

# Earnings Quality on Bucharest Stock Exchange Regulated Market

Mihaela Maria Mihalcea

„1st of December 1918” University of Alba Iulia, Romania

[miha.ela\\_89@yahoo.com](mailto:miha.ela_89@yahoo.com)

## Abstract

*The quality of earnings is an important issue regarding the correct assessment of the financial performance of an economic entity, of the sustainability of earnings. The quality of earnings is of real interest to investors and other stakeholders, giving them confidence that the earnings presented are relevant and reliable, are not affected by accounting manipulations and can be maintained in the future. An earnings quality index for companies with values between 1 and 100 is published annually by Thomson Reuters. The purpose of this research is to draw investors' attention to the importance of earnings quality and to present the quality of earnings on the regulated market of the Bucharest Stock Exchange. For the analyzed companies, 63 in number, the general average of the quality of earnings, for 8 years on average, is 40. Most companies, 65%, have an average located in the middle range [31-70]. No company has an average of over 90 and only 1 has an average of less than 10. Half have an average earnings quality below 39. Even if we do not have an average for any company located in the higher quality range, this level is reached however in 5% of the total number of observations of 16 companies, in at least one year for each of them.*

**Key words:** earnings quality, investors, earnings management, persistence, accruals

**J.E.L. classification:** M41, M43, M49

## 1. Introduction

Earnings quality is a fundamental concept for investors in assessing the financial performance of an economic entity, in the decision-making process, being a topic that has also captured the attention of regulators and researchers. Earnings quality refers to the ability of reported earnings to reflect the company's true earnings, as well as the usefulness of reported earnings to predict future earnings. Earnings quality also refers to the stability, persistence and lack of variability of reported earnings. (Bellovary et al., 2005). Dechow et al. (2010) assess the quality of earnings through the persistence of earnings, their smoothness and the size of accruals.

The quality of earnings and, more generally, the quality of financial reporting, are of interest to users of financial statements, giving them confidence. Low quality earnings are inefficient because they reduce economic growth by misallocating capital.

## 2. Literature review

International specialty literature abounds in earnings quality studies. Reference is the work of Schipper, K., & Vincent, L. (2003) and that of Dechow, P. M., & Schrand, C. M. (2004). In Romania there are studies that treat this topic tangentially, mainly addressing financial reporting quality (Gajevszky, 2015) or earnings management (Istrate et. Al., 2015, Brad et. Al., 2016).

The literature associates the quality of earnings with several dimensions.

A first characteristic of the quality of earnings is sustainability, persistence. (Revsine et al., 1999; Bodie et al., 2002). The researchers interpreted the slope coefficient in a regression of the change in the level of gains as a measure of their persistence. In the equation  $Earnings(t+1) = a + b * Earnings(t) + \epsilon$ ,  $b$  measures persistence. The closer the coefficient is to 1, the more persistent the gains. In order to induce persistence, companies can resort to earnings smoothing - a

side of earnings management that overall decreases their quality (Dechow & Schrand, 2004).

Another characteristic of the earnings quality refers to their ability to predict future earnings. (Lipe 1990).

The quality criteria of financial reporting, as a whole (relevance, reliability, comparability) also apply to the quality of earnings.

Earnings quality is a function of performance. Performance is among the determinants of the quality of earnings presented by Dechow et.al. (2010). Also, between the variables included in the eight models regarding the earnings quality presented by Bellovary et al. (2005) we find numerous performance rates (return on assets, gross margin, liquidity current ratio, return on total capital). Thus, the earnings quality provides relevant information about a company's financial performance and the degree to which current performance is indicative of future performance (Dechow et. Al., 2004).

An important measure of the quality of earnings is the size of the accruals defined as the difference between earnings and cash flow. Also, the deviation between profit and operating cash flow measures the quality of earnings (Richardson, 2003). In a study made by Ramadan, I. Z. (2015), the quality of earnings (dependent variable) is expressed by the ratio between Operating cash-flow / EBIT. The greater these differences, the lower their quality.

### **3. Research methodology**

Our scientific approach started from the 'earnings quality' indicator published annually by Thomson Reuters together with the annual financial statements of a company. This was the impetus for the detailed study on the quality of earnings. After analyzing the specialized literature, we sought to find out how Romanian companies relate to this chapter. Thus, the data on the quality of earnings for the companies listed on the regulated market of BSE were extracted from the Thomson Reuters database. A period of 20 years was considered, 1998-2017, but data were available only from 2003, for 63 companies, apart from banks and financial intermediation and insurance companies. The data were not continuous throughout the analyzed period, missing in certain years. With an average of 8 years per company, we extracted a total of 496 observations.

