
The Importance of Using Financial Failure Prediction Models as Analytical Procedures to Verify the True Financial Position of the Company – Case Study at Hikma Pharma society 2017-2022-

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Abstract:

Through our paper, we seek to highlight the impact of using the Financial Deterioration Prediction Methods (KIDA-SHERROD-ALTMAN) to demonstrate the true status of the enterprise, which is a service for users of the financial statements of the enterprise, and accordingly the study was divided into two parts, one in which the definitions of the basic variables were addressed, while the other part included the application of the aforementioned curriculum at the level of pharmaceutical manufacturer HIKMA for the chain time 2017-2023.

Our study found both Sherrod and Altman's competence and ability to spare the auditor from potential detection risks by giving them a very rough picture of the real financial situation of the institution under examination.

Keywords: Professional Opinion, Auditor, Methods of Financial Decline

Jel Classification Codes: C53 ; G17 ; G33.

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1. Introduction:

It has increased the interest of many professionals and academics, especially at the accounting level, as well as auditing accounts besides the financial suitability of the institution and its various aspects, but they have not been able to regularly acquaint themselves with the different concepts associated with this aspect such as financial stumbling, financial decline, and financial decline. This explains the complexity and complexity of aspects of this phenomenon, and is the primary motivation for researchers to analyze different concepts of financial failure and associated terminology and analyze its most important causes, its manifestations and its most important results.

On the other hand, many external auditors tend to use various ratios and analytical procedures to determine the real financial situation of the institution and compare it with what is authorized in its financial lists. In order to obtain a sound opinion on the enterprise's financial position and capacity Thus, The following key question could therefore be asked:

Does the application of financial failure prediction approaches help to demonstrate the company's financial capacity?

To answer the main formats, the study asked us to develop the following sub-questions:

- To what extent does the application of the altman model enable the auditor to avoid potential detection risks?
- Does using the KIDA model help anticipate the financial future of an enterprise?
- What impact does the use of SHERROD method have on the validity of the reference report on the enterprise's status?

1.1. Study hypotheses:

Looking at previous problems, the study required the establishment of the following hypotheses:

- The application of the **Altman** model helps to determine and compare the true financial position of an enterprise with what is authorized in its financial statements, resulting in an impartial technical opinion on the sincerity and integrity of the organization's financial position, thereby avoiding or reducing certain audit risks:
- The analysis process through the Sherrod equation helps to significantly reduce the risk of checking financial listings.
- By analysing the financial situation by adopting KIDA method, the auditor can express an impartial technical opinion on the sincerity and integrity of this situation.

1.2. Objectives of the study:

We aspire through our search to reach a set of following goals:

- Remove the disorder that surrounds what predictive models of financial failure are by addressing its most important aspects, and apply it on the ground to the Foundation of Pharma Wisdom of Algeria.

- Indicate how the auditor uses these methods in the analysis process.
- Addressing the importance of adopting analytical procedures containing financial failure prediction equivalents in drawing the auditor's attention to aspects involving material errors that reduce the latter's risk.

1.3. Study methodology:

This study was based on two research methodologies:

- **Descriptive approach:** this curriculum has been based on everything related to the theoretical aspect of our current study and this is through the review and analysis of various literature related to the study points.
- **Applied method:** This is done through the adoption of previous equations on the ground in order to address the organization's actual financial situation.

2. Theoretical aspect:

2.1. Concept of analytical procedures in auditing:

IFAC's draft International Auditing Standard No. **ISA .No.520**, which replaced IFAC International Auditing Guidance **No. 12 of 1988**, defined analytical procedures as (IFAC, 2019): "an assessment of financial information by examining the expected relationships between financial and non-financial information, as well as enquiring about specific fluctuations and relationships that are inconsistent with the related financial information, or that deviate efficiently from the projected amounts".

In summary, the analysis using previous equations allows the auditor to assess the realism and integrity of an enterprise's financial position, which in turn leads to a correct opinion on the legitimacy of an enterprise's financial accounts related to this aspect.

2.2. Definition of financial failure:

BEAVER's 1966 study is one of the first research done on fiscal decline (Aouni & Zehouani, 2022), following which he presented a sophisticated model of composite financial ratios, which is used as an early warning of financial failures well in advance until other studies focused on the same subject in both the United Kingdom and Canada, where they relied on mathematical methods to derive the potential for financial failure of the institution (Amendola, 2011).

