QUALITY OF EARNINGS AND EARNINGS MANAGEMENT

A Primer for Audit Committee Members

BY ROMAN L. WEIL

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As an audit committee member, you are familiar with the terms "quality of earnings" and "earnings management." This primer defines these terms and explains your role in performing oversight of a company's financial statements.

What is Quality of Earnings?[1]

The terms "quality of earnings" and "earnings quality" have no single, agreed-upon meaning. Both terms are used when making accounting choices; considering the business cycle, including timing of transactions; and discussing earnings management [see page 2].

Accounting Choices

- Some use "quality of earnings" to mean the degree to which management's choices of accounting estimates can affect reported income (these choices occur every period). For example: those who use the term in this manner judge an insurance company's earnings to be of low quality. The company's management must re-estimate its future payments to the insured, by period — and the estimates are made about long-term imponderables, such as how long a person will live or future earnings on investments. Such estimates are difficult to quantify, or fuzzy, which gives the company the opportunity to report a wide range of periodic earnings. The result: even if management does not use fuzzy estimates to manipulate its earnings, the opportunity is there — which causes users to think earnings numbers are of low quality.

- Others use the phrase to mean the degree to which management takes advantage of its flexibility. For them, an insurance company that does not vary its methods and estimating techniques, despite the opportunity to do so, has high-quality earnings.

- Some have in mind the proximity in time between revenue recognition and cash collection on the one hand, and expense recognition and cash expenditure on the other. For them, the shorter the delay, the higher the quality. A company with all cash sales, no warranty or other after-market promises, and no long-term assets has high-quality earnings. A company engaged in a long-term construction project with cash collections near project's end, and construction equipment with long depreciable lives, has low-quality earnings.

- Still others use the phrase to mean the degree to which managers, when faced with a choice of items that have a high impact on earnings, choose items that result in income recognition that's more likely to lead to recurring patterns of income. For them, the more likely an item of earnings is to recur, the higher its quality will be.

- Consider, for example, a car dealer who leases cars to customers. The leasing dealer who uses operating lease accounting has perfectly matching revenue recognition and cash collection, but the recurring nature of the revenue, with monthly receipts, might

1: This section uses material from the textbook *Financial Accounting: An Introduction to Concepts, Methods, and Uses, 13th edition*, published by South-Western, Cengage Learning, 2010, and written by Clyde P. Stickney, Roman L. Weil, Katherine Schipper and Jennifer Francis.

mislead the unwary reader of financial statements into thinking that the key, income-generating transaction — the signing of the lease — recurs.

Often, the latter two groups trade off: Consider the dealer leasing a car long-term and receiving monthly collections. The dealer who uses sales-type lease accounting scores low on proximity of revenue recognition (all at the time of signing the lease) to cash collection, but highlights the non-repetitive nature of the transaction. The leasing dealer who uses operating lease accounting exactly matches revenue recognition and cash collection, but disguises the fact that the key transaction — leasing the car — happens only once.

When considering the company's income-earning event, one could mean the underlying economic event (car dealer signs the lease) or the revenue recognition (the dealer using operating lease accounting receives cash). This is a good example of the need for careful interpretation of "quality of earnings" in discussions and documents. A writer who focuses on the episodic nature of signing lease agreements may deem this company's earnings low quality because transactions do not regularly recur, while a writer who focuses on cash flow will consider the earnings high quality because the cash flow is regular.

Some who refer to "earnings quality" suspect that managers usually will make choices that enhance current earnings and present the firm in the best light, regardless of the firm's ability to generate future, similar earnings.

Business Cycles

In regard to business cycles, management's actions often have no impact on the stability and recurrence of earnings. Compare a company that sells consumer products and has repeat sales every week vs. a construction company that builds to order. Companies in noncyclical businesses, such as some public utilities, likely have more stable earnings than ones in cyclical businesses, such as steel. Some use "quality of earnings" to refer to the stability and recurrence of basic revenue-generating activities. Those who use the phrase this way rarely associate earnings quality with accounting issues.

What is Earnings Management?[2]

"Earnings management" is not a technical term in accounting or finance. However, it occurs when 1.) firm management has the opportunity to make accounting decisions that change reported income, and 2.) exploits those opportunities.

Accounting Estimates

Accounting for business operations requires judgment and estimates. For example, one can't measure revenue without estimating when customers will pay, how many will not pay, how many will return goods for refund, and costs to the seller for fulfillment of warranty or maintenance promises.

