

DOES FINANCIAL DISTRESS INCREASE THE COST OF RUNNING A FIRM?

A MULTI-DIMENSIONAL REVIEW



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Introduction

A firm is in financial distress if it is unable to meet its financial obligations due to inadequate cash flow, decreasing profitability, or deteriorating operational performance. Financial difficulty has traditionally been associated with high debt in capital structures. The more the debt, the greater the burden of fixed interest payments and the

Abstract

Financial distress is viewed as a consequence of excessive debt, weak cash flows, or declining profitability. However, beyond its financial implications, distress also increases the overall operating cost of firms. This article examines how financially distressed firms incur higher costs across multiple dimensions compared to financially stable firms. After reviewing the existing literature, the study analyses the impact of financial distress on labour costs, supplier credit terms, borrowing costs, and overhead expenses. The findings indicate that employees demand wage premiums, suppliers tighten trade credit conditions, lenders impose higher borrowing costs through distress premiums, and firms incur substantial legal, advisory, and restructuring expenses during distress. These factors, when taken together, create a self-reinforcing cycle in which rising costs further deepen financial instability. The study finds that financial distress extends beyond a purely financial phenomenon, acting as a catalyst for higher operational costs and significantly increasing firms' overall economic burden.

greater the likelihood of default. But high leverage is not the sole cause of financial distress. Other elements that might cause a firm to be in distress include (but are not restricted to) continuous loss of revenue, decreasing market demand, operational

inefficiencies, severe economic conditions, poor management decisions, misappropriation of funds, and interruptions in the supply chain or competitive positioning.

One of the most prevalent causes of financial distress is a large drop in revenue, as smaller cash inflows make it more difficult for a company to pay its fixed and variable costs. This might gradually drain liquidity and put pressure on the firm's working capital position. Also, financial crisis frequently brings with it some extra indirect costs (e.g., legal expenses) which are higher than those of non-distressed firms. Stakeholders perceive more risk in transacting with distressed firms, and these raise their operating and financing expenses. For instance, suppliers may shorten credit periods or demand advance payments, customers may be reluctant to do business with financially weak firms or may ask for an extended credit period, and employees may seek higher wages due to

employment uncertainty. Likewise, lenders might place tighter loan terms or increase interest rates. These factors can further raise the working capital requirements as well as financing costs of the firm, even if its sales are falling. Hence, financially distressed firms are often trapped in a vicious cycle, where decreasing financial performance results in greater operational and transaction expenses, which in turn exacerbate liquidity constraints and undermine financial stability.

In the Indian context, the Insolvency and Bankruptcy Code (IBC), 2016 has brought a momentous change in the corporate insolvency framework by introducing a time-bound resolution process and strengthening creditor rights. The Code also increased the importance of timely debt resolution and highlighted the need for firms to maintain stronger financial stability to avoid insolvency proceedings.

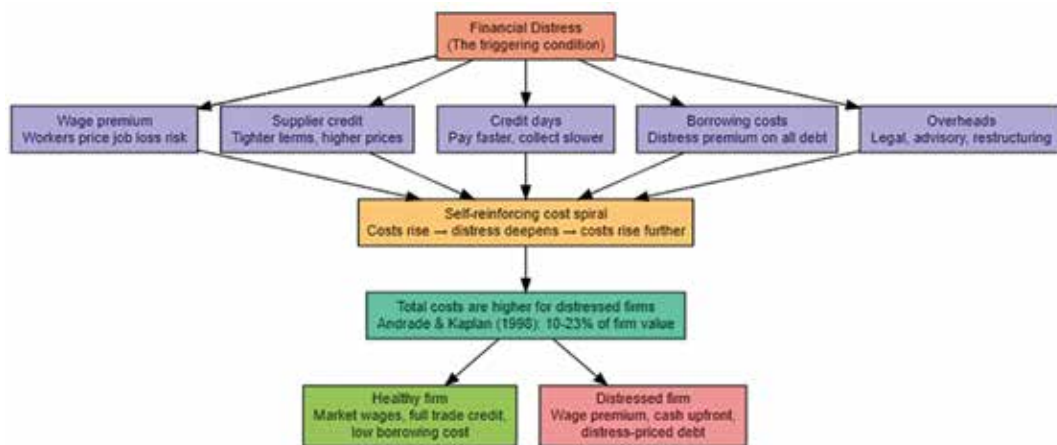


Figure:1

The above flowchart shows the overall framework of this paper and the relationship between financial distress and the increase in its operating cost. It demonstrates the impact of financial distress on several aspects of a firm's cost structure simultaneously, such as labour costs, supplier credit, borrowing costs, and overhead costs. These combined cost burdens generate a self-reinforcing cost spiral that worsens financial distress. The framework explains why financially distressed firms have higher total costs than financially stable firms.

