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Enhancing Financial Stability: The Contribution of Earnings Quality in Iraqi Industrial Companies to Mitigate Financial Distress

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Abstract

Typically, the quality of earnings significantly influences a company's overall performance. Existing literature suggests that earnings quality can potentially enhance a company's access to creditors and investors, thereby improving its financial performance, even though empirical evidence on this matter is scarce. This study utilizes data from companies listed on the Iraq Stock Exchange (ISE) to investigate whether earnings quality (QoE) can act as a safeguard against financial failure. According to the research findings, the quality of accruals, representing changes in cash flows from operational activities, exerts an adverse impact on the Z value. This suggests that corporate entities face a decrease in their Z value when they struggle to manage accruals from their operational activities effectively. Additionally, the persistence of earnings can impede a company's financial performance, leading to a decline in the Z value. In many cases, companies fail to generate expected earnings or financial accruals, and there is a lack of predictability in their earnings that could help improve their financial performance and reverse the downward trend. Furthermore, the study's results reveal that the surveyed Iraqi firms are either currently experiencing financial difficulties or heading in that direction. This underscores the need for proactive measures to address issues related to their product offerings, closely scrutinize operational processes, and focus on increasing cash flows. These actions collectively play a pivotal role in achieving success and averting financial failure.

Keywords: *Earnings Quality, Industrial companies, financial failure.*

1. Introduction

Businesses operating in hazardous environments are susceptible to the risk of bankruptcy or financial failure, with adverse consequences for both the business and its shareholders (Foo & Pathak, 2019). As Odom & Sharda (1990) noted, businesses failing to generate financial returns commensurate with their investments face the looming threat of bankruptcy, rendering them unable to sustain their operations. Additionally, corporations can deteriorate and become vulnerable to business failure when they lose the ability to maintain earnings and solvency (Akintoye et al., 2019). While achieving high-quality earnings is essential, it's not the sole preventive measure against business failure. Instead, it constitutes a crucial variable that should be considered to avert financial collapse.

The accuracy of reported financial data is of paramount importance, as investors rely on it to forecast future cash flows and assess growth prospects over a specific timeframe. Financial

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reporting serves as a means to communicate business growth to stakeholders (Bazaz & Mashayekhi, 2010). The extent to which companies report their financial actions, especially in the context of finance, may influence corporate performance and growth (Akintoye et al., 2019). Inaccurate information can lead to poor decision-making, emphasizing the need to identify profitable businesses. Decision-making is greatly influenced by this factor (Al-Shar & Dongfang, 2017), making it a challenging and imperative concept.

Despite the significance of Quality of Earnings (QoE), there is no single method or metric for evaluating earnings quality. Therefore, it is recommended to employ a range of criteria to determine whether earnings are of high quality, potentially yielding reliable statistics and data that investors can trust (Abdelkarim & Debi'e, 2015). Some academics argue that auditors play a pivotal role in assessing QoE by identifying intentional or unintentional errors. They posit that auditor effectiveness and diligence significantly impact their ability to uncover errors (Dechow et al., 2010).

This study undertakes an examination of a sample consisting of ten companies spanning the years 2012 to 2020. The primary objective is to assess the Quality of Earnings (QoE) for industrial corporations listed on the Iraq Stock Exchange (ISE) and explore its relationship with their financial sustainability. The study is designed to serve various purposes: to review existing literature on QoE and its association with financial distress, identify key determinants, and lay the foundation for future empirical investigations in this domain. It also highlights areas of research that have received limited attention.

The study's findings offer valuable insights, alerting businesses to the need to monitor and address circumstances that could lead to financial losses. Furthermore, the results emphasize the importance of Iraqi companies implementing criteria that better represent the quality of their earnings. Distinguishing itself from prior research, this study focuses on the link between QoE and financial failure, a critical aspect for survival in the business environment.

This research is anticipated to make several contributions: Firstly, it employs various measures of earnings quality, encompassing a broad spectrum of recognized indicators in this field. Secondly, given that an analysis of financial statements can serve as a crucial gauge of a nation's economic efficiency, regulators attach significant importance to the assessment of earnings quality over time. Thirdly, management and shareholders should take into account QoE when analyzing time-series data, as this indicator of financial performance can serve as an early warning signal to avert potential failures.

