RATING THE QUALITY OF CORPORATE EARNINGS

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Abstract

The accounting profession has been under considerable scrutiny since the Enron debacle. While many reforms have been proposed, some issues remain ignored. Companies are afforded wide latitude in selecting accounting methods, and the principles they choose lead to greatly varied results when we look at annual financial statements. This paper develops a methodology to rate the quality of earnings. First, “quality of earnings” is defined, and then a rating schema is developed. The purpose is to give investors a baseline by which they can judge the extent to which they can base future earnings on past performance.

“Earnings quality” is defined as the extent to which accounting methods mirror the manner in which the company operates. The grading scheme is simple, based on the standard college A – F format. It is hoped that this rating system (and definition of earnings quality) will find widespread use in helping investors make sound choices.

Introduction

Highly publicized scandals have damaged investor confidence and brought considerable attention to corporate accounting. New laws and regulations, notably Sarbanes-Oxley, will have some effect on preventing frauds in the future. However, outright frauds are but one problem facing the accounting profession. Perhaps the most egregious, and therefore noteworthy, problem is when reported corporate earnings have little to do with the core operations of a company. Nothing currently being discussed addresses the issue that due to legitimate gray areas of accounting, reported earnings, so eagerly followed by investors worldwide and an integral part of many highly disseminated metrics (such as earnings per share and price-earnings ratio) might not represent the operations of a company.

When investors think of a company they usually have some idea what this company does. It is not unreasonable for this prudent investor to believe that the reported earnings are related to the operations of the company, and therefore as the prospects for the company improve so should the earnings track along a similar course. The converse would operate the same way. If the investor felt that the outlook for the company had deteriorated, the investor would surmise that the future earnings should be negatively impacted.

“Earnings and its components relate to an individual enterprise during a particular period. Over the life of an enterprise (or other very long period), total reported earnings equals the net cash receipts excluding those from capital changes … but that relationship between earnings and cash flows rarely, if ever, holds for periods as short as a year …”

From the date a company starts in business to the date it ceases operations, the choice of accounting principle has no effect on the cumulative earnings. However, as the quote from the Statement of Financial Accounting Concepts No. 1 indicates, there can be significant variability when earnings are reported on an annual basis.

Clearly the answer is not to stop reporting earnings. Interested third-party financial statement users have a need to know the earnings. The choice of accounting principle can be prescribed based on which principle is a truer representation of the company’s operations, but in the past when faced with similar decisions the accounting profession has chosen to not dictate accounting policy. A number of times the profession and its governing bodies have had opportunities to restrict choice down to a single method of accounting, and each time the powers that be have opted to allow choice.

Currently companies have the right and responsibility to select accounting methods from the menu of acceptable choices. This paper does not suggest changing that freedom of choice. However, financial statement users have a right to know if the principles reflect the core operations of the company, or in other words, are they buying the earnings they believe they are buying. This disclosure to financial statement users can be accomplished by rating corporate earnings.

**Background**

In 2002 a wave of accounting scandals broke as a number of leading companies admitted to misstating their financial statements and promoting a false impression of their economic status. There was also a general perception that more accounting scandals were just waiting to be uncovered, which led to the third straight down year in the stock market. The fallout was profound. Investors lost confidence in the U.S. financial system, the independent audit process and the accounting profession.

In the aftermath, Congress sought to examine the breakdowns of “watch-dog” groups including security analysts, the Securities and Exchange Commission (SEC) and credit rating agencies. The October 8, 2002 report to the Senate Committee on Government Affairs asserted that sell-side analysts lacked objectivity, which came as little surprise to Wall Street professionals. Seasoned investors have long known sell-side analysts more closely resembled marketing professionals, and have ignored their directional calls (focusing instead on earnings estimates). Unfortunately, the widely distributed “buy” recommendations on “anything.com” by sell-side analysts was attractive to the average investor at a time when self-directed investing was peaking.

The SEC was another putative warden, but in reality resource constraints limit the SEC’s ability to detect wrongdoing. “To uncover such fraud requires a considerably more in-depth audit than the SEC has thus far been equipped or oriented to do.” Furthermore, the Securities Act of 1933 expressly rejected the idea of direct government audits of companies’ books.

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Congress passed legislation (Sarbanes-Oxley) which was designed to appease the public, if not actually makes some forward progress in corporate accountability. As required by Sarbanes-Oxley (the “Act”) the SEC scrutinized the role of credit rating agencies based on their growing influence in the operations of securities markets. Among the findings were that rating agencies should place more weight on the “analytical significance of various account quality issues.” Credit rating agencies, on the other hand, are of the view that they do not conduct formal audits of rated companies or search for fraud. Clearly there is a divide in what double-checks regulators and investors expect, and what was actually present.

