

# Measuring the Earnings Quality in Iraqi Commercial Banks On the Basis Of Net Income and Net Operating Cash Flows



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**Abstract**— The purpose of this study is to determine the influence of the net operating cash flow and net income as an indicator of the earnings quality in Iraqi commercial banks, with a view to testing the influence of net operating cash flow to the earnings quality. In order to realize the purpose of this study, the published financial statements has taken into consideration for (4) banks listed in Iraq Stock Exchange during the period of 2012 – 2015, where the researchers have analyzed the relationship between the net income and the operating cash flow by calculating the operating cash flow index for each bank which indicates how the reported income can continue for future periods regardless the current amount of net income. Hence, the net income does not reflect realistic earnings power of the period without comparing it with the operating cash flow, and for that the users of financial statement have to measure the earnings quality to reveal any influence on the net income and to gauge the ability of reported earnings in generating cash flows, and to know about these earnings are sustainable for future periods or not.

**Keywords**— Earnings quality; operating cash flow; net income

## 1. Introduction

The decisions based on net income vary according to the different kinds of users of the financial statements; while shareholders use the net income as a measure of managers' performance; lenders depend on net income to make credit decisions; the potential investors depend on net income to assess their investments by measuring the productive ability of the current earning for generating sustainable earnings in future periods; Finally the financial analysts classify the net income as an introduction to the decision-making process [2].

However, giving high attention to the net income figure (Bottom line of income statement) by different kinds of users through decision making process does not mean they have taken rational decisions, because using the net income may lead to omission some information included in the accruals items which used in decision-making process and so on affect the results [4].

It is important to know the role of the information included within the accruals items in predicting the sustainability of returns in future periods, as any increase in the returns accompanied by an increase in the accruals items indicate for the low quality of earnings, and this low earnings quality leads to unsustainable returns in the future. Hence, the accruals items can be used to predicate the earnings quality and performance of the companies [4]. Thus, the quality of earnings measured by accruals items is a good indicator for the financial position of the company which not taken into consideration by investors, creditors and other users of financial statements [3].

According to Dechow & Schrand, 2004 in [6], earnings are high-quality if they reflect the current operating earnings of a company and display an adequate indicator of future operating earnings that provide a perfect measure for the company's earnings power.

This study search with the theme of the link between the net operating cash flow and the net income as an indicator of the quality of earning in the Iraqi commercial banks with concentrate on two substantial aspects are, firstly to determine the relationship between the net operation cash flow and net income, secondly to measure the influence of this relationship on the earnings quality of these banks.

## **2. STATEMENT OF THE PROBLEM**

The problem of research is the availability of multiple tools that can be used by the preparers of the financial statements (Negatively or positively), including the using of personal judgments; for example, the proportion of bad debts, the choice of accounting policy and the using of flexibility in accounting standards like delaying recognition of expenses and accelerating recognition of revenues. In contrast, the users of the financial statements do not have the corresponding tools to reveal the level of influence on the net income which enable them to measure the earnings quality.

## **3. THE OBJECTIVE OF THE STUDY**

The objective of this study is to determine the relationship between the net operating cash flow and net income. And to measure the influence of this relationship on the earnings quality of commercial banks listed in Iraqi Stock Exchange to serve as an indicator for different kinds of users of financial statements.

## **4. THE IMPORTANCE OF THE STUDY**

The importance of this study stems from the importance of the net income for different users of financial statements, including investors, creditors and so on.

From the perspective of the investor, low earnings quality is undesirable because they lead to a failed distribution of its resources. And at the level of economic unity, low earnings quality leads to the transformation of economic resources from realistic projects and activities with an effective economic return to projects that are not expected to have an economic return. Also at the national level, the impact of low earnings quality is greater, because misleading numbers of income hinder the economic growth and lead to misallocation of resources and capital.

