

Checking Financial Accruals of a Company in 5 Minutes

% oldschoolvalue.com/blog/valuation-methods/how-to-check-accruals-company/

A week or so ago, I had a guest post about accruals and determining quality of earnings and since then, I've implemented an accrual analysis section in the

[stock valuation models and financial accruals](#).

Rather than going over the whole accrual topic again, read the article on [determining earnings quality through accruals](#).

Financial Accruals and the balance sheet

Signal of Future Stock Performance?

Based on a [6 page report](#) (pdf) produced by Bernstein Investment Management and Research, companies with low balance sheet accruals out performed companies with high balance sheet **financial accruals** by 8-10%.

Other than the equations for finding the accrual ratios from the previous post, I don't have any information on how Bernstein modified their conditions to get the results, but the theory is the same and is important to understand.

Cash Flow vs Financial Accruals Accounting

Majority of my focus has been on cash flow where there is less room for accounting manipulation because in the real world, we pay cash for something and receive cash for products or services rendered.

This is an **ideal** scenario and is basically means that earnings should equal the change in cash.

However, this would cause accounting issues as a business could spend a lot of money building inventory one year and not selling it until the next.

Accrual accounting attempts to fix such issues by matching costs with related revenues but the problem is that this method introduces subjective judgments and assumptions.

Here are some other quick observations regarding accrual accounting you need to understand.

Accrual Accounting Observations

(Read the PDF for detailed explanations.)

- Earnings growth due to accrual growth is not sustainable. This is like [cookie jar accounting](#) where a company "borrows" earnings from the future to make earnings look good today.
- Balance sheet accrual can indicate whether capital is being used properly. A company with high accruals can come from acquiring or merging with companies which expands the asset base. Low

balance sheet accrual companies tend to shrink their balance sheet through spin offs, share repurchases or large write offs. In these situations, it is usually removing bad performing assets or returning money to shareholders which is always a good use of capital.

- High accruals indicate that the company has expanded its asset base rapidly.
- Companies with high balance sheet accruals tend to have higher sales growth than low balance sheet accrual companies.
- High balance sheet accruals also have a higher ROE.
- Remember that maintaining a high sales growth or high ROE is difficult unless you have an entrenched moat. Such companies revert to the mean and disappoints analysts.
- Companies with low balance sheet accruals tend to have below average returns on equity. Analysts expect the company to lag.

All of this sounds a like regular value investing and [contrarian investing principles](#).

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Examples to Analyze

Let's analyze an example to nail the concepts into our heads. You and I have the benefit of hindsight bias with these examples.

I've chosen DLB as my first example because it is a current holding of mine and it's always a good idea to challenge current holdings with new ideas.

Both the balance sheet and cash flow accrual for DLB has been growing quickly. The accrual ratios suggest that DLB relies on accruals to post positive earnings. But the assumption can't just end there.

Cash has been increasing with decreasing debt, total liabilities well under control with consistently increasing net income.

If net income drops with accruals increasing, watch out.

The [Sloan ratio](#) is best when kept below 8%. You see in 2007 – 2009, it was much too high. It may have been that all those accruals finally got to the stock price in 2010 as it hit \$70. Then with news that DLB won't be included in Windows 8, the stock reverted to the mean level where all future revenue for Windows 8 is removed.

Do Accruals Indicate Stock Performance?

I must have gone through about 20 companies to try and find a obvious example, but it is much harder to find that I thought. Many companies with horrible accruals ended up shooting up with a stock price still strong after 5 years.

I'm not surprised though because the accrual ratio is still just one way of analyzing a company's health.

A better way to go about doing it would be to compare direct competitors to see how the ratios stand within the industry.

Your Homework

Here is your mission. Go through the numbers quickly for Western Digital (WDC) and tell me what you think about its accruals.

You shouldn't take more than 5 minutes.

There is no right or wrong answer as this analysis still involves some subjective thought processing.

Dolby (DLB)								
Accrual Ratio	2004	2005	2006	2007	2008	2009	2010	2011
Total Assets	\$ 261.87	\$ 586.28	\$ 739.29	\$ 991.70	\$ 1,336.15	\$ 1,581.32	\$ 1,711.77	\$ 1,884.39
Cash & Equivalent	\$ 78.71	\$ 372.40	\$ 412.49	\$ 368.47	\$ 394.76	\$ 451.68	\$ 545.86	\$ 551.51
Total Liabilities	\$ 118.54	\$ 125.14	\$ 145.00	\$ 194.54	\$ 286.89	\$ 240.21	\$ 238.04	\$ 220.87
Short Term Debt	\$ 1.29	\$ 1.35	\$ 1.44	\$ 1.56	\$ 1.59	\$ 1.62	\$ -	\$ -
Long Term Debt	\$ 13.58	\$ 12.12	\$ 10.89	\$ 9.69	\$ 7.78	\$ 5.83	\$ -	\$ -
Net Operating Assets (NOA)	\$ 79.49	\$ 102.21	\$ 194.14	\$ 439.94	\$ 663.87	\$ 896.88	\$ 927.88	\$ 1,112.00
Net Income	\$ 39.84	\$ 52.29	\$ 89.55	\$ 142.83	\$ 199.46	\$ 242.99	\$ 283.45	\$ 309.27
CFO	\$ 46.86	\$ 80.42	\$ 132.50	\$ 162.97	\$ 264.47	\$ 273.23	\$ 327.30	\$ 403.69
CFI	\$ (30.91)	\$ (31.08)	\$ (114.45)	\$ (192.80)	\$ (271.34)	\$ (236.50)	\$ (44.36)	\$ (236.70)
Balance Sheet								
Aggregate Accrual	\$ 32.04	\$ 22.72	\$ 91.93	\$ 245.81	\$ 223.92	\$ 233.01	\$ 31.00	\$ 184.13
Cash Flow								
Aggregate Accrual	\$ 23.89	\$ 2.95	\$ 71.50	\$ 172.66	\$ 206.32	\$ 206.27	\$ 0.51	\$ 142.28
Denominator in Ratio	\$ 63.47	\$ 90.85	\$ 148.17	\$ 317.04	\$ 551.91	\$ 780.37	\$ 912.38	\$ 1,019.94
Balance Sheet								
Accrual Ratio	50.47%	25.01%	62.04%	77.53%	40.57%	29.86%	3.40%	18.05%
Cash Flow Accrual Ratio	37.65%	3.25%	48.25%	54.46%	37.38%	26.43%	0.06%	13.95%
Sloan Accrual Ratio	9.12%	0.50%	9.67%	17.41%	15.44%	13.04%	0.03%	7.55%
Earnings	\$ 0.43	\$ 0.50	\$ 0.80	\$ 1.36	\$ 1.74	\$ 2.11	\$ 2.45	\$ 2.75

