THE EFFECT OF EARNING QUALITY ON LIQUIDITY RISK BY APPLYING ON BANKS REGISTERED IN IRAQI STOCK EXCHANGE

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Summary: Liquidity risk arise from the sudden withdrawals on deposits and other bank liabilities, which makes the bank was obliged to sell its assets in a short period, with lowest prices. Liquidity risk looks at differences in net income and market value of the property rights resulting from the difficulty faced by the Bank in access to cash at a reasonable cost, from sale assets or access to new deposits. Commercial banks are exposed to many of constant continuing changes in the economic environment that leads to many risks to effect on various activities, like lending, investment etc. The liquidity risk is one of those risks that commercial banks face, which affected by a range of variables, the most important is the quality of earnings.

Keywords: accounting, earning quality, liquidity risk

1. Introduction

The banking sector is one of the most important sectors and influential of the economy in response to variables, whether international or local. The most important of these variables in technological developments, global financial markets, freedom from constraints, and remove the barriers that prevent some financial institutions to work in specific sectors, and directing to develop risk management and lending. All of these will increase the growth of international competition in this sector, while seeking to attract foreign capital with the increasing role of the universality institutions such as the Bank for International Settlements (BIS) to overseeing of international banking institutions starting from Basel 1988 and beyond issuing a lot of institutions for control, supervision, disclosure and transparency and reducing of financial risk.

Problem: Iraqi banks are facing problem of liquidity risk, therefore there is a need to reduce these risks, to avoid the bankruptcy, and the question will be as follow: Is there an effect of the quality of earnings in the liquidity risk?

Hypothesis: our main hypothesis says that there is no significant effect of the quality of earnings in the liquidity risk.

Methodology: The methodology will dependence on the resources and researches to cover the theoretical side, either the practical side will be covered through mathematical models accredited. For achieving the objective of this research will be: concept and importance of the quality of earnings, profit quality measurements, concept of liquidity risk, measuring liquidity risk, the model of search and testing the research hypothesis.

2. Literature survey

Hence we noted that Jones (1991) is considered one of the first who wrote about the phenomenon of earnings management, where he put a model for monitoring this phenomenon, and later there have been many studies in this area that are dependent one way or another on this model.
According to Oriole (2003) the object of research to identify the extent of the practice of Spanish companies to manage their profits, and included the sample of study 35 companies listed on the financial market of Spain within the index (IBEX 35).

Qiang and Terry (2005) conducted a study on US companies which made their data available in the market during the study period from 1993 to 2000, and examined the relationship between ownership incentives for managers (ownership shares), and earning management. The cited study assumed that managers who get high ownership incentives they are more inclined to do to sell their shares in the future, and this is what drives them to earnings management to increase their share value to be sold. The study founded that managers who get high ownership incentives are more inclined to do to sell their shares in the future, and they are more inclined to provide earnings reports conform to or exceed analysts’ forecasts.

The study of Martinez (2007) showed that the characteristics of the effectiveness of audit committees as the size of the Audit Committee, the independence of their members, the degree of concentration of ownership and the level of financial and knowledge expertise of their members are affect the quality of the auditor’s report.

3. Earning Quality

Net income is the most important item in the financial statements, it is an indicator of added value for company, which is the indicators that help guide the allocation of resources in the capital markets, and in fact, the theoretical value of the shares of the company is the present value of future profits. Hence the increase in these profits represent a reflection of the increased value of the company, while the decline in earnings indicates that this decline in value. The financial analysts looking to profit as the most important item in the input which they adopt in the decision-making process, but the dependence on the number of profit alone, without regard account some of the factors may lead to a reduction in the quality of earnings level, such as management of earning and high rate of accruals. This, in turn may lead to a non-reasonable decision, because of its focus on the size of the profits without focusing on quality.

3.1. The Concept of Earnings Quality

Researchers addressed the concept and quality earnings in several meanings depending on the different users of financial statements and their goal of use, and depending on the different point of view as it contains earning from the properties make them characterized quality.

