Earnings Quality

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Abstract

Regulators, academics, and practitioners all have their own interpretation of earnings quality; that is, there is no consistent definition of earnings quality across these three important groups. Regulators view quality earnings as reported earnings that protect investors by providing reliable financial information concerning the company. Academics' perspective is that high quality earnings are based on the relevance of the reported earnings information to shareholders, creditors, and other users of the financial information. Practitioners define earnings quality as earnings that are sustainable, repeatable, and reflect long-term trends. While there are multiple interpretations of earnings quality, an overarching concept can be determined. Regulators, academics, and practitioners perceive earnings in a way that they feel helps to support investors' needs; the area of agreement for all is due to their focus on the users of earnings. As a whole, earnings quality is information that reflects high quality earnings relevant to a firm's financial performance, through persistence, predictive ability, and the reflection of long-term trends.

I. Introduction

There has been a large amount of discussion and research over the years regarding the topic of earnings quality. Questions addressed and discussed include: What is earnings quality? How do you define earnings quality? How do you identify high quality earnings? The answer to those questions often varies based upon the user of the financial information. In general, regulators view reported earnings as high quality if they comply with generally accepted accounting principles (GAAP) and protect investors by providing reliable financial information regarding the company. Academia, on the other hand, often views earnings quality in relation to the relevance of the reported earnings information to shareholders, creditors, and other users of the financial information. Last, practitioners view earnings quality as reported earnings that are sustainable, repeatable, and reflect long-term trends. The definitions and perspectives put forth by these three groups have some similarities, but they also vary in important ways. Considering the importance of each group to society and their role in the financial reporting process, these differences and discrepancies in how they define and interpret high quality earnings can have far reaching implications for the financial reporting process. In this paper, I will discuss the overall concept of earnings quality (i.e. the most consistent interpretation of what earnings quality is), and how each of these three groups define earnings quality. I will also provide perspective on why regulators, academics, and practitioners all have developed their own interpretation and definition of what represents earnings quality.

II. Defining Perspectives on Earnings Quality

Regulators provide oversight, enforcement, and guidance within the financial reporting process and markets. In general, regulators seek to maintain financial confidence in the market, protect consumers, and decrease the risk of fraudulent behavior in the market. Regulatory entities that are involved in the financial reporting process and influence reported earnings include the Financial Accounting Standards Board (FASB), International Accounting Standards Board (IASB), and Securities and Exchange Commission (SEC).

FASB's view concerning the quality of reported earnings is that the "…purpose of financial reporting is to provide information that is useful for business decisions…and considers

decision usefulness the overriding criterion for judging accounting choices" (Schipper and Vincent, 2003, p. 97). As for International Financial Reporting Standards (IFRS), as developed by the IASB, researchers have determined that there is "…no significant quality [difference] between reports [that are] prepared under U.S. GAAP and … international accounting standards. [This concept helps to] …inform the debate regarding acceptance of IFRS-based financial statements from international firms listed on [the] U.S. stock [exchange]…" (Moehrle, Anderson, Ayres, Bolt-Lee, Debreceny, Dugan, Hogan, Maher, and Plummer, 2009, p. 416). IFRS' adoption by foreign issuers shows that there is a slight difference created as quality of reported earnings increases, the level of earnings management decreases (den Besten, 2012, p. 11). The FASB's Statement of Financial Accounting Concepts (SFAC) clarified that they look at "Higher quality earnings [to] provide more information about the features of a firm's financial performance that are relevant to a specific decision made by a specific decision-maker" (Dechow, Ge, and Schrand, 2010, p. 344). Through convergence work on the Conceptual Framework: Objective and qualitative characteristics, the IASB and FASB clarified that "If financial information is to be useful, it must be relevant and faithfully represented" (*Statement of Financial Accounting Concepts*, p. 16). These features result in improving user's confidence. The SEC has administered rules that are designed to promote complete public disclosure, as well as, to protect investors from fraudulent and manipulative behavior in the markets (Securities And Exchange Commission-SEC, 2015). Ultimately, the SEC wants to protect investors while regulating the market, looking at the behavior of companies, and finding areas for improvement. One particular research paper, sums up the overarching quality theme that all regulators are aiming for, "…is the need to distinguish between persistent and non-persistent components of income, which is related to the need to distinguish between ongoing cash flows/accruals and revisions in asset stocks" (Dichev, Graham, Harvey, and Rajgopal, 2013, p. 13). Although the perspectives on earnings quality by these various regulatory entities vary to an extent, the common view of earnings quality put forth by these entities is that high quality earnings protect investors by providing them reliable information on which to base their investment decisions.