Gresse argues that what characterizes an enterprise's economic failure is negative value added, which indicates that the enterprise's consumption outweighs its output, making it unable to pay for the total elements of production that contributed to economic activity at market prices (wages of employees, social burdens, degradation, financial burdens, etc.) (Gresse, 2003).

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Thus, a comprehensive definition of financial failure can be given as an enterprise's inability to generate returns that cover the costs of its activity and so proportionate and the potential risks that result in its inability to meet its debts within its maturities.

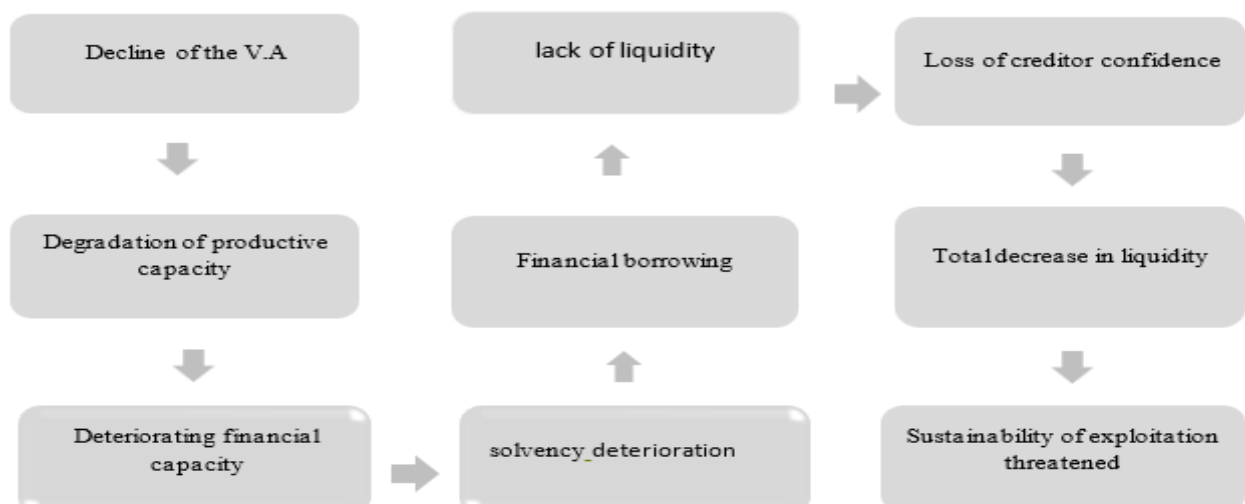
2.3. Financial failures in the Society:

In addition, there are a number of manifestations of the institution whose destination is bankruptcy and divided into internal and other external manifestations, including (Abbas, 2018):

- Change in the financial structure of the economic unit, such as excessive and increasing reliance on borrowing, especially on short-term debt, and work to increase the enterprise's financial lift;
- The Foundation's failure to keep pace with modern technical and technological developments, but simply to rely on traditional means and techniques to carry out its various activities, thereby limiting the efficiency and effectiveness of its operations, especially under conditions of intense competition in markets;
- The inaccuracy of the control of working capital, resulting in increased prices and continuous accounting of items of goods and accounts owed for goods sold;
- The institution's inability to distinguish profitable activities from others;
- The timely completion of the final accounts and financial statements;
- The Foundation's inability to pay suppliers' dues in their respective dues despite the fact that they have been warned to stop supplying the Foundation with the necessary primary materials and even to take legal action and bring cases against them before the competent courts.
- The fluctuation and decline in the organization's sales for consecutive periods followed by a gradual decline in its profits and the likelihood that this situation will continue for years on end.

We can show the stages of financial breakdown as follows:

Figure No. (1) Causes and manifestations of the Foundation's financial failure



Source: Prepared by the researcher.

We therefore conclude that the institution's financial failure is mainly reflected in the emergence of some indicators of underperformance. Higher costs of activities, compared with their productivity and lower value added, repeated and gradually through the institution's financial cycles, up to the bankruptcy stage and inability to stay in the market.

2.4. The most important stages of financial Decline:

The International Federation of Accountants (IFAC), through its issuance of Standard ISA No.570"Continuity of exploitation", Imposed on auditors to assess an enterprise's ability to continue to exploit it by adopting appropriate analytical procedures.

The Researcher Gordan study is one of the most important features of the analysis of the company's financial situation(Gordan, 1993), who considers that financial failure is undergoing the following basic stages:

2.4.1 Emerging phase:

During this phase, several indicators are shown as an early warning of financial failure, including lack of demand for the Foundation's products, severity of competition, lack of credit facilities, increased burdens on the lack of working capital.

