The Impact of Free Cash Flows on Financial Performance of a Sample of the Banks Listed in Iraqi Stock Exchange

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Abstract— *The purpose of this study is to demonstrate the concept of free cash flows and the concept of financial performance, and the impact of free cash flows on financial performance for a sample of banks listed on the Iraq Stock Exchange. The study sample consisted of 13 banks "listed" in the Iraq Stock Exchange from 2007 to 2019. Lehn et al. (1993) and Jutami et al. (2011) are used to measure free cash flows. In addition. financial performance is measured through Return on Assets Ratio, Return on Equity Ratio, and Tobin's Q scale. This study concluded: Free cash flows have a statistically negative effect on financial performance. The researcher also recommends that boards of directors form committees to monitor and assess the commitment to achieving the inefficient investment fields of free cash flow investment strategies.*

Keywords— *Free cash Flows, financial performance.*

I. INTRODUCTION

The free cash flow theory indicates that companies that achieve high cash flows can face a difference in objectives between shareholders and managers; shareholders ask managers to invest in projects that increase their shares and maximize their wealth. However, managers can invest in projects that achieve their benefits, although that investment is made in projects that achieve negative net current value, creating not all investments. The financial performance of companies is undoubtedly a key pillar for determining the value of companies and their share prices in the financial market. So, the efficiency of company managers in making their decisions, including investment decisions in projects of positive net value, can contribute to this and enhance the financial performance of companies. The misuse of free cash flows can have a negative impact on the financial performance of companies and the valuation of their shares in the financial market.

Problem Description

The preliminary review of the research sample banks reveals a weak interest in the concept of free cash flows and their measurement in the local environment. Free cash flow is essential in reporting how money is disposed of and the banks' investment efficiency. Weak interest in the concept of free cash flows negatively affects the stock prices of these banks and their financial performance. It results in the incorrect evaluation of shares in the financial market and the failure to allocate financial resources and direct them towards sound investment fields. From the above, the research problem can be formulated through the following question:
What is the impact of free cash flows on the financial performance of the research sample banks?

II. LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

A-The concept of free cash flows and their types

Jensen was the first to refer to the concept of free cash flows in the context of its introduction of the agency's problem in 1986, reflecting the additional or remaining cash flows required by future projects to achieve a positive current net value. Although it dealt with the theory of free flow, it did not refer to a specific mechanism to measure it, and since then, this concept has received attention. Researchers, analysts, and users of financial reports have appeared in accounting literature under various terms, for example, surplus CashFlow, Cash Flow, Distributable, and Disposable Cash Flow. There was no agreement among researchers on a unified concept of free cash flow for their differing views based on the angle from which (Hyunghaa, 2011:8) is seen., so free cash flow theory assumes that when units achieve large free cash flows and do not have profitable investment projects, this may lead managers to abuse FCF and exploit the power they possess in the direction of their benefits or investment to increase the resources under their control, creating the problem of overinvestment and widening the agency's problem and conflicts of interest between managers and shareholders (Mostaghimi et al. 2014:1) Free cash flow reflects cash acquisition outside of those used to maintain assets or finance new investments and represents overinvestment by managers seeking to avoid exposure to a face, which leads them to hesitate to pay dividends or external financing through indebtedness, which may lead to overinvestment, even if they are in projects with a negative and useless net current value of the company and will have a negative impact on its profitability and value in the financial market. (Kadioglu & Yilmaz, 2017:1) which justifies (Wang's 2010:409) view, finds that it represents inactive cash flows because they are considered financial resources allocated at the discretion of the administration. (Putri et al., 2006:5) see, the increasing free cash flow strategy can reduce the conflict and problems of the agency that arise between managers and shareholders. The

increase can be distributed in the form of profits to shareholders, which indicates that managers have put the interest of shareholders as a priority. Free cash flows (FCF) are classified into two types: FCFF, and FCFE free cash flows, as the free cash flows available to the company refer to net operating cash flows after paying all expenses necessary for the company's management and operation and available for distribution to shareholders, payment of obligations and expansion of investment. Fixed assets and working capital (Fahmi & Sulhan, 2020:47), while free cash flows available to ownership refer to net operating, cash flows available for distribution to shareholders, and investment expansion after paying all capital expenditures and requirements necessary to maintain the company's current production capacity (Akinleye. et al., 2018:259) according to the researcher The difficulty of defining a unified concept of free cash flow. However, it can be expressed as representing the cash owned by the company after paying capital expenditures, distributing profits, and paying commitments, and that the efficiency of the administration in using excess cash may contribute to reducing the agency's costs and increasing the company's profits and value in the financial market.

