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By contrast, when loan losses are recognised, that is, while a bank decides that a certain portion of a loan will not be collected and therefore must be charged off or written off, the amount of the loss is deducted from the asset category loans and from reserves for loan losses. Thus, charge-offs are considered relatively nondiscretionary.⁴ In this case, the amounts of earnings are unchanged. However, the loan value shows the true status and is called 'asset quality'. We are surprised that minimal attention has focused on charge-offs of the banking industry and discuss the differences between earnings quality and asset quality.

Wahlen ([1994](#)) used three proxies, namely, NPL (disclosure of supplementary descriptions on the balance sheet), LLP (disclosure of the expense item on the income statement) and loan charge-offs (disclosure of the notes on statements) for the banking risk of asset true value. He determined that, although LLP is readily available among all information, LLP also mixes various information contents of earnings management (EM), risk-based capital requirement and tax effect. Moreover, loan charge-offs have less discretion to capture the true quality of banking assets. This case can explain the finding that market investors respond positively when Citicorp announced that it would add US\$3 billion to its LLR.⁵

Second, we examine CEO turnover in privately owned banks (POB) and government-owned banks (GOB). Many studies distinguish CEO turnover into forced and voluntary turnovers ([Hazarika, Karpoff, & Nahata, 2012](#); [Huson, Parrino, & Starks, 2001](#)). However, we point out that classifying CEO turnover into forced and voluntary is meaningful only in POBs because the managerial behaviour of forced and voluntary turnovers in GOBs is often the same. The evaluation of CEOs in POBs is conducted on the basis of profit maximisation. Thus, the incoming CEOs of POBs are able to disconnect their performance from that of their predecessors. Forced turnover in POBs are posited to conduct the earnings and NPL baths more actively than voluntary turnover. However, the evaluation of GOBs is conducted on the basis of financial performance and political mandate ([Shen & Lin, 2012](#); [Shen, Hasan, & Lin, 2014](#)). In GOBs, CEOs are commonly appointed by the government and are not fully accountable for poor performance, which can be a result of political guidance and not managerial ability. Thus, these newly appointed CEOs are not highly concerned about comparing previous performance with their current performance. Previous studies using samples from the USA do not consider state-owned enterprises because of the small number of such enterprises in the country. Our estimated results show that forced turnover in POBs results in an active conduct of earnings bath, followed by a voluntary turnover in POBs. No earnings bath is observed in GOBs.

Third, the behaviour of forced CEO turnover may be different when the turnover is attributed to mergers and acquisitions (M&As). Mahajan and Lummer ([1993](#)) argued that the effects of CEO turnovers are influenced by various factors, such as the source of succession. Theories of external governance typically propose that CEO succession after M&As is forced by the board and that the successor is recruited from outside the firm. New CEOs, who are assigned by a new board, commonly possess a mandate to restructure bank assets and liabilities. Therefore, CEO succession after M&As

fosters a strong motivation to aggressively change the earnings report and particularly highlight the poor performance prior to their appointment. However, Lehn and Zhao (2006) showed that, although 57 per cent of CEOs are replaced following an acquisition, 83 per cent of such CEOs are replaced within 5 years. Thus, many M&A deals take time to complete the consolidation. During the interim, the successful bidder may ask the existing CEOs to clean the bad assets before appointing a new CEO. Therefore, the bath occurs before the CEOs are appointed, thereby weakening the forced turnover effect on earnings and NPL baths. Bornemann et al. (2015) excluded M&A turnovers from the sample given that the managerial behaviour during M&A turnovers is presumably driven by incentives that differed across cases. Thus, new CEOs after M&As may shed light on various types of bath behaviour depending on the completion of consolidation. In this aspect, our study compared the big bath effects with internal versus external turnovers.

Finally, although the term 'big bath' is commonly used in the literature, the term 'big' has not yet been defined. Defining 'big' is crucial because big bath accounting implies that firms recognise unexpectedly large provisions (managing earnings downward) when earnings are low. Haggard et al. (2015) mentioned that the bath has become a general term used to describe a large loss or an asset write-down, which are usually discretionary. Tokuga and Yamashita (2011) provided descriptive statistics and graphs to demonstrate extraordinary losses once new CEOs are appointed. However, they failed to define what extraordinary losses pertain to and why extraordinary losses were unable to conduct a regression analysis. Haggard et al. (2015) indicated that at least 1 per cent of the number of write-downs in total assets is referred to as 'big' using the nonbanking sector sample. Peek (2004) used the median of I/B/E/S (the Institutional Brokers Estimates System) earnings forecast to classify the 'big' unexpected loss in the nonfinancial sector. We fill this gap by providing an operational definition of 'big' bath.

We adopt the Taiwanese data for the following two unique aspects: first, the sample size of the three types of CEOs is relatively large because turnover in GOBs and POBs is common in Taiwan. A total of 151 CEO turnovers were included, which consisted of 72 GOB turnovers and 79 POB turnovers. However, nearly no GOBs are present in the USA. Thus, behaviour comparison between POBs and GOBs using US data is infeasible. In addition, the study on earnings bath and quality requires several types of data related to asset quality, such as LLP, NPL and charge-offs. Cross-country study is difficult because these types of data are considerably lacking in the often-used international databank, BankScope. Taiwan provided detailed data in this aspect. Although Taiwanese data were used, the study sheds light on the situation of other countries with similar financial and regulatory backgrounds.

The rest of this article is structured as follows: Section 2 shows the literature review for three related topics, namely, EM, CEO turnover and earnings bath. Section 3 provides the stylised fact analysis of CEO turnover and EM in Taiwan and presents the sample selection, data, variables and their descriptive statistics. Section 4 presents the hypotheses and econometric model used in this study.

Section 5 discusses the empirical results. Section 6 reviews the conclusions drawn and reports important policy implications.

2. Literature Review

After the recent global financial crisis, distorted managerial incentives received a significant share of the blame for excessive risk-taking and EM by banks ([Acharya & Richardson, 2009](#); [Huizinga & Laeven, 2012](#)). In the literature, EM was also tested on different attributes, such as firm industry, firm size, age of CEO and origin of CEO (e.g., internal or external). Manipulation of reported earnings by managers was well documented in the literature. An important explanation for EM by incoming CEOs is known as the big bath hypothesis, which states that incoming managers reduce the reported income during the initial part of their tenure. Therefore, the following two sections discuss the big bath in earnings and explain the relationship between CEO turnover and earnings bath.

2.1 Big Bath in Earnings

Despite the considerable number of studies focusing on EM in the banking sector, EM is mainly related to loss avoidance and earnings smoothing as defined by Burgstahler and Dichev ([1997](#)), Degeorge, Patel, and Zeckhauser ([1999](#)) and Shen and Chih ([2005](#)) and is unrelated to the big bath.

Financial reports are used to convey information on company performance, whereas managerial judgment and company-specific knowledge are needed to conduct the reports in context, including the status of assets, costs and revenue allocation. Then, managers can select the reporting methods, valuations and disclosures that are consistent with the company business and optionally increase the value of accounting. Given that financial reporting is imperfect, the possibility that arises for managers is the use of a preferable reporting method that does not truthfully reflect the company's actual financial status, that is, EM ([Healy & Wahlen, 1999](#)). Studies on earnings bath and CEO turnover using banking data are few compared with the bulk of studies on the three conventional types of EM, namely, loss avoidance, earnings smoothing, and earnings aggressiveness ([Bhattacharya, Daouk, & Welker, 2003](#)). The three types of EM have attracted considerable academic interest in the literature.⁶ However, EM they used did not contain a big bath in earnings, which is the particular type of managerial behaviour that new CEOs use to modify the earnings stream.

An earnings bath in accounting is a one-time charge taken against income to reduce assets. This charge results in low future expenses. The objective of a big bath is to 'recognise one big loss' in a single year to demonstrate an increased net income in the future years. McNichols and Wilson ([1988](#)) argued that a big bath implies that firms recognise an unexpectedly large provision (managing earnings downward) when earnings are low. Thus, managers transfer earnings to future periods because they receive minimal sanction from investors for the additional loss reported in the current period.

