CHARTA LEARNING · LESSON NOTES

Financial reporting quality

CFA Level I · Financial Statement Analysis

You will learn: Judge whether reported numbers can be trusted and will last: place reports on the quality range, name the conditions behind poor reporting, and spot warning signs by comparing figures.

Running example: Worked examples follow one made-up company, Kestrel Components ($ millions). Year one profit 40, 30 million shares, analysts' EPS forecast $2.00, tax rate 25%.

1. Reporting quality and earnings quality

- Reporting quality asks whether the statements are useful for decisions: relevant, and a faithful representation (complete, neutral, free from error). Earnings quality asks whether profit is sustainable (likely to repeat) and gives an adequate return. The ideas are the same under IFRS and US GAAP.
- They are separate scales. An honest report of a poor year is high reporting quality and low earnings quality. Assess reporting quality first: if reports are biased or not compliant, earnings cannot be judged at all.
- Reported profit is a single number, so two firms can match on it and differ greatly. Take the headline apart: how much comes from the main business and how much from events that will not return.

SAME PROFIT, DIFFERENT EARNINGS QUALITY (KESTREL AND NORWICK PARTS BOTH REPORT $40M)

Norwick recurring profit	40 − 12 one-off gain (warehouse sale)	**$28m**
Share that will repeat	28 ÷ 40	**70%**
Share that was one-off	12 ÷ 40	**30%**
Next year, if nothing new	40 → 28	**−30%**

Watch out: Treating reporting quality and earnings quality as one scale.

2. The range of reporting quality

- From best to worst: 1 rules followed, earnings lasting and adequate; 2 rules followed, earnings weak or one-off; 3 rules followed in form but choices and estimates biased; 4 rules broken, but the activity was real; 5 fabricated (invented transactions and balances, fraud).
- Moving right, first earnings get worse, then honesty, then the existence of the transactions. The further right, the less any number can be relied on.
- Bias goes both ways. Aggressive choices push profit and assets up now (booking sales early, spreading a cost over many years). Conservative choices push them down (quick write-offs, large reserves).
- Cookie jar: hide profit in good years, release it in bad years. Smoothing: steady earnings growth that real business rarely shows. Either way the picture is biased.

Watch out: Thinking compliant means unbiased, or that bias always inflates profit.

3. Why misreporting happens: the three conditions

- Poor reporting tends to need three conditions together (the fraud triangle). Motivation: a reason to want a different number (meeting analysts' forecasts, a bonus, avoiding a loan covenant breach, lifting the share price before selling shares).
- Opportunity: weak internal controls, a board or audit committee that does not push back, an audit that is only a sample, and estimates outsiders cannot check. Rules give room too: IFRS allows capitalising development costs, upward revaluation of property and reversal of inventory write-downs; US GAAP does not.
- Rationalisation: the belief that it is defensible (everyone does it, the rules allow it, we will make it up next year). Small first steps grow.
- The conditions show risk, not proof. Most managers are ordinary people under pressure.

EPS = net income ÷ shares; leverage = debt ÷ EBITDA (earnings before interest, tax, depreciation and amortisation)

PRESSURE ON KESTREL

Depreciation, 8 year life	400 ÷ 8	**$50m**
Depreciation, 10 year life	400 ÷ 10	**$40m**
Profit boost after tax	(50 − 40) × 0.75	**$7.5m**
EPS on old lives / as reported	52.5 ÷ 30 / 60 ÷ 30	**$1.75 / $2.00**
Leverage (covenant at most 3.0x)	400 ÷ 130	**3.08x, a breach**
After capitalising $8m of costs	400 ÷ (130 + 8)	**2.90x**

Watch out: Treating the three conditions as proof that something happened.

4. Red flags: receivables and inventory

- Red flags do not prove poor reporting; they show where to look. The best ones are relative: set figures that should move together side by side and ask why they do not.
- Days sales outstanding (DSO) is the average days customers take to pay. Days inventory outstanding (DIO) is days of sales held as stock. This lesson uses year end balances to trace a trend; other lessons use averages. Watch the direction.
- Receivables rising far faster than revenue means slow customers or sales booked early. Inventory rising faster than cost of goods sold means stock may be obsolete, and old stock not written down overstates assets and profit.

