Journal of Accounting and Economics 56 (2013) 34–41

Contents lists available at ScienceDirect

Journal of Accounting and Economics

journal homepage: www.elsevier.com/locate/jae

How should we think about earnings quality? A discussion of "Earnings quality: Evidence from the field"[☆]

Mark W. Nelson[a], Douglas J. Skinner[b,*]

[a] S.C. Johnson Graduate School of Management, Cornell University, NY 14850, USA
[b] University of Chicago Booth School of Business, IL 60637, USA

ARTICLE INFO

Available online 11 November 2013

JEL classification:
G30
M14
M41

Keywords:
Earnings quality
Earnings management
FASB
Survey methods
CFOs

ABSTRACT

Dichev, Graham, Harvey and Rajgopal (DGHR, in this issue) survey chief financial officers (CFOs) to elicit their views on earnings quality, broader trends in financial reporting, and the prevalence of earnings management. They provide some interesting insights on these issues. We discuss how CFOs' incentives in the financial reporting process are likely to affect what we can learn from them about earnings quality. We also discuss how DGHR's methodological choices regarding survey sample and question design affect their inferences, including what we can infer about the prevalence and magnitude of earnings management.

© 2013 Elsevier B.V. All rights reserved.

1. Introduction

Dichev, Graham, Harvey and Rajgopal (hereafter DGHR, in this issue) continues a series of papers in accounting and finance that draw inferences about corporate financial policies from surveys of corporate chief financial officers (CFOs).[1] These papers provide many novel insights in a variety of areas. The goal of DGHR is to provide survey evidence on CFOs' views about earnings quality. To supplement and enrich these results, the authors also present results from one-on-one interviews from a small sample of CFOs and two accounting standard-setters.

We summarize and discuss a number of aspects of DGHR, including motivation, method, results, and inferences. We agree with the authors that the findings potentially inform policy and research discussions on earnings quality issues. Nevertheless, we also raise questions about the appropriateness of applying this approach to the earnings quality literature as well as about some of the inferences drawn by the authors.

☆ This is an invited discussion of the paper by Dichev et al. (2013) based on our invited discussions of the paper at the 2012 JAE conference. We thank Rob Bloomfield, Scott Emett, Michelle Hanlon, and Bob Libby for comments on prior versions.

* Corresponding author. Tel.: +1 7737027137.
E-mail addresses: mwn2@cornell.edu (M.W. Nelson), dskinner@chicagobooth.edu (D.J. Skinner).

[1] See Graham and Harvey (2001, 2002) on corporate finance, Graham et al. (2005, 2006) on financial reporting, Brav et al. (2005) on payout policy, and Ben-David et al. (2013) on managerial miscalibration. In accounting, many surveys have also elicited data from auditors; see, e.g., Bell et al. (2001), Gibbins and Newton (1994), Gibbins et al. (2001), Nelson et al. (2002), and Gibbins et al. (2005).

0165-4101/$ - see front matter © 2013 Elsevier B.V. All rights reserved.
http://dx.doi.org/10.1016/j.jacceco.2013.10.003

2. Contribution

2.1. Is there a single definition of earnings quality?

To open the paper, the authors state that "there are broad disagreements about how to define and measure it (earnings quality) (p. 2)." To support this statement, they list several candidate measures, including earnings persistence, predictability, asymmetric loss recognition, income increasing accruals, and the absolute value of accruals. Although these are certainly all earnings-related measures, it is not clear that the use of these measures reflects disagreement in the literature about what earnings quality means.

Like art, how one thinks about earnings quality is to some degree in the eye of the beholder: this term is primarily used in financial statement analysis—the decisions being made and the decision contexts are likely to vary. In a recent review on this topic, Dechow et al. (2010, p. 344) indicate that "(h)igher quality earnings 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* (emph. added)" and "(w)e reach no single conclusion on what earnings quality is because "quality" is contingent on the decision context." Given the inherently context-specific nature of earnings quality, it is not surprising that earnings quality is not defined or measured in a uniform way in our literature. Therefore, DGHR should not be viewed as resolving a disagreement in the literature as much as contributing insights from CFOs with respect to this topic.

