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Quality of Earnings

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Integrity & Quality

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Integrity and quality have always been a focus of the American financial reporting system. However, recent events have shown that there is room for improvement. These events, coupled with increasingly complex global business structures, demand that the time for improvement in quality and integrity is now. We recognize that the current state of the financial reporting system and the profession is not perfect. Deloitte & Touche is committed to being leaders for the profession, our clients, and other companies on the journey of improvement.

Although the faith of the investing public will be restored, investors are certain to seek more information and ask more questions regarding the quality of financial reporting and a company's financial condition. The investing public's needs and demands regarding the quality of financial reporting and understanding a company's financial condition have multiple aspects. These include, but certainly are not limited to, the quality of earnings, liquidity, strength of the balance sheet, and transparency of an enterprise's financial reporting—each of which, while intertwined, is a separate, complex subject. Because earnings are at the forefront of the investing public's mind, this document focuses on how audit committee members, boards, management, and other financial statement users can better understand and assess the quality of earnings.

Role of Management and the Audit Committee Relative to Quality of Earnings. Management has always had responsibility for the selection and application of accounting principles, as well as the underlying estimates and judgments used in applying such principles. Hence, management is ultimately responsible for the quality of earnings.

In contrast, the role of the audit committee has evolved over time. This evolution saw significant changes in 1999 after The Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees issued its report, which resulted in the implementation of various rules and standards by the stock exchanges, regulatory bodies, and standards-setting bodies. Among other things, the new rules and standards require discussion among the audit committee, management, and the external auditors regarding the quality, not just the acceptability, of the entity's accounting principles as applied in the financial statements. It is important to recognize that the quality of accounting principles is not the same as the quality of earnings, but the two are inherently linked in that the judgments used in selecting and applying such principles directly impact the quality of earnings.

External Auditors' Communication with Audit Committees. The American Institute of Certified Public Accountants' Statement on Auditing Standards (SAS) No. 90, *Audit Committee Communications,* established the requirement for external auditors and the audit committee to discuss the quality of the accounting principles used in the entity's financial statements. Specifically, SAS No. 90 requires that the external auditor:

> "Discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the entity's accounting principles as applied in its financial reporting. The discussion should be open and frank and generally should include such matters as the consistency of the entity's accounting policies and their application, and the clarity and completeness of the entity's financial statements, which include related disclosures. The discussion should also include items that have a significant impact on the representational faithfulness, verifiability, and neutrality of the accounting information included in the financial statements. Examples of items that may have such an impact are the following: selection of new or changes to accounting policies; estimates, judgments, and uncertainties; unusual transactions; and accounting policies relating to significant financial statement items, including the timing of transactions and the period in which they are recorded."

"You can't take a sharp picture of a fuzzy object."

Joseph Grundfest
Stanford Professor of
Business and Law

What is the Quality of Earnings? The quality of earnings is difficult to define and, although there are no definitive criteria by which to evaluate it, there are many factors that can be considered in assessing the quality of earnings. Taken as a whole, the quality of earnings can generally be summarized as the degree to which earnings are cash or noncash, recurring or nonrecurring, and based on precise measurement or estimates that are subject to change. Evaluating the quality of earnings will help the financial statement user make judgments about the "certainty" of current income and the prospects for the future.

For those assessing the quality of earnings, it is critical to understand that "lower" quality earnings are not necessarily indicative of poor financial reporting or the misapplication of accounting policies, judgments, and estimates. In many cases, the "lower" quality earnings items relate to transactions that by their nature are more subjective or have a higher degree of risk or uncertainty. In addition, accounting standards by design are flexible so that they can be applied across many industries, geographies, marketplaces, and differing circumstances.

A common factor is that some degree of judgment and/or estimation is usually necessary in the application of accounting principles. That degree varies according to how measurable, predictable, and common a certain transaction or situation may be. For example, a bank cannot predict with precision what portion of its outstanding loans will be collected, but historical data, industry information, and knowledge of the customer base and market trends can all help to estimate the loan loss reserve. In doing so, management can apply its policy for reserves and interpretation of the underlying assumptions in a manner that can be characterized as relatively "conservative" or "aggressive" in nature. However, because the item being measured is unknown as of yet and is likely not to be known for some time, one cannot say that the estimate is "right" or "wrong." This is why clear and adequate disclosure is imperative.

