



## The Impact of the Capital Structure on the Financial Default / an Analytical Research in Sample of Companies of the Ministry of Industry and Minerals

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### Abstract:

The objective of this research is to study the effect of capital structure on financial default. As it is the first research of its kind that deals with this sample of companies affiliated to the Ministry of Industry and Minerals and these companies were chosen especially because they suffer from financial deficit problems. The importance of this research lies in determining the importance of the components of the capital structure and knowing their impact on financial default in the research sample companies. The research sample represented a number of companies of the Ministry of Industry and Minerals located in Baghdad Governorate. The statistical methods represented in used financial ratios in the analysis to evaluate the research variables, which are both capital structure ratios (Long-term debt ratio to equity and long-term debt to total asset) and liquidity ratios (Current ratio, Quick ratio, Cash ratio) and used the programs (SPSS v26) and (Excel 2010) and the moment structure analysis program (AMOS) was adopted in order to calculate each of the standard deviation, correlation coefficient and specificity to find the relationship between the research variables and test its hypotheses. The results showed that the capital structure had no effect on the cases of financial defaults in the companies.

**Paper type:** Research paper.

**Keywords:** Capital structure, Financial default.

### **1.Introduction:**

In this research we attempted to study and analyze the effect of the capital structure on the financial default of a sample of companies of the Iraqi Ministry of Industry and Minerals, as these companies suffered from financial deficit problems for many years, as shown in the balance sheet of these companies. Therefore, the research relied on financial and statistical analysis methods in order to find the relationship and influence between the research variables.

The research problem, objectives, and the financial and statistical methods used in the analysis are also showed, and a number of financial data tables related to these variables are also showed.

The research also presented the hypotheses that were formulated depending on the research problem and research model, the theoretical aspect of the capital structure and the financial default, leading to the research results and conclusion.

### **2. Literature review:**

There is Many studies that have dealt with the variable of capital structure, Yarah et al (2017) presented a study that dealing with the effect of capital structure on financial performance, the objective of the study was to understand the behavior of the companies, the study sample, in how to choose the financing structure, to determine the relationship between the financing structure and the performance of the companies, and to discuss the nature of this relationship, determine the financing structure effect on financial performance in companies, and the results showed that there was no significant relationship or effect of the capital structure in the performance indicators. Manual and Lee (2019) suggested a study dealing with the effect of capital structure on the financial distress, the objective was to know the effect of the capital structure on the financial default of non-financial companies, to studied the effect of financial leverage on the financial default of companies, to know the effect of debt maturity on the financial default of companies, to examine the impact of the equity structure on the financial default of companies and to measure the effect of the structure of assets on the financial default. Amen (2021) proposed a study that dealt with capital structure the objective of the study was to determine how to choose the capital structure and the factors influencing its selection, and to show the impact of private funds and long-term foreign debts on the financial performance and to know how to choose the financial policy to adapt to the prevailing circumstances and to determine the relationship between the capital structure and the financial performance. Theoretical results were represented in the fact that each element of the capital structure has its own cost, which represents the minimum return that must be achieved on projects. Ali et al (2022) suggested a study that objective to tested whether effective tax rate and firm-specific factors (tangibility, risk, profitability, non-debt tax shields, firm size, growth opportunities and liquidity) impact the capital structure of multinational firms, and the results showed that there was a significant and positive effect of profitability, tangibility, risk and non-debt tax shields on total debt measures and long-term of capital structure.

