



**THE MEDIATING ROLE OF EARNINGS
QUALITY IN THE RELATIONSHIP BETWEEN
ACCOUNTING CONSERVATISM, FINANCIAL
PERFORMANCE, AND MARKET VALUATION:
AN EMPIRICAL STUDY OF LISTED FIRMS IN
IRAQ**

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THESIS APPROVAL PAGE

I certify that in my opinion the thesis submitted by İbrahim Mosa MOHAMMED titled “THE MEDIATING ROLE OF EARNINGS QUALITY IN THE RELATIONSHIP BETWEEN ACCOUNTING CONSERVATİSM, FİNANCİAL PERFORMANCE, AND MARKET VALUATION: AN EMPIRICAL STUDY OF LISTED FİRMS IN IRAQ” is fully adequate in scope and in quality as a thesis for the degree of PhD.

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DECLARATION

I hereby declare that this thesis is the result of my own work and all information included has been obtained and expounded in accordance with the academic rules and ethical policy specified by the institute. Besides, I declare that all the statements, results, materials, not original to this thesis have been cited and referenced literally.

Without being bound by a particular time, I accept all moral and legal consequences of any detection contrary to the aforementioned statement.

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Signature :

FOREWORD

In the name of Allah, the most beneficent, the most merciful.

I Dedicate this work to my Parents, Wife and Children.

Then, I dedicate this scientific research to everyone who supported me in achieving this achievement, especially my family, who gave me all the, respect, and support.

ABSTRACT

This thesis examines the impact of accounting conservatism on earnings quality, firm performance, and market valuation among Iraqi listed firms, with a focus on the mediating role of earnings quality. Using Structural Equation Modeling on data from Iraqi listed firms (2017–2022), the study finds a strong positive relationship between accounting conservatism and earnings quality, confirming that conservative practices enhance reporting reliability. However, the direct effects of conservatism on firm performance and market valuation are non-significant, indicating that conservatism alone does not directly improve these outcomes. Instead, earnings quality mediates the relationship between conservatism and firm performance, driving better financial outcomes through enhanced reporting reliability. The indirect effect on market valuation remains non-significant, reflecting the nuanced relationship between conservatism and investor perceptions. This study underscores the role of conservative accounting in enhancing financial reporting reliability and calls for further research into cross-industry dynamics and regulatory influences in emerging markets.

Keywords: Earnings Quality; Accounting Conservatism; Company Performance; Market Value.

ÖZ

Bu tez, Irak'taki halka açık şirketler arasında muhasebe ihtiyatlılığının kâr kalitesi, firma performansı ve piyasa değeri üzerindeki etkisini, kâr kalitesinin aracı rolüne odaklanarak incelemektedir. Irak'taki halka açık şirketlerden (2017–2022) elde edilen veriler üzerinde Yapısal Eşitlik Modellemesi kullanılarak yapılan çalışma, muhasebe ihtiyatlılığı ile kâr kalitesi arasında güçlü bir pozitif ilişki olduğunu ortaya koymaktadır. Bu bulgu, ihtiyatlı muhasebe uygulamalarının finansal raporlama güvenilirliğini artırdığını doğrulamaktadır. Bununla birlikte, ihtiyatlılığın firma performansı ve piyasa değeri üzerindeki doğrudan etkileri anlamlı bulunmamıştır; bu da ihtiyatlılığın tek başına bu sonuçları doğrudan iyileştirmedeğini göstermektedir. Ancak, kâr kalitesi, ihtiyatlılık ile firma performansı arasındaki ilişkiye aracılık ederek raporlama güvenilirliğini artırma yoluyla daha iyi finansal sonuçlar sağlamaktadır. Piyasa değeri üzerindeki dolaylı etki ise anlamlı bulunmamış ve bu durum ihtiyatlılık ile yatırımcı algıları arasındaki nüanslı ilişkiyi yansıtmaktadır. Bu çalışma, ihtiyatlı muhasebenin finansal raporlama güvenilirliğini artırmadaki rolünü vurgulamakta ve sektörler arası dinamikler ile gelişmekte olan piyasalardaki düzenleyici etkilerin daha fazla araştırılmasını önermektedir.

Anahtar Kelimeler: Muhasebe Karlarının Kalitesi; Muhasebe Muhafazakarlığı, Şirket Performansı; Piyasa Değeri.

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ABBREVIATIONS

FASB	: Financial Accounting Standards Board
GAAP	: Generally Accepted Accounting Principles
IFRS	: International Financial Reporting Standards
IASB	: International Accounting Standards Board
ASQ	: American Society for Quality
OCPA	: Organization for Certified Public Accountants

SUBJECT OF THE RESEARCH

The research centers on examining the intricate relationships between earnings quality, accounting conservatism, financial performance, and market valuation, with a particular focus on their interconnected effects within industrial companies listed on the Iraq Stock Exchange. This study seeks to empirically test the nature and strength of these relationships using various statistical and econometric models, aiming to clarify how these dynamics influence both the decision-making processes within firms and the broader investor perceptions in the market. By understanding the degree to which accounting conservatism and earnings quality serve as drivers of firm performance and market value, the research contributes to the ongoing discourse on enhancing transparency and reliability in financial reporting practices.

Earnings quality is a fundamental factor in determining both the market valuation of firms and their intrinsic value, making it a vital tool for stakeholders and managers alike. High-quality earnings provide insights into an organization's true economic performance, aiding stakeholders in making informed decisions and potentially reducing information asymmetry between management and external parties. Accounting conservatism, meanwhile, serves as a stabilizing factor by encouraging prudence in reporting, which may mitigate risks associated with aggressive accounting practices or earnings manipulation. Given these considerations, this research seeks to explore whether accounting conservatism positively impacts firm value directly or if its influence is mediated by the quality of reported earnings.

In recent years, the competitive pressures on firms to meet or exceed financial analysts' forecasts have often led to the adoption of "creative accounting" practices that may distort the perceived profitability and stability of a firm. Such practices, while potentially benefiting management in the short term by enhancing the company's stock appeal, may undermine the long-term interests of both the firm and its stakeholders. By exploring the extent to which earnings quality mediates the relationship between accounting conservatism and firm value, this study sheds light on whether conservative accounting practices contribute to genuine performance enhancement or if they are merely cosmetic adjustments.

This research ultimately addresses a critical problem in accounting and finance: the potential impact of earnings management on the suitability and reliability of

accounting information for stakeholders. To address this, the study poses several key questions: Is there a positive relationship between accounting conservatism and earnings quality? How does accounting conservatism correlate with firm performance and market valuation? Can earnings quality serve as a mediating factor that enhances the perceived value of accounting conservatism? The answers to these questions aim to provide a nuanced understanding of how conservative financial practices and high-quality earnings impact firm value and investor trust in a competitive market environment.

PURPOSE AND IMPORTANCE OF THE RESEARCH

The primary purpose of this study is to explore and clarify the relationships between accounting conservatism, earnings quality, and financial performance within the context of Iraqi industrial companies. At a theoretical level, the study seeks to establish a conceptual foundation that justifies the role of accounting conservatism in influencing earnings quality and, consequently, financial performance. This theoretical framework enables a deeper understanding of how conservatism impacts the reliability of reported earnings and informs stakeholders about the sustainability and predictability of firm performance. On an empirical level, the study aims to rigorously test these relationships by applying quantitative models to a sample of industrial firms, thereby substantiating the effect of accounting earnings quality on performance.

This research has a dual significance. First, it investigates the mediating role of earnings quality on the relationship between accounting conservatism and firm performance, while also examining how these factors collectively affect market valuation. The study employs both accounting-based measures, such as return on assets (ROA), and market-based measures, such as Tobin's Q, to assess firm performance comprehensively. This dual measurement approach underscores a critical distinction: accounting metrics reflect historical performance, whereas Tobin's Q provides a forward-looking perspective, influenced by investor sentiment. Consequently, this research addresses the question of whether firms and stakeholders should prioritize historical achievements or future expectations in their evaluations.

Furthermore, the importance of this study is rooted in its contribution to both the academic literature and practical applications within the field of accounting and finance.

By focusing on earnings quality and accounting conservatism—key topics in contemporary accounting thought—the research provides valuable insights into their impact on corporate performance. This study advances the understanding of how the informational content embedded in earnings quality can influence management decisions and enhance the decision-making process for various stakeholders.

Finally, this research seeks to promote investor awareness regarding the significance of earnings quality in firm valuation. By illustrating how high-quality accounting earnings enhance transparency and mitigate information asymmetry, the study opens new pathways for attracting investor interest. In sum, this research not only contributes to the academic discourse on accounting conservatism and profit quality but also offers practical implications for fostering a more informed investment environment.

METHOD OF THE RESEARCH

To rigorously examine both the mediating (indirect) and direct relationships between accounting conservatism, earnings quality, firm performance, and market valuation, this study employs structural equation modeling (SEM) using SmartPLS 4 software. SEM is particularly effective for this analysis as it enables simultaneous examination of multiple relationships, providing a comprehensive view of both direct effects (e.g., the impact of accounting conservatism on firm performance) and indirect, or mediating, effects (e.g., the role of earnings quality in the relationship between accounting conservatism and firm performance).

In analyzing direct relationships, SEM allows for estimating the pathways from accounting conservatism as an independent variable directly to firm performance and market valuation as dependent variables. This approach identifies the extent and strength of conservatism's immediate effects on these outcomes, forming a baseline for understanding its direct influence.

To assess the mediating, or indirect, effects, SmartPLS 4 facilitates a sophisticated mediation analysis in which earnings quality is introduced as a mediator. Using this approach, the study examines whether the influence of accounting conservatism on firm performance and market valuation is channeled through improvements in earnings quality. The software's bootstrapping method provides robust

estimates of the mediation effects by generating confidence intervals, thereby enhancing the reliability and validity of the results.

By incorporating earnings quality as a mediating variable, the SEM approach with SmartPLS 4 allows the study to decompose the total effect of accounting conservatism into its direct and indirect components. This path analysis clarifies whether earnings quality strengthens, weakens, or fully explains the relationship between accounting conservatism and financial outcomes. Moreover, the software's visual path modeling capabilities provide a clear representation of the relationships, making it easier to interpret the direct and indirect pathways.

This methodological framework not only quantifies the strength of each path but also highlights how conservative accounting practices, mediated by earnings quality, ultimately influence firm performance and market valuation. By leveraging the capabilities of SmartPLS 4, this study offers a detailed understanding of the causal mechanisms linking accounting conservatism, earnings quality, and financial outcomes, thereby contributing valuable insights to the fields of accounting and finance.

RESEARCH PROBLEM AND HYPOTHESES

The central research problem of this study revolves around understanding the nuanced roles of accounting conservatism and earnings quality in shaping firm performance and market valuation. Specifically, while accounting conservatism is theoretically intended to enhance financial reliability by promoting cautious and prudent reporting, its actual effects on firm value and earnings quality remain ambiguous. This ambiguity raises questions about whether conservative accounting practices genuinely improve the quality of earnings or if they potentially obscure financial performance by limiting transparency. This issue becomes especially pertinent within the Iraqi industrial sector, where evolving regulatory frameworks and unique market conditions could amplify these effects.

To explore these dynamics, this study addresses critical questions: Does accounting conservatism directly enhance firm performance and market valuation, or are its effects more accurately understood through the mediating influence of earnings quality? Additionally, the study aims to clarify whether higher earnings quality,

potentially induced by conservative accounting practices, serves to improve firm performance and elevate market valuation by reducing information asymmetry and enhancing the reliability of financial statements. These inquiries are essential in environments where conservative financial reporting practices might be leveraged to meet or exceed market expectations, thereby creating a need to rigorously test whether conservatism contributes positively to corporate financial health and investor perception.

Hypotheses

In alignment with the research problem, the following hypotheses have been formulated to empirically test the direct and indirect effects of accounting conservatism on firm performance and market valuation, with a focus on the mediating role of earnings quality:

Direct Effects

Hypothesis 1 (H1): Accounting conservatism is positively related to earnings quality among listed firms in Iraq.

This hypothesis posits that more conservative accounting practices result in higher earnings quality by promoting reliability and caution in financial disclosures.

Hypothesis 2a (H2a): Accounting conservatism is positively related to firm performance among listed firms in Iraq.

This hypothesis explores the direct relationship between accounting conservatism and firm performance, without the mediating influence of earnings quality.

Hypothesis 2b (H2b): Accounting conservatism is positively related to market valuation among listed firms in Iraq.

Similar to H2a, this hypothesis tests the direct impact of accounting conservatism on market valuation, independent of earnings quality.

Mediating Effects of Earnings Quality

Hypothesis 3a (H3a): Earnings quality mediates the relationship between accounting conservatism and firm performance among listed firms in Iraq.

This hypothesis suggests that the impact of accounting conservatism on firm performance is mediated through earnings quality. It proposes that conservative

accounting practices lead to higher earnings quality, which, in turn, positively influences firm performance.

Hypothesis 3b (H3b): Earnings quality mediates the relationship between accounting conservatism and market valuation among listed firms in Iraq.

This hypothesis proposes that the effect of accounting conservatism on market valuation operates through earnings quality. It implies that earnings quality, enhanced by conservative accounting practices, contributes to improved market valuation.

These hypotheses enable a structured exploration of the direct and indirect effects of accounting conservatism, with particular attention to whether earnings quality serves as a key intermediary that amplifies or moderates the impact of conservative practices on firm performance and market valuation. Through this examination, the study seeks to contribute to a clearer understanding of how conservative accounting, mediated by earnings quality, influences firm outcomes and informs stakeholders in the Iraqi industrial sector.

POPULATION AND SAMPLE

The study focuses on a sample drawn from the population of industrial companies listed on the Iraq Stock Exchange. This sector was chosen due to its economic significance and the availability of consistent, reliable data. Selecting industrial companies serves the study's objectives by targeting firms with a direct influence on investors' decisions and financial statement users, particularly in assessing the credibility of reported financial information and the strategic decisions made by management to secure future earnings.

Several criteria were applied in selecting the sample to ensure that the data would be comprehensive and reflective of stable, ongoing operations. Firstly, all companies included in the sample were required to operate continuously throughout the study period, as disruptions could compromise data reliability and consistency. Secondly, the sample companies needed to regularly publish financial statements and maintain available accounting data relevant to the study's variables. This availability of data is crucial for accurately calculating the variables in the study model. Finally, companies were selected based on a uniform fiscal year ending on December 31, which ensures

comparability across financial periods and aligns the reporting timelines for consistency in analysis.

These criteria collectively support the study's goal of accurately analyzing the relationships among accounting conservatism, earnings quality, and firm performance in a representative segment of the industrial sector.

SCOPE AND LIMITATIONS / DIFFICULTIES

This study focuses on exploring the relationships among accounting conservatism, earnings quality, firm performance, and market valuation within the industrial sector in Iraq. The scope is limited to a sample of industrial companies listed on the Iraq Stock Exchange, spanning the period from 2016 to 2021. By concentrating on this specific sector and region, the study aims to provide insights into how conservative accounting practices influence financial outcomes in an emerging market context, where regulatory frameworks and corporate governance practices are evolving.

One of the primary limitations of the study is the narrow geographical and sectoral focus, which may restrict the generalizability of the findings to other industries or regions. Industrial companies in Iraq operate under unique economic and regulatory conditions that may differ significantly from those in other countries or sectors. Additionally, the reliance on secondary data from publicly available financial statements may limit the depth of analysis, as this data may not fully capture internal management practices or strategic considerations affecting earnings quality and conservatism.

Another limitation is related to the availability and reliability of financial data. Although the sample companies meet the study's criteria for consistent financial reporting, fluctuations in data quality or reporting standards over the study period may introduce potential biases. Furthermore, economic instability or political factors within Iraq may have influenced the financial performance of these companies, creating challenges in isolating the effects of accounting conservatism and earnings quality from broader macroeconomic variables.

The study also faced certain methodological difficulties, particularly with regard to the use of structural equation modeling (SEM) via SmartPLS 4. While SEM offers robust insights into the direct and indirect relationships among variables, it requires

complex assumptions and large sample sizes for optimal reliability. Given the limited sample size, there may be constraints in the statistical power of certain path estimates, potentially impacting the precision of the findings.

Despite these limitations, this study contributes to the literature by examining an under-researched market and providing valuable insights into the implications of accounting conservatism and earnings quality for financial performance and market valuation. Future research may expand on these findings by applying similar analyses to other sectors or geographic regions, or by incorporating qualitative data to complement the quantitative analysis and offer a more holistic view of the factors influencing financial outcomes.



1. CHAPTER ONE: CONCEPTUAL FRAMEWORK

The quality of accounting earnings is a fundamental factor that significantly influences the valuation of an enterprise. High profitability ratios, achieved after covering all expenses and obligations, indicate that a company has generated sufficient net cash flows to fulfill its commitments and provide returns to shareholders. This profitability is not only a measure of the firm's immediate success but also a reflection of its ability to use available resources efficiently, enhancing its overall value. When the profitability ratio increases, it signifies an upward trajectory in the firm's value, whereas a decrease could imply a decline in this value, which may concern both internal management and external stakeholders.

Maintaining a high level of accounting earnings quality is therefore crucial, as it directly impacts the enterprise's valuation. Superior earnings quality fosters enhanced accuracy in future financial forecasts, enabling firms to provide reliable and relevant information to investors. This high-quality information reduces uncertainty for investors, enhancing their decision-making process and confidence in the firm's financial stability. Conversely, inaccuracies in reported accounting earnings pose significant risks, particularly concerning the amount of earnings available for distribution. If reported earnings include gains from asset revaluation or are inflated by earnings management practices, they may not represent genuine financial performance. In such cases, the distributed earnings might effectively draw from the firm's capital base rather than its operational income, which can undermine the firm's value and financial stability in the long run.

Thus, establishing and maintaining a robust framework for assessing the quality of accounting earnings is critical for sustaining firm value. This chapter will explore the concept of accounting earnings in depth, examining its components, implications for firm valuation, and its broader significance within financial reporting practices. Through this conceptual analysis, the chapter aims to clarify the role of earnings quality in ensuring accurate representation of firm performance, fostering investor trust, and ultimately enhancing the long-term value of the enterprise.

1.1. The Concepts of Earnings Quality

Earnings quality represents the degree to which reported earnings accurately reflect a company's true economic performance. High-quality earnings are not only consistent and sustainable over time, but they also provide reliable information that stakeholders—particularly investors and creditors—can use to predict future cash flows and evaluate the firm's financial health. Earnings quality thus transcends the simple presentation of earnings; it encapsulates the alignment between reported financial outcomes and the actual operational success of a company. By offering a clear, accurate portrayal of financial performance, high-quality earnings play a pivotal role in supporting sound financial decision-making and fostering confidence in the firm's reported results.

This section delves into the key aspects of earnings quality, beginning with its foundational concept, followed by an exploration of its importance within financial reporting and valuation. Subsequent discussions will cover the distinct characteristics that signify high-quality earnings, the determinants influencing earnings quality, and the measures used to assess it. This examination will provide a comprehensive understanding of earnings quality, laying the groundwork for analyzing its effects on firm performance and market valuation.

1.1.1. Definition of Earnings Quality

Earnings quality refers to the extent to which reported earnings accurately reflect a company's true economic performance and offer predictive value for future earnings. This concept underscores the importance of the income statement as a critical source of information for investors and creditors, who rely on disclosed earnings to evaluate the firm's financial health, management's effectiveness, and future cash flow potential. Kieso and Waygandt (2003) highlight that high-quality earnings enhance the decision-making process by aligning reported earnings with a company's operational reality and future performance expectations.

