Quality of Earnings

Quality of earnings refers to the degree that the earnings are accurate and dependable. It is very beneficial to study the financial statements and determine if the individuals who prepared them adhered to reasonable assumptions about accruals and adhered to other good accounting practices. By doing this, you can determine whether the earnings numbers are trustworthy or questionable.

We will have more to say about the quality of earnings in the future. For now, let us say two things. First, the most effective way to boost earnings cheaply and dishonestly is to boost sales cheaply and dishonestly. And the most effective way to boost sales dishonestly is with unreasonably generous credit terms. This has a favorable effect on sales initially, but eventually this effect evaporates and in its place materializes uncollectable accounts receivable. This deceitful ploy usually shows up first in an increase in accounts receivables and a decrease in accounts receivable turnover.

Second, when companies make bad forecasts about what their customers want, these mistakes will show up first in an increase in inventories, and a decrease in inventory turnover.

A**ccounts receivable turnover** and **inventory turnover** are far from foolproof, and determining quality of earnings is much more complex than crunching just two numbers; but if we had just two numbers to crunch to determine quality of earnings, we would want those two numbers to be **accounts receivable turnover** and **inventory turnover**.

If you would like to see exactly how to calculate these numbers, read the **Financial Ratio Analysis** section of the **How-to-Invest-in-Stocks page**.