The study is structured as follows: It commences with an introduction, followed by Section 2, which delves into the relevant literature. Section 3 outlines the research methodology, while Section 4 presents the empirical findings. Finally, Section 5 encapsulates the conclusion.

2. Literature Review

2.1. Earnings Quality and Financial Failure

Recently, financial statement users and accountants have given a lot of attention to the concept of earnings quality. Although there is no particular definition of quality of earnings, it is undoubtedly an important concept. To put it more precisely, there have been numerous definitions, but none of them are accepted worldwide (Holt, 2013). Finding a single definition of this concept in an in-depth review of literature is extremely challenging. Cash flow from

activities is referred to as fixed QoE based upon the most prevalent methods accessible or relevant to the concept of QoE. When existing earnings is greater than the operations 'cash flow, this implies that corporate is of low quality and has no a strong capability of creating profits. (Lyimo 2014). In light of this, researchers contend that the poor correlation between earnings and future stock return can be related to the low (QoE) (Akintoye et al, 2019).

Even though no clear definition of (QoE) has been agreed yet, the Accounting Standards Board (ASB) and the Financial Accounting Standards Board (FASB) presented a framework for a series of characteristics: verifiability, timing, comparability, secure representation and understandability. Earnings that do not have these features are of questionable quality and credibility (Hasnan et al, 2016). Researchers have different definitions of the term "earnings quality. (Entwistle & Phillips 2003) contend that QoE have to be consistent with the principal objective of financial reports, which is to facilitate and ensure the reliability of financial statement users.

According to (Dechow, 1994), earnings are highly significant for a vast group of stakeholders as they provide data on company performance. Earnings are one of the primary indicators that managers and investors use to identify and evaluate opportunities of investment (Lyimo, 2014). Earnings represent the most all-inclusive measure of financial reporting's quality (Lev, 1989). Additionally, existing and future investors, for contracting purposes, utilize earning to extrapolate value-related data from earning pattern (Khuong et al,2020).

(Ball& Shivakumar,2008) indicated that quality of earnings, are one of the most significant indicators of a corporate 's potential future cash flows. When reported earnings precisely represent underlying economic procedure and condition and help users of financial statements make better decisions, financial statements are considered to be of high quality. Additionally, if earnings represent a company's transparency and give users essential accounting data to assess the firm's performance, then it is possible to obtain high earnings quality (Yohan, 2017). The most crucial factor for increasing the effectiveness of the capital market is the (QoE) reported in the financial statements. QoE is dependent on a number of variables, hence there is no established metric that determines it (Ewert, 2011). As low-quality earnings have a detrimental impact on company's financial success, high-quality earnings reveal more about company's financial performance characteristics (Hasnan et al, 2016). Information on the corporates" financial performance over time must be included in financial reports. As additional data about the characteristics of company's financial performance are determined by the (QoE), this is dependent on information quality.

The suitability of financial performance and the accounting system's capacity to measure performance each contribute to determining the (QoE) (Lyimo,2014). (Dang et al,2020) concentrated on measuring QoE through accruals quality (AQ), Earnings persistence (EP), and Earnings predictability (E Pr).

2.2. Accruals quality (AQ)

(Chan et al., 2001) employed accruals to gauge QoE and came to the conclusion that there was an negative correlation among accruals and dividends, arguing that investors usually connect great accruals through administrative manipulation. (Houge & Loughran, 2000) indicated that investors place too much emphasis on short-term current cash flow while neglecting the value of long-term cash flow, which minimizes QoE as (AQ) and cash flow are two crucial factors in interpreting earnings. There are numerous academic studies that demonstrate administrative profit manipulation (Fried, 1994, Teoh et al, 1998). Since investors rely on the reported final income, they are thus tricked in this manner as managers decrease earnings by increasing

accruals, or the increase in accrual accounting (Khuong et al,2020).

2.3. Earnings Persistence (EP)

One of the most crucial metrics employed to assess a corporate's performance is corporate earnings because it determines its value. (Francis, 2004). Since there are fundamental limitations in accounting systems, it is highly possible that corporate's earnings shown in the financial statements do not match the earnings a corporate actually produced, moreover, stability in earnings can be seen a high- quality earnings for corporates (Al-Shar & Dongfang, 2017).

