EARNINGS QUALITY: AN ANALYSIS

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Abstract : Corporate Scandals of the last decade have been the result of manipulation and misrepresentation of financial statements by vested interests. Though such manipulations are done by using various accounting techniques the sole aim has always been to misguide the users of financial statements. In such a scenario investors, creditors and other stakeholders are more concerned about the" Quality of Earnings", that is the extent to which the reported earnings truly reflect the financial health of the firm. Earnings Quality is the ability of the firms reported income to predict the future earnings of the company. In recent times Accrual Earnings has gained attention as an important indicator of earnings quality. Accrual is the difference between firms accounting earnings and its cash flows. Thus accruals quality indicates future earnings and accrual ratio is a measure of earnings quality. High aggregate accruals and a high accrual ratio indicate poor earnings quality. The study analyzes the earnings quality of an insurance firm. It is concluded that of all the years considered for the study only two years the Quality of Earnings is satisfactory. The study also suggests that analysts and investors must increasingly use Earnings Quality measures along with other tools for stock analysis to make informed decisions.

Key Words: Earnings Quality, Accrual Earnings, Accrual Ratio

I. INTRODUCTION

Financial Statements are prepared to provide information about the financial position, performance and changes in financial position of an enterprise those who use them for making economic decisions. This is the basic objective of Financial Reporting. Corporate Accounting Scandals in recent times have been possible with the misrepresentation or manipulation of financial statements by managements or third parties. Such manipulations though permissible have violated either legal or professional norms with the sole intention of deceiving the users of financial statements. This is more commonly found in transition economies which have been undergoing instable economic conditions and the exposure of firm's world over to global environments increasing their economic and financial risk. Thus weak firms have been resorting to Earnings Management, an action of manipulating accounting results for the purpose of creating an altered impression of business performance (Mulford & Comiskey,2002)

In such a scenario investors and stakeholders have been showing a growing concern about a firms "Quality of Earnings" or the extent to which the reported earnings reflect the operating fundamentals of a firm. Earnings quality is the reasonableness of reported earnings. It assesses if

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a firm's earnings are "repeatable, controllable and bankable". Accounting standards world over
provide that earnings is a superior measure for predicting future cash flows which help investors and other stakeholders to take informed decisions. Financial analysts are concerned with something more than the net income statement of a company. The various financial statements and disclosures may not help in assessing the quality of earnings. Earnings quality provides a framework to enable an in depth discussions of operating and non-operating income.

Earnings Quality refers to the ability of reported income/earnings to predict a company's future earnings. It can be defined as earnings which sketch accurate image of a company performance, predict future performance of the company, and help investors in optimizing investing decisions. Earnings quality helps to predict a company's future earnings and an important aspect of evaluating the company's financial health.

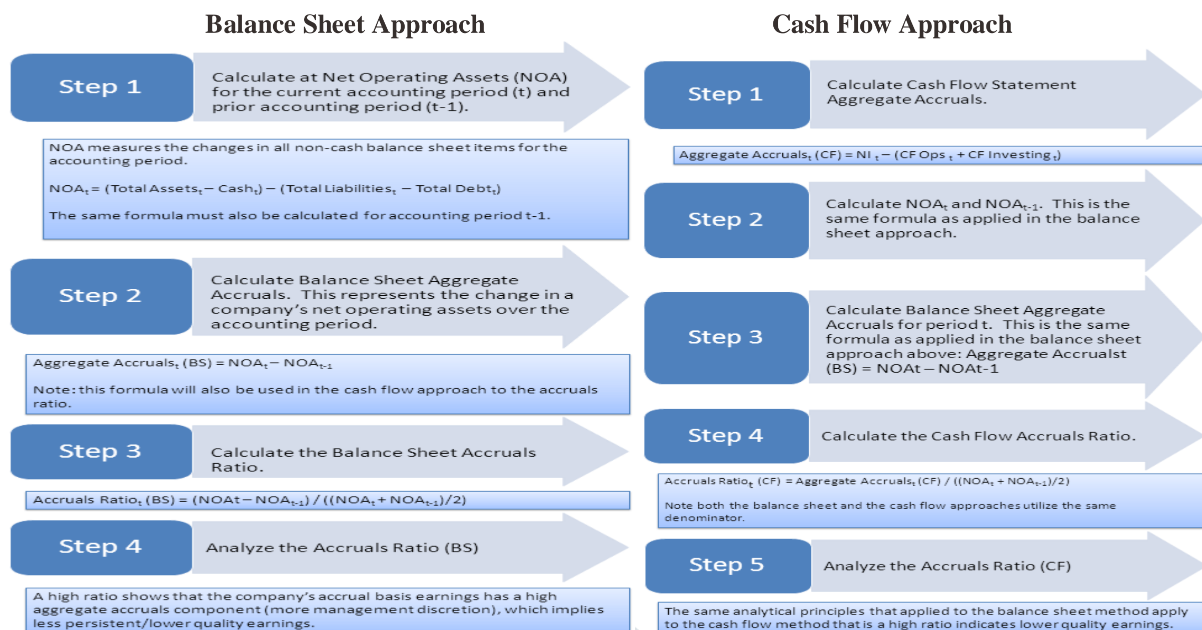
Accrual Earnings has gained attention in recent times as an important indicator of earnings quality. Accruals represent the difference between firms accounting earnings and its underlying cash flows. Accounting statements are prepared using accrual policies hence there could be a huge probability of the net profits differing from the actual cash proceeds of the firm. Since investors rely on the accounting information for decision making the quality of accruals becomes an indicator of future earnings.

