Information in Accruals About the Quality of Earnings

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Working paper

This paper provides a systematic examination what accounting accruals — defined as the difference between earnings and free cash flows — can tell investors about earnings quality in the future.

Our results provide several important new insights.

We show that information in accruals about earnings quality extends beyond the set of accruals considered by Richard Sloan in a 1996 study. In fact, the additional accruals we consider provide relatively more information about future stock returns and future SEC enforcement actions than the original accruals considered by Sloan.

At the same time, we show that liability accruals play a unique role in providing information about earnings' quality. While liability accruals, per se, have little direct information about earnings quality, they play an important role in extracting information about earnings quality from asset accruals.

In addition, we show that both the sales growth and efficiency components of accruals contribute to the information in accruals about earnings quality.

Taken as a whole, our evidence suggests that information in accruals about earnings quality is not concentrated in a particular component of accruals. Total accruals provide a parsimonious and robust measure of earnings quality.