2.4.2 Liquidity deficit phase:

One manifestation of this phase is that the company's assets are greater than its liabilities and that the enterprise is unable to meet its financing needs

2.4.3 Financial insolvency phase:

At this stage, the enterprise suffers from its inability to cover its debts and pay its expenses.

2.4.4 Total insolvency phase:

During this phase, there are several indicators that may lead to the institution's failure in future periods:

- The institution's excessive reliance on loans;
- The deterioration of the enterprise's current asset position;
- Negative indicators of an enterprise's financial performance using financial ratios;
- Gradually decrease the Foundation's profits for consecutive periods;
- The institution's lack of competitiveness.

2.4.5 Bankruptcy Declaration Stage:

This is the final stage through which the Foundation is unable to meet its debts to its lenders, forcing some of them to waive their investments and undertake every legal action to protect their rights. This situation results in the bankruptcy of the Foundation and liquidation.

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Generally speaking, the financial failures of an enterprise can be represented by the following format:

Figure No. (2) Financial failures of the Foundation



Source: <https://www.toptal.com/finance/turnaround-consultants/financial-distress>, Website visited on: 12-08 -2024 at 20:17

We therefore conclude that the Foundation's financial failure starts from its financial stalling phase, which marks the beginning of the financial downturn with a slight deviation, which explains minimal and stalled cash flows. and then the transition to a liquidity risk phase, which shows us a stronger financial downturn than the previous one, which explains a greater stumbling block in cash flows and even an increase in the size of the enterprise's obligations to its creditors, At the financial hardship stage, we note a strong decline that is difficult to control, resulting in a liquidity crisis and increased commitments that lead to financial failure and subsequent bankruptcy and liquidation.

2.5. The importance of predicting the financial failure of the institution:

The importance of predicting financial failure stems from many stakeholders' interest in them. It is important for the following (Abadi & Riad Mezher Abdullah, 2022):

- Investors:** They are most interested in predicting the financial performance of an enterprise and the subject of financial failure, in order to make different investment decisions and avoid hazardous ones, and to trade among available alternatives.
- Creditors or lenders:** In order to assess the success of the financial institutions they lend in order to ensure that their donated funds are properly recovered or are expected to be awarded.
- Management:** Management is concerned with the subject of predicting financial failure in order to make decisions and corrective actions to save the institution in a timely manner.
- **Government agencies:** Government agencies represented by their public administrations are concerned with the subject of financial failure in order to help them perform their oversight function on economic institutions and ensure their safety.
- **External auditors:** The interest of external auditors stems mainly from the fact that they have great responsibility for auditing the financial statements of those financial institutions.

It should also be noted that a range of requirements are required in the audited financial statements and statements in order to effectively predict financial failure. The most important of these conditions are:

The audited financial statements and statements should be comprehensive and objective;

- The external auditor must take into account the institution's internal circumstances to establish realistic assumptions on which to base its future expectations;
- The auditor must select effective models and methods that take into account important and influential variables on the enterprise's activity as fundamental variables in the forecasting process;
- The forecast period should be short, so that the shorter this period, the more accurate the forecast process.

2.6. Models used to predict financial failure:

In conjunction with some major financial crises in 1960, researchers have increasingly focused on the audit aspect about the financial breakdown of enterprises that threatens their sustainability, especially since it is incumbent on the external auditor to verify the extent to which the enterprise applies the principle of continuity, and therefore it is necessary to use various financial ratios (liquidity, indebtedness, profitability,... related to this aspect, which is one of the most important sources of financial failure prediction equations.

It should also be noted that there are qualitative models for predicting an enterprise's financial failure that will be addressed after the presentation of quantitative models, In addition to the above, there are several financial failure measurement models developed by researchers based on their studies on the Foundation's performance and financial position. These studies are limited to the table below:

Table No. (1) Most important quantitative models used to measure an enterprise's financial failure

Researcher	Year of Research	Researcher	Year of Research
MEYER & PIFER	1970	FUIMER	1984
WILCOX	1971	ZMIJEWSKI	1984
LEV	1971	SHERROD	1987
DEAMIN	1972	KOH	1990
BLUM	1974	HART	1992
LIBBY	1975	PAZ	1992
SINKEY	1975	EDWARDS	1993
ARGENTI	1976	LEE & HAN KWON	1996
MOYER	1977	WARD & FOSTER	1997
TAFFLER & TISSHOW	1977	LENNOX	1999
OHLSON	1980	DIMITRAS SLOWINSKI & SUSMAGA ZOPOUNIDIS	1999
VEAZY	1981	PATTERSON	2001
TAFFLER	1982	SHUMWAY	2001
BOOTH	1983	ANANDARAJA AND LEE	2004

Source: Prepared by the researcher based on

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Radwan Amar, Hussein Al-Kaysari, Comparative Study of Financial Failure Prediction Models, Tashtrien University Journal of Research and Scientific Studies, vol. 05, No. 05 Syria, 2015, p. 135.

