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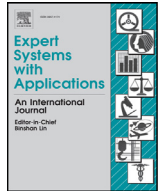
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Ensemble boosted trees with synthetic features generation in application to bankruptcy prediction



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ABSTRACT

Bankruptcy prediction has been a subject of interests for almost a century and it still ranks high among hottest topics in economics. The aim of predicting financial distress is to develop a predictive model that combines various econometric measures and allows to foresee a financial condition of a firm. In this domain various methods were proposed that were based on statistical hypothesis testing, statistical modeling (e.g., generalized linear models), and recently artificial intelligence (e.g., neural networks, Support Vector Machines, decision trees). In this paper, we propose a novel approach for bankruptcy prediction that utilizes Extreme Gradient Boosting for learning an ensemble of decision trees. Additionally, in order to reflect higher-order statistics in data and impose a prior knowledge about data representation, we introduce a new concept that we refer as to synthetic features. A synthetic feature is a combination of the econometric measures using arithmetic operations (addition, subtraction, multiplication, division). Each synthetic feature can be seen as a single regression model that is developed in an evolutionary manner. We evaluate our solution using the collected data about Polish companies in five tasks corresponding to the bankruptcy prediction in the 1st, 2nd, 3rd, 4th, and 5th year. We compare our approach with the reference methods.

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1. Introduction

Prediction of an enterprise bankruptcy is of great importance in economic decision making. A business condition of either small or large firm concerns local community, industry participants and investors, but also influences policy makers and global economy. Therefore, the high social and economic costs as a consequence of corporate bankruptcies have attracted attention of researchers for better understanding of bankruptcy causes and eventually prediction of business distress (Zhang, Wang, & Ji, 2013).

The purpose of the bankruptcy prediction is to assess the financial condition of a company and its future perspectives within the context of long-term operation on the market (Constand & Yazdipour, 2011). It is a vast area of finance and econometrics that combines expert knowledge about the phenomenon and historical data of prosperous and unsuccessful companies. Typically, enterprises are quantified by a numerous indicators that describe their

business condition that are further used to induce a mathematical model using past observations (Altman & Hotchkiss, 2010).

There are different issues that are associated with the bankruptcy prediction. Two main problems are the following: First, the econometric indicators describing the firm's condition are proposed by domain experts. However, it is rather unclear how to combine them into a successful model. Second, the historical observations used to train a model are usually influenced by imbalanced data phenomenon, because there are typically much more successful companies than the bankrupted ones. As a consequent, the trained model tends to predict companies as successful (majority class) even when some of them are distressed firms. Both of these issues mostly influence the final predictive capability of the model.

Previous works. First attempts of the formal bankruptcy prediction trace back to the beginnings of the 20th century when first econometric indicators were proposed to describe predictive abilities of business failure (Fitzpatrick, 1932; Merwin, 1942; Winakor & Smith, 1935). The sixties of the twentieth century brought a turning point in the survey of the early recognition of the business failure symptoms. First of all, the work of Beaver (1966) initiated

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application of statistical models to the bankruptcy prediction. Following this line of thinking, Altman (1968) proposed to use multidimensional analysis to predict corporate bankruptcy that was further developed by others (Altman & Loris, 1976; Blum, 1974; Deakin, 1972; Edmister, 1972; Ketz, 1978; Koh & Killough, 1990; Laitinen, 1991; Libby, 1975; Meyer & Pifer, 1970; Pettway & Sinkey, 1980; Rujoub, Cook, & Hay, 1995; Sinkey, 1975; Wilcox, 1973). In parallel, a great interest was paid to the generalized linear models that can be used in both decision making and providing certainty of the prediction (Aziz, Emanuel, & Lawson, 1988; Grice & Dugan, 2003; Hopwood, McKeown, & Mutchler, 1994; Koh, 1991; Li & Miu, 2010; Ohlson, 1980; Platt & Platt, 1990; Platt, Platt, & Pedersen, 1994; Zavgren, 1983; Zmijewski, 1984). Additionally, the generalized linear models are of special interest because estimated weights of the linear combination of economic indicators in the model can be further used to determine importance of the economic indicators.

Since nineties of the 20th century artificial intelligence and machine learning have become a major research direction in the bankruptcy prediction. In the era of increasing volumes of data it turned out that the linear models like the logistic regression or logit (probit) models are unable to reflect non-trivial relationships among economic metrics. Moreover, the estimated weights of the linear models are rather unreliable to indicate the importance of the metrics.

In order to obtain comprehensible models with an easy to understand knowledge representation, decision rules expressed in terms of first-order logic were induced using different techniques, naming only a few, like rough sets (Dimitras, Slowinski, Susmaga, & Zopounidis, 1999) or evolutionary programming (Zhang et al., 2013). However, the classification accuracy of the decision rules are very often insufficient, therefore, more accurate methods were applied to the bankruptcy prediction. One of the most successful model was support vector machines (SVM) (Shin, Lee, & Kim, 2005). The disadvantages of SVM are that the kernel function must be carefully hand-tuned and it is impossible to obtain comprehensible model.