Earnings	\$ 0.43	\$ 0.50	\$ 0.60	\$ 1.20	\$ 1.74	\$ 2.11	\$ 2.40	\$ 2.73
Stock Price	\$ 24.57	\$ 16.99	\$ 32.10	\$ 44.86	\$ 31.53	\$ 41.74	\$ 69.51	\$ 30.70

Balance Sheet Financial Accruals

Western Digital (WDC)								
Accrual Ratio	2004	2005	2006	2007	2008	2009	2010	2011
Total Assets	\$ 1,159.20	\$ 1,588.60	\$ 2,073.30	\$ 2,901.00	\$ 4,875.00	\$ 5,291.00	\$ 7,328.00	\$ 8,118.00
Cash & Equivalent	\$ 377.80	\$ 485.20	\$ 550.70	\$ 700.00	\$ 1,104.00	\$ 1,794.00	\$ 2,734.00	\$ 3,490.00
Total Liabilities	\$ 671.60	\$ 886.50	\$ 916.10	\$ 1,185.00	\$ 2,179.00	\$ 2,099.00	\$ 2,619.00	\$ 2,630.00
Short Term Debt	\$ 15.20	\$ 20.10	\$ 24.60	\$ 12.00	\$ 27.00	\$ 82.00	\$ 106.00	\$ 144.00
Long Term Debt	\$ 52.70	\$ 32.60	\$ 19.40	\$ 10.00	\$ 482.00	\$ 400.00	\$ 294.00	\$ 150.00
Net Operating Assets (NOA)	\$ 177.70	\$ 269.60	\$ 650.50	\$ 1,038.00	\$ 2,101.00	\$ 1,880.00	\$ 2,375.00	\$ 2,292.00
Net Income	\$ 151.30	\$ 198.40	\$ 394.60	\$ 564.00	\$ 867.00	\$ 470.00	\$ 1,382.00	\$ 726.00
CFO	\$ 190.00	\$ 460.70	\$ 401.50	\$ 618.00	\$ 1,399.00	\$ 1,305.00	\$ 1,942.00	\$ 1,655.00
CFI	\$ (226.50)	\$ (314.30)	\$ (336.70)	\$ (383.00)	\$ (1,321.00)	\$ (551.00)	\$ (986.00)	\$ (793.00)
Balance Sheet								
Aggregate Accrual	\$ 243.50	\$ 91.90	\$ 380.90	\$ 387.50	\$ 1,063.00	\$ (221.00)	\$ 495.00	\$ (83.00)
Cash Flow								
Aggregate Accrual	\$ 187.80	\$ 52.00	\$ 329.80	\$ 329.00	\$ 789.00	\$ (284.00)	\$ 426.00	\$ (136.00)
Denominator in Ratio	\$ 55.95	\$ 223.65	\$ 460.05	\$ 844.25	\$ 1,569.50	\$ 1,990.50	\$ 2,127.50	\$ 2,333.50
Balance Sheet								
Accrual Ratio	435.21%	41.09%	82.80%	45.90%	67.73%	-11.10%	23.27%	-3.56%
Cash Flow Accrual Ratio	335.66%	23.25%	71.69%	38.97%	50.27%	-14.27%	20.02%	-5.83%
Sloan Accrual Ratio	16.20%	3.27%	15.91%	11.34%	16.18%	-5.37%	5.81%	-1.68%
Earnings	\$ 0.70	\$ 0.91	\$ 1.76	\$ 2.50	\$ 3.84	\$ 2.08	\$ 5.93	\$ 3.09
Stock Price	\$ 8.65	\$ 15.04	\$ 17.85	\$ 21.00	\$ 30.94	\$ 30.47	\$ 28.02	\$ 38.04

Final Thoughts

Red warnings signs won't show up for every stock that you look at. If you do this exercise with AAPL, you will notice that it breaks all rules. As a cash flow investor, I've focused most of my energy on the cash flow until now, but understanding how that cash flow is related to earnings is a great check to include in your analysis.

The financial accruals ratio won't help you find killer investments, but it will help with building a healthy portfolio. I've yet to see how I can fully maximize the lessons from here myself, but I will definitely be including a check in the accruals in my [investment process](#) and [stock valuation models](#) to speed things up.

About Jae Jun

