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

Michael Kirschenheiter, Nahum D. Melumad

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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.