BIG BATH ACCOUNTING: MOTIVES, TECHNIQUES AND POSSIBILITIES OF PREVENTION

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Abstract

Annual financial statements must be accurate and trustworthy in order for users to make suitable decisions. This reality has become a need in recent years, and its significance has increased as a result of the current financial crisis, which saw large financial institutions and other corporate entities fall and liquidate. Despite the existence of strong accounting standards to control accounting financial transactions, it is often hard to prevent financial statement preparers from manipulating the judgments of financial statement readers in their favor. Big bath accounting was created to give a more appealing corporate image and to attract as many potential investors as possible. This could arise as a result of organizational pressure on new management to recognize failure or weaknesses in order to avert such failures. When a potential loss cannot be avoided in the current period, this technique can identify future costs as well as the loss in the current era. As a result, management takes a "huge bath" by deferring the cost estimates and clearing the desks. As a result, profits will be larger than predicted in the next period. According to the study, big baths are one of the best earnings management techniques because they suit management's interest in building investor confidence without violating any accounting rules, though they are unethical and, if misused, can harm a company's reputation if discovered later by users of such financial statements.

Keywords: Big Baths, Earnings Management, Income Smoothing, Techniques of Big Bath

Introduction

Any organization's statement of financial reports are the means via which interested parties can learn about the financial performance of the organization. These stakeholders' crucial decisions are dependent on the information derived from the financial accounts. Therefore, the users of financial statements rely on the accuracy and dependability of annual financial reports to make sensible and suitable judgments. This reality has become a need in recent years, and its significance has increased as a result of the current financial crisis, which saw large financial institutions and other corporate entities fall and liquidate.

Investor confidence in the financial reporting process has been undermined recently by corporate scandals and accounting irregularities at big corporations around the world. To produce clear, timely, and reliable financial statements, accounting systems should adhere to a set of objective and consistent criteria. When corporations are under increasing pressure due to economic instability, managers frequently turn to the accounting department to improve the bottom line and so update, panel beat, and manipulate the company's information content. Even while rigorous accounting rules exist to guide financial accounting activities, it is sometimes impossible to prevent financial statement preparers from manipulating financial statement users' decisions in their favor (Wang, 2008).

Account manipulation, according to Stolowy and Breton (2004), "is the ability to increase or reduce reported net income at will". They devised a framework for categorizing account manipulation actions in respect to two types of risk "systematic and financial", and divided them into two categories: 'earnings management and creative accounting', of which big bath is a subset. According to Amat and Gowthorpe (2004) "account manipulation is also known as creative accounting, large bath accounting, earnings management, accounting magic, financial engineering, cosmetic accounting, window dressing, innovative accounting, merger magic, cookie jar reserves, and income smoothing".

Big bath accounting, on the other hand, was established in order to project a more desirable corporate image and attract as many investors as possible. The operations of a corporation are reflected in financial statements. They also provide a forum for stakeholders to make decisions based on the information included in financial statements for businesses (Yoon & Miller, 2002). The concept of huge bath accounting was born out of this.

Earnings information is typically aimed to be controlled by individuals in charge of the organization's affairs as part of the financial statements. Such activities can be carried out by picking appropriate accounting procedures that are aligned with the company's target profit and management's wishes. According to Siregar and Utama (2008), “various methods were adopted, including the big bath, income minimization, income maximization, and income smoothing. Big bath is a behavior accounting that deserves to be recognized among these patterns”.

When a manager applies accounting policies, he or she may reduce revenue while increasing expenses for the current year. It's known as the “big bath”, and analysts and auditors have dubbed it “accounting magic”. This could happen as a result of organizational pressure on the new management to admit failure because both the old and new management wanted to avoid such failures. When a future loss cannot be avoided in the reporting period, this technique can identify future costs as well as the loss in the current era. As a result, management takes a "big bath" by postponing cost estimates and cleaning desks. In lieu of this, profits for the following period will be rise than expected.

Literature Review

"The attempt to increase reported earnings in subsequent periods by charging items that may have a negative future impact to expenses in the current period, further worsening current period business results in an accounting period in which results are bad," is how the term "big bath" is usually delineated (Itoh, 2007). According to Yoshihiro and Tomoaki (2011), a huge bath is a process carried out by a corporation when its annual earnings decline is too large to be offset by discretionary goods.