According to Munshid and Yacoub (2020), the concept of earnings quality can be viewed through two primary attributes: suitability and informational content. First, the quality of earnings is conditional on the relevance of the information to a particular

decision. For example, earnings information may serve a distinct purpose for investors evaluating long-term growth compared to creditors assessing a firm's liquidity. Second, the quality of disclosed earnings depends on the financial information's ability to accurately depict the firm's performance, offering insight into the organization's financial health that supports sound financial judgments.

Earnings quality remains a multi-dimensional concept, lacking a universally accepted definition. Stakeholders such as investors, creditors, accounting standard setters, and auditors each interpret earnings quality according to their unique interests. For instance, standard setters prioritize compliance with generally accepted accounting principles (GAAP), while creditors focus on the ability of earnings to generate cash flows adequate to meet debt obligations. Consequently, numerous studies offer diverse perspectives on earnings quality based on differing objectives and the anticipated benefits of high-quality financial reports (Hamid & Hassan, 2020).

The value of high-quality earnings lies in its predictive ability. As noted by Don and Bellovwy (2005), earnings quality acts as an indicator of both current performance and future profitability, offering a foundation upon which management and analysts build forecasts and assess operational efficiency. It is not merely a static measure but rather an essential component of evaluating a firm's stability and sustainability in profit generation. This dimension of earnings quality serves as a cornerstone for financial analysts and management, who aim to support the firm's long-term objectives of profitability and growth while attracting investor interest and strengthening capital portfolios (Al-Bamerni, 2020).

Further, Warrad (2017) posits that earnings quality encapsulates the predictive ability of current earnings to mirror expected cash flows and future firm values. High-quality earnings signal consistent, stable earnings, which enhance stakeholders' confidence in the organization's future. In essence, the predictive nature of high-quality earnings ensures that current performance can be used as a reliable benchmark for future profitability and growth.

In conclusion, high-quality earnings are not only indicative of a firm's present success but also serve as a robust indicator of its future performance. When earnings accurately reflect a firm's operational reality and are consistent over time, they enhance the ability of stakeholders to make informed decisions that align with the firm's long-

term goals. Thus, earnings quality is fundamental to maintaining stability, attracting investment, and sustaining growth within the competitive landscape.

1.1.2. The Importance of Earnings Quality

The importance of earnings quality stems from the foundational role that earnings play in financial decision-making across various stakeholders. Regardless of quality, reported earnings are one of the primary inputs used in evaluating a firm's financial health and its ability to generate value, which in turn impacts investment and strategic decisions (Al-Sharif, 2009). Earnings, particularly indicators such as net income and earnings per share, are closely tied to the market valuation of a company's stock and are perceived as a reflection of the firm's capacity to generate consistent, reliable cash flows (Bayoumi, 2012). Accordingly, the importance of earnings quality is rooted not only in the profit figures themselves but also in their accuracy and reliability as indicators of the firm's operational efficiency and financial stability.

High-quality earnings offer a clearer picture of a company's resource utilization, allowing stakeholders to assess whether resources are being employed optimally. This precision is crucial for boards of directors, who rely on earnings quality to make informed decisions about future growth strategies, resource allocations, and performance evaluations (Al-Taie & Alani, 2017). Furthermore, earnings quality supports long-term strategic decisions, as it enables reliable assessments of current performance and improves forecasts of future profitability.

For external stakeholders, particularly investors and analysts, high-quality earnings are indispensable for understanding the company's distribution potential. Reliable profit figures guide the board's decisions regarding dividends, which are key considerations for shareholders and can influence investor confidence and market perceptions of the firm's stability (Obaid & Akbar, 2016). The level of trust that users place in financial statements is thus directly tied to the perceived quality of reported earnings, with higher-quality earnings reducing the risk of misrepresentation and enhancing the credibility of reported figures (Mousa, 2017).

However, flexibility in accounting standards can allow management a degree of discretion in how earnings are reported. This latitude introduces a potential for earnings

manipulation, where management may adjust financial results to present a favorable image of the company's performance. Although such practices may temporarily benefit the firm by enhancing its financial image, they undermine the credibility and reliability of the financial statements over the long term. Consequently, a growing emphasis is placed on high-quality earnings, defined as profit figures that are both accurate and suitable for making informed economic decisions (Ibrahim, 2017).

The critical role of earnings quality is further supported by accounting literature, which emphasizes that high-quality earnings provide a robust basis for evaluating the firm's current status and predicting future outcomes. Transparent and high-quality earnings disclosures reinforce external parties' trust in management and positively influence the firm's reputation among investors and analysts (Ahmed, 2013). In sum, earnings quality is pivotal to maintaining investor confidence, enhancing corporate reputation, and ensuring that reported earnings serve as an honest and useful indicator of financial performance. Through this lens, the importance of earnings quality becomes evident as it impacts both the firm's present valuation and its future growth prospects.

1.1.3. Characteristics of Earnings Quality

Earnings quality can be assessed through several key characteristics, each of which reflects how well reported earnings capture a company's true financial performance. These characteristics—persistence, predictive ability, discretionary accruals, and accrual quality—are integral to evaluating the reliability of earnings, as they provide insights into whether earnings are sustainable and indicative of future financial health (Francis et al., 2004). Each of these characteristics, derived from time-series analysis of financial data, contributes to a comprehensive understanding of what constitutes high-quality earnings.

Persistence of Earnings refers to the degree to which current earnings can be expected to continue into future periods. This characteristic is crucial because consistent profitability often indicates a stable and robust economic foundation for the firm. Persistent earnings reflect an ability to generate steady earnings over time, enhancing investor confidence and providing a more accurate basis for firm valuation. High persistence suggests that reported earnings are less likely to be influenced by one-time events or accounting manipulations, whereas significant fluctuations or low persistence

could signal instability or unreliable reporting. Continuity in earnings serves as a measure of earnings quality, as stable earnings allow stakeholders to make more rational and informed decisions based on predictable financial outcomes (Mushtaq et al., 2021).

Predictive Ability of earnings is the capacity of current earnings to provide insights into future performance. In the context of financial reporting, predictive ability aligns with the Financial Accounting Standards Board's (FASB) conceptual framework, which emphasizes relevance in financial information. Earnings with high predictive ability help stakeholders, including analysts and investors, forecast future earnings with greater accuracy, thereby supporting long-term planning and investment decisions. When earnings demonstrate low variability and maintain a consistent trajectory, they are more likely to have strong predictive value, suggesting that the company's operations are sustainable and resilient (Olaoye & Adewumi, 2020).

Discretionary Accruals represent the degree of management's influence over accounting estimates and judgments. These accruals involve managerial decisions on aspects such as asset depreciation schedules, revenue recognition timing, and expense allocation, which directly impact the reported earnings. Discretionary accruals are often scrutinized as they may reflect attempts at earnings management, where management adjusts financial results to meet specific targets or market expectations. The presence of significant discretionary accruals can diminish earnings quality, as it may indicate that the reported figures are not entirely reflective of the company's operational reality. Understanding the impact of discretionary accruals requires separating them from non-discretionary accruals, which are rooted in normal business activities and are less subject to managerial manipulation (Richardson et al., 2001).

Accrual Quality is assessed by the alignment between earnings and operating cash flows. High-quality accruals minimize the gap between net income and cash flows from operations, indicating that earnings are closely tied to actual cash-generating activities. Accrual quality is essential because it reveals how well earnings reflect underlying cash flows, which are a primary indicator of a company's liquidity and sustainability. Accruals help in recording the economic effects of transactions within the periods in which they occur, thus providing a more comprehensive picture of financial performance regardless of cash receipts or payments at any given time (Dechow & Skinner, 2000). Accruals free from estimation errors or significant adjustments enhance

the reliability of earnings, as they closely approximate future cash flows and provide a clearer indication of a firm's financial health (Abs, 2016).

Together, these characteristics form the foundation of earnings quality, with each one offering unique insights into the consistency, reliability, and predictive power of reported earnings. By understanding and measuring these attributes, stakeholders gain a deeper appreciation of the quality of a firm's earnings, which is essential for making informed decisions and accurately assessing long-term financial stability.

1.1.4. Determinants of Earnings Quality

Earnings quality is influenced by a range of internal and external factors that shape the reliability, accuracy, and predictive value of reported earnings. These determinants include the role of auditors, firm characteristics, governance structures, financial reporting practices, market conditions, and other external pressures. Each of these factors contributes uniquely to the overall quality of a firm's earnings, affecting how well reported earnings align with economic reality and support informed decision-making by stakeholders.

Auditors play a critical role in determining earnings quality by minimizing intentional and unintentional misstatements in financial reports. The quality of an audit influences the degree to which earnings can be trusted, as auditors assess the accuracy of financial statements and work to correct or report any material misstatements. Their effectiveness is shaped by various factors, including litigation risks, reputational concerns, and their level of independence (Tam et al., 2019). A rigorous audit can increase earnings quality by ensuring that earnings reflect the firm's true financial performance.

Company Size is another factor that impacts earnings quality. Larger companies often face more scrutiny, which may lead them to adopt more conservative accounting methods. While some studies suggest that larger firms may exhibit lower earnings quality due to complex operations and increased potential for income-smoothing practices, others argue that larger firms may have higher earnings quality because they are subject to rigorous auditing and regulatory oversight (Al-Bamerni, 2020).

Stock Market Drivers influence earnings quality through motivations linked to financing needs and shareholder expectations. Companies aiming to raise capital through initial public offerings or attract investment may engage in earnings management to present favorable financial results. This can lead to short-term improvements in reported earnings that may not reflect sustainable performance, impacting earnings quality negatively. Evidence suggests that companies driven by valuation objectives may manipulate earnings to meet market expectations, which can reduce the informational value of reported earnings (Yuan, 2019).

Corporate Governance mechanisms significantly affect earnings quality by providing a system of checks and balances within the firm. Effective governance, particularly the independence of the board of directors from management, enhances transparency and discourages earnings management. Good governance practices involve clear disclosure of executive compensation, a separation of ownership and management, and comprehensive internal controls, all of which foster higher earnings quality by reducing opportunities for profit manipulation (Al-Bamerni, 2020). Governance structures that support accountability ensure that financial statements are more likely to present an honest picture of the firm's financial health.

Firm Performance also influences the quality of reported earnings. Poorly performing companies may have greater incentives to engage in earnings management to mask underlying weaknesses. This behavior can compromise earnings quality by distorting earnings to present an artificially positive outlook. The "opportunistic" perspective suggests that managers may use earnings information to benefit themselves by misleading stakeholders, while the "information" perspective posits that managers may instead use their judgment to enhance the usefulness of earnings data for future predictions (Yuan, 2019).

Other Financial Reporting Practices can affect earnings quality through strategic classifications within the income statement. Some firms may use discretion to shift expenses or income between periods to smooth earnings, thereby meeting or exceeding market expectations. Practices such as interim reporting adjustments and selective categorization of income and expenses can artificially increase the stability of earnings, although they may not accurately reflect the firm's actual financial performance (Yassin et al., 2015).

External Factors such as cost-benefit considerations, litigation risk, and market conditions further influence earnings quality. Companies may weigh the costs and benefits of adopting aggressive accounting practices, as such choices carry the risk of legal repercussions and reputational damage if financial results are later deemed misleading. Litigation risk, in particular, can deter earnings management by increasing the potential costs of misrepresentation. Additional determinants identified in research include cash flow stability and annual reporting of losses, both of which have been found to impact the perceived quality of earnings (Ahmed & Baajja, 2014; Katz, 1990).

Together, these determinants provide a comprehensive view of the factors that influence earnings quality. Understanding these determinants is essential for stakeholders who rely on accurate, high-quality financial information for decision-making. Each factor contributes to either strengthening or weakening the reliability of reported earnings, shaping how well earnings reflect a firm's actual economic performance.

1.1.5. Methods for Assessing Earnings Quality

Despite significant progress in the field of accounting, the quality of earnings remains a topic of debate due to the absence of a universally accepted measure. This study addresses this gap by adopting several specific attributes of earnings to provide a more objective measure of earnings quality (Muhammad, 2017). The measures of earnings quality are divided into distinct categories, as outlined below and illustrated in Figure 1.

Persistence of Earnings is a key measure of earnings quality that assesses the sustainability of earnings over time. Persistent earnings indicate that current earnings are likely to continue into the future, offering stability and reliability to stakeholders. Earnings with high continuity are indicative of high quality because they reflect consistent financial performance rather than temporary gains. This continuity allows investors to predict future earnings more confidently and helps to reduce information risk, thereby enhancing the intrinsic value of the firm (Ismail et al., 2012). As Schipper et al. (2003) note, continuity in earnings strengthens investor confidence, especially when earnings are closely linked to actual cash flows, which are more indicative of sustainable income.

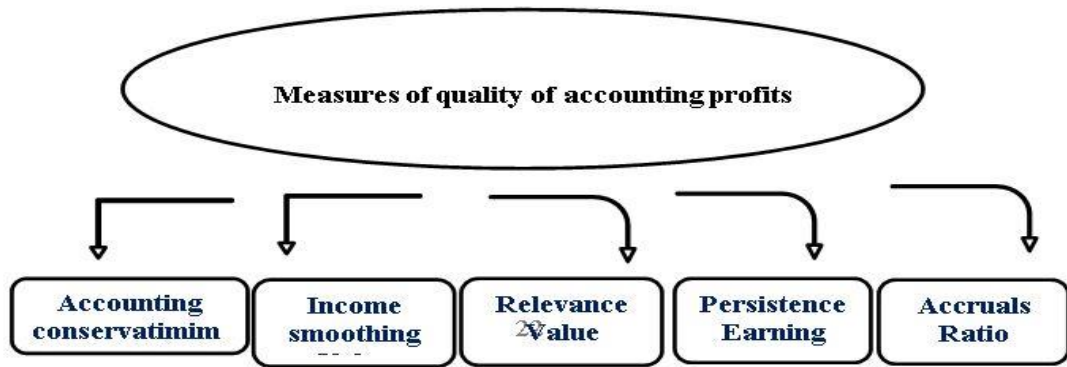


Figure 1: Measures of the earnings quality

The continuity equation is expressed as follows:

$$Earnings_{i,t+1} = \beta_0 + \beta_1 Earnings_{i,t} + \epsilon_{i,t}$$

- $Earnings_{i,t+1}$ represents revenues from continuing operations of company i for the following year,
- $Earnings_{i,t}$ is the revenue from continuing operations for the current or base year,
- $\epsilon_{i,t}$ denotes the standard error or adjusted error,
- β_0 is the constant of the equation, and
- β_1 is the adjusted coefficient or slope.

If β_1 is close to 1, earnings are considered persistent and high-quality, while a value close to 0 indicates less stability and lower quality.

Predictive Ability of earnings measures the extent to which current earnings forecast future financial performance. Earnings with high predictive ability align with the Financial Accounting Standards Board's (FASB) emphasis on relevance in financial reporting, as they provide valuable insights into future income. The higher the predictive accuracy of earnings, the more they contribute to earnings quality, allowing stakeholders to make informed long-term decisions. Earnings that exhibit high predictive ability reduce information asymmetry and support greater financial stability (Olaoye & Adewumi, 2020).

Accruals Quality refers to the alignment between earnings and cash flows from operations. High-quality accruals reduce the discrepancy between reported income and

actual cash flows, enhancing reliability. The accruals ratio provides insight into the proportion of earnings derived from accruals, with a lower ratio generally indicating higher quality:

$$\text{Accrual Ratio} = (\text{Net Income} - \text{Cash Flow from Operations}) / \text{Average Total Assets}$$

A lower accrual ratio implies that earnings rely less on accruals, reducing the risk of earnings manipulation and indicating higher quality.

Discretionary Accruals involve managerial adjustments in accounting estimates. Although some discretion is permissible, excessive discretionary accruals can lead to earnings manipulation, reducing earnings quality. Discretionary accruals are derived by separating total accruals into discretionary and non-discretionary components, often requiring estimation through models like the Healy (1985) model or the Jones (1991) model.

Value Relevance is measured by how well accounting figures explain stock returns. It is represented by the adjusted R^2 in the following model:

$$RET_t = a_0 + b_1 EARN_t + b_2 \Delta EARN_t + \varepsilon_t$$

where:

- RET_t is the entity's return for one year (t),
- $EARN_t$ is income before extraordinary items for year t,
- $\Delta EARN_t$ is the change in income before extraordinary items from year t, scaled by market value at year-end $t-1$.

Timeliness measures the responsiveness of earnings to economic changes, both positive and negative, using explanatory power. The model for timeliness includes a dummy variable to indicate positive or negative returns:

$$EARN_{j,t} = a_{0,j} + a_{1,j} NEG_{j,t} + \beta_{1,j} RET_{j,t} + \beta_{2,j} NEG_{j,t} \cdot RET_{j,t} + \varepsilon_{j,t}$$

where:

- $RET_{j,t}$ represents return for entity j in year t,
- $EARN_{j,t}$ is net income before extraordinary items,
- $NEG_{j,t}$ is a dummy variable that equals 1 if return is negative.

Accounting Conservatism is measured using the conservatism index (C-score), which examines reserves as a proportion of net operating assets:

$$C_{it} = ER_{it} / NOA_{it}$$

where:

- C_{it} is the conservatism index,
- ER_{it} represents estimated reserves during period t ,
- NOA_{it} denotes net operating assets (book value of assets minus liabilities).

Income Smoothing is calculated as follows:

$$SMOOTH_i = \sigma(NIBE_{j,t}) / \sigma(CFO_{j,t})$$

where:

- $SMOOTH_i$ is income smoothing for firm
- $\sigma(NIBE_{j,t})$ is the standard deviation of net income before extraordinary items,
- $\sigma(CFO_{j,t})$ is the standard deviation of operating cash flows.

The ratio helps assess the extent to which accruals are used for smoothing, with values under 1 indicating high covariance and potential accrual use for income stability.

These formulas and indicators provide a structured framework for assessing the quality of accounting earnings, covering both cash-based and accrual-based measures. By integrating these models, stakeholders gain a multidimensional view of earnings quality, supporting robust financial analysis and decision-making.

1.2. The Concepts of Accounting Conservatism

Accounting conservatism is a cornerstone of prudent financial reporting, emphasizing caution in the recognition of income and assets while ensuring that potential losses are acknowledged promptly. This principle has evolved as a protective mechanism in accounting, designed to prevent overestimation of a company's financial health and to offer stakeholders a conservative, reliable view of financial outcomes. By prioritizing the recognition of probable expenses and liabilities over speculative gains, conservatism mitigates the risk of financial overstatement and aims to provide a buffer against market volatility and economic uncertainty. In practice, this cautious approach

influences both the reported financial results and the perceptions of investors and creditors, who rely on conservative financial statements for a more stable assessment of firm value.

1.2.1. Definition of Accounting Conservatism

Accounting conservatism has long been recognized as a fundamental concept in financial reporting, rooted in the need to temper optimism in accounting practices with prudence and caution. Historically, it emerged as a response to the inherent uncertainty in business operations, serving to protect stakeholders by ensuring that financial statements present a restrained view of a company's financial position. In practice, this approach involves recognizing losses and liabilities as soon as they are probable, while revenues and asset values are only recognized when they are certain and realized. This conservative approach minimizes the risk of overstated earnings or inflated asset values, aiming instead to provide a buffer against potential future losses (Hadi, 2022).

