

# Measuring the Quality of Profits: Evidence from Banks Listed in the Iraq Stock Market

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## ABSTRACT

The aims of study to measure the quality of profits for a number of private banks and the number (10) banks listed in the Iraq stock market for the period from (2010-2018) using the scale of the quality of receivables, which consist of ordinary receivables and extraordinary receivables. The study relied on two main hypotheses and the research found that the banks that achieved the quality of profits during the years of research are (Al-kaleej, Elaph, Al-estethmaar, Ashur) As for the banks that were the lowest quality of profits, they are (Al-tegara, Al-etemaan, Mansour, Al-Ahli, Baghdad, Middle East), so the research made a recommendation to private banks with low profit quality to pay attention to the continuous analysis of ordinary and extraordinary receivables to address deficiencies and weaknesses and take into account the quality of profits because this is reflected in the decisions of investors and users of financial statements.

**Keywords:** Quality of receivables, Quality of earnings, Quality of ordinary receivables, Quality of extraordinary receivables, Quality of earnings matrix

## Introduction

The informational content of profits is one of the most important items contained in the published financial statements as financial indicators on the basis of which many decisions are taken by the relevant parties, management uses profit to determine rewards or expansion of activity or contraction and creditors enable them to the company's ability to meet its obligations towards them, and the quality of profits is defined as the ability of investors to predict extraordinary operating profits based on financial information [1]. Receivables can be used as an indicator that reflects the quality of profits in companies, where the low level of receivables indicates an increase in the accuracy of judgments and estimates and thus an increase in the level of quality of profits, while profits accompanied by an increase in receivables indicate a low level of accuracy of judgments and estimates and thus a low accuracy in calculating profits, which leads to a decrease in the quality of profits, and this low quality leads to weak future returns, as the quality of profits indicates the ability of profits disclosed in the company's real profit statement and predicting future profits [2]. In this context, the importance of the

quality of profits was emphasized as an indicator for the parties using the financial statements and enhancing the confidence of these parties in the published information, so this research came to focus on the measure of the quality of receivables and their components, ordinary receivables and extraordinary receivables in distinguishing between banks with high profit quality and banks with low profit quality.

## Literature Review

### The concept of profit quality

Profit quality refers to declared profits and is considered more quality when it approaches the company's long-term value [3]. High-quality profits provide more information about the features of the company's financial performance related to a specific decision taken by a specific decision-maker [4]. The quality of profits is an important part of the financial analysis process, high-quality profits help beneficiaries to make rational investment decisions [5]. Users of financial statements can use profits as financial

indicators to infer the company's current reality, evaluate past performance and predict it in the future [6]. It is the degree to which it reflects the profits achieved from the actual cash flows of the company. The profitability ratio represents the area of interest of investors, management and lenders, investors are looking for profitable opportunities to direct their money to them and management can verify the success of their operational policies, while lenders feel safe when lending their money to companies that make profits and are able to pay their obligations and debts [7, 8, 9]. The concept of profit quality can also be achieved through the ability of current profits to continue for future periods, and the more profits enjoy continuity, this indicates a high level of profit quality [10, 11, 12], and the quality of profits helps investors to distinguish between good and bad investments, which in turn reduce the risk of estimation and thus reduce the cost of capital and equity [9]. Therefore, the quality of profits is defined as the ability of investors to predict extraordinary operating profits based on financial information [1]. As the quality of profits indicates the ability of profits disclosed in the company's real profit statement and forecasting future profits [2]. The role played by the quality of profits in the decision model is related to (quality, size of receivables, perseverance, predictability, timeliness, business environment, and financial reporting model) [13, 14]. Many researchers have divided the factors that affect the quality of profits into two types, the first is the inherent or inherent features such as (management decisions, audit, organization and standards, information systems). The second type is the factors that reflect the financial reporting process such as operational risks and operating environment [15], and the advantages of the quality of profits understand the reality of the financial integrity of the company as high-quality companies enjoy high transparency in terms of ethical culture and clear disclosure and reflect good financial statements in economic reality and therefore Reflection in earnings and higher stock prices and the ability of earnings to predict future cash flows, and profits are characterized by quality when the level of extraordinary maturities decreases [16], one of the activities affecting the quality of profits is operational activities and making some administrative decisions such as increasing sales or providing credit facilities to customers such as granting discounts on sales and thus influencing the increase in profits and influencing financial statements during the period and other activities that affect the quality of profits are investment activities such as repurchasing shares from the management to reduce the number of shares and increase profitability during a specific period of time and the importance of the quality of profits appears in the impact on reducing the risk of asymmetry of information and cash retention Where studies have shown that companies that suffer from