(Ball& Shivakumar,2008) stated that QoE represents the Earnings persistence, that is, the persistence in current year's earnings can be a good indicator of future company's profits. . Hodge (2003) indicated that dissimilarity between reported profit s and real, unbiased and precise profits can determine the (QoE). (Mikhail et al (2004) examined the profit and cash flow, in their definition of QoE , and came to the conclusion that QoE is high when Earnings are included in future cash flows.

2.4. Earnings Predictability (E Pr)

QoE is a critical metric for corporate having no positive results in earnings and poor performance because of high accruals. The reported financial statements, particularly the net earnings as the last and most important data signaling profit or loss and predictability of corporate's performance, are the focus of various stakeholders, including managers of corporates, equity analyst, and other key players in the capital market (Duarte et al, 2022). (Albedal et al,2020) addressed the financial statements and their importance in predicting stock returns in future. Earnings predictability is a relevant element, a topic of the present research .(Holt, 2013) indicated that QoE is ability of predicting Earnings and cash flows. (Dang et al,2020). clarified that QoE refers to the sensibleness of reported earnings and is among the features of earnings to Can be easily replicated over a series of reporting periods.

3. Sample, Variables and Methodology

1.3. Sample

The sample includes information from Iraqi industrial firms that are registered on ISE, and it includes a 9-year period from 2012 to 2020. They are independent companies, and we avoided using their branches in the analysis to prevent uncertainty and inaccurate information concerning the financial activity. Therefore, researchers should use standardized data created in accordance with international standards in order to obtain a clear image of these industrial organizations. The data was obtained from ISE 's official website, which publishes an in-depth report on companies' operations during the fiscal year, a combined report in accordance with Global standards and endorsement by a legal body directly monitors their operations. Out of 21 industrial firms (10) were selected as a sample. The cause of it is that a number of companies failed because of conditions related to those of the companies, including conflict and economic crises brought on by the terrorist activities of ISIS. Additionally, not each company has full data for the aforementioned time series. However, the companies selected as a sample for the study were those that were operational and had comprehensive data, meaning that no data or observations were missing. (90) observations in all were made over a period of (9) years by (10) different companies.

2.3. Study Methodology

Analytical approach is one that investigates the relation among two or more variables using basic steps that begin with hypothesis formulation and deliberating its concepts. After that, data is collected, measured and analyzed. Then results are reached, then conclusions and recommendations are set, and deductive approach is employed in quantitative research (Chit & Wang, 2014: 11). The research will be conducted using a Analytical approach, in which we will start formulating hypotheses and discussing each theoretically and practically. Then, data will be collected from the ISE website, measured, and then analyzed. Based on the results, conclusions will be made to determine if the study's hypotheses are valid or not. The research has two variables, the dependent variable Companies fail financially and the independent variable (Earning Quality). The quality of earnings index consists of three indicators, according to the following:

1. Measure variable (Earning Quality)

Measure the variable (Earning Quality) are as the following

a. (AQ), measured based upon the relation below

$$\frac{TCA_{j,t}}{Assets_{j,t-1}} = b_0 + b_1 \frac{CFO_{j,t-1}}{Assets_{j,t-1}} + b_2 \frac{CFO_{j,t}}{Assets_{j,t-1}} + b_3 \frac{CFO_{j,t+1}}{Assets_{j,t-1}} + \varepsilon_{j,t}$$

($TCA_{j,t}$) represents accruals of a firm (j) for a year (t), ($Assets_{j,t-1}$) represents assets of a firm (j) for a year (t), and ($CFO_{j,t}$) are cash flows from the operation activities of (j) for year (t), and ($E_{j,t}$) is the variable of random error (j) for year (t).

b. Earnings persistence can be computed by the use of the formula below:

$$\frac{Earn_{j,t}}{Assets_{j,t-1}} = \delta_0 + \delta_1 \frac{Earn_{j,t-1}}{Assets_{j,t-1}} + v_{j,t}$$

($Earn_{j,t}$)represents the profits of company (j) for year (t).

c. Earnings predictability can be computed using the formula below:

$$Pred_{j,t} = \sqrt{\sigma^2(\hat{v}_{j,t})}$$

Where ($Pred_{j,t}$) represents the earnings predictability for company (j) for year (t) and (Ej,t) represents the square root of error variant of earnings predictability.