The Financial Accounting Standards Board (FASB, 1980) formally addressed the importance of conservatism in Concept Statement No. 2, defining it as a response to uncertainty, where accounting practices should adequately consider the risks and volatility associated with the business environment. Under this definition, conservatism acts as a selective mechanism, favoring principles that prevent overstatement, thus enhancing the reliability of financial statements for users, particularly during periods of economic downturns or financial crises. Scholars like Hayn and Givoly (2000) argue that conservatism operates by choosing accounting policies that delay revenue recognition, expedite expense recognition, and value assets and liabilities at their most realistic—if not pessimistic—values. Wolk et al. (2013) further describe it as a tool to account for future uncertainties by adopting conservative estimates, which helps stakeholders make informed decisions based on a realistic financial assessment.

Given its emphasis on caution, accounting conservatism plays a pivotal role in managing information asymmetry and fostering stakeholder trust. In uncertain market conditions, it helps to mitigate the risks that arise from competitive pressures and unpredictable economic environments. Despite differing definitions across the literature, the common thread remains clear: conservatism is a forward-looking principle designed to protect various stakeholders by emphasizing caution and reliability in financial

reporting. Thus, adopting conservatism as a core principle aids in the preparation of financial reports that stakeholders can trust, especially in times of uncertainty and economic fluctuation.

1.2.2. Importance of Accounting Conservatism

The significance of accounting conservatism lies in its ability to mitigate risks, enhance reliability in financial reporting, and protect the interests of various stakeholders—especially during periods of financial volatility. As economic and financial crises have underscored, conservative accounting practices serve as a safeguard for shareholders, creditors, and other parties by ensuring a cautious approach to revenue and asset recognition. The application of conservatism has directed accounting research toward understanding the motivations behind conservative practices and the benefits they offer in enhancing transparency and accountability in financial reporting (Abu Al-Khair, 2008).

Accounting conservatism also provides a counterbalance to management's potential inclination to present overly optimistic financial results. In scenarios where management compensation is linked to profitability or net assets, there may be a temptation to defer losses and accelerate revenue recognition to secure bonuses or maintain positions. However, conservatism restricts such flexibility, promoting a more reliable portrayal of the company's financial standing. As a result, it helps stakeholders evaluate the quality of disclosures, identify potential risks, and make informed decisions based on credible information (Rajab, 2011).

The benefits of accounting conservatism extend beyond protecting against financial misrepresentation. By emphasizing transparency, conservatism fosters trust among stakeholders and reinforces ethical standards in financial reporting. Additionally, it helps companies avoid excessive costs associated with overvalued assets, including potential legal and administrative expenses. Thus, conservatism plays a pivotal role in formulating robust accounting policies and standards that prioritize caution, promote ethical practices, and support the long-term stability and credibility of financial reports. This approach ultimately strengthens the integrity of financial reporting processes, aligning with the interests of shareholders, management, and accountants alike.

1.2.3. Types and Implications of Accounting Conservatism

Accounting conservatism is grounded in the principle of caution, prioritizing the recognition of expenses and liabilities sooner than revenues and assets. This approach acts as a buffer against potential overstatement of financial health, offering stakeholders a more realistic view of the firm's current and future position. Despite criticisms that conservatism introduces bias by favoring losses over gains, its enduring application highlights its crucial role in financial reporting, especially during periods of uncertainty (Francis et al., 2013). The practice of conservatism aligns with the need for reliability in financial statements, offering justifications rooted in contractual, legal, tax, and regulatory contexts. Accounting conservatism has evolved to include different applications—conditional and unconditional conservatism—that support its cautious objectives in varied ways.

Conditional conservatism, also known as earnings conservatism, is event-driven and requires firms to recognize losses as soon as they are probable, while gains are deferred until realization. This responsive approach adjusts financial reporting to reflect immediate economic realities, such as market declines or asset impairments, thereby providing stakeholders with a conservative assessment of net assets. Unconditional conservatism, or balance sheet conservatism, applies a steady approach by undervaluing assets and overestimating liabilities on an ongoing basis, independent of specific events. For example, companies may adopt conservative asset valuation practices, such as immediate expensing of certain intangibles or applying accelerated depreciation. This steady baseline offers stakeholders an inherently cautious financial position over time.

The rationale for conservatism is multifaceted. Contracts and agency theory underpin one of the main justifications, as conservatism mitigates conflicts of interest between management and stakeholders. In debt covenants, for example, conservatism limits dividend distributions and ensures minimum asset values, thereby protecting creditors and investors from potential overstatement of earnings (Hamdan, 2011). Legal considerations further reinforce this approach; conservative estimates can shield companies from legal liabilities that might arise if overvalued assets or earnings lead to financial disputes. Managers, thus, often use conservatism to minimize exposure to

litigation by adopting practices that avoid exaggerating the firm's financial performance (Hamdan, 2011).

Tax incentives also play a significant role in the adoption of conservative practices. By understating asset values or deferring revenue recognition, firms can reduce their taxable income, consequently lowering their current tax burden. This conservative approach to tax reporting aligns with the financial interests of companies, especially where minimizing tax payments can enhance cash flow management (Khalil, 2003; Garcia Lara et al., 2009). Regulatory considerations similarly support conservatism, as regulatory bodies favor conservative reporting practices that enhance financial stability. By requiring or encouraging conservatism, regulators help promote a reliable financial reporting environment, which is particularly important during periods of economic uncertainty (Saudi, 2013).

While accounting conservatism offers substantial advantages, it also presents notable disadvantages. Among its primary benefits, conservatism provides stakeholders with a cautious portrayal of financial health, protecting creditors and shareholders from overvaluation risks. It supports ethical standards in accounting by fostering prudence and discouraging overly optimistic reporting. For less-experienced investors, conservatism adds an additional layer of protection by delivering financial figures that are less likely to mislead (Abu Jarad, 2015). Additionally, conservatism encourages prudent valuation practices, such as conservative asset valuations, which contribute to stakeholder trust and objective financial reporting (Iqbal & Al-Qudah, 2014).

However, conservatism can also undermine other accounting principles, such as neutrality, comparability, and consistency. By consistently understating assets and deferring gains, conservatism may distort the true financial picture, which can hinder comparability and obscure the company's actual growth trajectory. This bias may challenge financial analysts in accurately assessing the company's value, as conservative valuations may mask growth potential and lead to misjudgments in financial analysis (Abu Jarad, 2015). Therefore, while conservatism is integral to cautious financial reporting, its limitations must be recognized to balance transparency with prudence.

In sum, accounting conservatism encompasses both conditional and unconditional approaches, each serving distinct purposes in managing financial uncertainty and enhancing the reliability of financial reports. By balancing benefits such

as risk mitigation, legal protection, and regulatory alignment against potential drawbacks, conservatism remains a fundamental yet complex principle in contemporary financial reporting, supporting stability and cautious evaluation of financial health.

1.2.4. Methods of Measuring Accounting Conservatism

Accounting conservatism can be measured using a variety of models, each with its own theoretical and practical applications. These methods help in quantifying conservatism by assessing how accounting practices influence earnings reporting, asset valuations, and other financial metrics. Key models include the Asymmetric Timeliness of Earnings, Hidden Reserves, Negative Accounting Accruals, Market-to-Book Ratio, and the Asymmetric Accruals-to-Cash Flows. Each of these approaches offers a different perspective on conservatism, addressing specific facets such as response to economic conditions, reserve levels, and balance sheet conservatism. Below is a detailed explanation of each method.

Asymmetric Timeliness of Earnings (AT) (Basu, 1997): This method examines the speed at which accounting profit responds to bad news (losses) compared to good news (gains), highlighting a conservative approach by recognizing losses sooner than gains. Known as a model that assesses the relationship between earnings and stock returns, it suggests that conservatism leads to a quicker acknowledgment of negative economic events, thus protecting stakeholders from overstated profitability. The model has been widely used but faces criticisms, particularly concerning its efficiency in time-series data, where it may suffer from selection bias and variances over multiple periods (Givoly et al., 2007). The Asymmetric Timeliness model can be calculated as follows:

$$X_{it}/P_{it-1} = \alpha_0 + \alpha_1 DR_{mt} + \beta_0 R_{it} + \beta_1 DR_{mt} + R_{it}$$

where:

- I: Fiscal year
- X_{it} earnings per share for company I in fiscal year t
- P_{it} : The stock price at the beginning of fiscal year t
- DR_{mt} : is a dummy variable that equals 1 for negative stock returns and 0 for positive stock returns.

Hidden Reserves (HR) (Penman and Zhang, 2002): The hidden reserves measure evaluates conservatism based on the presence of “secret” reserves created by conservative accounting practices. This model assumes that reserves in commodity inventory, research and development (R&D), and advertising expenses contribute to conservatism. Although difficult to quantify directly, these hidden reserves indicate the degree of conservatism in a firm’s financial statements. The following formula estimates hidden reserves by incorporating reserves for inventory, R&D, and advertising:

$$C\text{-score} = ER \div NoA$$

Where:

- C- score: the degree of accounting conservatism
- ER: Estimated Reserves
- NoA: Estimated net assets
- The estimated reserves for this model are measured based on three elements: commodity inventory, research and development expenses, and advertising expenses. Therefore, the above equation can be reformulated as follows:
- C-score = ***INV res+R&Dres+ADV res*** ÷ NOA:
- Where: INVERS: commodity inventory reserves (calculated using the Lifo method and appearing in the margins of the financial statements).
- ***R&Dres***: R&D reserves (calculated through the amortization premium for R&D expenses).
- ***ADVred***: Advertising reserves (measured by the amortization premium for previously capitalized advertising expenditures).

Negative Accounting Accruals (NAA) (Givoly and Hayn, 2000): This measure focuses on non-operating accruals, assessing conservatism based on the tendency to delay the recognition of economic gains while accelerating the recognition of losses. By observing the accumulation of non-operating accruals, this measure captures the conservative practice of recognizing losses promptly. Negative accruals increase with greater conservatism, providing insights into the firm’s approach to revenue and expense recognition. The model is calculated as:

$$Total\ Accruals = (Net\ Income + Depreciation) - Operating\ Cash\ Flows$$

Market-to-Book Ratio (MTB): This model uses the ratio of a firm's book value to its market value to assess the degree of conservatism in financial reporting. A low book-to-market ratio suggests a conservative valuation of assets, as it indicates that the book value of a company's assets is lower than its market value. This approach aligns with the concept of conservatism by demonstrating that conservative accounting practices can lead to a lower valuation on the books compared to market perceptions. The market-to-book ratio is calculated as follows:

$$\text{Conservatism Ratio} = \text{Book Value of Equity} / \text{Market Value of Equity}$$

Alternatively, if needed for shares:

$$\text{Conservatism per Share} = \text{Book Value (Shares + Profit Reserves)} / \text{Number of Shares}$$

Asymmetric Accruals-to-Cash Flows (AACF) (Ball and Shivakumar, 2005): This model, introduced by Ball and Shivakumar, aims to estimate conservatism by examining the relationship between accruals and cash flows. It particularly targets private companies where stock price information may not be as available, offering a measure of conservatism based on the differential treatment of cash flows and accruals in response to economic conditions. This method uses a regression model to explore the sensitivity of earnings to positive and negative cash flow changes.

1.3. The Concepts of Financial Performance

The concept of financial performance has evolved alongside the broader transformations in financial management, shaped significantly by shifts in the economic environment and advancements in analytical methods. Initially, financial performance was narrowly defined, with early financial reports providing limited insights that primarily served as records of economic activity without much analytical value. As the field progressed, particularly with the advent of the industrial revolution, the focus of financial management began to expand beyond mere record-keeping to include sourcing of funds, safeguarding institutional rights, and ensuring data accuracy for informed decision-making.

By the mid-twentieth century, financial management incorporated principles of scientific analysis, emphasizing the importance of financial statements, data transparency, and institutional structure. In the 1960s and 1970s, financial performance

measurement grew to include strategic planning tools, such as budgeting and cost analysis, which laid the groundwork for evaluating productivity and profitability. The rapid technological advancements of the 1980s and 1990s further accelerated this evolution, allowing financial performance analysis to be conducted with increased precision and efficiency, thanks to digital tools and advanced financial models (Al-Bashir, 2017).

This section explores the concept of financial performance in contemporary terms, highlighting the financial ratios and analytical tools that stakeholders use to assess the success of business organizations. These metrics not only capture the efficiency of resource utilization but also reflect the organization's ability to generate value and ensure sustainable growth. Understanding these foundational concepts is essential for evaluating the financial health and competitive standing of an organization in today's dynamic economic landscape.

1.3.1. Concepts and Importance of Financial Performance

The concept of performance, particularly in financial terms, has been explored from diverse analytical and managerial perspectives, resulting in a variety of definitions. This diversity stems from the different goals and viewpoints among researchers, with some focusing on quantitative metrics while others adopt a more holistic view that incorporates organizational, social, and economic dimensions. Performance, therefore, is not merely a matter of ratios and numerical data; it reflects how effectively an organization achieves its goals and meets the expectations of its stakeholders (Al-Dawi, 2010). Al-Taweel and Al-Abadi (2013) emphasize that performance is integral to management, as it provides a framework for evaluating results and comparing outcomes. In this sense, performance can be expressed in financial indicators that reveal how well an organization utilizes its resources, creating a basis for judgment on the effective management of available assets. Zubaidi (2017) adds that this concept encapsulates an organization's success in fulfilling the needs of diverse parties, while Hamza (2012) frames performance as the pursuit of goals with maximum efficiency, where efficiency represents an optimal relationship between inputs and outputs, enhancing productivity.

In the context of financial performance, this term encompasses the efficiency and effectiveness with which an organization manages its financial resources to achieve

profitability and growth. With today's competitive and globalized environment, measuring financial performance has become critical for business continuity and resilience. Financial performance reflects an organization's capacity to generate earnings, optimize the use of assets, and achieve a stable financial position, forming the foundation of its market presence and long-term viability. Najla (2015) points out that financial performance offers a comprehensive view of a business's health, guiding managerial decisions that influence the company's competitive standing. The assessment of financial performance involves evaluating how well a company converts its resources into income and profit, measuring its capacity to sustain growth and meet both internal and external objectives. This definition includes the efficiency with which a business utilizes its resources to produce desired outcomes, showcasing the impact of financial strategies on operational success (Aggarwal & Thakur, 2013).

The importance of financial performance lies in its role as a primary indicator of organizational health and strategic effectiveness. Osman (2014) explains that effective financial performance management ensures the availability of liquidity and profitability, supporting investment and financing decisions while mitigating associated risks. Maintaining liquidity helps shield the organization from bankruptcy risks, strengthens financial stability, and enables the achievement of appropriate returns on investment. Financial performance also enhances access to external financing, creating opportunities for expansion, increased resource utilization, and operational growth. By effectively managing the cost of capital, financial performance increases organizational value, attracting investors and enhancing the firm's appeal within the marketplace.

Operational efficiency, resource allocation, and resilience to financial crises are further strengthened through robust financial performance, which aids in minimizing the impact of economic disruptions. Organizations with stable financial performance can respond more effectively to crises, maintain consistent operations, and reduce potential risks, building confidence among stakeholders. Effective financial performance management improves relationships with both internal and external stakeholders, fostering trust and facilitating smooth interactions. It also facilitates timely and accurate reporting, allowing senior management to identify and oversee areas requiring focused attention. Reports generated through sound financial performance practices provide valuable insights for decision-making and direct management's attention to responsibility centers that need improvement.

In sum, financial performance is essential for assessing profitability, ensuring liquidity, securing financing, and maintaining operational stability. Through goal setting, performance evaluation, and resource alignment, financial performance forms the basis for sustainable growth, enabling an organization to achieve its strategic objectives in alignment with both short- and long-term goals. By providing a structured framework for assessing profitability, monitoring resource efficiency, and fulfilling stakeholder expectations, financial performance becomes a critical measure of organizational success and resilience in a competitive business environment.

1.3.2. Financial Performance Standards

According to Al-Salhi (2016), business organizations use a variety of standards to evaluate their financial performance effectively. These standards are represented by a set of indicators that provide insight into past performance, industry benchmarks, and future targets. They include the following:

Historical Standards: These standards are derived from the organization's own financial statements from previous years. By comparing current performance against past results, financial management can monitor the organization's progress, identify trends, and use this historical data to inform future planning.

Absolute Standards: Business organizations may use fixed values or universally accepted ratios as benchmarks for performance. These absolute standards serve as stable reference points, providing a means to evaluate ratios that are commonly used across industries, ensuring comparability and consistency in assessing performance.

Sectoral Standards: Financial analysts utilize sectoral standards to assess performance in relation to industry peers. These standards represent the average performance within the sector, making them especially relevant for organizations that share similar characteristics. Sectoral standards enable organizations to gauge their competitive standing and identify areas for improvement relative to industry norms.

Target Standards: These are goal-oriented benchmarks that organizations aim to achieve as outlined in their planning budgets. By comparing actual results to these target standards, organizations can identify variances and implement corrective measures. This

practice helps ensure alignment with strategic objectives and enables timely adjustments to stay on course toward achieving desired outcomes.

These standards, collectively, offer a comprehensive framework for evaluating financial performance, allowing organizations to measure progress, benchmark against industry standards, and align with future objectives.

1.3.3. Factors Affecting Financial Performance

Financial performance is influenced by a variety of internal and external factors that together shape an organization's efficiency and effectiveness. These factors are crucial in enabling accurate, objective evaluations of the organization's inputs, processes, and outputs, ultimately helping to identify strengths and weaknesses within the system. The factors are interdependent, forming a framework within which decisions are made to address and improve upon identified issues (Pascal, 2009).

One of the primary factors is the organizational structure, which serves as the framework where all organizational activities, roles, and relationships converge. The structure establishes communication channels, assigns responsibilities, and allocates resources, all of which are critical in executing strategies and achieving organizational goals. A well-defined structure aids in delineating tasks and supporting efficient decision-making, helping the organization to implement plans effectively and maintain clear role definitions (Al-Khatib, 2010).

The organizational climate is equally influential, encompassing the transparency and style of management, the approach to decision-making, and the development of the human element. It reflects the overall atmosphere in which employees work, including how well they understand the organization's objectives and their role within it. A positive organizational climate promotes sound, efficient performance by fostering a supportive environment for decision-makers and encouraging employees to take initiative. This climate provides valuable feedback on administrative and financial performance, ensuring that standards are consistently applied and aligned with organizational goals (Al-Bashir, 2011).

Technology is another critical factor, as it encompasses the methods, tools, and systems an organization uses to achieve its goals. Different types of technology may be

implemented depending on the organization's needs, such as custom production for specific consumer requests, continuous production technology for ongoing processes, and large-batch production for volume efficiency. Effective technological integration enhances resource utilization, enables innovation, and aligns with organizational goals to improve overall performance (Al-Khatib, 2010).

Lastly, organizational size impacts performance by influencing the complexity and scalability of processes. Organizations are commonly classified as small, medium, or large, with size often measured by total assets, sales, deposits, or value added. As organizations grow, managing them can become more complex, potentially affecting performance efficiency. However, larger organizations often attract more attention from financial analysts, which can enhance credibility and decrease the informational cost per unit in financial reporting. Thus, while larger size can lead to operational challenges, it can also provide a strategic advantage in terms of visibility and stakeholder engagement (Al-Khatib, 2010).