The data were centralized, sorted, analyzed in Excel, and the results presented both in descriptive form and in the form of tables and graphs for better intelligibility.

The research methods used include analytical, qualitative and quantitative, inductive and deductive methods.

### **4. The StarMine Model on earnings quality used by Thomson Reuters**

Earnings quality results are also published by Thomson Reuters, which is one of the world's most trusted providers of financial, accounting, legislative, tax, governance and media information. Wikipedia characterizes them as 'a giant of financial information and media.' Thomson Reuters sells electronic news and data to traders, fund managers and analysts, as well as databases and other information for lawyers, accountants, scientists and doctors.

Along with financial information of companies, Thomson Reuters calculates an earnings quality score using the StarMine model.

StarMine defines earnings quality as the extent to which previous earnings are reliable and are likely to persist.

High earnings quality reflects a company's current and past operating performance and indicates future operating performance. Poor earnings quality does not necessarily imply their manipulation, but reflects a likelihood of deterioration in the figures compared to the past.

StarMine uses a multi-factorial approach to estimate earnings quality. Unlike other models that focus exclusively on accruals, StarMine EQ model analyzes sources of earnings based on their sustainability. The model targets four levels:

- **Accruals:** The term 'accrual' refers to income and expenses recorded in the absence of cash trading at that time, based on accrual accounting. Eight different sources of accruals are included depending on their contribution to revenue persistence.

- Cash Flow: When earnings are supported by cash flow, the probability of their sustainability is much higher. Unlike accruals, cash flow is not affected by the estimation error and is therefore more reliable than accruals.
- Operational efficiency: measured through the rate of return on assets (ROA). When revenues result from efficient operational activity and good use of assets, they are more likely to persist.
- Exclusions: The final concept used by the StarMine Earnings Quality model is a measure of the degree to which reported revenue reflects operating income. The difference is attributed to "special items" and "other exclusions" that have a negative impact on future revenue growth.

The StarMine EQ score allows an objective comparison of the quality of a company's revenue in relation to all other companies. The model ranks stocks whose earnings are backed by cash flows and other sustainable sources and penalizes those with earnings due to accruals and other less sustainable sources.

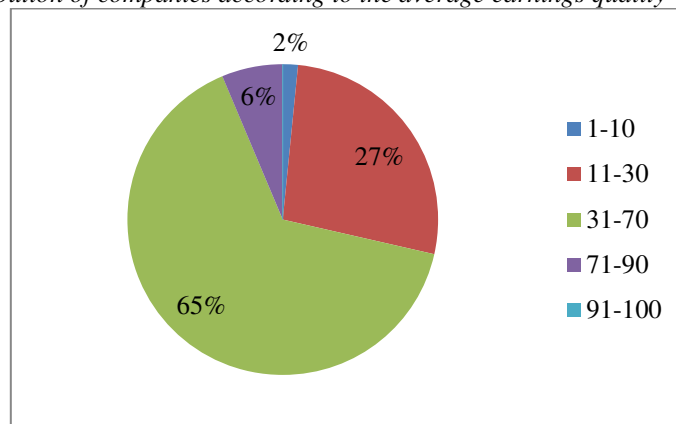
The StarMine model materializes in a percentage ranking (1-100) of shares based on the sustainability of earnings, 100 representing the highest rank.

The scores are then associated with one of the following five ranges 1-10, 11-30, 31-70, 71-90, 91-100.

## 5. Findings

The overall average of earnings quality is 40, and the distribution of companies according to the average of earnings quality is shown in Chart 1. Most companies, 65%, have an average in the middle range [31-70]. No company has an average of over 90 and only 1 has an average of less than 10. Half have an average earnings quality below 39.

Figure no.1. Distribution of companies according to the average earnings quality



Source: author's projection

Even if we do not have for any company an average located in the higher quality range, this level is still reached in 5% of the total number of observations of 16 companies, in at least one year by each of them. Table no. 1 highlights the previous information, as well as the percentage of the total number of observations and the number of companies that reach in at least one year a value of the quality of earnings from each interval.

