Big Bath Accounting following Natural Disasters

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ABSTRACT: Practitioners and academics widely suspect that managers engage in "big bath" reporting behavior as a form of earnings management, but conclusive evidence of this behavior has been difficult to document due to the inherently endogenous nature of reporting the large nonrecurring charges necessary to engage in a big bath. We introduce a novel approach to identify big bath accounting using natural disasters to address this problem and argue that natural disasters provide an ideal exogenous shock to examine big bath accounting. Consistent with opportunistic reporting, we find that, relative to both matched firms unaffected by natural disasters and matched firms affected by natural disasters that do not take an earnings big bath, big bath firms experience greater improvements in post-disaster earnings for multiple years and higher future stock returns. We also find that CEOs of big bath firms receive relatively larger increases in bonus compensation in the years following the natural disaster. Results from cross-sectional analyses based on managerial incentives and firm monitoring mechanisms further support the notion that the big baths are driven by opportunistic reporting. Overall, our evidence suggests that managers take advantage of the occurrence of natural disasters by engaging in opportunistic big bath reporting behavior.

Keywords: Natural disasters, big bath accounting, earnings management
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