

# Big Bath and Management Change

**Yoshihiro Tokuga**

Graduate School of Management, Kyoto University

**Tomoaki Yamashita**

Graduate School of Economics, Kyoto University

June 2011

## Big Bath and Management Change

Yoshihiro Tokuga<sup>1</sup>  
Tomoaki Yamashita<sup>2</sup>

### Big Bath

This paper is a case study concerning earnings management. “Earnings management is the choice by a manager of accounting policies, or actions affecting earnings, so as to achieve some specific reported earnings objective.” (Scott [2009], p.403). As this definition indicates, earnings management can be considered from two perspectives: “the attempt to bring about reported earnings favorable to management through the selection or changing of accounting procedures” (accounting policies manipulation) and “the attempt to control reported earnings by changing actual transaction details or the timing of transactions (real activities manipulation) (Otomasa [1998], p.533).

Various earnings management tactics exist. According to Scott (2009), these are 1) the big bath, 2) income minimization, 3) income maximization, and 4) income smoothing. Among these patterns, big baths and income smoothing are accounting behaviors that merit particular notice. Income smoothing has been addressed in other case study materials. In this paper we focus on big bath accounting.

Provided that other conditions are the same, ordinarily management is disposed toward income smoothing. This is because stable earnings are desirable in capital markets and for contracts with other organizations. Accordingly, when earnings are expected to fall below or exceed targeted earnings, managers can be expected to engage in earnings management to increase or decrease earnings. However, at times managers adopt accounting policies to

---

<sup>1</sup> Professor of Accounting, Graduate School of Management, Kyoto University

<sup>2</sup> PhD. candidate, Graduate School of Economics, Kyoto University

dramatically decrease earnings. This is the tactic known as “big bath”.

The term “big bath” is ordinarily defined as “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” (Itoh 2007, p.207).<sup>3</sup> A big bath may be taken, for example, “during the periods of organizational stress or reorganization” or when “a firm must report a loss” (Scott 2009, p.405). The likelihood of a big bath being taken when a management change occurs is also high. This is because firms seek to use a change of management as an opportunity to remove factors that may put pressure on future business performance.

Changes of management can be divided into “hostile changes” and “amicable changes” according to the relationship between the predecessors and successors<sup>4</sup>. Hostile management changes involve hostile relationships and amicable management changes involve amicable relationships<sup>5</sup>. In hostile management changes, the newly appointed management may take a big bath in its first fiscal year in office. That is because “the expectation exists that even if an enormous extraordinary loss is recorded, management’s own reputation will not suffer owing to the shifting of responsibility to the compensation system in place at the time or to other people” (Obinata [2007], p.263). In U.S. textbooks

---

<sup>3</sup> The big bath tactic can also be considered as something akin to measures taken to assure the soundness of a firm’s financial standing, called *umidashi* in Japan (Otomasa [1998], p.534). *Umidashi* is a real activities manipulation “Involving the strategy of attempting to strengthen the business base and boost future earnings through asset streamlining” by means of “revelation of asset valuation losses” (Otomasa [1998], p.534).

<sup>4</sup> Management changes are sometimes classified as “forced (non-routine) management changes” and “routine management changes.” Forced management change refers to dismissal or removal from office, and regular management change refers to death, completion of term of office, etc. It will suffice to confirm this using any of the references mentioned in this paper.

<sup>5</sup> Opinions are likely to differ on the criterion to be used in determining what is “hostile” and what is “amicable.”

and elsewhere, the term “big bath” often refers to this situation.

On the other hand, in cases of amicable management change, a big bath may be taken at the time of (during the fiscal year of) the predecessor’s resignation. In Japan in particular, owing to the existence of “Japan-specific circumstances such as the resigning manager having authority to name the manager for the next fiscal period,” (Otomasa [1998], p.536) the possibility exists that a resigning manager (the predecessor) will take a big bath to enable the successor to make a fresh start in the first year in office<sup>6,7</sup>. This can be considered a big bath, characteristic of Japanese firms.