Also there are several of studies dealt with the financial default which is relatively recent topic has many studies have dealt with it to. Tan (2012) presented a study in financial distress and firm performance this study aimed to re-examine the relationship between performance and influence in an international context to study the indirect costs of financial default. The conclusions of this study confirm that companies with low financial leverage tend to have more acceptable perform than companies that have high financial leverage. As well as the crisis amplifies the Inverse relationship for financial default and performance in corporate, and companies with high indebtedness face poor performance during crises. Al-Amin and Tabakh (2018) presented a study aimed to study the role of financial ratios in forecasting financial failure. The objective of this study is to obtain the best collection of financial ratios from the financial list, which can be used to predict the company, whether it fails or succeeds. Two

financial ratios out of 18 indicate their ability to distinguish between a troubled company and a good one. Giarto and Fachrurrozien (2020) suggested a study with the title the effect of leverage, sales growth, cash flow on financial distress with corporate governance as a moderating variable, the objective of the study is to definition the effect of cash flow, leverage, sales and growth on financial distress using moderating variable which is the corporate governance, The results shows that leverage has positive effect to financial distress. Cash flow has a significant negative effect to financial distress. Sales growth has no significant effect to financial distress. Corporate governance is able to weaken the positive impact of financial leverage and strengthen the reverse impact of sales growth on financial distress, but it is not able to strengthen the reverse impact of cash flows of financial distress. Barbaglia et al (2023) suggested a study dealing with financial default, the objective of the study is to forecasting loan default using machine learning, the results confirm that the performance is provides more accurate results in making predictions, and that the most important variables in explaining the default are both the loan interest rate and the local economic characteristics.

The research problem focused on studying the impact of the capital structure on the financial default in the industrial companies that represented the research sample, as these companies have suffered from financial default problems in repayment for many years, especially since these companies depend in determining the mixture of their capital structure on financing with long debts term and at very high rates, and as a result, the financial statements of these companies represented by the balance sheet showed a permanent deficit in very high amounts, which requires addressing this problem with study and analysis, as the capital structure of the researched companies consists of equity and interest-bearing debt because it focuses on a mixture of debt and equity to finance In the company, incorrect decisions regarding the capital structure lead to the occurrence of financial default, which ultimately leads to bankruptcy. In other words, in order to maximize the value of the company, the management must be able to select the optimal ratio of debt and equity mix as the main sources of financing and thus avoid falling into financial default and its consequences for the company.

The objectives of this research are to recognize and identify the elements of the capital structure in the companies from the research sample, to show the impact and importance of each of these elements in the financial default of these companies, and to show how to choose these elements and the factors that affect their choice. It also stresses the importance of adopting the optimal capital structure because of its impact on the profitability of these companies and the level of influence of the capital structure on the occurrence of financial default.

### **3. Material and Methods:**

The research included three parts, the first is the descriptive approach used to complete the theoretical aspect of the research by relying on books, papers, and thesis related to the subjects of the study. The second is the analytical method, where the financial reports of the research sample companies, represented by the general budget, will be approved, and the current operations revealed and analysed using financial indicators, which are each of the indebtedness ratio. long-term and the long-term debts to total assets ratio to assess capital structure, and the ratio of trading and the quick ratio and the cash ratio to evaluate the financial default to calculate each of the research variables, depending on the solid scientific sources that used these indicators in the measurement, and the third included the use of statistical methods for analysing the relationship between variables by using the programs (Microsoft Excel 2010, SPSS v26) and adopting the AMOS statistical analysis, which is one of the programs that are subject to the SPSS v26 statistical analysis package, and it is one of the programs through which the data can be analysed statistically and that is subject to the SPSS v26 statistical analysis package For the phrase (Analysis of Moment Structures).

Financial ratios were used in order to measure, analyse and evaluate the research variables as they will be shown in the following table:

**Table 1:** Financial ratios used to evaluate variables

Research variables	Financial ratios
Capital structure	Long-term debt ratio to equity (LTDE) long-term debt to total asset (LTDTA)
Financial default	Current ratio Quick ratio Cash ratio

A sample of the financial statements of the research sample companies was obtained, which was analysed using the previously mentioned financial ratios, which will be mentioned as follows:

**Table 2:** Long-term debt to equity ratio evaluation

Company Name	2016	2017	2018	2019	2020	2021
Al-Zawraa General Company	3.940	3.914	3.873	3.758	3.624	3.468
Industrial Development Directorate	6.529	4.111	3.736	2.416	0	0
General Company for Steel Industries	2.715	1.519	1.510	1.584	1.609	1.513
The General Company for Food Products	3.839	3.336	3.326	3.356	3.342	3.323
Electronic systems	0.106	0.105	0.104	0.103	0.102	0.049
Engineering examination and qualification	0.569	0.590	0.574	0.571	0.552	0.550
Mean	2.048					
maximum	6.529					
minimum	0					

**Table 3:** Long-term debt to total asset ratio evaluation

Company Name	2016	2017	2018	2019	2020	2021
Al-Zawraa General Company	0.606	0.479	0.374	0.379	0.362	0.385
Industrial Development Directorate	1.370	1.028	0.821	0.510	0	0
General Company for Steel Industries	0.621	0.633	0.740	0.825	0.891	0.890
The General Company for Food Products	2.747	2.438	2.576	2.475	2.332	2.259
Electronic systems	0.027	0.028	0.029	0.030	0.030	0.014
Engineering examination and qualification	0.150	0.149	0.153	0.160	0.161	0.158
Mean	0.744					
maximum	2.747					
minimum	0					

**Table 4:** Current ratio evaluation

Company Name	2016	2017	2018	2019	2020	2021
Al-Zawraa General Company	0.881	0.900	0.927	0.934	0.933	0.928
Industrial Development Directorate	2.459	2.885	19.815	3.056	1.143	1.088
General Company for Steel Industries	0.955	1.197	1.136	1.013	1.070	1.157
The General Company for Food Products	0.363	0.615	0.609	0.652	0.706	0.736
Electronic systems	0.676	0.639	0.645	0.621	0.620	0.630
Engineering examination and qualification	0.916	0.925	0.927	0.871	0.866	0.866
Mean	1.537					
maximum	19.815					
minimum	0.363					

**Table 5:** Quick ratio evaluation

Company Name	2016	2017	2018	2019	2020	2021
Al-Zawraa General Company	0.685	0.684	0.773	0.838	0.841	0.829
Industrial Development Directorate	2.429	2.858	19.644	3.035	1.135	1.084
General Company for Steel Industries	0.795	0.910	0.838	0.799	0.852	0.870
The General Company for Food Products	0.256	0.441	0.431	0.474	0.521	0.572
Electronic systems	0.664	0.627	0.633	0.609	0.608	0.619
Engineering examination and qualification	0.914	0.923	0.917	0.866	0.862	0.863
Mean	1.435					
maximum	19.644					
minimum	0.256					

**Table 6:** Cash ratio evaluation

Company Name	2016	2017	2018	2019	2020	2021
Al-Zawraa General Company	0.012	0.004	0.029	0.011	0.011	0.008
Industrial Development Directorate	2.165	2.599	18.204	2.816	1.009	1.004
General Company for Steel Industries	0.011	0.022	0.016	0.012	0.038	0.010
The General Company for Food Products	0.047	0.060	0.123	0.130	0.124	0.115
Electronic systems	0.094	0.086	0.086	0.109	0.104	0.112
Engineering examination and qualification	0.556	0.586	0.581	0.523	0.523	0.532
Mean	0.900					
maximum	18.204					
minimum	0.004					

These results were converted into rates and then analysed statistically using the previously mentioned statistical methods in order to identify the effect of capital structure on financial default.

### 3.1 Research population and sample:

The research problem focused on studying the impact of the capital structure on financial default, as choosing the optimal mix of capital structure elements for each company depends on its policy that is determined by the financial management for it by reference to a large group of different reasons and data that differ between organizations, as the company's capital structure consists of property rights and debts that bear interest, as it focuses on a mixture of debt and property rights to finance the company, and the various financing decisions taken by the management are responsible for the vitality and financial health of the company, in other words maximize the value company management must be able to determine the optimal ratio of the mixture of debt and equity as the main sources of financing, and thus avoid falling into financial default and its consequences for the company. Thus, the main problem of the research can be identified by the following question:

(Does the capital structure affect the financial default?)