A different approach aims at automatic feature extraction from data, i.e., automatic non-linear combination of econometric indicators, which alleviates the problem of a specific kernel function determination in the case of SVM. This approach applies neural networks to the bankruptcy prediction (Bell, Ribar, & Verchio, 1990; Cadden, 1991; Coats & Fant, 1991; Geng, Bose, & Chen, 2015; Koster, Sondak, & Bourbia, 1991; Salchenberger, Cinar, & Lash, 1992; Serrano-Cinca, 1996; Tam, 1991; Tam & Kiang, 1992; Wilson & Sharda, 1994; Zhang, Hu, Patuwo, & Indro, 1999). The main problem of the neural networks lies in the fact that they can fail in case of multimodal data. Typically the econometric metrics need to be normalized/standardized in order to have all features of the same magnitude. This is also necessary for training neural networks so that the errors could be backpropagated properly. However, the normalization/standardization of data do not reduce the problem of the data multimodality that may drastically reduce predictive capabilities of the neural networks. That is why it has been advocated to take advantage of different learning paradigm, namely, the ensemble of classifiers (Kittler, Hatef, Duin, & Matas, 1998). The idea of the ensemble learning is to train and combine typically weak classifiers to obtain better predictive performance. First approaches but still very successful were bagging (Breiman, 1996) and boosting (Freund & Schapire, 1996; Friedman, 2001; 2002; Zięba, Tomczak, Lubicz, & Świątek, 2014). The idea of boosting was further developed to the case of unequal classification costs (Fan, Stolfo, Zhang, & Chan, 1999) and imbalanced data (Galar, Fernandez, Barrenechea, Bustince, & Herrera, 2012). Recently, the boosting method was modified to optimize a Taylor expansion of the loss functions, an approach known as *Extreme Gradient Boosting*

(Chen & He, 2015a) that obtains state-of-the-art results in many problems on Kaggle competitions.¹ Recently, it has been shown that the ensemble classifier can be successfully applied to the bankruptcy prediction (Nanni & Lumini, 2009) and it significantly beats other methods (Alfaro, García, Gámez, & Elizondo, 2008).

Contribution. In this paper we propose a novel method for bankruptcy prediction that makes use of Extreme Gradient Boosting (Chen & He, 2015b) for developing regularized boosted trees (Chen & He, 2015a; Johnson & Zhang, 2011). Best to our knowledge, such an approach was not applied to solve the problem of predicting financial condition of the companies. However, this method is successfully applied to many classification problems (Chen & He, 2015a) and widely used in winning Kaggle competitions. The model is also insensitive to imbalanced data phenomenon because it enables to select AUC measure for evaluation and forces proper ordering of the imbalanced data. To improve the prediction of the model we use ensemble of boosted trees, where each base learner is constructed using additional *synthetic features*. The synthetic features are developed at each boosting step in an evolutionary fashion by combining features using an arithmetic operation. Each synthetic feature can be seen as a single regression model. The purpose of the synthetic features is to combine the econometric indicators proposed by the domain experts into a complex features. The synthetic features can be seen as hidden features extracted by the neural networks but the fashion they are extracted is different. At the end, we test our solution using collected data about Polish companies.

Organization of the paper. The paper is organized as follows. In Section 2 the ensemble boosted trees is introduced as the model for bankruptcy prediction. In Section 3 we present the experimental results gained on real dataset representing the financial condition of the Polish companies. The paper is summarized by the conclusions in Section 4.

2. Methodology

2.1. Extreme Gradient Boosting Framework

Let us denote by $\mathbf{x} \in \mathcal{X}$ a vector of features describing an enterprise, where $\mathcal{X} \subseteq \mathbb{R}^D$ and by $y \in \{0, 1\}$ a label representing whether the enterprise is bankrupt, $y = 1$, or not, $y = 0$. Further, we utilize decision trees as discriminative models, more precisely, Classification and Regression Trees (CART). A CART tree can be represented by the weights associated with the leaves in the tree structure

$$f_k(\mathbf{x}_n) = w_{q(\mathbf{x})}, \quad (1)$$

where $q(\mathbf{x}_n)$ is the function that takes an example \mathbf{x} and returns the path id in the structure of the tree, $q: \mathbb{R}^D \rightarrow \{1, \dots, T\}$, T is the number of paths (leaves). A path is ended with a leaf that contains weight w_i .

We aim at learning an ensemble of K decision trees (Chen & He, 2015a)

$$h_K(\mathbf{x}) = \sum_{k=1}^K f_k(\mathbf{x}), \quad (2)$$

where $f_k \in \mathcal{F}$, for $k = 1, \dots, K$, and \mathcal{F} is a space of all possible decision trees (CART). In order to obtain a decision for new \mathbf{x} one could calculate a conditional probability of a class for h_K as follows:

$$p(y = 1|\mathbf{x}) = \sigma(h_K(\mathbf{x})), \quad (3)$$

where $\sigma(a) = \frac{1}{1+\exp(-a)}$ is the sigmoid function.

¹ www.kaggle.com/

For given training data $\mathcal{D} = \{\mathbf{x}_n, y_n\}_{n=1}^N$, the model is trained by minimizing the following criterion:

$$L_{\Omega}(\boldsymbol{\theta}) = L(\boldsymbol{\theta}) + \Omega(\boldsymbol{\theta})$$

$$= \sum_{n=1}^N l(y_n, h_K(\mathbf{x}_n)) + \sum_{k=1}^K \Omega(f_k), \quad (4)$$

where $\boldsymbol{\theta}$ represents the parameters of the model, i.e., $\boldsymbol{\theta} = \{f_1, \dots, f_K\}$, $\Omega(\boldsymbol{\theta}) = \sum_{k=1}^K \Omega(f_k)$ is a regularization term and $L(\boldsymbol{\theta}) = \sum_{n=1}^N l(y_n, h_K(\mathbf{x}_n))$ is a loss function. In this work we consider the binary classification task, for which we use the logistic loss

$$L(\boldsymbol{\theta}) = \sum_{n=1}^N [y_n \log(1 + \exp\{-h_K(\mathbf{x}_n)\}) + (1 - y_n) \log(1 + \exp\{h_K(\mathbf{x}_n)\})]. \quad (5)$$

The ensemble model for this loss function is known as LogitBoost model (Chen & He, 2015a).

