Journal DOI: 10.36713/epra1013|SJIF Impact Factor (2021): 7.473 ISSN: 2347-4378
EPRA International Journal of Economics, Business and Management Studies (EBMS)
Volume: 9 | Issue: 11| November 2022 -Peer-reviewed Journal

# THE ROLE OF KEY FINANCIAL PERFORMANCE INDICATORS IN INVESTMENT DECISION

**Thamir Salih Edan[1], Raad Abidmuslim Hraiga[2], Raghad Muneer Farhan[3]**

[1]*The General Directorate of Education in Najaf Al-Ashraf Governorate.*

[2]*The General Directorate of Education in Najaf Al-Ashraf Governorate.*

[3]*College of physical Education and sport science.*

**Article DOI: https://doi.org/10.36713/epra11780**
**DOI No: 10.36713/epra11780**

## ABSTRACT

***The preliminary review of the financial reports of the banks listed on the Iraqi Stock Exchange reveals the existence of an untapped cash block that is reflected in the Key financial performance indicators (Financial KPI's). The study discusses the fact that the Financial KPI's of the banks listed in the Iraqi Stock Exchange are among the factors that have a role in the decision to buy bank shares by investors. Therefore, the study aims to test the role of the Financial KPI's represented by financial leverage, liquidity, capital adequacy and profitability in the decision to purchase bank shares by investors, by testing the strength and direction of the relationship and testing the impact size of the Financial KPI's in the decision to purchase bank shares by investors of a sample of commercial banks listed in the Iraq Stock Exchange (the regular market) amounted to (10) banks for the period (2020-2016). Among the most important conclusions reached by the study, there is no role for indicators of liquidity, capital adequacy and risk in the investment decision. The role of debt indicators is not important in the investment decision. There is a role for profitability indicators in the investment decision.***

**KEYWORDS:** ***debt indicators, Liquidity Indicators, Capital adequacy, Profitability Indicators***

## I. INTRODUCTION

To know the efficiency and effectiveness of the performance of an activity that must be measured. To measure the performance of an activity, a set of indicators are used that reflect the efficiency of this performance, and through which it is possible to judge the effectiveness of its current performance and predict its future performance. The Financial KPI’s form the basis for evaluating the efficiency and effectiveness of the performance of companies, especially those listed in the capital markets, by the company's management or capital providers alike. With regard to capital providers, investors need to be familiar with a wide range of financial performance indicators of the companies they are considering transferring their funds to in order to ensure appropriate investment decision are taken. The company’s management’s knowledge of the financial indicators that investors focus on when deciding to buy shares contributes to knowing their preferences and thus contributes to the possibility of attracting them to buy the company’s shares. The preliminary review of the financial reports of the banks listed in the Iraqi Stock Exchange reveals the existence of an untapped cash block that is reflected in Financial KPI’s. Therefore, the study seeks to achieve its main objective of verifying whether the Financial KPI’s of the banks listed in the Iraqi Stock Exchange have a role in the decision to buy bank shares by investors; By verifying the existence of a relationship and impact of the Financial KPI’s in the decision to purchase bank shares by investors. To achieve the objectives of the study, we test the following hypotheses:

1- There is a statistically significant relationship between the main financial performance indicators and investment decision.

2- There is a statistically significant effect of the main financial performance indicators in investment decision.

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## II. LITERATURE REVIEW

### 1. Concept of Financial KPI’s

To know the efficiency and effectiveness of the performance of an activity that must be measured. To measure the performance of an activity, a set of indicators is used that reflects the efficiency of this performance, and through which it is possible to judge the efficiency of its current performance and predict its future performance. Economically, the main performance indicators of companies are used to determine the efficiency of their performance and to predict their future economic status. Key performance indicators mean the factors by which the performance, development or performance of the company's business can be effectively measured. In the capital markets, to measure the efficiency of companies' performance, the main focus is on the Financial KPI’s. According to (Prajapati.2019:35) study, the Financial Performance Index is a measure of how well a company uses its assets from its core business model and generates revenue. This term is also used as a general measure of the overall financial health of companies over a certain period of time and can be used to compare the performance of similar companies in the same industry or activity. Financial KPI’s is a tool for evaluating a company's performance and for assessing the success of a particular activity. According to a study (Schwab et al, 2019:8), KPIs are useful tools for monitoring and controlling the company's overall financial health. Financial KPI’s the starting point for monitoring and analyzing the financial problems that the company may encounter and developing programs to solve them. With regard to the company, the Financial KPI’s are a set of measurement tools that the financial manager uses to evaluate and compare the financial performance of the company during a certain period. For investors, they need a wide range of financial performance indicators in order to ensure that appropriate investment decision are made.