B. The importance of free cash flows

Free cash flows are of great importance to companies and users of financial statements that can be summarized as follows:

1- Free cash flows are of great importance in increasing cash distributions, paying off debts and interest due to creditors or lenders, buying back the company's shares, buying new investments and new assets.(Alnawaiseh,20017:1)

2-Free cash flows allow companies to look for opportunities to increase the value of the stock. (Ghodrati, & Hashemi, 2014:2001)

3-Free cash flows are important applications for shareholders in assessing the financial integrity of the company. (Akumu, 2014:1)

4-Increased free cash flow can reduce the agency's conflict, which arises because of the concerns of both parties (shareholders and managers). (Widyasti & Putri, 2021:275)

5- High free cash flow attracts investors seeking effective opportunities to invest their surplus resources effectively (Akinleye et al., 2018:258)

C. Defining financial performance

Financial performance is a measure of the company's achievement of its objectives and objectives, thereby meeting the needs of stakeholders, especially shareholders. It is defined as "the economic-financial situation of a company at a given time, so it is called financial effectiveness" (Busaule 2011:3); it represents the company's "overall financial health within a certain period." (Bhunia.et al. 2011:269), as well as the company's ability to generate new financial resources from time to time through day-to-day operations according to a certain period to achieve stability and security of the company. (Gatuhu, 2013:4) expressed as the company's ability to manage and control its resources. (Fatihudin 2018:554). It reflects "the product of the financial resources achieved by the company during the fiscal year that serves as a mirror of the

company's activities, the level of production and the extent to which it exploits its resources efficiently and efficiently. To achieve its objectives and maximize its value, (Abdul Hamid & Alazzawi2018:10) find it "the degree to which company's policies and results operations are measured in monetary terms. (Wanyonyi, 2018:3). Argue that is "a presentation of the entire financial situation of the company within a specified period. " Gudo argues that it is "a measure of the company's achievement of its financial objectives guided by relevant financial objectives and standards. (Gautam, 2018:10) others see it as "the ability to use operating and investment options and systems to achieve financial stability. For business (Al_Khero. et al. 2019: 35), while seeing both (Munene et al. 2019:4) represents "the ability to work efficiently, profitably, survive, grow and respond to opportunities and environmental threats, (Eton. et al. 2019:117) they find it reflects a measure of how they used. Commercial Company for its resources to generate revenue" and beyond that others find "as a result of the efforts made by the administration to achieve the company's business objectives" (Mulyono. et al. 2019:59). The importance of evaluating financial performance lies in following up on the implementation of the company's specific objectives as well as measuring this is the success of the company in providing information to various levels and other entities outside the company, and also to detect the defects and weaknesses in the company's activity and conduct a comprehensive analysis of it with the statement of its causes to develop the necessary solutions for it and correct it, and working on reading out in future mistakes to ensure better financial performance.

D. The importance of financial performance

The prevailing view of financial performance in advance was characterized by the fact that it represents the company's ability to collect profits, but today the financial performance has become another concept that takes into account the point of view of the beneficiary of the financial blames and benefits he wants to get from the company, managers aim for well-being and profit, shareholders are looking to invest capital through the company's ability to distribute profits, and employees want to continue working and raise wages When achieving high performance, business partners are looking for the company's continuity and stability and the government considers the financial performance of the company through its ability to pay taxes, credit companies are interested in the ability of the company to pay its obligations on the specified date, and the community looks at the financial performance through the ability of the company to provide opportunities for its members because of the social responsibility these companies bear towards all the children of the community (AbdulHamid & Alazzawi, 2018:10), corporate financial performance has critical implications for countries' economic growth. His study was of great importance to resource providers to make the right investment decisions. On the other hand, poor financial performance can lead to corporate failure and a crisis that negatively impacts economic growth. Financial performance depends on several factors. Some of them are capital adequacy, asset quality, management

efficiency, liquidity, and GDP. Therefore, in order to ensure proper financial performance, companies should focus on factors that are likely to affect profitability (Gautam, 2018:7) and explain financial performance In different terms, such as profitability, efficiency, competition, concentration, productivity, the ability to meet negative challenges and contribute to the stability of the financial system (Amene & Alemu, :292). Many criteria are used to measure it, such as accounting value, market value, social performance, etc. The profitability index is used as an alternative to financial performance. If any company's profit rate is higher and higher, it has good financial performance and vice-versa. (Hoang. et al., 2019:78) Financial performance today has become an issue of common interest as it reflects a state of development. Good financial performance is the prerequisite for companies to achieve sustainability. Human capital is one of the most important management tools that can improve the financial performance of companies (Eton. et al., 2019:118). So, companies need discipline in maintaining good financial performance to continue producing cash flow to finance the company's operations in the short term. (Mulyono et al., 2019:65)