The problem of learning such model can be solved iteratively by adding a new weak learner $f_k(\cdot)$ in the k -th training iteration assuming that models $f_1(\cdot), \dots, f_{k-1}(\cdot)$ are already trained. We can present the loss function for single example $l(y_n, h_k(\mathbf{x}_n))$ in the following manner:

$$l(y_n, h_k(\mathbf{x}_n)) = l(y_n, h_{k-1}(\mathbf{x}_n) + f_k(\mathbf{x}_n)) \quad (6)$$

We assumed additive regularization term, therefore we can represent it in the following form:

$$\sum_{i=1}^k \Omega(f_i) = \Omega(f_k) + \Omega(h_{k-1}) = \Omega(f_k) + \text{constant} \quad (7)$$

As a consequence, we can represent the general learning criterion (4) as

$$L_{\Omega}(\boldsymbol{\theta}) = \sum_{n=1}^N l(y_n, h_{k-1}(\mathbf{x}_n) + f_k(\mathbf{x}_n)) + \Omega(f_k) + \text{constant} \quad (8)$$

Further, approximating the objective function using the Taylor expansion with respect to $h_{k-1}(\mathbf{x}_n)$ yields

$$L_{\Omega}(\boldsymbol{\theta}) \simeq \sum_{n=1}^N [l(y_n, h_{k-1}(\mathbf{x}_n)) + g_n \cdot f_k(\mathbf{x}_n) + \frac{1}{2} \cdot h_n \cdot f_k^2(\mathbf{x}_n)] + \Omega(f_k) + \text{constant}, \quad (9)$$

where g_n is the first derivative with respect to $h_{k-1}(\mathbf{x}_n)$

$$g_n = \frac{\partial l(y_n, h_{k-1}(\mathbf{x}_n))}{\partial h_{k-1}(\mathbf{x}_n)}, \quad (10)$$

and h_n is the second derivative with respect to $h_{k-1}(\mathbf{x}_n)$

$$h_n = \frac{\partial^2 l(y_n, h_{k-1}(\mathbf{x}_n))}{\partial h_{k-1}^2(\mathbf{x}_n)}. \quad (11)$$

Considering the logistic loss (4) we have

$$g_n = -y_n \frac{\exp\{-h_{k-1}(\mathbf{x}_n)\}}{1 + \exp\{-h_{k-1}(\mathbf{x}_n)\}} + (1 - y_n) \frac{\exp\{h_{k-1}(\mathbf{x}_n)\}}{1 + \exp\{h_{k-1}(\mathbf{x}_n)\}}$$

$$= -y_n \frac{1}{1 + \exp\{h_{k-1}(\mathbf{x}_n)\}} + (1 - y_n) \frac{1}{1 + \exp\{-h_{k-1}(\mathbf{x}_n)\}}$$

$$= -y_n (1 - \sigma(h_{k-1}(\mathbf{x}_n))) + (1 - y_n) \sigma(h_{k-1}(\mathbf{x}_n))$$

$$= \sigma(h_{k-1}(\mathbf{x}_n)) - y_n, \quad (12)$$

In calculating the first derivative we took advantage of the sigmoid function property, namely, $\sigma(-a) = 1 - \sigma(a)$. It can be observed, that $\sigma(h_{k-1}(\mathbf{x}_n))$ has interpretation of the probability of observing the class indexed by 1 for the example \mathbf{x}_n .

We can make use of $\sigma'(a) = \sigma(a)(1 - \sigma(a))$ property to calculate the second derivative, h_n

$$h_n = \sigma(h_{k-1}(\mathbf{x}_n))(1 - \sigma(h_{k-1}(\mathbf{x}_n))) \quad (13)$$

There are different possible regularization terms. However, in our considerations we focus on the regularizer in the following form:

$$\Omega(f_k) = \gamma T + \frac{1}{2} \lambda \sum_{t=1}^T w_t^2, \quad (14)$$

where λ and γ are the parameters of the regularization term. For the tree representation with weights the objective function given in (9) can be presented in the following manner:

$$L_{\Omega}(\boldsymbol{\theta}) \simeq \sum_{n=1}^N [g_n w_{q(\mathbf{x}_n)} + \frac{1}{2} h_n \cdot w_{q(\mathbf{x}_n)}^2] + \gamma T$$

$$+ \frac{1}{2} \lambda \sum_{t=1}^T w_t^2 + \text{constant}$$

$$= \sum_{t=1}^T [(\sum_{j \in I_t} g_j) w_t + \frac{1}{2} (\sum_{j \in I_t} h_j + \lambda) w_t^2] + \gamma T + \text{constant}$$

$$= \sum_{t=1}^T [G_t w_t + \frac{1}{2} (H_t + \lambda) w_t^2] + \gamma T + \text{constant}, \quad (15)$$

where $I_t = \{n | q(\mathbf{x}_n) = t\}$ is the set of indexes of instances associated with the t -th leaf in the tree, $G_t = \sum_{j \in I_t} g_j$ and $H_t = \sum_{j \in I_t} h_j$. Assuming the known structure of the tree, the optimal value of the weight in the t -th leaf is as follows:

$$w_t^* = -\frac{G_t}{H_t + \lambda} \quad (16)$$

The optimal value of the approximated objective function is given by

$$L_{\Omega}(\boldsymbol{\theta}) \simeq -\frac{1}{2} \sum_{t=1}^T \frac{G_t^2}{H_t + \lambda} + \gamma T + \text{constant} \quad (17)$$

The key problem in the above consideration is that the structure of the tree is not given in advanced and searching all possible structures is computationally infeasible. To overcome this issue the tree is being constructed starting from the root and further the best attribute to be located in the root is selected and the best split point for the attribute is chosen. The splitting process is performed until the quality of the model is improved. As the splitting criterion we take the info gain:

$$\mathcal{G} = \frac{G_L^2}{H_L + \lambda} + \frac{G_R^2}{H_R + \lambda} - \frac{(G_L + G_R)^2}{H_R + H_L + \lambda} - \gamma, \quad (18)$$

where $\frac{G_L^2}{H_L + \lambda}$ is the score value calculated for the left child, $\frac{G_R^2}{H_R + \lambda}$ for the right child and $\frac{(G_L + G_R)^2}{H_R + H_L + \lambda}$ is the score value if splitting is not performed. Parameter γ penalizes addition of more leaves to the tree structure.