### 2. Types of Financial KPI’s

The studyer divides the Financial KPI’s into four main groups, which may be of great interest to current and potential investors.

### 2.1 Debt Indicators

Indicators of indebtedness measure the extent to which the assets cover the future obligations of the company and payable in the future. The debt indicators measure the company's ability to meet its debts and long-term obligations. Debt financing has always been a double-edged sword, at least in emerging markets; In many cases, debt financing was an effective tool in achieving growth for companies by enabling them to expand their activities by exploiting these debts in investments that achieve returns, and this is what investors prefer. In other cases, debt financing was a cause in the bankruptcy of companies as a result of the magnitude of the risks inherent in repaying these debts with their interests if these debts were sacrificed in unprofitable investments or when the financial markets were exposed to crises.

### 2.2 Liquidity Indicators

Liquidity indicators measure the company's ability to meet its short-term debts and obligations. According to the study (Prajapati,2019:36) the liquidity ratio is an indicator of whether the company's current assets are sufficient to meet its obligations when they become due. The liquidity ratio is a financial measure used to determine the company's responsibility to pay its debts and current obligations without increasing external capital. According to the study of (Töyli et al. 2013:332) liquidity is an important component of the business continuity of the company and reflects its ability to cover short-term obligations and pay all outstanding claims; Optimum liquidity management is a requirement of an efficient business. Based on a study (Akhtar et al,2011:35) liquidity refers to the company's ability to keep up with the balance all the time between financial inflows and outflows within the short term. The fact that banks invested their money and exploited the market boom in the hope of maximizing their profits led to their neglect of the issue of liquidity, which had a negative impact on them, as they were unable in many cases to meet the requirements of their clients as soon as the signs of crises appeared, which resulted in depositors rushing to withdraw their money from the banks. Recognizing the importance of liquidity in the work of banks, Basel III dealt with potential short-term liquidity pressures. To cover short-term liquidity pressures, banks are required to hold sufficient liquid and high-quality assets to withstand any stressed funding scenario over a period of 30 days. On the other hand, the company's high liquidity ratio may be a negative factor to attract investment, as the presence of an untapped cash block by the company's management is considered by investors as the low effectiveness of the company's performance.

### 2.3 Capital adequacy and risk indicators

Capital adequacy is the bank retaining part of its capital to enhance confidence between the bank and its clients with regard to the performance and distribution of banking services. Capital adequacy is the final line of protection against any expectation of losses that may result from market risks, credit risks, operational risks or other risks that the bank may be exposed to. According to the study of (Das & Deb,2021:388) capital adequacy is considered as a mechanism that aims to reduce the possibility of bank failure by absorbing the largest amount of losses in the event of failure of performance. According to (Atuahene et al.2021:46-47) a risk-based capital system ensures that banks have sufficient capital on hand to withstand losses while maintaining a safe and efficient market. On the other hand, the low capital adequacy ratio may lead depositors to refrain from dealing with these banks due to the high rate of risks that they may be exposed to. Banks that have a high capital adequacy ratio can easily absorb unexpected losses. On the other hand, investors do not prefer banks with high capital adequacy ratios. The presence of uninvested capital is inversely related to revenues.