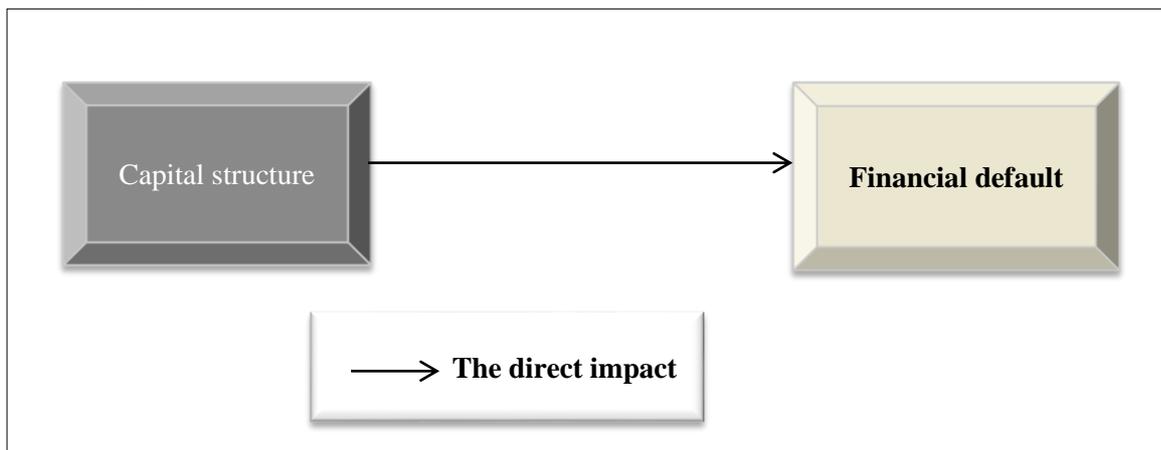
And thus the features of the problem can be diagnosed and framed in light of a number of sub-questions derived from the basic question, which are the following:

1. Does the capital structure have an effect on the financial default in the research sample?
2. Do long-term debts within the capital structure elements measured by long-term ratio indebtedness and the ratio of long-term debts to total asset affect the financial default of the research sample companies?

The research community consisted of companies affiliated to the Iraqi Ministry of Industry and Minerals, which numbered twenty-nine companies a deliberate sample consisting of six companies was selected, which are (the State Company for Steel Industries, the State Company for Food Products, the State Company for Electronic Systems, the General Company for Zawra, the General Company For engineering examination and qualification, the General Company for Food Products) due to its geographical location within Baghdad Governorate, in addition to the availability of data represented in the necessary financial statements.

### 3.2. Research Model:

The research model includes two main variables, namely (capital structure), which represents the (independent variable), and (financial default), which represents the (dependent variable), which we study and analyze in order to know the direct impact of the main variable on the dependent variable.



### **3.3 Hypothesis:**

Depending on the research problem and the search model, the researcher formulated the basic hypothesis and the null hypothesis that tests the relationship between the basic variables, which are both capital and financial default, and knowing the nature of the relationship between them through statistical methods represented by the simple linear regression test and the coefficient of determination, which seeks to prove its validity or rejection, as follows:

H0: The capital structure does not affect the financial default in the companies (research sample) at the level of significance ( $\alpha < 0.05$ ).

H1: The capital structure affects financial default in companies (research sample) at the level of significance ( $\alpha < 0.05$ ).