Congress has since tightened governance. Through Sarbanes-Oxley there was an accounting industry oversight board established to review the practices of accounting firms. Securities analysts can no longer report to investment banking. Credit rating agencies were admonished and the SEC was provided with more resources for investigation. Finally, there is a substantial increase in corporate disclosure required by Section 404 of the Act that, according to the Public Company Accounting Reform Board, will cost approximately $1.24 billion, or $90,000 per company (other estimates are much higher).

Will these measures be effective? Will they restore investor confidence? Will they protect investors even through the next bull market? Although sell-side analysts must be separated from investment banking, their bonuses are still based on overall company success, and investment banking drives Wall Street profits. Credit rating agencies still maintain they do not perform audits. Will the SEC continue to have their budget increased when the fervor has died down? Can a company’s audit committee, comprised of a few people, protect investors? As former SEC Chairman Richard Breeden warned “three or four individuals, no matter how much talent and time they are willing to bring to the job, are not going to match the internal and external audit functions.”

Will the expense companies are now incurring be worthwhile? Mr. Breeden also cautioned that “the law forces companies to pay more attention to internal controls. That is one of the great successes of the statute. But I’m very concerned that this will be turned into process rather than substance.” The question remains, who will be looking at all the increased disclosures and procedures now required of companies.

The changes that have occurred and mentioned above will have some impact. They will be most useful in stopping one spate of accounting scandal, the misappropriation of funds. In the news were companies like Tyco, Adelphia and Cendant, whose executives misused company funds. These changes, forged by the Act, will have a lasting impact in making these types of frauds

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5 A CFO Magazine survey revealed 48% of corporations expect to spend in excess of $500,000 implementing Sarbanes-Oxley. In a Wall Street Journal editorial (May 27, 2004) John Thain, CEO of the New York Stock Exchange, argued the price of Sarbanes-Oxley was too high. New listings for non-US companies have dropped significantly in 2004 due to the high cost of compliance.


more difficult. But this is a very limited (though highly publicized) scenario that just happens to garner wide-spread media attention.

One of a company’s most important pieces of financial information is the earning figure. The earnings figure gets used in the most widely disseminated metrics, earnings per share and the price-earnings ratio. According to the Financial Accounting Standards Board “the primary focus of financial reporting is information about earnings and its components.”

Furthermore:

“… earnings information is commonly the focus for assessing management’s stewardship or accountability. Management, owners, and others emphasize enterprise performance or profitability in describing how management has discharged its stewardship accountability.”

This information is broadly relied upon.

“Investors, creditors and others … may use earnings information to help them (a) evaluate management’s performance, (b) estimate “earnings power” or other amounts they perceive as “representative” of the long-term earnings ability of an enterprise, (c) predict future earnings, or (d) assess the risk of investing in, or lending to, an enterprise … Measures of earnings and information about earnings disclosed by financial reporting should, to the extent possible, be useful for those and similar uses and purposes.”

Earnings are used in a variety of metrics, such as the price-earnings ratio (P-E), which provides a basis for comparisons of valuations between and among entities.

However, all earnings are not the same. For any given transaction there might be a wide variety of acceptable accounting principles from which to choose. The effects of applying different principles might result in great disparity of earnings, but nonetheless, as long as the method chosen is acceptable and properly applied the financial statements (and the associated earnings figure) will receive an unqualified audit opinion.

Many believe accounting is black and white. It is more often the reality that accounting is shrouded in shades of gray.

“Uncertainty about economic and business activities and results is persuasive, and often clouds whether a particular item qualifies as an asset or a liability of a particular entity …”

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The prudent investor will understand the business a company is in, the economics of the industry, current trends and econometric data, competitor moves and the effects all this will have on the company, among other things. Putting all this information in the model the investor uses should allow them to make reasonable projections of a company’s earnings. The investor deserves to see an actual earnings figure that is devoid from variation resulting from fluctuation caused by the choice of accounting principle.

In periods where prices are only going one way, the effect of accounting principle choice can be somewhat isolated and anticipated. However, in periods where prices fluctuate (the more common situation), choosing an accounting principle that does not mirror the way the company operates can result in earnings that run counter to intuition and expectation.

While not a requirement, it certainly seems to make common sense that a company use those accounting principles that reflect their operations. When choosing an inventory costing method, companies may select from first-in, first-out (FIFO), last-in, first-out (LIFO) or weighted-average cost. The list of criteria the company uses to select an accounting principle is not based on how the inventory actually flows, but instead includes such considerations as does the method tend to produce higher net income, lower taxes, or provide a stronger balance sheet. This is counter to transparent financial reporting. The physical flow of goods will generally match one accounting method better than the others, but there is no requirement to use the method that matches the best.

A rating system that assesses how well the accounting choices a company makes mirrors their operations will allow investors to make an assessment of the degree to which the earnings figure can be relied upon. No value judgment is made about “good” or “bad” or “conservative” or “aggressive” accounting methods, only whether the principles chosen reflect the operations of the company.