## 5. HYPOTHESIS OF THE STUDY

The earnings quality affects the decisions of the users of financial statements about the profitability of the company and its sustainability for next years. And because there is a relationship between the net operating cash flow and net income, and this relationship influences the earnings quality of commercial banks listed in the Iraqi Stock Exchange. Hence, the hypothesis of the study states that:-

“Increasing the operating cash flow indicates fewer accruals have been recorded in the financial statements of the commercial banks listed in Iraqi Stock Exchange and more accurate estimates and judgments have been made by the management, consequently the earnings quality will increase, Vice versa”.

## 6. PREVIOUS STUDIES

*A. Bellovary et al., 2005, “Earnings Quality: It's Time to Measure and Report”.*

The study aimed to define the earnings quality and to know how to measure it in American companies. The study sample included two of the most popular medical companies in the USA in 2003.

It found in this study that it is possible to use the accruals items to predicate the earnings quality of companies, the low level of accruals refers to the high level of accuracy in the predictions and estimations and this lead to high level of quality of earning. The high level of quality of earnings indicates the ability of net earnings to reflect the realistic profitability of the company.

*B. Abdelghany, 2005 “Measuring the earnings quality”.*

The study aimed to measure the earnings quality of companies listed in New York Stock Exchange, where the researcher used a sample of 90 companies in the New York Stock Exchange. The researcher proposed that if there is a full consistency among the methods used in this study that leads to overall evaluation to the earnings quality, while if note, that means the earnings quality is not acceptable and it needs for further investigation. This study concluded that the different methods used to measure the quality of earnings led to different earnings quality.

*C. Kin Lo, 2008, “Earnings Management and Earnings Quality”.*

This study aimed to present the relationship between the management of earnings and the earnings quality to know about the degree of accuracy by which the earnings quality can be carried out.

It concluded that the management of earnings includes many undesirable practices which affect foremost the users of financial statements because of earnings quality declining as a result of the lack of representation of these earnings for the realistic performance of the company.

## 7. LITERATURE REVIEW

### *A. The concept of earnings quality*

The concept of earnings quality has different points of view according to the users of financial statements. The financial specialists realize that the earnings which contain unrealistic items lead to earnings with low quality, even if these unrealistic items are agreed with the generally accepted accounting principle, and these earnings will consider as high-quality earnings if it has the ability to generate a cash flow [6].

The free encyclopedia “Wikipedia” states that the earnings quality is the capability of reported earnings (Net Income) to predict the future earnings of a company, it is an evaluation standard for how a company’s earnings are controllable, continual, sustainable and bankable.

Yee, 2006 in [12] defines earnings quality as the ability of the reported earnings to accurately reveal the company’s fundamental earnings. Similar to Yee, Bellovary et al, ([3], [12]) note that the earnings quality is the ability of reported earnings (Net Income) in presenting the actual financial position of the company and predicting the future earnings of the company where the earnings quality represented by its sustainability for future periods.

We conclude that the earnings quality is the ability reported earnings (Net income) to express honestly and fairly about the real earnings of the company, and it is the extent to which the reported earnings are able to continue for future periods, and also able to reflect the actual financial position of the company.

### *B. The importance of earnings quality*

The earnings quality derives its importance from the importance of the earnings (Net Income) itself because the net income – regardless it has a high or low quality of earnings– is a fundamental item for investing and financing decisions for the company. Also, the net income with low quality may use for predicting the future earnings of the company and for evaluating the financial position of the company. In this regard, Dechow, 1994 in [7] stated that the net earnings have a big importance for using it for evaluating the financial position of the company by different kinds of users.

According to Chan et al, 2006 in [4], since the earnings quality indicates the ability of reported earnings in predicting the realistic earnings of the company and its sustainability for future periods, therefore the earnings quality has an important role in evaluating the financial position of the company for creditors, investors and different users of financial statements.

### *C. The relationship between net operating cash flows and net accounting income and their influence on earnings quality.*

Net operating cash flow differs from net accounting income for various reasons, and the non-cash flows is the first reason for this difference like amortization for intangible assets and depreciation expenses, these flow are not considered as a cash flows and so on it is reducing the net accounting income, but at the same time, it does not affect or manipulate the cash flow, the second reason is the timing of recognition of expenditures and revenues, another reason is including cash flow which classified in the statement of cash flows as financing or investing activities in the determination of net accounting income in spite of these are non-operating losses or gains [11].