Table no. 1. The quality of earnings for the observed period, for the analyzed companies

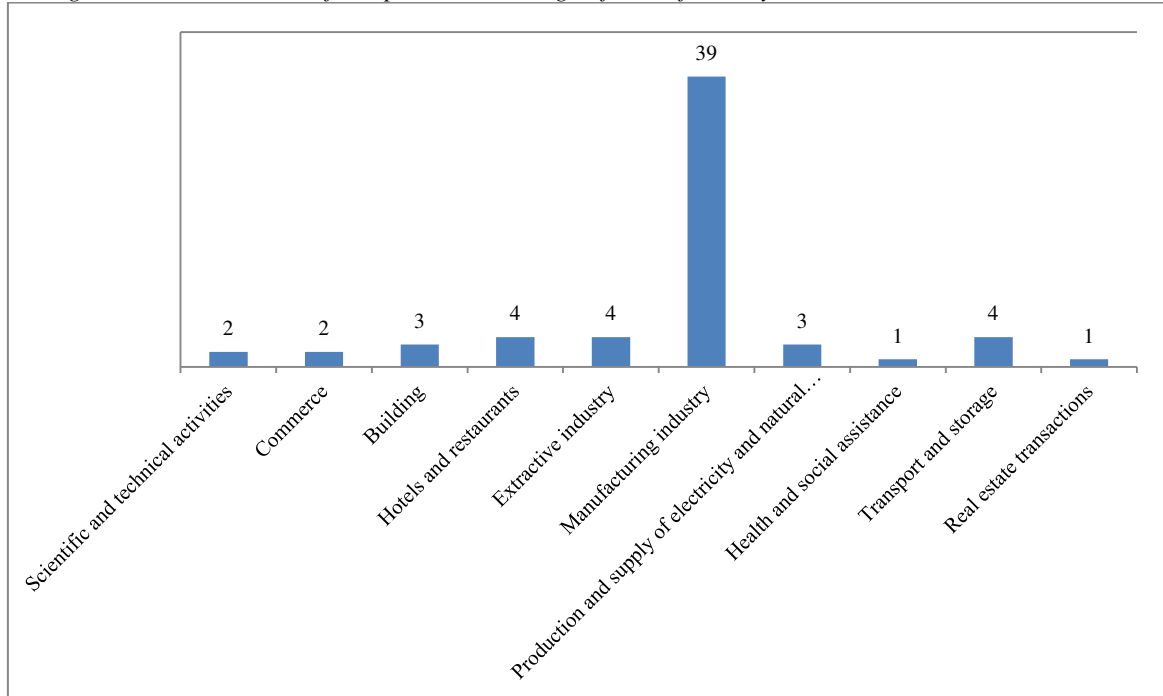
| EQ                     | 1-10 | 11-30 | 31-70 | 71-90 | 91-100 | Total |
|------------------------|------|-------|-------|-------|--------|-------|
| Number of observations | 73   | 137   | 187   | 73    | 26     | 496   |
| Percent                | 15%  | 28%   | 38%   | 15%   | 5%     | 100%  |
| Number of companies    | 44   | 52    | 57    | 39    | 16     | 63    |

Source: own calculations

The extreme values are reached by a company (Prefab SA) which for 10 years out of 11 has the earnings quality in category 11-30 and, on the opposite, positive pole, by a company (Aerostar SA) which for 7 years out of 14 has the quality of earnings included in category 91-100.

The analyzed companies are part of the following fields of activity.

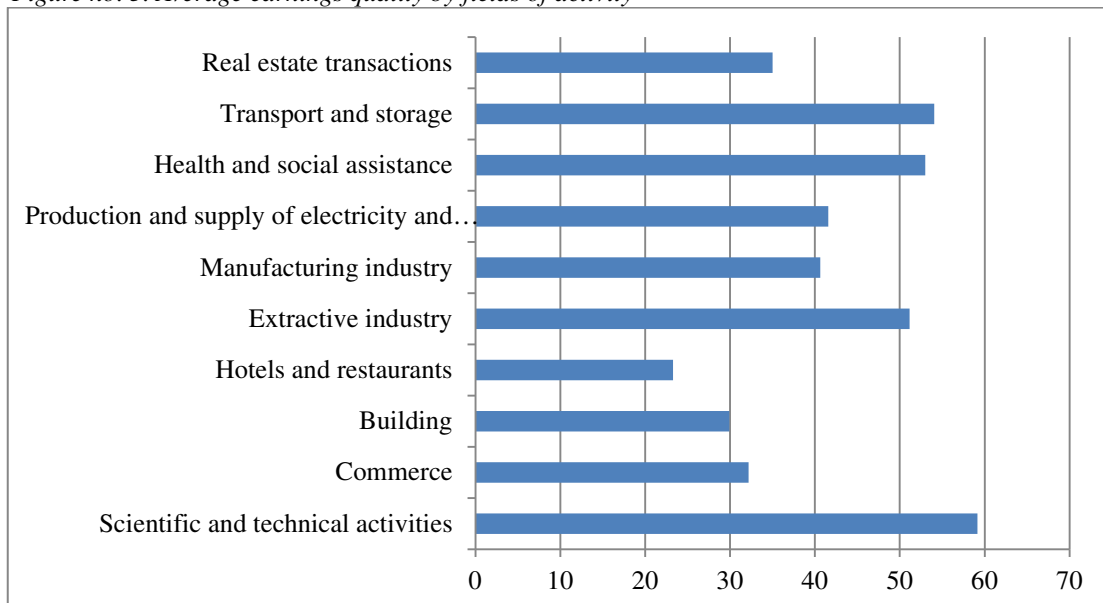
Figure no 2. Distribution of companies according to fields of activity