The model can be also regularized by setting minimal number of examples combined with each of the leaves, by setting maximal depth of the tree, by setting the percentage of features randomized for each iteration of constructing the tree or by adding the new tree with corrected influence of the trees in the committee

$$h_k(\mathbf{x}_n) = h_{k-1}(\mathbf{x}_n) + \epsilon f_k(\mathbf{x}_n), \quad (19)$$

where $\epsilon \in [0, 1]$ is called step-size or shrinkage.

2.2. Ensemble of boosted trees for bankruptcy prediction

Motivation. The motivation of applying boosted trees trained with the Extreme Gradient Boosting method to the bankruptcy prediction is that estimators of economic indicators describing the companies are characterized by high variance caused by relatively small number of samples. Practically it means that most of the values of some indicators are accumulated in some narrow segment but there are some companies that are described by relatively high/small values of those features. As a consequence, the application of gradient-based models like neural networks or logistic regression leads to the training issues and eventually poor prediction. The problem is also difficult to overcome when data is normalized or standardized. Contrary to this approaches ensemble tree-based learners take into account the order of feature values, not the values itself. Therefore, they are resistant to huge values of the economic indicators and do not need any pre-processing stage.

Synthetic features. Ensemble tree-based models can also effectively learn from data described by many features. We take advantage of this property by proposing the ensemble of boosted trees model dedicated to solve the problem of bankruptcy prediction. The central idea in our approach is to generate synthetic features that may have better influence on prediction than typical economic factors. The synthetic features are generated by random selection of two existing features and random selection of arithmetical operation to be performed on them. To estimate the probability of selecting the seed features we make use of popularity of the feature in the already created forest. The popularity of the feature in the forest is described by the total number of occurrences in trees that constitutes the forest. Let us denote the total number of occurrences of the d -th feature in the forest structure by m_d . We define the categorical distribution $\theta_F = [\theta_F^{(1)}, \dots, \theta_F^{(d)}, \dots, \theta_F^{(D)}]$ for selecting the features to be replicated in the following manner:

$$\theta_F^{(d)} = \frac{m_d}{\sum_{d=1}^D m_d}. \quad (20)$$

As a consequence, the most popular features are going to be selected for reproduction. The proposed procedure can be seen as a kind of an evolutionary approach that selects the strongest parents for the child feature.

The arithmetic operation is selected from uniform distribution defined on the set of possible values, $\{+, -, *, /\}$.

We motivate introduction of the synthetic features twofold. First, the synthetic features can be seen as regression models that represent complex relationships among features. Notice that such regression models cannot be trained using CART. Moreover, the synthetic features can be seen as a kind of hidden units in the neural networks but the manner they are extracted is completely different. Second, in case of small sample size, the synthetic features are easier to learn than training a complicated tree structure.

Learning algorithm. The procedure of constructing ensemble of base learners is described by Algorithm 1. In each of the training iterations one of the base learners h_k that represents boosted trees is trained with Extreme Gradient Boosting approach using dataset \mathcal{D} . Basing on feature importance m_d , $d = 1, \dots, D$ gathered from trained model h_k we select only those features, for which m_d is above given threshold value η . The trained model is further used to determine the popularity of the features and estimate the distribution θ_F .

Further, the synthetic features are generated using the following framework. Two features f_1 and f_2 are sampled from distribution θ_F . Next, the operation \circ is uniformly sampled from the set $\{+, -, *, /\}$. The value of new feature $f_{new} = f_1 \circ f_2$ is calculated for

Input : \mathcal{D} : training set, D_{new} : number of synthetic features, L : number of base learners, η : features acceptance threshold

Output: $H = \{h_1, \dots, h_K\}$: set of base learners

```

1 for  $k = 1, \dots, K$  do
2   Train  $h_k$  using  $\mathcal{D}$ ;
3   Remove features from  $\mathcal{D}$  for which  $m_d < \eta$ ;
4   Estimate  $\theta_F$  from model  $h_k$ ;
5   for  $d = 1, \dots, D_{new}$  do
6     Sample features  $f_1$  and  $f_2$  from distribution  $\theta_F$ ;
7     Sample operation  $\circ$  from  $\{+, -, *, /\}$ ;
8     Generate new feature  $f_{new} = f_1 \circ f_2$ ;
9     Extend  $\mathcal{D}$  with new values of  $f_{new}$ ;
10  end
11 end
12 return  $H = \{h_1, \dots, h_K\}$ ;

```

Algorithm 1: Ensemble of boosted trees with synthetic features

all examples in dataset \mathcal{D} . The process of creating synthetic features is repeated until the desired number synthetic features, D_{new} , is reached. The extended dataset is further used to construct the h_{k+1} base model.

3. Experiments

3.1. Dataset

Data preparation. To evaluate the quality of the approach we collected the data about financial condition of Polish companies. The process of selection data consists of choosing the sector, the database, the research period, the number of companies and the number of financial indicators that will be analyzed. First of all, in Poland, since 2004, many companies in the manufacturing sector went bankrupt, therefore we decided to analyze this sector. Then, we chose the database Emerging Markets Information Service (EMIS),² which is a database containing information on emerging markets around the world including the Polish one. The service provides access to 540 publications containing financial information, political, macroeconomic and companies news in local languages and English. Moreover, the source of base includes articles, news agency messages, the financial statements of companies, industry reports, stock quotes and statistics and analyzes macroeconomic data.

Next, the period of time was established which is 2007–2013 for bankrupt and 2000–2012 for still operating companies and it is due to the availability of data in the database EMIS. The research sample consists of bankrupt and still operating companies (imbalanced sample). In the period of 2007–2013 nearly 700 bankrupt enterprises (almost 2400 financial statements) were analyzed. In the period 2000–2012 more than 10,000 still operating ones, in this sample the company, which declared bankruptcy is excluded (more than 65 thousand financial statements) were taken into account. Finally, we determined the 64 financial indicators to be analyzed. This figure is due to the availability of data and the intensity of the occurrence in integrated models and financial analysis presented in related works (Tomczak, 2014a; 2014b; 2014c). The detailed methodology of collecting the data is described in Table 1.