Academics provide another perspective on earnings quality. In general, the academic view of reported earnings depends on the relevance of the information and the quality of the reported information with regards to a firm's financial performance. In one research paper

conducted by Dechow, Ge, and Schrand (2010), earnings quality is defined by the use of three features:

> First, earnings quality is conditional on the decision-relevance of the information… the quality of a reported earnings number depends on whether it is informative about the firm's financial *performance*, many aspects of which are unobservable. Third, earnings quality is jointly determined by the relevance of underlying financial performance to the decision and by the ability of the accounting system to measure performance. (Dechow, Ge, and Schrand, 2010, p. 344)

Another interpretation of earnings quality from an academic standpoint is that:

> High-quality reported earnings are amounts that can be expected to persist in the future. Earnings quality is higher when it results from revenues from a sustained customer base and objective measures of related costs. Two factors primarily compromise earnings quality: (1) the degree to which reported earnings [contain] amounts that will not persist in the future, and (2) earnings management. (Moehrle, Anderson, Ayres, Bolt-Lee, Debreceny, Dugan, Hogan, Maher, and Plummer, 2009, p. 415)

In addition to these interpretations of earnings quality, academics consider three constructs related to earnings quality. The three constructs associated with earnings quality are:

> … persistence, predictive ability, and variability…persistence captures the extent to which a given innovation remains in future realizations; predictive ability is a function of the distribution…of the innovation series; and variability measures the time-series variance of innovations directly. (Schipper and Vincent, 2003, p. 99)

Persistence in this context refers to sustainability. In other words, high-quality earnings are earnings that are sustainable into future reporting periods. As for predictability, it "…is the capacity of the entire financial reporting package, including earnings components and other disaggregations of the summary earnings number, for improving users' abilities to forecast items of interest" (Schipper and Vincent, 2003, p. 100). As for variability, earnings quality comes

from an absence of variability, indicating the occurrence of income smoothing. Smoothing "…is sometimes associated with high-quality earnings, one approach to assessing earnings quality is to test for evidence that income is inherently smooth because the business model and the reporting environment are not volatile or, alternatively, that management has engaged in smoothing practices" (Schipper and Vincent, 2003, p. 101). Smoothing is the use of "trickery" to obscure the actual financial volatility of a firm's economic performance, "…[masking] the true consequences of management's decisions" (Dechow and Skinner, 2000, p. 240). Although this includes management's within-GAAP reporting choices, those reporting choices "…can be considered to be earnings management if they are used to 'obscure' or 'mask' true economic performance, bringing us again back to managerial intent" (Dechow and Skinner, 2000, p. 240). For better clarification as to what this construct is getting at when it talks about smoothing, earnings management needs to be defined first.

Earnings management "...occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either *mislead some stakeholders* about the underlying economic performance of a company, or to *influence contractual outcomes* that depend on reported accounting numbers" (Dechow and Skinner, 2000, p. 238). With this in mind, what the construct variability is getting at is that smoothing can be characterized as earnings management when "too much" occurs (Dechow and Skinner, 2000, p. 238). While there is a clear line for what fraudulent accounting is, it is the judgment and estimates that are made within-GAAP that depend on managerial intent, which may involve earnings management. GAAP requires management to make judgments and estimates on earnings. The problem with this is that it is difficult to assess and identify when managers and firms partake in "abusive" earnings management through the practice of smoothing.

