

Another point is that analysis frequently involves comparing companies in the same industrial sector. As a consequence the analyst gains insights into what are the typical financial structures and operating margins in the industry.

Quality of earnings

An analyst is looking for sustainable profit and growth of that profit. So a key question to start with is to assess the extent to which the current earnings are subject to short-term influences or accounting manipulations. You should check for such things as:

- a. **changes of accounting** policies or accounting estimates
- b. pension holidays
- c. unusual asset disposals
- d. distortions caused by buying and selling business segments
- e. changes in the consolidation scope and of the interest percentages in associates and joint ventures
- f. anything else which suggests that short-term results will not be replicated in the long term.

This kind of subjective assessment of earnings is generally referred to as 'quality of earnings' and involves posing the question (as far as it is possible to tell) to what extent are the earnings revealed by the financial statements sustainable in future years? Some analysts will compare, in a longitudinal fashion, operating profit to net operating cash flow to identify and analyse the effect of accruals games on operating earnings. This is computed as follows:

$$\text{Quality of operating earnings} = \frac{\text{Net operating cash flow}}{\text{Net operating profit}}$$

A ratio of higher than 1 means that each currency unit of operating profit is supported by one currency unit or more of positive cash flow and can be considered to reflect high-quality operating earnings.

Increasingly, accounting standards try to restrict and regulate what information companies should provide about unusual transactions or changes in the components of the group. This information is important in helping analysts forecast future earnings, but in the past has been manipulated by some companies to try to mislead analysts. IAS 1, *Presentation of Financial Statements*, now prohibits the distinction of ordinary activities and extraordinary items on the face of the income statement. The IASB decided that extraordinary items are not that special in the sense that they result from the normal business risks faced by the company and, thus, do not warrant presentation in a separate caption of the income statement. Disclosures in the notes to the accounts (and even on the income statement) may, however, hold significant information to identify and analyse the effect of special and non-recurrent items and transactions. Indeed, IAS 1 requires that when items of income and expense are material, their nature and amount should be disclosed separately.