Bornemann et al. ([2015](#)), who used the German bank data, can be considered the first researchers to deal with big baths in earnings with CEO changes. They argued that engaging in big baths creates high volatility and showed that incoming CEOs increase DLLP and confirm big bath accounting. Except for this study, research on big baths in the banking sector in the event of CEO turnover is rare. Most investigations used DLLP to examine smooth earnings over the business cycle or earnings and not earnings bath. These studies include Liu and Ryan ([2006](#)), Shrieves and Dahl ([2003](#)), and Fonseca and González ([2008](#)), to name a few. Other studies discussed the effects of CEO turnover on risk taking ([Chen, Ebrahim, & Taboada, 2013](#)). Thus, the knowledge of how new CEOs conduct an earnings bath in the banking sector is primarily derived from theoretical reasoning without minimal empirical justification from the literature.

2.2 CEO Turnover and Earnings Bath

Kahneman and Tversky ([1979](#)) proposed that individuals evaluate performance relative to a benchmark rather than in absolute terms. The acquisition of extraordinary amounts of discretionary expenses reduces the net income of a bank during the turnover year and diminishes the benchmark to be achieved in the subsequent periods. Incoming CEOs can attribute poor performance to the long-term consequences of decisions that their predecessors have made or opted for. Therefore, they do not fear a loss in either managerial reputation or remuneration as a result of dissatisfactory bank performance during their first partial year in the post. This argument indicates why incoming CEOs are strongly inclined to engage in big bath accounting during the turnover year.

Numerous studies have shown that the departing and incoming CEOs may engage in EMs. The departing CEO may try to inflate earnings to mask poor performance, obtain an increased bonus, or enhance employability after leaving ([Godfrey et al., 2003](#); [Wells, 2002](#); [Wilson & Wang, 2010](#)). An incoming CEO may engage in an earnings bath in the opposite manner to that of the departing CEOs ([Yu, 2013](#)). Incoming CEOs are prone to benchmark reduction, such as the current realisation of future potential losses given that performance is often evaluated relative to a benchmark rather than in absolute terms ([Kahneman & Tversky, 1979](#)). Thus, the incoming CEO can display a relatively good performance and blame the poor performance on the previous CEO to obtain full credit for the subsequently good performance. Wells ([2002](#)), Godfrey et al. ([2003](#)) and Wilson & Wang ([2010](#)) focused on the agency problem of incoming CEOs, whereas Dechow and Sloan ([1991](#)), Pourciau ([1993](#)), Brickley, Coles, and Terry ([1994](#)), Reitenga and Tearney ([2003](#)) and Conyon and Florou ([2002](#)) emphasised the agency problem of outgoing CEOs. These studies reported that new management could generally benefit from discretionary accounting decisions to reduce the current income in the following manner: reporting low earnings by discretionary items can be blamed on the old management and reducing the historical bases for future comparisons. This study focuses on the managerial behaviour of the incoming CEO.

Asking the outgoing CEOs to reveal soft information on loans is difficult because it may disclose the hidden information on lending and because of the informational opacity of a bank's assets ([Stein, 2002](#)). Therefore, an incoming CEO is likely to be wary of the quality of bank assets created during the tenure of his/her predecessor. Such fears are particularly pronounced when the incoming CEO could be held personally liable for the poor performance of a bank. Although turnover events involve two distinct individuals, namely, the incumbent CEO and the incoming CEO ([Ronen & Yaari, 2010](#)), our study focuses on the EM behaviour of incoming CEOs on the basis of reasons for leaving of outgoing CEOs. DeAngelo ([1988](#)) determined that new CEOs take a big bath to transfer the blame for the company's poor performance on previous CEOs by using a corporate sample. Tokuga and Yamashita ([2011](#)) reported that Japanese firms take a big earnings bath when new CEOs are appointed. Similarly, Murphy and Zimmerman ([1993](#)), Pourciau ([1993](#)), Wells ([2002](#)), Godfrey et al. ([2003](#)), Geiger and North ([2006](#)) and Davidson III, Xie, Xu, and Ning ([2007](#)) used corporate samples.

3. Three Types of CEO Turnovers and Four Hypotheses

3.1 Three Types of CEO Turnovers

Three types of CEO turnovers are determined in our study. First, we classify banks into GOBs and POBs. GOBs refer to banks with government-owned shares amounting to more than 25 per cent; all others are classified as POBs ([Shen & Lin, 2012](#)). We further classify CEO turnovers in POBs into forced and voluntary. The literature (e.g., [Pourciau, 1993](#); [Wells, 2002](#)) investigates differences in the way managerial discretion is exerted during the so-called routine CEO changes (voluntary) on the one hand and non-routine CEO changes (forced) on the other hand. A routine turnover is characterised by a relatively orderly CEO succession process; a bank may (not) have the opportunity to adequately structure a non-(non) routine turnover. A typical example of a (non)routine turnover is CEO retirement (dismissal). Based on the criteria of Hazarika et al. ([2012](#)) for classifying turnovers, forced CEO turnover, as previously mentioned, includes those where the CEO was fired, forced out from the position, or departed because of unspecified policy differences. Meanwhile, voluntary CEO turnover includes retirement, leave without reason and acceptance of the incumbent of a comparable position elsewhere.

Once the forced and voluntary CEO turnovers were defined, we collect relevant CEO turnover information from various sources. First, the information on CEO turnover in a company can be obtained from annual reports, which require the co-signature of the general manager and the board chairperson.² Once the CEO turnover and the turnover year are identified, we classify the forced and voluntary CEO turnovers in POBs. Following the proposed definitions, we collect forced and voluntary CEO turnovers from the Market Observation Post System (MOPS) organised by the Taiwan Stock Exchange. This system records detailed information on CEO turnovers across listed firms, including the dates and reasons for resignation. Thus, CEOs resign because of M&As (i.e., forced turnover),

retirement (i.e., voluntary), or no evident reason. If the information indicates no evident reason, we further check other information sources, such as newspapers, company websites, and other references, to evaluate the reasons for the departure.

The information, which is listed in MOPS and provided by each company, is commonly vague. For example, the two most frequent reasons for CEO departures are ‘wish to spend more time with family’ and ‘(rescheduling of) personal career’. Thus, determining whether the leave is forced or voluntary is difficult. Therefore, we resort to commercial newspapers, such as *Businessweek*, *Now-days*, *Wealth* magazines among others, to verify the turnover reasons and minimise the risk of misclassification. We also check the names of the board directors in quarterly reports of the year for each respective year. We determine that more than 90 per cent of the executive turnovers were made public in the annual shareholder meeting held from April to June.

Then, we decide the turnover years. In most cases, only the incoming CEOs sign the annual reports. This common practice helped us identify the turnover year. However, in a few cases, the outgoing and incoming CEOs co-sign the annual reports. This situation complicates the determination of the turnover year. We conjecture that this situation occurs because the person controlling the company has not yet settled in. Thus, given that the disputes between two large shareholders are unsettled, each one assigns a favoured CEO. In this case, the subsequent year is counted as the turnover year.

Finally, once the CEO resignations and appointments among the publicly listed banks in Taiwan between 2002 and 2011 are identified, we estimate the ‘discretionary accruals’ (our measure of EM) during the year of resignation for each bank sample. On average, discretionary accruals are significantly positive in the year of resignation. Thereafter, we group the resignations according to the resignation date relative to the fiscal year-end of the bank.

3.2 Four Hypotheses

First, we discuss the motivation of forced and voluntary CEO turnovers in POBs for analysis. Given that CEOs of POBs focus exclusively on profit maximisation, the incentive to manipulate the relative performance between outgoing CEOs persists such that these CEOs can blame their predecessors for previous unsatisfactory performance. This condition is particularly true for the forced CEO turnover because the change in CEO indicates that the board is dissatisfied with the incumbent’s performance and expects good performance from the new CEO. Thus, the eagerness of newly appointed CEOs to show the relative performance is intensified so that they can take full credit for the subsequently good performance. Voluntary turnover indicates that the change in CEO is a result of the incumbent CEO’s retirement or a better job offer instead of an unsatisfactory previous performance. Thus, the newly appointed CEO is under less pressure to compare the relative performance.

Hypothesis 1 (H1, earnings bath in POB): The relative performance hypothesis indicates that forced CEO turnovers increase LLP more than voluntary CEO turnovers do. The voluntary CEO turnovers in

POBs may not even increase LLP.

