Earnings quality assessment

Abstract A quality of earning assessment is a tool used by analyst to determine the correlation between accounting income and economic income. The techniques to analyze accounting income and economic income include: comparing accounting principles, reviewing changes in accounting principles, analyzing discretionary and warranty expenditures, understanding replacement cost of assets and managements and auditors opinion of the company. A quality of earnings assessment of PepsiCo is applied to the various techniques to analyze accounting income and economic income.

Discuss Measures That may be used to asses the quality of a firms reported earnings. Companies prepare their financial statements based on accounting income, which does not depict an accurate picture of a company's financial position. To assess a company's reported earnings financial statements users should assess the company's quality of earnings. According to Schroeder, Clark, and Cathey (2009) quality of earnings is " the degree of correlation between a company's accounting and its economic income" (p. 158).

Accounting income " has been traditionally based on a set of rules and regulations utilizing an historical cost approach" (Kida & Hicks, 1982, p, 41). For example, if a building cost $40, 000 and the current market value is $50, 000, the building would remain on the books at $40, 000, which is the historical cost. Economic income differs from accounting income because " economic Income concepts, are thought of in terms of theoretical constructs, which reflect changing current value" (Kida & Hicks, 1982, p, 41).

In the previous example, economic income would have recognized the change in value of the building, which is $10, 000 higher than accounting income, the differences in the value of building is a affirmation that earnings quality is necessary to determine the correlation between accounting income and economic income. Following are the various techniques used to assess earnings quality. A. Accounting methods used should be compared to other companies in the same industry because accounting methods used can inflate earnings. For example, company A use FIFO to report cost of goods sold and company B use LIFO to report cost of goods sold.

During periods of inflation FIFO would produce a higher net income. According to Schroeder, Clark, and Cathey (2009), “ compare the accounting principles employed by the company with those generally used in the industry and by the competition. Do the principles used by the company inflate earnings” (p. 158). B. Changes in accounting estimates can inflate earnings. For example, if the life of an asset is estimated as five years and management change the estimate to 10 years, depreciation expense would decrease and net income would increase.

Schroeder, Clark, andCathey (2009), states “ review recent change in accounting principles and changes in estimates to determine if they inflate earnings” (p. 158). C. To inflate earnings an organization could reduce discretionary expenses. Schroeder, Clark and Cathey (200) states, “ determine if discretionary expenditures, such as advertising have been postponed by comparing them to those of previous periods” (p. 158). D. Companies may increase net income by not recording expenses “ assess

whether some expenses such as warranty expense, are not reflected on the income statement” (Schroeder, Clark, &Cathey, 2009, p. 158). E.

Analyze the replacement cost of a company’s inventory and assets and “ assess whether the company generates sufficient cash flow to replace it assets” (Schroeder, Clark, &Cathey, 2009, p. 158). If a company cannot replace inventory and assets the company will not be able to continue its business operations. F. To determine if a company has future uncertainties such as a lawsuit, there should be a review of notes to the financial statements. According to Schroeder, Clark, and Cathey (2009), “ review the notes to financial statements to determine if loss contingencies exist that may reduce future earnings and cash flows” (p. 58). G. To increase sales a company may relax their credit polices “ review the relationship between sales and receivables to determine if receivables are increasing more rapidly than sales” (Schroeder, Clark, &Cathey, 2009, p. 158). H. Auditor’s opinion of a company and managements discussion is an indication of the company ability to continue as a going concern. According to Schroeder, Clark, &Cathey (2009), “ review the management discussion and analysis section of the annual report and the auditor’s opinion to determine management’s opinion of the company’s future to identify any major accounting issues” (p. 58). Obtain an annual report for a large corporation and perform a quality of earnings Pepsi revenue recognition policy was compared to their competitor Coke to determine if Pepsi uses an accounting method that would inflate their earnings. Pepsi states, “ we recognize revenue upon shipment or delivery to our customers based on written sales terms that do not allow for a right of return” (p. 73). Pepsi revenue recognition method is similar to

Coke. Coke states, “ we recognize revenue when title to our products is transferred to our bottling partners, resellers or other customers.

Our sales terms do not allow for a right of return except for matters related to any manufacturing defects on our part” (p. 25). Pepsi and Coke have similar revenue recognition policies both companies recognize revenue when title passes to customers and they do no allow for a right of return. In February 2007 FASB changed accounting principle SFAS 159, Pepsis did change to the new accounting principle, however the change did not inflate their earnings. According to Pepsi “ FASB issued SFAS 159 which permits entities to choose to measure many financial instruments and certain other items at fair value.

We adopted SFAS 159 as of the beginning of our 2008 fiscal year and our adoption did not impact our financial statements” (p. 74). In review of management discussion and analysis section of the annual report and the auditor’s opinion, there were no major accounting issues or concerns with the company’s future growth. According to Pepsi management “ we applied our critical accounting policies and estimation methods consistently in all material respects and for all periods presented, and have discussed policies with our audit committee” (p. 51).

The auditing firm agree with Pepsi’s assertion and states “ in our opinion, the consolidated financial statement referred to above present fairly, in all material respects, the financial position of PepsiCo, as of December 27, 2008 and December 29th, 2007, and the results of its operations and it cash flows for each of the fiscal years” (p. 93). We applied our critical accounting

policies and estimation methods consistently in all material respectsand for all periods presented, and have discussed policies with our audit committee (p. 51).

In our opinion, the consolidated financial statement referred to above present fairly, in all material respects, the financial position of PepsicCo, as of December 27, 2008 and December 29th2007, and the results of its operations and it cash flows for each of the fiscal years. (p. 93) In 2008 Pepsi had sales of $43 billion and accounts receivables balance was 17. 15% of sales. In 2007 sales were $39 billion and accounts receivables balance was 17. 23% of sales. The percentage of sales to receivables increased by . 08 of a percent, which is an indication that Pepsi did not relax their credit policy to increase sales.

According to Schroeder, Clark, and Cathey, (2009) when assessing earnings quality accounts receivable should be reviewed “ ” review the relationship between sales and receivables to determine if receivables are increasing more rapidly than sales” (p. 158) Conclusion Economic income should be used to assess a company’s earnings because it is a better predictorof future cash flows than accounting income. Investors and creditors should perform an assessment of earnings quality prior to investing in a company to determine if the company inflated earnings and to predict future cash flows.

An assessment of earnings quality will help creditors determine the company’s ability to pay interest on the loans, and the assessment will help investors determine the company’s ability to pay dividends. References Hopwood, W. , Lenier, J. , & Young, G. (2010). Forensic accounting. New York,

NY: McGraw-Hill. Kida, T. E. , & Hicks, D. W. (1982). Economic Versus Accounting Income: The Impact of Education on Students' Concepts. Journal of Economic Education, 13(2), 40-46 Schroeder, R. , Clark, M. , , J. (20009). Financial accounting theory and analysis. Hoboken: John Wiley & Sons.