Importance of Disclosure. In many ways, Management's Discussion and Analysis (MD&A) is the primary vehicle for management to inform investors about the quality of a company's earnings. Because of the estimates and judgments inherent in the application of accounting principles, many components of earnings may be "fuzzy" and the reader of the financial statements should be alerted to that through complete and transparent disclosures in the financial statements, footnotes, and MD&A. The disclosures should convey that it is the object being measured that contributes to the "fuzziness" rather than the camera (i.e., the accounting in the financial statements) or the photographer (i.e., management). It is helpful to provide the reader with enough information to facilitate an understanding of the various components of earnings and risks and uncertainties that influence the future results of the company.

The SEC confirmed the importance of clear and adequate disclosures in its May 2002 proposed rule, Disclosure in Management's Discussion and Analysis about the Application of Critical Accounting Policies. To improve transparency of financial reporting and disclosure, the SEC is proposing disclosure requirements that would enhance investors' understanding of the application of companies' critical accounting policies by focusing on the significance of certain estimates to a company's financial condition and the impact on the overall financial performance if those estimates changed. The December 2001 cautionary advice on pro forma discussions in earnings releases, which warned against misleading investors by using calculations of earnings not reconciled to or based on GAAP, is also intended to help ensure that such discussions avoid creating "double images" in financial reporting.

Characteristics Affecting the Perceptions of Quality of Earnings. It is an oversimplification to refer to the quality of earnings as "good" versus "bad," or even "high" versus "low." Quality of earnings is relative and covers a spectrum. There are characteristics affecting the quality of earnings that can be considered by financial statement users to assist in the evaluation of particular earnings components.

"As the complexity and subjectivity of judgments increase, the inherent level of precision in the financial statements decreases, which is a fact that investors should be told. What they think they know now, is that the numbers at the bottom of the income statement — net income and earnings per share — are the conclusive, perhaps even infallible, measures of a company's performance for a period. That's not really true, of course, and investors need a better picture."

Robert K. Herdman, Chief Accountant of the SEC, in a January 2002 Speech to the Financial Executives Institute

The following table indicates characteristics and examples of both income and expense earnings components.

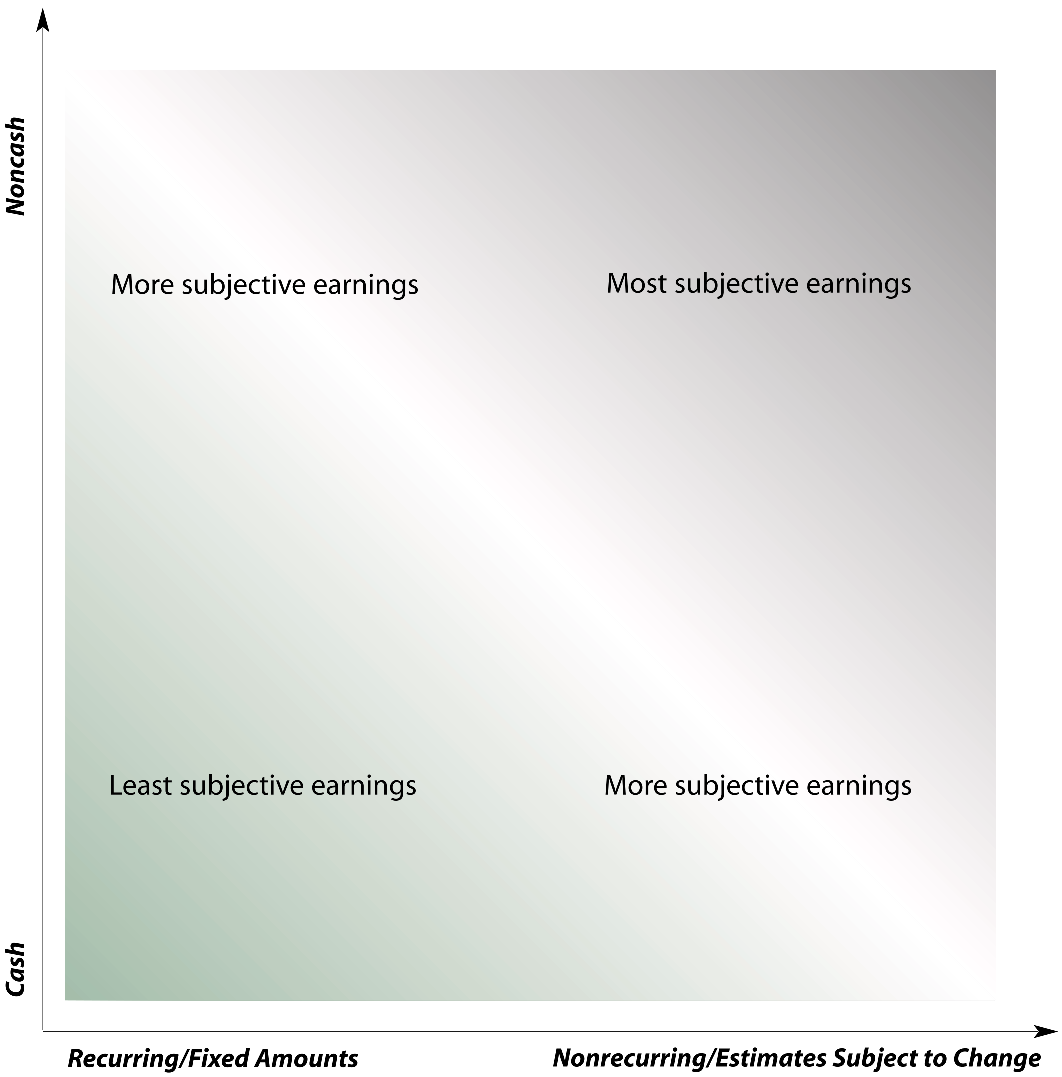
CASH ⟷ NONCASH
BASED ON FIXED AMOUNT ⟷ BASED ON ESTIMATE
RECURRING ⟷ NONRECURRING