Second, the CEOs of GOBs may behave differently from those of POBs. Given that the CEOs of GOBs possess two mandates, that is, profit maximisation and political policy goals, GOB managers bear less responsibility for poor performance. For example, the poor performance of GOBs may be attributed to government guidance, such as injecting funds to state-owned enterprises, subsidising poor families by charging low or even no interest rates and even providing assistance when the stock market plummets during a crisis. Even when existing CEOs maximise bank profit, they may be unable to secure the position because of the overall government policy consideration. By contrast, even when existing CEOs perform unsatisfactorily, they may not be replaced. The CEOs may also be changed after a presidential election when they perform well ([Shen & Lin, 2012](#)). Accordingly, new GOB CEOs are less motivated to engage in an earnings bath because their performance is disconnected from their promotion.

Hypothesis 2 (H2, earnings bath in GOB): Newly appointed GOB CEOs do not undertake an earnings bath because their evaluation is not based on the relative performance.

Third, this study considers a big bath in asset quality. When CEOs initially increase the LLP, they are expected to write off the NPL because the relative performance of asset quality is also an important indicator of the safety and soundness of banks. In addition, a lower NPL reduces information asymmetry by indicating earnings sustainability. However, this theoretical conjecture has not been confirmed by empirical studies. Thus, we fill this void by postulating the third hypothesis.

Hypothesis 3 (H3, NPL bath): A big bath in asset quality (NPL bath) indicates that forced CEO turnovers in POBs engage in a considerable charge-off NPL, followed by voluntary CEO turnovers in POBs and (forced or voluntary) CEO turnovers in GOBs.

Finally, we also discuss that the M&A dates and new CEO appointment dates may not be the same because completing a consolidation takes time. A successful bidder may ask the incumbent CEO to clean the bad assets upon completing M&As but subsequently assign the new CEO. Thus, the big bath may not occur during the date of CEO turnover but occur during the date of M&A.

Hypothesis 4 (H4, earnings bath in M&A): When the completion of the consolidation takes time, the big bath may start upon completion of the M&A, when the date is earlier than the appointment of a new CEO.

4. Econometric Model of Big Bath

Basically, our empirical specification follows closely the models used in the literature to test the earnings management hypothesis of the banking industry. Our earnings bath is examined by using DLLP as the dependent variable given that DLLP is the earning deduction term. DLLP, as the largest accrual in relation to bank size, is widely considered an optimal managerial tool for accounting manipulation in the banking sector ([Brady & Sinkey, 1988](#)). Our NPL bath is examined by using

ChargeOff as the dependent variable. The managerial behaviour of *ChargeOff* responding to CEO turnovers may differ from that of DLLP. The proportional percentage of *ChargeOff* justifies the need to increase LLP. Overprovision is implied if a bank increases the amount of LLP considerably without writing off the proportional amount of bad assets. Moreover, CEOs are less concerned about the asset quality than earnings even though the asset quality is an important indicator of bank safety and soundness.

Thus, the two specifications used in our examination of the big bath in terms of earnings and NPL are expressed as follows:

$$DLLP_{i,t} = \alpha_0 + \alpha_1 D_{TURNOVER_{i,t}} + Control + \varepsilon_{i,t} \tag{1}$$

$$ChargeOff_{i,t} = \beta_0 + \beta_1 D_{TURNOVER_{i,t}} + Control + \varepsilon_{i,t} , \tag{2}$$

where *i* and *t* denote the *i*th bank at time *t*, respectively. Our dependent and independent variables are explained as follows.

Following Beatty, Chamberlain, and Magliolo (1995), Ahmed, Takeda, and Thomas (1999), and Beatty, Ke, and Petroni (2002), we set DLLP as the residuals obtained by regressing LLP on the lagged change in total loans outstanding ($\Delta LOANS$), net loan charge-offs (NCO), NPLs, and change in NPLs (ΔNPL), thereby representing the LLR. All variables are deflated by the initial value of the total assets in a year (just equals to the value at the end of $t - 1$).⁸

The concerned coefficient, $D_{TURNOVER}$, is the dummy variable that is equal to one when a new CEO is appointed and is equal to zero otherwise. Specifically, $D_{TURNOVER}$ is equal to one for [$t = 0$ to 2] and zero for [$t = -2$ to -1], where $t = 0$ is the year that a CEO assumed office, $t = 1$ is the first year after a new CEO takes charge, and so on. The big bath in earnings suggests a positive α_1 , whereas the big bath in asset quality suggests a positive β_1 .

Following the literature as Greenwald and Sinkey Jr (1988) and Leaven and Majnoni (2003), we also set our control variables as $\Delta LOANS$, NCO, NPL, ΔNPL and LLR.

Finally, following the instructions of Leaven and Majnoni (2003), *Year* control dummies are intended to catch time-specific effects such as the regulatory changes affecting the earnings management. Table 1 provides a brief summary of the definitions and sources of all the variables in the preceding equations.

Table 1. Definition of Variables in Regression Models		
		Sources
Dependent Variables		

		Sources
DLLP	The amount of discretionary loan loss provision. Based on the work of Beatty et al. (1995), Ahmed et al. (1999) and Beatty et al. (2002), DLLP is the residual obtained from LLP determinant regression	TEJ
<i>ChargeOff</i>	The amounts obtained after the NPLs are written off	TEJ
Independent Variables		
GOB and POB	GOB: Government-owned banks, which are determined if more than 25% shares are owned by the government. POB: Government holds less than 25% of the shares	Shen and Lin (2012)
D_{TURNOVER}	Is equal to 1 if the period when new CEOs take charge ($t = 0$ to 2 years), and 0 otherwise ($t = -2$ to 1 years)	MOPS
$D_{\text{TURNOVER_M\&A}}$	Is equal to 1 if the period when new CEOs take charge from M&A activities, and 0 otherwise	MOPS
D_{FORCE}	Is equal to 1 if it is a forced CEO turnover in POB and 0 if it is voluntary CEO turnover	MOPS
NCO	Net loan charge-offs	TEJ
NPL	Non-performing loans	TEJ
ΔNPL	Change in non-performing loans	TEJ
LLR	Loan loss reserves	TEJ
<i>BigBath</i>	A dummy variable, which is equal to unity if DLLP exceeds the mean and k times of standard deviation. Mean is the 5-year average of DLLP. Our k is 1, 1.5, and 2, which is used to examine the robustness of the estimated results. We also use <i>ChargeOff</i> to examine the same issue	Peek (2004)
Source: Market Observation Post System (MOPS), Taiwan Economic Journal (TEJ), and so on.		

5. Source of Data

The CEOs in our study are the general manager and the chairperson of the board of directors. As mentioned, the turnover data are collected from the MOPS and other sources (see Section 3 for details). The bank financial ratios are obtained from the *Taiwan Economic Journal*. The sample period covers the period from 2002 to 2011, where 2002 is chosen as the initial year because it was the year when 14 financial-holding companies were established in Taiwan, which launched a new era in the financial system.

[Table 2](#) lists the turnover sample from 2002 to 2011. The number of turnovers is roughly even across 10 years, with the highest number of cases in 2005, 2006, and 2008. During our sample period, 151

CEO turnovers were indicated, where the numbers of POB and GOB turnovers were 79 and 72, respectively. Among the POB turnovers, the forced and voluntary ones are roughly even, that is, 37 (46.84%) and 42 (53.16%), respectively.⁹ Considering 11 turnover cases resulting from M&As, we conduct the analysis with and without M&A turnover to examine the robustness of the estimated results.

Table 2. Sample of CEO Turnover in GOB and POB (forced and voluntary)					
Year	Number of Total CEO Turnover (%)	POB (Private-owned Banks)			GOB (Government-owned Banks) CEO Turnover
		CEO Turnover	POB and Forced Turnover	POB and Voluntary Turnover	
2002	5 (3.82)	2	1	1	3
2003	6 (4.58)	3	2	1	3
2004	13 (9.92)	5	3	2	8
2005	21 (16.03)	10	4	6	11
2006	22 (16.79)	11	6	5	11
2007	15 (11.45)	7	4	3	8
2008	22 (16.79)	14	5	9	8
2009	19 (14.50)	10	5	5	9
2010	13 (9.92)	7	3	4	6
2011	15 (11.45)	10	4	6	5
Total	151 (100)	79 (52.32%)	37 (46.84%)	42 (53.16%)	72 (47.68%)

Source: Market Observation Post System (MOPS) organised by the Taiwan Stock Exchange (TSE).