In sum, factors such as organizational structure, climate, technology, and size each play a distinct yet interconnected role in shaping financial performance. By understanding and strategically managing these factors, organizations can strengthen their performance, adapt to changing environments, and make informed decisions that align with their overall objectives.

1.3.4. Financial Performance Objectives

The objectives of financial performance evaluation are multifaceted, aimed at diagnosing organizational issues, assessing efficiency, and facilitating optimal resource use. Financial performance evaluation provides insights that guide institutions in several key areas. The first objective is to enable organizations to make optimal use of resources, ensuring that financial and operational assets are allocated and utilized effectively. This objective is closely followed by the goal of aiding in financial and strategic decision-making, allowing for thorough analysis and comparison to drive informed choices.

Another critical objective is to clarify the impact of the financing structure on organizational profitability, revealing the efficiency of funding strategies and their role in overall performance. By evaluating the financing framework, organizations can assess

whether their capital structure aligns with long-term goals and profitability targets. Moreover, financial performance evaluation serves as a safeguard, ensuring that decisions are based on objective data rather than subjective judgment or bias. This approach enables institutions to accurately identify areas within the organization that require improvement, development, or restructuring. Through such positive diagnosis, financial performance evaluation helps enhance strengths and address weaknesses, maximizing the institution's value in the financial and business landscape (Arab Administrative Organization, 2009).

From another perspective, financial performance evaluation serves several fundamental goals within an economic institution. Boutawata (2019) emphasizes that a primary objective is to measure the organization's success in sustaining its activities and achieving its strategic goals. Success in financial performance is defined as a composite of efficiency—maximizing resources—and effectiveness—meeting objectives reliably. This dual measure helps ensure the organization's long-term viability and growth potential.

Additionally, a robust financial performance system provides critical information across different levels of administration, supporting a coherent decision-making process at each managerial tier. By evaluating financial performance, organizations can observe their development over time, identifying trends that indicate progress or areas for concern. This process not only enables benchmarking but also fosters a spirit of competition among departments, driving improvement and aligning activities with organizational goals. Ultimately, financial performance evaluation serves as a tool for sustaining growth, promoting internal accountability, and positioning the organization competitively within its sector.

1.3.5. Methods of Measuring Financial Performance

Despite their long history of use, financial ratios remain one of the fundamental tools relied upon by investors, creditors, and other stakeholders to assess firm performance. These ratios gained prominence as the management of firms became separated from ownership, creating a demand for consolidated financial reports that offer insights into an organization's performance. Ratios and financial indicators

facilitate a detailed examination of financial statements, allowing for a comparison of actual results with planned outcomes (Al-Jarjawi, 2008).

Financial ratios serve as a bridge, providing valuable data on operational efficiency, financial health, and overall performance. These ratios include both accounting-based measures and market-based measures, such as return on assets (ROA) and Tobin's Q, each providing unique insights. Accounting-based measures are rooted in historical data, while market-based measures, like Tobin's Q, reflect investor expectations and future outlooks.

Evaluating financial performance through ratios also comes with challenges that can impact the effectiveness of these assessments. For instance, large firms with diverse business units often struggle to find standardized ratios that allow for meaningful comparisons, as operations may vary significantly across different sectors. Additionally, inflation can distort financial statement elements over time, and differences in accounting practices (such as depreciation or inventory valuation) can hinder comparisons between firms. Ratios must be interpreted within a broader context, as high liquidity ratios may indicate a robust cash position but could also suggest inefficient cash management if liquidity exceeds operational needs. As such, financial performance analysis often requires a set of integrated ratios to provide a balanced view (Al-Hinnawi, 1998).

In this study, we rely on specific ratios to assess firm performance, including return on assets and Tobin's Q. These indicators allow us to measure both profitability and market valuation. Profitability ratios, in particular, are highly valued by investors, management, and creditors. These ratios reflect the efficiency of management in generating returns from assets, sales, and shareholders' equity, which is critical in attracting new investors, evaluating managerial success, and ensuring creditors' confidence.

Two primary profitability ratios used in this analysis are return on assets (ROA) and return on equity (ROE).

Return on Assets (ROA): ROA is a fundamental indicator of profitability that demonstrates the firm's efficiency in using its assets to generate earnings. It is calculated by dividing net income by total assets. An increase in ROA signifies an improvement in profitability, which often translates to a higher market value per share, as higher net

income boosts earnings per share, a key metric influencing stock value. ROA reflects management's ability to utilize assets effectively and can be calculated as follows:

$$\text{Return on Assets} = (\text{Net Profit} / \text{Total Assets}) \times 100$$

Return on Equity (ROE): ROE is a measure of profitability that assesses the firm's ability to generate earnings from shareholders' equity. It is calculated by dividing net income by total equity. A higher ROE indicates a stronger return on investment for shareholders, as it reflects the efficiency of management in generating earnings from equity capital. ROE also signals the company's capacity to increase shareholder value by driving up earnings, thereby boosting earnings per share and, ultimately, stock value. ROE can be calculated as follows:

$$\text{Return on Equity} = (\text{Net Profit} / \text{Total Owners' Equity}) \times 100$$

In summary, financial ratios such as ROA and ROE provide a quantitative basis for evaluating firm performance, helping investors, management, and creditors make informed decisions. While ratios offer valuable insights, they must be applied with caution and in conjunction with other analytical tools to account for limitations related to inflation, firm size, and accounting practices. These measures are instrumental in understanding a firm's profitability, operational efficiency, and overall financial health, forming a comprehensive approach to performance evaluation.

1.4. The Concepts of Market Valuation

Market valuation represents the assessment of a company's overall worth in the marketplace, reflecting the collective perspective of investors on its future earnings potential, growth prospects, and financial stability. This concept is foundational in finance, as it influences a company's ability to attract investment, secure financing, and determine shareholder wealth. Market valuation is primarily based on observable metrics such as stock prices and is influenced by both intrinsic factors—such as a company's financial health, earnings, and asset base—and extrinsic factors, including market trends, investor sentiment, and economic conditions. Understanding market valuation is essential for stakeholders to gauge a company's current standing, make informed investment decisions, and align strategies with market expectations.

In the following section, we will explore the various methods and factors that contribute to an accurate and comprehensive view of market valuation, emphasizing its relevance in assessing firm performance and informing strategic decision-making.

1.4.1. Definition of Market Valuation

The concept of market valuation is defined with slight variations across financial literature, primarily as the product of a company's stock price at the end of a financial period and the total number of shares held by shareholders (Elexander et al., 2012). This measure reflects the aggregated value investors assign to a company based on its financial health, growth prospects, and market standing. Market valuation serves as a key indicator of firm value, aligning closely with one of the fundamental goals of financial management—maximizing shareholder wealth. As outlined by Westen and Brigham (1971), financial management prioritizes actions and decisions that enhance the firm's value, as reflected in its market valuation.

Market valuation, however, is subject to fluctuations driven by a company's financial performance, broader economic conditions, and market forces such as supply and demand for its stock. An increase in market value typically signals economic growth and prosperity, whereas a decline may indicate economic stagnation or recession (Salama, 1997). From a shareholder perspective, market valuation serves as both a performance metric and an indicator of management's success in building value. In publicly traded companies, this value is calculated by multiplying the number of outstanding shares by the share price, offering an immediate snapshot of the company's perceived worth in the market.

For both management and investors, maximizing market value is a primary objective. Financial management views this measure as a critical indicator of success, while investors regard market value as a gauge of a company's stability, growth potential, and overall performance in the competitive landscape.

1.4.2. Factors Affecting Market Valuation

Maximizing the market value of shares stands as a fundamental objective in financial management, guiding every decision related to investment and financing. Each

financial decision is expected to either preserve or enhance the company's stock value. Market valuation, however, is influenced by multiple factors with varying degrees of impact. These determinants play a significant role in shaping the perceived value of a company's shares in the marketplace.

One key factor is the forecasted earnings per share, as projections of higher earnings can drive positive expectations and thus elevate the share price. Additionally, the timing and reliability of dividend payments contribute to market valuation, where consistent and timely dividend flows generally bolster investor confidence and can lead to a higher stock valuation. The risk level associated with the company's projects also affects valuation; higher risk can lead to decreased stock prices, while lower-risk investments with robust profit forecasts tend to attract investors, thereby increasing the stock's market value.

The company's financing structure is another essential determinant, particularly in relation to its use of financial leverage. A well-balanced structure can enhance value by supporting growth without compromising financial stability. However, an excessive reliance on debt may jeopardize the company's ability to meet its obligations, thus negatively impacting stock valuation. Dividend policy further influences the market value, as it affects the internal funds available for reinvestment while also aiming to meet investor expectations. A flexible approach to dividends can satisfy investor demand for immediate returns, but it may reduce funds available for future growth.

Beyond these internal factors, external elements also play a crucial role in determining market valuation. Factors such as the overall financial strength of the company, stability and growth in earnings, and investor confidence in the company's continuity contribute to market perception. Companies with stable and growing earnings reassure investors of the business's long-term viability, enhancing market value. Some companies also issue free shares from reserves rather than cash dividends, which can attract investors by providing capital appreciation potential without reducing cash reserves. Additionally, macroeconomic conditions like inflation rates impact market valuation, as higher inflation may drive investors to seek assets with potential for higher returns.

Finally, local market dynamics, such as the activity of parallel markets and the availability of a formal trading platform like the Baghdad Stock Exchange, also affect

market valuation. In the absence of a robust stock exchange, for instance, companies may find it challenging to achieve optimal stock valuation, leading to a lower perceived market value of shares. Consequently, these factors—both internal, like earnings forecasts and dividend policies, and external, such as inflation and market infrastructure—collectively shape the market valuation of a company's shares, reflecting investor sentiment and influencing the company's financial standing in the marketplace.

1.4.3. Methods of Market Valuations

Market valuation is essential for assessing a company's worth, helping investors understand if it is undervalued, fairly valued, or overvalued. This valuation extends beyond stock price alone, encompassing assets, liabilities, and potential future cash flows. Investors and acquirers rely on market valuation to make informed decisions, especially when comparing companies with different capital structures. Enterprise value—a comprehensive measure that includes both assets and liabilities—provides an in-depth view of a company's financial health, making it especially relevant during acquisitions, where potential liabilities must be considered alongside asset value.

For publicly traded companies, calculating market value is straightforward; it involves multiplying the stock price by the total number of outstanding shares. However, for non-listed entities, valuation requires a more detailed examination of assets, liabilities, and expected cash flows. A variety of methods have been developed to estimate market valuation accurately. These methods consider a combination of asset values, future earnings, and the broader financial context to provide an accurate picture of the company's worth. The most widely used methods include:

Net Assets Method: This method, grounded in financial accounting, calculates enterprise value by subtracting total liabilities from total assets as recorded on the balance sheet. Assets are typically measured at historical cost minus accumulated depreciation, providing a net book value that reflects shareholders' equity. While straightforward and easy to apply, this method has limitations, as the historical cost may not accurately represent the current market value, especially in inflationary contexts. The Net Assets Method is calculated as:

$$WP = A - P0 = KW$$

where:

WP: Enterprise value (net accounting value)

A: Total balance sheet value of assets

P₀: Balance sheet value of liabilities

KW: Value of equity on the balance sheet.

Exchange Value Method: This replacement approach estimates the financial outlay required to replace an enterprise's assets. Often used by investors deciding between purchasing a company or developing similar assets independently, this method considers both physical and technological depreciation, adjusting for factors such as obsolescence. The exchange value method is represented by:

$$WON = WOB (1 - Zf) (1 - Zm)$$

where:

WON: Net replacement value (considering asset wear and obsolescence)

WOB: Total replacement value (new fixed asset value)

Z_f: Technical physical use index

Z_M: Obsolescence factor (reflecting technology changes).

Net Assets Revalued Method: Expanding on the Net Assets Method, this approach adjusts for inflation and other economic factors by revaluing assets to reflect current market prices. It considers sector-specific inflation rates, making it particularly useful for industries where assets depreciate or appreciate due to external economic factors. The relationship for this method is given as:

$$\text{Market Value Adjusted} = \text{Total Assets Adjusted} - \text{Total Accounts Payable Adjusted}$$

This method is especially relevant when historical cost does not reflect the current financial situation due to inflation or changes in market conditions.

Tobin's Q Ratio: Tobin's Q, developed by James Tobin, calculates market valuation by comparing the market value of a firm's assets plus the book value of liabilities to the replacement cost of assets. When Tobin's Q is less than one, it suggests

that the firm may be undervalued and potentially attractive for acquisition, as the market price of assets is below replacement cost. Conversely, a Q ratio greater than one signals favorable growth opportunities, indicating that market confidence in the company is high. Tobin's Q is calculated as:

$$\text{Tobin's } Q = \frac{(\text{Market Value of Assets} + \text{Book Value of Total Liabilities})}{\text{Replacement Cost of Assets}}$$

This method is particularly valuable as it considers both current market valuations and potential future earnings, providing insight into a firm's future growth potential.

These valuation methods offer diverse perspectives on market valuation, allowing for a comprehensive analysis that incorporates both tangible assets and broader market perceptions. Whether using basic financial statements or complex indices, each approach contributes unique insights into the market value of a company, enabling investors and financial analysts to make more informed decisions. By applying these methods, stakeholders gain a better understanding of the company's true worth, balancing immediate financial realities with potential future growth.

1.5. Financial Statements and the Role of Reporting Quality in Market Valuation

The purpose of financial reporting lies at the foundation of the conceptual framework, aiming to provide accurate and useful information for investors, creditors, and other stakeholders to make informed financial decisions. Effective financial reporting aligns with qualitative standards that support comparability, consistency, and reliability across various reporting periods and organizational contexts. This section elaborates on financial reporting's impact on valuation by examining the objectives, essential elements, comparability, and the role of international standards in enhancing transparency and reliability.

Objectives of Financial Reporting and Market Valuation

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) articulate that the core objective of financial reporting is to provide information that benefits stakeholders in making economic

decisions, such as investments, credit assessments, and regulatory oversight (FASB, 2010). Financial reporting thus directly informs market valuation by helping stakeholders assess a firm's financial health, profitability, and growth potential, which in turn influences stock prices and investor confidence. For example, high-quality, consistent reporting allows users to evaluate the organization's success in achieving financial goals, such as profitability or cash flow stability, which are pivotal indicators in determining a firm's market value.

Furthermore, financial reporting's primary objectives—accurate depiction of economic resources, obligations, and changes therein—enable investors to project future cash flows and assess liquidity and solvency. This transparency improves investors' ability to evaluate company performance relative to peers, facilitating decisions that align with both current value and potential for future growth. Consequently, financial statements offer a basis for calculating important metrics such as the Price-to-Earnings ratio (P/E) and Earnings Per Share (EPS), which directly inform stock valuation.

Key Financial Statement Components and Their Role in Market Valuation

Each financial statement plays a distinct role in shaping market valuation by providing specific financial insights:

Income Statement: Summarizes revenue and expenses over a period, reflecting profitability and operational performance. Consistent revenue growth in income statements signals strong business health and often leads to positive adjustments in market valuation.

Statement of Financial Position (Balance Sheet): Reports assets, liabilities, and equity at a specific date, presenting a snapshot of financial stability. Investors use balance sheets to evaluate solvency and leverage, both of which significantly impact valuation.

Statement of Cash Flows: Shows cash inflows and outflows, categorizing them into operational, investing, and financing activities. Cash flow statements provide insights into liquidity and the firm's capacity to sustain operations, invest in growth, and service debts—all essential for accurate valuation.

Statement of Retained Earnings: Tracks changes in retained earnings, connecting the firm's net income to shareholder equity. Consistent retained earnings growth suggests stability and potential for future dividends, appealing to long-term investors.

Comparability in Financial Reporting and Its Impact on Valuation

Comparability enables stakeholders to identify economic similarities and differences across reporting periods and among peer organizations. The IASB and IFRS emphasize comparability as an essential characteristic, arguing that it allows investors to make relative valuations, assess performance within an industry, and determine a company's position within competitive markets. However, comparability faces challenges in practice, particularly when companies operate under varying national regulations or accounting standards, making it essential to adopt standardized frameworks like IFRS.

Empirical evidence shows that IFRS adoption positively impacts comparability and market valuations by reducing discrepancies in financial reporting across international markets (Choi et al., 2013). Enhanced comparability allows investors to make more precise judgments on company performance, leading to more accurate and often higher valuations.

Role of IASB and IFRS in Standardizing Financial Reporting for Global Valuation

The IASB and IFRS frameworks aim to ensure that financial information is comparable, relevant, and faithfully represented across global markets, directly supporting transparent valuation processes. By implementing a cohesive framework for financial reporting, these standards reduce ambiguity and promote investor trust in financial data. For multinational corporations, harmonized standards mean that investors can confidently assess companies from different jurisdictions, which strengthens cross-border investment flows and, by extension, market valuations.

In essence, the adoption of IFRS standards aligns reporting with the expectations of global capital markets, enhancing the quality and comparability of financial statements. This transparency encourages foreign investment by reducing risk premiums associated with uncertain or opaque financial information.

Analytical Approaches and the Quality of Financial Statements

The quality of financial statements plays a significant role in investor perception and, ultimately, market valuation. High-quality reporting is typified by reliability, timeliness, and consistency with GAAP or IFRS standards. Financial analysts use these qualities to interpret earnings, calculate risk-adjusted returns, and determine appropriate valuation multiples for different companies. For example, companies with consistently high-quality earnings reports often achieve premium valuations because they provide a clearer, less volatile picture of financial health.

In addition, metrics like Earnings Quality (EQ) and Discretionary Accruals (DA) serve as proxies for understanding the reliability of reported earnings. Companies with high earnings quality are less likely to rely on accounting maneuvers to inflate results, and such companies tend to enjoy higher valuations due to the perceived lower risk of financial misrepresentation.

Methods of Market Valuation: From Financial Statements to Investor Decisions

Valuation models such as Tobin's Q ratio, Market-to-Book ratio, and the Discounted Cash Flow (DCF) method are commonly used to evaluate market value by relying on financial statement data. Tobin's Q, for instance, measures the market value of assets relative to their replacement costs, indicating whether a firm's stock is overvalued or undervalued. Similarly, the DCF method uses future cash flow projections derived from financial statements to estimate intrinsic value, guiding investors in making buy or sell decisions.

2. CHAPTER TWO: THEORETICAL FRAMEWORK

This chapter lays the theoretical groundwork necessary to understand the complex dynamics underpinning the study's primary constructs: accounting conservatism, firm performance, market valuation, and earnings quality. Each of these constructs is explored through relevant theoretical lenses, which provide insight into their roles and interconnections within corporate finance and strategic management. The chapter begins by examining theories related to accounting conservatism, specifically Contracting Theory and Agency Theory, which offer perspectives on the mechanisms that promote conservative financial practices to mitigate risk and align stakeholder interests. Following this, theories on firm performance—namely the Resource-Based View (RBV) and Stakeholder Theory—highlight the internal resources and stakeholder relationships that drive a firm's competitive advantage and financial success. Next, the discussion turns to theories on market valuation, featuring the Efficient Market Hypothesis (EMH) and Behavioral Finance, to capture both rational and behavioral influences on market dynamics. Finally, theories relevant to earnings quality, including Information Asymmetry Theory and Signaling Theory, are reviewed to understand how information flows affect perceptions of financial performance. This theoretical framework sets the stage for the subsequent literature review, which synthesizes empirical findings on the relationships between these constructs, guiding the hypotheses and analytical approaches in this study.

