What is Quality of Earnings?

Worksheet

Quality of earnings measures how accurately reported net income reflects a company's true, sustainable operating performance. High-quality earnings are recurring, conservative, and closely tracked by operating cash flow; low-quality earnings rely on estimates, one-time gains, or aggressive accounting.

Questions

1. Which is the strongest sign of high-quality earnings?
A) Net income far exceeds operating cash flow
B) Net income closely tracks operating cash flow
C) Profit driven mainly by asset sales
D) Frequent accounting policy changes

2. A company's profit rose mostly due to a one-time gain on a lawsuit settlement. This is a sign of:
A) Higher earnings quality
B) Lower earnings quality
C) No effect on earnings quality
D) Improved core operations

3. A Quality of Earnings (QoE) report is most commonly used in:
A) Payroll processing
B) Mergers and acquisitions due diligence
C) Daily bookkeeping
D) Sales tax filing

4. Extending depreciable asset lives to cut depreciation expense and raise net income is:
A) A sign of improved sales
B) An earnings quality red flag
C) Required by GAAP every year
D) Unrelated to earnings quality

5. Company A reports $10 million net income and $9.5 million operating cash flow. Company B reports $10 million net income but only $2 million operating cash flow. Which has higher earnings quality?

6. A firm's net income grew 15% this year, but $8 million of a $12 million total profit increase came from a one-time gain on selling a building. What is the recurring (core) profit growth?

7. A retailer increases reported profit by extending the useful life it uses to depreciate its stores from 20 to 30 years, cutting annual depreciation expense. How should an analyst treat this?

8. Define: What does 'quality of earnings' mean?

9. Define: What is a classic red flag for low earnings quality?

10. Define: Why do one-time gains lower earnings quality?

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Answer Key

1. B) Net income closely tracks operating cash flow - Cash-backed earnings are harder to manipulate and more sustainable.

2. B) Lower earnings quality - One-time, non-recurring gains do not reflect sustainable core performance.

3. B) Mergers and acquisitions due diligence - Buyers commission QoE reports to normalize a target company's true earnings power.

4. B) An earnings quality red flag - It boosts reported profit through an estimate change, not real operating improvement.

5. Compare net income to operating cash flow (OCF) for each Company A: OCF/NI = 9.5/10 = 0.95 (95% cash-backed) Company B: OCF/NI = 2/10 = 0.20 (only 20% cash-backed) Company A shows higher-quality earnings - its profit converts closely to real cash

6. Total profit increase = $12 million Non-recurring gain = $8 million Recurring (core) increase = 12 8 = $4 million Much of the reported growth is not sustainable - quality of earnings is lower than the headline 15% suggests

7. Depreciation expense fell purely due to an accounting estimate change, not better operations The extra reported profit did not come from selling more or controlling costs An analyst should flag this as a red flag lowering earnings quality, and consider adjusting net income back to a comparable basis

8. How well reported net income reflects a company's true, sustainable, cash-backed operating performance.

9. Net income growing much faster than operating cash flow over several periods.

10. They are non-recurring and inflate profit without reflecting improved core operations.

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