Characteristic	Example	Characteristic	Example
Cash earnings	Recurring sales for which cash has been received	Noncash earnings	Goods sold in exchange for stock of another company
Based on fixed and certain amounts from completed transactions	Recurring sales of tangible delivered products	Based on amounts subject to change due to changes in estimates and future market conditions	Mark-to-market derivative contracts
Result from consistent application of accounting principles	Consistent application of LIFO method of inventory valuation	Result from discretionary changes to existing accounting principles that result in earnings but no cash increase	Switch to the FIFO method of inventory valuation
Result from consistent application of estimation principles and methods	Consistent application of pension expense calculation assumptions	Result from changes in application of estimation principles and methods that increase earnings but not the reliability of the estimate	Change in the assumed rate of return on pension assets
Result from estimates for which the range of possible balances is relatively small	Changes in the accounts receivable reserve that has a $100,000 range for the possible balance	Results from estimates for which the range of possible balances is relatively large	Changes in the environmental contingencies reserve that has a $1 million range for the possible balance
Based on transactions that are recurring	Rental income	Based on transactions that may recur but cannot be predicted or are unusual or nonrecurring	Settlement of litigation
Based on assets that are probable of recovery or liabilities that are fixed and certain	Interest expense	Based on assets with uncertainty of recovery or liabilities subject to change	Expenses associated with warranty reserves
Result from arm's-length, commonly executed transactions with independent parties	Sales to an independent customer	Result from sales to related parties or uniquely structured transactions	Sales to an off-balance sheet, special purpose entity
Result from assets or liabilities recorded at cost	Interest on investments	Result from assets or liabilities recorded at fair value	Mark-to-market, held for sale investments
Reflect proposed external/internal audit adjustments as presented in the financial statements	Repairs and maintenance expense that reflects the recording of external auditor adjustments for expenses that were originally capitalized	Do not reflect proposed external/internal audit adjustments as presented in the financial statements	Repairs and maintenance expense that does not reflect the recording of external auditor adjustments for expenses that were erroneously capitalized

Continuum of Earnings Quality. As the previously listed criteria suggest, the evaluation of earnings quality is not a black-and-white issue. The application of generally accepted accounting principles (GAAP) at most companies results in reported earnings comprised of components that span a broad earnings quality spectrum.

The graph below suggests that the quality of earnings is directly related to the portion of the earnings that represents current or near-term cash flow. Furthermore, the quality of earnings is also directly related to the certainty and likelihood or frequency of the earnings. It is important to remember that placement is a subjective process and depends heavily on the understanding of the nature of the transactions and accounting principles giving rise to a particular income or expense item.