### 2.4 Profitability Indicators

The ultimate goal of any company and any investor alike is to achieve profits. Profitability is the company's ability to generate profits, and profit is simply the revenue remaining after all expenses related to the business activities of the company have been paid; Profitability ratios are a set of metrics that can be used to measure a company's profitability. Profitability ratios are one of the most widely used ratios in financial analysis because they determine the efficiency of operational performance and management efficiency. According to the study (Elsiefy,2013:22) Profitability is an indicator of strong performance and it reflects the efficiency of the bank's management in allocating available resources to assets with high returns in light of the bank's risk profile. In addition, sustainable levels of profitability provide a barrier against capital erosion during economic conditions difficult, and thus provide protection for the rights of shareholders and creditors alike.

## 3. Investment Decision

Investing is allocating resources to something with the expectation that it will generate income or will rise in value in the future and ultimately make a profit. According to study (Joseph&Varghese,2017:52) investing is the sacrifice of current money for future cash flows. With regard to the financial markets and investing in the shares of listed companies, there are many investment decisions related to stock trading, such as: stock selection, stock purchase and sale, length of time to keep stocks, and the size of stocks to be traded. The current study discusses some of the factors affecting the investment decision of buying shares, as the investment decisions of buying shares are affected by various factors, some of which the studiers identified. According to the results of the study (Hemalatha,2019:457) there are many factors that directly or indirectly affect investment decisions, such as capital adequacy, tax benefits, expected return on investment, liquidity, risk size, and financial security. In addition to the above factors, there are other factors that affect the decision to purchase company shares; According to the study (Joseph & Varghese, 2017: 55) As far as the success of any investment is concerned, the timing of the purchase is critical. Briefly, the acquisition price of the shares to be included in the investment portfolio depends mainly on the timing decision. If the investor wants to make any gains, He has to buy when the shares are sold at a low price and sell them when the price is high.

### 3.1 Types of Investment

Depending on the time period, financial investments are divided into short-term and long-term investments. Based on the study (Yunusovn,2021:90) short-term investment is investment in securities that are freely traded and held for a period not exceeding one year, and are usually referred to as tradable (liquid) securities. Achieving current profits and avoiding long-term investment costs. Investing for the long term gives investors an opportunity to reap returns in the form of cash flows and capital gains. Investing is a complex procedure, and these complications are increased by the behavior of the stock market. The main reason for the complexities in investment decisions is the large number of participants who show various feelings and behavioral patterns while making investment decisions.

## 4. The Financial KPI's and their role in the decision of investors

Investors make their investment decisions backed by their rational views, experience and information available to them. Because of the uncertainty, investors are likely to face financial loss. Uncertainty is reduced when useful information about the company's performance is obtained. As the investment decision is based on a key factor in the decision-making process, which is useful information that reduces uncertainty and allows choosing the best alternative. Information about the company's performance plays an important role in investment decisions to reduce

the risks associated with these decisions. Only (Gill et al,2018:758) more informed investors can make better investment decisions. Informed investors can handle risk more efficiently because this knowledge enables them to reduce the uncertainty associated with investing in the capital markets. Corporate reports should provide information on Financial KPI's for current and potential investors to allow them to make effective investment decisions. Hence, the disclosure of the Financial KPI's should lead to an increase in the demand for the company's shares and an increase in its market value in the financial market (Voll,2016:215) In terms of indebtedness indicators, there is an inherent conflict of interest between lenders and stockholders. Additional borrowing enhances shareholder profitability, but is a risk to lenders as they become more vulnerable without benefiting from the additional return. Therefore, there is a limit beyond which lenders will not finance the company (Coulon,2019:64). With the exception of shareholders, potential lenders and investors will have long accounts when deciding to transfer part of their wealth to finance an economic unit that has a high percentage of indebtedness, due to the high percentage of risks associated with such financing, especially with long-term investment. According to a study (Pardosi&Hutabara,2020:106) investors will be interested in companies that have a high debt ratio value because debt can act as an incentive to increase the company's profits. High debt will affect the high profit that the company will get if the company gets a high profit, the investor will get Also, a high return that is directly proportional to the increased risks that investors must face due to the high debt ratio Regarding the liquidity index according to a study (Sajid et al,2016:85) Investors are interested in knowing this ratio, as this ratio shows the ability of the company's current assets to repay Its short-term debt When the liquidity ratio is high, the company will be more able to pay its short-term obligations. If the ratio is low, this indicates that the company is unable to pay its short-term obligations and that the company will be financially weak but will not fail. However, the high ratio of liquidity It will not be an attractive factor for investors, as the presence of an untapped cash block for the company is an indication of a low level of activity and therefore performance.With regard to the capital adequacy index, there is no consensus about the impact of the requirements of Capital adequacy on the performance of banks according to a study (Riadi, 2018: 1016) The high ratio of capital adequacy reflects the overall stability of capital and the low risks that banks may be exposed to, as this ratio enables banks to distribute the granted credit more widely. On the other hand, according to the study (Jung,2021:512) the banks' retention of a high ratio of capital adequacy will limit their basic operations and reduce their profitability. This may limit investors' appetite for buying bank shares. According to (Elsiefy,2013:33) the amount of capital invested by banks affects the rate of return on equity investments. The less the bank's capital, the higher the rate of return for the bank's shareholders. Hence the natural tendency of investors to invest in banks with a low capital adequacy ratio. As for profitability indicators, according to a study (pardosi&Hutabara,2020:106) that the return on shares is one of the factors that attract the attention of investors in investing and it is also a reward for the decision to bear the risks of the investment activities that have been undertaken. Therefore, it is very expected that companies that achieve profitability will attract investor.