From the relationship between net operating cash flow and net accounting income, the operating cash flow ratio (Index) has derived which examine the ability of net earnings in generating operating cash flow, [Operating cash flow index (ratio) = Cash flow from operations ÷ Net income], If the difference

between the net income and net operating cash flow become lesser, the quality of earnings becomes higher [1].

For many financial analysts, the operating cash flow is the better criterion for measuring the realistic earnings of the company than the net income, and they urge that the operating cash flows are the best measure for the company's profitability than the reported earnings [7].

Comiskey & Mulford, 2000 explained in [5] that the earnings quality is not only related to the availability of the net income but also required to test the ability of the reported income to generate cash flows. So when we look at the different items of income statement it is important to put in our consideration the ability of these items to generate cash flows. They added that there is flexibility in the cash flow statement which can be used by managers in the preparation of cash flow statement by classifying the cash flows for operating, investing or financing activities. This will not affect the total cash flows of the company, but it will affect the operating cash flow which considers as an item in the measuring the quality of earnings, and so on it affect the earnings quality.

## **8. METHODOLOGY**

For this study, the researchers used the quantitative analysis which based on the analytical method in order to analyze the data collected from the financial statements of the banks, in order to determine the influence of the independent's variables "Net operating cash flow and net accounting income" on the dependent variable "earnings quality".

The study population represents the Iraqi commercial banks, listed in the Iraq Stock Exchange consist of three banks for the period 2012- 2015.

## **9. DATA COLLECTION**

In this study, the researcher used the primary and secondary data. The primary data included the scientific articles, accounting books and the specialized periodicals of the subject of net operating cash flow, net accounting income, and earnings quality. The secondary data included the financial statements (Balance sheet, income statement & statement of cash flows) for banks through the Iraq stock exchange website ([www.isx-iq.net](http://www.isx-iq.net)).

## **10. DATA ANALYSIS AND DISCUSSION**

After collecting the financial data of the banks used in this study for the period 2012 – 2015, the quantitative analysis which based on analytical method was used in order to analyze and study the data by using operating cash flow index (ratio) as a tool for analysis where this is the most appropriate method to stand on the earnings quality of a company. The results of the financial analysis are shown below:-

A. Calculating the operating cash flow ratio for Trans Iraq Bank

Year	Items	Trans Iraq Bank
2012	Net Income	393,284,000
	Operating Cash Flow	(62,781,712)
	Operating Cash Flow Index	(0.16)
2013	Net Income	2,050,486,000
	Operating Cash Flow	52,239,526,000
	Operating Cash Flow Index	25.48
2014	Net Income	5,070,004,000
	Operating Cash Flow	110,812,748,000
	Operating Cash Flow Index	21.86
2015	Net Income	8,352,047,000
	Operating Cash Flow	41,174,666,000
	Operating Cash Flow Index	4.93

**Table.01:** OPERATING CASH FLOW INDEX FOR TRANS IRAQ BANK

Table [1] indicates to the operating cash flow index of Trans Iraq Bank [Cash flow from operating activities ÷ Net income], this index measure the ability of bank's net income to generate operating cash flows. Generally, this indicator starts negatively in 2012 then tends to increase in 2013 & 2014, and declined in 2015. By analyzing the (Net income – Net operating cash flow) relationship, we can understand that the increase in net income is not always a positive indicator to judge the ability of bank's profits to generate operating cash flows.

Coming back to table [1], we can notice that the bank has reported a net profit of 393,284,000 IQD in 2012, but this income has a negative earnings quality and the reason behind this is the negative net operating cash flow that appeared in the cash flow statement of the bank in 2012. This means that this income is unrealistic, it will not continue for future periods and it is a fake number which may include profits of other periods in this period and not recognition of some current period expenditure.

