The Assessment and Implications of Earnings Quality: An Investor's Perspective

The Q-Group

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“Earnings Quality”

Accounting Horizons (2003)

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Earnings Quality – Outline

- Alternative definitions of earnings quality
- Academic research
- Standard setting
- Investment implications

Earnings Quality – Definition

- Plethora of definitions:
  - Core earnings
  - Recurring (sustainable) earnings
  - Operating earnings
  - Unmanaged earnings
  - Predictable earnings
  - Smooth earnings
  - Correspondence to operating cash flows

Earnings Quality – Definition

Benchmark One:

- **Earnings quality is the extent to which reported earnings correspond to economic income as defined by Hicks (1939):**

  The amount that the firm can pay out in dividends (that is, the amount that can be consumed) during a period, while leaving the firm equally well off at the beginning and the end of the period.

- **Not context dependent**
- **But also not observable, operational, or practical**

Earnings Quality – Definition

Benchmark Two:

- **Earnings quality is a function of the earnings' *decision usefulness***
  - **Based on the FASB's conceptual framework and on direct observation of the function of earnings in capital allocation**
    - **"Financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit and similar decisions." (Concepts Statement #1)**
    - **Decision usefulness is the overriding criterion for judging accounting choices (Concepts Statement #2)**
  - **Decision usefulness is highly operational and very practical**
  - **But context dependent – it provides an empirically tractable benchmark once the decision context is identified**

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Earnings Quality – Definition

- As a practical matter, earnings quality (however defined) may depend on some or all of:
  - Characteristics of firm's business model
  - Economic factors and environment
  - Characteristics of financial reporting system
  - Goals and incentives of managers in making reporting choices
  - Expertise and incentives of auditors
  - Enforcement function
  - Activities of intermediaries (analysts, financial press, investment bankers)

Earnings Quality – Definition

In sum:

- No consensus on the definition of earnings quality, or even on what construct is intended
- Context dependent definitions make it difficult or impossible to make general statements
  - Context also supplies a perspective, so that earnings with high quality in one context may have low quality in another context
- "Earnings quality" may be a proxy for something else that is the actual construct of interest
  - Earnings quality may be a summary indicator of the economic and institutional forces operating on the financial reporting process
  - Capital market participants may actually be interested in one or more of those forces, not in earnings quality per se

Earnings Quality

and

Academic Research

Earnings Quality – Academic Research

- **Much academic research that considers earnings quality relies on the criterion of decision usefulness**
  - Specify (implicitly or explicitly) the decision context
    - User and use
  - Test earnings for the attribute that would enhance or contribute to that decision
  - There are many users and uses to which accounting numbers are put
  - The focus today is on equity investing – but this is not a sufficient description of the decision context
    - Long or short?
    - Over what time horizon?

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Earnings Quality – Academic Research

- **Categories of academic research**
  1. Tests of specific properties of earnings that are posited to be associated with quality
  2. Tests of relevance of earnings (and book value) for stock prices (and returns) over time
  3. Comparative association of earnings and other summary performance measures with stock prices
  4. Relation between earnings quality and other economic characteristics (e.g., cost of capital)
  5. Tests of quality of financial reporting standards
  6. Tests for earnings management

Earnings Quality – Academic Research

1) **Tests of specific properties of earnings that are posited to be associated with quality**

   a. **Time series properties of earnings**

   b. **Relations among earnings, cash, and accruals**

Earnings Quality – Academic Research

a) Time series properties of earnings

- **Persistence:** ***autocorrelation in earnings realizations***
- **Predictive ability:** ***forecasting ability***
- **Variability:** ***standard deviation of earnings realizations***

What is decision context implicit in the above?

Earnings Quality – Academic Research

i. **Persistence**

- High quality earnings are sustainable, recurring
  - Sometimes referred to as "core earnings"
- To measure persistence researchers generally regress the future value of a variable on its current value

$$X_{t+1} = \alpha + \beta X_t + \varepsilon$$

  - β measures persistence and the closer β is to one, the more persistent is X (when $\beta = 1.0$, the series is a random walk)

Earnings Quality – Academic Research

i. **Persistence (Cont.')**

- **Persistence has been shown both analytically and empirically to be associated with larger investor responses to reported earnings**
  - **The earnings response coefficient (ERC):**

$$R_{j,t} = \alpha_j + \gamma_j X_{j,t} + \varepsilon_j$$

  - **The larger the γ, the larger the ERC**

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Earnings Quality – Academic Research

i. Persistence (Cont.')