The features considered in the research studies are described in details in Table 2. Basing on the collected data we distinguished five classification cases, that depends on the forecasting period

- *1stYear* – the data contains financial rates from 1st year of the forecasting period and corresponding class label that indicates

² <http://www.securities.com>

Table 1

The methodology of collecting the training data.

| Name | Criterion | Selection |
|---|---|--|
| sector | the highest number of bankruptcies in the sector compared to other sectors | the manufacturing sector |
| database of financial statements period | The availability of databases financial statements availability | EMIS 5 years before bankruptcy in the period of 2007–2013, 2000–2012 for still operating companies |
| bankrupt companies | availability of at least one financial report in the analyzed period of five years before the bankruptcy of a company | nearly 700 from 1000 bankrupt enterprises were selected in the period of 2007–2013 (almost 2400 financial statements were analyzed) |
| still operating companies | the availability of a minimum of three consecutive financial statements in the period 2000–2012 | more than 10,000 from 17,000 businesses still functioning were chosen (more than 65 thousand financial statements were taken into consideration) |
| financial indicators | used in the integrated models and financial analysis | 64 financial ratios were analyzed (see Table 2). |

Table 2

The set of features considered in classification process.

| ID | Description | ID | Description |
|-----|--|-----|---|
| X1 | net profit / total assets | X33 | operating expenses / short-term liabilities |
| X2 | total liabilities / total assets | X34 | operating expenses / total liabilities |
| X3 | working capital / total assets | X35 | profit on sales / total assets |
| X4 | current assets / short-term liabilities | X36 | total sales / total assets |
| X5 | [(cash + short-term securities + receivables - short-term liabilities) / (operating expenses - depreciation)] * 365, | X37 | (current assets - inventories) / long-term liabilities |
| X6 | retained earnings / total assets | X38 | constant capital / total assets |
| X7 | EBIT / total assets | X39 | profit on sales / sales |
| X8 | book value of equity / total liabilities | X40 | (current assets - inventory - receivables) / short-term liabilities |
| X9 | sales / total assets | X41 | total liabilities / ((profit on operating activities + depreciation) * (12/365)) |
| X10 | equity / total assets | X42 | profit on operating activities / sales |
| X11 | (gross profit + extraordinary items + financial expenses) / total assets | X43 | rotation receivables + inventory turnover in days |
| X12 | gross profit / short-term liabilities | X44 | (receivables * 365) / sales |
| X13 | (gross profit + depreciation) / sales | X45 | net profit / inventory |
| X14 | (gross profit + interest) / total assets | X46 | (current assets - inventory) / short-term liabilities |
| X15 | (total liabilities * 365) / (gross profit + depreciation) | X47 | (inventory * 365) / cost of products sold |
| X16 | (gross profit + depreciation) / total liabilities | X48 | EBITDA (profit on operating activities - depreciation) / total assets |
| X17 | total assets / total liabilities | X49 | EBITDA (profit on operating activities - depreciation) / sales |
| X18 | gross profit / total assets | X50 | current assets / total liabilities |
| X19 | gross profit / sales | X51 | short-term liabilities / total assets |
| X20 | (inventory * 365) / sales | X52 | (short-term liabilities * 365) / cost of products sold |
| X21 | sales (n) / sales (n-1) | X53 | equity / fixed assets |
| X22 | profit on operating activities / total assets | X54 | constant capital / fixed assets |
| X23 | net profit / sales | X55 | working capital |
| X24 | gross profit (in 3 years) / total assets | X56 | (sales - cost of products sold) / sales |
| X25 | (equity - share capital) / total assets | X57 | (current assets - inventory - short-term liabilities) / (sales - gross profit - depreciation) |
| X26 | (net profit + depreciation) / total liabilities | X58 | total costs / total sales |
| X27 | profit on operating activities / financial expenses | X59 | long-term liabilities / equity |
| X28 | working capital / fixed assets | X60 | sales / inventory |
| X29 | logarithm of total assets | X61 | sales / receivables |
| X30 | (total liabilities - cash) / sales | X62 | (short-term liabilities * 365) / sales |
| X31 | (gross profit + interest) / sales | X63 | sales / short-term liabilities |
| X32 | (current liabilities * 365) / cost of products sold | X64 | sales / fixed assets |

bankruptcy status after 5 years. The data contains 7027 instances (financial statements), 271 represents bankrupted companies, 6756 firms that did not bankrupt in the forecasting period.

- *2ndYear* – the data contains financial rates from 2nd year of the forecasting period and corresponding class label that indicates bankruptcy status after 4 years. The data contains 10173 instances (financial statements), 400 represents bankrupted companies, 9773 firms that did not bankrupt in the forecasting period.
- *3rdYear* – the data contains financial rates from 3rd year of the forecasting period and corresponding class label that indicates bankruptcy status after 3 years. The data contains 10503 instances (financial statements), 495 represents bankrupted com-

panies, 10008 firms that did not bankrupt in the forecasting period.

- *4thYear* – the data contains financial rates from 4th year of the forecasting period and corresponding class label that indicates bankruptcy status after 2 years. The data contains 9792 instances (financial statements), 515 represents bankrupted companies, 9277 firms that did not bankrupt in the forecasting period.
- *5thYear* – the data contains financial rates from 5th year of the forecasting period and corresponding class label that indicates bankruptcy status after 1 year. The data contains 5910 instances (financial statements), 410 represents bankrupted companies, 5500 firms that did not bankrupt in the forecasting period.