In such cases, the corporation may agree to “take a huge bath” for them to hype the stated setback. The goal is to show a larger deficit this year, followed by a larger profit the following year. This is accomplished by allocating subsequence expenses to the reporting year rather than the following period. As a result, management will be able to declare higher (positive) earnings in the coming term (Fridson & Alvarez 2002).

According to Riahi-Belkaoui, (2004) ”big bath accounting is a form of accounting innovation defined by three sets of circumstances”. He said, “the first occurs when a company is failing and decides to further reduce earnings for the term. They claim that the motive for this strategy is management's belief that, given the company's already poor earnings, a heavier hit would force them, not the firm, to suffer proportionately more. Because expenses are recognized now rather than later, they will have no effect on next year's profit”. This is a technique for falsifying financial data to make the next year appear more optimistic. As a result, because the expenses were previously recognized the previous year, the huge bath makes it easier to record larger earnings in later periods (Jordan & Clark, 2004).

According to Riahi-Belkaoui, (2004), “the second scenario is when a corporation realizes a substantial non-recurring profit and seeks to reduce future costs by incurring certain expenses now in order to recognize reduced costs during future bad times”. The big bath scenario, as described by Riahi-Belkaoui (2004), occurs when a corporation replaces its CEO, with the goal of clearing the decks in order to boost future revenues. In this case, Sikora's (1999) explanation of the phenomena of big bath accounting applies: it (big bath) refers to significant non-recurring losses or expenses that eat up the present period. Furthermore, it may be advantageous for a new CEO to begin with a poor outcome, as if created by the predecessor, in order to eventually appear as if he or she saved a sinking ship. The anchor effect, which states that an earlier result will be used as a point of reference for later outcomes, can explain this (Kahneman, 2011).

Henry (2008) “Take a big bath if you're going to take one. Remember every solid piece of negative news you've ever received. There is always a way to get out of a situation. Regardless of how horrible the situation is. That way, you can get as much bad news out of the way as quickly as possible”. Otomasa, (1998) said “the big bath strategy is used to reduce an organization's earnings in the long run for the greater good. It is, however, contingent on the link between successors and predecessors. It is termed hostile change when a management takes a major bath in its first fiscal year. And it's known as amicable change when a huge bath is taken at the period of the predecessor's resignation. These tactics strengthen the management for future earnings”.

Motive behind Big Bath

Increasing rivalry and the recent economic condition are just two of the issues corporations use accounting exploit tactics to hide imminent losses and/or inflate current year expenses, depending on the situation, in order to put the company in the best possible light. This does not imply that accounting norms have been disregarded, but rather that "loopholes" in the law have been utilized to paint the company in a more positive light.

Managers may seek to control earnings because they believe reported results impact investor and creditor decisions, which is why they are involved in the big baths activity (Schroeder, 2011). For example, "during periods of organizational stress or reorganization" or when "a firm must announce a loss," a large bath may be taken (Scott 2009). When a management transition occurs, there's a good chance that a huge bath will be taken. This is because companies want to utilize a change of management as an avenue to eliminate issues that could put subsequence corporate performance under strain.

According to the connection between the predecessors and successors, management transitions can be classified as "aggressive" or "amicable." Changes in management that are hostile involve hostile relationships, while changes in management that are friendly involve friendly ties. In the event of a inimical management change, the newly appointed management may take a substantial hit in their first decision in office. This is because "management's own reputation will not suffer owing to the transferring of responsibility to the compensation mechanism in existence at the time or to other persons" even if "an large unusual loss is reported" (Obinata, 2007).

The large bath strategy is similar to umidashi, or steps intended to ensure the coherent of a company's financial position, which are used in Japan (Otomasa, 1998). “Umidashi” is a real-life activity manipulation that entails "a technique of seeking to improve the business base and boost future revenues through asset streamlining" via "asset valuation losses disclosure" (Otomasa, 1998). In a word, the goal of large bath is to increase investor trust and build loyalty.

"Forced (non-routine) management changes" and "routine management changes" are two terms used to describe management changes. The terms "forced management change" and "regular management change" are used interchangeably. Constant management change relates to demise, the end of a term of office, and so on, whereas “forced management change refers to dismissal or removal from office”. The criterion to be employed in defining what is "hostile" and what is "amicable" is likely to divide opinion. and elsewhere, the expression "big bath" typically refers to this situation.