poor quality of profits have problems in the asymmetry of information between internal and external parties [17], and in studies that have proven a relationship between the quality of profits and dividends, the higher the quality of profits, the likelihood of the company paying dividends increases and the amount of those distributions increases with the quality of profits [18], there is also a positive relationship between the quality of profits and stock returns through increasing the degree of liquidity in the company [19]. The quality of profits is derived from (characteristics of the time series of profits, relationships between cash, accruals and income, execution decision) and many studies have shown the importance of the quality of profits for information users if financial reports and profits in particular constitute an important source of information and affect investment decisions [20].

### Profit quality measures

- Measures based on accounting basis such as (quality of receivables, continuity of profits, predictability capacity, income preparation)
- Market-based metrics such as (appropriateness of value, timeliness, accounting conservatism) [21]

#### Accounting standards

##### Quality of receivables

Measure the quality of receivables; it is done according to the following model:

$$TCA_{i,t} / Asset_{i,t} = a0 + a1 (CFO_{i,t-1} / Asset_{i,t}) + a2(CFO_{i,t} / Asset_{i,t}) + a3 (CFO_{i,t+1} / Asset_{i,t}) + V_{i,t}$$

Whereas:-

$TCA_{i,t}$  / Total current receivables of the company (i) in the period (t) calculated on the basis of (changes in current assets - changes in current liabilities - changes in cash + changes in debt)

$Asset_{i,t}$  / Average total assets of the company (i) in the period (t), (t-1)

$CFO_{i,t}$  / cash flows from operations of the company (i) in the period (t) calculated on the basis of net profit before extraordinary items minus total accruals which are found by (changes in current assets - changes in current liabilities - cash changes + changes in debt + depreciation expense)

$V_{i,t}$ / Residual Regression

##### Continuity of profits

Profits are of high quality when they are sustainable, meaning that the level of stability in profits is a guide to their sustainability and can be used as a predictor of the future performance of the company and is a good predictive performance for investment and this is done through quantitative measurement using the method of simple linear regression analysis has been used [22] by

estimating the regression coefficient B1 through the following model: -

$$X_{i,t}/A_{i,t-1} = B0_{i,t} + B1_{i,t}X_{i,t-1} + E_{i,t}$$

As:

$X_{i,t}$ / Per share of income for period t

$A_{i,T-1}$  / Total assets of the company for year T

$X_{i,t-1}$ / Income per share for the period T-1

$E_{i,t}$ / represents the firm's antagonistic error

The (B) is relied upon, that is, the closer you are to [1], the more continuous ( $X_i$ ) is, and the closer you are to zero, the less continuous [15].

#### *Predictability of profits*

Based on the profit continuity model, the formula for the ability to predict profits is derived as follows:

$$Prid_j = \frac{1}{\sqrt{\sigma^2(v_j.t)}}$$

$Prid_j$  = Ability to predict company profits (j) during year (t)

$\sqrt{\sigma^2(v_j.t)}$  = The square root of the variance of the company's estimation error (j) during the year (t), as the increase in the value of the square means a decrease in the ability to predict profits, and this means a decrease in the level of profit quality.

#### *Preamble income*

Income boot is measured by the standard deviation of net profit before extraordinary items to the standard deviation of operating cash flows [22].

$$Smooth_{i,t} = \sigma(Earn_{i,t}/TA_{i,t-1}) / \sigma(CFO_{i,t}/TA_{i,t-1})$$

According to the following equation:-

Whereas: -

$Smi_{i,t}$  / refers to the level of profit of the company (i) during the period (t) and the higher the percentage than the correct one

This is an indication of a low level of profit quality.