Continuum of Earnings Quality



Indicators of Overall Earnings Quality. The characteristics affecting the quality of earnings provide a basis for considering the individual income and expense items that comprise earnings. There are various indicators in the financial statements that readers can use to assess earnings on a high level. These are:

- Overall consistency of accounting policies from year to year or quarter to quarter
- Overall degree of estimation or subjectivity in determining earnings
- Trend in reserve balances
- Transparency of footnote disclosures
- Complexity of MD&A and discussion of nonrecurring, unusual transactions
- Presence of pro forma measures of earnings
- Disclosure of related-party transactions
- Ratio of net income to cash from operations
- Uncertainties and contingencies disclosed in the footnotes and MD&A

This list is not comprehensive; depending on circumstances unique to an industry or company, there may be other indicators. Many industries have common measures that are widely used and followed. It is not advisable to rely on a single indicator to assess overall earnings quality; rather, it is appropriate to consider all indicators in the aggregate as part of the process described in the next section.

Audit Committee Focus. In today's environment, no one will dispute that the role of the audit committee is expanding. The public is focused on the quality of earnings; so too should the audit committee. The following is a framework for a process that audit committees can undertake for assessing the quality of earnings. The frequency with which it is undertaken should be determined by individual committees. It is recommended that the process be executed regularly, at least once a year, if not quarterly.

1) Read the financial statements, 10K, annual report, and interim filings.

2) Be familiar with current press coverage regarding the financial performance and practices of the company.

3) Read the most recent analysts' reports on the company.

4) Consider earnings components in relation to the earnings continuum.

5) Consider the overall indicators of earnings quality.

6) Understand the sources of earnings and consider the characteristics affecting the quality of the various earnings components. The accompanying table indicates some common earnings sources and would be expanded by other examples unique to each company and industry. Enhance the understanding by engaging management and the external auditors in open dialog regarding the quality of earnings.

The questions in the appendix provide a framework for discussions among management, the audit committee, and the external auditors during this process. The knowledge and insights gained from this process should not remain in the confines of the audit committee. Rather, to serve the best interests of all parties, they should be shared with the entire board.

Common Earnings Sources
Sales of goods to independent customers under normal payment terms
Sales of goods to related parties
Sales under installment agreements or special arrangements
Sales with contingencies or after-sale obligations
Costs of goods/services sold
Earnings from investment sources
Financing expenses
Gain/loss on sales of assets
Gain/loss on settlement of litigation
Warranty expense
Bad debt expense
Inventory reserve changes
Impairment charges
Pension expense
Gain/loss on mark-to-market derivatives
Gain/loss on mark-to-market investments
Restructuring reserve changes
Merger reserve changes
Other reserve changes

Closing Thoughts. Indeed, there is no single characteristic by which to measure the quality of earnings. However, this should not prevent financial statement users, particularly audit committees and management, from being on the leading edge of quality financial reporting and investor needs. There are certain characteristics, indicators, and questions that can and should be considered to assess the quality of earnings. In doing so and by making changes when deemed appropriate, a company demonstrates its commitment to creating lasting value for all its constituencies, particularly its investors.

Appendix

Questions to Consider in Assessing Quality of Earnings

The following questions provide a framework for a dialog among the audit committee, management, and the external auditors regarding the quality of earnings. This list is not meant to be comprehensive, nor are all questions applicable in all situations. Users should consider whether there are questions specific to a company or its industry that should also be addressed. The answer to any one question does not complete an overall assessment of quality of earnings; audit committee members should weigh the answers in the aggregate, draw their own conclusions, and suggest actions they deem appropriate.

General

- What accounting principles have changed since the last reporting period?
- What was the earnings impact of any changes in accounting principles?
- What prompted changes in accounting principles?
- Are the accounting principles selected by management in line with those of peers in your industry?
- What are the most significant estimates made by management in the current financial report? What was the range of possible balances for such estimates?
- What changes in accounting estimates were made during the period and which were disclosed in the earnings release? If they were not disclosed, why not?
- How close to analysts' expectations were earnings? Over time, has there been a recognizable trend in the difference between actual earnings and analysts' expectations?
- How close to management's plan were earnings? Over time, has there been a recognizable trend in the difference between actual earnings and management's plan?
- How close was the company to meeting or violating any debt covenants or other contractual commitments?
- If bonuses or other compensation are based on earnings measures, how close to the threshold was the determination?
- Were there any adjustments to earnings to determine pro forma earnings for purposes of determining bonuses or other compensation? If so, did the appropriate committees of the board review these matters?
- Are the company's earnings trends significantly different from those of its peers or those dictated by market conditions? If so, why?
- Did nonrecurring transactions affect earnings in the current period and particularly near the end of the period?
- What related-party transactions exist? What was the earnings impact of related-party transactions?