2.1. Theories Related with Accounting Conservatism

Theories related to accounting conservatism provide a foundation for understanding the motivations and implications behind conservative accounting practices, which prioritize caution in financial reporting to mitigate potential risks and uncertainties. At the forefront are the Contracting Theory and Agency Theory, both of which highlight the necessity of conservatism as a tool to address issues of information asymmetry, conflicting interests, and contractual obligations. Contracting Theory emphasizes conservatism's role in aligning the interests of creditors and shareholders, ensuring that potential liabilities are acknowledged promptly, thus safeguarding stakeholder interests. Meanwhile, Agency Theory addresses conservatism as a mechanism to limit managerial discretion, thereby reducing the risks associated with

opportunistic financial reporting. Together, these theories underscore the protective and regulatory role of accounting conservatism, contributing to enhanced financial stability and greater investor confidence in the firm's reporting practices.

2.1.1. Contracting Theory

Contracting Theory serves as a fundamental rationale for the application of accounting conservatism, emphasizing its role in mitigating the accounting risks that arise due to information asymmetry between company management and external stakeholders. In practical terms, conservatism becomes a valuable tool in enhancing the efficiency of management and debt contracts. For instance, in management incentive and bonus contracts, which often tie managerial rewards to accounting measures like net income, conservatism prevents management from manipulating reported earnings solely to increase their personal benefits. Without conservatism, managers might employ aggressive accounting practices to recognize future income prematurely or defer losses to inflate current-period net earnings, consequently increasing their reward payout. This behavior, if unchecked, can mislead stakeholders about the company's true financial health and value (Kassab, 2011).

Moreover, conservatism plays a crucial role in debt contracts, where lenders rely on conservative accounting practices to ensure that assets are not overvalued and liabilities are accurately reported. By requiring stricter verification of gains compared to losses, conservatism limits management's ability to present an overly optimistic financial position, thus safeguarding creditors from unforeseen financial distress that could arise if the company fails to meet its obligations. When companies pursue additional financing, the conservatism principle further ensures that the book value reflects a realistic rather than inflated asset valuation, allowing for fairer and more accurate equity or debt issuance.

Watts (2003) argues that by prioritizing loss recognition over gain recognition, conservatism helps curb opportunistic managerial behavior, particularly in contexts where managers may prioritize short-term personal gain over long-term organizational value. This asymmetrical approach creates a "buffer" in net assets, effectively reducing the likelihood of overstated earnings or assets and establishing a higher standard for recognizing uncertain gains. Thus, conservatism acts as a corrective force, promoting

the quality and reliability of financial reporting and fostering a stronger alignment between reported figures and economic reality.

In this context, Contracting Theory positions accounting conservatism as a strategic, protective measure that reinforces the trustworthiness of financial statements, thereby enhancing stakeholder confidence. It ensures that management's actions remain consistent with contractual obligations and minimizes potential conflicts arising from differing interests and information disparities among stakeholders. Through these mechanisms, conservatism emerges as a critical means of preserving the integrity of financial reporting and supporting efficient corporate governance, reflecting its longstanding justification in the field of accounting (Hamalainen, 2012; Watts, 2003).

2.1.2. Agency Theory

Agency Theory provides a critical framework for understanding accounting conservatism by explaining how conflicts of interest between owners (principals) and managers (agents) influence corporate disclosure practices. In situations where ownership and management are separated, as is common in most modern corporations, managers are often incentivized to pursue their interests, sometimes at the expense of shareholders. This divergence in objectives gives rise to agency costs, where the company incurs expenses to align managerial actions with shareholder interests.

In practical terms, Agency Theory suggests that managers might manipulate the complexity or clarity of financial disclosures to reflect a more favorable image during profitable periods while obfuscating poor performance by complicating financial reports. Hassan et al. (2019) emphasize this behavior, noting that managers may hide adverse information or make annual reports difficult to interpret when the company performs poorly. This selective disclosure helps management maintain their reputation and financial rewards while potentially misinforming stakeholders.

Agency Theory also sheds light on the ways accounting conservatism can mitigate these issues. By requiring stricter standards for recognizing gains over losses, conservatism serves as a check on managers' ability to overstate the company's financial health, thus protecting shareholders from inflated earnings or asset values. This conservative approach in financial reporting, by focusing on verifiable information,

reduces the risk of managerial opportunism and enhances the credibility of financial statements.

Jensen and Meckling (1976) describe the agency relationship as a contractual bond, wherein principals delegate certain decision-making authorities to agents in exchange for fiduciary responsibility. However, given their information advantage, agents may act opportunistically prioritizing their personal gain, which could involve withholding relevant information or spending excessively on non-value-adding activities. This self-serving behavior is further fueled by managers' ability to control certain reporting elements, like income smoothing or delayed loss recognition, to maintain favorable financial appearances.

In response, agency theory suggests a dual approach: explicit contracts, such as those with boards of directors, and implicit contracts, as seen with external auditors and tax authorities, to help monitor managerial conduct. Moreover, the theory is based on rational behavior, assuming that each party seeks to maximize personal gain. Consequently, principals often design incentives and enforce controls to encourage managers to focus on enhancing shareholder value.

Ultimately, Agency Theory positions accounting conservatism as a strategic tool to counterbalance the potential conflicts of interest inherent in the principal-agent relationship. By fostering reliable and prudent financial reporting, conservatism helps ensure that managerial actions remain aligned with shareholder objectives, reinforcing the integrity of financial disclosures and bolstering stakeholder confidence in corporate governance.

2.2. Theories Related with Financial Performance

Theories regarding financial performance offer valuable frameworks for understanding how companies can build and sustain competitive advantage. Two prominent theories that relate directly to financial performance are the Resource-Based View (RBV) and Stakeholder Theory. The RBV centers on the strategic utilization of a firm's internal resources—such as capabilities, assets, and organizational competencies—as critical drivers for achieving superior performance and sustainable competitive advantage. This theory emphasizes that performance is fundamentally

rooted in unique, valuable resources that are difficult for competitors to imitate. Stakeholder Theory, in contrast, emphasizes the firm's relationship with its various stakeholders, including shareholders, employees, customers, and suppliers. This perspective suggests that aligning the interests and expectations of these groups plays an essential role in fostering company growth, long-term performance, and corporate reputation. Together, these theories underscore both the internal resources and external relationships that influence a company's overall success and ability to thrive in a competitive environment.

2.2.1. Resource-Based View (RBV)

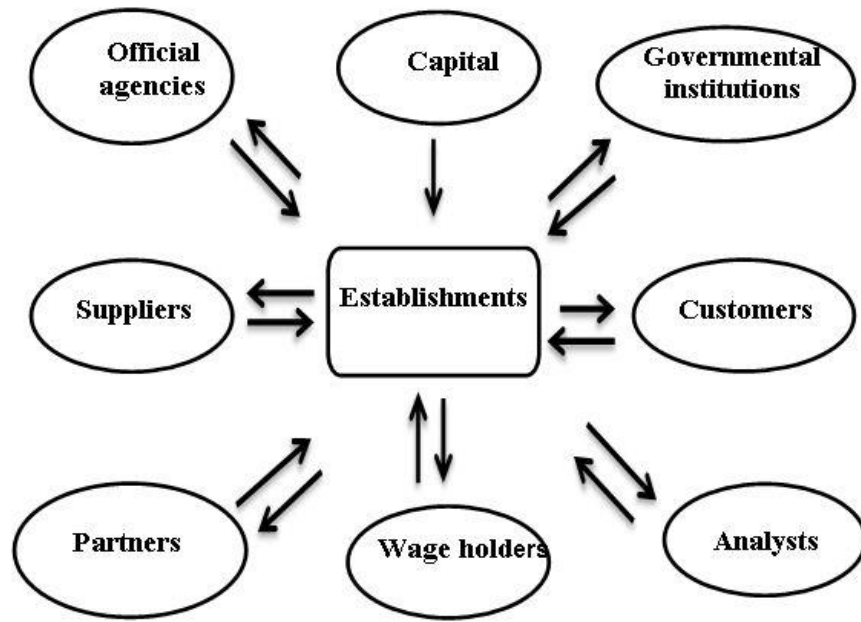
The Resource-Based View (RBV) contends that a firm's performance is inherently tied to its unique resources and capabilities, which, if valuable, rare, inimitable, and non-substitutable, provide sustained competitive advantage (Yusoff & Alhaji, 2012). RBV argues that a firm's internal resources—whether they include physical assets, specialized knowledge, or organizational processes—serve as primary drivers of success. Unlike theories that focus on external environmental factors, RBV emphasizes that the critical determinants of competitive advantage lie within the organization itself. This approach is complemented by resource dependence theory, which highlights the necessity for organizations to establish stable transactions with their environments to secure the resources needed for survival (Htay & Salman, 2013). To this end, managers must strategically link their firm with external factors, often engaging in resource exchanges that support organizational stability and flexibility. Additionally, transaction cost theory provides further context by examining the operational costs associated with acquiring and managing external resources, such as information and contractual costs, which impact a firm's internal and external transactions (Umm Khalifa, 2006). Together, these perspectives underline the importance of both internal resources and carefully managed external linkages in shaping firm performance and fostering resilience.

2.2.2. Stakeholder Theory

Stakeholder theory, as found in much of contemporary accounting literature, highlights the company's responsibility to all parties involved with or affected by its actions—not just shareholders. This perspective originated nearly a century ago from concerns that stakeholders other than shareholders, such as employees, suppliers, and local communities, also have rights that should be safeguarded. The theory asserts that while shareholders, as owners, have traditionally held priority in corporate governance, they are not the only parties with legitimate claims on the company's resources. The theory of stakeholders introduces a more comprehensive framework where managers and boards of directors are responsible for balancing the diverse interests of all groups impacted by the company's activities (Vasudev, 2012).

Agency theory initially concentrated on the shareholder-manager relationship, contending that conflicts arise when managers prioritize personal gain over shareholder interests. Stakeholder theory, however, expands on this by recognizing that conflicts and competing interests extend beyond this singular relationship. In this view, organizations are not only accountable to shareholders but also to a broader community of stakeholders with interests in the company's long-term success and ethical standards. Shiboub (2016) refers to this broadened accountability as “the theory of extended agency,” underscoring the necessity for managers to address various stakeholder needs to achieve balanced and sustainable corporate governance. This inclusive perspective advocates for respecting the rights and expectations of all stakeholders, viewing these relationships as essential to the company's survival and growth.

Furthermore, stakeholder theory recognizes that these diverse interests are often in conflict, which can make decision-making complex. For example, consumers may demand high-quality, affordable products, while employees seek better wages and benefits. Investors prioritize risk management and high returns, while communities might expect companies to engage in socially responsible actions, such as charitable contributions and environmentally sustainable practices (Jensen, 2001). The practical challenge here is navigating these conflicting demands in a way that upholds the company's ethical responsibilities without compromising financial objectives.



*Source: Prepared by the researcher

Figure 2: Stakeholder Theory

Another challenge presented by stakeholder theory is its inherent potential for increased agency costs. As it imposes multiple goals, beyond the maximization of shareholder wealth, it can lead managers to exercise discretion over company resources in ways that may not align with shareholder priorities. In some cases, this may result in the allocation of resources to satisfy a broader range of stakeholders at the cost of shareholder value, which may drive up agency costs (Baraq & Ben Zaway, 2012). However, proponents argue that in prioritizing stakeholder relationships, companies ultimately promote sustainable growth and social welfare, making a strong case for stakeholder theory as a guiding framework for responsible corporate governance.

2.3. Theories Related with Market Valuation

Theories related to market valuation offer foundational perspectives for understanding how financial markets assess the value of companies. Two dominant theories in this area are the Efficient Market Hypothesis (EMH) and Behavioral Finance. These theories provide contrasting views on how information is processed and reflected in market prices. The Efficient Market Hypothesis posits that financial markets are efficient, meaning that all available information is quickly and accurately incorporated

into stock prices, leaving no room for investors to achieve consistent above-market returns through analysis or market timing. In contrast, Behavioral Finance challenges this notion, suggesting that psychological and cognitive biases influence investor decisions, leading to market inefficiencies that can distort valuations. Together, these theories provide complementary insights into the dynamics of market valuation, helping to explain both rational and irrational elements that drive asset prices.

2.3.1. Efficient Market Hypothesis

The Efficient Market Hypothesis (EMH) suggests that asset prices in financial markets fully reflect all available information, meaning that it is impossible for investors to consistently achieve returns that outperform the market average through analysis or market timing alone. This theory, formulated in the mid-20th century and rigorously developed by economist Eugene Fama in the 1970s, posits that because all relevant information is immediately and uniformly incorporated into asset prices, any advantages one might obtain through new information are momentary and quickly offset by the market's adjustments.

EMH assumes rational behavior among market participants, who actively compete, analyze, and respond to information. This continuous interaction ensures that prices are not systematically over- or under-valued; instead, they align closely with the intrinsic value of assets. The theory is often summarized with three forms of market efficiency: weak, semi-strong, and strong. Each form corresponds to different levels of information integration, ranging from historical prices alone (weak form) to all public (semi-strong) and even private information (strong form). In a perfectly efficient market, investment strategies based on publicly available data, including technical and fundamental analysis, cannot yield above-average returns after adjusting for risk.

While EMH has been a cornerstone of financial theory, it is not without criticism. Critics argue that markets are influenced by irrational investor behavior, which can lead to mispricing and opportunities for abnormal returns—concepts that are core to Behavioral Finance. Nonetheless, EMH remains foundational in understanding how information dissemination and market competition contribute to pricing mechanisms in financial markets.

2.3.2. Behavioral Finance

Behavioral Finance presents an alternative view to the Efficient Market Hypothesis by asserting that financial markets are not always perfectly rational; instead, they are influenced by the psychology and social behavior of market participants. This perspective suggests that social pressures and cognitive biases significantly shape corporate behavior, including their approach to financial reporting. According to Behavioral Finance theorists, managers often act in response to social expectations, pressures, and perceived norms to align corporate activities with socially accepted behaviors. This drive for social alignment can influence companies to disclose non-financial information within their reports, aiming to illustrate their commitment to social responsibilities and responsiveness to societal demands.

Additionally, Behavioral Finance theorists argue that managers may engage in strategic impression management, complicating financial reports to create a favorable perception among users. In cases where managers seek to manage or mitigate negative perceptions, reports may be made intentionally complex or difficult to interpret, thereby obscuring certain performance indicators. This strategic complexity can serve to influence stakeholders' interpretations, presenting the company in a favorable light even if it may occasionally conflict with strict transparency norms or principles.

Overall, Behavioral Finance recognizes that market dynamics are affected by behavioral biases and social influences, introducing a nuanced understanding of how human psychology impacts corporate disclosures, investor reactions, and market outcomes.

2.4. Theories Related with Earnings Quality

The theories related to earnings quality primarily encompass two influential perspectives: Information Asymmetry Theory and Signaling Theory. Information Asymmetry Theory focuses on the uneven distribution of information between a company's management and its external stakeholders. This disparity can impact the quality and reliability of reported earnings, as managers may possess insights into the firm's actual financial position and future outlook that are not readily available to

investors. Such informational imbalances can lead to adverse selection and moral hazard, affecting stakeholders' ability to make fully informed decisions.

Complementing this view, Signaling Theory posits that managers, aware of the information asymmetry, may utilize financial reports to convey signals to the market about the company's true condition. By carefully crafting earnings disclosures, management can indirectly communicate confidence in the firm's performance or growth prospects, thereby enhancing stakeholders' perceptions of earnings quality. Through these theories, scholars and practitioners better understand the motivations behind earnings disclosures and the potential implications for investor trust and market efficiency.

2.4.1. Information Asymmetry Theory

Information Asymmetry Theory is foundational in understanding how disparities in information between a company's management and its external stakeholders impact earnings quality. According to this theory, management may deliberately withhold or selectively disclose critical information, using privileged access to insights for financial gain. Such actions allow management, often in coordination with large investors, to potentially generate extraordinary returns based on specific insider information. Bhattacharya et al. (2013) highlight that this behavior places large investors at an advantage over smaller investors, who lack similar access to the company's internal data.

Information asymmetry occurs when there is an imbalance in the quality, quantity, and accessibility of information available to different parties within the financial markets (Chang et al., 2006). This imbalance is particularly evident with companies trading on public exchanges, where management generally holds far greater internal knowledge than what is accessible to outside investors. Even when the same information is publicly available, the ability to interpret and act on this information varies widely between insiders and external parties. Moreover, management can use this disparity to shape market perceptions strategically, at times obscuring or delaying the release of negative information to avoid market repercussions, leading to a significant distortion in stock valuations.

The asymmetry in information extends beyond selective disclosure, as company executives are often positioned to exploit this gap for personal or organizational advantage, potentially resulting in inefficiencies in market pricing. Healy and Palepu (2001) discuss how such practices can result in adverse selection, where uninformed investors end up purchasing overpriced shares while informed insiders divest underperforming stocks, leading to a resource misallocation across economic sectors. Over time, this asymmetry in information erodes market efficiency, distorts earnings quality, and ultimately affects investor confidence and resource allocation.

Thus, Information Asymmetry Theory underscores the ethical and economic implications of selective information disclosure, spotlighting the need for regulatory oversight to protect against the misuse of privileged information.

2.4.2. Signaling Theory

Signaling Theory in accounting literature emphasizes the role of disclosure in reducing information asymmetry, particularly regarding earnings quality and transparency. This theory posits that managers of well-performing companies are incentivized to signal their strong performance by providing financial disclosures that are clear, direct, and easy to interpret. Conversely, companies with weaker financial performance may choose to obscure unfavorable information through complex, jargon-heavy reporting. In this way, signaling theory suggests that companies' performance is not solely conveyed through the quantity of information disclosed but also through the clarity and accessibility of these disclosures.

According to Hassan et al. (2019), managers of underperforming companies may deliberately complicate financial reports to minimize the visibility of poor results, thus attempting to mitigate the impact of these results on market perceptions and stock prices. This strategy, although ethically questionable, is intended to shield management from potential investor backlash by reducing the transparency of adverse financial data. Signaling Theory, therefore, underscores that effective disclosures—those that are both complete and easily understandable—serve as a positive signal to the market, differentiating robust companies from those that may be struggling. Consequently, the theory supports the importance of not only comprehensive but also straightforward and transparent reporting, which allows investors to make better-informed decisions.

2.5. Developing Hypotheses Through Theoretical Frameworks

The theories outlined in this chapter—spanning accounting conservatism, firm performance, market valuation, and earnings quality—offer essential perspectives for formulating and supporting the hypotheses of this study. Each theoretical framework provides unique insights that justify the hypothesized relationships among these constructs, thereby strengthening the analytical foundation of the research.

Contracting Theory and Agency Theory, as they relate to accounting conservatism, underscore the importance of conservative accounting practices in addressing agency problems and aligning the interests of stakeholders. Contracting Theory suggests that conservatism limits the inflation of net assets and earnings, thus safeguarding stakeholders from opportunistic behavior by management. This aligns with the hypothesis that conservative financial practices have a protective effect on firm performance, reducing the risk of asset overvaluation and ensuring more stable earnings quality. Agency Theory, with its focus on the principal-agent relationship, further supports this hypothesis by positing that conservatism acts as a regulatory mechanism, mitigating conflicts of interest that might otherwise compromise earnings quality.