- Larger ERC is viewed as capturing a larger valuation multiple attached to persistent (i.e., recurring) earnings
- A highly persistent earnings number is considered sustainable, that is more permanent and less transitory so a given realization for a persistent earnings series is a more readily usable short cut to valuation by, for example, a P/E ratio.

Earnings Quality – Academic Research

i. **Persistence (Cont.')**

- **Examples of persistence:**
  - **Dechow and Schrand (2004) persistence parameters:**
    - **0.71 earnings before extraordinary items**
    - **0.76 operating earnings**
    - **0.65 cash from operations**
  - **Sloan (1996) persistence parameters:**
    - **0.84 earnings from continuing operations**
    - **0.76 accruals**
    - **0.85 cash flows**
  - **Cross-sectional averages**

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Earnings Quality – Academic Research

i. Persistence (Cont.')

- Examples of persistence:
  - Francis et al (2005):
    - Mean earnings persistence over 10 years = 0.482 (σ = 0.368)
    - Range = 0.94 to -0.04
    - Firm-specific averages
- Analysis of persistence differs by:
  - Measure to be tested
  - Means of estimating (e.g., x-sectional, firm specific)
  - Time period

Earnings Quality – Academic Research

ii. Predictability

- Ability to forecast an item of interest
  - Future earnings?
  - Future components of earnings (e.g., operating earnings)?
  - Cash flows?
  - Other (user defined)?
- Over what <u>time</u> <u>period</u> is predictability to be assessed?

Earnings Quality – Academic Research

ii. Predictability (Cont.')

- Affected by firm's business model and economic situation
  - Cyclical firms' earnings may be difficult to predict
  - Growing firms' earnings may be difficult to predict
    - Do such firms have low quality earnings?
    - How should earnings appropriately reflect the firm's economics?

Earnings Quality – Academic Research

ii. Predictability (Cont.')

- **Predictive ability often measured as standard deviation of forecast errors**

$$X_{j,t} = \lambda_{0,j} + \lambda_{1,j} X_{j,t-1} + \varepsilon_{j,t}$$

- **Predictability =**

$$\sqrt{\sigma^2(\hat{\varepsilon}_j)}$$

Earnings Quality – Academic Research

ii. **Predictability (Cont.')**

- **Research results are mixed**
  - **Earnings predict future operating cash flows better than current operating cash flows do (Dechow, Kothari, and Watts, 1998)**
    - **1, 2, and 3 year ahead predictions**
    - **Both earnings and current cash flows have incremental forecasting ability for future cash flows**
    - **Control for firm's industry and cash flow cycle**

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Earnings Quality – Academic Research

ii. Predictability (Cont.')

- Barth, Cram and Nelson (2001) find that current cash flows and disaggregated accruals predict future cash flows better than aggregated earnings do

$$\mathbf{CF}_{i,t+1} = \phi + \sum_{\tau=1}^{k} \phi_{t-\tau}\mathbf{EARN}_{i,t-\tau} + \upsilon_{i,t}$$

$$\mathbf{CF}_{i,t+1} = \phi + \phi_1\mathbf{CF}_{i,t} + \phi_2\Delta\mathbf{AR}_{i,t} + + \phi_3\Delta\mathbf{INV}_{i,t} + + \phi_4\Delta\mathbf{AP}_{i,t} + \phi_5\mathbf{DEPR}_{i,t} + \phi_6\mathbf{AMORT}_{i,t} + \phi_7\mathbf{OTHER}_{i,t} + \upsilon_{i,t}$$

- Control for industry and cash flow cycle

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Earnings Quality – Academic Research

ii. **Predictability (Cont.')**

- The earnings response coefficient (ERC) is an increasing function of both persistence and predictability (Lipe, 1990)
  - Where predictability relates only to current earnings for future earnings
- Capital market behavior suggests a strong focus on predictive ability, perhaps deriving from a valuation notion
  - Less emphasis on persistence
  - Tendency to use persistence to mean predictive ability

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Earnings Quality – Academic Research

iii. Variability

- Smooth earnings (over time) → high quality earnings
  - Business model not volatile?
  - Reporting environment not volatile?
  - Managers engage in smoothing behavior?
    - E.g, Freddie Mac, Fannie Mae
  - Low variability → high predictability?
    - Usefulness in valuation context?

Earnings Quality – Academic Research

iii. Variability (Cont.')

