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Earnings quality: Evidence from the field ☆

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ABSTRACT

We provide insights into earnings quality from a survey of 169 CFOs of public companies and in-depth interviews of 12 CFOs and two standard setters. CFOs believe that (i) above all, high-quality earnings are sustainable and repeatable; specific characteristics include consistent reporting choices, backing by actual cash flows, and absence of one-time items and long-term estimates; (ii) about 50% of earnings quality is driven by non-discretionary factors such as industry and macro-economic conditions; (iii) in any given period, about 20% of firms manage earnings to misrepresent economic performance, and for such firms 10% of EPS is typically managed; (iv) earnings manipulation is hard to unravel from the outside but peer comparisons and lack of correspondence between earnings and cash flows provide helpful red flags. In addition, CFOs disagree with current standard setting on a number of issues including the sheer number of promulgated rules, the top-down approach to rule-making, the neglect of the matching principle, and the emphasis on fair value accounting. They indicate that a rules-based culture makes the audit function centralized and mechanical, and hinders the development of audit professionals. A summary impression from our work is that CFOs view earnings quality as more of a single and unconditional characteristic, in contrast to current research where measures of earnings quality are strongly conditional on the decision setting. This CFO view is related to their idea of “one number” – a single earnings metric that shapes both their interactions with external stakeholders and internal decision-making.

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1. Introduction

The concept of earnings quality is fundamental in accounting and financial economics. Yet, there are broad disagreements about how to define and measure it. The list of candidate measures is long: earnings persistence, predictability, asymmetric loss recognition, various forms of benchmark beating, smooth earnings, magnitude of accruals, income-increasing accruals, absolute value of discretionary or abnormal accruals, and the extent to which accruals map into cash flows. Complicating the measurement of earnings quality, archival research cannot satisfactorily parse out the portion of managed earnings from the portion resulting from the fundamental earnings process (Dechow et al., 2010). Thus, a number of vexing questions have been difficult to address with archival work because answers often rely on unobservable managerial intent. Examples of such questions include the following: What opportunities and constraints do managers trade off to choose one set of earnings attributes over the other? What accounting policies promote higher quality earnings? How prevalent is earnings management? What is the typical magnitude of earnings management? How can an outside investigator tell whether ex-ante earnings quality is poor before observing ex-post outcomes such as restatements and SEC enforcement actions? These are the types of questions we endeavor to answer.

In this paper, we provide insights about earnings quality from a new data source: a large survey and a dozen interviews with top financial executives, primarily Chief Financial Officers (CFOs). Why CFOs? First, CFOs are the direct producers of earnings quality, who also intimately know and potentially cater to consumers of earnings information such as investment managers and analysts. CFOs make the key decisions on how to apply accounting standards in their company, and whether to use or abuse discretion in financial reporting. Second, CFOs commonly have a formal background in accounting, which provides them with keen insight into the determinants of earnings quality, including the advantages and limitations of GAAP accounting. Third, CFOs are key decision-makers in company acquisitions (see Graham et al., 2012), which implies that they have a working knowledge of how to evaluate earnings quality from an outsider's perspective. Finally, CFOs have access to much tacit knowledge about earnings quality through their networks of financial executives in their industry and geographical neighborhood, e.g., from informal conversations about earnings management in peer companies.

Although field studies suffer from their own problems (potential response bias, limited number of observations, whether questions on a survey instrument are misinterpreted, do respondents do what they say, do they tell the truth, do they recall the most vivid or their most representative experience), surveys offer a potential way to address often intractable issues related to omitted variables and the inability to draw causal links that are endemic to large-sample archival work. Surveys and interviews also allow researchers to (i) discover institutional factors that impact practitioners' decisions in unexpected ways and (ii) ask key decision makers directed questions about their behavior as opposed to inferring intent from statistical associations between proxy variables surrogating for such intent. Critically, we try to provide some idea about “how it all fits together”, i.e., about the relative importance of individual factors and how they come together to shape reported earnings. Our intent is to provide evidence on earnings quality, complement existing research, and provide directions for future work.

Our key findings fall in three broad categories. The first includes results related to the definition, characteristics, and determinants of earnings quality. On definition, CFOs believe that, above all, quality earnings are sustainable and repeatable. More specific quality characteristics include consistent reporting choices over time, backing by actual cash flows, and absence of one-time items and long-term estimates – all factors that affect earnings sustainability. This view of earnings quality is consistent with a valuation perspective, where investors view the firm as a long-life profit-generating entity, and value is based on estimating and discounting the stream of future profits. Consistent with this view, current earnings are considered to be high quality if they serve as a good guide to the long-run profits of the firm. The dominance of the valuation perspective is confirmed in the responses to our survey question about how interested parties use earnings. However, we also find that the stewardship uses of earnings (debt contracts, managerial compensation) and internal uses (in managing own company) rank closely behind the valuation use. In addition, executives often refer to their reliance on “one number” for both external and internal reporting. The resulting impression is that the reported earnings metric serves consistent and integrated purposes across these different uses, and thus earnings quality is shaped by and in turn influences all of these uses. This “one number” view of reported earnings, and the single overarching concept of earnings quality mentioned above, stand in contrast to the current research consensus that emphasizes the conditional nature of earnings quality (i.e., earnings quality as a patchwork of earnings characteristics which gain or fade in importance depending on the decision setting). In terms of determinants, CFOs estimate that innate factors (beyond managerial control) account for roughly 50% of earnings quality, where business model, industry, and macro-economic conditions play a prominent role.

The second set of results relates to how standard setting affects earnings quality. CFOs feel that reporting discretion has declined over time, and that current GAAP standards are somewhat of a constraint in reporting high quality earnings. A large majority of CFOs believe that FASB's neglect of matching and emphasis on fair value adversely affect earnings quality. CFOs would like standard setters to issue fewer rules, and to converge U.S. GAAP with IFRS to improve earnings quality. Further, they believe that earnings quality would improve if reporting choices were to at least partly evolve from practice rather than being mandated from standards. CFOs also feel that the rules-orientation of the FASB has centralized and ossified the audit function, depriving local offices of discretion in dealing with clients, and hindering the development of young auditing professionals. Overall, CFOs have come to view financial reporting largely as a compliance activity rather than as a means to innovate to deliver the best possible information to stakeholders.

Our third set of results relates to the prevalence, magnitude, and detection of earnings management. Our emphasis is on observable GAAP earnings and on a clear definition of earnings management, asking for within-GAAP manipulation that