Regarding firm performance, the Resource-Based View (RBV) and Stakeholder Theory provide complementary frameworks for understanding the drivers of competitive advantage and value creation. RBV suggests that internal resources are critical to sustaining high firm performance, which informs hypotheses related to the influence of strategic resource utilization on financial outcomes. Stakeholder Theory, in turn, emphasizes that aligning company actions with stakeholder expectations fosters reputational capital and long-term success. These perspectives lend theoretical support to hypotheses linking strong resource management and stakeholder relations to higher firm valuation and consistent financial performance.

Theories relevant to market valuation, including the Efficient Market Hypothesis (EMH) and Behavioral Finance, provide contrasting views on how information and behavioral factors affect asset pricing. EMH asserts that market prices fully reflect available information, suggesting that companies practicing transparent reporting and accurate valuation methods will enjoy stable stock prices, an assumption that aligns with hypotheses on the role of transparent financial practices in market stability. Behavioral

Finance, on the other hand, recognizes the impact of cognitive biases and social factors on valuation, supporting hypotheses that suggest strategic reporting behaviors may influence investor perceptions and market responses.

Finally, Information Asymmetry and Signaling Theories frame hypotheses around earnings quality and transparency. Information Asymmetry Theory explains the challenges stakeholders face in accessing accurate financial data, which may impact their trust and investment decisions. In alignment with the hypothesis that high-quality earnings reporting enhances market confidence, Signaling Theory proposes that companies with strong financial performance will seek to communicate this through clear, accessible reports, signaling robustness to the market. Conversely, companies with weaker performance may obscure financial reports, thereby affecting perceptions of earnings quality and firm stability.

In summary, the theories presented in this chapter provide the conceptual basis for hypothesizing relationships among accounting conservatism, firm performance, market valuation, and earnings quality. By integrating insights from these frameworks, the study constructs a comprehensive theoretical foundation to examine the dynamics of these key constructs within corporate finance and strategic management.

2.6. Literature Review

The literature review provides a foundation for understanding the complex interplay between accounting conservatism, earnings quality, financial performance, and market valuation. By examining prior research on these interrelated constructs, this section seeks to contextualize the current study within the broader body of scholarly work and highlight key insights and empirical findings that inform the study's hypotheses. Specifically, this review synthesizes evidence on how accounting conservatism impacts financial performance and market valuation, explores its relationship with earnings quality, and assesses how earnings quality subsequently influences firm performance and market valuation. Drawing from both regional and international studies, the review will also underscore methodological approaches and theoretical perspectives that previous scholars have employed, thus offering a basis for the analytical frameworks and hypotheses formulated in this study. Through this comprehensive review, the current study seeks to bridge gaps in the literature and

advance understanding of the mechanisms that drive transparency, reliability, and value in financial reporting.

2.6.1. Relationship Between Accounting Conservatism and Financial Performance / Market Valuation

The Several studies have explored the relationship between accounting conservatism and financial performance or market valuation across various contexts.

Hamden (2011) investigated the level of accounting conservatism among Jordanian joint-stock companies and its effect on improving the quality of financial reports, which indirectly impacts financial performance and market valuation. By examining data from 50 Jordanian industrial companies over the period from 2001 to 2006, the study utilized Pooled Data Regression and logistic regression to analyze this relationship. The findings revealed a decrease in conservatism levels within Jordanian companies' financial reports. However, the study also established a significant positive correlation between conservatism and improved report quality, particularly as viewed by external auditors, suggesting conservatism's role in enhancing transparency and reliability in financial reporting.

Al-Sahly (2009) focused on accounting conservatism in Saudi Arabia, a market with unique regulatory conditions. The study sought to measure the degree of conservatism among Saudi joint stock companies and its fluctuations post-establishment of the Saudi Capital Market Authority. Using regression analysis, Al-Sahly discovered that conservatism was generally low in Saudi companies, with larger companies exhibiting even lower conservatism levels compared to smaller entities. Post-regulatory reforms, conservatism practices saw a slight increase, reflecting regulatory influence on financial transparency. The study advocated for greater conservatism to improve financial disclosures, enhancing investor confidence and, consequently, market valuation.

Abu Al-Khair (2008) examined conservatism practices in Egyptian publicly traded companies, employing both analytical and field research methods to evaluate conservatism's effects on market valuation. Testing four hypotheses related to conservatism and market responsiveness, the study found that conservatism's impact on

investor perception varied significantly with market maturity. Specifically, a high response to negative news suggested that conservatism serves as a stabilizing factor, curbing market overreactions to adverse information. This study indicated that higher conservatism in accounting practices helps balance the market's responses to both positive and negative information, thus stabilizing share value over time.

Novalia and Nindito (2016) analyzed the effects of accounting conservatism on equity assessment among industrial firms on the Indonesian Stock Exchange. Collecting data from 18 companies over three years, the researchers employed multiple linear regression to assess conservatism's influence. Using the Basu and MTB models, the study concluded that accounting conservatism had a mixed impact on equity valuation. While conservatism alone did not always correlate positively with firm valuation, it was found to complement economic value added (EVA) when assessing corporate worth. Thus, the research underscores conservatism's nuanced impact on investor equity evaluations.

Abu Hamida (2017) evaluated accounting conservatism's impact on economic value added among joint-stock companies on the Palestine Stock Exchange. Utilizing a descriptive-analytical approach, the study spanned from 2010 to 2015 across 24 companies. Through the accruals model, Abu Hamida found a significant positive relationship between conservatism and economic value added, indicating that conservatism contributes positively to a company's valuation in the market. The findings imply that conservatism enhances the perceived stability of Palestinian companies, leading to greater market confidence and potentially improving stock performance.

Sarawi (2019) investigated conservatism's influence on return on assets (ROA) and economic value added (EVA) among industrial companies listed on the Amman Financial Market. The study, which analyzed data from 47 firms between 2010 and 2017, used multiple regression models to assess conservatism's financial impact. Sarawi discovered that accounting conservatism positively influenced ROA while having an inconclusive effect on EVA. These findings indicate that while conservatism bolsters asset returns, its effect on broader valuation metrics may vary based on company-specific factors such as debt ratio and size.

Abu Hadeeb (2018) focused on conservatism's influence on profitability margins and asset turnover in Jordanian industrial companies. Employing descriptive statistics

and the Wilcoxon signed ranks test, the study found that conservatism positively correlated with profitability in high-margin firms but showed no significant effect on asset turnover. The results highlighted conservatism's role in stabilizing earnings and maintaining investor confidence. However, the absence of a significant impact on asset turnover suggests that conservatism's effects are more pronounced on profitability rather than operational efficiency, pointing to its limited role in influencing short-term asset performance.

2.6.2. Relationship Between Accounting Conservatism and Earnings Quality

The relationship between accounting conservatism and earnings quality has been the focus of extensive research, with numerous studies exploring how conservatism influences the quality and reliability of reported earnings.

Ahmed (2011) examined the correlation between accounting conservatism and earnings quality within Bahraini joint-stock companies. This study, spanning from 2006 to 2008, analyzed 10 firms listed on the Bahrain Stock Exchange, employing a multiple regression model to evaluate how conservatism impacts profit quality. Findings revealed a significant positive relationship between conservatism and earnings quality; a higher degree of conservatism reduced total accruals, thus enhancing profit quality. Additionally, the study noted that conservatism improved financial statement credibility, contributing to more informed investment decisions and a better understanding of profit quality among stakeholders.

Hartam & Kresnawati (2021) investigated the role of accounting conservatism in earnings management within Indonesian companies, with a particular focus on how this relationship is moderated by the unit's life cycle. Conducted over the period 2016–2019, the study found that certain companies lean towards conditional conservatism—a type that responds more dynamically to fluctuations in economic circumstances. Although further regression testing was suggested, the study highlights that a firm's life cycle stage can moderate the influence of conservatism on earnings management practices, implying a nuanced role for conservatism depending on organizational maturity and operational consistency.

Ahmed (2011), in another analysis, extended the examination of accounting conservatism's effect on earnings quality among 18 Bahraini companies over the period 2006–2008. Using the book-to-market ratio and the Richardson & Salton model, this study found a consistent positive relationship, reinforcing that higher conservatism decreases total accruals, thereby improving the quality of earnings. This work adds to the understanding that conservatism contributes positively to accurate, stable profit reporting and supports improved quality of earnings over time.

Mashoka (2015) aimed to measure the prevalence and impact of accounting conservatism in firms listed on the Amman Financial Market from 2001 to 2010, spanning the industrial, financial, and services sectors. Using Basu's (1997) model, this study observed that industrial sector companies tended to adopt more conservative accounting practices than other sectors. Additionally, firms displayed heightened conservatism pre-financial crisis, likely as a risk mitigation strategy. These findings underscore the relationship between conservatism, earnings quality, and external economic factors, recommending future research to address how conservatism supports earnings quality and mitigates earnings management.

Diche et al. (2012) focused on earnings quality through a survey of 165 financial managers in public joint-stock companies, supplemented by in-depth interviews. Findings indicated that high-quality earnings tend to be continuous, rely on appropriate disclosures, and avoid extensive long-term estimates. The study further noted that nearly half of the earnings quality could be attributed to factors involving non-discretionary accruals. While approximately 20% of companies actively managed earnings to mask actual performance, the study demonstrated that earnings manipulation is often difficult for external parties to detect, highlighting the role of conservatism in promoting sustainable, high-quality earnings.

Hamdan (2012) analyzed earnings quality in Jordanian industrial public companies listed on the Amman Stock Exchange, examining factors that influence profit quality, including conservatism, company size, debt contracts, return on investment, institutional governance, and audit quality. The study, which covered 50 companies over the period 2000–2004, concluded that high conservatism is associated with superior earnings quality in Jordanian industrial companies. It also found that factors like company size and audit quality directly affect profit quality. Hamdan's study advocates

for enhanced institutional governance and improved models for profit quality assessment, underscoring conservatism's role in elevating earnings quality.

2.6.3. Relationship Between Earnings Quality and Financial Performance / Market Valuation

The relationship between earnings quality and firm performance or market valuation has been explored through various studies, each providing insights into how the quality of reported earnings can impact both the operational success and market valuation of firms.

Hassan & Farouk (2014) examined the connection between firm characteristics and earnings quality within the Nigerian oil and gas industry. Focusing on factors like firm size, financial leverage, institutional ownership, profitability, liquidity, and growth, the study utilized the modified Jones model by Dechow (1995) to assess earnings quality. Results indicated that financial leverage, liquidity, and growth had a positive effect on profit quality, suggesting that these factors contribute to a firm's ability to report reliable earnings.

Akintoye et al. (2019) analyzed the impact of earnings quality on the growth of Nigerian industrial firms over a ten-year period (1996–2006). Utilizing various earnings quality indicators, such as the predictability and accrual quality indexes, the study found that while accrual quality had a negative impact on sales growth, the conservatism index positively influenced growth. This study highlights earnings quality as a critical determinant of firm growth, emphasizing the importance of quality earnings as a driver of sustainable business expansion.

Richardson, Sloan, Soliman, and Tuna (2001) explored how accruals relate to earnings quality, emphasizing the role of accruals in reflecting both current and future financial performance. By analyzing the information provided by non-current accruals, the study found that these accruals offer substantial insight into future stock returns and firm activities. It concluded that information on total accruals (both current and non-current) serves as a comprehensive measure of earnings quality, with implications for future valuation.

Dechow et al. (2010) addressed the diverse measures of earnings quality and the variation in results across different methodologies. The study classified earnings quality indicators into three categories: characteristics of earnings, investor responses to earnings, and external indicators of earnings manipulation. The findings highlighted that earnings quality is context-dependent, shaped by the specific circumstances of each firm and market, further connecting quality to performance indicators.

Shaaban and Dashli (2021) investigated the effect of earnings quality on operational performance among firms listed on the Damascus Stock Exchange. The study focused on indicators such as operating profit, net operating cash flow, and the book value of shares. Findings indicated a significant relationship between high-quality earnings and better operational outcomes, including enhanced cash flow and solvency. The study noted a decrease in accounts receivable with improved earnings quality, signaling effective management of working capital.

Majeed (2015) utilized earnings quality to explain capital structure among firms listed on the Iraq and Amman stock markets. The study analyzed cases of high and low earnings quality as indicators of information symmetry or asymmetry, affecting firms' cost of capital. Earnings quality was measured through eight characteristics, including accrual quality, continuity, stability, and conservatism. Results showed that higher quality earnings correlate with lower costs of capital, emphasizing that firms with high earnings quality send positive signals to the market, promoting self-financing and efficient capital structure management.

Al-Sharif (2017) conducted a comparative analysis of earnings quality among industrial firms listed on the Palestinian and Jordanian stock exchanges. Over an eight-year period, the study found that Jordanian firms had higher earnings quality than their Palestinian counterparts, suggesting that institutional factors might contribute to quality differences. The findings also implied that Jordanian firms offer better dividend prospects, which benefits investors seeking high-quality, consistent returns.

Al-Khalayla (2014) investigated the correlation between profit-based and cash-based performance indicators and stock return variability. Based on a study of firms listed on the Amman Financial Market, the findings revealed a positive correlation, indicating that earnings-based indicators provide superior insights into stock returns

compared to cash-based measures. This relationship underscores the role of high-quality earnings as a reflection of firm value in the market.

Hamdan (2012) examined factors influencing earnings quality among Jordanian industrial firms, including accounting conservatism, company size, debt contracts, and governance. The study concluded that conservatism and audit quality are significant factors for achieving high-quality earnings. Additionally, larger firm size was associated with improved earnings quality, suggesting that robust governance and auditing mechanisms are essential for financial transparency and firm performance.

Al-Daour and Abed (2009) explored the effects of earnings management on stock prices in the Palestine Stock Exchange. The study found that earnings management practices can significantly influence share prices, with companies manipulating financial metrics to attract investors. The findings highlighted the need for regulatory measures to address earnings management and ensure that share prices reflect genuine firm performance.

Ezat (2019) examined the interaction between earnings quality, report readability, and the cost of capital within Egyptian firms. The study concluded that while readability alone had no effect on capital costs, high-quality earnings combined with readable reports reduced capital costs. This suggests that transparent and high-quality earnings reports contribute to investor confidence, reducing the firm's cost of capital.

Ali et al. (2019) focused on the impact of earnings quality on the sustainability of Iraqi tourism firms. Findings indicated a strong relationship between high-quality earnings and business continuity, with quality earnings enhancing investor confidence. The study emphasized the importance of earnings quality for the sustainability and long-term value of firms, particularly within the Iraqi context, where tourism is vital for economic development.

2.6.4. Developing Hypotheses Through Literature Review

The comprehensive review of prior studies provides a strong foundation for developing the hypotheses that will guide this thesis, particularly concerning the Iraqi market context. The studies reviewed shed light on several critical relationships, namely between accounting conservatism, earnings quality, firm performance, and market

valuation. Each of these constructs has been shown to play a central role in enhancing transparency, reducing agency conflicts, and providing stakeholders with a reliable basis for decision-making, which is especially pertinent for emerging markets like Iraq. In the following assessment, we explore how the findings from previous research can substantiate the thesis's hypotheses and offer valuable insights for the Iraqi market.

2.6.4.1. The Relationship Between Accounting Conservatism and Financial Performance / Market Valuation

Prior studies, such as those by Hamden (2011) and AL Sahlly (2009), have demonstrated a significant association between accounting conservatism and improved financial report quality, which, in turn, bolsters firm performance. Specifically, Hamden (2011) identified that higher conservatism leads to more credible financial reporting, thus improving external stakeholders' confidence, which is critical in attracting and retaining investment. Applying these findings to Iraq, where investor confidence has often been hindered by economic instability, accounting conservatism could play a substantial role in supporting market valuation by ensuring that financial reports reliably reflect the company's financial condition and performance.

In contexts like Iraq, where market mechanisms are still developing, applying conservatism can mitigate the impact of potential economic shocks and provide a stable foundation for performance evaluation. This aligns with the findings of Abu Hamida (2017), who observed that accounting conservatism positively impacts economic value added, a performance metric that investors highly regard. The integration of accounting conservatism into Iraqi financial reporting may thus encourage greater investment by presenting a conservative estimate of firm performance, thereby protecting stakeholders from unforeseen financial volatility.

2.6.4.2. The Relationship Between Accounting Conservatism and Earnings Quality

Studies by Ahmed (2011) and Mashoka (2015) highlighted that accounting conservatism is positively correlated with earnings quality, as it promotes more cautious and consistent earnings reporting practices. This relationship is particularly relevant in

emerging markets like Iraq, where earnings manipulation or inconsistencies may deter investor interest and destabilize market perception. The conservatism principle, as demonstrated in these studies, can be crucial in minimizing managerial discretion in earnings reporting, reducing the occurrence of accrual-based earnings management practices. This has a direct bearing on earnings quality, making financial statements more reliable and less prone to manipulation.

Given Iraq's regulatory environment, which is still developing, embracing conservatism could limit the risks associated with informational asymmetry between managers and shareholders. Moreover, as Abu Hadeeb (2018) found in the Amman Stock Exchange context, conservatism is an effective tool to enhance the credibility of financial information. For the Iraqi market, this suggests that by adopting a conservative accounting stance, firms could improve earnings quality, which would enhance the reliability of financial data available to investors, thus supporting a transparent market environment.

2.6.4.3. The Relationship Between Earnings Quality and Financial Performance / Market Valuation

The studies by Hassan & Farouk (2014) and Shaaban & Dashli (2021) have shown that higher earnings quality is associated with improved operational performance and market valuation, primarily by enhancing the reliability of financial data. For example, Shaaban & Dashli (2021) observed that quality earnings directly improve operational efficiency metrics like net operating cash flow and solvency. For Iraq, focusing on earnings quality could facilitate a similar enhancement in operational stability and performance, which is essential for long-term sustainability in a developing market. Moreover, in line with Al-Khalayla (2014), which demonstrated a significant relationship between earnings-based performance indicators and stock returns, Iraqi firms could utilize earnings quality as a signal to investors, thereby boosting market valuation.

Furthermore, Dechow et al. (2010) provided insights into how earnings quality measures can impact investment decisions, particularly by highlighting the importance of aligning reported earnings with investors' performance expectations. For Iraqi firms, where market perceptions might be swayed by geopolitical or economic fluctuations,

achieving high earnings quality can offer investors greater confidence, thereby supporting stock price stability and favorable market valuation.

2.6.4.4. Contextualizing the Findings for the Iraqi Market

In Iraq's emerging market, where accounting standards and regulatory enforcement are less established than in mature markets, the principles of accounting conservatism and earnings quality hold particular relevance. Many of the studies reviewed emphasized the importance of these factors in enhancing firm transparency and reliability. For instance, the studies by Al-Sharif (2017) and Majeed (2015) demonstrate that conservatism and earnings quality can help firms in volatile environments achieve better financial performance and capital structure management, respectively. Such findings are directly applicable to the Iraqi context, where firms face heightened financial uncertainty and market sensitivity.

The findings also highlight that firms in developing markets can leverage conservatism and high earnings quality as signals of reliability, especially important in Iraq's market, which may be viewed by external investors as high-risk. Implementing practices aligned with conservatism and improving earnings quality would thus not only support firm performance but also attract domestic and international investors, as seen in studies like those by Akintoye et al. (2019). Additionally, the emphasis on stakeholder confidence, as observed by AL Sahlly (2009) and Sarawi (2019), can further resonate in the Iraqi market by fostering a more stable financial environment, a key consideration for economic growth and resilience.

