

Trueman and Titman, 1988

Title: An Explanation for Accounting Income Smoothing

Type: Analytical

Category: Earnings Management - Motivation

Summary:

General

This paper addresses a weakness in the extant theory of the time. They attempt to show, analytically, that managers have incentives to smooth income numbers. Up to that point there was evidence that they did, but no theory to say why they would do so rationally. Not only that, but they also address how smoothing might result in an increased stock price. The paper performs its analysis from the point of view of a firm seeking debt financing, but claims the results are readily extendable to firms with any stakeholders that want smooth earnings (meaning almost all stakeholders).

They posit firms smooth earnings in an attempt to decrease price volatility. This will result in a lower cost of capital. First, debt holders are found to treat everyone like they are managing earnings, whether they are or not. Based on that finding, they find that managers will always have incentive to manage earnings. Firms without the ability to manage earnings will then be hurt because debt holders are going to discount them as if they were managing earnings, so not only are they potentially hurt by the negative news they have to convey but they are also hurt by the fact that banks still treat them like they were managing earnings. Because the price is going to come out to be the same one way or another, stockholders won't care whether the firm manages earnings or not (I'm not sure I buy that one).

The findings above are all based on no bankruptcy costs. If bankruptcy costs are allowed into the model, then smoothing will not only avoid losses but can also increase value. They also relax the assumption of costless EM, and find that managers will only manage earnings when the benefits exceed the costs. Also, it becomes more costly to shift earnings as economic income becomes easier to infer and as ability to shift decreases.

Critical Review:

Weaknesses

- The paper doesn't address the effects on those firms with high earnings numbers. How will those firms signal to the market that they are strong enough to not have any need to manage earnings?
- The paper is also silent about the effects of mandatory conservatism or about increases in overall conservatism over time (Basu 1997).