What Determines an Earnings String?

Bok Baik  
College of Business  
Seoul National University  
bbaik@snu.ac.kr

David B. Farber  
Trulaske College of Business  
University of Missouri-Columbia  
farberd@missouri.edu

Marilyn F. Johnson*  
Eli Broad College of Business  
Michigan State University  
john1614@bus.msu.edu

Han Yi  
Price School of Business  
University of Oklahoma  
han.yi@ou.edu

November 2007

Abstract: The purpose of this study is to understand better the role of fundamentals and earnings management in an earnings string. Using a large sample of firms with at least eight consecutive quarters of nonnegative changes in earnings, we find that accounting fundamentals exhibit increasing growth until about the fourth quarter prior to the string break. Further, we show that peaks in fundamentals predict a string break, reinforcing the importance of fundamentals for the continuation of a string. We only observe evidence of positive abnormal accruals when momentum in fundamentals slows. Analyses indicate that without earnings management, strings would not have continued. We also document that earnings management helps firms obtain a benefit in the form of higher returns. Finally, we show that earnings management is more consistent with managerial optimism rather than opportunism. Overall, results indicate that both fundamentals and earnings management are important for a string, with earnings management serving as an effective stop-gap measure when fundamental growth declines.

Keywords: Earnings Strings, Accounting Fundamentals, Earnings Management, Managerial Optimism

Data Availability: All data used in this study are publicly available in the sources identified in the manuscript.
1. Introduction

The purpose of this paper is to provide insights into the determinants of an earnings string, a widely studied phenomenon in accounting research. Empirical research indicates that the market values strings, and at end of a string, this value quickly dissipates (e.g., Barth, Elliott, and Finn 1999). More recent studies examine reasons for the market’s assessment of strings. For example, Ghosh, Gu, and Jain (2005) find that firms with annual strings and concurrent revenue growth have higher-quality earnings than firms with annual strings without concurrent revenue growth. Myers, Myers, and Skinner (2007) provide evidence suggesting that income smoothing is used to sustain quarterly strings. Myers et al. (2007) indicate that while their evidence points to an earnings management story to explain a string’s sustainability, the string may instead reflect underlying economic strength (p. 281). In their discussion of Myers et al. (2007), Gu and Jain (2007) suggest that the difference in smoothing between the string sample and the control group in Myers et al. (2007) may not be economically important. This difference aside, in general it is difficult to quantify the impact of smoothing on earnings-per-share (EPS) growth. Because measures of earnings management (i.e., abnormal accruals and smoothing) in these studies are averaged across the entire length of the string, it is not clear whether earnings management was used to sustain a string during any particular period. What is also not clear is the extent to which underlying fundamentals sustained the string from period to period. Thus, we are left to wonder whether earnings management, underlying fundamentals, or some combination of the two sustain strings. The main goal of our paper is to shed light on these issues. We predict that underlying economic strength is important for a string. We also predict that given the costs of detected earnings management, firms will likely manage earnings when economic growth declines.

1 We define an earnings string as a nonnegative, seasonally differenced, split-adjusted change in quarterly earnings per share.