Penman (2003) had pointed that high quality earnings are the earning that contain a good indicator for future earnings, with regard to the current performance of the company. It can evaluate the definition of earnings depending on the target of the financial analysis of the current performance of the company and assess to what extent can rely on this performance to forecast future performance of the company.

3.2. The Importance of Accounting Earnings Quality

Deriving the importance of the earning quality from the importance of the earning themselves; the company’s profits, regardless of quality, is an important input in the process of making financial and investment decisions, as well as the earning are used in many forecasting studies of the performance of current and future company. Those important return to used earning of performance evaluation by a large number of users. As the earning quality go back to the ability of disclosed profits in the expression of real profits of the company and its usefulness in forecasting future profits, earnings quality is an important aspect in assessing the financial situation of enterprises by many parties, such as potential investors, creditors and users of
The earnings quality in the company may be used as an indicator of dividends, especially the fact that the last of the important things to be taken into account when making investment decisions.

### 3.3. Metrics Quality Earnings

Several metrics are used to determine earnings quality level, and this is due to the difference users for financial statements and thus differing goals of the use of those statements, leading to differing views regarding the concept of earnings quality, and this leads the different scales used to determine the level of earnings quality. Where we can review these metrics as follows: Firstly, the continuity of earning: many researchers used continuity of earnings as a metrics of earnings quality, continuity is the link of current earnings and future earnings. It is the degree of continuity of the current earning during future period (Altamuro and Betty, 2007). Secondly, the absence of earning from earnings management interventions: (See: Jenkins, 2006). Thirdly, matching revenues and expenses: the timing of recognition of revenue is measure of determining the earnings quality (Risberg, 2006).

### 3.4. The Reasons for Measuring Earnings Quality

The earnings quality measuring become increasing interesting in the recent years, especially after the collapse in large companies, in the United States. (Shroeder, 2001).

### 3.5. The Concept of Earnings Management

Since the separation of ownership from management company directors sought to win owners trust confidence by trying to expand the property and to achieve stability in income. This is done to increase the ratio of cuts in a period of high profits and distributed in a period of low profits, which suggests the owners that the company continues to achieve a profit, even if the company achieved a net loss. The net profit declared gives an indication misleading to the decision-maker; it reflects the state of profit with a loss (Aflatooni and Nikbakht, 2010).

### 4. Liquidity Risk

Liquidity in the meaning of the absolute mean cash money, either liquidity in the technical meaning the ability of assets to switch to cash quickly and without losses, and liquidity is a relative concept reflects about the relationship between monetary and easy switching assets to cash quickly and without losses, and the required fulfilled liabilities. So it can’t determine the liquidity of a bank or any individual except within the limits of its obligations. The liquidity in the banking system, means: the difference between the resources available and the money used in different types of assets within the balance imposed by the banking guidelines generally accepted, or that the banks are in the case of an abundance of liquidity when funds are available surplus to the bank’s ability to borrow.

There are three dimensions liquidity (Howells & Bain, 2000, 8): time, risk and cost. The importance of liquidity comes from the need for banks to liquidity to meet the needs of its customers to the money, while their customer needs facing either through withdraw their deposits at the bank or by borrowing, and that such needs continuous, so should these banks are always ready to face such requirements.

Bank liquidity can be divided into two main parts (Hempel and Simonson, 1994): the initial reserves are as follows: cash is owned by the commercial bank without win earning, consisting of reserves at the level of a single bank of five components: cash in local and foreign currency in the bank fund, cash deposits in the Central Bank, deposits in other local banks, checks under collection and deposits in foreign banks abroad.
The secondary reserve are liquid assets which generating return for the bank including the securities and trading bills discounted, which can be converted into cash when you need liquid, and achieve these reserves in the field of liquidity multiple benefits. Liquidity risk of the inability of the bank to face the shortage of liabilities or to fund increases in assets and when the liquidity of the bank is not sufficient it cannot get enough money, whether by increasing the obligations or carry a reasonable cost to transfer its assets quickly into liquid assets, which affects the profitability, in extreme cases it can lead to insufficient liquidity lack of financial solvency of the bank. The importance of Risk Management may be concentrated in the following points:

1- Assisting in the forming of a clear future vision.
2- Development of a competitive advantage for the bank.
3- Risk assessment and hedging against it, so as not to affect the bank’s profitability.
4- Help in making pricing decisions.
5- Development of securities portfolios management and work to diversify those securities.
6- Help the bank to calculate the capital efficiency ratio according to the new suggestions of Basel Committee.

5. Analysis of Results

The research sample consisted of 16 bank, was obtained statements for the period from 2004 to 2014, While the search form has been formulated by relying on a set of control variables is the size of the company, return on equity and financial leverage, The model takes the following formula:

\[ LR_i = \beta_0 + \beta_1 T Ai + \beta_2 Size i + \beta_3 ROE_i + \beta_4 LEV_i + \varepsilon_i \]

Where

- \( LR_i \) = Liquidity Risk of firm i. It measured using the ratio of current assets to current liability
- \( T Ai \) = Earnings quality of firm i. It is proxy by Total accrual. It calculated on the basis of the difference between net income and cash flow from operating activities
- \( Size_i \) = size of firm i. It is calculated using the natural logarithm of total assets of a company
- \( ROE_i \) = Return on equity of firm i in year t. It is measured using the ratio of net profit of company to total equity
- \( LEV_i \) = financial leverage of firm i in year t. It is calculated using the ratio of total debt to total assets.
- \( \varepsilon_i \) = the error term for firm i

The following results were generated after the estimation of equation above as shown below.

<table>
<thead>
<tr>
<th>Variables</th>
<th>Coefficients</th>
<th>Std. Error</th>
<th>t-statistic</th>
<th>Prob.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constant</td>
<td>-2.235</td>
<td>1.259</td>
<td>-1.747</td>
<td>0.083</td>
</tr>
<tr>
<td>TA</td>
<td>-.616</td>
<td>0.785</td>
<td>-1.414</td>
<td>0.283</td>
</tr>
<tr>
<td>LEV</td>
<td>0.124</td>
<td>0.286</td>
<td>0.405</td>
<td>0.643</td>
</tr>
<tr>
<td>ROE</td>
<td>0.253</td>
<td>0.095</td>
<td>3.047</td>
<td>0.004</td>
</tr>
<tr>
<td>Size</td>
<td>0.818</td>
<td>0.127</td>
<td>1.828</td>
<td>0.080</td>
</tr>
<tr>
<td>R-square</td>
<td></td>
<td>0.0654</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Adj. R. square</td>
<td></td>
<td>0.545</td>
<td></td>
<td></td>
</tr>
<tr>
<td>F-statistic</td>
<td></td>
<td>5.246</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pro.(F-statistic)</td>
<td></td>
<td>0.033</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Durbin Watson</td>
<td></td>
<td>2.647</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: authors’ calculations
Table 1. shows that the value of F-statistic equal to 0.033 and this indicates that a significant statistical model in general. While the R-square value equal to 0.654. This means that changes in the dependent variable due to be the independent variable and control variables by 0.654 while returning the remainder to other factors. By focusing on the research hypothesis it turns out that there is a relationship between the benefits and risks of liquidity in the banks all the research sample. The dues also affect the liquidity risk.

6. Conclusion

The study focused on measuring the impact of earnings quality to liquidity risk, and used the total accruals as a proxy for earnings quality, while the measurement of liquidity risk through the ratio of current assets to current liabilities, as was the use of a number of control variables (SIZE, ROE, LEV). The study reached that there is a significant effect on liquidity risk, so researchers recommend Iraqi banks to raise attention to earnings quality in order to reduce the liquidity risk that can be exposed the Iraqi banks, especially under the effect of unstable environment that the banks works in it.

References

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