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

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

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