Notes: 1. CEOs are defined as the chairperson of the board and the general manager.

2. Forced CEO turnover in POBs: CEOs were fired, forced to leave or left following a policy disagreement through takeover and bankruptcy and other reasons. Voluntary CEO turnovers in POBs: board-driven, retirement and other reasons.

3. Government-owned banks (GOBs) are banks in which the government owns more than 25% share. The remaining banks consist of the sample of privately owned banks (POB).
4. A total of 11 cases are derived from M&A activities (shared 23.12% of all 37 forced cases). reasons. Moreover, 18 observations are deleted from the sample because of the lack of accounting data and other reasons.

6. Hypothesis Testing

6.1 Basic Statistics

The *t*-test is employed for basic statistics to examine our hypotheses. [Table 3](#) examines the pattern of LLP/TA 2 years leading and lagging the turnover years as well as the concurrent turnover year, where the turnover year is denoted as year $t = 0$. Considering these CEO turnovers, we are interested in investigating whether LLP/TA is larger in year $t = 0$ than that in years $t - 1$ and $t - 2$ to justify whether the LLP is indeed different before and after the turnover.

Panel A of [Table 3](#) considers forced CEO turnovers in POBs. The LLP/TA at $t = 0$ is indicated as the highest value across 5 years. We also calculate the *t*-value to examine H1 and H2. The statistical null hypothesis of equality is between the LLP/TA at $t = 0$ and that at $t = 1$. In addition, the hypothesis of equality is between the LLP/TA at $t = 0$ and that at $t = -1$.

Table 3. LLP/TA: Two Years Before and After CEO Turnover					
Year	t – 2	t – 1	t	t + 1	t + 2
Panel A: POB forced turnover (N = 37)					
Mean (%)	0.85	0.92	1.25	0.72	0.88
Standard deviation (%)	0.31	0.18	0.32	0.29	0.24
Medium (%)	0.87	0.88	1.18	0.75	0.85
Panel B: POB voluntary turnover (N = 42)					
Mean (%)	0.68	0.73	0.78	0.78	0.72
Standard deviation (%)	0.29	0.36	0.36	0.28	0.32
Medium (%)	0.78	0.82	0.76	0.81	0.74
Panel C: GOB turnover (N = 72)					

Year	$t - 2$	$t - 1$	t	$t + 1$	$t + 2$
Mean (%)	0.66	0.73	0.80	0.75	0.70
Standard deviation (%)	0.21	0.15	0.26	0.19	0.27
Medium (%)	0.70	0.75	0.75	0.78	0.68

Panel D: The tests of the differences

POB forced turnover: $H_0: LLP/TA(t) = LLP/TA(t + 1)$; t -value = 2.35***

POB forced turnover: $H_0: LLP/TA(t) = LLP/TA(t - 1)$; t -value = 1.85**

POB voluntary turnover: $H_0: LLP/TA(t) = LLP/TA(t + 1)$; t -value = 0.20

POB voluntary turnover: $H_0: LLP/TA(t) = LLP/TA(t - 1)$; t -value = 1.20

GOB turnover: $H_0: LLP/TA(t) = LLP/TA(t + 1)$; t -value = 1.15

GOB turnover: $H_0: LLP/TA(t) = LLP/TA(t - 1)$; t -value = 0.920

POB forced turnover versus POB voluntary turnover at t ; t -value = 2.31

POB forced turnover versus GOB turnover at t ; t -value = 3.09***

POB voluntary turnover versus GOB turnover at t ; t -value = 1.81**

Source: The authors.

Notes: 1. Period $t = 0$ is defined as the concurrent year that a new CEO takes charge of a bank; $t = 1$ and 2 are 1 and 2 years after the turnover, and $t = -1$ and -2 are 1 and 2 years before the turnover.

2. If the date of turnover falls around the first quarter, then the CEO is considered to have maintained the position throughout the entire previous year.

3. *, ** and *** are significant at the 10%, 5% and 1% levels, respectively.

$$H_0: LLP/TA(t = 0) = LLP/TA(t = 1) \text{ or } H_0: LLP/TA(t = 0) = LLP/TA(t = -1)$$

The t -values for the two equality hypotheses are equal to 2.35 and 1.85, respectively (see panel D), thereby confirming that an earnings bath of the forced CEO turnover date exists (H1). Panel B considers the POB voluntary turnover sample. Although the LLP/TA in year $t = 0$ is larger than that in other years, the t -values for these equality hypotheses are insignificant, thereby also supporting H1.

Panel C uses the GOB turnover sample, similar results as those in panel B are obtained. A large LLP in year t is rejected, thereby supporting H2.

We also compare the LLA/TA between forced and voluntary turnovers in POB at $t = 0$. In [Table 3](#), the t -value is 2.31, rejecting that the LLA/TAs are the same for the two types of turnovers. Thus, the CEOs of forced POBs have a stronger incentive to raise more LLP than those of voluntary cases, thereby supporting H1. Moreover, past CEOs are blamed for the poor performances in the past, and the new CEOs take full credit for the subsequent high-quality performances. Similarly, the CEOs of forced POBs raise more LLP than those of the GOB turnover.

Next, we examine the NPL bath of *ChargeOff* patterns across 5 years for the three types of CEO turnovers. The results presented in [Table 4](#) are similar to those from using LLP/TA reported in [Table 3](#), except for voluntary CEO turnover in POBs. The largest amount of charge-off actions is exercised by the incoming CEO for forced POBs, followed by those for the voluntary POBs and GOBs. When using voluntary CEO turnover, the equality hypothesis of *ChargeOff* between $t = 0$ and $t = 1$, as well as that between $t = 0$ and $t = -1$, is not rejected, thereby contradicting H3.

[Figure 1](#) also plots the LLP/TA two years before and after the event years. In each year, three bars are drawn representing turnovers from forced POB (black bar), voluntary POB (grey bar), and GOB (white bar). Only the forced POB turnover exhibits the highest bar during the event year. [Figure 2](#) plots the *ChargeOff*/TA two years before and after the event year. Again, we still find forced POB to have significant bath management compared to voluntary POB or GOB.

Table 4. <i>ChargeOff</i> : Two Years Before and After CEO Turnover					
Year	t – 2	t – 1	t	t + 1	t + 2
Panel A: POB forced turnover (N = 37)					
Mean (%)	0.058	0.059	0.070	0.063	0.065
Standard deviation (%)	0.027	0.023	0.021	0.025	0.021
Medium (%)	0.053	0.062	0.067	0.067	0.066
Panel B: POB voluntary turnover (N = 42)					
Mean (%)	0.048	0.043	0.053	0.051	0.047
Standard deviation (%)	0.018	0.017	0.012	0.023	0.018
Medium (%)	0.051	0.046	0.050	0.048	0.049
Panel C: GOB turnover (N = 72)					

Year	$t - 2$	$t - 1$	t	$t + 1$	$t + 2$
Mean (%)	0.030	0.038	0.043	0.042	0.038
Standard deviation (%)	0.013	0.029	0.015	0.011	0.009
Medium (%)	0.035	0.036	0.075	0.044	0.040

Panel D: The tests of the differences

POB forced turnover: $H_0: ChargeOff/TA(t) = ChargeOff/TA(t + 1)$; t -value = 1.84***

POB forced turnover: $H_0: ChargeOff/TA(t) = ChargeOff/TA(t - 1)$; t -value = 1.92**

POB voluntary turnover: $H_0: ChargeOff/TA(t) = ChargeOff/TA(t + 1)$; t -value = 0.02

POB voluntary turnover: $H_0: ChargeOff/TA(t) = ChargeOff/TA(t - 1)$; t -value = 1.47

GOB turnover: $H_0: ChargeOff/TA(t) = ChargeOff/TA(t + 1)$; t -value = 0.00

GOB turnover: $H_0: ChargeOff/TA(t) = ChargeOff/TA(t - 1)$; t -value = 0.73

POB forced turnover versus POB voluntary turnover at t -year; t -value = 2.21***

POB forced turnover versus GOB turnover at t -year; t -value = 2.25***

POB voluntary turnover versus GOB turnover at t -year; t -value = 1.82**

Source: The authors.

Notes: 1. Term $t = 0$ is defined as the first year the incoming CEO takes charge of the banks. $t = 1$ and 2 are 1 and 2 years after turnover, and $t = -1$ and -2 are the former 1 and 2 years before the turnover.