2.2. What can CFOs tell us about earnings quality?

Previous survey work in this genre produces novel insights beyond what is possible from traditional empirical archival research. For example, a great deal of empirical research in corporate finance attempts to provide a better understanding of the determinants of capital structure and payout policy. However, that research has made limited progress in answering some open questions in this literature, such as why industrial firms are not more heavily levered given the apparent tax advantages of debt and why dividends are such a persistent phenomenon in spite of the apparent advantages of stock repurchases. Evidence from large-sample surveys of CFOs provides researchers with fresh ideas about what CFOs actually do in practice and so helps to calibrate empirical research. Brav et al. (2005) provide evidence that managers often set dividend policy based on changes in nominal dividends-per-share, as opposed to following more conventional ways of thinking about dividend policy (such as payout ratios based on the Lintner model). This evidence is useful because it helps researchers develop and test alternative theories of payout policy—survey evidence can be used to inform and influence other methods of investigation, including large sample empirical work.

The reason these studies have been so informative is largely because CFOs (managers) are directly involved in the decisions of interest—we learn from managers about how and why they make the decisions they do. It is less obvious that managers' views about earnings quality are of interest because it is not clear why they have any particular comparative advantage in determining a universal definition of earnings quality that can be used in the literature. Earnings quality is an amorphous idea that is used in a variety of financial statement analysis contexts, so perhaps the views of key users, such as analysts or investors, would be of more interest.

DGHR's perspective is that managers' views on earnings quality are of interest because managers make the financial reporting decisions that generate the earnings numbers that are of interest. But it is not clear that earnings quality is a construct that is of much import to them or that they have earnings quality in mind when they make financial reporting decisions. It is also possible and perhaps likely that managers' particular views about earnings quality are affected by their financial reporting incentives, a point we discuss further in Section 3.

To the extent there is disagreement in the literature, it seems to reflect differences of opinion about whether earnings quality has mostly to do with earnings persistence (higher quality earnings are more persistent) or the extent to which earnings reflect underlying economic reality. For example, artificially smoothed earnings are likely to be more persistent (and so of high quality in one sense) but may not reflect the underlying volatility of the firm's business (and so of low quality in another). In this situation, the more volatile time series could be seen to be of higher quality because it more faithfully reflects the underlying economics. However, if the artificially smoothed series better reflects the firm's ability to generate long run economic value (that is, the smoothed earnings trend signals the firm's long run ability to deliver increases in earnings in spite of shorter-run volatility in its business), it is less clear that the artificially smoothed series is of lower quality. A lot depends on management intent and the decision context of the user.

To the extent managers use their discretion in the financial reporting process to improve the signal value of earnings (that is, to increase informativeness about the underlying economics), management discretion can improve earnings quality. Moreover, the normal operation of the accruals process is such that it smooths out the volatility of cash flows and so results in a smoother and more informative measure of economic performance (*e.g.*, Dechow, 1994; Dechow and Skinner, 2000). Conversely, to the extent that managers use their financial reporting discretion to distort the signal value of earnings (that is, they engage in opportunistic earnings management to obscure the economics), earnings quality is reduced. All of this means that it will be hard to reach definitive conclusions about how different earnings measures (such as accruals, discretionary accruals, the use of unusual items, the absolute value of accruals) relate to earnings quality without specifying something about the user and the decision context.

Put differently, DGHR view CFOs as a lens through which to identify the characteristics of high-quality earnings. However, like any lens, this one can add distortion. Without knowing the particular incentives of the CFO, it is difficult to

Download English Version:

https://daneshyari.com/en/article/5086692

Download Persian Version:

https://daneshyari.com/article/5086692

Daneshyari.com