“Earnings Volatility, Cash Flow Volatility, and Informed Trading”
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Summary

This paper addresses a very important question:

“Does earnings that are smoother or more volatile than cash flows provide or garble information?”

The paper adopts a new approach

The paper provides some interesting results and thorough analyses
Research Design

- How informed trading relates to the difference in volatility
  
  \[ \text{SPREAD/PIN} = \text{ACEV} + \text{SIZE} + \text{TURN} + \text{AMI HUD} + \text{PRC_INV} + \text{YEAR} \]

  ACEV: the difference between earnings volatility and cash flow volatility

- Proactive discretion versus neutral application of accounting rules
  
  - Controlling for accounting rules
  
  - Decomposing ACEV into nondiscretionary and discretionary components
  
  - Interact ACEV with extremely bad (good) performance where managerial discretion is informative
Earnings vs. Cash Flows

Research into the relative merits of cash flows and earnings uses various criteria for judging which is better:

- More persistent and less volatile (e.g., Dechow 1994)
- More strongly associated with future cash flow realizations (e.g., Barth, Cram, and Nelson 2001)
- More strongly associated with contemporaneous stock price performance or market value (Penman and Sougiannis 1998).
Concern #1

Paper is written under the presumption that more informed trading indicates that public information is less informative. P.7

- “...consistent with theories that predict more informed trading when public information is less informative,...” (Abstract)

However, another stream of theoretical research posits that public announcements can increase idiosyncratic beliefs among market participants (Kim and Verrecchia 1994, 1997).

- Barron, Byard and Kim (2002) examine changes in the information among around earnings announcements and conclude “that an important role of accounting disclosures is to trigger the generation of idiosyncratic information by elite information processors…” (Abstract)
Concern #2

Issues related to the variables:

- Are accounting rules properly controlled for by including industry fixed effects, leverage, market-to-book ratio, institutional ownership, etc.

- Can we interpret the results as incremental role for proactive discretion after controlling these variables
Concern #3

Results reported in Table 6 may need to be revisited:

- the large coefficients on non-discretionary accrual component of earnings volatility
- Can we interpret the non-discretionary component as generally insignificant (p.24)
### Table 6 (Panel B)

<table>
<thead>
<tr>
<th>VAR</th>
<th>Pred sign</th>
<th>SMOOTH OLS Coeff.</th>
<th>SMOOTH OLS t-stat</th>
<th>VOLATILE OLS Coeff.</th>
<th>VOLATILE OLS t-stat</th>
</tr>
</thead>
<tbody>
<tr>
<td>ACEV_NDA</td>
<td>?</td>
<td>-196.56</td>
<td>-2.22</td>
<td>-159.56</td>
<td>-2.34</td>
</tr>
<tr>
<td>ACEV_DA</td>
<td>?</td>
<td>-1.25</td>
<td>-3.09</td>
<td>0.10</td>
<td>1.92</td>
</tr>
</tbody>
</table>
Future Work

1. Expand the analyses to debt markets – perhaps more sophisticated compared to equity markets.

2. Use alternative measures for informativeness such as the framework developed by Barron, Kim, Lim and Stevens (1998).
CONCLUSIONS

- This paper addresses a key question: “Do earnings that have different volatility compared to cash flows provide or garble information?”

- I suggest an alternative interpretation of the increase in informed trading

- I am not completely persuaded that proactive discretion contributes to the garbling of information and an increase in informed trading