E. Impact of free cash flows on financial performance

Free cash flows show the company's amount of cash after spending the number of costs required to save or expand property and other expenses. Companies show the available cash company after considering the amount spent on development (Eton. et al., 2019:118). Wang (2010) studied the impact of free cash flows on the company's performance in Taiwan. The study found that free cash flows had statistically significant effects on the company's financial performance. On the one hand, higher free cash flows lead to higher expenditures, which thus reduced the company's performance. On the other hand, the results indicated that free cash flows created due to the efficiency of managers Operations would contribute to a positive relationship between free cash flows and the company's performance. The positive impact may be due to the increase in investment opportunities for free cash flows, which leads to an increase in the value of the company by increasing its financial performance (Wang,2010:417), as the Study of (Hong. et al. 2012) found evidence that supports Jensen's free cash flow hypothesis (1986) suggests that conflicts of interest between corporate directors and shareholders become more acute in the presence of large cash flows, thus adversely affecting the company's financial performance. Thus, investors and managers should thoroughly analyze free cash flow and avoid useless business due to frequent free cash flow, leading to investment and loss risks. (Hong et al., 2012: 335)

This was confirmed by the khidmat & Rehman (2014) study, where the results showed that free cash flows tended to affect the company's financial performance adversely. (Khidmat & Rehman, 2014:22), on the contrary, other studies have reached results that are not consistent with the above. The study of (Mansourlakoraj & Sepasi, 2015:146) conducted on the Tehran Stock Exchange for five years found that free cash flow has a moral and positive impact on the company,

and the value and performance can be improved by increasing it. Those results were contrary to the agency's theory and agreed with that finding. Fathi & Manian's (2017) findings indicated that free cash flows have a positive and significant relationship to the company's performance and are not consistent with the (Fathi, 2017:5), and Manian hypothesis. Agala (2018) also agreed when it indicated a statistically significant positive relationship between free cash flows and its financial performance. The results showed that the increase in Free cash flows spends more resources on company managers, who then deploy resources to generate more revenue and profits. These results are therefore inconsistent with Jensen's free cash flow hypothesis (1986) (Agala, 2018:108)

This study also indicated that companies with high cash flows tend to manage their profits upwards. Specifically, the independence of audit committees and the quality of external audits, and the company's ownership structure reduced the scope of profit management when free cash flows were available. (Agala, 2018:41-42).

According to a review of the above literature as well as the background provided on free cash flows and financial performance, the research hypothesis can be formulated as a whole:
"Free cash flows have affected the financial performance of the banks in the research sample."

III. RESEARCH METHODOLOGY

A. Statistical Society and Samples

The research community includes (banking sector) which represents private companies listed on the Iraqi Stock Exchange. The researcher used banking sector companies listed on the Iraqi Stock Exchange and for the period (2007-2019). The researcher's choice of this sector lies in its importance as one of the most important sectors that provide Iraq with good national income. Also, it is currently one of the most active sectors in the trading of shares as it is one of the most effective and efficient sectors in trading within the Iraqi stock market compared to the rest of the sectors.

Sampling method

The number of banking companies listed on the Iraqi Stock Exchange is nineteen. The researcher used thirteen banks, which constitutes (68%) of the number of banking companies listed on the market.

B. Variable measurements

Independent variable measurement (free cash flows)

Two measures measure the independent variable of free cash flows:
- Lehn. et al. scale (1993)
Which measures the cash flows available to the property and consists of the following equation:

$$FCF = (OCF - T - IEXP - CDIV - PDIV)/(Sales)$$

They represent:

FCF	flowsfor free cash
OCF	Operating Cash Flow
T	income tax
IEXP	Interest Expense

CDIV   Common Stock Distributions
PDIV   Premium Stock Distributions
Sales   Sales
- Jutami et al. scale. 2011)
Which measures the cash flows available to the company and consists of the following equation:

$$FCF = (NP - \Delta FE - \Delta WC) / (Total\ Assets)$$

They represent:
FCF   Free Cash Flows
N.P.   Net Profit
ΔF.E.   change with fixed assets
ΔW.C.   change with capital
Total assets   total assets
Measuring financial performance:
    Three measures measured the second child variable of the company's financial performance:
- *Asset yield ratio measure*
    It is the most commonly used measure" in accounting literature to measure the company's financial performance and consists of the following equation:

$$ROA = NI / TA$$

They represent:
ROA   return on assets
N.I.   Net Income
TA   Total Assets
- The ratio of return on equity measure consists of the following equation:

$$ROE = NI / Equity$$

They represent:

ROE   return on ownership
N.I.   Net Income
Equity   return for shareholders
- The Tobin's Q scale depends on the market value of corporate shares with the corresponding book values and by the following equation:

$$Q = (MVE + PS + DBET) / TA$$

They represent:
MVE;   the total market value of the company's shares.
P.S.   Cash Value for Premium Shares
DBET   liabilities (short-term+long-term) minus short-term assets
TA;   Total Assets
Measuring the age of the bank
    The bank's age was used as a controlled variable and measured by the number of years from the bank's establishment to the date of the search period.

C. Fitting Research Models

    To provide data appropriately to test hypotheses, the researcher standardized the results of the measures used to measure financial performance in all of them in one composite measure and the two measures of free cash flow in one composite scale. The composite scale is a measure derived from a series of facts that reflect the status of the phenomenon in question, as the composite scale is configured by merging some separate indicators into a single indicator based on a particular model. Hence, the composite scale measures

multidimensional concepts in an ideal way that combines the characteristics and dimensions provided by individual metrics, that cannot be achieved by a single individual scale—using principal component analysis, which converts individual key metric values into standard values to strip them of their different units and convert them into homogeneous and standard values that can then be standardized into a single composite scale.

TABLE 1. Descriptive statistics of search variables

Descriptive Statistics					
	N	Minimum	Maximum	Mean	Std. Deviation
LEV	169	.000	1.112	.54582	.208289
Age	169	16.000	323.000	185.00000	70.370956
Per	169	-2.026	3.408	.00000	1.000000
FCF	169	-3.283	5.137	.00000	1.000000
Valid N	169				

    The most important thing to note from the previous table is that the sample size of all variables is 169 views, which means that there are no abnormal or missing values in the data of all variables.
    We also note the equal value of the average variables, with the average free cash flow and financial performance on the composite scale .00,000, as described in the table above, which is acceptable, with standard values ranging from 3 to 3.
Testing the research hypothesis
To test the hypothesis, the "linear regression" model was formulated:
To test this hypothesis, the "linear regression" model has been formulated:

$$Per_{it} = B_0 + B_1\ FCF_{it} + B_2\ Age_{it} + \varepsilon_{it}$$

Where:-

ε_{it} = Miscalculation errors.
B_0= The regression equation constant, which represents the value of the child variable when the value of the independent variable and the officer is equal to zero.
$B_1\ B_2$= slope used to measure the type and amount of effect
Using the SPSS statistical program, the results were as follows:

TABLE 2. Summary of the hypothesis test model

Model Summary				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.474[a]	.225	.216	.885664
a. Predictors: (Constant), age, FCF				
b. Dependent Variable: Per				

    The table above shows the summary of the model summary that the link(R) value between variables was 0.474. The R Square selection coefficient was 0.225, representing the "interpretive force" of the model used. The independent variable free cash flow and the variable age of the bank explain the value of 22.5% of the variable dependent financial performance and the standard deviation of the std. Error of the

Estimate error was 885,664.0, which is a low number, and the lower this type of error, the better statistically, as reflected in the table (3), a variation test of agency hypothesis:

TABLE 3. HideR variation of a hypothesis

ANOVA[b]						
Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	37.789	2	18.895	24.088	.000[a]
	Residual	130.211	166	.784		
	Total	168.000	168			
a. Predictors: (Constant), age, FCF						
b. Dependent Variable: Per						

The table above shows the ANOVA variation analysis that the calculated F value was 24.088, which is greater than its scheduled value calculated according to the df (166.2) degree of 3.00 at the 5% indication level, and that the Sig test morale level was 0.000, which is 0.000 less than the acceptable error value in social sciences and predetermined by 0.05, This indicates the appropriateness of the statistical model used to test the hypothesis, as well as the table (4) of the regression function coefficients of the second hypothesis as follows:

TABLE 4. Regression function transactions for hypothesis

Coefficients						
Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	1.048	.197		5.310	.000
	FCF	-.178	.070	-.178	-2.531	.012
	Age	-.006	.001	-.398	-5.658	.000
a. Dependent Variable: Per						