2. *, ** and *** are significant at the 10%, 5%, and 1% levels, respectively.

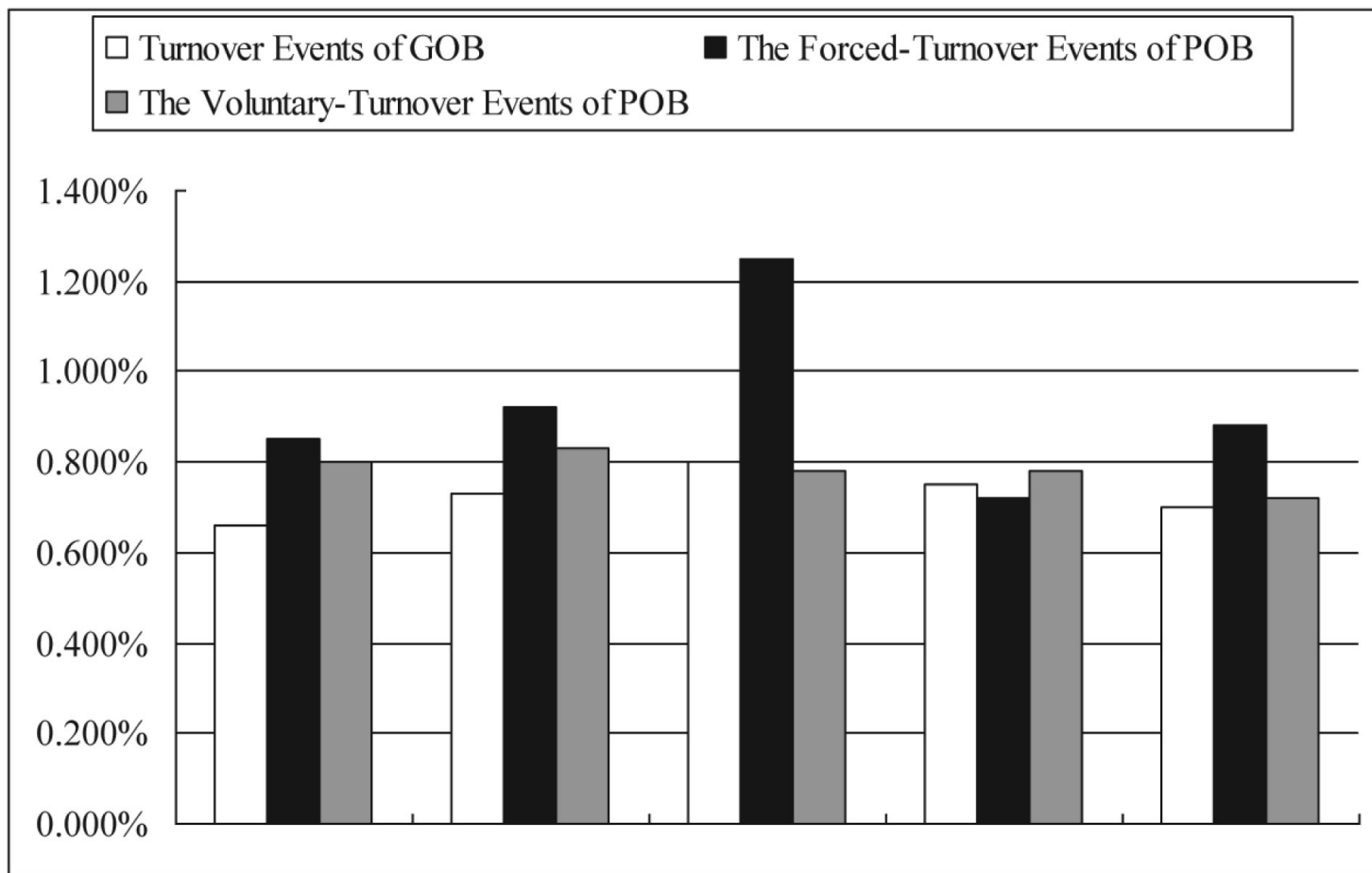


Figure 1. LLP/TA Patterns Two Years Leading, Concurrent to and Lagging the Turnover Years

Source: The authors calculation from the banks' annual financial reports.

Notes: 1. In each year, three bars are drawn representing turnovers from forced POB (black bar), voluntary POB (grey bar), and GOB (white bar).

2. 151 CEO turnovers were indicated, where the numbers of POB and GOB turnovers were 79 and 72, respectively. Among the POB turnovers, the forced and voluntary ones are roughly even, that is, 37 (46.84%) and 42 (53.16%), respectively.

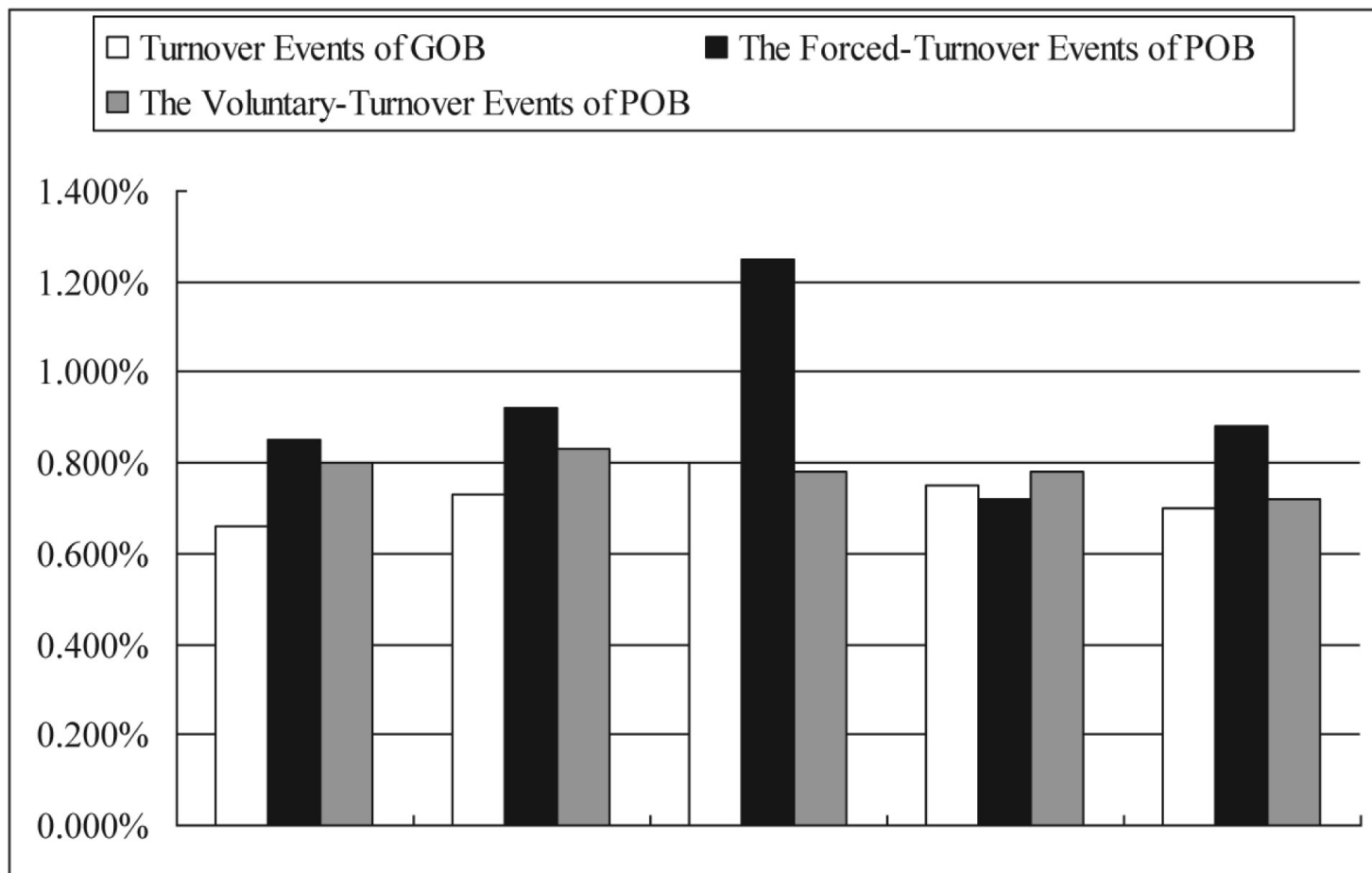


Figure 2. *ChargeOff/TA Patterns Two Years Leading, Concurrent to and Lagging the Turnover Years*

Source: The authors calculation from the banks' annual financial reports.

