

Can “Big Bath” and Earnings Smoothing Co-exist as Equilibrium Financial Reporting Strategies?

Michael Kirschenheiter, Nahum D. Melumad

First published: 17 December 2002

<https://doi.org/10.1111/1475-679X.00070>

Citations: 286

Abstract

We study a model of financial reporting where investors infer the precision of reported earnings. Reporting a larger earnings surprise reduces the inferred earnings precision, dampening the impact on firm value of reporting higher earnings, and providing a natural demand for smoother earnings. We show that for sufficiently “bad” news, the manager under-reports earnings by the maximum, preferring to take a “big bath” in the current period in order to report higher future earnings. If the news is “good,” the manager smoothes earnings, with the amount of smoothing depending on the level of cashflows observed. He either over-reports or partially under-reports for slightly good news, and gradually increases his under-reporting as the news gets better, until he is under-reporting the maximum amount for sufficiently good news. This result holds both when investors are “naïve” and ignore management’s ability to manipulate earnings, or “sophisticated” and correctly infer management’s disclosure strategy.

Citing Literature



[Download PDF](#)

ABOUT WILEY ONLINE LIBRARY

[Privacy Policy](#)

[Terms of Use](#)

[About Cookies](#)

[Manage Cookies](#)

[Accessibility](#)

Wiley Research DE&I Statement and Publishing Policies

Developing World Access

HELP & SUPPORT

Contact Us

Training and Support

DMCA & Reporting Piracy

OPPORTUNITIES

Subscription Agents

Advertisers & Corporate Partners

CONNECT WITH WILEY

The Wiley Network

Wiley Press Room

Copyright © 1999-2024 John Wiley & Sons, Inc or related companies. All rights reserved, including rights for text and data mining and training of artificial intelligence technologies or similar technologies.

WILEY