## III. Materials and Methods

### 1. Measure the Study Variables

#### 1.1 Measuring leverage ratio (lev)

The financial leverage ratio for each bank of the study sample was measured by dividing the total liabilities at the end of each year during the study period by the total assets at the end of that year and using the equation below:

#### 1.2 Measuring Liquidity Ratio (Liq)

The liquidity ratio of each bank in the study sample was measured by dividing the total current assets at the end of each year during the study period by the total current liabilities at the end of that year and using the equation below:

$$\text{Liquidity} = \frac{\text{Current Liabilities Total}}{\text{Current Assets Total}}$$

#### 1.3 Measuring the capital adequacy ratio (Cap ade)

The capital adequacy ratio of banks listed in the Iraq Stock Exchange is measured according to the equation below. The studyer extracted the capital adequacy ratio disclosed in the financial reports of the study sample banks as shown below-:

$$\text{Capital Adequacy Ratio} = \frac{\text{Risk Weighted Net Assets}}{\text{Capital Rule}}$$

**1.4 Measuring Profitability ratio (prof)**
The profitability ratio for each of the banks in the study sample was measured through the return on shareholders' equity by dividing the income achieved after tax at the end of each year during the study period by the total shareholders' equity at the end of each year and using the equation below:

$$\text{the return on shareholders} = \frac{\text{incurred income after tax}}{\text{total shareholders' rights}}$$

**1.5 Measure the size of the investment (inve)**
The volume of investment for each bank of the study sample was measured by calculating the natural logarithm (Ln) of the total trading volume during the year for each bank of the study sample and throughout the study period.

**2. Hypothesis testing**
**2.1 Testing the first hypothesis** (there is a statistically significant relationship between the Financial KPI's and the investment decision).

| Table (6) Pearson correlation test for the first hypothesis | | | | | |
|---|---|---|---|---|---|
| | | **Lev** | **Liq** | **Cap ade** | **Prof** |
| **Inve** | **Pearson Correlation** | **0.413** | **-0.344** | **-0.161** | **0.419** |
| | **Sig.** | **0.001** | **0.007** | **0.131** | **0.001** |

Table (6) shows the results of the test for the Pearson Correlation coefficient. It shows that there is a direct relationship between the financial leverage index and the investment decision, with correlation coefficient of (413.0) and a significant significance of (0.001) less than (0.05), meaning that the increase in financial leverage is offset by a increase In the value of bank shares purchased by investors. there is an inverse relationship between the liquidity index and the investment decision with a weak correlation coefficient of (-0.344) and a significant significance of (0.007) less than (0.05), meaning that the increase in liquidity is offset by a decrease in the value of bank shares purchased from Before the investors. there is an inverse relationship between the capital adequacy and the investment decision with a very weak correlation coefficient of (-0.161) and without significant significance amounting to (0.131) more than (0.05). ) There is a direct relationship between the profitability of banks and the investment decision with a correlation coefficient of (0.419) and a significant significance (0.001), meaning that the increase in the profitability of banks is matched by an increase in the shares of banks purchased by investors.
According to the above results, the study hypothesis is accepted, which states (there is a statistically significant relationship between the Financial KPI's and the investment decision).