As such, the fear of misusing smoothing practices brought about the idea of using the changes in cash flows to capture the variation of unmanaged earnings. Where the "…extreme values of the smoothing measures indicate how much volatility has been removed from the [earnings] by means of accruals taken in response to economic shocks" (Schipper and Vincent, 2003, p. 101). The idea behind unmanaged earnings is that they are more informative than smoothed earnings, due to the lack of "noise" that is created by management's influence. Reflecting "…the true consequences of management's decisions…" showing the natural occurrence of volatility of earnings (Dechow and Skinner, 2000, p. 240). However, despite

requiring management to provide clear documentation on how they produce their estimates, it is still difficult for them to provide an unbiased opinion separate from the underlying economic incentives that management face (Dechow and Skinner, 2000, p. 241). It is management's "noise" that leads academia to believe that a clearer measure of a firm's true economic performance is created through the use of unmanaged earnings.

In addition to regulators and academia's perspective on earnings quality, there still remains the view of the practitioners (corporate/private accountants). While there are many variations on the meaning of earnings quality from a practitioner's standpoint, some interpretations do overlap. However, the resulting low correlation on the consensus of earnings quality's meaning has the potential to lead to the notion that there might be "noise" in its measure (Dichev, Graham, Harvey, and Rajgopal, 2013, p. 11). The most common theme in practitioners' interpretation of earnings quality is that it "…relates to reported earnings that are sustainable, repeatable, recurring, consistent, reflecting long-term trends, and/or have the highest chance of being repeated in future periods" (Dichev, Graham, Harvey, and Rajgopal, 2013, p. 11).

In order to obtain a clearer understanding on how practitioners perceive earnings quality, researchers have conducted surveys on a large number of Chief Financial Officers (CFOs). CFOs will represent the practitioners' view since they are the "…direct producers of earnings quality…" the key decision-makers in company acquisitions, and they understand how to apply accounting standards in their company (Dichev, Graham, Harvey, and Rajgopal, 2013, p. 2). In a research paper conducted by Graham, Harvey, and Rajgopal (2005), they found that CFOs believe that earnings are the basis for consideration by investors and not cash flows. In a survey of over 400 executives and CFOs, they found that "An overwhelming majority of CFOs prefer smooth earnings (versus volatile earnings). Holding cash flows constant, volatile earnings are thought to be riskier than smooth earnings" (Graham, Harvey, and Rajgopal, 2005, p. 5). Having earnings that are less predictable, as a result of volatility and missed benchmarks, result in market risk. Executives would rather sacrifice economic value "…in exchange for smooth earnings" (Graham, Harvey, and Rajgopal, 2005, p. 5).

There are four insights behind the benchmark behavior of management. First, to management, "…accounting earnings matter more…than cash flows for financial reporting purposes…" (Graham, Harvey, and Rajgopal, 2005, p. 6). Second, managers are more

"…interested in meeting or beating earnings benchmarks primarily to influence stock prices and their own welfare via career concerns and external reputation…" (Graham, Harvey, and Rajgopal, 2005, p. 6). This concept corresponds with CFOs' view on earnings misrepresentation, in that they "…feel that most earnings misrepresentation occurs in an attempt to influence stock price, because of outside and inside pressure to hit earnings benchmarks, and to avoid adverse compensation and career consequences for senior executives" (Dichev, Graham, Harvey, and Rajgopal, 2013, p. 3). Third, managers care a lot more about smooth earnings; holding cash flows constant. Finally, "…managers are willing to sacrifice economic value to manage financial reporting perceptions" (Graham, Harvey, and Rajgopal, 2005, p. 6). All four insights are connected to the underlying notion of fear in market backlash and overreaction in the short-term, giving up long-term market value as a result. From the survey of over 400 executives, it was found that "…78% of the surveyed executives would give up economic value in exchange for smooth earnings" (Graham, Harvey, and Rajgopal, 2005, p. 5). The market's reaction is the reason behind executives' rationalization for sacrificing long-term economic value. CFOs argue that, "…(financial market pressure and overreactions) [encourage] decisions that at times sacrifice long-term value to meet earnings targets" (Graham, Harvey, and Rajgopal, 2005, p. 5). This notion hints at the idea that "unsophisticated" investors may be a concern for CFOs and these investors are influenced by reported earnings (based on GAAP or non-GAAP).