2.6.4.5. Conclusion

The reviewed literature collectively supports the development of hypotheses that account for the interconnectedness between accounting conservatism, earnings quality, and firm performance or valuation. For the Iraqi market, these relationships provide a blueprint for enhancing transparency, fostering investor trust, and improving regulatory adherence. By integrating findings from diverse markets and adapting them to Iraq's unique economic landscape, this thesis can propose well-founded hypotheses on how conservatism and earnings quality impact financial performance and market valuation.

Ultimately, adopting these practices could facilitate more robust financial reporting, contributing to the long-term stability and growth of Iraq's financial market.



3. CHAPTER THREE: TESTING RELATIONSHIP BETWEEN ACCOUNTING CONSERVATISM, FIRM PERFORMANCE, AND MARKET VALUATION

This chapter presents the methodology, tools, and approach used in the applied analysis, focusing on industrial companies listed on the Iraqi Stock Exchange. The chapter aims to empirically assess the interrelationships between accounting conservatism, firm performance, and market valuation within the Iraqi business environment, where unique economic and market factors shape corporate financial practices. By drawing upon data from the financial statements of these companies and supplementary information from the Iraqi Stock Exchange's annual bulletins and reports, this chapter provides a structured approach to testing the hypothesized relationships between the key study variables.

To systematically address the research objectives, the chapter is divided into two main sections. The first section outlines the study design, data sources, and variable measurement methods, tailored to capture the nuances of financial reporting and performance metrics within the Iraqi industrial sector. The second section involves detailed statistical analyses, employing regression and other relevant tests to determine the degree of association and causal impact among accounting conservatism, firm performance, and market valuation indicators. This structured approach ensures that the analysis reflects the context-specific characteristics of Iraq's financial market, facilitating a more robust understanding of the role these variables play within the Iraqi corporate landscape.

3.1. Sample of Research

The study targets industrial companies listed on the Iraq Stock Exchange (ISX), reflecting the regulatory and operational environment unique to the Iraqi financial market. Given the ISX's adherence to specific instructions from regulatory authorities, it provides an optimal setting for investigating the study's variables. Thus, the research sample comprises a selection of six industrial companies from the ISX, each with accessible annual financial reports spanning the period from 2017 to 2022. These

companies represent diverse sectors within Iraq's industrial landscape and offer the requisite data to calculate and analyze the study's core variables.

Table 1 outlines the selected industrial companies within the ISX, detailing each company's capital, year of establishment, and respective industry focus.

Table 1: Industrial Companies in the Study Sample

Series	Company Name	Year of establishment
1	Modern Sewing Company	1988
2	National Company for Chemical and Plastic Industries / Mixed Joint Stock Company	1962
3	Modern Chemical Industries Company / Private Joint Stock Company	1946
4	Iraqi Carpets and Furniture Company	1989
5	Al-Kindi Company to Produce Vaccines and Veterinary Medicines / Mixed Joint Stock Company	1990
6	Ready-made clothing production and general trade company / mixed shareholding	1976

*Source: Prepared by the researcher based on the official website of the Iraq Stock Exchange.

This sample provides a representative cross-section of Iraq's industrial sector, facilitating a robust analysis of accounting conservatism, firm performance, and market valuation in the Iraqi market context.

3.2. Research Model and Variables

In this section, the research model and variables are presented to define the analytical framework for testing the hypotheses related to accounting conservatism, firm performance, and market valuation. This framework aims to capture the distinct dynamics of Iraqi industrial companies by focusing on specific variables relevant to the financial reporting and market practices within the Iraq Stock Exchange. The research model is structured to facilitate the investigation of direct and indirect relationships among the variables, ensuring alignment with the study's objectives.

The selection of variables is grounded in both theoretical and empirical literature, with each variable chosen for its relevance to measuring accounting conservatism, firm performance, or market valuation. These variables are further defined and operationalized to reflect the specific financial and market conditions within the Iraqi context, allowing for targeted analysis. By centering on these core elements, this section establishes a coherent methodological foundation for evaluating the study's research model and guiding the empirical tests applied in subsequent sections.

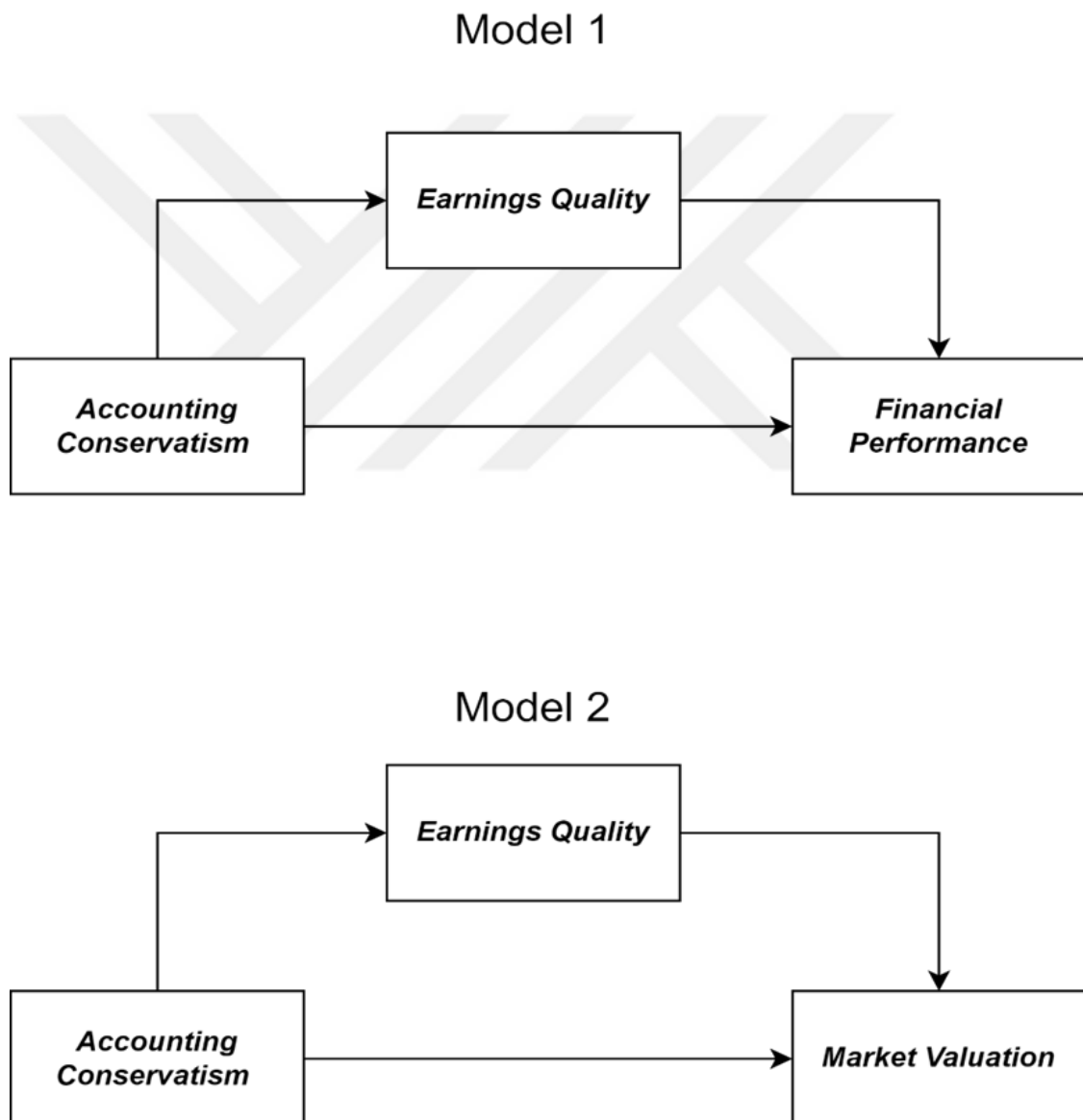


Figure 3: Research Models

The research model for this study, as illustrated in Figure 3, represents a framework that maps the relationships among the independent variable (accounting conservatism), mediating variable (earnings quality), and the dependent variables (firm performance and market valuation). This model supports an in-depth examination of how conservative accounting practices, guided by hypotheses drawn from theoretical and empirical literature, impact financial performance and market valuation, with earnings quality serving as an intermediary.

The independent variable, accounting conservatism, represents practices in financial reporting that err on the side of caution, prioritizing the recognition of losses over gains to minimize over-optimistic reporting. As Wolk et al. (2013) posited, accounting conservatism plays a critical role in mitigating uncertainty and risk by adopting prudent measures, ensuring that financial reports offer a conservative outlook on the company's financial position. In this study, accounting conservatism is assessed through financial indicators such as negative accounting accruals, which provide a quantifiable measure of conservative reporting tendencies.

Earnings quality, the mediating variable, reflects the extent to which reported earnings truly represent the firm's financial performance and are capable of predicting future profitability. The quality of accounting earnings is defined as "the ability of disclosed earnings to predict the future earnings of the unit" (Kieso & Weygandt, 2003). High earnings quality, therefore, suggests stable, predictable earnings that accurately depict a firm's ongoing financial condition. This study employs measures such as income smoothing and accrual ratios to assess earnings quality, consistent with Warrad's (2017) view that high-quality earnings reflect expected events impacting future cash flows and accurately convey the firm's value to stakeholders.

The first dependent variable, firm performance, serves as a broad metric of organizational success and includes financial metrics like return on assets (ROA) and return on equity (ROE). Firm performance has evolved to encompass not only profitability but also factors like risk, growth rates, and value maximization, as emphasized by Lotfi et al. (2015). This strategic view considers a range of elements that influence an organization's long-term success beyond immediate profit maximization, thus aligning with modern financial performance indicators.

Market valuation, the second dependent variable, captures how the firm is valued in the market, often viewed as the aggregate market capitalization of the firm. Definitions of market value vary, with Alexander et al. (2012) describing it as the share price at the fiscal year's end multiplied by the number of outstanding shares. In this study, market valuation is quantified through metrics like Tobin's Q ratio, which compares market value to replacement costs, and the net assets method, providing insight into the firm's position relative to its book value. These measures help contextualize the firm's perceived worth in the broader market and reflect how conservatism and earnings quality may influence valuation.

Data is gathered from the financial reports of industrial companies listed on the Iraq Stock Exchange, utilizing both annual reports and related publications. By examining firms in a specific market environment, this model provides a framework to assess how conservative accounting practices and the quality of reported earnings impact firm performance and market valuation in the Iraqi context. This approach enables a comprehensive analysis that ties together key financial and market-based outcomes, grounded in a context-sensitive methodology aligned with prior research on the subject.

3.3. Descriptive Statistics

To provide a clear and insightful analysis, focusing on ratios and relative metrics—rather than absolute values—can yield a more meaningful perspective on the financial characteristics and performance trends within the sample. By examining ratios, we gain insights into proportional relationships, which tend to offer more stable comparisons, especially when dealing with companies of varying sizes. Here's an analysis of key ratios from the sample:

Table 2: Descriptive Statics

Company	Accrual Ratio	Income Smoothing	Return on Assets (ROA)	Return on Equity (ROE)	Tobin's Q	Market Value
1	0.11613	0.77938	16.94	20.92	2.08	18.93
2	-0.48946	0.19576	4.55	7.21	2.71	5.88

3	-0.11584	0.12322	2.22	2.46	0.87	2.43
4	0.19418	1.22387	16.48	19.62	1.55	18.05
5	0.00884	0.85553	2.94	3.07	1.14	3
6	-0.76277	0.01104	2.82	5.04	3.88	3.93

The accrual ratio values across companies indicate varying levels of accrual-based earnings management. Company 1 has a positive accrual ratio, suggesting a more aggressive approach to recognizing income, while Company 6 shows a substantial negative accrual ratio, potentially pointing to conservative earnings management. This variance in accrual ratios highlights different management strategies, with companies possibly adjusting accruals to influence reported earnings.

The income smoothing ratios show that only two companies, Companies 1 and 4, exhibit values significantly above zero, indicating a tendency toward income smoothing practices, which can reduce the volatility of reported earnings. Such smoothing could signal efforts to meet investor expectations by reducing apparent fluctuations in performance, although this can sometimes obscure underlying operational volatility.

The return on assets (ROA) and return on equity (ROE) ratios provide insights into each company's operational efficiency and profitability. Company 1 exhibits relatively high ROA and ROE values, suggesting strong asset utilization and shareholder return. In contrast, Company 3 has notably lower ROA and ROE figures, indicating less efficient asset use and lower returns to shareholders. The variation in these ratios among companies reflects different levels of operational efficiency and capital structure effectiveness, which could be linked to each company's unique strategic focus and industry positioning.

Tobin's Q ratio, which compares market value to asset replacement cost, reveals considerable variation as well, with Companies 2 and 6 showing the highest Tobin's Q values. These elevated values suggest that the market perceives these companies as having strong growth prospects or intangible assets, potentially reflecting investor confidence. In contrast, Company 3 has a Tobin's Q below 1, which may indicate that

the market values it below its replacement cost, suggesting limited growth potential or underperformance relative to asset value.

The market value ratios also show divergence, with Companies 1 and 4 reporting higher values, which may point to stronger market perceptions of stability or profitability. This suggests that, even within the Iraqi industrial sector, investors assign significantly different valuations to these companies, likely based on perceived earnings quality, growth prospects, and market positioning.

Overall, by focusing on ratios, we gain a clearer picture of each company's strategic approach and financial health without the distortive effect of large absolute values. These ratios provide essential insights into accounting conservatism, earnings management, and market performance, allowing for more reliable comparisons and interpretations of financial strategies and outcomes in Iraq's industrial sector.

3.4. Results and Findings

In this chapter, we present the empirical findings from the statistical analyses conducted to test the study's hypotheses regarding the impact of accounting conservatism on firm performance and market valuation among industrial firms listed on the Iraq Stock Exchange. This analysis includes both direct and indirect effects, examining the mediating role of earnings quality as stipulated in the hypotheses. The results are organized sequentially, starting with a preliminary correlation analysis to explore basic associations between variables, followed by regression models that allow for formal hypothesis testing. By examining both the correlation and regression outcomes, we seek to obtain a comprehensive understanding of the relationships between accounting conservatism, earnings quality, firm performance, and market valuation.

3.4.1. Correlation Analysis Results

The correlation analysis offers an initial exploration of the relationships among the main variables: accounting conservatism, earnings quality, firm performance, and market valuation. Although correlation analysis is limited in establishing causality, it provides an essential foundation for understanding the strength and direction of

associations within the sample. Pearson correlation coefficients and p-values are used to identify statistically significant associations that suggest potential connections in line with the study's hypotheses.

The Correlation Analysis section serves to provide initial insights into the associations between accounting conservatism and the study's dependent and mediating variables, particularly earnings quality, firm performance, and market valuation. While correlation alone does not imply causation, it is useful in identifying the potential strength and direction of relationships, which can later be formally tested through regression analysis.

Table 3: Correlation Between Accounting Conservatism Measures and Earnings Quality Indicators Among Listed Iraqi Companies

Independent variable (Accounting Conservatism)	Mediating variable (Earnings Quality)	Pearson Correlation	P.Value
Total Receivables	Accrual ratio	0.859**	0.000
Operating Accruals	Accrual ratio	0.157	0.361
Negative Accounting Accruals	Accrual ratio	0.778**	0.000
Total Receivables	Income Smoothing	0.397*	0.017
Operating Accruals	Income Smoothing	0.002	0.989
Negative Accounting Accruals	Income Smoothing	0.390*	0.019

*Significant at level ($p < 0.05$), ** Significant at level ($p < 0.01$)

For Hypothesis 1 (H1), which posits a positive association between accounting conservatism and earnings quality among listed firms in Iraq, the correlation analysis indicates statistically significant associations. Specifically, total receivables and negative accounting accruals show significant positive correlations with the earnings quality metrics (accrual ratio and income smoothing). While these findings align with H1, they do not establish causality and must be interpreted cautiously. Total receivables, in particular, exhibit a strong positive correlation with the accrual ratio ($r = 0.859$, $p < 0.01$), suggesting that higher total receivables are associated with improved earnings

quality. This result is further supported by a moderate positive correlation between total receivables and income smoothing ($r = 0.397$, $p < 0.05$), implying that conservative accounting practices regarding receivables are linked to smoother earnings. Similarly, negative accounting accruals show a significant positive correlation with both the accrual ratio ($r = 0.778$, $p < 0.01$) and income smoothing ($r = 0.390$, $p < 0.05$), reinforcing the view that conservative adjustments enhance earnings quality. Conversely, operating accruals display negligible correlations with both earnings quality indicators, which may imply that they do not play a significant role in determining earnings quality within this sample. These results provide initial support for H1, suggesting that elements of accounting conservatism, particularly related to receivables and negative accruals, contribute to higher earnings quality in Iraqi firms.

Turning to Hypothesis 2a (H2a), which suggests a positive association between accounting conservatism and firm performance (measured by Return on Assets and Return on Equity), the correlation analysis does not indicate statistically significant relationships. Total receivables and negative accounting accruals show weak to moderate positive correlations with ROA and ROE, while operating accruals exhibit negative correlations. However, all p-values exceed the 0.05 significance level, suggesting that these associations are statistically insignificant. These findings highlight the need for deeper analysis using SEM to explore potential indirect effects or confounding variables. These findings suggest that, within this sample, accounting conservatism may not have a direct effect on firm performance, as initially hypothesized. This outcome warrants further examination in the regression analysis to determine if any underlying indirect relationships might be revealed.

Table 4: Correlation Between Accounting Conservatism Measures and Firm Performance Among Listed Iraqi Companies

Independent variable (Accounting Conservatism)	Dependent variable (Firm performance)	Pearson Correlation	P.Value
Total Receivables	Return of Assets	0.223	0.198
Operating Accruals	Return of Assets	-0.101	0.563
Negative Accounting Accruals	Return of Assets	0.263	0.126

Total Receivables	Return of Equity	0.210	0.226
Operating Accruals	Return of Equity	-0.152	0.384
Negative Accounting Accruals	Return of Equity	0.272	0.113

*Significant at level ($p < 0.05$), ** Significant at level ($p < 0.01$)

For Hypothesis 2b (H2b), which proposes a positive association between accounting conservatism and market valuation, the correlation analysis reveals mixed results. Notably, total receivables and operating accruals show significant negative correlations with Tobin's Q ($r = -0.368$, $p < 0.05$; $r = -0.353$, $p < 0.05$, respectively). While these correlations suggest that certain conservative practices may be perceived unfavorably by the market, these findings do not confirm or reject H2b and should be further examined through SEM to explore indirect effects via earnings quality or other mediating variables. This result suggests that higher levels of conservatism, as measured by these variables, are associated with lower market values, potentially due to the market's perception of conservatism as overly cautious or restrictive. Negative accounting accruals, however, show a non-significant positive correlation with Tobin's Q ($r = 0.209$, $p > 0.05$), indicating that some conservative practices might be viewed more favorably or neutrally by the market. When considering owner equities as an alternative market valuation metric, no statistically significant correlations are observed for any of the conservatism measures. These findings complicate the interpretation of H2b, as they suggest that the impact of conservatism on market valuation may vary depending on the specific aspect of conservatism in question and how it is perceived in the market context.

