Big bath accounting

Business, Accounting

Big Bath Accounting is the direct opposite of the Optimism principle, which involves the overstatement of a company's profits and the overvaluation of its assets (Jiang, 2006). It is defined as the accounting procedures undertaken by a company's management for the specific purpose of bringing down the profit figures for the current year. The end objective is to achieve increased profit figures for the subsequent year.

The lower the figures are for the current year as the base year, the higher the computed increases will be in terms of rates of return and profitability ratios for the next year. This, then, will paint a better picture of the management's overall performance. (Riahi-Belkaoui, 2003, p. 135)

Thus, taking a bath would mean writing off unusable assets or those that were acquired to implement old projects, recording provisions for all kinds of estimated losses and expenses, and deferring revenues to arrive at a reduced current income figure. (Riahi-Belkaoui, 2003, p. 135)

As necessary, management would change the company's accounting policies, manipulate discretionary accruals, decide to adopt a new accounting standard at a suitable time, and revise operational standards for variables such as manufacturing overhead and general expenses. Management can choose to do any of these things to protect its own interests or to generally serve its own purposes. The Positive Accounting Theory (PAT) establishes that a company's management would naturally make decisions that are bent toward maximizing their own utility and not necessarily the company's profits. (Scott, 2008).

To counter these managerial tendencies, the Agency Theory is primarily focused on establishing ways for a principal (or the company stockholders) to motivate an agent (or the company manager) to do things that for the best interest of the former – the principal or the company stockholders (Rabin, 2003, p. 809).

The prevailing conflict in what is best for each of the two parties – the stockholders and the management team – would have to be minimized (Scott, 2008).

In the process, agency costs are incurred for the various methods employed to synchronize the management's interests with the stockholders'.

There are recommended ways to counter the Big Bath Accounting practices. Auditing would help to identify the Big Bath-related decisions made by management. They would then be detailed in the auditor's report for the company's board of directors (representing the company's stockholders) to be alerted about them. Budget constraints (budgeted net income minus actual) also ought to be accordingly brought up (Scott, 2008).

Management should then be required to explain all the issues that sprung forth from the Big Bath application. It would help, too, if managers are made to recognize that they are dispensable and replaceable, especially when the financial statements relay results that do not meet the approval of the company's stockholders.

The Big Bath Accounting practices are mostly undertaken to deflate the current year's income so as to have better chances of inflating the next year's income. But then, there would be little or no reason for a company to

" take a bath" if incentives are regularly given to its management based on actual income figures for each year and not on comparative increases year-on-year.

Big baths are known to be taken whenever there is a new management team in place that seeks to show depressed profitability levels as their take-off point so as to magnify the conjured positive effect of the company's profits in the succeeding years (Riahi-Belkaoui, 2003, p. 135). Mechanisms should be set up for management to not want this kind of leverage.

Fair Value Accounting

For all the criticisms lashed out by bankers and economists against the requirement of stating the bank's assets and liabilities at their fair or market values, it remains generally believed that such accounting standard would have enabled the government's monitoring agencies, the financial markets, the users of credit to see what was coming as early as the year 2007.

Fair value accounting would have mitigated the impact of the global financial crisis. In spite of the complaints currently piling up about the worsening level of investors' confidence in the financial markets as a whole with the fair value accounting as the cited culprit behind it all, authorities are ready to defend fair value accounting as part of the solution for the financial woes brought about by the global financial crisis.

While it is true that fair value accounting requires banks and companies to value their assets at their badly deflated market prices and that such devaluation of assets is further lowering the net assets worth of the entities, the same fair value accounting would have forced banks to be more

discriminate in – if not to totally refrain from – releasing loans like liquidity was not at all an issue.

The meager cash resources that the bank had would have been put on hold as required reserves to replace the portions of the lost market values of the bank's assets and securitized resources. As it is, it was too late when fair value accounting became the required system. The books of companies and banks alike have all been robust with overvalued assets that clung to historical or purchase costs that were long gone.

Fair value accounting would have led earlier to the writing off of bad debts – this one result would have let out the warning signals that, in turn, would have helped to arrest the liquidity problem at its onset.

In the aftermath of the financial tsunami, fair value accounting brings up additional troubles for the banks. Indeed, it is no lie that using today's market values for investment securities and for receivables is causing them to have worsened financial conditions as reflected in their financial statements. But then, it remains that fair value accounting is the wise and fair system to uphold if the investors' confidence is to be won back and if the circumstances that led to the global financial crisis are not to be repeated.

An alternative to fair value accounting would be transparent disclosures that should end the wave of misleading statements and inaccurate financial reports of public companies that misled thefinancemarkets during the last decades. Lack of transparency has brought about the large-scale accounting scandals that have sadly become a frequent occurrence (Lightstone & Driscoll, 2008, p. 8). Regulations like the Sarbanes-Oxley Act were

formulated and implemented to address these misdeeds, but it is, in the end, largely up to corporate bigwigs to decide to do the right thing for the sake of their companies, their stockholders and to a certain degree, their country.

Ethics in high places can be hard to come by. Disclosing the real scenario is the company's financial statements or in the notes attached thereto can be a difficult thing for the management to do. It would then be a question of how far they would go to protect their own hide or of how important to them is the upholding of truth. Truth can be painful to let out, as seen by the groans and complaints of the banks against having to present their assets and holdings at fair values.

But again, fair value accounting and transparency in giving the users of financial statements the true picture – whether they will be pleased or not about it – of the company's operating results and financial condition are the only means of re-establishing for good the lost confidence in capitalism and in the finance world.

At this point, there is little that can be achieved in digging up the spoils to trace how the huge catastrophe came about. The more important thing is to focus on what ought to be done and on getting it consistently done.

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