3. Applied aspect: Using financial failure prediction models to assess the true financial position of an enterprise

In this part of the study, we used only the models of Altman, Kida and Sherrod and their application to the Foundation of Pharma HIKMA of Algeria.

3.1. Using Altman Model 1977 to predict the financial failure of the Foundation of Pharma HIKMA:

One of the most important models in this area, which distinguishes this model from its predecessor (Altman 1965) is the replacement of the market value of an enterprise's shares with their book values, and its computational formula is the following:

$$Z = 0.717 X_1 + 0.847 X_2 + 3.107 X_3 + 0.420 X_4 + 0.998 X_5$$

The institution's financial position is classified based on the value of the z received.

- $Z \geq 2.9$: The Foundation's financial situation continues and its financial situation is stable and unsuccessful;
- $Z \leq 1.21$: The institution in question is exposed to financial failure;
- $2.9 \geq Z \geq 1.21$: The Foundation is within the grey zone, i.e. its current financial position cannot be judged.

By applying this form to the Pharma HIKMA Foundation for the period 2017-2022, we have obtained the results shown in the table below:

Table No. (2) Value of Z by ALTMAN Model for the Pharma HIKMA Foundation 2017-2022

Unit: thousands of dinars

Statement	2017	2018	2019	2020	2021	2022
Working Capital	7.660.194	5.469.895	3.570.478	2.380.583	2.096.360	2.462.504
Retained profits	9.124	9.124	9.124	89.873	48.239	225.079
Total debt	11.028.622	14.745.631	15.565.773	18.198.037	17.521.248	19.177.084
Inventory value of shareholders' rights	9.018.613	8.802.728	7.300.695	7.750.058	7.647.523	8.772.917
Pre-tax profit	1.175.221+	863.470+	1.172.074-	944.307+	1.263.451+	+1.890.449
Sales	14.052.356	13.883.080	10.047.078	14.658.503	18.163.367	19.285.430
Total liabilities	20.047.236	23.548.360	22.866.468	25.948.096	25.168.771	27.950.001
Total Assets	20.047.236	23.548.360	22.866.468	25.948.096	25.168.771	27.950.001
X1	0.4	0.19	0.2	0.08	0.1	0.09
X2	0.001	0.0004	0.0003	0.01	0.07	0.02
X3	0.1	0.1	-0.03	0.05	0.1	0.1
X4	0.82	0.7	0.5	0.5	0.6	0.4
X5	0.7	0.7	0.4	0.8	0.8	0.8
Z indicator value	1.5	1.14	0.55	1.23	1.51	1.45

In depth, we analyzed the financial situation of the organization and its rise in conjunction with the decline in the enterprise's earnings before interest and taxes (operational result) may lead to suspicion and high probability of the institution's inability to meet its long-term obligations which may lead to bankruptcy, as this ratio is calculated according to the following formula:

$$\text{Ratio of long-term debt to total capital} = \text{long-term debt} / \text{total capital}.$$

Where:

$$\text{Capital} = \text{long-term assets} + \text{working capital}$$

The following are also:

$$\text{Working capital} = \text{current assets} - \text{current liabilities}.$$

For further clarification, we calculated these values by applying to the institution under consideration according to the following table:

Table No. (3): Calculation of the ratio of long-term debt to the total capital of a wise institution for 2017 to 2022

Amounts: thousands of dinars

Years / Statement	2017	2018	2019	2020	2021	2022
Working Capital	7.660.194	5.469.895	3.570.478	2.380.583	2.096.360	2.462.504
Institutional Invested Capital	9.250.855	10.972.326	9.873.770	9.891.535	9.750.212	12.102.297
Long-term debt	232.241	2.169.597	2.573.075	2.141.476	2.102.689	3.329.380
Ratio of long-term debt to total capital	%2,51	%19,77	%26,05	%21,65	%21,56	%27,51
Difference Ratio	-	%17+	%6,28+	%4,4 -	%0,09 -	%5,95+
Foundation's Result before Interest and Taxes Paid	1.175.221+	863.470+	1.172.074 -	944.307+	1.263.451+	+1.890.449

