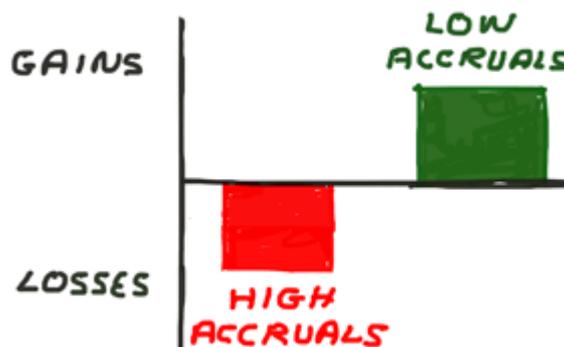


The Earnings Quality Indicator Used by ETFs



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Look under the hood of exchange-traded funds (ETFs) incorporating a quality factor and you will often find accruals being used. An accrual is an accounting entry recorded at the time a transaction occurs, regardless of whether not payment has been made. Accrual accounting allows businesses to report their sales and earnings performance without being beholden to the timing of transaction-related cash flows.



The downside of accrual accounting is the risk of those transactions not being completed in the future. Customers may not pay their bills or may push to renegotiate contracts. Inventories may be sold at lower-than-anticipated prices or even written down. There are certainly other examples, but one of the risks with accruals is too much optimism on the part of management. This excessive optimism can lead to lower future stock returns.

This was the conclusion reached by Richard Sloan in “Do Stock Prices Fully Reflect Information in Accruals and Cash Flows about Future Earnings?” (The Accounting Review, July 1996). In this oft-cited analysis, Sloan found that stocks with the lowest levels of accruals experienced abnormal returns of 4.9%. Stocks with the highest levels of accruals experienced abnormal returns of -5.5% over the following 12 months after being included in a portfolio. (An abnormal return is a return that is different than would be expected.) Subsequent studies confirmed the existence of an accrual anomaly. ETFs using an earnings quality component consider accruals.

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- [The Cash Flow Statement: Tracing the Sources and Uses of Cash](#) - Whereas accrual

accounting causes opaqueness between the balance sheet and the income statement, the cash flow statement reveals how much cash is actually flowing into and out of the business.

- **CFOs Identify Financial Statement Red Flags** - Lots of accruals and/or large changes in accruals warrant suspicion, say chief financial officers.

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AII Sentiment Survey

Pessimism rose to its highest level since last June, while neutral sentiment fell to a level not seen since last February. [More about this week's results.](#)

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The Week Ahead

AII's Jaclyn McClellan shares the findings from her latest analysis of robo-advisers with our [Eastern Michigan chapter](#) on Tuesday.

We'll see the first batch of third-quarter early reporters next week. Announcing earnings will be S&P 500 members Adobe Systems (**ADBE**), FedEx Corp. (**FDX**) and Lennar Corp. (**LEN**) on Tuesday; Bed Bath & Beyond (**BBBY**), CarMax (**KMX**), General Mills (**GIS**) and Red Hat (**RHT**) on Wednesday; and AutoZone (**AZO**) on Thursday.

The Federal Open Market Committee (FOMC) will hold a two-day meeting starting on Tuesday. The meeting announcement and updated committee member forecasts will be released at 2:00 p.m. ET on Wednesday. Fed chair Janet Yellen will hold a quarterly press conference at 2:30 p.m. ET. The CME's FedWatch Tool shows an 88% chance of rates staying unchanged. The odds for no change occurring at the December meeting are currently at 53.8%. The December odds are very much subject to change.

Elsewhere on the economic calendar, the National Association of Home Builders' September housing market index will be released on Monday. Tuesday will feature August housing starts. August existing home sales will be released on Thursday. Friday will feature the September purchasing managers' manufacturing index (PMI) flash.

In addition to Janet Yellen's press conference on Wednesday, three Federal Reserve officials will speak on a panel on Friday: Philadelphia president Patrick Harker, Atlanta president Dennis Lockhart and Cleveland president Loretta Mester.

The Treasury Department will auction \$11 billion of 10-year Treasury inflation-indexed securities (TIPS) on Thursday.

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