm size (InFSize) had a mean of 23.7406 and a standard deviation of 1.9067. Moreover, descriptive statistics for the mediator, Financial Distress Likelihood (FDL), measured by 1995 Altman Z-score model, showed a mean of 5.3408 and a standard deviation of 5.0328. Thus, based on this evidence, most firms during the study period were within the grey zone or likely to be financially distressed, since their Altman's Z-score lies between 4.75 and 6.25, as stated by Beltrame et al. (2022).

Financial performance and firm age were negatively correlated and not statistically significant ($r = -0.008$, $p > 0.05$), suggesting firm age has no meaningful influence on financial performance among the studied EAC-listed firms. This implies that the firm's age does not necessarily determine performance, but other factors of younger and older firms

can lead to varying financial performance. Also, it indicated that financial performance is positively and significantly associated with firm size ($r = 0.430$, $p < 0.05$), which suggests that larger firms tend to record better financial performance. These findings demonstrate that larger firms listed on the East African Community exchange markets can take advantage of stronger market positions, better financial resource access, and economies of scale (Mutumanikam & Adelin, 2024), thereby boosting their financial performance. This evidence demonstrates a negative and significant association between the likelihood of financial distress and financial performance ($r = -0.305$, $p < 0.05$). It also shows that firms having a higher likelihood of financial distress are likely to have inferior financial performance. Therefore, it is in agreement with the scholarly evidence of Mpora et al. (2025), who posit that heightened financial distress erodes firms' financial performance.

Table 1: Descriptive Statistics and Correlation Analysis

Variable	Mean	SD	Correlation Matrix			
			FP	Fage	Fsize	FDL
Financial Performance (FP)	-0.0305	0.1063	1			
Firm Age (InFage)	4.0088	0.5007	-0.008	1		
Firm Size (InFsize)	23.7406	1.9067	0.430***	-0.214***	1	
Financial Distress Likelihood (FDL)	5.3408	5.0328	-0.305***	0.381***	-0.415***	1

Hypothesis Testing

Model 1, Table 2, was adopted to examine the influence of control variables, which were firm size and firm age on the dependent variable. This model accounted for 20.30% of the variation in the dependent variable ($R^2 = 0.2030$). Overall, the model proved to be statistically significant ($F = 54.7569$, $p < 0.001$), hence underscoring the joint significant explanatory power of control variables. Firm age negatively and significantly affected the dependent variable ($\beta = -0.5606$, $p = 0.0000$). This implies that the dependent variable decreased by 0.5606 units for every one-unit increase in firm age when firm size is constant. In contrast, findings show that firm size has a positive but statistically insignificant impact ($\beta = 0.0104$, $p = 0.2661$), suggesting that the size of a firm failed to significantly explain the variation in the dependent variable.

Model 2 included financial distress likelihood (FDL), while retaining firm age and firm size. The model's explanatory power increased from 20.30% to 30.69% ($R^2 = 0.3069$). The ($\Delta R^2 = 0.1039$) shows that financial distress likelihood explains an additional 10.39% of the difference in financial performance, beyond that attributed to firm age and firm size in Model 1. To sum it up, the overall model remained statistically significant ($F = 63.3203$, $p < 0.001$). The results in Table 2 further revealed that financial distress likelihood had a negative and statistically significant effect ($\beta = -0.0253$, $p = 0.0000$) on financial performance, implying that a one-unit increase in financial distress likelihood leads to a 0.0253-unit decrease in financial performance, when holding firm size and age constant. Firm age remained negative and significant ($\beta = -0.2070$, $p = 0.002$), but its coefficient magnitude decreased after the introduction of financial distress likelihood. Firm size had a positive and statistically significant link with financial performance ($\beta = 0.0185$, $p = 0.0359$).

These results indicate that firms having a higher likelihood of financial distress record lower financial performance (Al Barrak et al., 2023) since financial distress raises the cost of external financing, restricts access to investment opportunities, hinders liquidity, and diminishes operational efficiency. As firms experience financial distress, they shift resources toward debt service and restructuring activities rather than to productive operations (Nguyen Thi et al., 2025), thereby inhibiting financial performance (Wu et al., 2020). They agree with recent empirical evidence indicating the significant but negative effect of financial distress likelihood on the financial performance of enterprises (Ahmad et al., 2020; De Mel & Buddhika, 2025; Kabishka & Vijayakumaran, 2023). However, the result of the present research disagrees with other studies by Boachie (2025), Jahan and Kabir (2019), and Madhushani and Kawshala (2018), who found that financial distress significantly and positively affects financial performance.

Table 2: Hierarchical Regression Results for Covariates and Financial Distress Likelihood on Financial Performance.

Variables	Model 1		Model 2	
	B	P-value	β	P-value
Firm Age	-0.5606109	0.0000	-0.2069906	0.0021
Firm Size (Fsize)	0.0104242	0.2661	0.0185166	0.0359
Financial Distress Likelihood (FDL)			-0.0253177	0.0000
R ²	0.2030		0.3069	
ΔR^2	-		0.1039	
F-statistics	54.7569***		63.3203***	

Conclusion and Recommendations

The current study's findings underscore the predictive relevance of the Altman Z-score, a metric of financial distress likelihood, as an indicator that gives early warning of financial performance. It lends empirical support to the view that financial distress likelihood is not merely a terminal outcome but a condition that progressively undermines financial performance. The study thus concludes that safeguarding listed firms against conditions that elevate financial distress likelihood is essential for preserving financial performance. Thus, grounded in these results, the management of these firms should establish sound financial distress monitoring systems that elicit early warning signals and allow timely corrective measures before financial distress likelihood adversely affects the firm's financial performance. Policymakers and regulators of the capital markets in the East African Community exchange markets need to reinforce disclosure requirements for financial distress likelihood signals in financial reporting. They should also encourage listed firms to have strong financial risk-management frameworks in place. Furthermore, policies that encourage corporate financial resilience, responsible borrowing, and early restructuring of financially vulnerable firms need to be enhanced to minimize the detrimental impacts of financial distress likelihood and support the sustainable financial performance of firms quoted in various exchange markets.

This study was limited by the utilization of the Altman Z-score as a dimension of financial distress likelihood, which uses accounting information which may not fully capture market-based, macroeconomic, and qualitative measures of financial distress. Additionally, the study was conducted on listed firms only, using secondary data, thereby restricting the generalizability of the results to unlisted firms, which include micro, small, and medium, as well as family-owned firms. Therefore, future research could employ other financial distress likelihood indicators, such as market-based or cash-flow-based indicators, to confirm the results. The study should also be extended to unlisted firms by employing mixed-method research approaches. Lastly, future studies could include additional constructs serving as mediators or moderators in the link between the study's predictor and outcome variables.

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