### **3.4 Capital structure:**

The capital structure is defined according to Shim and Siegel (2007) as a mixture of long-term funds used by the company in order to maximize the market value through an appropriate mixture of sources of these funds. Sharan (2012) added that the structure of Capital refers to the financing sources which include debt, equity capital, and mixed securities that the company uses to finance its assets, operations, and future growth. Capital has consequences for all companies because it has an impact on their market (Baker and Martin, 2011). Kartika et al (2020) suggested that it refers to the company's method of financing its assets by merging sources various financing, as the form of financing and the source of financing can determine company capital.

### **3.5 Determinants of the capital structure:**

**1. Growth and capital structure:** Githira and Nasieku (2015) confirmed that there is an important positive relationship between company growth and capital structure, and the relationship between growth and capital structure has been confirmed in the literature, however, the direction of this association is not the same according to different theories.

**2. Tangible and capital structure:** The asset structure is one of the important factors in capital structure decisions, as the company can use tangible assets as collateral to obtain more loans or even reduce their cost (Banda and Pratheepan, 2016). The size of fixed tangible assets is generally measured as the proportion of non-current assets out of the company's total assets (Kuč and Kaličanin, 2021).

**3. Profitability and capital structure:** Profitability can be defined as the final result of a number of policies and management decisions of the company, which is usually a means of measuring the company's success and an indicator for evaluating the manager's performance (Kartika et al, 2020). The theory of capture and the theory of exchange have opposite directions with regard to With regard to the relationship between profitability and the choice of capital structure (Nguyen et al, 2021).

**4. The size of the company and the capital structure:** The results of the studies showed that there is a significant relationship between the size of the company and the choice of capital structure, as the size of the company was the most important determinant, and then the greater the size of the industrial companies, the higher the level of debt, as the major manufacturing companies are exposed to lower levels of debt, risks, and then have high chances of taking on more business risks (Githira and Nasieku, 2015). The size of the firm can be measured based on its total sales, total assets, and average level of sales (Kartika et al, 2020).

### 3.6 Financial default:

Asfali (2019) defined the financial default as a stage of deterioration in financial conditions that occurs before bankruptcy or liquidation occurs. Oktasari (2020) added that it is the case in which the company's operating cash flow is insufficient or does not meet current obligations, and at the same time The context argues that the company reaches a situation in which it cannot meet its short-term obligations as a result of being affected by a wide range of factors. Faldiansyah et al (2020) pointed that condition appears when the company faces Inability or lack of funds to pay all obligations when due, and this situation is one of the early symptoms of financial default. Lumbantobing (2019) suggested that it is a situation in which the operating cash flows of the company are not sufficient to meet current obligations, as he sees. Sewpersadh (2022) defined the financial default as a decrease in the company's earnings, which increases the possibility of not settling its mandatory payments of interest and debt capital. Nugroho and Halik (2021) pointed that it represents a state of decline or declinem. Lee and Manual, (2019) represents the situation that In which obligations cannot be fulfilled by the organization.

### 3.7 Costs associated with financial default :

Financial default in companies entails many costs, which Sewpersadh (2022) divided into three groups as follows:

1. Direct default costs: accumulate from the legal process such as legal fees, accounting, filing, advisory fees, and other administrative expenses.
2. Indirect costs of default: which are often ignored in distressed companies, such as the loss of creditors and stakeholders, and the costs of depreciating the value of the company due to the actions of managers to protect their own self-interest, such as replacing assets and increasing operating costs.
3. Liquidation costs: These costs are incurred due to the disposal of the company's assets by selling them and closing its operations.

## 4. Discussion of Results:

Table 7 shows the results of the simple linear regression analysis of the impact of the capital structure on the financial default in companies, and it is noted that the capital structure did not achieve a significant effect on the financial default in companies, as the value of (F) calculated was (0.837), with a significant (0.367), which is It is greater than the level of significance (0.05), and this means that the effect of the independent variable, capital structure, in the dependent variable Financial default in companies is statistically insignificant. (97.6%) are due to other factors that were not included in the regression model.