The accruals ratio is a measure for analyzing earnings quality. A company's earnings has two components: cash earnings and aggregate accruals. Earnings comprising of high accruals is considered to be of low quality. Aggregate Accruals is the difference between Accrual Basis Earnings and Cash Earnings.

The accruals ratio can be determined using two approaches

- Balance sheet approach
- Cash flow statement approach

The first approach uses information from the balance sheet and the second use the cash flow statement. There is no benchmark ratio which with which the quality of earnings can be marked as good, strong, or poor. The smaller the accrual ratios the higher is the quality of earnings. The two approaches are diagrammatically presented below.



Source: https://financetrain.com/analyzing-earnings-quality-the-accruals-ratio/

Literature Review

Barth et al (2001) expressed that accounting practices have shifted from cash-based accounting to accrual accounting. This has not only provided enhanced information to users but also encouraged companies to exercise manipulation in accounting policies to report best business performance. Accrual accounting sets the ground for these discrepancies.

Dechow (1994) stated that cash flows face the difficulty of time recognition and have a lesser capability to predict firm's performance, therefore, accrual accounting better captures the economic performance of firms than cash flow accounting. Dechaw shows that accruals are inversely related to the quality of earning and argue that the accrual component of earnings though reflects a better financial picture of companies, high accruals management can result in hindering the quality of reported earnings.

Dechow & Dichev (2002) maintained that accrual accounting policies hinder the concept or real earnings. On one hand, accruals increase the credibility of earnings, but on the other hand its flexibility welcomes accounting discrepancies. Even though accruals enhances the credibility but it incorporate risk by overstating/ understating accounting earnings.

Dechaw & Schrand(2004) defined earnings quality can as earnings which sketch accurate image of a company performance, predict the future performance of the company, and help investors in optimizing investing decisions.

James A. Ohlson (2014) proceeds to discuss how the net accrual relates to growth in a firm's operating activities and the extent to which it can be informative or misleading. The study further integrates with the the role of accounting conservatism and quality of earnings.

Suresh et al (2018) reexamined the relative ability of earnings and cash flows in predicting future cash flows. They concluded that earnings show an increasing ability to predict future cash flows but accruals displayed no such trend.

Lyimo (2014) found there is no complete consistency among the measures of earnings quality. Evidence from this study suggests that analyst, investors and market participants should not use one measure of earnings quality since one measure of earnings quality cannot complement other measure of earnings quality.

Chan et al (2001) concluded accruals are negatively associated with future stock returns. Increased Earnings which are accompanied by high accruals suggest low quality earnings and hence are associated with poor stock returns.