2.2 **Testing the second hypothesis:** (there is a statistically significant effect of the Financial KPI's in the investment decision).

| Table (7) Determine Model the correlation coefficient for the multiple linear regression for the second hypothesis | |
|---|---|
| **R Square** | **R** |
| **0.2810** | **0.530** |

The above table shows the value of the correlation coefficient (R) between the independent variable and the Financial KPI's represented by (financial leverage, liquidity, capital adequacy, profitability) and the dependent variable (investment decision), which is (53%), which is an acceptable value that shows the strength of the relationship between the independent variables. and the dependent variable; As the table shows, (R Square) equals (0.2810) meaning that the independent variables explain (28.1%) of the variance or the variables that affect the dependent variable (investment decision) and that the remaining percentage is due to other reasons, including random error.

| Table (8) ANOVA - statistical significance test<br>Multiple linear regression for the second hypothesis | |
|---|---|
| **F** | **Sig.** |
| **4.397** | **0.004** |

The above table for analysis of variance (ANOVA) shows the results of the analysis of variance for multiple linear regression and confirms that the regression has a statistical significance and a significant level of (0.004) less than (0.05), so the study hypothesis is accepted, which states (there is a statistically significant effect of the Financial KPI's in Investment Decision.

| Table (9) Coefficients - Multiple linear regression test for the second hypothesis | | | |
|---|---|---|---|
| | **B** | **T** | **Sig.** |
| **Constant** | **21.334** | **10.94** | **0** |
| **Lev** | **1.28** | **0.511** | **0.612** |
| **Liq** | **-0.275** | **-0.784** | **0.437** |
| **Cap ade** | **-0.001** | **-0.325** | **0.747** |
| **Prof** | **20.37** | **2.633** | **0.012** |

The above table shows that the independent variable, the Financial KPI's (financial leverage, liquidity, capital adequacy, profitability) have an impact on the dependent variable (investment decision). The financial leverage has a positive effect with a regression coefficient of (1.28), but without significant significance, as it reached (0.612) more than (0.05). Liquidity has a negative impact on the investment decision with a regression coefficient of (-0.275), but without significant significance, as it reached (0.437) more than (0.05). Capital adequacy has a negative impact on the investment decision with a regression coefficient of (-0.001), but without significant significance, as it reached (0.747) more than (0.05). Profitability has a positive effect with a regression coefficient of (20.37) and a significant significance of (0.012) less than (0.05); This means that any increase in profitability by one degree is offset by an increase in the volume of the bank's shares purchased by investors by (20.37).

## IV. CONCLUSIONS

1- The study sample banks are characterized by moderate leverage ratios that balance the requirements of investors and lenders.
2- The study sample banks are characterized by high liquidity ratios.
3- The study sample banks are characterized by high capital adequacy ratios.
4- The study sample banks are characterized by low profitability rates.
5- There is a role for the indebtedness indicators of the study sample banks in the investment decision, but it is an unimportant role. Investors prefer investing in banks with high financial leverage ratios, and banks listed in the Iraqi market are characterized by not high leverage ratios.
6- There is no role for the liquidity ratios of the study sample banks in the investment decision. The banks listed in the Iraq Stock Exchange are characterized by high liquidity ratios; Investors consider the banks' high liquidity ratio as having an untapped cash block as a result of the banks' weak performance.
7- There is no role for capital adequacy ratios for the study sample banks in the investment decision. Banks listed in the Iraq Stock Exchange offer high capital adequacy ratios as an advantage, However, it is in fact a negative factor in attracting investment. Investors do not prefer investing in banks that have uninvested capital, as the presence of uninvested capital reduces shareholders' returns.
8- There is a role for the profitability ratios of the study sample banks in the investment decision. With the low profitability ratios of banks, profitability remains the ultimate goal for investors, and as expected, investors prefer investing in banks that make profits.

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