Earnings Quality

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CARE Conference
8 April 2006

CARE Participant Categories

- Young
- Middle aged
- Old
- Fossil
- Long since beyond it

Earnings Quality Issues Are Important

1. *Quality* issues underlie much accounting practice, research and teaching.
2. *Quality* makes us consider both demand (users) and supply (preparers) simultaneously.
3. *Earnings* quality is highly correlated with financial reporting quality generally.

1. Quality Issues Are Pervasive

- Quality issues underlie much accounting practice, research and teaching.

- Examples:
  - ✓ Price association studies: Information content and timeliness as measures of quality.
  - ✓ Costly contracting studies: Usefulness in debt, compensation contracts as indicators of quality.
  - ✓ The earnings management bubble.

2. Addressing Both Users and Preparers

- Quality makes us simultaneously consider:
  - Users (demand); and
  - Preparers (supply).

  ... both in concept and measurement.
- My interpretation of “quality” in financial reporting is similar to quality in any industry.
- GM cannot (should not) assess the quality of its autos without knowing what is important to its customers.
- The financial reporting industry is no exception.

3. Earnings Quality Is an Index of Financial Reporting Quality Generally

- Earnings quality flows onto:
  - Balance sheets; and
  - Cash flow statements (lesser degree)

- Our focus on *earnings* quality is not due only to the Wall Street focus on earnings.

Problems with Earnings Quality as a Concept

1. Quality means something different to different users.
2. Optimal financial reporting cannot be considered in isolation from disclosure.
3. Optimal quality depends on cost.

- Jake will discuss related measurement issues.

1. Quality Differs by User

- Relevance of market-book RSQs at the individual-security level differs between:
  - Well diversified portfolios; and
  - Poorly diversified portfolios.

- Debt and equity market demands differ:
  - Financial reporting (recognition) versus disclosure; and
  - Gains versus losses

⇒ One cannot discuss quality without a user group in mind.

⇒ "General purpose" financial statements are a myth.

2. Jointly Optimal Financial Reporting and Disclosure

- Assume: Financial reporting quality and disclosure quality are not independent.
- Then optimal financial reporting cannot be considered in isolation from its effect on disclosure (and v.v.).
- Example: Relative to simply counting actual CF outcomes, bringing more forward-looking information (revisions of CF expectations) into earnings could:
  1. Increase earnings quality measures (e.g., RSQ);
  2. Reduce disclosure quality (less accountability); and
  3. Reduce aggregate information quality.

3. Optimal Quality Depends on Cost

- Academics, accounting practitioners and analysts are cheerleaders for higher quality.
- We are demand-side analysts of financial reporting.
- However, companies (and those contracting with them) pay the cost.
- I am unaware of serious efforts to model and/or measure the financial reporting production function – i.e., the supply schedule.
- Sarbanes-Oxley and other large regulatory changes give us an ideal and timely experiment for identifying and measuring costs (supply).
- Do we as a group want to be associated with making the US financial markets less competitive?

Vacuous Summary

- All concepts have strengths and weaknesses.

- Earnings quality is no exception.