Income Smoothing and the Usefulness of Earnings

Peter Demerjian

John Donovan

Melissa F. Lewis-Western

Video Byte

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Abstract

A company's economic performance varies over time. But a company's executives can use earnings management to reduce the variability of reported earnings - a common measure of economic performance. This process, known as "income smoothing," has been debated by regulators and researchers. Some worry that executives may use income smoothing to mask poor economic performance. Others argue that income smoothing allows executives to report earnings that better reflect the company's true ongoing performance. A new study examines how income smoothing impacts debt contract design and financial covenant effectiveness to provide evidence on these issues. The study finds that debt contracts to borrowers who smooth income are more likely to include an earnings-based debt covenant. And income smoothers are less likely to experience a spurious covenant violation, where a debt covenant is violated even though credit risk has not increased. These findings suggest that smoothed earnings are more useful in monitoring borrows because they allow earnings to better reflect economic performance and credit risk. Income smoothing allows managers to leverage private information about permanent earnings to better reflect economic performance, creating a more meaningful financial picture for borrowers and lenders alike. Peter Demerjian, John Donovan, and Melissa F. Lewis-Western. "Income Smoothing and the Usefulness of Earnings for Monitoring in Debt Contracting." *Contemporary Accounting Research* (2019)