2. Measure the Variable (Financial Failure)

$$\sqrt{\sigma^2(\hat{v}_{j,t})}$$

This variable is computed, based upon a study performed by (Altman 1968) by the use of the formula below:

$$\boldsymbol{Z = 1.2X_1 + 1.4X_2 + 3.3X_3 + 0.6X_4 + 1.0X_5}$$

Where $\boldsymbol{Z}$ = failure indicator through which the firm's failure is predicted, or not

$$X_1 = \frac{Working\ Capital}{Total\ Assets}$$

$$X_2 = \frac{Retained\ Earnings}{Total\ Assets}$$

$$X_3 = \frac{Profit\ Before\ Interest\ And\ Tax}{Total\ Assets}$$

$$X_4 = \frac{Market\ Capitalization}{Book\ Value\ oF\ Debts}$$

$$X_5 = \frac{Revenue}{Total\ Assets}$$

Altman's model classifies firms into three types relying up on Z value as the following

- When $Z > 2.7$, company is successful.
- When $Z < 1.8$, company is failed or bankrupt.
- When Z between 1.8 and 2.7 firm is in a grey area, that it is not easy to determine company's status.

4. Discuss the Results

4.1. Descriptive Statistics

Table (1) Show descriptive statistics for the studied firms from 2012 to 2020, displaying the mean of (AQ) (-1.73) with a negative value. Furthermore, the table data demonstrates that companies lack the quality of accruals, which are cash flows generated by operational activities, and that their optimal conditions reach (0.04). When it comes to persistence of earnings, it reaches (33.76), which ensures that persistence of earnings will continue to be of the same quality but poses a concern because persistence in failure also exists.

While earnings predictability reaches (53.55) which is a great value, this value indicates there is predictability referring the circumstances would last in future. The financial failure index reaches dissimilar means, and most were low. On the other hand, the property rights 's market value to the book value of debt was high, and this would grant an chance for companies to avoid bankruptcy, companies sometimes issue new shares to make up for their lack of earnings. Despite frequent failure, companies continue to operate.

The mean of (z) value is (3.38), which is a great value which the firms recorded because (MC to BVD) values that raised its value, not the other indicators, ranging between (1.95) and (3.77). The extent to which the data is distributed normally was examined depending on (Jarque-Bera value), the whole indicators showed ratios of probability higher than (0.05), This implies that the data is normally distributed, and this allows using the methods of regression and correlation

Table 1: Statistical Description of the Study Variables.

Probability	Jarque-Bera	Maximum	Minimum	Std. D.	Mean	Indicators
0.14	3.11	0.065	-64.57	5.83	-1.63	A Q
0.24	0.83	33.84	31.14	0.18	28.04	E p
0.61	0.78	84.21	0.68	56.38	51.08	E pr
0.16	0.22	1.14	-1.44	0.51	0.66	WC/A
0.54	0.93	2.31	-0.21	0.52	0.39	RE/A
0.68	0.56	24.33	-0.76	2.03	0.91	PBIT/A

0.62	0.79	8.89	0.22	3.26	5.22	MC/BVD
0.34	2.04	3.81	0.03	0.39	0.38	R/A
0.63	0.73	3.77	1.95	1.07	3.38	Z

4.2. Pearson Correlation

The results of Table (2) displays the correlations among the earnings quality's three indicators and financial failure index. The accrual quality has an inverse correlation, that is, the more these accruals increase, (z) value will be reduced and causing a financial failure. The insufficient accruals from cash flows prevent industrial companies from being able to deal with their financial challenges. Furthermore, the persistence of earnings in the existing reverse form among corporates and financial failure may cause weak financial performance. That is, there is a continuous decline in earnings, posing a significant challenge to company managers and their inability to meet their objectives. In the term of earnings predictability, they are very weak, managers are not capable of predicting earnings and its relation to financial failure. Moreover, two indicators of earnings quality, *(AQ)* and *Earnings Persistence* are Accepted within significance level (0.01) and (0.05) regarding with the financial failure, while Earnings predictability is rejected.