Also by analyzing the earnings quality of Trans Iraq Bank we can understand that although the net income of 2015 is higher than the net income of 2014, but it is less quality of earnings as is shown in table [1], and this happened because there is a declining in cash flows from operating activities which was 110,812,748,000 in 2014 and it has become 41,174,666,000 in 2015. The increase in net income which synchronous with decreasing in cash flows from operating activities indicates more accrued has been recorded in 2015 compared with 2014 and the more accrued denotes that less accurate estimates and judgments and therefore the income growth is unrealistic, it will not continue for future periods and it has a low quality of earnings.

*A. Calculating the operating cash flow ratio for Ashur International Bank*

Table [2] indicates to the operating cash flow index of Ashur International Bank [Cash flow from operating activities ÷ Net income], this index measure the ability of bank's net income to generate operating cash flows. The bank's indicator of the period (2012-2015) was the lowest in 2012 then tends to increase in 2013 & 2014, and became the highest in 2015. By analyzing the (Net income – Net operating cash flow) relationship, we can understand that the decreasing of net income is not always a negative indicator to judge the ability of bank's profits to generate operating cash flows.

Year	Items	Ashur International Bank
2012	Net Income	16,622,635,580
	Operating Cash Flow	27,696,330,549
	Operating Cash Flow Index	1.67
2013	Net Income	15,755,502,516
	Operating Cash Flow	44,980,037,910
	Operating Cash Flow Index	2.85
2014	Net Income	9,654,689,000
	Operating Cash Flow	27,175,711,000
	Operating Cash Flow Index	2.81
2015	Net Income	10,785,328,000
	Operating Cash Flow	59,431,362,000
	Operating Cash Flow Index	5.51

**Table. 02 :** OPERATING CASH FLOW INDEX FOR ASHUR INTERNATIONAL BANK

Coming back to table [2], we can notice that the bank has reported a net profit of 16,622,635,580 IQD in 2012 with the lowest quality of earnings for the indicated period (15.14), then in 2013 the net income has decreased to be 15,755,502,516, but we notice it has more earnings quality compared with the earnings quality of 2012 and the reason behind this is the cash flow from operating activities has increased by (62%), the increasing of the operating cash flow indicates less accrued has been recorded in 2013 compared with 2012 and the less accrued denotes that more accurate estimates and judgments and therefore increasing the earnings quality. Consequently, the reported income will continue for future periods.

If we compare the financial data of 2014 with the financial data of 2012 for the Ashur International Bank, we can notice that the net income of 2012 is much higher than the net income of 2014, while in both years the operating cash flow was the same, but it is clear from the table [2] that the earnings quality of 2014 is higher than the earnings quality of 2012. This indicates that the reported income of 2012 was unrealistic and a lot of accruals has been recorded in 2012 to maximize the net income the year.

The operating cash flow index of Ashur International Bank in 2015 was the highest of the period 5.51 despite the reported income of 2015 is not the highest one in the same period, the reason behind this high earnings quality is the high cash flow from operating activities which indicates less accrued has been recorded in 2015 compared with previous years and the less accrued denotes that more accurate estimates and judgments and therefore increasing the earnings quality and the income will continue for future periods. The high earnings quality is a good indicator of the degree to which the net income of the business satisfies the quality criteria and indicates how well the business is performing from the earnings perspectives and so it predicts the future earnings of the business.

*B. Calculating the operating cash flow ratio for Bank of Baghdad*

Year	Items	Bank Of Baghdad
2012	Net Income	25,099,377,000
	Operating Cash Flow	380,046,727,000
	Operating Cash Flow Index	15.14
2013	Net Income	32,066,680,000
	Operating Cash Flow	413,709,825,000
	Operating Cash Flow Index	12.90
2014	Net Income	27,780,658,000
	Operating Cash Flow	68,914,159,000
	Operating Cash Flow Index	2.48
2015	Net Income	5,716,622,000
	Operating Cash Flow	(303,640,110,000)
	Operating Cash Flow Index	(53.12)

**Table.03:** OPERATING CASH FLOW INDEX FOR BANK OF BAGHDAD

Table [3] indicates to the operating cash flow index of Bank of Baghdad [Cash flow from operating activities ÷ Net income], this index measure the ability of bank's net income to generate operating cash flows. Generally, this indicator starts highly in 2012 then tends to decline in 2013 & 2014, and became negative in 2015. By analyzing the (Net income – Net operating cash flow) relationship, we can understand that the increase in net income is not always a positive indicator to judge the ability of bank's profits to generate operating cash flows.