3.2. Experiment setup

The goal of the experiment was to identify the best classification model for each of the bankruptcy prediction cases represented by the training data described in previous subsection. We took under consideration the following classification methods:

- **LDA**, linear discriminant analysis (Altman, 1968);
- **MLP**, multilayer perceptron with a hidden layer (Back, Laitinen, & Sere, 1996);
- **JRip**, decision rules inducer (Cohen, 1995);
- cost-sensitive variation of **JRip** (**CJRip**);
- **J48**, decision tree model (Quinlan, 1993);
- cost-sensitive variation of **J48** (**CJ48**);
- Logistic Regression (**LR**);
- cost-sensitive variation of Logistic Regression (**CLR**);
- AdaBoost (**AB**) (Freund & Schapire, 1996);
- AdaCost (**AC**) (Fan et al., 1999);
- Support Vector Machines (**SVM**) (Cortes & Vapnik, 1995);
- Cost-sensitive Support Vector Machines (**CSVM**);
- Random Forest (**RF**) (Ho, 1995);
- Boosted trees trained with Extreme Gradient Boosting (**XGB**);
- only the last tree of the ensemble of boosted trees, i.e., f_K , trained with the Algorithm 1 (**XGBE**);
- Ensemble of boosted trees trained with the Algorithm 1 (**EXGB**);

Most of the reference approaches were considered in the filed of bankruptcy prediction. Moreover, we had formulated the problem of predicting financial condition of the companies in terms of binary classification. Therefore, we had an opportunity to examine the quality of various machine learning approaches dedicated to solve two-class problems, even those, that are non-standard in the field of bankruptcy prediction.

Due to the imbalanced nature of training data, we utilized the Area Under ROC Curve (**AUC**) curve criterion to evaluate the quality of the models. For each of considered models we examined the quality of various settings of training parameters using 10 folds cross validation methodology. In Table 3 we present only the best results for each type of the considered classifiers.³

For the cost-sensitive models we set misclassification costs equal $\frac{N_-}{N_+}$ for minority examples and 1 for majority cases, where N_+ denotes number of minority examples and N_- stays behind the number of majority (Tomczak & Zięba, 2015).

For Ensemble of boosted trees we obtained the best results for the number of base learners equal 10 and number of synthetic features generated in each iteration equal 60. The feature is accepted for next iteration if was observed at least in 5% of trees in the forest. For testing boosted trees we used *xgboost*⁴ library for Python. For testing other methods we used *Weka Data Mining Tool*⁵ for Java.

3.3. Results

The experimental results are presented in Table 3. For each of the considered periods and examined models we present the mean (**MN**) and standard deviation (**STD**) for AUC measure that was calculated basing on 10 cross validation folds.

It can be noticed, that boosted trees significantly outperforms other models. For the reference classifiers the best results are gained by AdaBoost and AdaCost. For all datasets the last base learner of the ensemble f_K alone trained with the synthetic features (**XGBE**) gained slightly better results than the boosted tree model (**XGB**). The results were further improved if the base learners were formed in the ensemble structure using the synthetic features (**EXGB**).

To investigate the significance of difference between results gained by **XGB** vs. **XGBE**, **XGB** vs. **EXGB** and **XGBE** vs. **XGB** we applied signed rank Wilcoxon test. The p -values for considered pairs are as follows:

- for **XGB** vs. **XGBE** p -value is equal 0.003;
- for **XGB** vs. **EXGB** p -value is less than 0.001;
- for **XGBE** vs. **EXGB** p -value is equal 0.003;

Assuming the significance level equal 0.05, regarding the Wilcoxon test, we can reject all stated null median difference hypotheses. Concluding, **EXGB** performs better than **XGBE** and **XGB**, **XGBE** gained significantly better results then **XGB**.

3.4. Features importance evaluation

We evaluated the importance of the features by calculating the total number of the feature being observed in the nodes of forest structure by total number of nodes in trees that constitute the forest. In the other words, we take under consideration the categorical distribution $\theta_F^{(d)}$ defined in Eq. (20). In Table 4 we present 20 most important features for each of the considered classification cases. Analyzing the results presented in Table 4, it can be said that only three indicators X25 (adjusted share of equity in financing of assets), X40 (current ratio, the most frequently used ratio in the integrated models (Tomczak, 2014b)), X52 (liabilities turnover ratio) appeared in each research year. Therefore, they can be considered as useful in predicting bankruptcy of enterprises. It is worth noting that beside these three indicators, during the period considered the following indicators may also be useful: X13, X22, X31, X42 (profitability ratios), X15 (leverage ratios), X9, X36, X48, X52 (operating performance ratios), X5, X27, X58 (others). Because they occurred in 4 out of 5 years.

Further, we examine the popularity of the synthetic features generated to construct each of the base learners for *1stYear* dataset (see Table 5). For instance, we have a very popular feature that is observed in more than 3% of the nodes and can be calculated using formula $(X47/X27)$. Days inventory ratio is divided by financial expenses coverage ratio which means that operating performance and profitability of a company do matter. For the third base learner over 4% popularity was gained by the feature that can be calculated with formula $((X22 * X25) + X27)$. Return on investment times adjusted share of equity in financing of assets plus financial expenses coverage ratio which means that profitability and leverage of a company also do matter. Therefore, the presented approach can be used to discover synthetic features that are so far undefined by experts as relevant financial factors. However, it should be checked which ones are characterized by a higher correctness of classification of companies.

For the 10th base learner the generated synthetic samples are presented in Table 6. Most of the features are too complicated to be interpreted in straightforward way. However, some of the features like X46 or X29 survived replication procedure with high popularity measure. The new features are characterized by decreasing average popularity. Therefore the model is prone to overfitting. That issue should be controlled by proper value of features acceptance threshold (η , see Algorithm 1).

³ We selected the best model of each type according to the average value of AUC calculated from ten folds.

