

On the Relation between Accruals and Cash Flows

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ABSTRACT

Prior research identifies two important roles of accruals. First, accruals smooth fluctuations in operating cash flows. Second, accruals allow recognition of expected future losses in an asymmetric timely manner. While these two roles of accruals imply quite different relations between individual accrual components and operating cash flow news, prior research often focuses on the properties of *total* accruals, i.e., the difference of earnings minus operating cash flow. We decompose total accruals and identify the role of individual accrual components in terms of smoothing and asymmetric timeliness. We also identify a non-accounting factor, namely investment-cash flow sensitivity, that affects the relation between total accruals and operating cash flow news, and characterize how this factor confounds results in prior research. Overall, the paper underscores the importance of adopting a granular approach to identifying the roles of accruals in corporate financial reporting.