Application of Big Baths

Earnings management, income smoothing, or creative accounting are all terms used to describe the use of big bath (Van der, 2004). Information derived via income smoothing may have a different level of integrity than data derived from actual transactions. Creative accounting, according to Bhasin (2016), “is an accounting practice that adheres to accounting principles and standards but deviates from what those principles and standards are intended to achieve in order to convey the desired business image”.

EM is the process of leveraging accounting regulations' gaps and ambiguities to skew financial performance from what it is to what the corporation wants it to be (Branka, Ivana & Ivo, 2018). Managers utilize big bath to alter data in order to boost investor confidence, for example, by smoothing the bottom line. Book entries can be used in a variety of ways to manage revenue, with huge baths being one of them (Wild et al. 2001). Big bath or income smoothing, as the case may be, is not illegal and can be used as a strategic tool, according to Branka, Ivana, and Ivo (2018), which is why auditors commonly ignore it.

This period's profit reduction cost the manager a lot of money. Chosen periods, frequently a period of poor performance (often during a recession when rival firm reported similarly weak earnings) or recent developments, such as management changes, consolidation, or restructuring.

Big baths and Income Smoothing

This study will compare big bath and income smoothing to get a vivid idea of how "big bath" operate. Income smoothing is a fairly typical procedure that can last for several years. Smoothing income is a method of reducing profits volatility by leveling out earnings peaks over a period of years and raising earnings falls at the same time. As a result, actions are taken to decrease and "store" revenues in performing period for use in difficult years (Mulford & Comiskey 2002). "The big baths phenomena on the other hand, is more of a one-time thing because it is based on a transaction that is uncommon or non-recurring. Furthermore, "big bath are always used when there is a change in senior management or when the company experiences a loss. As a result, management will record higher earnings in the coming period" (Van der, 2004).

In that instance, income smoothing and huge baths are, in terms of frequency of application, diametrically opposed strategies. Earnings management or creative accounting refers to both the use of a large bath and the smoothing of revenue.

Big Bath Techniques

When a company's operations or subsidiaries must be drastically restructured or eliminated in order to remain competitive, this is a somewhat rare occurrence. When this happens, GAAP authorizes management to record an expected charge against earnings (a loss) to pay the adjustment costs. This anticipated loss is usually reported as a one-time charge against income, which means it is not included in recurring operating earnings.

It is typically accompanied by unfavorable news about the organization's rivalry, charging a big loss against current earnings has a negative impact on the recent stock price. This could rapidly rebound if the charge and related functional improvements are viewed favorably.

Big bath strategies are employed on the belief that if negative news must be reported, such as a loss due to significant restructuring, it is preferable to do so all at once and get it out of the way. As a result, these charges are based on estimations, it is preferable to estimate losses on the high side to minimize potential earnings shocks later.

According Mulford and Comiskey (2002), “common circumstances where the big bath approach may be applied are in: Operations restructuring, Troubled debt restructuring, Asset impairment and write-down, and Operations disposal”.

