

Sabrient/Gradient Earnings Quality Rank (EQR)



BACKGROUND

To develop the EQR Model, we started by identifying the variables, found to be significant in academic research and in Gradient's own analyst driven and empirical research.

From these variables, Gradient's research team, led by Dr. Donn Vickery, founder, and Nick Gibbons, associate director of research, selected the most salient accounting factors that are associated with a firm's future returns.

The Gradient variables were then quantified and backtested by Sabrient's research team, led by David Brown, founder, and Dan Tierney, senior analyst, to find those that have the highest correlation among financial statements and negative events.

The final variables were sized and scaled in such as way as to avoid "false positives." The factors most correlated with future returns became the model for the EQR rankings.

OVERVIEW

The Sabrient/Gradient Earnings Quality Rank (EQR) offer clients an objective and unbiased assessment of a company's relative potential risk due to accrual accounting practices, as reflected in key relationships between information contained in the firm's income statement, balance sheet and cash flow statement.

EQR combines the fundamentals-based quantitative methodology of **Sabrient Systems** with the academically rigorous, empirical research of **Gradient Analytics** to provide a reliable assessment of the relative quality (or lack of quality) of reported earnings for U.S. listed companies.

The result is a quantification of accounting-based measures associated with events that may negatively impact future earnings.

EQR rankings are generally orthogonal to other variables included in most quant models.

HOW CLIENTS USE EQR

- ✓ Identify high-risk companies with an objective, unbiased assessment by a reliable third party
- ✓ Early warning of accounting irregularities that can negatively impact corporate earnings
- ✓ See a company's level of relative risk at-a-glance with the EQR 1-to-5 rankings
- ✓ Import EQR 1-to-99 percentile scores into your own multi-factor quant models

EQR CHARACTERISTICS

Universe	Approximately 3,000 U.S.-listed stocks with a stock price \geq \$2 and market cap \geq \$150 million.
Momentum Metrics	None
Valuation Metrics	None
Risk Rankings	1 - 5
Percentile Scores	1 - 99
Updated	Weekly
Delivery	csv raw file format via FTP or email
Backtest	Backtest from 2000; summary on next page

RANKING METHODOLOGY

The universe for the EQR rankings is 3,000 of the largest market capitalization (\geq \$150 million), publicly traded companies on the U.S. stock exchanges narrowed by a stock price minimum of \$2. Using the EQR model, each company receives an *EQR Rank* and a *percentile score*. **Utilities, Investment Trusts, Holding Companies, Banking & Investment Services, and Insurance stocks are not ranked by EQR.**

Percentile Score

Each company is first given a percentile score of 1 to 99 relative to the total universe of stocks. The percentile scores are distributed into five groups to determine the EQR Rank. Clients may also use the percentile scores to build their own distributions. Higher scores indicate more conservative (favorable) accounting practices.

EQR Rank

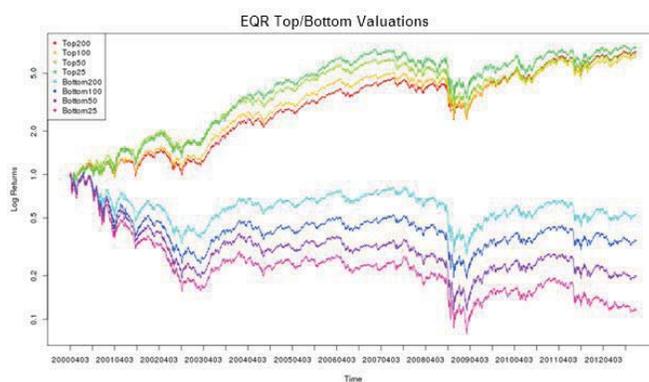
The percentile scores are distributed as follows for the final EQR Rank:

EQR RANK	RISK
1	Highest (most aggressive accounting practices)
2	2 nd Highest
3	Neutral
4	2 nd Lowest
5	Lowest (most conservative accounting practices)

The EQR rankings provide portfolio managers with a quick look at the overall quality and level of risk of a company's earnings. Additionally EQR rankings and percentile scores can be imported into a firm's own multi-factor quant models as a supplemental factor.

Backtest Summary

A forward-looking backtest from 2000, rebalanced weekly, resulted in the layered graphs shown below. Details of the backtest are available on request.



RELATED RESEARCH FROM GRADIENT ANALYTICS

The qualitative research behind our quantitative EQR rankings is Gradient's **Earnings Quality Analytics (EQA)**. EQA delivers comprehensive forensic accounting and corporate governance analysis of widely held public companies. Leveraging the latest academic research, the highly qualified and credentialed analyst team employs a rigorous two-step research process. This process objectively identifies companies with improving or deteriorating earnings quality characteristics before they are fully manifested in stock prices.

The team leverages an array of proprietary quantitative tools to measure the earnings quality of a firm's financial statements, in addition to corporate filings and management statements. The analysis manifests itself in a series of company-specific Research Reports, Notes, Alerts and Bulletins, as well as in a Concerns List and Standouts List. Thematic accounting issues pertinent to multiple companies or sectors are covered in our Issue Commentary reports.

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