$\sigma(Earn_{i,t}/TA_{i,t-1})$  / refers to the standard deviation of return relative to the total assets of the company (i) during the period (t)

$\sigma(CFO_{i,t}/TA_{i,t-1})$  / Indicates the standard deviation of net operating cash flows relative to total assets of the company (i) during the period (t)

#### *Market-based metrics*

##### *Value appropriateness*

The measure of value appropriateness is the most common and best among the market measures of the quality of profits [22], as the appropriateness of value is measured as a contemporary relationship between stock prices, profits and book value of shares, as the appropriateness of value is based on the explanatory power ( $R^2$ ) of the regression equation, which is based on the level of returns and change in profits according to the following equation:

$$RET_{j,t} = \delta 0_{j,t} + \delta 1_{j,t}EARN_{j,t} + \delta 2_{j,t}\Delta EARN_{j,t} + \varepsilon_{j,t}$$

$RET_{j,t}$  = Corporate Return (j) for Period (t)

t, EARN j = Company income before year-end extraordinary items (t)

$EARN_{j,t}\Delta$  = Change in Company Income Year-end (t)

#### *The right timing*

The source of building this measure is the stock return, and it is embodied in the appropriate time as an ability to achieve profits in contrast to good news and bad profits, as the appropriate time is a measure of the quality of profits, and the measurement is made using the following equation:- [19]

$$EARN_{j,t} = \alpha 0_{j,t} + \alpha 1_{j,t}NEG_{j,t} + \beta 1_{j,t}RET_{j,t} + \beta 2_{j,t}NEG_{j,t}RET_{j,t} + \varepsilon_{j,t}$$

$EARN_{j,t}$  = net income before extraordinary items of company (j) in year (t)

$NEG_{j,t}$  = a dummy variable that gives a value of [1] if the return value is zero

$RET_{j,t}$  = the return of the company (j) during the year (t)

#### *Accounting reservation*

The practice of accounting conservatism achieves the high quality of profits, and the indicator records the degree that applies accounting conservatism [12]. Conservatism is measured by the (C-score) indicator through the following equation:

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

whereas:-

Cit = reservation index

$ER_{it}$  = Estimated reserves of the firm for the period (t)

$NOA_{it}$  = net operating assets (book value of operating assets minus operating liabilities)

## **Method and Research Hypotheses**

1. The research relied on measuring the quality of earnings on the use of the receivables quality scale method, which is one of the accounting methods among the many accounting and market methods for measuring the quality of profits that the research addressed.

2. Limits, research community and research sample

- The spatial limits of the search / the scope of the search in relation to the spatial limits includes the Iraqi private banks listed in the Iraq Stock Exchange

- The temporal limits of the research/ represented by the lists and financial reports of the Iraqi banks, the research sample issued by the Securities Commission of the Iraq Stock Exchange for the period (2010-2018)

- The research community and the research sample

The research community is represented by the banking sector, and the research sample was the Iraqi private banks, as it was a deliberate sample consisting of [10]

banks that were chosen because of the availability of the required financial information and the availability of their data, as well as because they are listed in the Iraq Stock Exchange and have a long period of time in the field of work and thus the possibility of relying on reports published for many years.

### Analyze the Results

The quality of the profits of the research sample banks listed in the stock market in this research was measured by the quality of receivables

**Table 1.** The regular dues of the banks of the research sample for the period (2010-2018)

Ashoor	Baghdad	Alastethmar	Alahly	Almansor	Ielaaf	Altegary	Alkaleeg	Alsharq alawsath	Aletman	Banks Years
31.197	-49.180	13.886	-14.446	-59.507	130.010	-197.783	62.419	-146.203	-69.547	2010
72.278	-41.648	18.145	-26.561	-55.056	41.752	305.923	64.546	16.342	-221.016	2011
100.133	-5.385	26.241	-44.43	-799	-90.467	-330.768	74.765	13.618	-135.356	2012
110.597	-50.942	26.168	-45.975	5.294	266.526	-318.838	134.116	-19.219	-144.945	2013
109.086	68.262	29.835	-64.856	-165.004	62.404	-232.842	167.366	-94.339	-120.217	2014
100.716	-187.779	25.771	-100.716	16.705	-2.721	-364.761	159.727	-131.410	-189.368	2015
227.460	-42.693	22.131	-30.016	-3.377	249.723	-261.342	108.037	-165.204	-117.154	2016
128.047	-2.380	30.841	-76.144	-109	149.091	-352.601	103.306	-385.348	-157.433	2017
151.573	40.401	25.049	-73.368	85.964	18.626	-282.231	135.394	-160.189	239.974	2018
114.565	-30.150	24.230	-52.944	-19.543	91.660	-294.121	112.186	-119.106	-155.001	Average
54.177	72.437	5.413	27.849	68.984	117.840	55.627	112.186	123.560	53.848	STDEVA