In this paper, we treat the case of Nissan as an example of a hostile management change and Shiseido as an example of an amicable management change.

#### Case 1. Nissan Motor Company

In this section, we analyze a hostile change of management and the utilization of a big bath tactic in the case of Nissan Motor Company, the second ranking automaker in the Japanese market. Mired in a prolonged business slump, Nissan brought in Mr. Carlos Ghosn from business partner Renault of France as chief operating officer (COO)<sup>8</sup>. In April 2000 Mr. Ghosn announced the implementation of the Nissan Revival Plan (hereafter “NRP”), a medium-term business plan to revive Nissan’s fortunes. Then, although Nissan recorded an

---

<sup>6</sup> Whether a change of management is the occasion for a big bath is entirely a question of the timing of the big bath, not a question of the incentive for the big bath. For further information, refer to Obinata [2007], p.263.

<sup>7</sup> In such cases, it is conceivable that the measure adopted is not a big bath, but rather discretionary behavior to augment earnings in the period before a management change for the purpose of giving credit to a departing manager. At any rate, in cases where this type of behavior is observed owing to an amicable change of management, the question of economic incentive has no clear answer. In the case of Japan, it is unclear which behavior is more preferable to the manager (particularly when there are other potential options) and for what reason.

<sup>8</sup> In this case, however, the predecessor, Mr. Yoshikazu Hanawa did not relinquish his position as president. Still, it is true that Mr. Ghosn assumed substantive management authority. Accordingly, it is thought that a substantive change of management occurred.

enormous loss in the fiscal year ended March 2000, the firm subsequently achieved a V-shaped recovery in business performance in the period immediately after Mr. Ghosn assumed office<sup>9</sup>.

It is highly likely, however, that the recording of an enormous loss in the fiscal year ended March 2000 was a big bath taken for the purpose of staging a V-shaped recovery in subsequent periods. The following accounting policy analysis confirms this point.

**Table 1. Possible Accounting Policies in the Fiscal Year Ended March 2000 and Their Impact<sup>10</sup>**

| Possible Accounting Policy  | Change   | Remarks (Item Amounts)  |
|---|--|---|
| 1) Accounting treatment of the reserve for product warranty   | Calculation of the estimated reserve for product warranty was changed from a historical performance basis to the recording of estimated cost within the warranty period from the following fiscal year onward.   | -¥48,493 million  |
| 2) Accounting treatment of shortfalls in the qualified pension plan and employees' pension fund, etc. | With regard to the pension fund shortfall, a change was made from charging the shortfall to expenses at the time of the receipt of contributions to charging the shortfall to expenses at the time the fund runs | Calculation of the estimated reserve for product warranty was changed from a historical performance basis to the recording of estimated cost within the warranty period |

<sup>9</sup> Strictly speaking, detailed analysis to evaluate the success or failure of the Nissan Revival Plan is necessary. However, in this paper we do not touch on the success or failure of the plan.

<sup>10</sup> We refer to Itoh [2007], p216. The items marked with a star (\*) are technical accounting policies, while the other items are real activities manipulation.

|  |   |   |
|--|---|---|
|  | short. To unify accounting procedures at certain consolidated subsidiaries, the method of recording provision for retirement was changed from recording 40% of the amount payable which will be required if the employee voluntarily retires immediately on the balance sheet date to recording 100% of it. | from the following fiscal year onward.        |
| 3) Recording of a business restructuring reserve   | A reasonable estimate of costs expected to occur in future in accordance with the Nissan Revival Plan was recorded.   | -¥232,692 million                             |
| 4) (i) Gain on sale of fixed assets,<br>(ii) Gain on sale of investment securities of subsidiaries and affiliates* |   | (i) ¥321 million<br>(ii) ¥27,715 million      |
| 5) (i) Loss on sale of fixed assets,<br>(ii) Loss on valuation of investments and liabilities*                     |   | (i) -¥26,256 million<br>(ii) -¥51,668 million |

As Table. 1 indicates, the amount of the business restructuring reserve, item 3), is conspicuously large. This is a reserve for plant closings attendant on implementation of the NRP. Although this would have a major negative impact on earnings in the fiscal year ending

March 2000, it would be advantageous for future earnings. In addition, technical accounting policies such as items 1) and 2) and material accounting policies attendant to the change in situation such as the sale of fixed assets in item 5) suggest that Nissan purposely engaged in earnings management to worsen business performance.