Wage Premium and Financial Distress

There is a type of hidden labour costs that firms

facing high financial distress risk must incur, i.e., the wage premium. If employees believe the firm is more likely to go bankrupt, they will demand higher pay to compensate for reduced certainty about their future earnings, job security, and career prospects. This wage premium is not a voluntary cost but a structurally incorporated cost that increases automatically with the distress risk of a firm. Financial distress affects not only investors and creditors but also employees. Employees working for financially weak companies are not sure about their salaries, job security, promotions, and their future career prospects. This can lead to higher wages or a wage premium in risky firms or industries.

This idea is well supported by Graham et al., (2023) in their study. They explored almost 234,000 workers in the U.S. companies that went bankrupt and observed employee’s income drops after a corporate bankruptcy. Annual earnings of these workers were estimated to 13-14 % less a year after bankruptcy. The present value of the total loss in earnings over six years was about 87 percent of annual pre-bankruptcy earnings. The authors argue that workers anticipate these risks and thus demand higher wages to compensate for the potential loss of future earnings. This wage premium represents an extra indirect cost of financial distress for the firm. The paper finds that more leveraged and lower credit rated firms also pay significantly higher wage premia to employees. For instance, the wage premium for firms with BBB rating is 3.04% of firm value while the wage premium for firms with AA rating is 1.05%.

Berk et al. (2010) show that the capital structure of distressed firms plays a significant role in the determination of human cost, specifically, the risks faced by employees in distressed firms. The model predicts that firms with more risk-averse employees or higher labor risk will optimally choose lower leverage firms and that higher wages are associated with higher firm leverage.

When taken as a whole, these two studies demonstrate that the wage premium represents a structurally embedded cost that rises automatically as distress deepens, directly linking the firm’s financial condition to its labour cost. The following diagram explains how the distressed firms pay a wage premium.

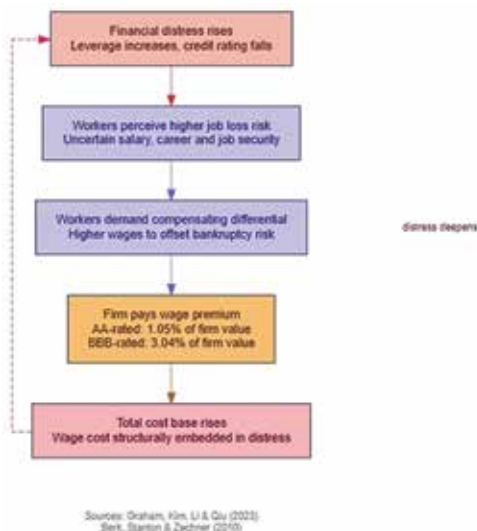


Figure:2

Supplier Credit and Procurement Costs

The fundamental argument is developed by Petersen and Rajan (1997), who establish a direct correlation between supplier credit terms and buyer creditworthiness. The paper states that the last group is distressed firms, for whom low profits lower the credit offered by suppliers. Financially weaker firms with lower incomes are given shorter credit terms and must pay higher effective prices that include a risk premium. As suppliers perceive the higher likelihood of default, the implicit cost of trade credit increases significantly for distressed firms. They find that the availability of trade credit is closely related to the creditworthiness and financial status of the firm. The financially distressed firms are provided with shorter credit terms and lower supplier financing as suppliers perceive them as riskier borrowers.

Wilner (2000) in his study observed that suppliers may initially assist financially distressed firms in order to keep the business relationship going. However, the overall balance of power fluctuates when the buyer becomes extremely dependent. Because the troubled company has few options, suppliers may then demand advance cash payments, restrict credit availability, or raise pricing. The company’s cost of goods sold increases due to higher input costs. Suppliers see distressed firms as more likely to default and therefore shorten credit periods, demand fast payments, or demand advance payment terms to protect themselves from the risk of non-payment in the future. The author also finds that suppliers change their trade credit relationships in times of financial distress.

Suppliers are informal lenders, and they change trade credit strategically based on the financial position of the borrower (Cuñat, 2007). The author also finds that suppliers are using trade credit strategically to hedge against their risk exposure and to keep their commercial relations with their buyers. Financial distress affects not only supplier relationships but also customer payment behavior. Customers dealing with financially weak firms may delay payments, reduce purchase commitments, or negotiate longer credit periods because they perceive the distressed firm to be in a weaker bargaining position. As a result, cash inflows decrease while suppliers simultaneously demand faster payments or advance cash terms. This creates

a working capital squeeze where cash leaves the firm more quickly than it enters. Therefore, distressed firms face increased cash outflows and decreased cash inflows, thereby leading to working capital imbalance, intensifying liquidity pressures, and operational instability.