“… There are some who seem to harbor the hope that somewhere waiting to be discovered there is a comprehensive scoring system that can provide universal criterion for making accounting choices …”

The concept of rating credit was pioneered by John Moody (founder of Moody’s) in 1909. Moody’s rating is expressed as a letter grade and provides an assessment of creditworthiness, implying the likelihood that debts would be repaid. “Credit ratings are currently used more as benchmarks for market participants than as a source of information for investors …” Some rating agencies (and individuals) assess corporate earnings based on differing standards, such as whether the accounting policies are “aggressive” or “conservative,” with the underlying implication that one is better than the other. The rating system proposed by this paper does not make such a value judgment. Quality is defined as the extent to which accounting policies represent the operations of the company. The closer the policies mirror the operations, the more likely the reported earnings figure will move in ways that investors predict.

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The Ratings Model

The income statement provides a substantial quantity of information, but in the end boils down to one number – net income, a term used interchangeably in this paper with “earnings”. Since net income is a single figure, a single figure used ubiquitously in financial reporting, it makes intuitive sense for the rating to be a single figure as well. Many grading schemes are available. To be most useful to the investing public, it should be a system that is easily understood. This paper proposes that the rating of corporate earnings be done on an A through F scale. Virtually every user will realize that “A” is exceptional and “F” is failing. In addition, there are also the grades of B, C and D. It is a possibility that plus and/or minus grades can be used. Every user will recognize that “A” is better than “B” and “B” is better than “C” and so, on, but what it does it mean to get a particular grade? Or, in other words, how will the analyst know which grade to award? The following narrative descriptions are used for each letter grade:

A: In every respect the accounting choices mirror the core operations of the company
B: In most respects the accounting choices mirror the core operations of the company
C: In some respects the accounting choices mirror the core operations of the company
D: In many respects the accounting choices do not mirror the core operations of the company
F: In most respects the accounting choices do not mirror the core operations of the company

The process for gathering the information to deliberate a grade would involve two stages. First the company would have to provide information that allows an analyst to determine if the accounting choices follow the operations of the company. This would include gathering actual data to compare to the accounting choices made. The areas where this information would be collected would include:

- revenue recognition
- depreciation methods
- inventory costing methods
- pension plans
- accounts receivable allowance and write-off policy
- lease capitalization policy
- inter-company transactions
- changes in accounting principles
- changes in accounting estimates
- adjustments
- SIC code
- NACIS code
- Definition of core business
- % of revenue from major business lines
- # of consecutive quarters meeting earnings estimates
- # of consecutive quarters of earnings growth
In addition to examining the accounting policies, information would be collected that allowed comparison to how the company actually operated. The closer the accounting policies are to the operations, the higher the grade.

The second step of the analysis would involve trend and ratio analysis, mostly focused on examining the inter-relationships between financial statement accounts and looking for any situations that could result in the manipulation of earnings. The net income of a company has to be able to rise and fall with the operations and be free of management interference.

Once the analysis is done, the actual rating awarded would be deliberated by a committee, very similar to the way credit ratings are awarded. The committee would actually determine the grade, which will allow for unusual and mitigating circumstances to be taken into account.

While very simple in concept, the implications could be enormous and solve multiple existing problems.

- Facilitate investment comparison – Reported earnings do not provide figures to do direct business comparisons, and despite this, the price-earnings ratio is one of the most widely used methods to evaluate investments.
- Enhance management responsibility – Investors have long looked to credit ratings to enhance management responsibility. In order to maintain a quality debt rating management must manage cash flow. The same responsibility can be achieved with the rating. Management now selects accounting methods without regard for well the method tracks the actual operating paradigm of the company. This rating will be the first attempt to rate the appropriateness of management’s accounting choices.
- Ferret out earnings manipulation – It seems the market loves stocks that have their earnings manipulated, up to the point the manipulation cannot be maintained. Then everyone (investors, regulators, etc) is unhappy. As part of the evaluation process protocols will be taken to isolate situations where earnings have been manipulated. Management’s influence on earnings should come from running the company, not “cooking the books.”

**Conclusion**

As the Enron situation showed, only institutional investors who could afford subscriptions to sophisticated independent research like the Center for Financial Research and Analysis were forewarned of the coming demise. Credit rating agencies kept Enron as investment grade right up to the bankruptcy filing, causing many to questions how reliable the credit ratings are. Rating corporate earnings for quality, with quality defined as how closely the chosen accounting principles mirror the operations of the company, will allow investors to gauge how much reliance they can put on earnings continuing at past levels. The higher the rating, the more reliance investors can place on predicting the future earnings based on the past and allowing for predicted market, environment, tax, regulatory, etc changes.
References


We find that poor innate earnings quality is associated with better governance structures, consistent with firms building governance mechanisms in response to earnings quality features inherent to their business models and operating environments. We find that better discretionary earnings quality is associated with better governance, consistent with managers responding to governance structures when making reporting decisions. Both perspectives can thus be accommodated within a single framework, provided a valid separation of the innate and discretionary portions of earnings quality. Such a sep