Table 2: Testing the Correlation Between Earnings Quality Indicators and the Financial Failure Variable.

	Z	**A Q**	**E p**	**E pr**
Z	1			
A Q	-0.41*			
E p	-0.61**	0.33*	1	
Epr	0.05	0.27*	-0.08	1

The Correlation is significant at the 0.01 level (2-tailed).**

The Correlation is significant at the 0.05 level (2-tailed).*

4.3. Empirical Results

Based upon the table results (3), it is obvious that (AQ) has a negative effect reaching (-0.292) on (Z) value . That indicates that the flows based on cash flows from operational activities in their present pattern, cause decrease in (Z) value, leading to an inescapable financial failure. Furthermore, (Ep) has a negative impact reaching (-0.405) in financial failure index. It indicates that the companies' present earnings are insufficient to satisfy their financial obligations, and this could result in their failure. The two hypotheses of the earnings quality and Earnings persistence are accepted since the significance level is (0.01). Earnings predictability is not reliable, and no correlation exists between earnings predictability and financial failure, which is ineffective and unreliable.

The coefficient of determination (R-squared) reaches (0.95), indicating that Earnings quality, Earnings persistence, and Earnings predictability can be explained from the financial failure (0.95), Which indicates the appropriate explanatory model and the accurate results that the research has reached. The study results are in line with earlier research indicating that the (QoE) can reflect the company's actual financial performance. Increasing earnings and disclosing them honestly is one way to improve performance, which is expressed in QoE (Chandrarin, 2003).

More importantly, investors, creditors, accounting policy makers, and governments are all pay great intention to (QoE). When profits are dishonestly tampered because of the manager's

manipulation methods, company will face obstacles in the future that will reflect poorly on its performance (Albedal et al,2020). A study conducted by (Duarte et al, 2022), on firms registered on the Shanghai Stock Exchange, showed that failing or financially distressed companies lack quality in their earnings. Since investment opportunities have a significant impact on the value of a company's real assets, which are reflected in the stock market price, the accuracy of the financial statements is crucial for presenting investment opportunities and enhancing overall performance both Currently or in the future (Dang et al,2020).

Table 3: Testing the Effect Between Study Variables.

Independent Variable	Dependent Variable	Coefficient	Std. Error	t-Statistic	Prob.	Decision
C		-0.241	0.0411	-0.6212	0.4984	Rejection
A Q	Z	-0.292	0.0569	-3.1323	0.0024	Acceptance
E p	Z	-0.405	0.0104	-39.4541	0.0041	Acceptance
E pr	Z	0.027	0.0289	0.3251	0.6221	Rejection
R-squared	0.95					
F-statistic	0.67.252	Method: Least Squares				
Prob(F-statistic)	0.000	$Z = -241 - (0.292)AQ - (0.405)EP + (0.027)EPR$				

5. Conclusions

In summary, this study explored the relationship between Quality of Earnings (QoE), comprising Quality of Accruals, Earnings Persistence, and Earnings Predictability, and their association with financial failure, measured using the Z value, within ten companies listed on the ISE from 2012 to 2020. The findings revealed that the quality of accruals, representing changes in cash flows from operational activities, adversely impacted the Z value, signifying a decline in value due to firms' struggles in managing accruals from their operations. Additionally, earnings persistence emerged as a factor hindering companies' financial performance, resulting in a decline in the Z value. Most firms frequently failed to generate expected earnings or financial accruals, lacking predictability in their earnings to improve financial performance and reverse the downward trend. The results indicated that surveyed Iraqi firms were either experiencing or heading toward financial failure, necessitating significant measures to address product-related issues, enhance operational processes, and boost cash flows, all critical components for achieving financial success. Given the absence of prior studies employing these variables to assess QoE and its relationship with financial failure, direct comparisons with similar previous research were not possible. We encourage colleagues in other countries to replicate and expand upon this study to determine the consistency of these results across different regions and explore the potential for enhanced insights through the inclusion of additional variables. We believe that further research in these areas will significantly advance our understanding of earnings quality.

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