With regards to privately versus publicly owed firms, it has been determined that "…private firms place more emphasis on cash flow from operations than public firms, suggesting…that capital market motivations drive the focus on earnings" (Graham, Harvey, and Rajgopal, 2005, p. 20). Alternatively, the emphasis is placed on pro-forma earnings for unprofitable firms, firms with young CEOs, and firms that have high earnings guidance (Graham, Harvey, and Rajgopal, 2005, p. 20). These firms reflect the behavior of "…firms responding to capital market pressure to use pro-forma earnings to make weak GAAP earnings more palatable" (Graham, Harvey, and Rajgopal, 2005, p. 20). This concept behind pro-forma earnings making "weak GAAP" earnings easier to stomach has others, such as regulators, concerned about the practices and behavior of companies that report under a non-GAAP or pro-forma basis.

Unlike companies that report earnings under GAAP, "Non-GAAP earnings numbers are alternate measures of performance usually calculated by excluding from GAAP earnings certain

items, deemed by management, as transitory or nonrecurring" (Seetharaman, Wang, and Zhang, 2014, p. 18). This reflects the CFOs' view of earnings quality being absent of "one-time" items. One of the main differences between GAAP and non-GAAP reporting is that non-GAAP is unaudited. Additionally, "…non-GAAP measures are not well defined and have few uniform characteristics across firms…" (Seetharaman, Wang, and Zhang, 2014, p. 18). It was also found that due to the lack of a well-defined measure for non-GAAP data, managers had multiple opportunities to exclude recurring expenses by "…opportunistically classifying them as one-time or nonrecurring" (Seetharaman, Wang, and Zhang, 2014, p. 18, 21). These pro-forma earnings numbers have the ability to affect the judgments of "less-sophisticated" investors. In response to the unclear guidelines, regulators made it required that "…public companies [reconcile their] non-GAAP financial measures to the most comparable GAAP financial measures when companies disclosed material [using] non-GAAP financial measures" (Seetharaman, Wang, and Zhang, 2014, p. 18). Despite the steps taken by regulators, there continues to be concerns about companies reporting data on a non-GAAP basis in order to conceal GAAP-based measures.

III. Understanding the Differences

The benefits of all three groups: regulators, academics, and practitioners vary with regard to their perspective of earnings quality. Due to their different perspectives, it creates an underlying benefit that is not necessarily made clear. Each group looks at earnings quality in a different light, all with the underlying intention of reporting earnings in the best interest of the investors. Ultimately, regulators want to represent the true financial earnings of a company, "…[capturing] the transactions' economic substance as accurately as possible" (Gao, 2013, p. 861). Given the SEC's recent goal, this is particularly relevant; the SEC aims "…to improve the quality of financial reporting, which includes reducing earnings management" (Dechow and Skinner, 2000, p. 236). Currently, there still remains an unclear definition of earnings management, especially when it comes to operating within GAAP. While there is a "…clear conceptual distinction between fraudulent accounting practices…and those judgments and estimates that fall within GAAP and which may comprise earnings management depending on managerial intent", there still remains uncertainty around earnings management (Dechow and Skinner, 2000, p. 239). Regulators, such as the SEC, "…seem to have a broader concept in mind

than financial fraud when they talk about 'earnings management,' although this has not…been made explicit" (Dechow and Skinner, 2000, p. 238). In other words, the systematic reported earnings choices made within GAAP, such as income smoothing, can amount to earnings management. Depending on managerial intent, income smoothing can potentially be treated as fraudulent accounting. Regulators aim to show the true economic earnings of a company, however, the practice of income smoothing within GAAP, makes this difficult to achieve their goal.