Financial Statement Presentation and Disclosure

- Are all gains and losses properly classified as operating or nonoperating?
- Do the MD&A and footnote disclosures clearly and adequately explain significant accounting policies and estimates?
- Are nonrecurring and/or complex transactions adequately disclosed?
- Were pro forma presentations of earnings used? If so, why? Were they reconciled back to GAAP earnings?
- Are there any significant assets and liabilities that are recorded at fair value? If so, which ones? What was the method for determining the fair value? What impact did the recording of fair value have on earnings?

Unrecorded External/Internal Auditors' Proposed Adjustments

- Was materiality used as the reason for not recording any or all the proposed external/internal audit adjustments?
- If the proposed external/internal audit adjustments had been recorded, collectively or individually, what would have been the impact on earnings?
- How would the recording of proposed external/internal audit adjustments have altered the company's earnings situation in relation to meeting analysts' expectations, management's plan, debt covenants, or compensation plans tied to earnings performance?
- SEC Staff Accounting Bulletin 99, *Materiality*, offers guidance on the characteristics of misstatements. This guidance is useful in assessing the quality of earnings:
  - Are there any intentional misstatements?
  - Did any of the misstatements arise from segments of the business that have been identified as playing a significant role in the company's operations or profitability?
  - Do any of the misstatements affect the company's compliance with regulatory requirements?
  - Do the misstatements, collectively or individually, change income to a loss, or vice versa?
  - Do any of the misstatements arise from an item capable of precise measurement?

Revenue Recognition

- Were there any unusually large sales recorded immediately prior to period end? What was the nature of the transaction?
- Are there significant installment sales?
- Are there significant sales in exchange for a note receivable or other noncash consideration? If so, have adequate reserves been placed against such receivable?
- Are gross margins rising while sales are stagnating or declining?
- Are there any contingencies related to any sales transactions such as the right of return, right of refund, or ability for the customer to resell? If so, what is the nature of such contingencies?
- Are there any side agreements associated with sales transactions? If so, what is the nature of such agreements?
- Are there any sales transactions for which revenue was recorded, but the goods remained in the possession of the company? If so, why?
- Does the company have any post-sale obligations? Have these been considered in accounting for the sale?
- Are large, nonrecurring revenue sources disclosed?
- Are there unusual trends in the allowance for doubtful accounts receivable?
- Are there uncertainties about collections?
- Have payment terms or other forms of financing been extended to any customer? If so, why and how much?

Expenses

- Were there any unusually large expenses recorded immediately subsequent to period end? What was the nature of the expense?
- Have any costs been deferred or not accrued?
- Are recurring expense amounts improperly characterized as nonrecurring?

Inventory

- Over the long term, is there an unusual relationship between inventory and sales (e.g., sales levels are decreasing but inventory levels are increasing)?
- Are books adjusted or are differences dismissed in taking the physical inventory?
- Are inventory obsolescence, returns, and warranty reserves adequate?

Fixed Assets and Intangibles

- Were tests performed to detect impairment of long-lived assets? Were there any indications of impairment based on the tests? If so, were appropriate write-downs taken?
- Was there a change in the depreciable or amortizable life of fixed assets or intangibles? If so, what gave rise to that change?
- Was there a change in the method of capitalization or depreciation? If so, why?
- Are capitalization and depreciation policies consistent with those of competitors?
- Is goodwill tested for impairment annually and on an interim basis when conditions require?
- Was the two-step goodwill impairment test properly applied?

Reserves and Liabilities

- Are there any unusual trends in total reserves?
- What changes were made to existing reserves?
- What reserves were added in the current period?
- Did estimates related to the calculation of reserves (e.g., warranty, environment, etc.) change in the current period? If so, why, and what was the impact on earnings?
- What reversals or additions were made to merger or restructuring reserves? Were such reversals or additions adequately classified and disclosed?
- Do factors such as falling securities market values, drops in interest rates, and projected increases in health care costs require revision in accounting estimates related to benefit plans?
- Have all probable and estimable contingent liabilities been recorded?
- What gave rise to changes in contingent liabilities from the prior year?
- What off-balance-sheet debt exists? What is the operating reason for having off-balance-sheet debt?

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