From the table 1 we notice that the value of the fixed limit ( $a = 0.707$ ) is not statistically significant, as the value of significance was (0.398), which is greater than the level of significance (0.05). It means that the fixed limit is not statistically significant, while the value of the marginal slope (b) was (0.416), which is also statistically insignificant because the value of significance is (0.367), which is greater than the level of significance (0.05), and these results indicate the acceptance of the second null hypothesis, which states: There is no significant, statistically significant effect of the capital structure on financial defaults in companies.

**Table 7:** Results of a simple linear regression analysis of the impact of capital structure on corporate financial default

independent variable	Dependent variable							
	Financial default in companies							
capital structure	fixed limit a	significance	marginal tendency b	significance	R <sup>2</sup> value	F value	significance	the decision
	0.707	0.398	0.416	0.367	0.024	0.837	0.367	not significance

### 5. Conclusion:

The results of the financial analysis of the research using financial indicators (the ratio of long-term indebtedness), which were used to assess the capital structure, proved that the components of the capital structure of the research sample companies consisted of long-term debt and property rights, which in turn consists of (reserves and capital), as it owned all From the General Company for Electronic Systems and the General Company for Engineering Examination and Qualification, the lowest rates of long-term debts in relation to owned financing, and thus these companies were the best in terms of using owned financing and owning the least expensive capital among all the other companies in the research sample and the one with the least potential to face default problems Repayment, and the results of the financial analysis using financial indicators (the ratio of long-term debts to total assets), which were used in evaluating the capital structure of the research sample companies, showed that each of Al-Zawraa State Company, the General Company for Electronic Systems, and the General Company for Engineering Inspection and Qualification had positive and very good results as these companies have the largest amount of assets in relation to other companies, the research sample, and thus they are able to obtain more external debts within the components of their capital structure.

The results of the liquidity (circulation ratio), which were used in evaluating the financial default of the research sample companies, proved that the Al-Zawraa General Company, the General Directorate of Industrial Development, the General Company for Steel Industries, and the General Company for Engineering Inspection and Qualification have achieved results that ranged from being very satisfactory to somewhat good results. With regard to the absolute growth criterion, as the current assets of these companies were high in relation to their current liabilities, which means that they are in a good position with regard to the risks of default and default. The General Company for Industrial Development, the General Company for Steel Industries, and the General Company for Engineering Inspection and Qualification have achieved results that ranged from being very satisfactory results to somewhat good results in relation to the absolute development criterion, as the current assets free of stock (which is idle capital) for these companies were high in relation to their current liabilities Which means that it is in a good position with regard to the risks of default and default. Thus, the results of this ratio support the results of the trading ratio that were talked about in the previous point, the results of the liquidity (cash ratio), which was used in assessing the financial default of the research sample companies, It also proved that the General Directorate for the Development of the Industrial Company achieved very satisfactory results with regard to the criterion of absolute growth, as the cash owned by the company as one of the components of its current assets is

sufficient to pay off its current liabilities, which means that it is in a good position with regard to the risks of default and default, as these results show that each of the General Industries Company Steel and the General Company for Engineering Inspection and Rehabilitation had low liquidity for this indicator, which is unlike the previous two indicators, as it has very low cash within its current assets, as is the case with the remaining companies within the research sample.

The results of the statistical analysis that tested the second research hypothesis stated that the capital structure did not achieve a significant effect on financial defaults in companies, as the calculated (F) value reached (0.837), with a significance of (0.367), which greater than the level of significance (0.05), and this means that The effect of the capital structure on the financial default in companies is not statistically significant, which pointed to acceptance of the null hypothesis.

Based on these results, we reach the need for the management of companies that obtained unsatisfactory results with regard to their capital structure assessment indicators, and in particular companies that relied on long-term debts at very high rates, to reconsider the mix and proportions of the components of the private capital structure by looking at the financial management literature, specifically the capital structure, in order to take corrective measures and make the necessary improvements in order to obtain an ideal capital structure that reduces costs to the lowest possible level and provides the largest amount of financing in return by using long-term debts when making a financing decision and working to invest the amounts of these debts in successful projects that achieve sufficient returns to pay these amounts.

