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Understanding of Proxies in Earning Quality: An Introduction

KEYWORDS

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ABSTRACT *An earning quality reflects the company's current operating performance, is a good indicator of future operating performance and is a useful measure for assessing firm value. Greater earning persistence is a meaningful definition for earning quality only if earnings truly reflect performance during the period and if current period performance persists in future periods. Earnings of high quality are attributable to conservative accounting standards and / or strong cash flows. The study will examine key issues of proxies relating to earnings quality, including the attributes of high-quality earnings with relevance and reliability.*

INTRODUCTION

An earning quality reflects the company's current operating performance, is a good indicator of future operating performance and is a useful measure for assessing firm value. Earnings quality, in accounting, refers to the overall reasonableness of reported earnings It is an assessment criterion for how "repeatable, controllable and bankable" a firm's earnings are, amongst other factors, and has variously been defined as the degree to which earnings reflect underlying economic effects, are better estimates of cash flows, are conservative, or are predictable. Earnings are of high quality when return on equity is a good measure of the internal rate of return on the company's current projects.

Greater earning persistence is a meaningful definition for earning quality only if earnings truly reflect performance during the period and if current period performance persists in future periods. Persistence alone is not indicative, however, of high quality earning; the earnings stream must also reflect underlying intrinsic value. Earning quality can vary among companies as a function of accruals even in the absence of intentional earnings manipulation. Unlike the determination of cash flow, the determination of earnings requires estimations and judgments and some companies require more forecasts and estimates than others. Earning quality can be improved when accruals smooth out value-irrelevant changes in cash flows, but earning quality is reduced when accruals are used to hide value-relevant changes in cash flow. Both relevance and reliability are needed to have high quality earnings.

Accounting information with high quality takes a part of protecting the investors. While insiders may manipulate accounting information of the firm in the processes of corporate control transfer and others assets restructuring, the quality of accounting information may be decreased. When a firm practices conservative accounting, changes in the amount of its investments can affect the quality of its earnings. Growth in investment reduces reported earnings and creates reserves. Reducing investment releases those reserves, increasing earnings. If the change in investment is temporary, then current earnings is temporarily depressed or inflated, and thus is not a good indicator of future earnings. This study develops diagnostic measures of this joint effect of investment and conservative accounting. We find that these measures forecast differences in future return on net operating assets relative to current return on net operating assets. Moreover, these measures also forecast stock returns—indicating that investors do not appreciate how conservatism and changes in investment combine to raise questions about the quality of reported earnings.

EARNINGS QUALITY

In the prior empirical study, Biddle, Seow G. G., Siegel A. (1995) and Liu J., D. Nissim, J. Thomas (2002) show that earnings are the main source of firm-specific accounting information, so my study uses earnings quality as a proxy for information quality. Earnings quality measure is based on the model in Francis, J., R. LaFond, P. Olsson, and K. Schipper (2005) which uses a combination of the Jones model (1991) and Dechow and Dichev's (2002) model.

$$\frac{TACC_{it}}{TA_{it}} = \varphi_0 + \varphi_1 \frac{1}{TA_{it}} + \varphi_2 \frac{\Delta REV_{it}}{TA_{it}} + \varphi_3 \frac{PPE_{it}}{TA_{it}} + \varphi_4 \frac{CFO_{it-1}}{TA_{it}} + \varphi_5 \frac{CFO_{it}}{TA_{it}} + \varphi_6 \frac{CFO_{it+1}}{TA_{it}} + \varepsilon_{it}$$

Where:

$TACC_{it}$ = total accruals for firm i in year t, defined as the difference between net income before extraordinary items and operating cash flow,

ΔREV_{it} = change in revenue for firm i in year t,

PPE_{it} = gross property, plant and equipment for firm i in year t,

CFO_{it} = cash flow from operations in year t,

TA_{it} = average total assets for firm i in year t.

To estimate earnings quality, firstly consider the model above by each industry-year. The residuals (abnormal accruals) reflect:

1) estimation error in a firm's accruals
2) intentional accrual manipulations by the firm's management

Therefore, this measure meets Lambert, R., C. Leuz, and R. Verrecchia (2007) definition of information quality. Because the magnitude of the residuals is an inverse indicator of earnings quality, the negative of (time period) standard deviation of the residuals as measure of earnings quality (EQ), so that higher values of EQ indicate higher earnings quality.