For example, a retail business might have net income equal to 3% of revenues. A change in its estimates of uncollectible accounts by two-tenths of a percent or by 20 basis points, such as from 2.0% to 2.2%, will have a 4.0% effect on net income. One is unlikely to say that any one estimate for uncollectibles in the range of 2.0 to 2.2% of sales is better than another. Management can choose the number in that range and effect a swing of 4% in net income.

The SEC has long recognized that accrual accounting requires such estimates and, since 2003, has required companies to list the critical accounting judgments and estimates that underlie its financial reporting.

Focus on something concrete, such as the expected percentage of uncollectible accounts illustrated above. There will inevitably be a range, such as from 1.50% to 1.75%, within which no one number is most accurate. Management has to choose a number. Under ordinary circumstances with non-declining business operations, the higher the number, the lower the income reported this period. The wider the range of reasonable estimates, the more management's choice will influence bottom-line net income and comprehensive income. (The SEC's fair value release suggests companies and, by implication, their audit committees need to focus more on clear presentations of Other Comprehensive Income and Comprehensive Income than heretofore.)

Management's ability to choose a number from a reasonable range and be confident no one can say some other number is better gives them the opportunity to manage earnings. When management's number-choice is made with an eye to its effect on net or comprehensive income, it is engaging in "earnings management."

Timing of Transactions

Management can decide to paint the office

2: This section adapted from a book on corporate governance for board members that Roman L. Weil , the author of this piece, is writing with John D. Wilson, Esq. of Shearman & Sterling LLC.

in December. All other things being equal, management will report lower earnings in that office-painting period than in other periods. Management can choose when to paint and, thereby, manage earnings.

In a more complex example, management of a company that uses a LIFO cost-flow assumption for inventories has an opportunity to manage earnings by timing end-of-year purchases. In times of rising prices, management can buy during this period (thus increasing cost of goods sold and reducing income) or delay purchases until the next period (thus decreasing this period's cost of goods sold and increasing income). Management can choose when to buy and, thereby, manage earnings.

Many writers restrict the term "earnings management" to the selection of estimates that achieve an earnings target, and would not use the term to refer to the timing of transactions.

Audit committee members must be aware of the ways in which management's accounting-related choices provide opportunities to manage earnings — through timing of transactions and making estimates. The company's summary of critical accounting policies and estimates, required by the SEC, provides a checklist to guide thinking.

Using the Summary of Critical Accounting Policies as a Guide

Audit committee members can use the summary of critical accounting policies as follows:

1) Understand the transactions that require management to make the judgment or estimate. (For example, a company that mentions its accounting for inventory as significant is telling us it has more goods for sale during a period than it in fact sells.)

2) Understand the choices available to management in U.S. GAAP or, now, under IFRS, to account for the transactions in item 1. (In the U.S., the company can use FIFO or LIFO or weighted-average cost-flow assumptions or specific identification. The company reporting under IFRS cannot use LIFO.)

3) Understand what management chose and why. (A company choosing LIFO likely does it to defer income tax payments in times of rising prices and increasing inventories.)

4) Most important, understand the potential a given choice provides for earnings management. (If you don't know how a company using LIFO can manage earnings by delaying year-end purchases, you won't know to ask whether there have been unusual year-end accelerated or deferred purchases.)

When you understand how a company's transactions intertwine with its accounting principles, you will be able to determine whether a company engages in earnings management.

Roman L. Weil, Ph.D., CPA, is V. Duane Rath Professor Emeritus of Accounting at the University of Chicago Booth School of Business. He is Program Fellow at Stanford Law School and Visiting Professor of Accounting at Harvard Law School. He is co-founder of the Chicago/Stanford/Tuck Directors' Consortium and the Advanced Curriculum for Fund Directors. He has co-authored and co-edited more than a dozen books, and is working on a book on corporate governance for board members.

For further information:

- **AICPA Audit Committee Effectiveness Center**
  http://www.aicpa.org/audcommctr/homepage.htm
- **Audit Committee Toolkits:**

  Public Company
  http://www.aicpa.org/Audcommctr/toolkitscorp/homepage.htm

  Private Company
  http://www.aicpa.org/Audcommctr/toolkitscorppriv/homepage.htm

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  Government
  http://www.aicpa.org/Audcommctr/toolkitsgovt/homepage.htm
- **Quality of Earnings Case Study Collection**
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