As already mentioned, a big bath may be taken immediately before the predecessor's departure when a management change is amicable or immediately after the successor's assumption of office when a management change is hostile. Mr. Ghosn was an outside manager dispatched from alliance partner Renault in response to a prolonged slump, not a manager who came up through the ranks at Nissan. Accordingly, the management change between Mr. Ghosn and his predecessor, Mr. Yoshikazu Hanawa<sup>11</sup> could be considered a hostile management change. It would not be surprising if Mr. Ghosn expected that his own reputation would not suffer even if he recorded an enormous loss in the fiscal year ended March 2000 and placed the responsibility on his predecessor. Circumstances made it easy for Mr. Ghosn to implement accounting policies on contract earnings and take a big bath in his first year as COO.

## Case 2 Shiseido

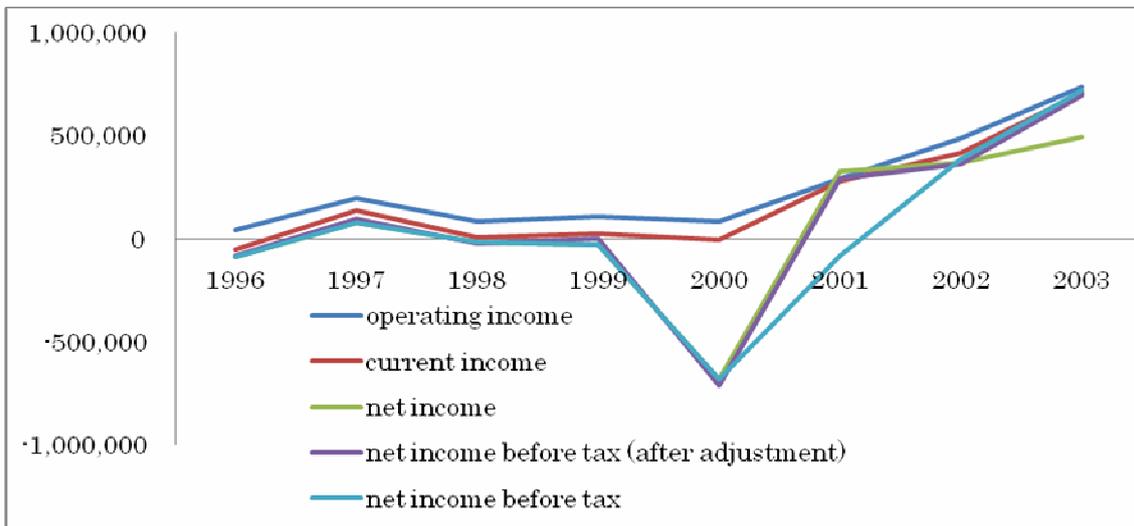
Following the Nissan case study, we now analyze a case concerning Shiseido. This case is similar to the Nissan study in that it involves the relationship between management changes and big bath tactics. Nevertheless, the situation at Shiseido differs greatly from that at Nissan. This is because the Shiseido case is closely tied to a management personnel system characteristic of Japanese firms, as confirmed in the following discussion.

---

<sup>11</sup> As mentioned in a previous footnote, since Mr. Yoshikazu Hanawa did not relinquish his position as president, this change of management was a change in the substantive sense of the word.

Shiseido is a large Japanese cosmetics firm founded in 1872. Amid dramatic changes in the external environment, such as deregulation within its industry, the accounting big bang, and mergers between competitors, Shiseido had been implementing management reform for more than a decade to break down its outdated management structure. Figure 2 shows the changes in Shiseido's business performance.

