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Lower Stock Returns and Higher Volatility Found at Companies with Opaque SEC Filings, Poor Earnings Quality, Study Finds

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Companies with Low Quality Filings Have 17% Lower Return, 13% Greater Volatility Than Those with the Most Transparent Filings

There is a correlation between the quality of a company's financial filings and its stock price performance and volatility, according to a study released today by RateFinancials Inc., a New York-based independent research firm that specializes in rating financial reporting. The study found that companies with poor earnings quality, the most opaque and inadequate 10-K, 10-Q, and other public documents, and poor governance standards have lower equity returns and more volatility than companies with stronger practices in these areas.

The study is based on a close examination of the SEC filings and stock price data for 124 companies in the S&P 500 during the two and half year period between January 1, 2002 and May 31, 2004. Although all the documents examined appeared to be filed in accordance with regulatory requirements, some filings were demonstrably less transparent and less comprehensive when compared to an objective standard.

"These results are further proof that while all SEC filings are thought to be equal, some are more equal than others," said Victor Germack, founder and president of RateFinancials. "Complete, easy to understand filings should give investors a greater degree of confidence in the competence and integrity of management. On the other hand, if you can't understand a company's filings, think twice before buying its stock."

The most highly rated companies in the study with the best combination of return and volatility were Energizer Holdings (NYSE:ENR) and Fortune Brands (NYSE:FO). The companies with the lowest rating, poorest stock return and highest volatility were Electronic Data Systems (NYSE:EDS) and Siebel Systems (Nasdaq:SEBL).

RateFinancials rated the companies in this study using a consistent methodology.

First, RateFinancials examined each company's filings and financial statements to determine the quality of their earnings and the strength of their accounting policies. This means deciphering whether a company's earnings are attributable to higher sales or lower costs rather than artificial profits created by accounting anomalies and earnings management. Among the questions RateFinancials asked were: Are earnings altered substantially as a result of an accounting policy change or a one-time gain? And are the financial assumptions a company uses to value its assets, liabilities and pension obligations reflective of market history and current market conditions?

Secondly, RateFinancials looked at general transparency. Here the firm focused on whether the filing had clear and complete footnotes and included a detailed management discussion & analysis section (MD&A). For instance, do the footnotes breakout restructuring charges in detail and adequately portray the performance of a company's various units and subsidiaries? Do the footnotes fully discuss the effect of accounting rule changes and the use of derivatives? Does the MD&A provide the components of revenue growth in detail? Finally, RateFinancials examined each company's corporate governance, considering such issues as: Does the company have a staggered board? Does it engage in related party transactions? Do its executives receive excessive compensation or have golden parachutes?

All companies received a final score based on a rising scale from one to five stars, with one star as the lowest possible score and five stars as the highest. (Because there was not enough one star or five star rated companies -- the lowest and highest scores -- within the data to make a sample of either group statistically significant, the study focused on the companies that earned either two, three or four stars.)

The study revealed a strong link between the star ratings and stock price. During the period of the study the average equity return of the lowest rated companies in the study was 15.6%, while the companies rated three stars delivered an average return of 21.2% and the shares of the highest rated firms in the study returned a very impressive 32.8%.

The study also found that the average investment risk associated with the lowest scoring companies, as measured by stock price volatility, was significantly greater than that of their higher scoring peers. RateFinancials found that two star companies had an average volatility of 42.1% compared with 32.4% and 29.5% for companies with three and four stars, respectively.

The study was conducted by Charles Roberts, an adjunct professor of quantitative studies at Farleigh Dickinson University, who spent over twenty years as a quantitative and risk management analyst at a major Wall Street investment house.

About RateFinancials

RateFinancials Inc. is a New York-based, independent risk research firm that rates and ranks the financial reporting of the largest U.S. public companies based on their SEC filings, such as 10-Ks, 10-Qs, 8-Ks and other filings. The firm's ratings focus on financial reporting, quality of earnings and corporate governance. RateFinancials does not speak with company management, as the firm believes the financial reports must speak for themselves. RateFinancials does not make earnings estimates or provide any investment recommendations. The firm was founded in 2002 by experienced investment bankers and equity research analysts, many of whom are Chartered Financial Analysts. For more information, visit: www.ratefinancials.com.