

What Is Accounting Quality and Why It Matters

A Quick Walk Through the Recent Age of Miracle, Wonder & Other Lies

It has been a wild couple of years for financial statements. And by “wild,” we mean the quality of financial accounting information hit lows we could not have imagined. Let’s start with the basics.

The concept of accounting quality is predicated on the idea that financial reporting is designed to provide financial information that is both relevant and faithfully represents a company’s actual financial condition. Financial reporting quality is essential to maintaining vibrant and healthy capital markets. **It is that simple.**

KCR’s equity research team has been at this for a combined 55 years and has been publishing research via KCR since 2010. The academic on the team teaches accounting and is a blue-chip name in the field of behavioral finance. We cannot recall accounting distortions being this severe. Ever.

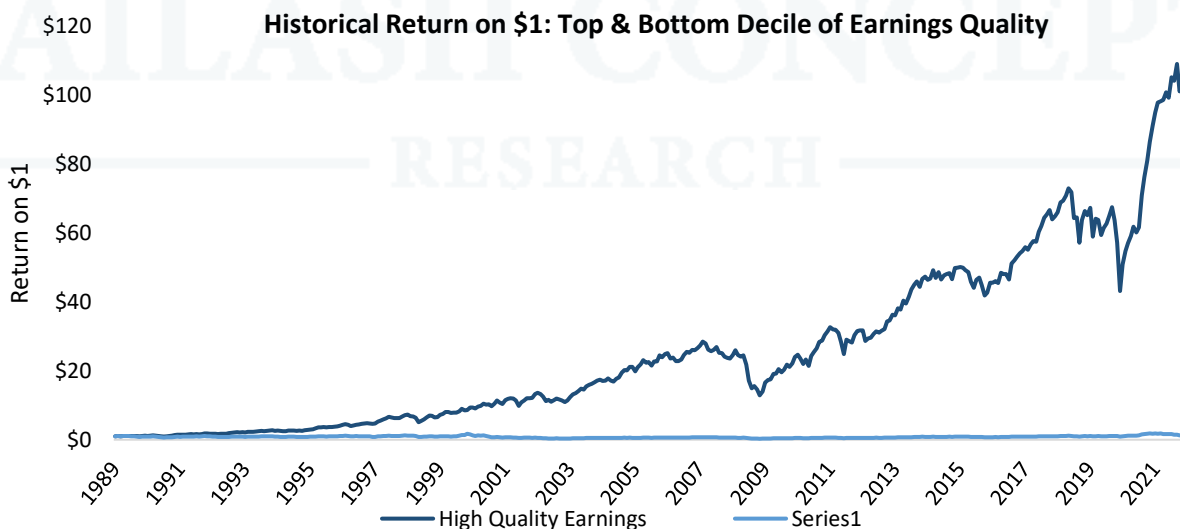
Things are so off the charts that the new head of the [SEC led out](#) by implying that the sponsors of a company promising final mile delivery in...outer space had misled investors. We would later pan the improbable promises of [Lilium](#), valued at \$3.3 billion, which asserted they would revolutionize short-haul flight with yet to be built battery powered mini-planes.

Dishonesty like this led famed short-seller, Jim Chanos, to dub this “[The Golden Age of Fraud](#)” in an article for the Financial Times. Short sellers are often made into villains. But with hindsight, the world often wishes the good ones’ warnings were heeded earlier. We will venture a guess that the thousands of Enron employees who lost everything wish regulators paid more attention to investors like Mr. Chanos.

Why Does Earnings Management and Earnings Quality Matter in One Chart – Small & Mid Cap Universe

KCR’s equity ranking tools offer proprietary calculated information on 95 metrics in five major buckets. Those buckets are Valuation, Balance Sheet, Earnings Quality, Analyst Quality, and Market Quality. **The chart below omits 4 out of the 5 buckets - not something we recommend - and shows the compound returns to the top-ranked 10% and bottom-ranked 10% stocks based on our Earnings Quality score.**

Small & Mid Cap Stocks with High Quality Earnings Obliterate Stocks with Low Quality Earnings