Notes: 1. In each year, three bars are drawn representing turnovers from forced POB (black bar), voluntary POB (grey bar), and GOB (white bar).

2. 151 CEO turnovers were indicated, where the numbers of POB and GOB turnovers were 79 and 72, respectively. Among the POB turnovers, the forced and voluntary ones are roughly even, that is, 37 (46.84%) and 42 (53.16%), respectively.

6.2 Four Case Studies

We also illustrate four graphical cases (matching the first three hypotheses) to provide intuition on the effects of CEO turnover on earnings and NPL baths. The case studies complement the basic statistics and regression analysis.

6.2.1 Forced Turnover of POB Without M&As: China Trust Bank

On 21 July 2006, the China Trust Bank appointed a new chairman of the board.¹⁰ This appointment was a forced turnover because the previous CEO was involved in an insider trading scandal and was forced

to resign. Thus, we choose 2006 as the event year, and the forced turnover is identified for POBs. [Figure 3](#) plots the LLP and *ChargeOff* 3 years before and after the event (2003–2009). The graphical bars of LLP and *ChargeOff* are minimal before and after 2006, but they abruptly increased in 2006. In 2006, the LLP was 52.04 billion New Taiwan dollars (NTD), which was five times larger than that of the non-event years. *ChargeOff* displays a similar pattern as that of LLP. In 2006, both values are statistically significantly higher than those in other years. The increase in LLP results in an abrupt drop in earnings (after interest and tax) to 11.69 billion NTD. The unprecedented high LLP and *ChargeOff* are consistent with H1 and H3.

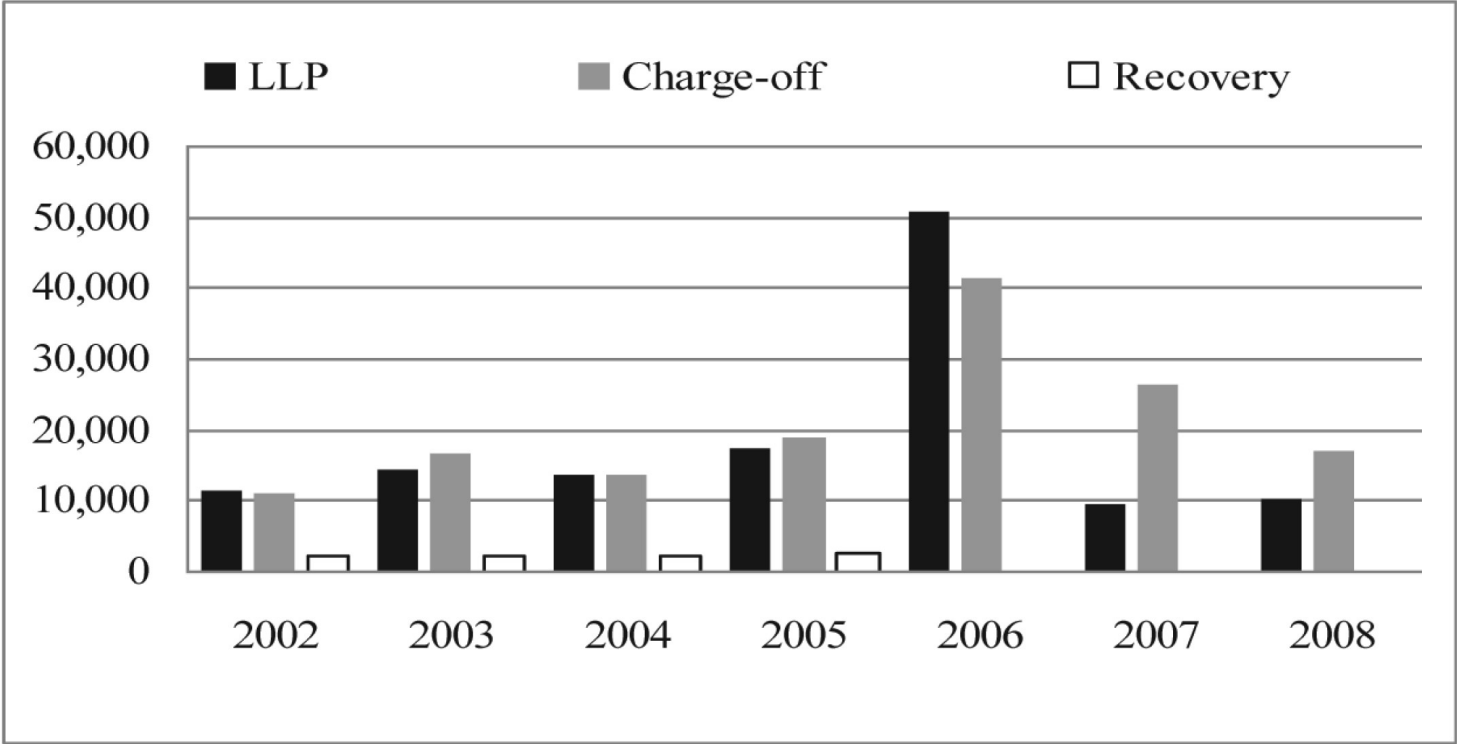


Figure 3. Forced CEO Turnover of POB: China Bank in the turnover event of 2006

Source: The authors calculation from the annual financial reports of China Trust Bank.

We also plot the recovery, which is small and close to zero. The small recovery is observed in all cases. Thus, changing the CEOs does not affect recovery. However, we do not discuss the plot again in the following sections.

6.2.2 Voluntary Turnover of POB: Taipei Fubon Trust Bank

In July 2006, the Taipei Fubon Trust Bank appointed a new CEO because the former CEO had reached retirement age.¹¹ This case is evidently classified as a voluntary turnover. As the expected retirement year of the existing CEO is widely known, the candidates for new CEO started to write off bad loans 1

year ahead. Thus, in [Figure 4](#), LLP and *ChargeOff* started to increase 1 year prior to the event year ($t - 1$) and continued to the event year and the year after ($t + 1$). The LLP and *ChargeOff* in the event year are insignificantly larger than those in other years. However, an earnings bath is indicated and starts 1 year earlier than the event year, which is also consistent with H1 and H3.