Coming back to table [3], we can notice that the bank has reported a net profit of 25,099,377,000 IQD in 2012 with high quality of earnings (15.14), then in 2013 the net income has increased to be 32,066,680,000, but we notice it has fewer earnings quality compared with the earnings quality of 2012 and the reason behind this is the percentage of increase of net income (27%) is less than the percentage of increase of net operating cash flow (8%), so the earnings quality in 2013 became 12.90 which is less than 2012.

In 2014 the earnings quality ratio is declined by (80%) compared with 2013 to be 2.48 and this sharp declining in this ratio is due to the intense reducing of the cash flow from operating activities which declined by (83%) compared with the operating cash flow of 2013, the declining of the cash flows from operating activities means more accrued has been recorded in 2014 compared with 2013 and the more accrued denotes that less accurate estimates and judgments and therefore declining the earnings quality.

The reported income in 2015 is 5,716,622,000 whereas the earnings quality is negative as shown in table [2]. The positive income reported in the income statement which synchronous with negative cash flows from operating activities reported in the cash flow statement indicates more accrued has been recorded in 2015 compared with previous years and the more accrued denotes that less accurate estimates and judgments and therefore the reported income is unrealistic, fake and have no consistency, and it has low quality of earnings.

*C. Calculating the operating cash flow ratio for Credit Bank of Iraq*

Year	Items	Credit Bank Of Iraq
2012	Net Income	22,946,962,000
	Operating Cash Flow	133,834,571,000
	Operating Cash Flow Index	5.83
2013	Net Income	11,531,884,000
	Operating Cash Flow	38,485,947,000
	Operating Cash Flow Index	3.34
2014	Net Income	13,443,102,000
	Operating Cash Flow	(55,777,861,000)

	Operating Cash Flow Index	(4.15)
2015	Net Income	11,638,708,000
	Operating Cash Flow	(9,301,961,000)
	Operating Cash Flow Index	(0.80)

**Table.04:** OPERATING CASH FLOW INDEX FOR CREDIT BANK OF IRAQ

Table [4] indicates to the operating cash flow index of Credit Bank of Iraq [Cash flow from operating activities ÷ Net income], this index measure the ability of bank's net income to generate operating cash flows. Generally, this indicator starts highly in 2012 then tends to decline in 2013 while it has become negative in 2014 & 2015. By analyzing the (Net income – Net operating cash flow) relationship, we can understand that the increase in net income is not always a positive indicator to judge the ability of bank's profits to generate operating cash flows.

Coming back to table [4], we can notice that the bank has reported a net profit of 22,946,962,000 IQD in 2012 with a very good quality of earnings (5.83), then in 2013 the net income has declined to be 11,531,884,000 in the same time the operating cash flow also declined in 2013 compared with 2012, also we notice it has fewer earnings quality compared with the earnings quality of 2012 and the reason behind this is the percentage of declining of the net operating cash flow (71%) is more than the percentage of increase of net income (49%), so the earnings quality in 2013 became 3.34. The declining of operating cash flow by this much indicate that more accrued has been recorded in 2013 compared with 2012 and the more accrued denotes that more accurate estimates and judgments and therefore the quality of earnings has reduced.

In 2014 and 2015 the earnings quality ratio became negative and this sharp declining in this ratio is due to the negative cash flow from operating activities which reported in the statement of cash flows, the negative cash flows from operating activities means huge amount of accrued has been recorded in 2014 and 2015 compared with 2012 and 2013 and the more accrued denotes that less accurate estimates and judgments and therefore declining the earnings quality to that much which indicate that the reported income of 2014 and 2015 is not realistic at all and it is not continued for future periods.