Objectives of the Study

1. To examine the firms true earnings.
2. To analyze the Earnings Quality of the firm.

Data &Methodology

The study examines the performance of one Life Insurance Company, whose name has been kept confidential. Data has been sourced from the Annual Reports of the Company. The study has been restricted to a period of 6 years only for want of data. The firm has been in operation for the past 10 years only.

The study has used the Balance Sheet Approach to calculate aggregate accruals and the accrual ratio which is used to measure earnings quality. Studies have concluded that the balance sheet Approach is superior to the Cash Flow Approach for measuring earnings quality. The results of both methods may differ but are highly correlated. According to this approach aggregate accruals are the change in net operating assets (NOA) from one period to the next.

Aggregate Accruals = NOAt – NOAt-1

where NOA = (Total Assets – Cash) – (Total Liabilities – Debt)

Accruals Ratio = (NOAt – NOAt-1) / (NOAt + NOAt-1)/2

The accrual ratio is a measure to identify firms who have low non-cash or accrual-derived earnings when compared to their cash flow. There is no benchmark ratio with which the quality of earnings can be marked as good, strong, or poor. The smaller the accrual ratios the higher is the quality of earnings. When free cash flow is greater than net income, cash earnings are higher than accrual earnings, and the accrual ratio is negative which is good.

Analysis and Findings

Aggregate Accruals is an indicator of the true earnings of the firm. A high level of aggregate accruals reflects poor earnings quality. Falling aggregate accruals means higher amount of cash based earnings.

Table 1: Aggregate Accruals and Accrual Ratio

Balance Sheet Approach		2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Step 1	NOA_t	-999,287	-926,324	-1,236,932	-1,074,726	-1,601,983	-1,637,837
Step 2	NOA_{t-1}	-795,318	-999,287	-926,324	-1,236,932	-1,074,726	-1,601,983
Step 3	**$NOA_t – NOA_{t-1}$ (Aggregate Accruals)**	**-203,969**	**72,963**	**-310,608**	**162,206**	**-527,257**	**-35,854**
Step 4	$NOA_t + NOA_{t-1}$ /2	-897,302.5	-962,805.5	-1,081,628	-1,155,829	-1,338,355	-1,619,910
Step 5	$NOA_t – NOA_{t-1}$ / $NOA_t + NOA_{t-1}$ /2	0.2273	-0.0757	0.2871	-0.1403	0.3939	0.0221
	Accrual ratio	**22.73%**	**-7.57%**	**28.71%**	**-14.03%**	**39.39%**	**2.21%**

Source: Annual Reports and authors compilation

The results (Table: 1) indicate that the firm has generated both positive and negative aggregate accruals. If payables are more than receivables or if incomes are received upfront that is in advance or firm has large non cash expenses, then it will generate negative accruals. On the other hand if organizations have high levels of receivables it gives rise to high positive accruals. Similarly a negative accrual ratio indicates good quality of earnings. But very high negative accrual ratio is also not desirable

An ideal situation is having low levels of aggregate accruals and an accrual ratio which is close to zero. High positive or high negative aggregate accruals or accrual ratios are not sustainable and do not indicate good earning quality.

It is therefore concluded that the Quality of Earnings for the years 2013/14 and 2017/18 are satisfactory as the accrual ratios are closer to zero.

Conclusion

Investors and analysts track net incomes as a measure of fundamental analysis to make investment decisions. If a company's net income is higher than it was in the previous years it means the company has a good earnings prospect. But how reliable are the earnings reported in the financial statements. Companies manipulate or manage their earnings by using different accounting techniques and present a positive view of their activities.

Investors should thus beware of firms who have large positive accruals over long periods of time as they indicate low quality of earnings. Thus assessing the earnings quality of a firm along with other fundamental measures of analysis to make investment decisions would ensure sound decision making.

Limitations and Further Scope for Study

The study was restricted to one company only and data for a limited period was considered. A comparative study of two or more firms would be would be more relevant. A longer period of study would help in drawing appropriate conclusions. Analyzing the earnings quality of manufacturing organizations which have huge inventories and receivables rather than service organizations would be ideal as they have a larger scope to manage their earnings by using different accounting principles and conventions. Earnings Management takes care of fluctuations in earnings and hence measuring earning quality has become indispensible as financial statements cannot be taken at their face value.

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