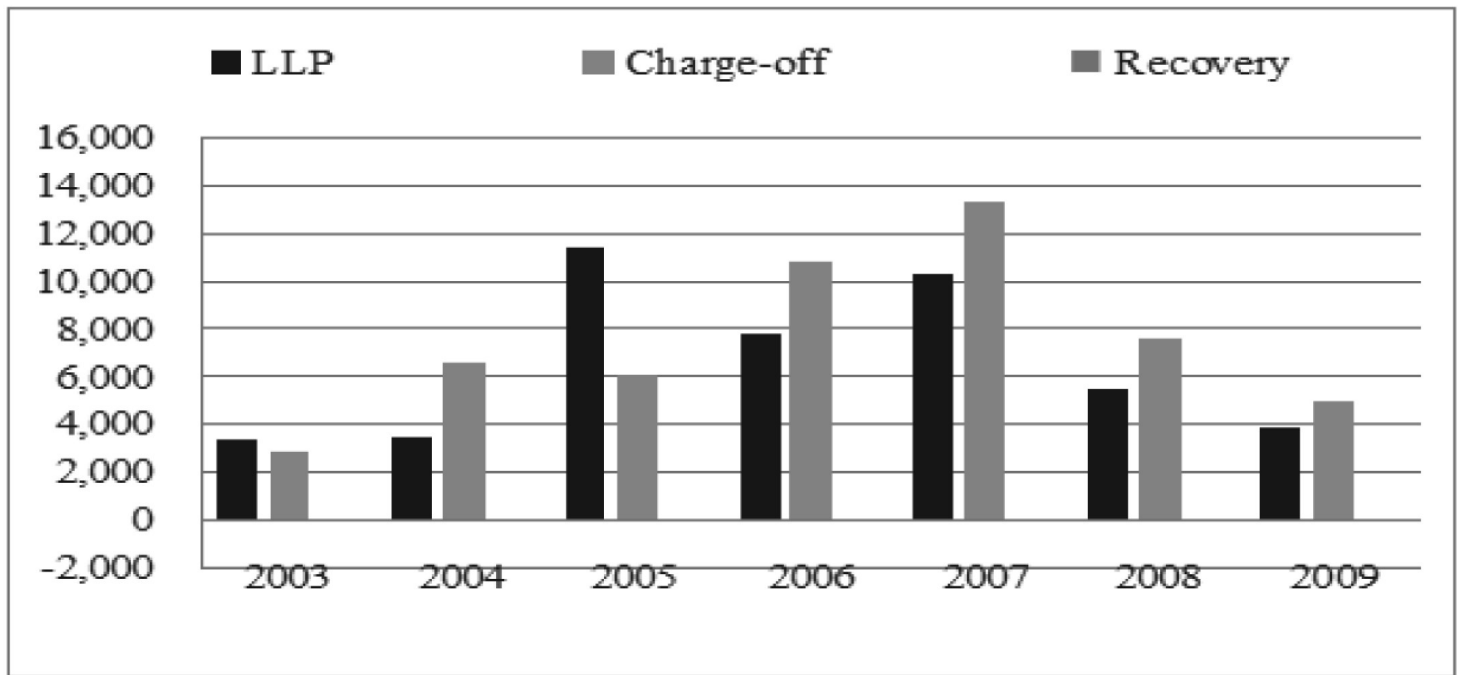


Figure 4. Voluntary CEO Turnover of POB: Taipei Fubon Bank in the turnover event of 2006

Source: The authors calculation from the annual financial reports of Taipei Fubon Bank.

6.2.3 Turnover of GOB: Cooperative Bank

On 12 May 2006, the Cooperative Bank, which is a GOB, appointed Mr. Wu as the new CEO because the former CEO has retired. In [Figure 5](#), the LLP does not increase significantly during the 2006 turnover year. Instead, LLP was highest in 2003, which was the first year after the financial reform in Taiwan. Thereafter, LLP dropped slightly every year. *ChargeOff* displays a similar pattern. Thus, LLP and *ChargeOff* support H2 and H3.

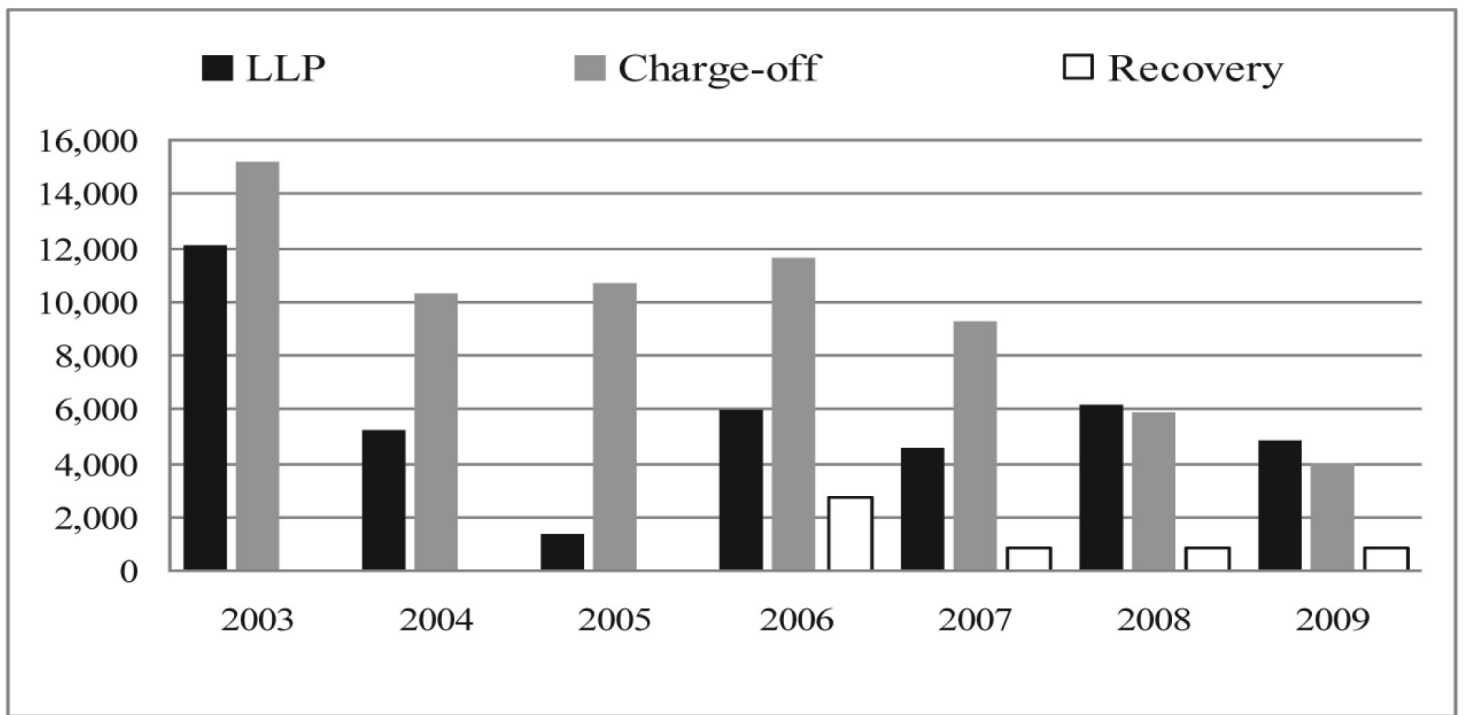


Figure 5. CEO Turnover of GOB: Cooperative Bank in the turnover event of 2006

Source: The authors calculation from the annual financial reports of Cooperative Bank.

6.2.4 Forced Turnover of POB Driven from M&As: Chang Hwa Bank

H4 suggests that CEO turnovers as a result of M&As may not conduct big baths at the CEO turnover event date but at the M&A date. A good example is the auction case of state-owned Chang Hwa Bank. In November 2005, Tai Sin Bank purchased a 22.01 per cent share in Chang Hwa Bank and became its largest shareholder, and the government became the second largest. Before appointing the new CEO on 24 November 2006, Tai Sin Bank announced its new bank management policy of cleaning bad assets. Thus, the earnings bath was conducted 1 year before the CEO turnover, as shown in [Figure 6](#).