Source: Kailash Capital, LLC, Small & Midcap Universe; Data from 4/30/1989 – 3/31/2022

For those interested in the data from our S&P500 Universe, please reach out to research@kailashconcepts.com

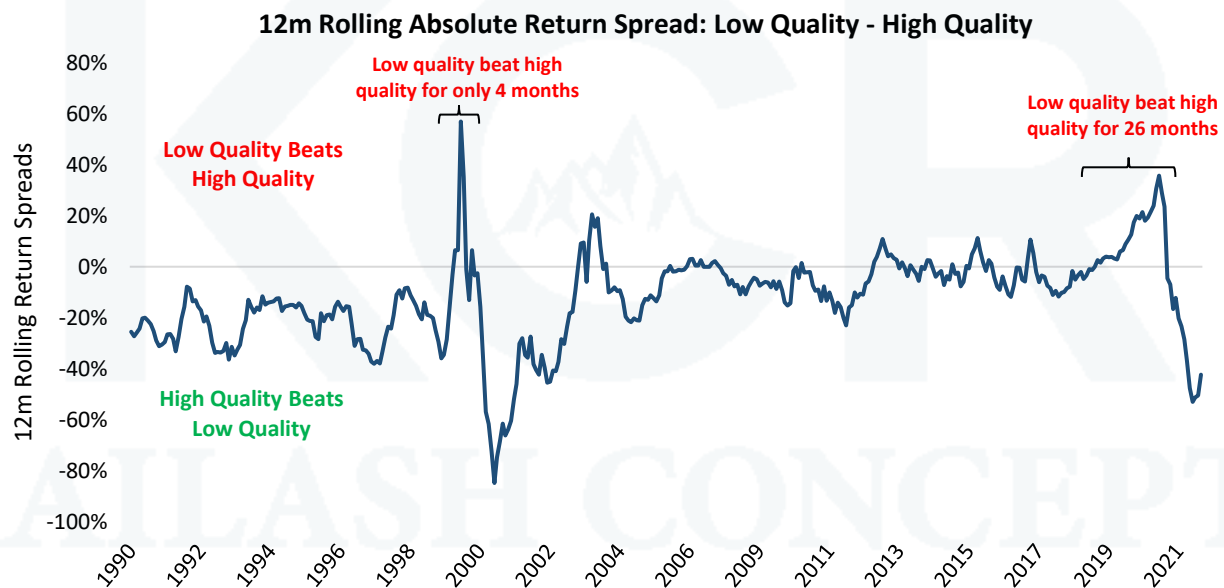
The Importance of Accounting Quality in Four Quick Charts

The chart below shows:

- The spread of 12-month returns between KCR’s top and bottom ranked stocks based on earnings quality
- When the line is **above** “0%,” it means stocks we identify as having low-quality earnings are beating stocks we identify as having high-quality earnings
- When the line is **below** “0%,” it means stocks we identify as having low-quality earnings are losing to stocks we identify as having high-quality earnings
- **The bubble in low-quality stocks in the dot com mania was sharp but only lasted 4 rolling 12-month periods**
- **The bubble in THIS cycle began in December of 2018 and lasted for 26 rolling 12-month periods before imploding**

Pretty simple and intuitive. Stocks with low-quality earnings underperform those with high-quality earnings with shocking consistency.

Stocks KCR Identifies as High-Quality Earnings Crush Those We Identify with Low-Quality Earnings



Source: Kailash Capital, LLC, Small & Midcap Universe; Data from 4/30/1989 – 3/31/2022

Look at the utter collapse since the low-quality peak in November of 2020. You might be tempted to think that means low quality has “troughed.” Maybe for a trade. But we don’t do that. As discussed in our [Growth Investing](#) piece last Friday, KCR is an **Investment Newsletter** people. We are not here to make your broker rich.

Look at the post-dot.com period. From February 2000 through August 2003, high-quality earnings consistently and repeatedly crushed low-quality stocks. KCR believes history rhymes and the hucksters and frauds will continue to get pummeled.