- How measured?
  - Standard deviation of earnings metric over time
  - Variance of income metric relative to variance of cash flow metric
  - Relative variability of income components
  - Correlations of accruals and cash flows

Earnings Quality – Academic Research

iii. Variability (Cont.')

- Leuz, Nanda, and Wysocki (2003) – two measures of smoothing interventions:

  1. Measure relative variability as ratio of standard deviation of operating earnings to standard deviation of cash from operations

  $$\frac{\sigma(\mathrm{OE})}{\sigma(\mathrm{CFO})}$$

     - Lower values → smoothing behavior

  2. Measure relative variability as correlation between changes in accounting accruals and changes in operating cash flows

     - Negative correlation → smoothing behavior

Earnings Quality – Academic Research

iii. Variability (Cont.')

- Barth, Elliott, Finn (1999)
  - Firms with a multiyear series of increasing earnings have lower variance of earnings than other firms
  - P/E multiple increases with length of series of increasing earnings
  - Investors apparently reward firms that have a series of increasing earnings

Earnings Quality – Academic Research

iii. Variability (Cont.')

- **Maydew, Schipper, Vincent (1999)**
  - **Divesting firms sacrifice (cash) tax savings in choosing method of divestiture in order to gain smoother earnings – firms will give up $0.19 for each dollar of smoothed earnings**

Earnings Quality – Academic Research

b) Relations among earnings, cash, and accruals

- Closeness to cash → higher quality earnings
  - Accruals reduce quality of earnings
- One measure is ratio of CFO to operating income
- But association of earnings with stock prices stronger than association of CFO with stock prices

Earnings Quality – Academic Research

b. Relations among earnings, cash, and accruals (Cont.')

How are accruals measured?

- Estimation of discretionary accruals (Dechow, Sloan, Sweeney 1995)

$$\mathrm{NDA_t} = \alpha_1\left(\frac{1}{\mathrm{A_{t-1}}}\right) + \alpha_2\,(\Delta\mathrm{REV_t} - \Delta\mathrm{REC_t}) + \alpha_3\,(\mathrm{PPE_t})$$

$$\text{and}\quad \mathrm{DA} = \mathrm{TA} - \mathrm{NDA}$$

- Discretionary accruals imply earnings management and lower quality earnings

Earnings Quality – Academic Research

b. **Relations among earnings, cash, and accruals (Cont.')**

– **Direct estimation of accruals-to-cash relations**

- **Dechow and Dichev (2002)**
- **Accrual quality measured as the extent to which working capital accruals map into operating cash flows**
- **Firm specific regressions of working capital accruals on last year, current year, and one year ahead cash flow from operations**

$$\Delta WC_t = b_0 + b_1 CFO_{t-1} + b_2 CFO_t + b_3 CFO_{t+1} + \varepsilon_t$$

- **Quality of accruals measured as standard deviation of residual from the above regression (higher std dev ➔ lower quality)**
- **Quality of working capital accruals positively related to earnings persistence**

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Earnings Quality – Academic Research

b. Relations among earnings, cash, and accruals (Cont.')

- Dechow and Dichev (2002) (Cont.')
  - Accrual quality, in the absence of earnings management, is sytematically related to firm and industry characteristics
  - Lower quality accruals are
    - Greater in absolute magnitude
    - Associated with longer firm operating cycles
    - Associated with firm losses
    - Associated with greater variability in sales, cash flows and earnings

Earnings Quality – Academic Research

b. **Relations among earnings, cash, and accruals (Cont.')**

- **Cash flows typically assumed to be objective and not manipulable**
  - **Dynegy (2001) – manipulated classification**
  - **Sunbeam (1997) – securitized receivables to increase CFO**
  - **Parmalat (2003) – misrepresented cash balance**

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Earnings Quality – Academic Research

2) Tests of relevance of earnings (and book value) for stock prices/returns over time

- General form of regression:

$$R_{j,t} = \beta_{0,t} + \beta_{1,t}\Delta \text{Earnings}_{j,t} + \beta_{2,t}\text{Earnings}_{j,t} + \varepsilon_{j,t}$$

- Francis and Schipper (1999)
  - Evidence of declining relevance is over-time decrease in R^2 of this annual regression for 1952-1994

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2) **Tests of relevance of earnings (and book value) for stock prices/returns over time (Cont.')**