DSO = receivables ÷ revenue × 365; DIO = inventory ÷ COGS × 365

KESTREL, YEARS 1 TO 3

Revenue growth, year 3	500 ÷ 450 − 1	**11.1%**
Receivables growth, year 3	100 ÷ 68 − 1	**47.1%**
DSO, year 1 and year 3	50 ÷ 400 × 365; 100 ÷ 500 × 365	**45.6 and 73.0 days**
Inventory vs COGS growth	114 ÷ 62 − 1; 300 ÷ 240 − 1	**84% vs 25%**
DIO, year 1 and year 3	62 ÷ 240 × 365; 114 ÷ 300 × 365	**94.3 and 138.7 days**

5. Red flags: profit against cash, and other signs

- Accruals measure profit not backed by cash. Cash flow approach: net income − operating cash flow − investing cash flow. Balance sheet approach: change in net operating assets (total assets less cash and short term investments, minus total liabilities less borrowings).
- Divide by average net operating assets for the accruals ratio. A higher or rising ratio means lower earnings quality; a very negative ratio means high quality. A fast growing firm can legitimately have a widening gap, but it needs an explained, evidenced reason.
- More flags: a falling bad debt allowance while receivables rise, longer depreciation lives, capitalising costs peers expense (which also moves cash out of operating into investing cash flow), big fourth quarter adjustments, changes of auditor or chief financial officer, and repeated one-off charges.

> **Accruals = NI − CFO − CFI; accruals ratio = accruals ÷ average net operating assets**

KESTREL ACCRUALS, YEARS 1 TO 3 (NET INCOME 40, 50, 60)

Year 1 accruals	40 − 38 + 20	**$22m**
Year 2 accruals	50 − 30 + 24	**$44m**
Year 3 accruals	60 − 14 + 26	**$72m**
Accruals ratio, year 1 / year 3	22 ÷ 400; 72 ÷ 500	**5.5% / 14.4% (year 2: 9.8%)**
Cash conversion (CFO ÷ NI)	year 1 / year 3	**95% / 23%**

6. Clusters and adjusting the numbers

- Each sign alone has an innocent reading (a big customer wanting longer terms, stock before a launch, a better job for the chief financial officer). Together the innocent explanations run out.
- A cluster raises the probability of a problem but does not prove it. Step up the work: read the notes on policies and estimates, compare with peers, question management, and adjust the numbers to size the risk.

KESTREL YEAR 3 ADJUSTMENT (PRE-TAX PROFIT 80, TAX 25%, 30M SHARES)

Remove longer-life boost	80 − 10	**$70m**
Allowance shortfall (5% of 100 = 5, held 3)	5.0 − 3.0	**$2m**
Adjusted pre-tax profit	70 − 2	**$68m**
Adjusted net income	68 × 0.75	**$51m**
Adjusted EPS vs $2.00 reported	51 ÷ 30	**$1.70**

Key takeaways

- Reporting quality and earnings quality are separate scales; judge reporting quality first.
- The range runs from compliant with lasting earnings, through weak, biased and non-compliant, to fabricated.
- Bias can raise or lower profit (aggressive, conservative, cookie jar, smoothing).
- Motivation, opportunity and rationalisation together raise the risk of misreporting; they are not proof.
- Red flags are relative: receivables and inventory against sales, accruals against cash.
- A cluster of flags is stronger evidence than one; adjust the numbers and ask management.

Quick check

1. A firm reports a poor year fully and faithfully. Reporting and earnings quality?
   Answer: High reporting quality, low earnings quality.
2. Name the three conditions usually present together when reporting is poor.
   Answer: Motivation, opportunity and rationalisation.
3. Net income 60, CFO 14, CFI −20, average NOA 400. Accruals ratio?
   Answer: 60 − 14 + 20 = 66. 66 ÷ 400 = 16.5%.