

Earnings Quality

By **Mano Mahadeva, CPA, MBA** | Column Editor

Long-term creditors are primarily concerned with evaluating the ability of a company to service its debt and long-term solvency. Short-term creditors are more concerned with immediate liquidity, as they expect to get paid in a much shorter timeframe. Equity investors deal with the residual risk and ultimate value of the company. Regardless of the objective, it is important for any constituency to evaluate the earnings quality of the company to make investment or credit decisions.

Earnings quality is important for a company's financial well-being, which improves capital market efficiency. Companies with high earnings quality are considered less risky because their earnings can be taken to the "bank." Therefore, these companies are accorded with a higher price-to-earnings multiple reflecting this lower risk and for their use of conservative accounting policies.

What is earnings quality? Well, there is neither a set definition nor a particular set of criteria to determine this. Mere compliance with Generally Accepted Accounting Principles or other standards does not ensure earnings quality. And accounting choices involve judgment, which means different persons may interpret the economics of a transaction differently, due to the existence of different companies, in different industries, each with a differing environment and circumstance.

It is important for an equity investor or creditor to understand earnings quality to gain a clear understanding of a company's true state of financial health. This is a very complex undertaking and requires expertise across areas of accounting, finance, strategy and governance, as well as a strong knowledge of the industry in which a company operates.

Companies with high earnings quality have compelling traits, some of which are observable. Ethical culture and clear, concise and transparent disclosures are two such traits. We have seen leaders set an ethical culture at the "top" and drive this behavior throughout their organizations. Having the presence of a strong governing board comprised of independent directors and a strong audit committee would round out a strong governance function and enhance earnings quality at this company. The voluntary disclosure of information by a company, as a complement to financial statements, can also help improve investor confidence. This could take many forms – press releases, webcasts, conference calls or any other form of announcement. More disclosure, in itself, does not mean it is better information, but the clarity of disclosure that covers the application of accounting principles, its timing and the use of estimates will help improve earnings quality.

There are many key measures that can be used to determine earnings quality. Generally, earnings should follow the underlying economic activity of a business, converting accounting standards



to reality. Earnings are typically estimates of subsequent cash flows. An analyst may confirm this by taking a look at the ratio of cash flow from operations to net income of a company. The closer they are to one, the higher the quality of earnings, as it is more difficult to manipulate cash flows; so is the use of financial ratios – activity, solvency, liquidity and debt ratios – to compare risk and return relationships of firms of different sizes and in distinct industries. All four ratios are interrelated and rely on integrated use to provide for earnings quality of a company based on its competitive position, financial strength and profitability.

So how do questions arise about earnings quality? Lower earnings quality does not necessarily mean the company is following bad or aggressive practices. We have to keep in mind that some companies may have a lower earnings quality because of what they do or where they are in a business cycle. So companies dealing with a volatile business, such as working with derivatives or commodities, may show greater volatility than one which is not. Similarly, a higher growth company may show lower quality due to its rapid growth curve with cash well behind. At times, companies get ahead of themselves by setting high expectations with the hope that reality catches up! This gap becomes too large, due to a market turndown, and we witness fallout.

The difference between earnings and cash are the accruals. And accruals can be estimated accurately, manipulatively or incorrectly. Manipulative accruals result in an unusual rise in accounts receivable, unusual capital expenditures, inventory build ups and large and frequent special or one-time transactions. Incorrect application could mean the use of an inappropriate metric. In a high-earnings quality setting, the best choice is one that reflects the economics of the underlying transaction.

Quality financial statements should reflect economic reality. Economic reality is not always easy to compute because companies dump everything into their reports and leave the interpretation to investors. In the long run, in an economic recovery, companies that reflect high-quality earnings will be rewarded with higher stock prices than those that muddy the waters. ■

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