- Collins, Maydew, and Weiss (1997) regress price on earnings, on book value, and on both, 1953-1993.
  - Value relevance of earnings declines over time
  - Combined value of relevance of earnings and book values is stable over time
- Assumes market price or returns is the appropriate benchmark

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2) **Tests of relevance of earnings (and book value) for stock prices/returns over time (Cont.')**

- One explanation for declining relevance is decline in earnings quality over the period
  - Due to nonrecurring items and negative earnings
  - Due to change in nature of firm operations (business model) for a significant number of firms and accounting has not kept pace with these changes
- Declining relevance could be due to factors other than declining earnings quality
  - More timely alternative sources of information
  - Other information in financial statements (notes, MDA)

Earnings Quality – Academic Research

3) **Comparative association of earnings and other summary performance measures with stock prices**

  – **Securities analysts and other capital market participants often maintain that "earnings-like" numbers are more value relevant for stock prices than GAAP earnings.**

  – **Does this reflect lower quality of earnings (using association with stock prices as the appropriate benchmark)?**

Earnings Quality – Academic Research

3) **Comparative association of earnings and other summary performance measures with stock prices (Cont.')**

- **Pro forma earnings – no formal definition. Generally exclude special or nonrecurring items and sometimes noncash items (➔ more persistent?)**
- **Bradshaw and Sloan (2002):**
  - **Regress long window return on analysts' forecast errors (STREET) vs GAAP forecast errors**

$$R_{j,t} = \alpha_0 + \alpha_1 FE_{STREET} + \alpha_2 FE_{GAAP} + \varepsilon$$

  - **After 1992, STREET FEs more highly associated (higher coefficient) with returns than GAAP FEs**
  - **Pro forma earnings higher quality?**

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Earnings Quality – Academic Research

3) **Comparative association of earnings and other summary performance measures with stock prices (Cont.')**

- Compare relative association of GAAP earnings and industry specific performance measures specified by analysts (EBITDA, CFO, non-GAAP measures) for 15 industries with annual returns (Francis, Schipper, and Vincent, 2003)
  - Assess relative and incremental (to GAAP earnings) explanatory power
  - Earnings is not dominated by any other measure for any of the 15 industries
  - Most of the other metrics provide incremental explanatory power to GAAP earnings
- Indirect indication of earnings quality, at least with respect to some competing measures

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Earnings Quality – Academic Research

4) **Relation between earnings quality and other economic characteristics of the firm**

   – Cost of capital

      • Francis, LaFond, Olsson, and Schipper (2005)

         – Cross sectional regressions 1975-2001

Earnings Quality – Academic Research

4) Relation between earnings quality and other economic characteristics - cost of capital (Cont.')

   – Find an association between attributes of earnings and cost of equity capital (in order of degree of association)

      • Accrual quality (closeness to cash) → Neg.
      • Persistence → Neg.
      • Smoothness → Neg.
      • Predictability → Neg
      • Value relevance → Neg.
      • Timeliness → Neg.

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Earnings Quality – Academic Research

4) Relation between earnings quality and other economic characteristics (Cont.')

- Dual class firms
  - Francis, Schipper, and Vincent (2005)
    - Compare OLS slope coefficients from regression of returns on earnings for single class and dual class stocks
    - Slope coefficient on single class stocks greater
      - ➔ less credible, lower quality earnings of dual class stocks

Earnings Quality – Academic Research

5) Tests of quality of financial reporting standards

- Qualitative characteristics related to FASB's conceptual framework
  - Relevance – timely accounting recognition of economic phenomena; predictive value
  - Reliability – representational faithfulness; verifiability
  - Comparability – similar things are accounted for similarly both through time and cross-sectionally
  - Not necessarily compatible criteria – attributes often must be traded off (e.g., more relevance for less reliability)

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Earnings Quality – Academic Research

5) Tests of quality of financial reporting standards (Cont.')

- **Tests for *relevance and reliability* of changes in standards or of new standards**
  - ***Relevance and reliability* are two of the FASB's main criteria for choice among accounting standards**
  - ***Relevance and reliability (combined)* measured as association with stock prices or returns**

$$P_{j,t} = \alpha_j + \gamma_j X_{j,t} + \varepsilon_j \quad \text{or} \quad \Delta P_{j,t} = \alpha_j + \gamma_j \Delta X_{j,t} + \varepsilon_j$$

  - **Are stock prices/returns the right benchmark?**

Earnings Quality – Academic Research

5) Tests of quality of financial reporting standards (Cont.')