**Figure 2 The changes in Shiseido's business performance(1996-2003)**



The profit figures show a sharp decline in net income in the fiscal years ended March 2001, March 2002, and March 2005. Although profits increased in fiscal 2004 following a decline (especially in net income), earnings decreased in the fiscal year ended March 2009 as a result of the impact of the worldwide recession triggered by the financial crisis.

It is very interesting that fiscal 2000 (the year ended March 2001) and fiscal 2004 (the year ended March 2005) coincide with the resignation of presidents of the firm. Mr. Akira Genma resigned in fiscal 2000 and was replaced by Mr. Morio Ikeda (Figure 3). In turn, Mr. Ikeda resigned in fiscal 2004. Unlike the case of Nissan, big baths were taken, not in the

successors' first years in office, but rather in the years the predecessors departed<sup>12</sup>.

**Figure 3**

|                          |                       |             |              |
|--------------------------|-----------------------|-------------|--------------|
| Transitory (fiscal) year | 1996                  | 2001        | 2005         |
| President & CEO          | Akira Gemma           | Morio Ikeda | Shinzo Maeda |
| Chairman                 | Yoshiharu<br>Fukuhara | Akira Gemma | Morio Ikeda  |

First, we analyze the year of Mr. Genma's resignation (the settlement of accounts for the fiscal year ended March 2001), the Genma-to-Ikeda transition period.

**Figure 4 Breakdown of Extraordinary Losses in the Fiscal Year Ended March 2001 (the Year of Mr. Genma's Resignation)<sup>13</sup>**

| Breakdown of Extraordinary Losses   | Description   | Impact on Earnings |
|---|---|--------------------|
| 1) Net obligation at transition immediately expensed for post-employment benefits |   | -¥69,072 million   |
| 2) Valuation loss on goodwill   | Loss on revaluation of goodwill a subsidiary in North America had hold.                               | -¥13,225 million   |
| 3) Restructuring costs  | Costs related to reorganization of the group companies  | -¥8,717 million    |
| 4) Valuation loss on financial assets   | (i) Loss on devaluation of investment securities (ii) Loss on devaluation of capital stock investment | -¥1,606 million    |

<sup>12</sup> The firm also recorded an enormous extraordinary loss for the fiscal year ended March 2002 and posted a net loss. Should this be considered a big bath? Although this is an interesting question, we do not discuss it in this paper since it would divert focus from the main issue.

<sup>13</sup> No extraordinary profits were recorded in the settlement of accounts for the fiscal year ended March 2001.

Although items 1), 2), and 4) are extraordinary losses attendant on changes in accounting standards, there is room for discretion in item 1). Firms were able to choose to implement either a lump-sum amortization or straight-line amortization over 15 years of any net retirement benefit obligation that occurred at the time the transition was made to the accounting standard for retirement benefits when retirement benefits accounting was introduced. Shiseido chose lump-sum amortization. Had Shiseido used 15-year straight-line amortization, it would have been necessary to record expenses of approximately ¥4,605 million each fiscal year<sup>14</sup>. It is conceivable that Shiseido avoided the squeezing of future profits that would have resulted from selecting 15-year straight-line amortization.

Also, as indicated in Fig. 4, item 3) consists of restructuring costs within the Shiseido Group. Specifically, these costs are a ¥2,770 million loss on disposal of inventories that occurred at the time of the transfer of the toiletries business from Shiseido (the parent company) to a subsidiary, a ¥269 million loss on disposal of fixed assets, a ¥5,650 million adjustment to the consolidated book value of land attendant on subsidiary liquidation, and ¥27 million in liquidation losses on the sale of real estate and the liquidation of a subsidiary engaged in the construction design business.