Coefficients' regression function coefficients show that the constant value of the regression equation B_0 was 1.048 and that the slope equivalent mile value was B_1 -0.178, which shows the effect of the independent variable on the dependent variable (by factor B), and indicates the negative value of the factor. Thus, there is an B_1 adverse effect between the dependent and independent variables; in other words, that any increase in the independent variable (free cash flows) by one degree leads to a decrease of 17.8% in the dependent variable (financial performance) with the stability of all other independent variables. The following form confirms the reverse relationship between the two variables as the downward trend of the curve refers to that relationship:

Table 4 also indicates that the value of the FCF variable T was -2.531 and at a moral level of 0.012, which is 0.012 less than the acceptable error in social sciences and predetermined by 0.05, which means that the sample data provided convincing evidence of the acceptance of the research hypothesis to prove the statistical effect, which means that "free cash flows have a statistically significant impact on the financial performance of the banks in the search sample."
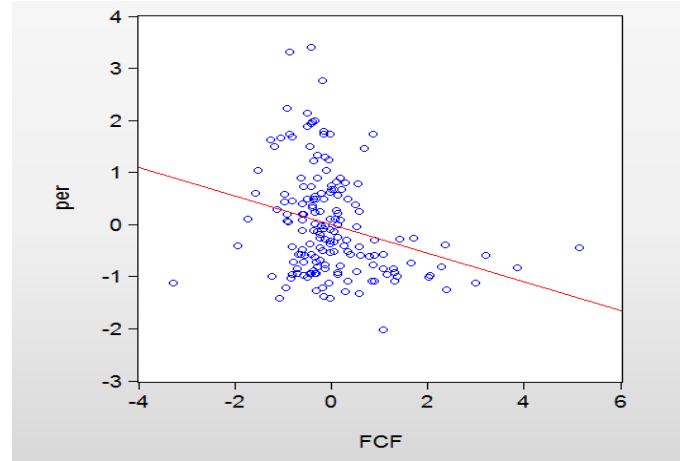

Fig. 1. The relationship between free cash flow and financial performance

The table also shows that the slope equivalent mile value was B_2 0.006 - which shows the effect of the controlled variable on the dependent variable (by coefficient B). The negative value of the factor indicates that there is an adverse effect between the two B_2 variables and that the value of the Age variable was -5.658 and at a moral level of 0.000, which is 0.000 less than the acceptable error level in the social sciences and predetermined by 0.05, which means that its effect was statistically significant.

The regression equation adopted in the hypothesis test can be reformulated in the light of the results that have been reached and which can be used to predict the following form:

$$per = 1.048 - 0.172 * FCF + 0.006 * Age$$

The following form presents the repetitive runway, which shows the natural distribution of the statistical trumpets of the regression equation, which shows the accuracy of the previous regression equation. It shows that the conditions for testing the decline analysis are met graphically by distributing points around the straight line, which proves that the statistical trumpets follow the natural distribution.
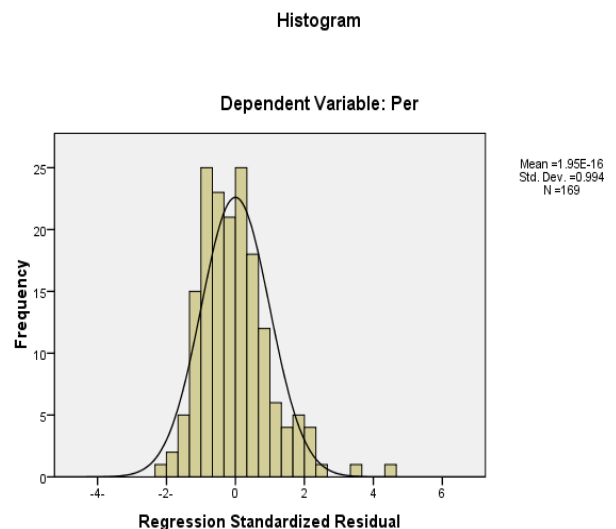

Fig. 2. Repetitive runway and natural distribution of hypothesis condoms

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IV. RESULTS OF HYPOTHESES

The results of the research hypothesis test are consistent with those of Dr. Hong. et al. (2012) and khidmat & Rehman (2014) supported Jensen's free cash flow hypothesis, which indicates that conflicts of interest between corporate directors and shareholders become more acute in the presence of large free cash flows thus adversely affecting the company's financial performance. The results of this research are not consistent with the findings of Fathi (2017) & Manian and the Agala Study (2018), which indicated that free cash flows had a significant correlation with the company's performance and were not consistent with the free cash flow hypothesis.

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