⁴ <https://xgboost.readthedocs.org/en/latest/>

⁵ <http://www.cs.waikato.ac.nz/ml/weka/>

Table 3

Experimental results for considered classification models.

| | 1stYear | | 2ndYear | | 3rdYear | | 4thYear | | 5thYear | |
|--------------|-------------|------|-------------|------|-------------|------|-------------|------|-------------|------|
| | MN | STD | MN | STD | MN | STD | MN | STD | MN | STD |
| LDA | .639 | .083 | .660 | .037 | .688 | .030 | .714 | .063 | .796 | .041 |
| MLP | .543 | .042 | .514 | .042 | .548 | .041 | .596 | .049 | .699 | .059 |
| JRip | .523 | .030 | .540 | .025 | .535 | .022 | .538 | .026 | .654 | .049 |
| CJRip | .745 | .112 | .774 | .073 | .804 | .054 | .799 | .070 | .778 | .035 |
| J48 | .717 | .059 | .653 | .068 | .701 | .062 | .691 | .076 | .761 | .049 |
| CJ48 | .658 | .047 | .652 | .047 | .618 | .061 | .611 | .025 | .719 | .046 |
| LR | .620 | .065 | .513 | .042 | .500 | .000 | .500 | .000 | .632 | .119 |
| CLR | .704 | .065 | .671 | .032 | .714 | .034 | .724 | .041 | .821 | .037 |
| AB | .916 | .020 | .850 | .029 | .861 | .023 | .885 | .031 | .925 | .026 |
| AC | .916 | .023 | .849 | .022 | .859 | .022 | .886 | .015 | .928 | .023 |
| SVM | .502 | .006 | .502 | .006 | .500 | .000 | .500 | .000 | .505 | .006 |
| CSVM | .578 | .040 | .517 | .064 | .614 | .040 | .615 | .034 | .716 | .039 |
| RF | .851 | .044 | .842 | .028 | .831 | .031 | .848 | .027 | .898 | .035 |
| XGB | .945 | .033 | .917 | .027 | .922 | .025 | .935 | .024 | .951 | .024 |
| XGBE | .953 | .024 | .941 | .019 | .929 | .049 | .940 | .027 | .954 | .018 |
| EXGB | .959 | .018 | .944 | .021 | .940 | .032 | .941 | .025 | .955 | .019 |

Table 4

Ranking of features for each of the datasets.

| Rank | 1stYear | | 2ndYear | | 3rdYear | | 4thYear | | 5thYear | |
|------|---------|------------------|---------|------------------|---------|------------------|---------|------------------|---------|------------------|
| | ID | $\theta_F^{(d)}$ | ID | $\theta_F^{(d)}$ | ID | $\theta_F^{(d)}$ | ID | $\theta_F^{(d)}$ | ID | $\theta_F^{(d)}$ |
| 1 | X16 | .0519 | X40 | .0473 | X15 | .0506 | X22 | .0461 | X25 | .0627 |
| 2 | X52 | .0380 | X15 | .0449 | X22 | .0382 | X52 | .0446 | X22 | .0480 |
| 3 | X32 | .0378 | X27 | .0404 | X52 | .0369 | X15 | .0413 | X27 | .0379 |
| 4 | X28 | .0355 | X5 | .0342 | X27 | .0337 | X25 | .0385 | X15 | .0356 |
| 5 | X5 | .0347 | X25 | .0341 | X40 | .0325 | X27 | .0345 | X52 | .0326 |
| 6 | X40 | .0333 | X36 | .0336 | X5 | .0309 | X40 | .0322 | X53 | .0284 |
| 7 | X9 | .0319 | X22 | .0277 | X25 | .0260 | X58 | .0257 | X14 | .0248 |
| 8 | X11 | .0308 | X42 | .0277 | X31 | .0257 | X42 | .0252 | X40 | .0247 |
| 9 | X59 | .0308 | X31 | .0268 | X12 | .0250 | X13 | .0250 | X42 | .0238 |
| 10 | X23 | .0266 | X13 | .0266 | X42 | .0234 | X36 | .0237 | X36 | .0236 |
| 11 | X25 | .0245 | X12 | .0220 | X13 | .0233 | X31 | .0234 | X54 | .0236 |
| 12 | X55 | .0245 | X35 | .0218 | X53 | .0230 | X5 | .0232 | X12 | .0216 |
| 13 | X17 | .0233 | X9 | .0216 | X57 | .0229 | X53 | .0228 | X58 | .0215 |
| 14 | X14 | .0221 | X58 | .0212 | X37 | .0216 | X6 | .0215 | X41 | .0210 |
| 15 | X29 | .0214 | X11 | .0209 | X48 | .0205 | X35 | .0209 | X44 | .0193 |
| 16 | X13 | .0210 | X48 | .0209 | X6 | .0202 | X48 | .0205 | X48 | .0193 |
| 17 | X58 | .0210 | X52 | .0208 | X35 | .0198 | X9 | .0201 | X9 | .0192 |
| 18 | X30 | .0192 | X57 | .0205 | X41 | .0188 | X24 | .0197 | X31 | .0192 |
| 19 | X57 | .0192 | X55 | .0184 | X32 | .0184 | X38 | .0197 | X32 | .0190 |
| 20 | X56 | .0174 | X6 | .0179 | X36 | .0182 | X29 | .0186 | X16 | .0189 |

Table 5

Ranking of features for first 3 base learners.

