The First Cut

Stocks With Attractive Accrual Ratios

The First Cut is designed as a starting point for investors. Each issue we list the top stocks that pass relatively simple screens of interest to individual stock pickers. AAII's Stock Investor Pro *screening software is used to generate the First Cut listing.*

While most investors focus on earnings to measure profitability and company success, it can be insightful to see if cash flow generation corresponds with earnings. Earnings are calculated under the principles of accrual accounting, while cash flow measures the direct consumption and generation of cash. An accrual is any recorded amount that isn't a cash transaction, including accounts receivable, accounts payable, allowances and reserves. So, earnings are influenced by these factors even if no cash was used or created in the process. The cash flow statement divides the uses and sources of cash into three primary segments—operating, investing and financing cash flows. The operating segment measures cash generation and usage from day-to-day operations. The investing section captures investment and divesture in the long-term capital of the firm, while the financing segment examines how the company finances its capital (equity and debt) and how it rewards its shareholders through dividend payments. (Visit the lessons on financial statements on AAII.com for further information: www.aaii.com/classroom).

Professor Richard Sloan examined the cash and non-cash component (accruals) of earnings to measure the quality of earnings and the impact on future stock prices. Sloan found that companies in which non-cash accruals strongly increased earnings (positive accruals) underperformed the companies in which cash flow exceeded earnings (negative accruals). Sloan's testing was focused on adjusting balance sheet assets and liabilities to measure accruals, but a similar analysis can be accomplished by directly comparing net income to elements from the cash flow statement. We calculate an accrual ratio by subtracting the sum of cash from operations and cash from investing from net income and dividing the result by the average total assets over the last year.

The First Cut screen started with domestic, exchange-listed stocks with a minimum price of $5.00 per share. Financial stocks were excluded because their operating and investing cash flow segments are not comparable to other types of firms. Stocks were required to have cash flow from operations greater than net income for the most recent 12 months. The First Cut stocks also had to have positive net income for the most recent 12 months. As a screen for financial strength, the passing stocks have a long-term debt-to-equity ratio of less than 50%. The price-to-cash-from-operations and the price-to-earnings ratios provide a feel for the valuation levels of these stocks. The 20 stocks with the lowest accrual ratio made the First Cut.

—*John Bajkowski, president of AAII*

Stocks With Operating Cash Exceeding Net Income Ranked by Accrual Ratio

Company (Ticker)	Accrual Ratio (%)	Net Income TTM ($ Mil)	Cash From Opers TTM ($ Mil)	Cash From Investing TTM ($ Mil)	Avg Total Assets TTM ($ Mil)	Lt Debt to Equity (%)	Price to Cash From Opers (X)	P/E Ratio (X)	Share Price (3/17) ($)	Industry
Forestar Group Inc. (FOR)	(51.5)	48.2	66.9	420.7	852.7	19.7	8.0	8.3	12.80	Construction Services
The Ultimate Software Group (ULTI)	(37.2)	30.3	159.5	358.2	1,309.1	0.9	36.2	196.2	194.65	Software & Programming
Maui Land & Pineapple Co. (MLP)	(27.6)	21.8	33.9	(0.3)	42.8	38.6	6.3	9.7	11.20	Real Estate Operations
Chipotle Mexican Grill, Inc. (CMG)	(27.5)	22.9	349.2	326.8	2,375.6	0.0	33.2	499.8	402.58	Restaurants
Empire Resources Inc. (ERS)	(27.2)	3.0	68.3	(2.6)	230.9	9.5	0.7	19.1	5.71	Chemical Manufacturing
Argan, Inc. (AGX)	(25.5)	56.7	245.0	(70.5)	462.1	0.0	4.2	18.1	67.20	Construction Services
Louisiana-Pacific Corp. (LPX)	(22.8)	149.8	342.3	286.3	2,103.8	31.3	10.4	23.9	24.70	Construction - Supplies and Fixtures
LogMeIn Inc. (LOGM)	(21.6)	2.6	92.3	7.5	449.5	15.3	55.8	995.2	97.95	Software & Programming
Anworth Mortgage Asset Corp. (ANH)	(17.6)	15.9	80.6	994.0	6,016.1	6.5	6.6	36.6	5.54	Real Estate Operations
Corcept Therapeutics Inc. (CORT)	(16.7)	8.1	18.4	(0.2)	60.4	0.0	60.8	143.3	9.90	Biotechnology & Drugs
RMR Group Inc. (RMR)	(16.7)	43.6	108.8	(2.8)	374.4	0.0	14.9	19.1	52.00	Real Estate Operations
F5 Networks, Inc. (FFIV)	(15.7)	370.4	697.0	43.1	2,356.6	0.0	13.8	26.8	148.79	Computer Networks
iRobot Corporation (IRBT)	(15.3)	41.9	116.4	4.2	514.8	0.0	13.9	39.7	59.46	Appliances & Tools
RELM Wireless Corporation (RWC)	(14.9)	2.7	10.7	(1.9)	41.0	0.0	6.6	26.2	5.10	Communications Equipment
Broadwind Energy Inc. (BWEN)	(13.4)	0.3	18.0	(2.5)	113.8	5.3	5.2	69.6	6.26	Misc. Capital Goods
Photronics, Inc. (PLAB)	(13.2)	27.1	110.3	49.5	1,005.5	8.5	6.9	28.8	11.10	Semiconductors
IMPAC Mortgage Holdings (IMH)	(13.1)	46.7	65.5	641.9	5,037.3	44.2	3.1	4.2	12.85	Real Estate Operations
Coach Inc (COH)	(13.0)	511.1	776.7	335.5	4,641.2	21.0	14.4	21.9	39.74	Apparel/Accessories
Crown Crafts, Inc. (CRWS)	(12.9)	6.2	13.4	(0.2)	54.3	0.0	5.9	12.9	7.90	Furniture & Fixtures
Masimo Corporation (MASI)	(12.8)	300.7	416.8	(25.1)	711.1	0.0	11.3	16.7	93.22	Medical Equipment & Supplies

Source: AAII's Stock Investor Pro, *Thomson Reuters. Data as of 3/17/2017.*