

O'glove, Thornton – Quality of Earnings

Free Press 2007, [Equity Investing], Grade ★★★★★

Recently, there was an article about Chinese IPOs in a Shanghai newspaper. The writer spoke to Yan Ding, head of Ceibs Research Center in Shanghai about the merits of investing in the avalanche of IPOs coming the market's way this year. "If somebody asks me whether to invest in an IPO, my answer is 'Yes!' If they should read the prospectus? 'No!' If they should borrow money? 'Yes!'" Feeling somewhat dizzy and rudderless, now seemed like a particularly good point in time to re-read Thornton O'glove's classic *Quality of Earnings*, built on his groundbreaking monthly report with the same name first published in 1971. The report was conceived during the author's early days working as a stock-broker in the 1960s, during which time an "issue craze" swept through the market, rendering prospectus-reading irrelevant. Considering today's +40 percent opening-day rigged China IPOs, this reviewer for one hears alarm-bells ringing. Hence, *entrée* of the seminal work on how diligent reading of corporate accounting does matter over time.

Quality of Earnings first and foremost deals with market inefficiencies via secrets hidden in (almost) plain sight. Accounting is said to be the language of business and some companies tell more lies than others. But who is the chicken and where is the egg? The companies? Investors? Auditors? Clients of investors? Society? Chapter 7, dealing with the differences between shareholder reporting and tax reporting is a case in point. But then of course it all circles back to the meta-debate of whether any of this matters, i.e. will it impact stock prices during the fund manager's tenure? Hence, the derogatory naming of these matters as "academic". Wouldn't the more appropriate designation be as part of the time-arbitrage playbook?

One of the most important questions upon re-reading the book is the issue of aging. *Quality of Earnings* is likely a cornerstone in most investors' bookshelves, albeit somewhat dusty. But this 1987-book can certainly be read with your 2014 glasses on. But obviously, some aspects of breaking new

ground are lost 27 years later. Howard Schilit's *Financial Shenanigans* and *Financial Fine Print* by Michelle Leder are more contemporary examples of successor books. The common denominator is the passion of teaching the reader the importance of forensic study of the accounting. As they say, offense wins games but defense wins championships. Doing tedious, time-consuming, mostly dead-end forensic accounting work is tough. And it won't make you the next-play hero. But over time plain ol' number crunching is a requirement to avoid permanent losses of capital. And the reasoning and case studies in this book will help you on that path.

The book is organized alongside order-of-complexity, common-sensical first. I found the early chapters "*Don't Trust Your Analyst*" and "*Don't Trust Your Auditor*" slightly clichéd and over-simplified. Despite the overflow of events in this direction since the book's publishing, has anything really changed? Do portfolio managers read more 10Ks and proxy statements now, skipping sell-side reports? Not likely. As the book progresses through the common snake pits in the P&L – non-recurring income, tax-reporting, working capital, debt, accounting changes etc. - complexity is turned-up a notch. The main drawback is the lack of actuality aspect in the case studies. They are certainly instructive still, but it does require a more dedicated reader. Overall, the book certainly fits in the mold of literature whose *modus operandi* centers on the "give a man a fish and you feed him for a day, teach him how to fish and he'll feed himself for life". The irony of course is that the *Quality of Earnings*® report, Footnoted® et al, live off of unwilling fishers.

"Because the documents were lengthy, very few [people] would take time out to read them. Accordingly, I concluded that one could obtain some edge on the market by diligently reading a prospectus from cover to cover". I believe this to be true today as well, even though Mr. Ding and his friend Mr. Market might burst out laughing.

Henrik Andersson, December 6, 2014