| Ranking | 1st Learner | | 2nd Learner | | 3rd Learner | |
|---------|-------------|------------------|-------------|------------------|-----------------------|------------------|
| | ID | $\theta_F^{(d)}$ | ID | $\theta_F^{(d)}$ | ID | $\theta_F^{(d)}$ |
| 1 | X16 | .0519 | X46 | .0402 | ((X22*X25)+X27) | .0437 |
| 2 | X52 | .0380 | (X47/X27) | .0332 | X29 | .0242 |
| 3 | X32 | .0378 | X29 | .0311 | X46 | .0240 |
| 4 | X28 | .0355 | X27 | .0300 | ((X18-X34)/X56) | .0240 |
| 5 | X5 | .0347 | (X18-X34) | .0281 | X9 | .0238 |
| 6 | X40 | .0333 | X34 | .0247 | (X11*X44) | .0224 |
| 7 | X9 | .0319 | X9 | .0228 | X27 | .0199 |
| 8 | X11 | .0308 | (X13-X46) | .0221 | ((X32/X15)+X27) | .0192 |
| 9 | X59 | .0308 | (X11*X44) | .0217 | (X24/X27) | .0181 |
| 10 | X23 | .0266 | (X21+X62) | .0206 | ((X46/X61)*(X61+X21)) | .0174 |
| 11 | X25 | .0245 | (X2-X45) | .0191 | ((X18-X34)/(X50*X52)) | .0167 |
| 12 | X55 | .0245 | X11 | .0183 | (X18-X34) | .0162 |
| 13 | X17 | .0233 | X37 | .0174 | X11 | .0155 |
| 14 | X14 | .0221 | X21 | .0170 | ((X18-X34)+X57) | .0149 |
| 15 | X29 | .0214 | (X61+X21) | .0168 | ((X61+X21)*X32) | .0149 |
| 16 | X13 | .0210 | X58 | .0166 | (X29-X58) | .0126 |
| 17 | X58 | .0194 | (X17-X5) | .0160 | X25 | .0123 |
| 18 | X30 | .0192 | X22 | .0153 | ((X13-X46)-X6) | .0123 |
| 19 | X57 | .0192 | X25 | .0138 | X58 | .0112 |
| 20 | X56 | .0194 | (X64-X37) | .0134 | X34 | .0107 |

Table 6
Ranking of features for considered by 10-th base learner.

| Ranking | ID | $\theta_F^{(d)}$ |
|---------|--|------------------|
| 1 | $(((((X18-X34)/X56)/X46)/(X24/X27))*(X11*X44))/((X18-X34)/(X36*X58)) + ((X38/X30)-(X22))/X46)$ | .0121 |
| 2 | $(((((X38/X30)-(X22)+(X46/X61)*(X61+X21)))*(X30)/((X22*X25)+X27)-(((X47/X27)-X46)*(X33*X39))*(((X38/X30)-(X22)+(X18-X34)/(X36*X58)))))+X46)$ | .0109 |
| 3 | $((X18-X34)*((X2-X45)*X46))+X46)$ | .0106 |
| 4 | $(((((X18-X34)/X56)/X46)-X49)-(((X22*X25)+X27)/(X29*(X18-X34)))*X22))$ | .0102 |
| 5 | $(((((X11-((X2-X45)/X25))-((X18-X34)/(X36*X58)))+((X11*(X11*X44)-(X1/X61)-(X2-X45)))/(X46)/(((X18-X34)/X56)/X46)/(X24/X27)))*X50))$ $*(X11/((X46+X34)*(X29-X58))))$ | .0094 |
| 6 | $(((((X22*X25)+X27)/(X29*(X18-X34)))*X22))$ | .0084 |
| 7 | X46 | .0077 |
| 8 | $((X29+X29)+((X22*X25)+X27)/(X29*(X18-X34))))$ | .0074 |
| 9 | $((X11*(X11*X44)-((X1/X61)-(X2-X45)))/(X46)/(((X18-X34)/X56)/X46)/(X24/X27)))*X50)$ | .0074 |
| 10 | $(((((X38/X30)-(X22)+(X46/X61)*(X61+X21)))*(X30)/((X22*X25)+X27)-(((X47/X27)-X46)*(X33*X39))*(((X38/X30)-(X22)+(X18-X34)/(X36*X58))))))$ | .0074 |
| 11 | $(((((X56+X48)-X11)+X46)+(((X56+X48)-X11)+X46)-((X38/X30)-(X22)))-X30)$ | .0074 |
| 12 | $(((((X22*X25)+X27)/(X29*(X18-X34)))*X22)+(X48+(X25/X31))))$ | .0072 |
| 13 | $((X48+(X25/X31))/((X35/(X26/X57))-X29))+(X48+(X25/X31)))$ | .0069 |
| 14 | $(X25-((X22*X25)+X27)/(X29*(X18-X34))))$ | .0067 |
| 15 | $(((((X22*X25)+X27)/(X29*(X18-X34)))*X22)+(X48+(X25/X31))-X46)$ | .0067 |
| 16 | $(X46)/((X46)/(((X18-X34)/X56)/X46)/(X24/X27))-((X13*((X61+X21)+X41)/((X2-X45)*X46)))/((X25/X31)-(X47/X27))))$ | .0067 |
| 17 | X29 | .0067 |
| 18 | $(((((X38/X30)-(X22)+(X18-X34)/(X36*X58)))+(((X47/X27)-X46)*(X33*X39))*(((X38/X30)-(X22)+(X18-X34)/(X36*X58)))))-(((((X38/X30)-(X22)+(X46/X61)*(X61+X21)))*(X30)/((X22*X25)+X27)-(((X47/X27)-X46)*(X33*X39))*(((X38/X30)-(X22)+(X18-X34)/(X36*X58))))))$ | .0064 |
| 19 | $((X46)/(((X18-X34)/X56)/X46)/(X24/X27)))*X29+X29))$ | .0064 |
| 20 | $(X58*((X18-X34)/(X36*X58)))+(X38/X30)-(X22))$ | .0064 |

4. Conclusions

The paper presents the novel approach for the problem of predicting the bankruptcy basing on the financial factors. We took under consideration the financial condition of Polish companies from 2007 to 2013 (bankrupt) and from 2000 to 2012 for (still operating). To solve the stated classification problem we applied the Extreme Gradient Boosting model. The results gained by the selected classifier were significantly better than the results gained by all reference methods that were applied to the problem of predicting financial condition of the companies before. Further, we proposed some extension of the Extreme Gradient Boosting that randomly generates new synthetic features. The application of such approach led to significant improvement of the quality of prediction. We also thoroughly discussed the relevance of the newly created features. The presented model is not limited to Polish companies but represents a general framework that can be applied to an arbitrary given data from the considered domain.

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