Source / table prepared by the researcher based on the annual reports of the banks

It is noted from Table (1) that the regular receivables of most banks were of a negative value, which means high quality profits and vice versa. Among the banks that

achieved high quality profits are (credit, commercial, and private). As for the banks that did not achieve quality profits, they are ( Gulf, investment, Assyria).

**Table 2 .**The extraordinary receivables of banks, the research sample for the period (2010-2018) in millions of dinars

Ashoor	Baghdad	Alastethmar	Alahly	Almansor	Ielaaf	Altegary	Alkaleeg	Alsharq alawsath	Aletman	Banks Years
-60.992	90.240	35.732	27.851	137.332	-195.390	181.536	-77.399	164.470	250.984	2010
-106.261	65.015	45.954	43.238	112.416	-77.860	283.452	-4.866	34.537	82.199	2011
5.170	53.084	-25.186	22.663	38.107	-107.939	338.325	-67.226	55.797	264.044	2012
-180.301	262.666	58.070	136.128	257.760	-189.266	302.148	-51.461	-14.685	177.287	2013
-127.771	49.704	-86.468	103.644	476.143	-200.998	402.044	-92.817	78.647	139.155	2014
-129.451	-409.208	-52.880	116.035	132.287	-115.320	288.312	-112.785	52.287	-47.868	2015
-261.204	311.705	-32.856	106.190	6.279	-191.964	355.085	-141.089	191.296	267.188	2016
-123.692	-326.606	-23.198	-20.859	201.297	-284.793	388.443	-226.279	291.733	142.970	2017
-157.215	111.890	-33.555	263	-1.734335	-131.627	219.430	-272.344	212.659	7.385	2018
-126.857	23.166	-12.710	59.461	-41.413	-166.128	306.531	-116.252	118.527	142.594	Average
74.194	241.253	48.680	56.774	649.677	63.547	73.565	85.269	100.611	112.607	STDEVA

Source / table prepared by the researcher based on the annual reports of the banks

Table 2 shows the extraordinary receivables, which are a good indicator for measuring the quality of profits, as negative values indicate a high quality of profits. Through the table, the banks that achieved quality profits are (AL-kaleeg, Elaf, ALethmaan, Assyria) during the years of research, or less The quality of profits, they are both (Iraqi Commercial, altheqa, Al-

Mansour, Al-Ahly) and the most profitable banks can be expressed through the profit quality matrix based on Table 2, which reflects the extraordinary receivables, as the banks with the quality of profits are indicated by the number (1). Banks that do not enjoy the quality of profits with the number (0) and as shown in Table 3.

**Table 3.**The profit quality matrix of the research sample banks for the period (2010-2018)

Ashoor	Baghdad	Alastethmar	Alahly	Almansor	Ielaaf	Altegary	Alkaleeg	Alsharq alawsath	Aletman	Banks Years
1	0	0	0	0	1	0	1	0	0	2010
1	0	0	0	0	1	0	1	0	0	2011
0	0	1	0	0	1	0	1	0	0	2012
1	0	0	0	0	1	0	1	0	1	2013
1	1	0	0	0	1	0	1	0	0	2014
1	0	1	0	0	1	0	1	0	0	2015
1	0	1	0	0	1	0	1	0	0	2016
1	1	1	1	0	1	0	1	1	0	2017
1	0	1	0	1	1	0	1	1	0	2018

Source / table prepared by the researcher based on the annual reports of the banks

## Conclusion

The results of the research showed the presence of informational content of the quality of the profits, thus enabling users to use the financial statements and make rational decisions. Their financial statements and that 60% of these banks have low profit quality, as well as the existence of a discrepancy in profits from one year to another, so the need to follow profit quality indicators to improve their profits by the research sample banks, and the need to conduct training courses by the stock market to demonstrate the importance of the accuracy and reliability of the profit number disclosed in The financial statements in order to be used in measuring the quality of profits and thus reflected in the financial decisions of the stakeholders.

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