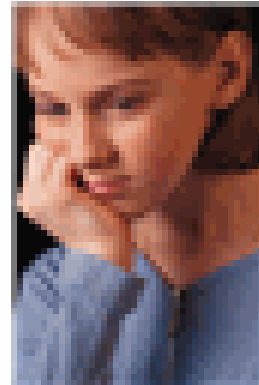


# *CARE Conference*

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what on earth is  
earnings quality?

Jake Thomas  
Yale University



## *Cathy's talk*

- Commendable that she took a high-level, philosophical view to untangle what is a mess.
- The tone of optimism is refreshing; networks are being built that reinforce the different observable attributes.
- The message that EQ is an underlying but unobservable construct is important to keep in mind
- Potential concern about sloppiness (EQ is used for convenience, even if not appropriate)

**I will be the grouchy old guy today!**

## *first, give props to Imhoff*

- Back in the early 1980's, Gene surveyed analysts on Accounting Quality
- Hand collected FAF data on Disclosure Quality (DQ)
- What did we find?
  - analysts agreed on AQ scores for different firms
  - AQ is not related to valuation (AQ unrelated to P/E)
  - AQ is positively related to accounting conservatism
  - AQ is positively related to DQ
  - AQ is negatively related to volatility & risk
- But don't managers choose AQ and DQ?
  - profitable firms had higher AQ; they were more conservative and had higher DQ

## *some conceptual issues re EQ*

- should EQ include properties of unmanaged earnings?
- is all earnings management bad, or only the opportunistic portion?
  - is unbiasedness the goal?
  - signaling pvt. information about future?
- what about level of disclosure?
- what's the role of guidance?

## *so, why be grouchy?*

- There isn't just one network that is being built, there are two or more.
- More important, some of these networks appear to be negatively related.
  - Both can't be measuring the same construct.
  - Researchers studying the links between EQ and other factors (such as governance) will now always get the result they want.
- Also, these constructs are related to a variety of economic factors (level of WC, growth, industry) that may be unrelated to EQ, but not picked up by researcher.

## *nature of conflicts*

- smooth earnings streams are good vs. earnings smoothing is bad
- conservative is good vs. unbiased is good
- increasing the earnings multiple vs. mark to market

## *different EQ measures*

- Had Ph.D. students create a database with a bunch of EQ measures from the literature
- Looked at
  - correlations across measures,
  - correlation with industry membership
  - correlation with fundamentals (ROE, P/E, ....)
  - variation across time

# *results*

- clusters
  - level of accruals
  - level of discretionary accruals
  - volatility of accruals/disc. accruals
  - correlation between accruals/cash flows
  - volatility of earnings
  - conservatism
- some clusters are negatively related to other clusters
- clusters are related to industry, fundamentals, and vary over time



*time to pay homage?*



- researchers should stop using earnings quality; instead, they could define & label appropriately the specific concept they have in mind.

## *What is Quality?*

“Quality . . . you know what it is, yet you don't know what it is. But that's self-contradictory. But some things are better than others, that is, they have more quality. But when you try to say what the quality is, apart from the things that have it, it all goes poof! There's nothing to talk about.

But if you can't say what Quality is, how do you know what it is, or how do you know that it even exists? If no one knows what it is, then for all practical purposes it doesn't exist at all. But for all practical purposes it really does exist. What else are the grades based on? Why else would people pay fortunes for some things and throw others in the trash pile?

Obviously some things are better than others . . . but what's the betterness? . . . So round and round you go, spinning mental wheels and nowhere finding anyplace to get traction. What the hell is Quality? What is it?”

*~ Zen and the Art of Motorcycle Maintenance*