ASSESSING THE QUALITY OF CORPORATE EARNINGS IN THE EURO AREA

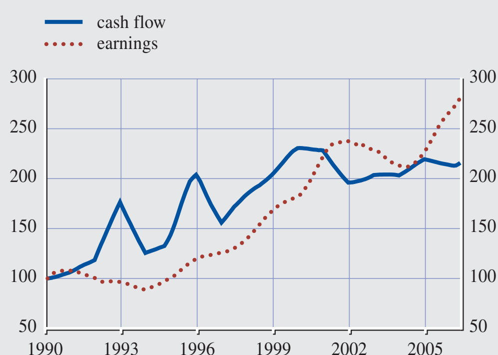
The balance sheets of euro area non-financial corporations improved greatly from 2003 onwards, partly owing to a significant improvement in aggregate profitability during this time, and corporate earnings are expected to remain robust throughout 2006 (see Chart 2.3 in the main text).[1] For a comprehensive credit risk assessment, it is important to analyse thoroughly the quality of earnings reported by firms. This Box attempts to shed some light on the quality of earnings reported by euro area firms listed on stock markets over recent years and it assesses the implications.

It is often difficult to evaluate earnings, because companies can highlight a variety of earnings figures: revenues, operating earnings, net income, and pro forma earnings. In addition, companies often calculate these figures rather differently. This means that their income statement alone may not be the most useful guide for evaluating their true earnings quality, which is an important aspect of an entity's financial health. Earnings quality refers to the ability of reported earnings to reflect a company's true earnings, as well as the usefulness of reported earnings in predicting future earnings. It also refers to the stability, persistence and degree of variability in reported earnings. One way of defining earnings quality is to consider how well

1 Behind the aggregate improvement, there have been substantial differences in financial performance across different sectors of the economy. For credit risk assessment, it remains important to differentiate between sectors. This topic has been explored in Boxes 5 and 6 in ECB (2005), *Financial Stability Review*, December.

Chart B4.1 Earnings and cash flow of euro area stock market listed companies

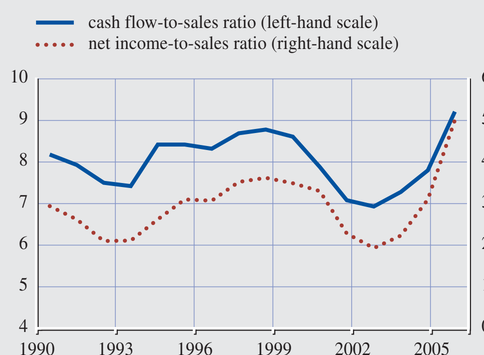
(index: Jan. 1990 = 100, 12-month moving averages)



Sources: Thomson Financial Datastream and ECB calculations.
Note: Earnings and cash flow are calculated using the EMU stock price index and the price-earnings ratio and price-cash flow ratio. Cash flows are defined as funds from operations.

Chart B4.2 Cash flow to sales and net income to sales of euro area stock market listed non-financial corporations

(%, medians)



Sources: Thomson Financial Worldscope and ECB calculations.
Note: Varying but increasing coverage of about 2,000 firms from 1997 onwards, 2005 covers around 200 firms. Cash flows are defined as funds from operations.

accounting measures of earnings convey information about the underlying phenomenon. Assessing the earnings quality of firms is thus important for financial stability, since a misperception of the robustness of corporate profits and thus of the creditworthiness of borrowers could ultimately have implications for the soundness of the financial system through realised credit risk losses for financial institutions and investors.

At an aggregate level, one way of assessing the quality of euro area firms' profits is to compare the earnings they report and their net income, with their cash flows. Cash flows are defined as funds from operations, and basically consist of earnings before preferred dividends, plus depreciation on fixed assets. In recent years, the profits reported by euro area firms listed on stock markets have diverged significantly from their cash flows, with reported earnings reaching all-time highs in early 2006, but cash flows remaining below their 2000 peak (see Chart B4.1). Net income excludes extraordinary items and changes in working capital. A similar conclusion is reached on the basis of firm-level data, which show that in 2005, the ratio of net income to sales (a measure of a firm's profit margin) reached its highest level for 15 years (see Chart B4.2). By contrast, the operating cash flow-to-sales ratio only slightly exceeded below the levels observed in the latter part of the 1990s. The large and growing gap that had existed between the two profit measures after 2000 suggests that euro area companies faced some challenges in generating cash flow. These difficulties may have been related to a dearth of attractive business opportunities or an unwillingness to invest as firms restructured their balance sheets. Furthermore, the high level of corporate earnings reported by firms in recent years seems to have been largely driven by cost-cutting measures (see Chart 2.2 in the main text) as well as, more recently, an increasing use of earnings to buy back shares instead of investing.[2] While efforts to make operations more efficient were necessary to repair corporate balance sheets, efforts to introduce growth-enhancing, and hence cash-flow-generating, measures may have been limited in this process.

2 See IMF (2006), "Awash with cash: Why are corporate savings so high?", *World Economic Outlook,* April, Chapter IV.

To conclude, there has been significant divergence between the profits reported by euro area firms and their cash flows since 2000. This divergence became even more marked after 2003, when reported earnings began to improve. The main explanation for this appears to have been a reluctance of firms in recent years to invest in cash-flow-generating projects. This may also partly explain why corporate debt levels were not significantly reduced despite the strong growth in reported earnings observed in recent years. To some extent, this therefore questions the quality of the earnings that have been reported by firms in the past few years and, especially, whether firms will be able to sustain high rates of profitability in the future. Caution is also called for when interpreting reported earnings figures, which for various reasons may sometimes overstate actual underlying developments in firms' ability to generate cash flow.