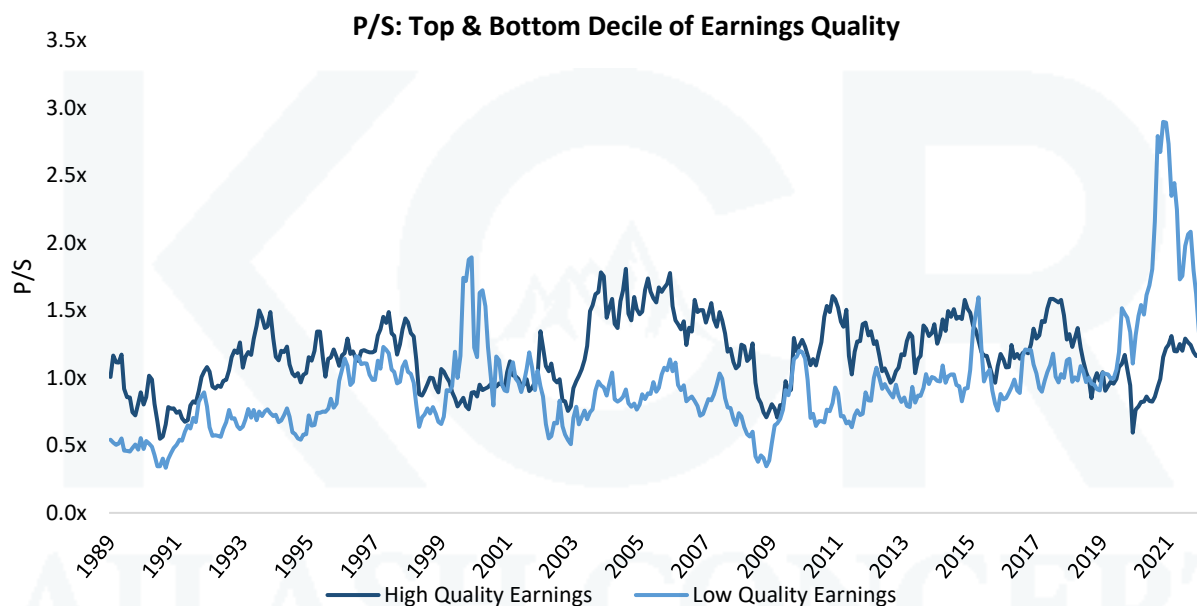
The Low Price of High Accounting Standards

Part of the reason KCR's equity research team believes low-quality stocks will continue to underperform their high-quality peers is the chart below.

- Light blue line is the price to sales ratio of stocks our model scores as having **Low-Quality earnings**
- Dark blue line is the price to sales ratio of stocks our model scores as having **High-Quality earnings**
- **Other than the peak of the dot.com bubble and today, Low-Quality earnings stocks have always been less expensive than High-Quality earnings stocks**

Despite the recent pullback, stocks with **Low-Quality earnings** are still vastly more expensive than stocks with **High-Quality earnings**. We believe there is more blood to be shed here.

Low-Quality Earnings Stocks are More Expensive Now vs. **High-Quality** Stocks than the Dot.Com Peak



Source: Kailash Capital, LLC, Small & Midcap Universe; Data from 4/30/1989 – 3/31/2022

That stocks with low financial reporting standards are typically cheaper than firms with high-quality earnings foots with intuition. KCR believes history rhymes and mean-reversion has a long way to go.

How to Measure Financial Reporting Quality

There are myriad approaches to measuring the quality of information CFOs and management teams put out. KCR has written a blizzard of papers about earnings quality over the years. Our write-up of arguably the most famous of them - Sloan's [accruals anomaly](#) - revisited the genesis of that signal and revisited some of the substantive literature since its original publication.