A Big Bath Scenario

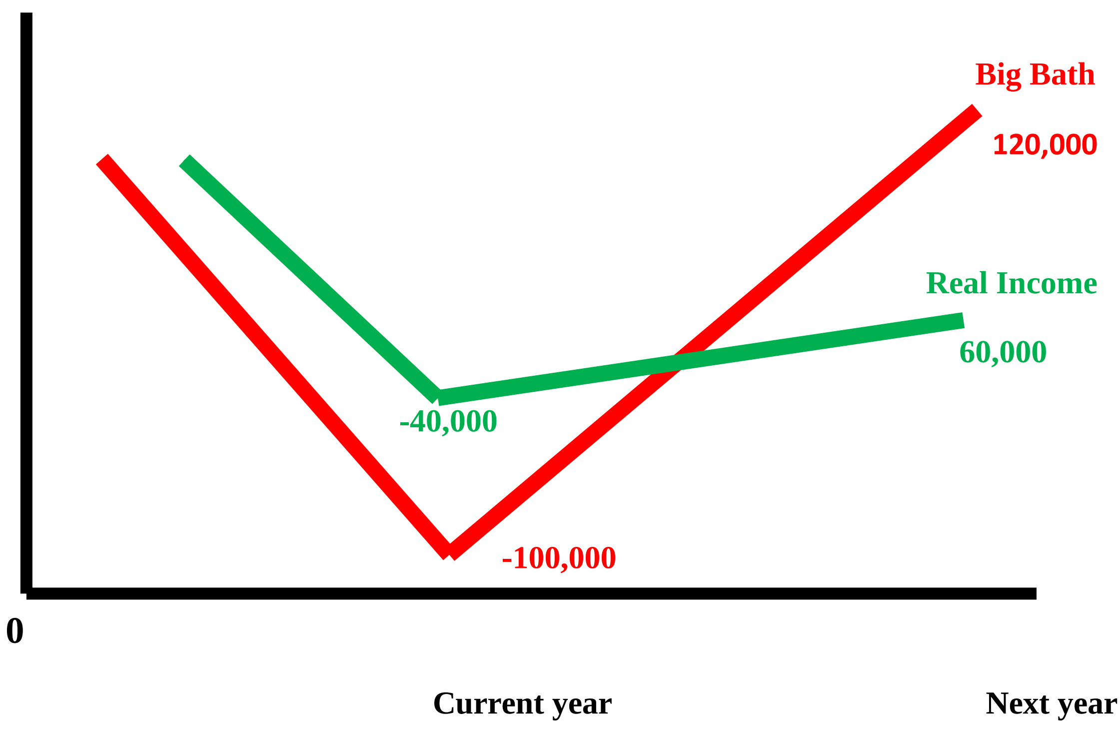
Consider the case below: Assume that business "A" is aware that its current-year stock market prediction will be missed. The following is how management decides to boost their loss from ₦40,000 to ₦100,000:

1) They write off ₦20,000 in goodwill after an unsuccessful acquisition, which stays on their balance sheet.
2) They accelerate depreciation, resulting in a ₦35,000 loss.
3) They depreciate obsolete assets for a total of ₦5,000.

Steps 1–3 allow the company to earn an extra ₦60,000 profit in the following reporting period, giving investors faith that the company has recovered. It's worth mentioning that corporation "A" cleverly developed the following win-win situation:

“Although the loss for the reporting period has grown from ₦40,000 to ₦100,000, it is doubtful that this would have a large influence on investor sentiment, as stakeholders appear to tolerate default market surprises better than good market surprises. The profit during the next period is increased”.

The Graphical Illustration



The loss was increased graidently to the amount of ₦100,000, although the actual loss for the time was ₦40,000, as seen in the Big bath graph above. The income increased fast the following year, reaching ₦100,000 at the end of the year, although the real income was just ₦60,000. The real income curve falls slowly and then rises slowly to ₦60,000 towards the end of the year.

Possibilities of Preventing Big Bath Accounting

Having a highly competent management team is the most effective method to avoid a catastrophic disaster. The task of management would be to examine all parts of operations to see where efficiency might be gained.

i. The company should create a whistleblower policy, encourage and reward whistleblowers, and keep the whistleblower's identity hidden and protected.
ii. Establishing good and effective corporate governance measures during times of financial difficulty or decline, which the incoming CEO can utilize to falsify the financial statement.
iii. Recognizing and punctuating the need of internal and external auditing in finding and reporting inaccurate estimates and preventing accounting fraud.
iv. Regularly switching external audit service providers from one reporting period to the other.
v. Continually reminding personnel of the code of ethics.

Conclusion and Recommendations

This study believes that not all income smoothing is bad, and that certain accounting wizardry can be harmless as long as it isn't done frequently. When a corporation employs huge baths as a tool, it must ensure that the baths do not cause harm to any of the stakeholders. It is critical for the organization to continue to create trust. When a corporation replaces its CEO, managers may use accounting magic, often known as a big bath, to clear the books. This might happen when the company is under duress. It may be ideal for a new CEO to begin with a poor outcome, as though created by his predecessor, in order to later look to be in charge of a sinking ship.

In order to accomplish so, management must employ competent accounting practices, ensuring that the integrity of the information given to stakeholders is unquestionable, as the goal of the big bath strategy is to increase investor confidence and foster loyalty. Big bath accounting is one of the most effective earnings management approaches for increasing investor trust while avoiding any accounting standards violations. It is, however, unethical, and if employed incorrectly, it can damage a company's reputation if discovered later by the interested parties.

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