Of course, it is possible that the restructuring costs reflected a change in management strategy and were not recorded for the purpose of changing the accounting figures. Nonetheless, the recording of such expenses “can also be considered to involve discretionary behavior by management” (Otomasa 1997, p.543). Shiseido, faced with unavoidable losses, may have decided to take advantage of the situation as an opportunity

---

<sup>14</sup> Net income before taxes and other adjustments after adjustment for this amortization is ¥4,830 million (net income before this adjustment was -¥59,637 million).

to also record restructuring costs and report even greater losses. In so doing, it would reduce the management burden on the newly appointed president in subsequent periods. If that is the case, this can be considered a material accounting policy by management.

Next, it is instructive to analyze the Ikeda-to-Maeda transition period (the settlement of accounts for the fiscal year ended March 2005).

**Figure 5 Breakdown of Extraordinary Losses in the Fiscal Year Ended March 2005 (the Year of Mr. Ikeda's Resignation)**

| Breakdown of Extraordinary Losses              | Description   | Impact on Earnings                        |
|--|---|---|
| 1) Gain on change of retirement benefit system | This is a gain in connection with the partial abolition of a defined benefit pension plan and transition to a defined contribution pension plan and a retirement benefit prepayment plan. | ¥998 million                              |
| 2) Retirement benefit-related costs            | This special additional amount occurred in connection with the implementation of a special early retirement incentive plan, etc.  | -¥11,711 million                          |
| 3) Restructuring costs                         | (i) Costs related to the reorganization of factories in   | (i) -¥1,859 million<br>(ii) -¥804 million |

|                                       |   |   |
|---------------------------------------|---|---|
|                                       | Japan (ii) Costs related to the liquidation and reorganization of affiliates  |   |
| 4) Valuation loss on financial assets | (i) Loss on devaluation of equity in affiliates (ii) Provision of allowance for doubtful accounts for loans to affiliates (iii) Loss on devaluation of investment securities (iv) Loss on devaluation of capital stock investment | (i) -¥968 million<br>(ii) -¥457 million<br>(iii) -¥158 million<br>(iv) -¥63 million |

As already mentioned, ample room for discretion exists even in restructuring costs. For instance, this might be true of the retirement benefit-related costs in item 2). As shown in the table, item 2) consists of a special additional amount that occurred in connection with the implementation of a special early retirement incentive plan and other items. That is, Shiseido implemented its first personnel retrenchment since its founding and reduced employment costs. Mr. Ikeda may have become the first resigning Shiseido president to take responsibility for business performance for having implemented an early retirement scheme. In light of these circumstances, we can probably conclude that Shiseido sought to advance restructuring during the predecessor's term of office to strengthen the management base (in this case, personnel reduction through early retirement) before implementing a management change (Otomasa 1994, p.33).

In light of the above points, how can we characterize the big bath taken by Shiseido? Two characteristics of management change in Japan are that the outgoing manager has the authority to name a successor and “that seniority-based revolving door appointments are accepted practice” (Itoh 2007, p.200). Shiseido can be considered a typical example of this type of management personnel system. At Shiseido, as a rule the president names a successor (a career Shiseido manager) and then becomes chairman (Figure 3). Accordingly, Shiseido’s management changes can be considered to be amicable.

In cases of amicable management change, what sort of accounting policies can be expected to be implemented? For instance, the implementation of accounting policies to bolster earnings and give credit to the departing president can be expected in the fiscal year of a president’s departure. The opposite case, in which the predecessor implements accounting policies to suppress earnings in the fiscal year of his departure to put in place a management structure favorable to the successor (or, in consideration of the predecessor’s own situation in staying on as chairman and director in subsequent periods), is also a possibility.

For Shiseido, the fiscal years ended March 2001 and March 2005 can be considered examples of the latter situation<sup>15</sup>. Of course, it is conceivable that the extraordinary losses of those two years are attributable to no more than restructuring and that the likelihood they are attributable to accounting policies is low. However, it should be noted that the departing managers went out of their way to record extraordinary losses and implement personnel retrenchment in a way that sullied their own reputations.<sup>16</sup> Even though this is a case of

---

<sup>15</sup> This is, of course, also possibly not the case. It probably depends on the decision-making sequence leading to the decision of what accounting policies to adopt and the decision to implement a management change.