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EQ = Earnings quality, measured by the negative of firm-specific (time period) standard deviation of residuals estimated

MAGNITUDES OF EARNINGS QUALITY

The effect of earnings quality for companies are higher quality of earnings, often helps companies to receive higher stock prices, higher credit limits, lower interest rates, etc. Because there are so many magnitudes of earnings quality, market participants use various aspects to estimate this quality. For instance, analysts might consider the following aspects when evaluating the quality of earnings:

- Earnings characteristics: earnings trend, major source of net income, conversion of sales into cash
- Firm characteristics: market share, brand awareness and loyalty, labor relations, performance, size, growth, investment, debt, etc.
- Financial ratios: debt-to-equity, total liabilities to total assets, rate of return on investment, earnings per share, price-earnings ratio, dividend payout ratio, net profit as a percentage of sales, percentage of expenses to sales, sales growth rate, etc.
- Firm financial reporting practices: financial statement classification, interim reporting, accounting methods used, etc.
- Firm governance and internal controls: internal controls, characteristics of the top management, managerial ownership and compensation, etc.
- Audit: auditor industry expertise, hours spent auditing, etc.
- External factors: politics interferences, tax regulation, capital requirements, etc.
- Capital market incentives: earnings-based targets, raising capital, etc.
- Properties of earnings: earnings persistence and smoothness, timely loss recognition, accounting conservatism, magnitude of accruals, target beating, etc.
- Investor responsiveness to earnings: accounting methods, auditor quality.
- External indicators of earnings misstatements: restatements, internal control deficiencies

FACTORS

A condition describing how earnings are recognized; earnings of high quality are attributable to conservative accounting standards and / or strong cash flows. Low quality earnings come from artificial sources, such as inflation or aggressive accounting. Quality of earning rating is subjective, but it does take into account matters such as corporate governance inventory to sales ratios and other factors.

An assessment of earnings quality would therefore be based on other factors, such as

- A correlation between reported earnings and underlying economic activity,
- The permanence and sustainability of reported earnings,
- The relationship between reported earnings and market valuation,
- The extent and impact of discretionary accruals,
- The transparency and completeness of disclosures,
- The impact of low reported earnings on corporate image,
- The company's handling of "bad news," and
- The degree to which earnings are good estimates of cash flows.

FINDINGS

The major proxies of the study are as follows:-

- **Based on Accruals:-**
- Misunderstanding the nature of the quality of accruals
- Manipulation of long term and short term accruals
- Estimation error in extreme accruals that reserves
- The influence of capital market incentives on firms' accounting choices, making them potential determinants of earnings quality.
- Evidence of earnings management to meet or beat earnings targets.
- External factors, including capital requirements, political processes, and tax and non-tax regulation, are associated with accounting choices.
- Tax regulations affect accounting choices.
- The decision makers considered include plaintiffs, auditors, capital market participants, boards/compensation committees, and analysts.
- A more persistent earnings number is indicative of higher earnings quality.
- Investor responsiveness to earnings is a direct proxy for earning quality.

CONCLUSION

The study has significant conclusions based on involve earning, fundamental performance of the organization and the measurement of the performance. Other aspects of financial statements get overlooked, even though these items may provide information about the quality of firms' reported earnings. This study describes a process that will assist you in determining to what degree the reported earnings have been manipulated by management. The results of the analysis won't deliver a definitive thumbs-up or thumbs-down regarding the quality of earnings, but it will enable you to better understand the risks in the firm's accounting for earnings. The study has examined key issues proxies relating to earnings quality, including the attributes of a high-quality earnings number and the tradeoff between relevance and reliability. The message of study is that earnings quality will vary even when managers follow GAAP with the best intentions. Furthermore, not every change in accounting policy and accruals signals an attempt to manipulate reported earnings. In order to determine the degree of earnings quality, investors must look at factors outside the financial reporting system that can affect earnings quality. Investors must also identify the types of accounts companies are most likely to manage and the circumstances in which earnings management is most likely to occur. Finally, investors can use metrics to quantify the degree of earnings management and some methods used to compare these metrics over time and across firms. There is significant need for the development of a uniform definition and a consistent model to measure earnings quality. The quality of earnings includes the ability of reported earnings to reflect the company's true earnings, as well as the usefulness of reported earnings to predict future earnings. The study takes into account factors that are expected to affect future earnings but that are not explicitly disclosed in the financial statements.

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