Table 5: Correlation Between Accounting Conservatism Measures and Market Valuation Among Listed Iraqi Companies

Independent Variable (Accounting Conservatism)	Dependent Variable (Market Valuation)	Pearson Correlation	P.Value
Total Receivables	Owner Equities	-0.197	0.251
Operating Accruals	Owner Equities	-0.077	0.657

Negative Accounting Accruals	Owner Equities	-0.160	0.350
Total Receivables	Tobin Q	-0.368*	0.027
Operating Accruals	Tobin Q	-0.353*	0.035
Negative Accounting Accruals	Tobin Q	0.209	0.221
*Significant at level ($p < 0.05$), ** Significant at level ($p < 0.01$)			

In summary, the correlation analysis provides initial indications of statistically significant associations in support of H1, particularly for total receivables and negative accounting accruals in relation to earnings quality. However, for H2a and H2b, the results show non-significant correlations for firm performance metrics and mixed findings for market valuation. These findings suggest that while correlations provide useful preliminary insights, further analysis through SEM is required to fully test these hypotheses and account for potential indirect effects. These preliminary results highlight the nuanced nature of conservatism's effects on firm outcomes and underscore the importance of using regression analysis to further investigate these relationships and account for potential mediating effects.

3.4.2. SEM Analysis Results

The Structural Equation Modeling (SEM) analysis offers an integrative approach to test the hypothesized relationships between accounting conservatism, earnings quality, firm performance, and market valuation. Using SEM allows for a simultaneous assessment of both direct and mediated effects, providing a comprehensive understanding of how these variables interact within the Iraqi market context. The analysis examines the direct influence of accounting conservatism on firm performance and market valuation and explores the mediating role of earnings quality, as proposed in Hypotheses 1 through 3b.

The SEM model results provide insights into how accounting conservatism practices impact both earnings quality and performance metrics. Path coefficients and significance values help to identify the strength and direction of each relationship, clarifying both expected and counterintuitive findings. The subsequent sections will

address each hypothesized relationship, presenting the relevant path coefficients and discussing their implications in the context of the Iraqi market.

3.4.2.1. Direct Effects Analysis

In this section, we explore the direct effects of accounting conservatism on key outcome variables, including earnings quality, firm performance, and market valuation. By focusing on the direct pathways within the structural equation model (SEM), we assess whether conservative accounting practices—characterized by cautious recognition of revenues and expenses—are associated with improved earnings quality, enhanced firm performance, and heightened market valuation. The results are evaluated in alignment with Hypotheses 1, 2a, and 2b, providing insights into the extent to which conservative accounting behaviors impact these metrics independently. The table below summarizes the path coefficients and significance levels for each direct relationship, facilitating a comprehensive understanding of these associations.

Table 6: Path Coefficients and Significance Levels for Direct Effects

Pathway	Path Coefficient	P Value	Significance
Accounting Conservatism → Earnings Quality	0.810	0.001	Significant
Accounting Conservatism → Firm Performance	-0.309	0.120	Not Significant
Accounting Conservatism → Market Valuation	-0.265	0.115	Not Significant

The analysis shows a significant positive relationship between accounting conservatism and earnings quality, as indicated by a path coefficient of 0.810 ($p = 0.001$). This statistically significant association suggests that conservative accounting practices are strongly linked to enhanced earnings quality among listed firms in Iraq, supporting Hypothesis 1. The positive path coefficient aligns with the theoretical expectation that conservative accounting, by prioritizing cautious income recognition and prudent valuation of assets and liabilities, enhances the reliability of financial information.

This finding is consistent with prior literature, which posits that conservative practices contribute to more stable and trustworthy financial reporting, thereby benefiting stakeholders by providing a clearer view of the firm's financial health. Such reliability in earnings quality could be especially critical in the Iraqi context, where stakeholders may place high value on the credibility and stability of financial disclosures.

Hypothesis 2a posits a positive relationship between accounting conservatism and firm performance, independent of earnings quality. However, the SEM results indicate that this relationship is not statistically significant. The path coefficient of -0.309 ($p = 0.120$) suggests a weak, non-significant association between conservative accounting practices and firm performance, as measured by return on assets (ROA) and return on equity (ROE).

This result implies that, within the sample of Iraqi firms, conservative accounting does not directly contribute to improvements in firm performance metrics. Instead, the negative direction of the path coefficient hints at a potential trade-off between the cautious approach of conservatism and the firm's short-term performance outcomes. The lack of significance in this relationship suggests that while conservatism may promote earnings quality, it does not directly influence the firm's profitability or operational success.

The direct relationship between accounting conservatism and market valuation is also evaluated, as proposed by Hypothesis 2b. According to the SEM results, this relationship is similarly non-significant, with a path coefficient of -0.265 ($p = 0.115$). This indicates that, contrary to the hypothesis, there is no strong evidence to suggest that conservative accounting practices lead to higher market valuations for firms listed in Iraq.

The negative, albeit non-significant, path coefficient may indicate that conservative practices, by limiting aggressive revenue recognition or cautious asset revaluations, might contribute to a more restrained perception of firm value in the eyes of investors. However, given the non-significance of this result, Hypothesis 2b cannot be supported based on the current analysis, highlighting the need for further investigation into market-specific factors that may influence the perceived value of conservatively reporting firms.

In summary, the direct effects analysis offers mixed support for the hypotheses. While a strong, significant relationship exists between accounting conservatism and earnings quality, the results do not provide conclusive evidence for direct effects on firm performance or market valuation. These findings reinforce the importance of further examining potential indirect pathways, especially through earnings quality, to understand how conservatism influences these outcomes.

3.4.2.2. Indirect Effect Analysis

This section investigates the mediating role of earnings quality on the relationships between accounting conservatism and the two dependent variables: firm performance and market valuation. According to the proposed hypotheses, earnings quality is expected to channel the influence of accounting conservatism in ways that enhance both financial performance and market perception. The structural equation model (SEM) results provide path coefficients and significance values that reveal the indirect effects of accounting conservatism through earnings quality, thus testing Hypotheses 3a and 3b.

Indirect Effect on Firm Performance (Hypothesis 3a)

Hypothesis 3a posits that earnings quality mediates the relationship between accounting conservatism and firm performance. In other words, the conservative financial practices employed by a firm are expected to enhance earnings quality, which subsequently contributes positively to the firm's performance outcomes.

Table 7: Indirect Effects on Market Valuation

Pathway	Path Coefficient	P Value	Significance
Accounting Conservatism → Earnings Quality	0.810	0.001	Significant
Earnings Quality → Market Valuation	0.633	0.002	Significant
Indirect Effect (Accounting Conservatism → Market Valuation via Earnings Quality)	0.512	0.040	Significant

As shown in the Table 7, the positive coefficient of 0.810 ($p = 0.001$) for the path from accounting conservatism to earnings quality confirms that conservative accounting practices significantly enhance earnings quality. Furthermore, the path from earnings quality to firm performance also shows a strong, positive effect (coefficient = 0.633, $p = 0.002$), supporting the hypothesis that higher-quality earnings contribute positively to firm performance.

The indirect effect coefficient of 0.512 ($p = 0.04$) for the relationship between accounting conservatism and firm performance, mediated by earnings quality, is statistically significant. This result suggests that while accounting conservatism may not directly improve firm performance, it indirectly does so through its positive influence on earnings quality. Thus, Hypothesis 3a is supported by the evidence, indicating that earnings quality acts as a meaningful mediator that strengthens the firm's financial outcomes when conservative practices are adopted.

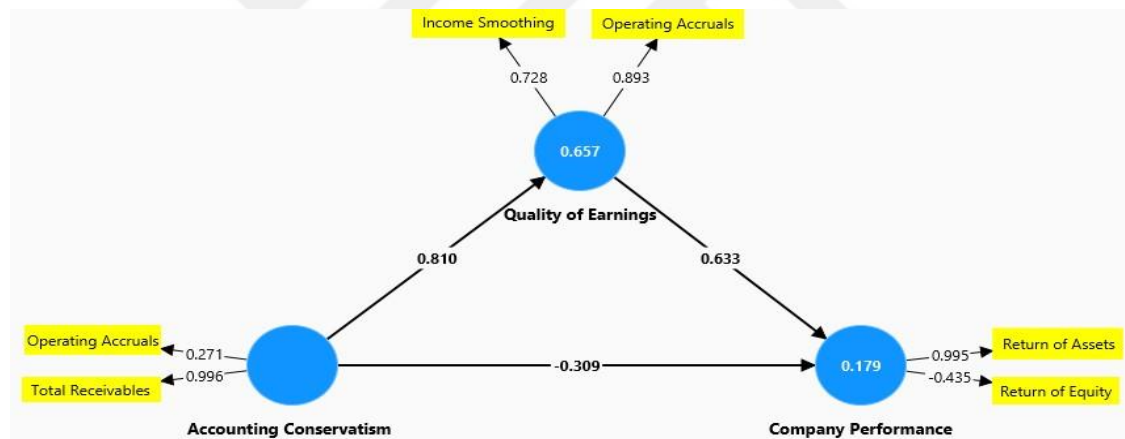


Figure 4: Structural Equation Model of Accounting Conservatism, Quality of Earnings, and Company Performance

As illustrated in Figure 4, the structural equation model captures the complex dynamics between accounting conservatism, earnings quality, and firm performance. The path coefficients demonstrate that while accounting conservatism has a direct negative effect on firm performance, it indirectly enhances performance through its positive impact on earnings quality.

Indirect Effect on Market Valuation (Hypothesis 3b)

Hypothesis 3b suggests that earnings quality mediates the relationship between accounting conservatism and market valuation. This hypothesis posits that conservative accounting practices are likely to improve earnings quality, which in turn enhances the firm's valuation in the market.

Table 8: Indirect Effects on Market Valuation

Pathway	Path Coefficient	P Value	Significance
Accounting Conservatism → Earnings Quality	0.784	0.010	Significant
Earnings Quality → Firm Performance	-0.308	0.001	Significant
Indirect Effect (Accounting Conservatism → Firm Performance via Earnings Quality)	-0.240	0.112	Not Significant

The results indicate that while accounting conservatism significantly enhances earnings quality (coefficient = 0.784, $p = 0.01$), the path from earnings quality to market valuation shows a significant but negative relationship (coefficient = -0.308, $p = 0.001$). This negative association suggests that, contrary to expectations, higher earnings quality—though beneficial from an accuracy and stability perspective—may not be favorably viewed by the market in terms of valuation, possibly due to perceived limitations in aggressive growth potential.

The indirect effect of accounting conservatism on market valuation through earnings quality has a coefficient of -0.240, which is not statistically significant ($p = 0.112$). This lack of significance implies that, while conservative accounting practices enhance earnings quality, this improvement does not translate into a positive impact on market valuation. As a result, Hypothesis 3b is not supported, indicating that in this context, the Iraqi market may not perceive the benefits of higher earnings quality as a factor that enhances firm valuation.

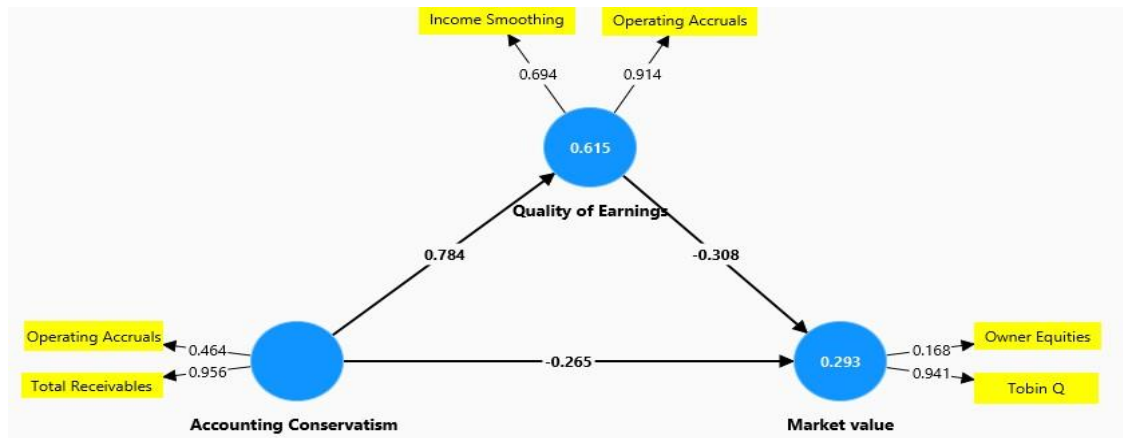


Figure 5: Structural Equation Model of Accounting Conservatism, Quality of Earnings, and Market Value

The structural equation model depicted in Figure 5 illustrates the mediation of quality of earnings in the relationship between accounting conservatism and market valuation. This model provides insight into how these variables interact to impact the market value of listed firms in Iraq.

Summary of Indirect Effects

The indirect effects reveal a nuanced role of earnings quality in mediating the relationship between accounting conservatism and performance outcomes. While earnings quality acts as an effective mediator that positively influences firm performance (supporting Hypothesis 3a), it does not serve as a favorable intermediary for market valuation (rejecting Hypothesis 3b). This divergence suggests that while investors may value high-quality earnings in assessing firm stability and performance, they may not necessarily associate it with higher valuation, particularly in markets where conservatism might be perceived as a constraint on growth.

CONCLUSION

This study synthesizes the findings on the impact of accounting conservatism on firm performance, market valuation, and earnings quality, contextualizing them within theoretical perspectives and previous literature. The empirical results confirm certain hypotheses while offering nuanced insights into the interplay of conservative accounting practices, stakeholder perceptions, and financial outcomes in the Iraqi context. These findings contribute to the literature by highlighting both the theoretical and practical implications of accounting conservatism in emerging markets.

Theoretical Contributions

The significant positive relationship between accounting conservatism and earnings quality aligns with Agency Theory, which underscores the role of conservatism as a governance mechanism that reduces information asymmetry between managers and stakeholders. By constraining managerial discretion, conservative accounting practices foster transparency and credibility in financial reporting. This supports Ahmed (2011) and Mashoka (2015), who found that conservatism limits accruals manipulation and strengthens the reliability of earnings. In the Iraqi context, where regulatory frameworks are evolving, this finding highlights the importance of transparency in fostering investor confidence, as posited by Information Asymmetry Theory (Jensen & Meckling, 1976).

While conservatism enhances earnings quality, its direct effect on firm performance and market valuation is not statistically significant. According to the Resource-Based View (RBV), internal resources such as financial prudence are expected to enhance competitive advantage (Barney, 1991). However, in this study, the cautious recognition of revenues and expenses did not lead to improved performance metrics like ROA and ROE. This divergence from studies such as Hamdan (2012), who observed positive effects of conservatism on profitability in Jordan, suggests that Iraq's high-risk business environment might require more aggressive growth strategies to achieve tangible performance improvements. Furthermore, the mixed results on market valuation align with Behavioral Finance theories, which highlight how investor psychology shapes perceptions of accounting practices. Iraqi investors, who prioritize short-term gains and rapid growth, may interpret conservatism as overly restrictive, reducing its appeal. Similar findings were reported by Novalia and Nindito (2016) in

Indonesia, where conservatism's effects on equity valuation were found to be context-dependent.

Practical Implications

The study confirms that earnings quality significantly mediates the relationship between accounting conservatism and firm performance, consistent with Signaling Theory (Spence, 1973). High-quality earnings, driven by conservative practices, signal financial stability and reduce perceived risks, enhancing long-term performance outcomes. Sarawi (2019) corroborates this result, demonstrating that enhanced earnings quality positively affects ROA in Jordanian firms. However, the mediation analysis reveals an unexpected negative relationship between earnings quality and market valuation. This challenges the conventional expectation that higher earnings quality leads to improved market perception. In the Iraqi context, this result may reflect a misalignment between investor expectations for growth and the perceived conservatism of financial reporting. Abu Al-Khair (2008) observed similar dynamics in Egypt, where conservative practices stabilized share values during economic downturns but did not support higher valuations in growth-focused periods.

These findings underscore the need for Iraqi firms to adopt a balanced approach. While conservatism builds a foundation of financial reliability and transparency, firms must integrate growth-oriented strategies to align with market expectations. This dual approach could help reconcile the stabilizing effects of conservatism with the dynamic demands of investors in emerging markets.

Future Research

This study's findings provide a foundation for further exploration of accounting conservatism, earnings quality, and their broader financial implications, particularly in emerging markets. Future research can address several key areas:

Cross-Industry Comparisons

Future studies should expand the scope by including firms from various industries beyond the industrial sector. This study focused on Iraqi firms listed on the stock exchange, but additional research could include non-listed firms or sectors such as services, banking, and agriculture. Comparative analyses across industries would provide a more nuanced understanding of how conservatism interacts with different

business models, risk profiles, and regulatory environments. For instance, studies could examine whether the stabilizing effects of conservatism are more pronounced in highly regulated sectors like banking or less regulated ones like agriculture.

Longitudinal Studies

Given the nature of conservatism, its benefits may manifest over an extended period rather than in the short term. Longitudinal studies could better capture the long-term effects of conservatism on firm performance, market valuation, and financial resilience. By analyzing trends over multiple economic cycles, researchers can assess whether conservatism contributes to financial sustainability, particularly in volatile markets like Iraq.

Cultural and Behavioral Factors

Behavioral Finance suggests that cultural and psychological factors influence investor perceptions of accounting practices. Future research could investigate how these factors shape the reception of conservatism in different emerging markets. Comparative studies between countries such as Iraq, Jordan, and Saudi Arabia could reveal how cultural norms and local market conditions mediate the relationship between conservatism and market outcomes. For example, how do societal attitudes toward risk and growth affect the perceived value of conservative reporting?

Alternative Methodological Approaches

Employing advanced econometric models or mixed-method designs could enhance the robustness of future research. For instance, structural equation modeling (SEM) could be combined with qualitative insights from interviews with financial managers, investors, and auditors. Such an approach would provide a deeper understanding of the strategic motivations behind conservative accounting and its perceived value among stakeholders.

Moderating Roles of Governance and Regulation

Stronger governance mechanisms and more robust regulatory standards could enhance the effectiveness of conservatism in promoting transparency and stability. Future studies could explore how corporate governance structures and regulatory environments moderate the relationship between conservatism, earnings quality, and performance outcomes. This would be particularly relevant in the Iraqi market, where

institutional challenges and regulatory gaps may influence the effectiveness of accounting practices.

Investor Sentiment and Market Perceptions

Building on the unexpected negative relationship between earnings quality and market valuation, future research could examine how investor sentiment shapes market perceptions. Studies could explore whether specific types of conservatism—such as cautious revenue recognition or prudent asset valuation—are viewed more favorably by investors seeking stability or unfavorably by those prioritizing growth.

By addressing these areas, future research can provide a more comprehensive understanding of accounting conservatism's role in emerging markets. This would not only advance academic knowledge but also offer actionable insights for firms and policymakers aiming to foster transparent, resilient, and investor-friendly financial systems.

In conclusion, this study contributes to the growing body of literature on the context-dependent nature of accounting conservatism. While conservatism strengthens earnings quality and builds financial stability, its effects on firm performance and market valuation remain complex and nuanced. The integration of theoretical frameworks such as Agency Theory, Signaling Theory, Behavioral Finance, and Information Asymmetry Theory enriches the understanding of these dynamics, offering valuable perspectives for both scholars and practitioners.

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CURRICULUM VITAE

Curriculum Vitae ; date and place of birth should not be specified; It consists of information about the university and department of graduation, degrees and awards received, publications of the researcher, if any, and academic and professional status. The CV should be written in third person singular language.