Together, these papers indicate that financially distressed firms face worsening trade credit conditions. As a firm’s financial health deteriorates, customers delay payments, suppliers reduce credit periods, demand stricter payment terms, and charge higher implicit costs to compensate for default risk.

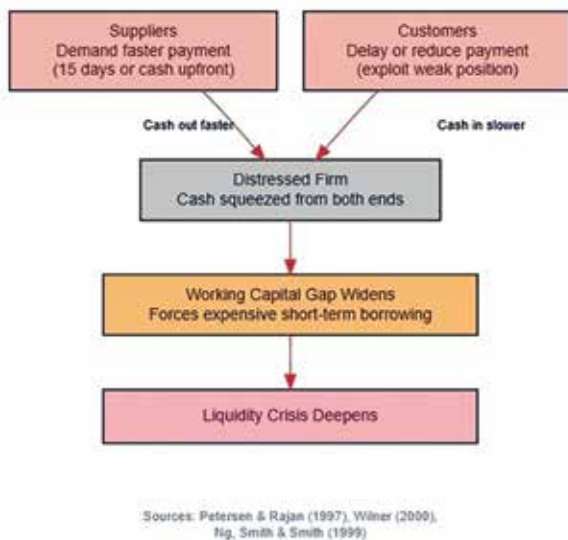


Figure:3

Cost of Borrowed Capital — The Distress Premium on Debt

The study by Andrade and Kaplan (1998) indicates that financially distressed firms have significantly higher borrowing costs as lenders require further compensation for the risk of distress. Their findings show a sharp increase in credit spreads with an increasing chance of default during times of financial instability. They found that the difference in corporate and government bond spreads is too broad to be explained purely by the predicted default losses, indicating a high-risk premium associated with debt pricing. Thus, distressed enterprises must pay higher interest rates not only because of the possibility of default but also because investors need to be compensated for systematic risk, uncertainty, and recovery values that are predicted to be lower. The authors also find that the market spreads-based risk-adjusted default

probabilities are much greater than the default probabilities based on historical default data. For example, the estimated historical 10-year default probability for BBB-rated enterprises is 5.22%, but the market-implied risk-adjusted likelihood is 20.88%, implying that lenders price debt in terms of forward-looking views of distress risk. As a firm’s financial state worsens, the risk perceived by creditors increases, resulting in wider spreads and much higher refinancing costs. The study also finds that the shift from safer credit ratings such as AA to riskier ratings such as BBB substantially increases distress-related costs, with the rise in risk-adjusted distress costs estimated at 2.7% of firm value. Overall, the study finds that credit spreads include a “distress premium” where lenders want higher yields to compensate for predicted default losses, uncertainty about recovery, and systematic economic risk, which raises the effective cost of borrowed capital for distressed firms.

The study firmly establishes that financial distress increases both default and recovery risk, which raises the cost of borrowed capital. Hence, the argument that financial distress leads to a “distress premium” on debt, increasing the effective cost of external financing, is justified.

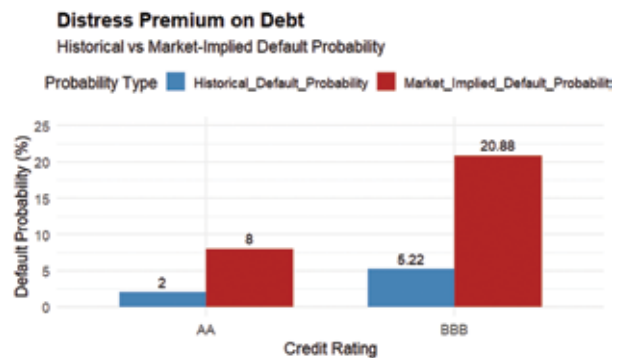


Figure:4

Overhead Costs and Indirect Burdens

There are certain costs that are incurred by financially distressed firms and not by financially stable firms. These costs arise directly from the distress situation itself and include legal and advisory fees, consultancy charges, costs of bankruptcy administration and the managerial burden of negotiating with creditors under financial pressure. As firms fall into distress, organizational resources are increasingly diverted

from productive operations to activities for survival and restructuring. Ben Branch (2002), in his study, argues that the economic costs of financial distress extend far beyond formal bankruptcy expenses. He finds that there are several expenses like professional fees, internal staff resource allocation, creditor-monitoring expenses, and transaction costs related to restructuring and distressed asset sales that distress firms incur. He further estimates that direct costs borne by firms that are related to bankruptcy may be in the range of 4.5%–6.3% of firm value, with claimholders also facing additional monitoring and marketability costs. The study emphasizes that indirect distress costs are often considerably larger than direct accounting costs. These include operational inefficiencies, lower market share, weakened supplier and customer relationships, tighter financing conditions and the abandonment of long-term strategic investments in favour of short-term survival decisions. Firms in distress may also be forced to sell assets at fire-sales, leading to additional economic losses. The paper estimates that the combined direct and indirect costs, to be between 12% and 20% of the value of the firm, showing the large overhead burden imposed by financial distress.