*D. Calculating the average operating cash flow ratio for the period (2012-2015) for all banks*

Trans Iraq Bank	Total Net Income for the period (2012-2015)	15,865,821,000
	Total Operating Cash Flow for the period (2012-2015)	204,164,158,288

	Average Operating Cash Flow Index (2012-2015)	12.87
Bank Of Baghdad	Total Net Income for the period (2012-2015)	90,663,337,000
	Total Operating Cash Flow for the period (2012-2015)	559,030,601,000
	Average Operating Cash Flow Index (2012-2015)	6.17
Credit Bank Of Iraq	Total Net Income for the period (2012-2015)	59,560,656,000
	Total Operating Cash Flow for the period (2012-2015)	107,240,696,000
	Average Operating Cash Flow Index (2012-2015)	1.80
Ashur International Bank	Total Net Income for the period (2012-2015)	52,818,155,096
	Total Operating Cash Flow for the period (2012-2015)	159,283,441,459
	Average Operating Cash Flow Index (2012-2015)	3.02

**Table.05:** AVERAGE OPERATING CASH FLOW INDEX FOR THE PERIOD (2012-2015) FOR ALL BANKS

Table [5] indicates the average operating cash flow index of the period (2012-2015) for each bank in this study. The Trans Iraq Bank has the highest average operating cash flow index of 12.87, while the Credit Bank of Iraq has the lowest average operating cash flow index of 1.80 despite its total net income is not its lowest among the four banks of study, It is higher than the total net income of both of Trans Iraq Bank and Ashur International Bank but because this bank (Credit Bank Of Iraq) has the lowest total operating cash flow among the four banks of study, so its average operating cash flow index become the lowest. This indicates that there is a relationship between the net operating cash flow and net income and both should be observed during the evaluating of the banks' earnings power.

Coming back to the Trans Iraq Bank, despite this bank has the highest average operating cash flow index of 12.87, but also it has the lowest total net income among the four banks of study. The reason behind this was this bank has a high total operating cash flow compared with the other banks of study, so its average operating cash flow index becomes the highest. This indicates that this income generates excellent cash flows and it will continue for future periods.

## 11. CONCLUSION

### *A. Specific conclusions.*

- There is an influence of the reported accounting income and cash flow from operating activities on the financial statements of commercial banks listed in Iraq Stock Exchange, which consider as a worthy source for the users of the financial statements.
- Not only depending on the reported income from the income statement to evaluate the earnings power of the commercial banks listed in the Iraq Stock Exchange. It is important to concentrate on the operating activities and know the components and resources of the reported income.
- This study mark that the cash flows from operating activities affects the quality of earnings of commercial banks listed in the Iraq Stock Exchange as any decrease or increase of the operating cash flow affect the net income.
- The reported income of commercial banks which used for this study is not always representing the actual and realistic earnings power of the banks.
- There are a lot of accruals recorded in the financial statements of the banks which used for this study, and this means a profit of future period has transferred for the advanced period.
- Reporting negative cash flow from operating activities in commercial banks which used for this study indicates that the net income is not able to generate a cash flow, and therefore it will not continue for future periods.

### *B. General conclusions.*

- Any decreasing or increasing of the net operating cash flow influences the earnings quality of commercial banks listed in Iraqi Stock Exchange for a giving level of net income.
- Measuring earnings quality helps the investors, creditors and other users of financial statements to reveal any influence has been made by managers on the net income.
- Measuring earnings quality helps the investors, creditors and other users of financial statements to gauge the ability of reported earnings for generating cash flows.
- Measuring earnings quality helps the investors, creditors and other users of financial statements to realize how the current reported earnings are sustainable for future periods.

## 12. RECOMMENDATIONS

- The users of financial statements should not only look at the reported net income to evaluate the earnings power of the commercial banks listed in Iraq Stock Exchange but also look at the net operating cash flow to know about the earnings quality.
- Recording accruals at suitable times in the financial statements of the commercial banks listed in the Iraq Stock Exchange, because more accruals lead to unrealistic net income, consequently this lead to earnings with low quality.
- Not to delay the expenses recognition in the preparing the financial statements of the commercial banks listed in the Iraq Stock Exchange because this lead to unrealistic net income, consequently this lead to earnings with low quality.

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