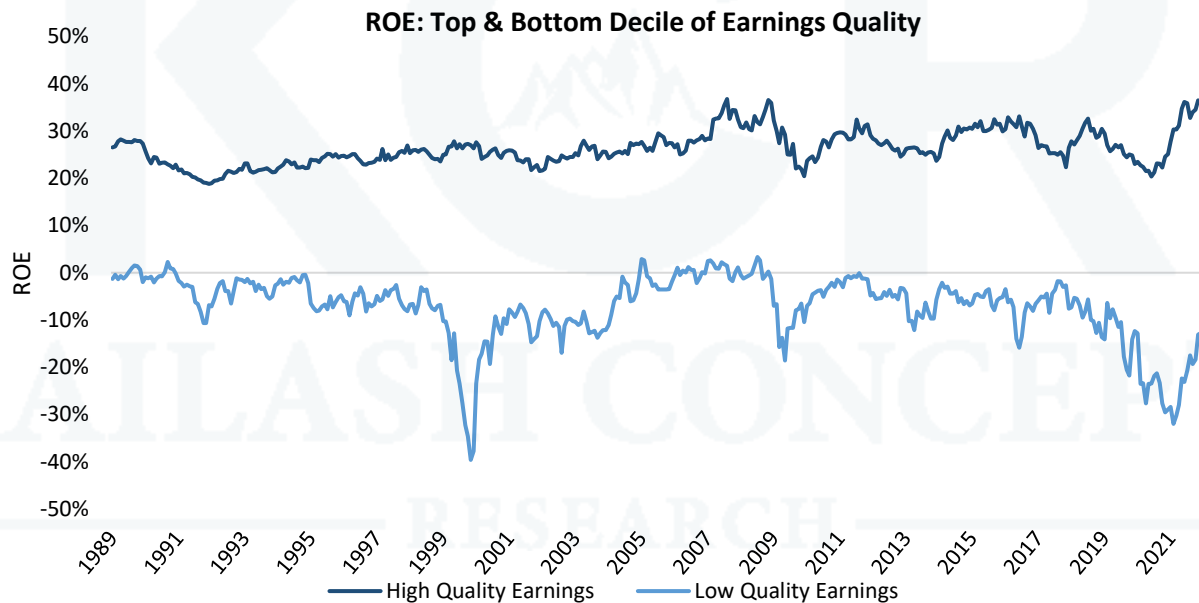
A less complicated but still highly effective measure of quality is return on equity (ROE). We wrote a three-part series on ROE, beginning with [The Quality Conundrum Part I](#). We can hear you **not** thinking.... "How do we get this team to my next cocktail party?"

Kidding aside, history is clear - this stuff matters.

KCR's Earnings Quality module uses a sophisticated multi-factor approach to balance ROE, among other items, to assess the quality of a given stock's financial reporting. The chart below shows the ROEs of stocks with **High-Quality** and **Low-Quality** earnings based on our Earnings Quality module.

Not complicated. Spread has never been wider than today.

ROEs of Stocks we Score as High-Quality are at Records While Low-Quality is Just Off Record Lows



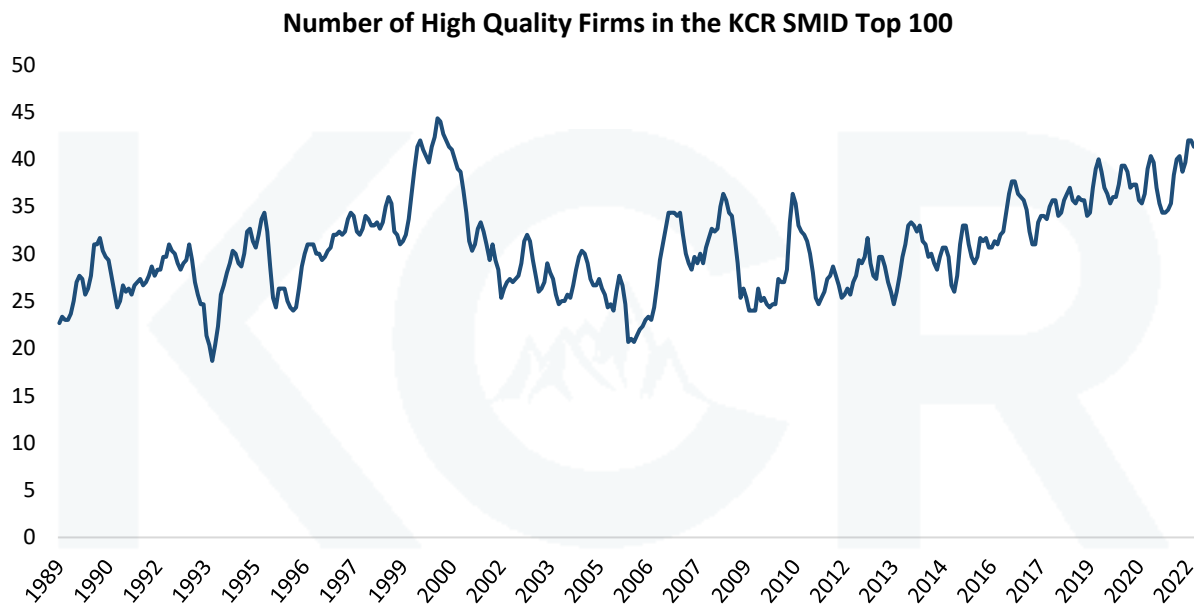
Source: Kailash Capital, LLC, Small & Midcap Universe; Data from 4/30/1989 – 3/31/2022