- Aboody, Barth, Kasznik (2004)
  - Examine association between share prices and disclosed, but not recognized, stock-option expense (SFAS 123), S&P500 1996-1998
  - Regress share price on control variables (BV, NI, growth) and compensation expense (from footnotes)
  - Coefficient on compensation expense negative and significant
    - ➔ investors view stock-based compensation expense as an expense of the firm and the SFAS #123 measure of the expense is sufficiently reliable to be reflected in share price

Earnings Quality – Academic Research

5) Tests of quality of financial reporting standards (Cont.')

- Ledesma and Vincent (2004)
  - Examine association between share prices and defined benefit pension plan disclosures, S&P500 1998-2002
  - No consistent evidence that pension assets, pension liability, pension cost, or components of pension expense are reflected in share prices or returns
  - Assume value relevance
  - Infer lack of reliability
    - ➔ SFAS 87 and SFAS 132 low quality accounting standards?
    - ➔ Failure elsewhere in the financial reporting system?

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Earnings Quality – Academic Research

6) Earnings management

Two views:

1. Flexibility in implementation of accounting standards provides managers the opportunity to communicate private information
   – Large theoretical literature
2. Flexibility in implementation of accounting standards provides managers the opportunity to intervene in the external financial reporting process with the intent of obtaining some private benefit
   • Large empirical literature

Earnings Quality – Academic Research

6) Earnings management (Cont.')

- How are earnings managed?
  - Two main types of earnings management
    - Accounting manipulation
      - » Accounting choices
      - » Write-offs, restructuring charges
    - Economic decisions
      - » Sell assets for gains
      - » Reduce R&D or advertising

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Earnings Quality – Academic Research

6) Earnings management (Cont.')

- **Empirical evidence that managers:**
  - Increase earnings prior to IPO
  - Increase earnings prior to insider share sales
  - Increase earnings for executive compensation
  - Increase earnings to avoid violating bond covenants
  - Manipulate earnings for regulatory purposes

Earnings Quality – Academic Research

6) Earnings management (Cont.') – empirical research

- Burgstahler and Dichev (1997)
  - Statistical evidence of discontinuities around zero in the distribution of earnings
    - Low frequency of small losses
    - High frequency of small gains

Earnings Quality – Academic Research

6) Earnings management – empirical research (Cont.')

- DeGeorge, Patel, and Zeckhauser (1999)
  - Evidence that earnings are managed to meet thresholds:
    - Positive profits
    - Sustained profits
    - Analysts' expectations
  - Future performance of such firms is relatively poor

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Earnings Quality – Academic Research

6) Earnings management– empirical research (Cont.')

- Anecdotal and empirical evidence that managers *smooth* earnings over time
  - Does smoothing reduce earnings quality?
    - No – if managers smooth earnings around an economically justifiable and (reasonably) accurate estimate of sustainable earnings?
    - Yes – if managers smooth to present a false impression of stability or sustainable growth?

Earnings Quality – Academic Research

6) Earnings management – empirical research (Cont.')

– **Research questions:**

- **How do these manager interventions affect the earnings quality constructs discussed above?**
  - – Persistence
  - – Predictability
  - – Variability
  - – Closeness to cash
- **What do managers expect to gain from the earnings management?**

Earnings Quality – Academic Research

6) Earnings management (Cont.')

- Fields, Lys, and Vincent (2001) – literature survey
  - Researchers have found little evidence that the posited earnings management was successful
    - E.g., no evidence that management compensation increased due to posited earnings management
  - Multiple, often incongruent incentives, complicate interpretation of the results of research on accounting choice because it is not clear which of management's incentives dominates.

Earnings Quality and Standard Setting

Earnings Quality – Standard Setting

- FASB Conceptual Framework: Earnings is supposed to capture the change in net assets (comprehensive income) except for exchanges with owners
  - Requires workable and robust definitions of assets and liabilities
  - The bottom line is not of great interest, per se
  - The components of income are of interest—but those line items are suppressed when earnings is considered as a standalone summary indicator of performance

Earnings Quality – Standard Setting

- To the extent assets and liabilities are volatile, earnings will be volatile
  - Places pressure on measurement attributes – fair values are more volatile than historical cost transaction amounts
- Net income contains items that may not be indicative of management performance
- The conceptual framework also focuses on the entire financial reporting package which includes notes, schedules, other financial statements in addition to the income statement.