Source: author's projection

The fields of activity that raise the average quality of earnings are, in the same order, professional, scientific and technical activities, transport and storage, health and social assistance, the extractive industry. On the opposite pole, hotels and restaurants have the lowest average earnings quality.

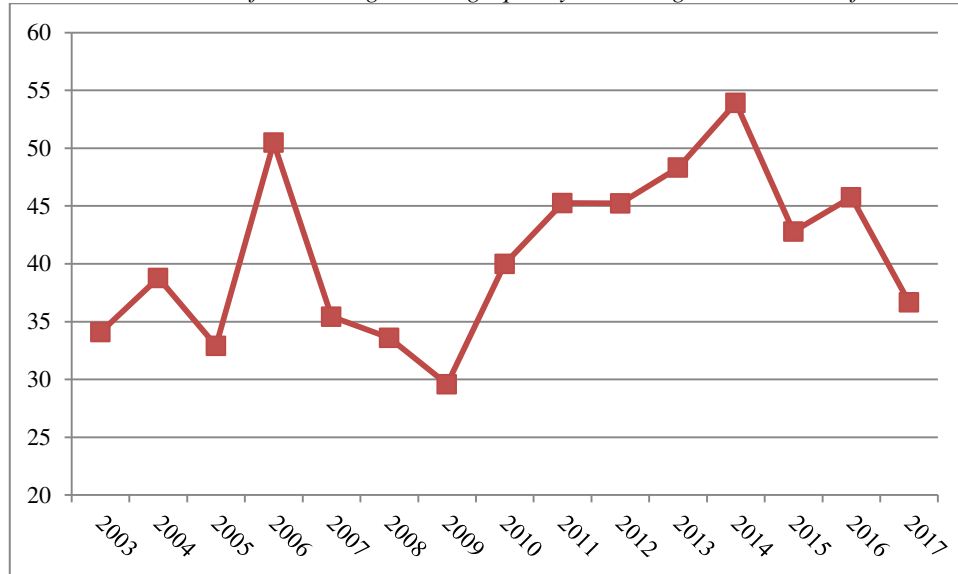
Figure no. 3. Average earnings quality by fields of activity



Source: author's projection

The general endurance over time is not a very optimistic one, but a fluctuating one. The average quality of earnings has a downward trend in the period preceding the economic crisis of 2008-2009. From 2010 it follows a progressive increase until 2014, after which it starts to decrease again. We wonder if it is anticipating an economic crisis again... We may find out the answer in the next period.

Figure no. 4. The evolution of the average earnings quality on the regulated market of BSE



Source: author's projection

## 6. Conclusions

The earnings quality is determined by several factors. Sustainability, persistence, lack of variability are qualities of earnings that, along with predictive ability, give investors confidence in the evolution of earnings.

Earnings management has a negative influence on their quality, so a high earnings quality assures investors that the figures have not been affected by accounting manipulations.

For companies listed on the regulated BSE market, the earnings quality data published by Thomson Reuters is not very encouraging for investors. On a scale of 1 to 100, the overall average earnings quality, for an average of 8 years, is 40. Most listed companies, 65%, have an average in the middle range [31-70]. No company has an average of over 90 and only 1 has an average of less than 10. Half have an average earnings quality below 39.

Even if we do not have for any company an average located in the higher quality range, this level is still reached in 5% of the total number of observations of 16 companies, in at least one year for each of them. A company (Aerostar SA) achieves earnings quality values in the category 91-100 for 7 years out of 14.

In conclusion, there are companies that care about the earnings quality in favor of investors, but overall, the Romanian capital market does not ensure investor confidence by reporting quality earnings and the general trend over time is not very optimistic, but fluctuating.

## 7. Acknowledgement

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