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smoothing, note co-authors Sydney Qing Shu of San Diego State University and Wayne B. Thomas of the University of Oklahoma.

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Is reporting company earnings so as to smooth them out over time a blameworthy practice? If so, corporate managers hardly think so, as a survey of several hundred executives some years ago found an overwhelming preference for smoothing for a whole variety of good reasons. Yet, as a new study in a leading accounting journal begins by pointing out, the practice is widely frowned upon.

The study, in the **American Accounting Association's *Journal of Management Accounting Research*,** then proceeds to bring a new measure of clarity to the issue –

and, in the process, is likely to increase the disfavor that in recent years has

risk-taking behavior." A more benign explanation is that managers "desire to help investors better predict future performance by...reduc[ing] the volatility of reported earnings caused by transitory items."

So which motive drives income-smoothing, a desire to cover up or a wish to inform? The study concludes that to a considerable extent the answer depends on the nature of executive compensation, specifically the relative size of the CEO's holdings of company stocks and stock options.

Stock grants, the professors write, "are intended to align managers' actions with shareholders' interests by linking managers' and shareholders' wealth. Consistent with high manager-shareholder alignment, we find that the relation between past income-smoothing and investors' ability to predict future earnings increases with stock holdings. This result is consistent with the information role of income-smoothing."

In contrast, they continue, option grants, while also a form of equity-based compensation, "offer a convex payoff structure where the value of the option to the manager relates positively to the volatility of the [underlying asset]. Managers therefore benefit proportionately more from engaging in risky actions...Consistent with managers' attempting to hide their excessive risk-taking activities (i.e., highly volatile performance)...the relation between income-smoothing and future earnings predictability decreases with option holdings."

Why the desire for earnings to appear smooth rather than volatile? Advantages of having a smooth earnings stream cited by executives in prior research include lower costs of equity, higher credit rating, greater assurance among customers and suppliers about terms of trade, and anticipation of higher growth prospects among investors.

The new paper seems likely to add to the doubts that prior research has raised about

about 1,700 companies, drawn from a large database of corporate finance and another of executive compensation. Income-smoothing is measured by changes in firms' net income compared to changes in discretionary accruals – non-cash accounting items that typically involve some element of uncertainty (for example, future receipts from receivables or estimates of inventory valuations) and thereby particularly lend themselves to manipulation.

The professors find that for the sample as a whole, a pattern of income-smoothing in the five years prior to a given year increases the predictability of earnings in the three years subsequent to that focal year. But, when the analysis takes into account compensation of company CEOs in focal years, stock holdings and option holdings yield opposite results. In the words of the study, "as stock holdings increase, the association between past income smoothing and predictability of future earnings increases...As option holdings increase, the association between past income smoothing and predictability of future earnings decreases."

In other words, stock holdings move managers to "use discretionary accruals to dampen the fluctuations in reported earnings caused by transitory items to better reveal to investors the firm's underlying (expected future) performance." In contrast, "as options increase... discretionary accruals are used by managers to mask the volatility of risky...operations." Further evidence of this unfortunate effect, the professors add, is seen by the fact that it increases where CEOs have the extra power of serving as board chairmen, or where they are relatively new to the job and under pressure to prove themselves, or when their options are out of the money (that is, would vest for less than the current price of company shares).

Noting the growing tendency in recent years for companies to grant restricted stock, which can't be sold for a specified period of time, the professors test its relationship to income-smoothing and find it to be similar to that of unrestricted common stock.

What about performance shares, which are granted conditional on companies'

The study, "Managerial Equity Holdings and Income-Smoothing Behavior," is in the spring issue of the ***Journal of Management Accounting Research***, which is published twice yearly by the **American Accounting Association**, a worldwide organization devoted to excellence in accounting education, research, and practice. Other journals published by the AAA and its specialty sections include *The Accounting Review, Auditing: A Journal of Practice and Theory, Accounting Horizons, Issues in Accounting Education, Behavioral Research in Accounting, Journal of Information Systems, Journal of Financial Reporting, Journal of Forensic Accounting Research,* and *Journal of the American Taxation Association.*

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