Earnings Quality and Short Sellers

December 31, 2003

Earnings quality is often defined in terms of persistence and sustainability. In this paper, earnings that are more persistent are viewed as higher quality. Examples of low-quality earnings include insufficient allowance for doubtful accounts, insufficient provisions for obsolete inventory, and aggressive revenue recognition practices that bring future revenues into the current period. Common to these examples of low earnings quality is the fact that current earnings are temporarily inflated but cash flows are unaffected.

The lower persistence of earnings resulting from high levels of accruals does not have to be a direct result of earnings management activity. The nature of accrual accounting is to accrue and defer past, current and anticipated future cash receipts and disbursements. The accrual process involves a significant amount of estimation of future cash receipts and payments, and a subjective allocation of past cash receipts and payments. In doing so, the accrual process creates accounts of varying reliability.

Our research shows that firms with high accruals — that is, those that reported income greater than operating cash flows — experience a decline in earnings performance in the following year. Also, firms reporting large accruals have been more likely to be subject to SEC enforcement actions and earnings restatements. Collectively, this suggests that the magnitude of accruals is a good indicator of earnings quality.

In this paper, I examine whether short sellers are able to identify and trade on earnings quality information embedded in accruals. Short sellers have particularly strong incentives to utilize measures of earnings quality because they can directly profit from the lower future performance of high-accrual firms.