

CONCEPT: RATIOS – QUALITY OF EARNINGS

- The **Quality of Earnings** ratio measures whether incoming cash flows are aligned with net income
 - Quality of Earnings is a common _____ ratio
 - Remember that income is not directly related to cash flow in accrual accounting.
 - We book revenues when we provide services to the customer, even if they haven't paid us yet
 - But if we are never receiving the cash from those customers, that signifies bad earnings quality

$$\text{Quality of Earnings Ratio} = \frac{\text{Net Cash Flow from Operating Activities}}{\text{Net Income}}$$

Analysis: This ratio measures how much cash the company's operations generated for every dollar of net income

Comparison: We want to receive as much cash as possible. The _____ this ratio, the higher the quality of earnings.

- Note that not all professors focus on this ratio when discussing quality of earnings. Other issues around earnings:
 - Quality of Earnings also refers to financial information that is _____ and _____
 - Using one-time gains (selling investments) to satisfy investor projections is called **earnings management**
 - Companies may also **inflate revenue** through **channel-stuffing**
 - > Encouraging customers to purchase large amounts of goods near period-end
 - > These goods may later need to be returned because they couldn't be resold

PRACTICE: MoneyCo had sales revenue and net income during the current year of \$100,000 and \$60,000, respectively. The total amount of stockholders' equity was \$600,000. The cash flow statement indicated that cash flows from operating activities, investing activities, and financing activities, were \$20,000, (\$30,000), and \$60,000. The company also paid dividends of \$10,000. What is MoneyCo's quality of earnings ratio?

- a) 0.10
- b) 0.16
- c) 0.20
- d) 0.33