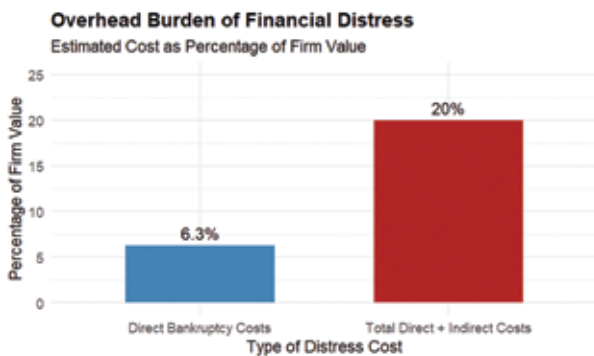


Figure:5

Conclusion

The findings across all cost dimensions clearly indicate that financially distressed firms incur

significantly higher overall operating costs than financially stable firms. Financial distress does not merely represent a shortage of liquidity or inability to meet obligations; rather, it creates a structural increase in the total cost of running the firm.

The evidence reviewed in this paper shows that distress affects nearly every component of the firm’s cost structure. Employees demand wage premiums to compensate for job insecurity and the risk of bankruptcy. Suppliers shorten credit periods, impose stricter payment conditions, and charge higher implicit prices due to the increased likelihood of default. Customers tend to increase the credit period due to the lower negotiating power of the distressed firms. Lenders incorporate a distress premium into borrowing costs, resulting in higher interest rates and broader credit spreads for financially distressed firms. At the same time, distressed firms incur additional overhead and indirect costs like legal fees, restructuring expenses, monitoring costs, managerial distraction, and operational inefficiencies.

What makes these costs more dangerous is that they arise precisely when the firm’s revenues, liquidity position, and operational flexibility are already under pressure. As a result, financial distress becomes self-reinforcing. Rising costs weaken the firm further, making recovery increasingly difficult over time. Taken together, the findings support the central argument of this study that financially distressed firms do, in fact, pay higher overall costs than financially stable firms. Financial distress, therefore, should not be viewed only as a financial condition, but also as an operational cost amplifier that increases the economic burden across labor, procurement, financing, and administrative functions. This further highlights the importance of early intervention, restructuring mechanisms, and insolvency frameworks such as the Insolvency and Bankruptcy Code (IBC) 2016, which aim to reduce the duration and economic costs of distress before they become irreversible.

Cost Dimension	Financially Stable Firm	Financially Distressed Firm
Wage costs	Employees accept standard market compensation due to stable employment expectations	Employees demand wage premiums to compensate for bankruptcy risk, job insecurity, and uncertain future earnings

Supplier credit terms	Suppliers provide normal trade credit periods and flexible payment arrangements	Suppliers shorten credit periods, demand advance payments, or restrict trade credit availability
Customer payment terms	Normal industry standards	Customers delay payments or ask for liberalised credit terms
Cost of borrowed capital	Base lending rate plus a modest credit spread reflecting low default risk	Base rate plus a substantial distress premium; risk-adjusted default probabilities rise sharply as credit quality deteriorates
Legal and advisory overheads	Minimal restructuring or bankruptcy-related expenditure	Significant spending on legal fees, restructuring consultants, monitoring, and bankruptcy-related administration
Managerial and Operational Burden	Management focus remains on growth, investment, and value creation	Managerial attention shifts toward survival, creditor negotiations, and restructuring activities
Total cost	Competitive cost structure focused on value creation	Cost rises for survival across multiple dimensions precisely when revenues, liquidity, and operational flexibility are under pressure

Table-1: The table shows an overall comparison of different dimensions of costs between firms that are financially stable and firms that are financially distressed.

In corporate finance, financial distress is generally treated as a consequence of excessive debt, a fall in revenues, insufficient cash flows, or poor market conditions. Distress occurs when firms cannot meet their financial obligations, and the resolution of that distress, whether through restructuring, asset sales, or bankruptcy proceedings, is the subject of much policy and academic attention.

This study starts from a different point. Rather than asking what causes distress or how it is resolved, it asks a more basic operational question: If a firm is in financial distress, does distress itself increase the cost of operating the firm?

Understanding this cost dynamic is important for a few reasons. It explains to managers the need for early intervention in distress. The longer the distress is carried out, the greater the cost baseline is, and the harder it is to return to financial stability. The study further explains the importance of resolution mechanisms such as the Insolvency and Bankruptcy Code (IBC), 2016, which serve not only as legal instruments for insolvency resolution but also as economic tools that help shorten the period of

financial distress and mitigate its associated costs.

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