Corporate Financial Reporting & Analysis:
Earnings Quality and Management

E-Content prepared by
Dr. Mohammad Anees
Department of Business Administration,
University of Lucknow, Lucknow
Contact:
Email drmohdanees@gmail.com
WhatsApp no. 9415179375

Quality of Earnings

Meaning:

The quality of earnings refers to that part of net income which is attributable the core operating activities of business during normal business environment.

High and Low Quality of Earnings

If a business reports an increase in profits due to improved sales in normal business environment or due to adopting cost reduction techniques the quality of earnings is considered to be high.

If on the other hand, a business reports high or low profits due to the following accounting tricks or manipulations such earnings are considered to be of poor quality:

1. Inappropriate use of accounting rules leading to increase/decrease in profits such as inventory valuation techniques (LIFO/FIFO), depreciation policy (written down value/ Fixed Installment Method), transfer to provisions (bad debts, taxes etc.)
2. Inflationary transactions
3. Sale of assets for gain or loss

Characteristics of high quality earnings

1. Such earnings are easily repeatable over a number of years
2. Conservative accounting policy is followed in such earnings
3. High quality earnings are based only on operating factors

How to calculate high quality earnings

It is quite subjective to calculate high quality earnings. Its accuracy depends upon the expertise of the person calculating the high quality earnings. The measure of high quality earnings is the ability of the company to generate income on the basis of operating activities of business. Still there is one formula to calculate the quality of earnings as given below:

Quality of Earnings Ratio= Net Cash from Operating Activities/Net Income reported

Case: Quality of Earnings

Company XYZ Ltd reports an increase in sales of 35% while it's operating expenses reduced by 7% and the net income increased by 22%. Another company ABC Ltd reports no significant increase in sales and no change in operating expenses but still increase in income by 30%.

Required:

Comment on the quality of earnings of both the companies.

Answer and Case Discussion

The quality of earnings of XYZ Ltd is high because these are based on core operating activities of sales and operating expenses. On the other hand, though the earnings of ABC Ltd are higher and in the opinion of a layman this company may be better but the earnings of ABC Ltd are of low quality because the increase in such income is based on accounting tricks, manipulations or other non-operating factors which are not real potential of this company. To conclude the income of XYZ Ltd is very likely to be repeated but the income ABC Ltd is least likely to be repeated. It may even show bad results in future.

Significance of Quality of Earnings

1. Investors always prefer high quality earnings as these results tend to be repeated in future years.
2. Quality of earnings shows the real potential of business.
3. Quality of earnings discloses the operating and non-operating factors influencing the income of the company.
4. Wrong accounting practices, manipulations and non productive activities in the business are easily traced with the help of quality of earnings.
5. Quality of earnings builds the value and reputation of the company.

Concluding Remarks

1. Quality of earnings is related with the operating and non-operating activities of business.
2. High quality of earnings takes into account the operating factors such sales and operating expense etc.
3. Poor quality of earnings is based on accounting tricks, manipulative practices and other non-repetitive factors.
4. High quality of earnings is reliable and most likely to be repeated in future.
5. Investors and analyst always prefer high quality earnings.
6. High quality earnings can be known accounting expertise.
7. An easy formula to know the quality of earnings is to calculate quality of earnings ratio by dividing Net Cash from operating activities by the reported income.

Earnings Management

Meaning:

Earnings management means the use of accounting techniques to intentionally influence the financial statement reporting to be highly positive. Figures appearing in the financial statements are highly inflated. Earnings management affects the quality of earnings badly and the credibility of company falls.

Techniques of Earnings Management

1. **Aggressive accounting**

   It is unethical use of accounting techniques in order to inflate the accounting profits.

   Example: Co. X may transfer its profits heavily to reserves at the time of good profits. But when company suffers from losses such as heavy bad debts due to non-payment of debtors, the company does not show actual bad debts and it starts using reserves against the bad debts and profits are not affected adversely.
2. **Financial restructuring**

   The company can overvalue its assets and write off its bad debts at the time of financial difficulties. This is a double harm to the accounting figures but temporarily accounting report becomes attractive.
3. **Wrong expense and revenue recognition**

   It is called income smoothing. The company records the income before it is recognized and does not recognize the bad debts or inflate the sales figures by recognizing the sales which are not actually made. All this leads to higher profits.

Objectives of Earnings Management

Earnings management may be on both the sides, inflating the profits or deflating the profits by way of deliberate accounting measures. There may be both good or bad objectives against earnings management

1. Personal gain of managers by earning commission on inflated profits
2. Stabilizing the market value of share in the market
3. Moving the profits to the next year in order show consistent results
4. Mobilizing capital from the market
5. Better bargain at the time of merger, takeover or amalgamation

Earnings Management vs. Quality of Earnings

From the earnings management the quality of earnings can be judged. If the managers do not intervene to influence the reporting of financial results through deliberate accounting techniques then quality of earnings is high otherwise not. Or simply say when earnings management is high the earnings quality is low and vice versa.

Concluding Remarks

1. Earning management is a deliberate intervention of managers into financial reporting.
2. Financial reporting may be shown inflated or suppressed.
3. Earnings management may be for positive reason and may be for negative reason.
4. Earnings management and earnings quality both are interrelated.