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Integrity Research

Growing Demand for Earnings Quality Research

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New York - Last summer, Richard Sloan—a leading expert in the field of earnings quality analysis—took leave from his tenured position at the University of Michigan business school to join Barclay's Global Investors (BGI). This move indicates that demand for earnings quality analysis continues to grow, even in the post-SOX world.

Richard Sloan and Earnings Quality

Sloan first received recognition for discovering the so-called “accruals anomaly” in the early 1990s. Then an assistant professor of accounting at Wharton, Sloan showed that companies with higher levels of accruals tend to fare worse over time than companies with lower levels of accruals. According to Sloan's analysis, an investment strategy that included buying companies with the highest earnings quality (lowest level of accruals) and shorting companies with the lowest earnings quality (highest level of accruals) could have produced *excess returns* of roughly 20%. In an investing world of increasingly elusive alpha, this was a monumental finding.

Sloan developed these insights during his tenure as an accounting professor at Wharton and the University of Michigan. Recently, however, Sloan has decided to take his work to the private sector. As a recent article in *BusinessWeek* reported, his decision to leave Michigan for BGI was not entirely for the money. “I just felt that BGI was getting ahead of me,” Sloan remarked. “I came here because this is where the leading edge of my research is now.”

BGI searches constantly for new quantitative “signals” to enhance its own proprietary quantitative models. Despite the changes imposed by Sarbanes Oxley, BGI says that earnings quality analysis remains a powerful input for their quantitative models. Even as individual signals have come and gone, the *BusinessWeek* article reports, earnings quality has been BGI’s single richest source of alpha over the last decade.

The Competitive Earnings Quality Research Market

While BGI has chosen to in-source its earnings quality research, many independent research providers have made good business of analyzing financial statements for the investment community. Some of these providers—such as Criterion (recently acquired by CFRA)—use quantitative processes to rate companies on the basis of earnings quality. By quantifying accruals and adjusting for factors that impact the quality of accruals, the Criterion/CFRA model works to single out companies with a high prospect for under- and over-performing the market. Criterion's white papers indicate that its accrual model was developed with assistance from three Wharton accounting professors, though it is unclear if Sloan had a direct role in developing it.

Other research providers—such as RateFinancials—use methodologies that go beyond quantitative assessments of earnings quality, incorporating qualitative assessments into their rating systems. In addition to performing standard measurements of earnings quality (measurements that look at levels and quality of accruals), RateFinancials also performs qualitative assessments to determine the accuracy, reliability and completeness of a company's footnotes, management discussion/analysis and corporate governance practices.

Integrity Research: Monitoring the Earnings Quality Research Providers

RateFinancials and CFRA are just two of the earnings quality research providers that Integrity research tracks. In the next month, Integrity will be putting out a comprehensive review of these providers to highlight the top players with the freshest ideas and most innovative product offerings. For more information about our upcoming ResearchInsight review, please contact Tom Rossman at (212)-845-9088 x804.