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The risk of earnings quality impairment

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Abstract

This paper reviews prior studies that provide an understanding of earnings quality concepts. It presents various definitions of earnings quality and discusses proxies used in empirical literature to measure earnings quality. Prior studies measure earnings quality by using time-series properties of earnings including earnings persistence, predictability, timeliness and volatility; relating accruals to future cash flows, associating earnings with stock market metrics such as stock prices and returns and assessing the level of discretionary accruals. The literature emphasizes that the quality of earnings is very important as the earnings figure is widely used in many contractual agreements and investing decisions.

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*Keywords:*Earnings Quality; Earnings Persistence; Predictability; Timeliness; Volatility

1. Introduction

The extant literature has not yet come to a unanimous conclusion on what earnings quality is; rather it is viewed as a conceptual term that can be defined from many different perspectives. Academic researchers have introduced and operationalized different dimensions of earnings quality construct using certain characteristics of earnings and its components. This conceptual paper describes the definitions from financial statements users' perspective and economic-based perspective, discusses various measures used in prior studies as proxies for earnings quality,

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explains the functions and limitations associated with each approach and provides examples of the application of each approach in existing studies on earnings quality.

2. Earnings Quality from Different Perspectives

The quality of earnings is usually defined in accounting studies from two different perspectives, the decision-usefulness perspectives and the economic-based perspectives. From a decision-usefulness perspective, earnings quality is regarded as being high if the earnings numbers are useful for decision making purposes. Based on this point of view, the notion of earnings quality is defined differently by different users of financial statements. For example, according to Dechow and Schrand (2004), analysts are likely to view earnings to be of high quality when the earnings numbers accurately reflect the company's current operating performance, are good indicators of future operating performance and are a good summary measure for assessing firm value. This is consistent with the objectives of financial analysts, which are to evaluate the performance of the company, assess the extent to which current earnings indicates future performance and determine whether the current stock price reflects intrinsic firm value (Dechow and Schrand, 2004). Investors are likely to have similar objectives. On the other hand, creditors and compensation committees may define high quality earnings as earnings that are easily convertible into cash flows and that reflect managers' real performance.

Financial statement users may also define earnings quality in terms of the 'absence of earnings management'. This is because the intentional manipulation of earnings by managers, within the limits possible in accounting standards, may distort the usefulness of earnings to users. Earnings that are persistent and predictable may not be of high quality if it is a result of earnings management. Managers may tend to manage earnings for a number of reasons including those related to capital market motivations, compensation and bonus as well as debt or lending contracts, which will result in low quality of earnings. According to Schipper and Vincent (2003), debt agreements based on low and defective earnings will induce unintended wealth transfers; overstated earnings used as an indicator of managers' performance in compensation contracts will result in overcompensation to managers; and low quality of earnings will provide defective resource allocation signals to investors.

Dechow and Schrand (2004) state that when earnings conform to the spirit and the rules of generally accepted accounting principles, they are of high quality in the eyes of regulators. Earnings should be free from fraud and show a true and fair view of a company's financial performance. However, accounting standard setters are also concerned with the effectiveness of the standards that they have promulgated. By focusing on the usefulness of earnings numbers to financial statements users, standard setters can evaluate quality of earnings prepared under a particular set of accounting standards.

Other than the decision-usefulness context, earnings quality has also been explained in prior research using the economics-based definition of Hicksian income (e.g. Dempster, 2008; Hodge, 2003; Schipper and Vincent, 2003). Shipper and Vincent (2003, p. 98) define earnings quality as "*the extent to which reported earnings faithfully represent Hicksian income, where representational faithfulness means correspondence or agreement between a measure or description and the phenomenon that it purports to represent*". This construct measures the quality of earnings based on its correlation with 'true earnings', which does not depend on accounting recognition rules and the implementation of the accounting rules. 'True earnings' is a neutral and context-free benchmark, yet difficult to assess as Hicksian income is not observable. However, since Hicksian earnings are not observable, the construct is not operational (Schipper and Vincent, 2003).

Similar to the Hicksian income definition, Yee (2006) explains that earnings quality depends on two main elements, the 'fundamental' earnings and reported earnings. The former is a profitability figure that measures a firm's ability to make future dividend payments, while the latter is an imperfect signal or estimation of 'fundamental' earnings that a firm announces. According to Yee (2006), earnings quality is based on the ability of reported earnings to quickly and precisely reveal a firm's fundamental earnings. The more accurate and timely that reported earnings reflect shocks in the present value of expected future dividends, the higher the quality of earnings.

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