The results of the liquidity indicators of the research sample companies, which were used in assessing financial default should also be taken into account, as these results show the need to work to reduce dependence on inventory in calculating liquidity, as it is idle capital that is high in cost and risk, and to work to increase the available cash within the components of the assets traded in sample companies. Research and the need to work to reduce the various costs incurred by companies and reduce waste caused by their operations and work to invest these amounts in projects and businesses that achieve returns for companies, in addition to the need to conduct the necessary studies and hold seminars and in cooperation with all departments of the Ministry of Industry and Minerals in order to develop the reality of the research sample companies And to find out their weaknesses and work to treat them in a way that contributes to the support and development of the Iraqi national economy, where it should work to enhance the productivity of the research sample companies by conducting comprehensive marketing research for the local market and relying on the results it reached in introducing new products within its production lines to meet The need of the Iraqi consumer and fulfils the requirements of diversification, innovation and innovation, thus competing with what is offered by the private sector and foreign products.

It is also necessary to work to keep pace with the changes that occur in all the various technical, manufacturing and innovative production fields that appear in the regional and local environments, and to transfer successful experiences from them to the national companies, which leads to The development of these companies and the national economy alike, in addition to the need to conduct the necessary economic feasibility studies before embarking on new projects and businesses and to verify the appropriateness of the implementation dates of these projects and what they can provide to the Iraqi environment of the necessary needs that serve the citizen and in a manner that achieves appropriate returns, which ensures that no Waste of money and consecutive losses.

**Authors Declaration:**

Conflicts of Interest: None

-We Hereby Confirm That All The Figures and Tables In The Manuscript Are Mine and Ours. Besides, The Figures and Images, Which are Not Mine, Have Been Permitted Republication and Attached to The Manuscript.

- Ethical Clearance: The Research Was Approved By The Local Ethical Committee in The University.

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## تأثير هيكل رأس المال في التعثر المالي/ دراسة تحليلية في عينة من شركات وزارة الصناعة والمعادن

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### مستخلص البحث

يهدف البحث إلى دراسة تأثير هيكل رأس المال على التعثر المالي حيث أنه يعد البحث الأول من نوعه الذي يتناول هذه العينة من الشركات التابعة لوزارة الصناعة والمعادن بالدراسة وتم اختيار هذه الشركات وعلى وجه التحديد كونها تعاني من مشاكل العجز مالي وتكمن أهمية هذا البحث في تحديد أهمية مكونات هيكل رأس المال ومعرفة تأثيرها على التعثر المالي في شركات عينة البحث. تمثلت عينة البحث بعدد من شركات وزارة الصناعة والمعادن والكائنة في محافظة بغداد واستخدم هذا البحث النسب المالية في التحليل لتقييم متغيرات البحث وهي نسب المستخدمة لحساب هيكل رأس المال (نسبة الديون طويلة الاجل الى حق الملكية ونسبة الديون طويلة الاجل الى مجموع الموجودات) ونسب السيولة لحساب التعثر المالي (النسبة الحالية، النسبة السريعة، نسبة النقدية) وتم اعتماد الطرق الإحصائية المتمثلة في البرنامجين (SPSS v26) و (Excel 2010) وبرنامج (AMOS) لحساب كل من الانحراف المعياري ومعامل الارتباط والنوعية لإيجاد العلاقة بين متغيرات البحث و اختبار فرضياتها. أظهرت النتائج عدم وجود تأثير لهيكل رأس المال على حالات التخلف المالي في الشركات.

نوع البحث: ورقة بحثية.  
المصطلحات الرئيسية للبحث: هيكل رأس المال، التعثر المالي.

● البحث مستل من رسالة ماجستير