Academics focus on earnings that are variable and sustainable, and result in high quality earnings. Earnings that are free of earnings management have the potential to influence investor opinions and can persist into the future. Additionally, academics look at management incentives and their behavior.

Practitioners on the other hand turn their focus to the earnings as the basis of consideration when it comes to reporting earnings. Practitioners focus on earnings because of four reasons (Graham, Harvey, and Rajgopal, 2005, p. 21). First, investors look for the use of a simple metric that is comparable across the industry, easy to understand, and summarizes company performance. Second, earnings get the most exposure by the media. Third, focusing on one number makes the task of predicting future value easier. Fourth, a firm's progress is evaluated based on whether they hit consensus.

When it comes down to comparing regulators, academics, and practitioners, looking at benefit of each group is not enough; discrepancies also need to be considered. The biggest discrepancy that all three groups have in common is how they look at the use of income smoothing. Regulators do not give a clear opinion on the matter, other than smoother income may be treated as fraudulent accounting, depending on the managerial intent (Dechow and Skinner, 2000, p. 239). As for academics, some are against the practice of smoothing, altogether. They deem smoothing to be equivalent to earnings management in that it is used to trick investors by obscuring the true volatility of a firm's economic performance. As such, academics feel that a clearer measure of a firm's true performance would be better reflected in the use of unmanaged earnings, clear of management's "noise." Practitioners on the other hand feel quite differently towards income smoothing. Practitioners prefer smooth earnings to volatile earnings. They deem volatile earnings to be riskier and less predictable, resulting in market risk for firms.

CFOs would sacrifice economic value in exchange for smooth earnings, rather than risk the overreaction of the market in the short-run.

In a few instances, members of the academic community have given the impression that they have not been recognized for their many contributions to the accounting community. They feel that:

> …the community has been less aware that the academy has contributed ideas that have enhanced the efficiency and effectiveness of practice…If the effects of academic ideas were more fully recognized…the practice, corporate, and regulator communities would be even more willing to invest in academe… (Moehrle, Anderson, Ayres, Bolt-Lee, Debreceny, Dugan, Hogan, Maher, and Plummer, 2009, p. 412)

One common theme that regulators, academics, and practitioners hint at is the need to rethink earnings management. At some point, all three groups briefly touch on the topic of earnings management; providing their perception of earnings quality and the problems that come with it. This concept leads to the idea that because there is not a clear-cut understanding as to what exactly earnings management is, it triggers negative outcomes that effect earnings quality as a result. The internal and external pressures and incentives behind misreporting earnings, and the abusive use of income smoothing all lead to events that harm investors and ultimately the firm. If regulators, academics, and practitioners have the same underlying intention towards investors, this in turn leads to the notion that it may be in the best interest for all three groups to come together to establish what constitutes earnings management. By establishing a clearer understanding of earnings management, earnings quality will in turn improve. Ultimately, a clearer understanding of earnings management will result in fewer discrepancies in earnings quality.

IV. Conclusion

Regulators, academics, and practitioners all have their own interpretation of earnings quality. Regulators view quality earnings as reported earnings that protect investors by providing reliable financial information concerning the company. Academics' perspective of earnings

quality is that high quality earnings are based on the relevance of the reported earnings information to shareholders, creditors, and other users of the financial information. Practitioners define earnings quality as earnings that are sustainable, repeatable, consistent, and reflect long-term trends. That said, an overarching concept of earnings quality can be determined. Regulators, academics, and practitioners perceive earnings in a way that they feel helps to support investors' needs; their area of agreement is focused on the users of earnings. Regulators want to represent the true financial earnings of a company. Academics want to report earnings that are variable and sustainable, free of the misuse of earnings management. Practitioners want to show earnings that are reliable, so as to be used as an easy means of understanding how a company is performing. All three groups intend to help investors have a clearer understanding of a company's true financial performance. As a whole, earnings quality is information that reflects high quality earnings relevant to a firm's financial performance, through persistence, predictive ability, and the reflection of long-term trends.

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