Source: Prepared by the researcher based on the Foundation's financial statements for 2017-2022

From the table above, we note that during 2018 and 2019, according to the applicable ALTMAN model, the Foundation was at risk of financial failure. The Z values were in this period, respectively: **1.5, 1.14, 0.55** values below **1.21** In order to verify the realities of this situation, we have conducted comparisons and analyses between some financial balance ratios and some other financial ratios, where we have concluded:

- In comparison (the ratio of long-term debt to total enterprise capital) with the values of operational results for the years of the study, we find that there is a high likelihood of the institution experiencing financial distress and distress for **2018** and **2019**, This is due to the decrease of the operational result for **2018**, reaching **+863.470.000 DZD** after the year 2017 was worth **+ 1.175.221.000 DZD**;
- The increase in the ratio of long-term debt to the Foundation's total capital in **2018**, at a rate of **19.77%**;

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- The Foundation recorded a negative operational result of **1.172.074.000 DZD** in 2019, a significant decrease from the previous year's + **863.470.000 DZD**;
- High ratio of long-term debt to total capital in **2019** at a rate of **26.05%**;

Only for the last years (**2020, 2021 and 2022**), Z values have risen, exceeding 1.21, the same period as the Foundation's operational results, which precludes the risk of financial distress or hardship during this period.

3.2. Using the KIDA model to predict the financial failure of the Foundation of Pharma Governance Algeria:

The five independent variables of the **KIDA 1980** model are:

- **X1** = Net profit/total assets.
- **X2** = Total shareholders' equity/total liabilities.
- **X3** = Current assets/current liabilities.
- **X4** = Net sales/total assets.
- **X5** = cash/total assets; The equation of this model is also as follows:

$$Z = 1.042 X1 + 0.42 X2 - 0.461 X3 - 0.463 X4 + 0.271 X5$$

The financial position of the Foundation is classified on the basis of the value of Z obtained. If the latter is positive, this means that the institution is in a state of financial stability and is in a position of financial failure. If the value of Z is negative, the institution is threatened by financial failure. Applying to the Foundation of Pharma Algeria, we receive the results shown in the following table:

Table No. (4) Z Value by KIDA Model for the Pharma HIKMA Foundation 2017-2022 (by DA)

Statement	2017	2018	2019	2020	2021	2022
Net Profit	45.620	215.885-	-1.502.033	449.363	241.195	1.125.393
Shareholders' rights	9.018.613	8.802.728	7.300.695	7.750.058	7.647.523	8.772.917
Sales	14.052.356	13.883.080	10.047.078	14.658.503	18.163.367	19.285.430
Cash	13.567.480	13.887.914	11.699.969	11.847.736	11.724.709	11.704.748
Current liabilities	11.028.622	14.745.631	15.565.773	18.198.037	17.521.248	19.177.084
Current Assets	18.456.575	18.045.929	16.563.176	18.437.144	17.514.919	18.310.208
Total debt	11.028.622	14.745.631	15.565.773	18.198.037	17.521.248	19.177.084
Total Assets	20.047.236	23.548.360	22.866.468	25.948.096	25.168.771	27.950.001
X1	0.002	-0.009	-0.07	0.02	0.01	0.04
X2	0.5	0.37	0.32	0.3	0.3	0.3
X3	1.7	1.2	1.06	1.01	0.99	0.95
X4	0.7	0.6	0.4	0.6	0.7	0.7
X5	0.7	0.6	0.5	0.5	0.5	0.4
Index Value Z	-0.7	-0.7	-0.5	-0.5	-0.5	-0.5

Source: From the researcher's preparation based on the financial statements of Hikma Foundation for 2017-2022

We note from the table above that for every year of study 2017-2022, Z values were negative, i.e., according to the applicable model, the institution is threatened by financial failure. However, the analysis and comparison of the various ratios and financial statements validated this situation for 2018 and 2019 only, while the rest of the study years saw a trend towards financial stability where the values of the Foundation's operational results gradually increased.

3.3. Using the SHERROD model to predict the financial failure of the Foundation of Pharma HIKMA Algeria:

The six independent variables of the SHERROD model are (messai, khaldi, & ben loulou, 2021):

- $X1 = W.C/ASS$
- $X2 = C.ASS/ASS$.
- $X3 = S.E/ASS$
- $X4 = N.P/ASS$.
- $X5 = ASS/LBS$.
- $X6 = E/F.ASS$.