<sup>16</sup> The departure of Mr. Ikeda can be considered to be his taking responsibility for the first personnel retrenchment since the founding of Shiseido.

restructuring, as previously mentioned, it is possible that management discretion is involved. Considering that a departing manager “is interested in crowning his career with a success, he may engage in accounting manipulation to generate profits for the purpose of improving his own reputation or increasing his compensation” (Otomasa 1994), we can conclude that some sort of management discretion is also involved in the choice to deliberately worsen business performance<sup>17</sup>. The interpretation that Shiseido predecessors used their departure as an opportunity to implement restructuring (a material accounting policy) to facilitate management for the succeeding managers or management teams is possible.

Accordingly, we can characterize the Shiseido big baths as having been taken by predecessors at the time of management changes to lighten the management burden of the incoming management teams.

#### Comparison of Nissan and Shiseido

Finally, we will compare the cases of Nissan and Shiseido. In the case of Nissan, Mr. Ghosn took full advantage of technical accounting policies and material accounting policies in the fiscal year he assumed office, took a big bath, and successfully staged a V-shaped recovery in subsequent fiscal years. Mr. Ghosn, who had been dispatched from Renault, faced no constraints from personal ties to his predecessor and was able to record an enormous loss in his first year in office and shift the blame to his predecessor. This is a characteristic of a big bath consequent to a hostile management change.

In the case of Shiseido, unlike the case of Nissan, it is highly likely that amicable

---

<sup>17</sup> For Shiseido’s management, although taking the decisive step of implementing the firm’s first personnel retrenchment might result in improving the company’s reputation, it might also greatly damage management’s reputation. In the case of Japan, however, where an external management labor market has not developed, the validity of this explanation is unclear.

management changes were implemented. In such cases, it is possible that a predecessor takes a big bath for the sake of the successor and a management change is implemented after management impediments have been removed. Two characteristics of the management personnel system of Japanese firms, revolving-door management change and the authority of predecessors to name their successors, may influence this practice. The Shiseido case study strongly reflects this characteristic of Japanese firms.

In this paper, we used case studies of Nissan and Shiseido to confirm how firms take big baths on the occasion of management changes. In addition to the generally considered big bath situation, the case where a successor takes a big bath attendant to a hostile management change, such as the situation at Nissan, users of financial statements must also bear in mind the case, common in Japanese firms, where a predecessor takes a big bath attendant on an amicable management change in keeping with the characteristics of the firm's management personnel system, such as the situation at Shiseido.

An understanding of the relationship between management change and big baths should make it possible for users of financial statements to perform analysis while paying attention to the accounting bias that occurs as a result of that relationship when analyzing Japanese firms.

## References

- Elliott, J. and W. Shaw. [1988] “Write Offs as Accounting Procedures to Manage Perceptions,” *Journal of Accounting Research*, Vol. 26, Supplement, pp. 91-119.
- Itoh, K. [2007] *Corporate Valuation*, Nihon Keizai Shimbun-sha.
- Otomasa, S. [1992] “The income decreasing behavior of Japanese firms: Toward the empirical analysis of Big bath,” *Kaikei* 151, p.p.533–545.
- Otomasa, S. [1994] “Top management turnover and earnings-based performance evaluation,” *Hannan Ronshu*, 30(2), p.p.27-40.
- Otomasa, S. [2009] *Financial Statement Analysis*, Dobunkan Shuppan.
- Obinata, T. [2007] *Advanced Financial Accounting*, Chuokeizai-sha
- Scott, William. [2009] *Financial Accounting Theory (5th Edition)*, Prentice Hall.
- Shuto, A. [2000] “Corporate Governance and Accounting Earnings: Top Executive Turnover and Firm Performance,” *Senriyama Shogaku* 52, p.p.83–123.
- Nikkei Business*. (2001, May 19, 2002, June 10, & 2007, June 4).
- Nihon Keizai Shimbun, morning edition*. (2001, twenty seven May).
- Shiseido’s financial reports & annual reports.