KCR's Earnings Quality Bucket is at Dot.Com Records in Our Ranking Model

Overall, our core ranking models are balancing Valuation, Balance Sheet Quality, Earnings Quality, Analyst Quality, and Market Quality. There are times in history when value spreads are so wide that valuation becomes more prominent in our models. Then there are times like today when the disparity in Earnings Quality is so wide that the model organically starts up-ranking stocks with high levels of accounting quality.

The chart below shows the number of stocks in our top 100 ranked firms with a top-decile Earnings Quality score. The number has only been this high at the peak of the internet mania. **More evidence suggesting that investors place a heavier emphasis in their conceptual framework for stock selection on the quality of earnings.**

KCR's Earnings Quality Module is Having an Outsized Impact on Top Stocks vs. History



Source: Kailash Capital, LLC, Small & Midcap Universe; Data from 4/30/1989 – 3/31/2022

CONCLUSION: Pay Less & Get More

Today is a rare moment in history where you can pay less for high-quality firms than it costs to invest in low-quality firms. KCR believes this foots with the promotional and highly speculative markets we are coming out of. When investors shift from FOMO and back to ensuring there is a margin of safety in their portfolios, **earnings quality** comes back with a vengeance.

The table below shows the fundamentals of:

- First Row: Stocks with the highest quality earnings that are also in the top 100 ranks of our model
- Second Row: Stocks with the highest quality of earnings according to our model regardless of rank
- Third Row: Stocks with the lowest quality of earnings

As old-timers, we cannot recall a more obvious time to focus research efforts on stocks with High-Quality earnings. This just isn't that complicated in our view.

KCR Believes This is a Generational Opportunity to Buy High Quality Stocks

	FCF/EV	P/S	EV/Sales	P/E	Fwd P/E	P/B	ROE	ROA	EBITDA Margins	Total Yield	Net Debt/Price	3 Yr Sales Grth
KCR Top High Quality	14%	0.8x	1.0x	9.5x	8.2x	2.4x	39.4%	10.2%	27.1%	7.4%	21.9%	22.2%
High Quality	8%	1.1x	1.5x	12.2x	9.4x	3.3x	38.3%	10.8%	28.4%	3.2%	25.5%	91.3%
Low Quality	-7%	1.3x	1.7x	-53.2x	240.7x	2.3x	-12.2%	-5.9%	-154.4%	-6.2%	12.5%	177.5%

Source: Kailash Capital, LLC, Small & Midcap Universe; Data from 3/31/2022 & ex Financials

For those interested in the data from our S&P500 Universe, please reach out to research@kailashconcepts.com.

For the list of the Top Decile of High Quality stocks in our Small & Mid Cap Universe based on KCR's Earnings Quality Module, please see Exhibit 1 below.



