

Smooth operator: When earnings management is a good thing

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New research from the Kelley School of Business makes the case that "smoothing the numbers" can be beneficial—if you have the right team in place to handle the job.

Smoothing, in this case, means adjusting accounting reserves up or down. And contrary to the common wisdom that all earnings management is bad, researchers have identified a setting in which it can be good.

In a paper titled "Managerial Ability and Income Smoothing," David Farber, an associate professor of accounting at the Indiana University Kelley School of Business at IUPUI, and fellow researchers Bok Baik of Seoul National University and Sunhwa Choi of Sungkyunkwan University find that when high-ability management teams use their discretion to smooth bumps in earnings, future earnings and cash flows become more predictable, and a firm's stock price improves.

"We found that more-capable managers who use discretionary accounting choices to signal future performance provide more-useful financial reporting," Farber said. "Firms with high-ability managers who smooth earnings have more-predictable earnings and cash flows, and the [stock market](#) incorporates that information into a firm's [stock price](#)."

"High-ability management teams are better able to anticipate changes in their firms' prospects and can therefore better estimate accrual adjustments necessary to smooth their earnings. These managers are trying to communicate to the market by saying, essentially, 'We had some volatility in earnings this period, but going forward, we expect earnings to follow the path based on the smoother earnings.'"

The study also showed that if a firm's management team is not high ability and attempts to smooth earnings, the firm will likely see negative implications, like less-predictable earnings and lower [stock](#) prices. Additionally, the reputations of managers in these firms will likely suffer.

A final version of the paper will be published in The Accounting

Review, one of the top scholarly [accounting](#) journals in the world, in July.

More information: Bok Baik et al. Managerial Ability and Income Smoothing, *The Accounting Review* (2019). [DOI: 10.2308/accr-52600](https://doi.org/10.2308/accr-52600)

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