The equation of this model is also as follows (hanane rezak, 2020):

$$Z = 17 X1 + 9 X2 + 3.5 X3 + 20 X4 + 1.5 X5 + 0.1 X6$$

The financial position of the organization is classified as follows:

- $Z > 25$ = Foundation is free from the risk of financial failure;
- $25 > Z > 20$ = The enterprise's risk of financial failure is low;
- $20 > Z > 05$ = Difficulty predicting the risks of financial failure;
- $05 > Z > - 05$ = The Foundation is at risk of financial failure;
- $Z > - 05$ = Strong risk of financial failure.

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Table No. (5) Value of Z by SHERROD Model of the Pharma HIKMA Foundation 2017-2022

Statement	2017	2018	2019	2020	2021	2022
Working Capital	7.660.194	5.469.895	3.570.478	2.380.583	2.096.360	2.462.504
Shareholders' Rights	9.018.613	8.802.728	7.300.695	7.750.058	7.647.523	8.772.917
Pre-tax profit	1.175.221+	863.470+	1.172.074 -	944.307+	1.263.451+	+1.890.449
Fixed Assets	1.590.661	5.502.431	6.303.292	7.510.952	7.653.852	9.639.793
Cash assets	13.567.480	13.887.914	11.699.969	11.847.736	11.724.709	11.704.748
Total Assets	20.047.236	23.548.360	22.866.468	25.948.096	25.168.771	27.950.001
Total liabilities	20.047.236	23.548.360	22.866.468	25.948.096	25.168.771	27.950.001
X1	0.4	0.19	0.18	0.09	0.1	0.08
X2	0.7	0.6	0.5	0.5	0.5	0.4
X3	0.5	0.37	0.32	0.3	0.3	0.3
X4	0.1	0.1	-0.04	0.04	0.1	0.1
X5	1	1	1	1	1	1
X6	5.7	1.6	1.16	1.03	0.99	0.91
INDIC.V (Z)	18.92	13.75	9.63	9.65	10.85	9.94

Source: Prepared by the Researcher based on Hikma Pharma Foundation's Financial Statements 2017-2022

According to the **ALTMAN** model applied to it, during **2018 and 2019**, the Foundation is exposed to financial failure, which is consistent with its financial situation. **(Ratio of long-term debt to total enterprise capital)** and its operational results for the years of study where we found that there is a high likelihood of financial distress and distress for 2018 and 2019.

This is due to a decrease in the operational result for **2018** and the same high long-term debt ratio to the total capital of the Foundation for **2018 and 2019** at successive rates of **19, 77% and 26.05%**, while **Z** value has exceeded for the rest of the years **(2020, 2021 and 2022)** is worth **1.21** and is the same period in which the values of the Foundation's operational results have risen, which precludes the likelihood of the latter experiencing any financial distress or hardship.

This is relatively consistent with the Sherrod model, the results of which were not reflected in the risk of financial failure during this period. This supports the quality of the **Altman & Sherrod** models in determining the financial status and position of the enterprise.

4. Conclusion:

The Foundation's continued activity and competitiveness in a precarious environment is the focus of all accounting and auditing practitioners, as well as the various users and stakeholders of the institution's financial statements; This is to assess their real financial situation. Accordingly, attention has increased to the need to find objective analytical methods that allow for the early detection of any unusual imbalances in an enterprise's financial accounts and the development of models that allow prediction of their viability in activity as well as the anticipation of early financial failures that an enterprise may experience from the stage of financial decline.

In conclusion to this study, some of Altman, Kida and Sherrod's financial failure prediction models have been applied to the institution under study, which is the most efficient in analysing the need for the financial position of the institution and predicting the extent to which it can continue to be active. Through the results of the analytical examination, researchers have found the following:

- ✓ The quality of both the Sherrod and Altman models in their accurate assessment of the Foundation's real financial situation based on comparisons between the results of these models and the various liquidity and financial balance ratios, which justifies the validity of the first and second hypotheses;
- ✓ The efficiency and ability of both Sherrod and Altman models to spare the auditor from potential detection risks by giving him a very rough picture of the real financial situation of the institution under examination to verify the truthfulness and fairness of their financial lists and their genuine representation of their real financial position.
- ✓ Kida's approach focuses on only two aspects (classification of enterprises according to positive and negative values) without the use of accurate accounting of the financial position of the enterprise, which means that this model does not focus on the multiple stages of financial failure experienced by the institution, which negates the validity of the third hypothesis.

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