Earnings Quality – Standard Setting

- Criticisms of FASB approach to earnings
  - Should reflect sustainable or normalized income number that is representative of the future and of management's performance
    - Inability to define sustainable or normalized income
    - Inability to define revenues (or expenses) except in terms of assets
    - Sometimes referred to as the "matching principle"
    - Requires various debits (e.g., deferred losses) and credits (e.g., deferred revenues) on balance sheet that do not meet the definitions of assets and liabilities
    - Income statement volatility

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Earnings Quality – Standard Setting

- Criticisms of FASB approach to earnings (Cont.')
  - FASB shift to balance sheet perspective
  - FASB shift to greater focus on fair value accounting
    - Closer to Hicksian view of income
  - Recent standards more "rules-based" and less "principles-based"

Earnings Quality – Standard Setting

- In the opinion of some, earnings quality is inversely related to the amount of judgment, estimation, and forecasting required of preparers of financial reports

  ➔ bright line rules preferred

  – But research and experience show that bright line rules lead to manipulations (e.g., leases and consolidations)

  – What is "optimum" amount of judgment and estimation?

- Or is quality is inversely related to the degree to which preparers take advantage of the requirements for exercising judgment and making forecasts and estimates, resulting in implementations that subvert the intent of the standards?

Earnings Quality – Standard Setting

- Financial reporting standards have increasingly required accelerated accounting recognition for incomplete transactions due to concerns about relevance
  - The reported numbers increasingly based on management estimates
    - Example: changes in fair values of certain marketable securities and certain derivatives
    - Example: recognition of impairment losses on fixed assets and purchased goodwill
  - When the objective of the management estimate is fair value, the accelerated recognition moves reported accounting income closer to Hicksian income – the potential cost is decreased reliability

Earnings Quality – Standard Setting

- Current standard setting environment affected by
  - Recent financial reporting scandals
  - Legislative response to those scandals
    - Sarbanes-Oxley Act alters many elements of financial reporting, auditing, and corporate governance
  - Commitment to international convergence
    - FASB's agenda decisions and contents and US GAAP will be influenced by convergence considerations
  - History – the environment for many years
    - Disputes over the role of financial reporting, particularly with respect to the income statement
    - General resistance to change that imposes real or perceived costs, including the cost of acquiring new expertise

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Earnings Quality

Implications

For Investors

Earnings Quality – Implications

Valuation

- Equity valuation models take many forms
  - Discounted cash flows (DCF)
  - Abnormal earnings (AE or residual income)
  - Multiples (relative valuation)
- Impact of earnings quality on models
  - DCF – pro forma financial statements
  - AE – forecast abnormal earnings
  - Multiples – P/E

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Earnings Quality – Implications

- If we assume that the investor's objective is:
  - To determine the intrinsic or economic value of the firm
  - Compare this measure with firm's current trading price
  - Make an investment decision (buy, sell, sell short)
- Then the question becomes whether the quality of earnings affects the estimate of intrinsic value and/or whether earnings quality affects the trading price of the stock.
- In either case, the quality of earnings is a potentially important factor in an investor's decision making process

Earnings Quality – Implications

Market –based measures of earnings quality

– How reliable is current share price as measure of intrinsic value?
– Has the reliability of price changed over time?
– Are investors “slow” to respond to information?
– Are investors biased in their response to information?

Earnings Quality – Implications

Earnings quality concept as an aggregator

- What is of interest is not earnings quality per se but the underlying determinant of the earnings quality attribute
- How well does the earnings quality concept aggregate the measure of interest?
  - Example: how well does earnings aggregate information about managerial performance?
- Do management's financial reporting choices provide a leading indicator of future firm performance?
- How well do the academic constructs (persistence, predictability, variability) represent the item of interest to investors?

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Earnings Quality – Implications

Implications of academic research for earnings quality:

- Focus of accounting researchers is on decision usefulness because the criterion can be operationalized within conventional social science research designs
- However, these designs also require a decision context (i.e., both a decision use and a user) so conclusions are inevitably context-specific
- The generality of inferences drawn from academic research on earnings quality, therefore, is constrained by the need to examine numerous specific contexts before attempting to draw broad inferences.

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Earnings Quality – Implications

Summary

- **Is earnings quality *per se* of interest to equity investors?**
- **Or is the underlying characteristic, for which earnings quality supposedly proxies, the item of interest?**
  - **The characteristic is context-specific (user and use) and so not generalizable**
- **If so, should we not focus on the underlying characteristic rather than trying to dissect earnings quality?**

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