KCR Small & Mid Cap Firms in Top Decile of Earnings Quality – April 2022

Earnings Quality				Earnings Quality				Earnings Quality			
Score	Ticker	Company Name	Market Cap (\$m)	Score	Ticker	Company Name	Market Cap (\$m)	Score	Ticker	Company Name	Market Cap (\$m)
99.9%	ZIM	ZIM INTEGRATED SHIPP SER LTD	8,623	96.7%	TROX	TRONOX HOLDINGS PLC	3,046	93.7%	HRI	HERC HOLDINGS INC	4,963
99.9%	DVAX	DYNAVAX TECHNOLOGIES CORP	1,333	96.6%	GOLF	ACUSHNET HOLDINGS CORP	2,969	93.6%	AAWW	ATLAS AIR WORLDWIDE HLDG INC	2,523
99.8%	EVRI	EVERI HOLDINGS INC	1,905	96.5%	MCRI	MONARCH CASINO & RESORT INC	1,637	93.5%	GNK	GENCO SHIPPING & TRADING	990
99.7%	APR	APRIA INC	1,328	96.4%	MUSA	MURPHY USA INC	4,986	93.4%	TSEM	TOWER SEMICONDUCTOR LTD	5,238
99.6%	DLO	DLOCAL LTD	9,223	96.3%	LW	LAMB WESTON HOLDINGS INC	8,699	93.4%	GPOR	GULFPORT ENERGY CORP	1,850
99.4%	SEAS	SEAWORLD ENTERTAINMENT INC	5,627	96.3%	R	RYDER SYSTEM INC	4,267	93.3%	DKS	DICKS SPORTING GOODS INC	8,234
99.4%	DDS	DILLARDS INC -CL A	5,207	96.2%	ASIX	ADVANSIX INC	1,438	93.2%	FIVE	FIVE BELOW INC	8,873
99.2%	RRR	RED ROCK RESORTS INC	2,983	96.1%	ACLS	AXCELIS TECHNOLOGIES INC	2,511	93.1%	ALGT	ALLEGIAN TAVEL CO	2,941
99.1%	HZO	MARINEMAX INC	885	96.1%	GCO	GENESCO INC	928	93.0%	PINC	PREMIER INC	4,268
99.0%	BKE	BUCKLE INC	1,645	96.0%	INVA	INNOVIVA INC	1,346	92.9%	CPE	CALLON PETROLEUM CO/DE	3,626
99.0%	HCC	WARRIOR MET COAL INC	1,909	95.9%	LAD	LITHIA MOTORS INC -CL A	8,854	92.8%	CMP	COMPASS MINERALS INTL INC	2,139
98.9%	WLL	WHITING PETROLEUM CORP	3,190	95.8%	TPR	TAPESTRY INC	9,808	92.8%	RMBS	RAMBUS INC	3,485
98.8%	MTDR	MATADOR RESOURCES CO	6,244	95.7%	TREX	TREX CO INC	7,523	92.7%	RL	RALPH LAUREN CORP	8,077
98.8%	OAS	OASIS PETROLEUM INC	2,820	95.7%	VSCO	VICTORIAS SECRET AND CO	4,366	92.6%	SSRM	SSR MINING INC	4,608
98.6%	GPI	GROUP 1 AUTOMOTIVE INC	2,883	95.6%	SAIA	SAIA INC	6,421	92.5%	RGLD	ROYAL GOLD INC	9,263
98.6%	OXM	OXFORD INDUSTRIES INC	1,529	95.5%	NVMI	NOVA LTD	3,112	92.5%	QLYS	QUALYS INC	5,570
98.5%	SLVM	SYLVAMO CORP	1,461	95.4%	MANH	MANHATTAN ASSOCIATES INC	8,760	92.4%	RCM	R1 RCM INC	7,445
98.4%	TDC	TERADATA CORP	5,284	95.3%	BJ	BJS WHSL CLUB HLDGS INC	9,162	92.3%	SSTK	SHUTTERSTOCK INC	3,390
98.3%	RCII	RENT-A-CENTER INC	1,667	95.2%	LPI	LAREDO PETROLEUM INC	1,351	92.2%	IPI	INTREPID POTASH INC	1,078
