



Earnings Quality

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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

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- All concepts have strengths and weaknesses.
 - Earnings quality is no exception.