Earnings Quality Checklist

The EQUITY TOOLKIT

Process

Do reported earnings accurately represent the underlying economics of the business?

1. What are True Earnings?

What is composition of cash flows?	See **Operational Frame**
What are Returns?	See **Financial Frame/Returns**

2. Where are Earnings Quality issues most likely to arise?

Means	High level of subjectivity in the accounting rules.
Motive	To manipulate earnings – eg Remuneration, cap.raises, IPO's etc.
Opportunity	Certain industries, jurisdictions; or times – e.g. interim results.

3. How do we analyse Earnings Quality?

Accruals	Difference between earnings and cash flow.
Compliance	With various accounting and regulatory standards.
Behavioural Proxies	Red Flags
Real World DD	External Validation

4. What does Earnings Quality tell us?

Is the **Level** of earnings quality an indicator of fundamental value?
Does the **Change** in earnings quality provide earnings momentum indicators?
Does the **Nature** of earnings quality provide risk indicators?
Is the **Perception** of earnings quality a possible share price indicator?

Context

Reported Earnings are an estimate of True Earnings. How reliable is this estimate?

True earnings are unknowable in advance.

Estimating provides a baseline for assessing accuracy of reported earnings.
If estimating is hard, reported earnings are less reliable.

Spend more time on analysis where problems more likely.

The greater the means, motive and opportunity for earnings manipulation, the greater potential for errors - both inadvertent and intentional. i.e the less reliable are reported earnings.

Different frameworks to answer same underlying question.

Highlights areas of subjectivity. Are accruals good or bad?
Non-compliance highlights risk, but compliance does not eliminate risk.
If it looks like a duck and quacks like a duck…
Especially important on fraud end of the spectrum.

How important are reported earnings to our investment

Trading based on PER - quality of E is important.
Trading based on Δ Earnings - drivers of Earnings Δ are important.
If Earnings Quality is poor, what else is wrong with company?
Can Earnings Quality add to a +ve/-ve narrative to multiply share price moves?

Earnings quality occurs on an asymmetric spectrum…

Reported Earnings

Good EQ	True Earnings	Bad EQ	Fraud

Relevance of position on spectrum depends upon relevance of earnings to investment decision.

Accruals Framework

The EQUITY TOOLKIT

1. Measure Composition of Accruals

2. Are these Accruals good or bad?

Earnings =	Cash Flow +	Accrual	
Income	Cash Received	Δ Receivables & Unearned Inc. + Profit on Asset Sales/Revals.	Revenue Recognition - What is the policy? Conservative or aggressive? One off profits being passed off as recurring income?
Op. Expenses	Cash Payments	Δ Payables & Inventory Δ Provisions & Other Accruals Share Based Payments	Working Capital - normal growth vs aberation (cf sales)? Channel stuffing? Off B/S financing? Provisions very subjective - high potential for earnings management. FX - operating or one off? -ve accrual ≠ good earnings quality. What is economic value of shares given up?
EBITDA	**Gr**oss **Op**. **C**ash **F**low	Δ in Working Capital + Δ Other	
D&A Expense	Cash Capex	Δ PPE, Intangibles & Other Capitalised Costs	Is capitalisation policy reasonable? What is capitalised? Relative to peers? Is depreciation correct? Useful competitive life? Replacement cost? What is maintenance capex. i.e required to maintain competitiveness?
Amort'n of Acq'd Intangibles	Acquisitions/ Asset Sales	Δ PPE + Acquired Intangibles	Are acquisitions growth or maintenance capex (e.g. R&D)? Review acquisition adjustments? Are asset sales business as usual or a business divestment? Does amort. of acquired intangibles reflect ongoing capex or merely acquisition accounting?
EBIT	GOCF - Capex		
Assoc. Income	Assoc. Divs Received. Loans to/from Assoc.	Δ Book val of Associates	One off dividends to boost cash flow? Booking Assoc. earnings with little transparency Operating losses funding through capitalised loans to associates?
Finance Exp.	Net Interest Paid	Δ Accrued Interest/Δ PPE Δ Liabilities/Provisions	Impact of paying or accruing interest is the same = increased debt. Difference is liquidity. Capitalising interest - Should it be capitalised? What proportion is capitalised? Relative to peers?
Tax	Tax Paid	Δ FITB/Tax Payable	Why is taxable profit different from account profit? Which is correct?
Minorities	Minority Divs Paid	Δ BS Minority interest.	Minority dividends are operating cash flow - not financing.
NPAT to Members	**Free Cash Flow**	**Accruals**	Are earnings or cash flow better estimate of (i) 'true earnings'? & (ii) future expectations
Δ in Comp. Inc.	Δ Assets/Liabs	Δ Equity Reserves	Profits/Losses on Assets Revals/FX/Pensions etc booked through Equity not P&L.
	Assumption of Liab.	Balance sheet grossed up	Assumption of debt = capex; Are liabilities created via a gross up of assets?

Accruals more likely to be bad when:

High

In Receivables, Inventory, Capex

Discretionary (not-related to growth); Provisions etc

In industry with greater subjectivity in estimating (e.g. construction).

Worse ← **Statistical Significance of Earnings** → **Better**

Accruals more likely to be good when:

Low

In Payables.

Non-discretionary (e.g. reflect growth); Returns are High

Industry with low fixed assets, small transaction values.

Red Flags Checklist

The EQUITY TOOLKIT

Red Flags	Comments
Management	
Poor Track Records	***"In business, leopards never change their spots"*** **Trevor Sykes**
Poor Incentives	**e.g. promote short term EPS growth over value creation etc.**
Insider selling	*"do as I do, not as I say"*
Related party transactions	Syphoning of profits? Massaging earnings? Indicative of poor governance?
Management changes.	There is almost always something more to change than "lifestyle"
Actual Results	
High Cash Accruals	High accruals should be treated as guilty until proven innocent.
Δ of Accounting Policies	Especially revenue recognition
Δ in application of accounting policies.	e.g. Increased proportion of capitalised R&D; Δ to useful life assumptions.
Accounting inconsistent with peers.	Less conservative treatment (e.g. revenue rec., capitalisation policy etc)
Returns substantially higher than peers.	Better business? Or different accounting?
Different profits under different regimes.	e.g. prudential filing vs stock exchange; Different geographies; Interim vs audited.
Profit growth just above target	e.g. 0%/guidance/incentive trigger.
Suspiciously smooth earnings	Indicative of earnings management. How sustainable?
Presentation of Results	
Complicated Corporate structure.	Why?
Complicated Accounts	What are they trying to hide? Or is business just complicated?
Constant restating of segmentals	Trying to hide organic trends? Indicative of poor strategy?
Pro-forma Earnings	Taking focus off true profits.
Consistent NRI's	Taking operating costs below the line.
Late filing of results	Poor systems? Trying to avoid attention?
Changing Auditor/Auditor Track Record	What is troublesome in the accounts?
Business Strategy	
Serial Acquisitions	Used to hide organic trends; Provide multiple tools to manage earnings.
Revenue Pivots	No proven business model? Changing industry structure?
Strategic Pivots	Problems in core business? Short term earnings management?

Context

How do incentives relate to other behaviour?

Should Red Flags be treated as a gateway condition?

e.g. Poor management history = don't invest.

or..

Examine all red flags in context...

"If it looks like a duck and quacks like a duck."

and

Make decision based on weight of red flags in conjunction with...

Relevance of these factors to investment decision.