98.3%	SAFM	SANDERSON FARMS INC	4,186	95.2%	DIOD	DIODES INC	3,916	92.1%	AN	AUTONATION INC	6,235
98.2%	CORT	CORCEPT THERAPEUTICS INC	2,386	95.1%	EAF	GRAFTECH INTERNATIONAL LTD	2,533	92.0%	LEVI	LEVI STRAUSS & CO	7,900
98.1%	LSCC	LATTICE SEMICONDUCTOR CORP	8,365	95.0%	MXL	MAXLINEAR INC	4,480	91.9%	INMD	INMODE LTD	3,063
98.1%	EXTR	EXTREME NETWORKS INC	1,576	95.0%	KSS	KOHL'S CORP	7,920	91.9%	TGH	TEXTAINER GROUP HOLDINGS LTD	1,875
98.0%	HRMY	HARMONY BIOSC HOLD INC	2,862	94.9%	EAT	BRINKER INTL INC	1,702	91.7%	GMED	GLOBUS MEDICAL INC	7,492
97.9%	TGLS	TECNOGLASS INC	1,203	94.8%	ALSN	ALLISON TRANSMISSION HLDGS	3,897	91.6%	CC	CHEMOURS CO	5,070
97.9%	SIG	SIGNET JEWELERS LTD	3,628	94.7%	JWN	NORDSTROM INC	4,321	91.6%	MOV	MOVADO GROUP INC	895
97.8%	RFP	RESOLUTE FOREST PRODUCTS INC	991	94.6%	PDCE	PDC ENERGY INC	7,007	91.5%	HRB	BLOCK H & R INC	4,402
97.7%	BYD	BOYD GAMING CORP	7,322	94.5%	FLGT	FULGENT GENETICS INC	1,882	91.4%	VSH	VISHAY INTERTECHNOLOGY INC	2,838
97.7%	EXP	EAGLE MATERIALS INC	5,104	94.5%	RRC	RANGE RESOURCES CORP	7,589	91.4%	ANF	ABERCROMBIE & FITCH -CL A	1,825
97.6%	LPX	LOUISIANA-PACIFIC CORP	5,320	94.4%	TXRH	TEXAS ROADHOUSE INC	5,809	91.2%	LITE	LUMENTUM HOLDINGS INC	7,047
97.5%	GSKY	GREENSKY INC	1,170	94.3%	UAA	UNDER ARMOUR INC	8,106	91.1%	ITOS	ITEOS THERAPEUTICS INC	1,135
97.4%	MGY	MAGNOLIA OIL & GAS CORP	4,240	94.3%	BLMN	BLOOMIN' BRANDS INC	1,958	91.0%	MEDP	MEDPACE HOLDINGS INC	5,861
97.3%	ZIP	ZIPRECRUITER INC	2,676	94.2%	NRC	NATIONAL RESEARCH CORP	1,009	90.9%	CEIX	CONSOL ENERGY INC	1,297
97.2%	GDEN	GOLDEN ENTERTAINMENT INC	1,687	94.1%	AMPH	AMPHASTAR PHARMACEUTICALS INC	1,713	90.8%	TMST	TIMKENSTEEL CORP	1,012
97.0%	POWI	POWER INTEGRATIONS INC	5,553	94.1%	CBRL	CRACKER BARREL OLD CTRY STOR	2,760	90.8%	MUR	MURPHY OIL CORP	6,239
97.0%	ALGM	ALLEGRO MICROSYSTEMS INC	5,390	94.0%	OI	O-I GLASS INC	2,061	90.7%	JW.A	WILEY (JOHN) & SONS -CL A	2,954
96.9%	OLN	OLIN CORP	8,198	93.9%	HAYW	HAYWARD HOLDINGS INC	3,855	90.6%	PLAB	PHOTRONICS INC	1,028
96.8%	KTB	KONTOOR BRANDS INC	2,331	93.9%	NFG	NATIONAL FUEL GAS CO	6,282	90.5%	EVTC	EVERTEC INC	2,946
96.8%	ABG	ASBURY AUTOMOTIVE GROUP INC	3,707	93.7%	CDRE	CADRE HOLDINGS INC	844	90.5%	ICUI	ICU MEDICAL INC	4,738

Source: Kailash Capital, LLC, Small & Midcap Universe; Data from 3/31/2022



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