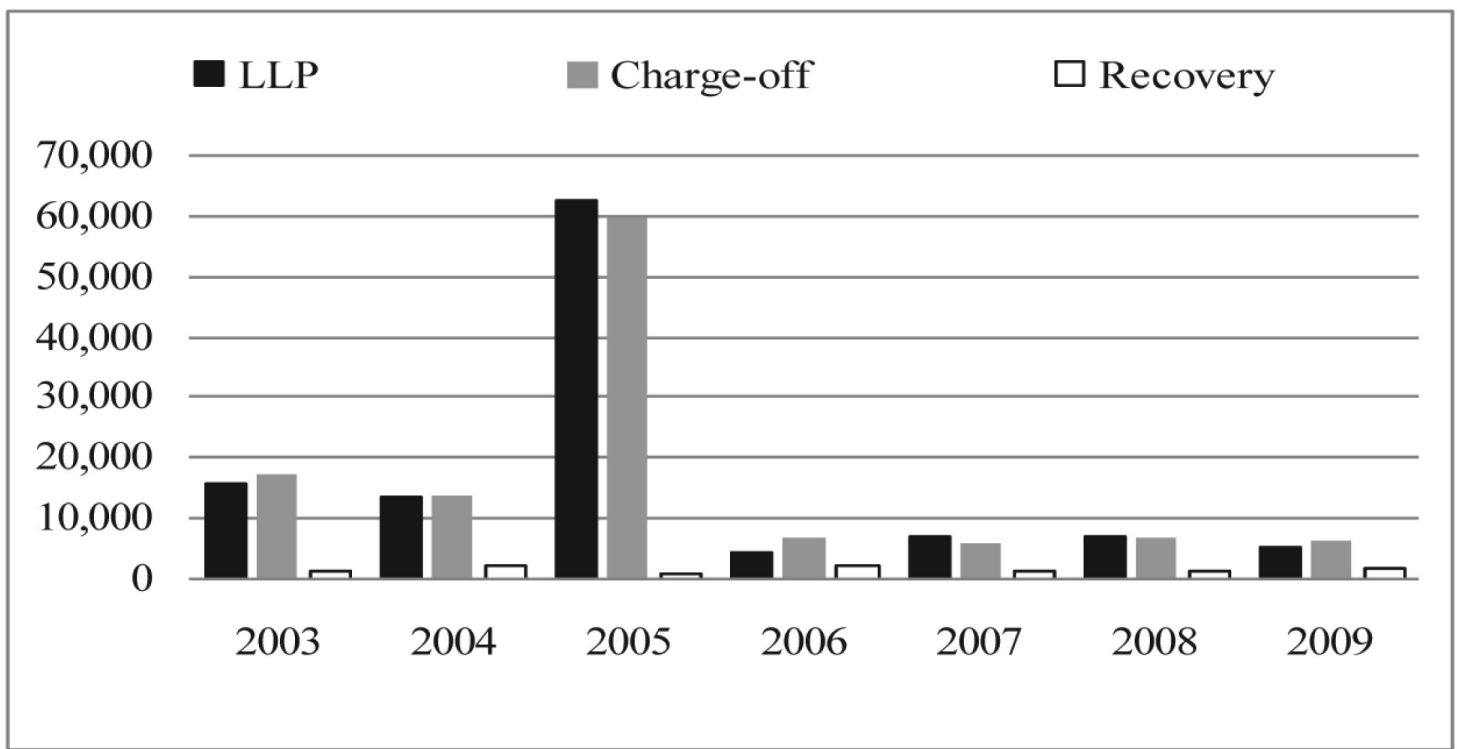


Figure 6. Forced CEO Turnover of POB as a Result of M&As: Chang Hwa Bank in the event year of 2006

Source: The authors calculation from the annual financial reports of Chang Hwa Bank.

In this case, the acquirer does not appoint a new CEO immediately after acquisition because disputes on detailed controlling rights are not completely settled on the board. The target filed a court dispute on the legality of the acquisition. During this process, the bidder, Tai Sin Bank, became the largest shareholder but did not fully control the board. Therefore, the new CEOs were yet to be appointed. During this period, the existing CEOs followed the instruction of the acquirer to raise LLP and clean the bad assets at the M&A date but not at the CEO appointment date. Thus, the date of increasing LLP is inconsistent with that of appointing new CEOs. As shown in [Figure 6](#), the significant changes of LLP and *ChargeOff* occurred in 2005 or the M&A year and not in 2006 or the turnover year, thereby confirming H4.

6.3 Regression Results

By using regression analysis, this section examines whether CEO turnover (i.e., D_{TURNOVER}) affects DLLP (earnings bath) and *ChargeOff* (NPL bath).

6.3.1 Earnings Bath: DLLP as Dependent Variable

We first test H1 and H2 by examining whether the newly appointed CEOs affect DLLP. [Table 5](#) presents the estimated results. In employing the entire sample (the first column), the coefficient of D_{TURNOVER} is

significantly positive at the 10 per cent level, suggesting that newly appointed CEOs insignificantly increase DLLP by pooling the entire sample.

When we employ only the POB sample, including forced and voluntary CEO turnovers (the second column of [Table 5](#)), the results resemble those using the entire sample, that is, the coefficient of D_{TURNOVER} is still significant at the 10 per cent level. Then, we employ the sample of forced CEO turnover. The dummy variable D_{TURNOVER} is equal to 1 for the period of $t = 0$ to 2 (2 years after the forced turnover) and 0 for $t = -2$ and -1 (2 years before the forced turnover). The coefficient of D_{TURNOVER} is significantly positive at the 1 per cent level. Finally, we consider the sample of voluntary CEO turnover. The coefficient is significant at the 10 per cent level. Thus, H1 is supported, given that forced turnovers exhibit a stronger big bath in earnings than that of voluntary CEO. Furthermore, voluntary CEO turnovers show an insignificant big bath in earnings.

However, the coefficient becomes insignificant when the GOB sample is used (the last column of [Table 5](#)), supporting H2, that is, newly appointed CEOs do not take earnings baths for GOBs.

Table 5. Big Bath in Earnings: Dependent Variable (DLLP)						
Sample Type	Whole Sample (POB + GOB)		POB			GOB
			All POB	Forced	Voluntary	
Constant	−2.36 (−8.49)***	−0.93 (−5.31)***	0.69 (2.68)***	−2.17 (−1.67)*	−1.24 (−1.85)**	−1.23 (−7.60)***
D_{TURNOVER}	1.39 (1.65)		0.68 (1.70)*	2.35 (3.03)***	1.10 (1.73)*	−1.33 (−0.84)
$D_{\text{TURNOVER}} \times D_{\text{FORCE}}$	−	1.44 (1.830)**	−	−	−	−
$D_{\text{TURNOVER_M\&A}}$	−	−	−	−	−	−
ΔLOANS	1.36 (0.73)	0.57 (1.26)	2.35 (1.93)**	0.78 (1.82)**	1.52 (1.36)	−0.77 (−1.52)
NCO	0.15 (1.68)*	1.18 (0.75)	−1.39 (−1.26)	−0.78 (−0.49)	−3.35 (−1.42)	−0.26 (−1.10)
NPL	0.77 (1.85)**	1.26 (1.70)*	3.57 (1.67)*	0.79 (1.35)	−0.79 (−1.76)*	1.20 (1.68)*
ΔNPL	1.50 (1.14)	−0.36 (−1.57)	3.26 (0.95)	−4.12 (−1.27)	2.25 (1.43)	−1.12 (−0.99)

Sample Type	Whole Sample (POB + GOB)		POB			GOB
			All POB	Forced	Voluntary	
LLR	0.95 (1.70)*	−1.20 (−1.35)	1.44 (1.99)***	−1.06 (−1.22)	−2.67 (−1.30)	0.85 (1.36)
Adj- R^2	0.2269	0.1969	0.2698	0.3150	0.2558	0.2148
Event obs.	151	151	79	37	42	72
Bank-year obs.	755	755	375	185	210	360
Control for year-effect	YES	YES	YES	YES	YES	YES

Source: The authors.

Notes: 1. DLLP: Discretionary LLP scaled by total assets.

2. D_{turnover} : It is equal to 1 for $t = 0$ to 2 if a turnover exists and 0 for $t = -2$ to -1 . Accordingly, 151 CEO turnovers occurred across 36 banks. Among them are 72 and 79 cases for GOBs and POBs, respectively.

3. D_{FORCE} : It is equal to 1 if a turnover is a forced CEO turnover in POB and 0 otherwise. Among them, the forced and voluntary events are 37 and 42, respectively.

4. $D_{\text{turnover_M\&A}}$: It is equal to 1 for $t = 0$ to 2 if a turnover is derived from M&A activities exists and 0 for $t = -2$ to -1 . Accordingly, 11 cases are derived from M&A activities (shared 23.12% of all 37 forced cases).

5. The turnover events are identified from the articles in the press published in some of the major Taiwanese newspapers and journals, such as *Businessweek*, *Now-days* and *Wealth*. The financial ratios related to the banks for the turnover cases are taken from TEJ.

6. The sample period ranges from 2002 to 2011.

7. Standard errors are adjusted by White heteroscedasticity-consistent and cluster effects in years.

8. Year dummies are included but are not reported to save space.

9. *t*-values are placed in parentheses. *, ** and *** are significant at the 10%, 5%, and 1% levels, respectively.

10. The bold characters show the coefficients of variables that we focus on.

6.3.2 NPL Bath: ChargeOff as Dependent Variable

We then examine H3, which is the big bath in asset quality, by investigating whether newly appointed CEOs actively charge-off the NPLs. The *ChargeOff* is the dependent variable. In [Table 6](#), the coefficient of D_{TURNOVER} is insignificant when the entire sample is used. Thus, although newly appointed CEOs increase the LLP, they do not charge-off the NPL immediately. When the forced turnover sample is used, the coefficient of D_{TURNOVER} becomes significant, but it is again insignificant when the voluntary CEO sample is used. Thus, the forcefully appointed CEOs raise the LLP and then immediately write off the NPL. By contrast, the voluntarily appointed CEOs increase the LLP but do not write off the NPL. Finally, the coefficient of D_{TURNOVER} remains insignificant for the GOB sample. Thus, H3 is supported.

Table 6. Big Bath in Asset Quality: Dependent Variable (*ChargeOff*)

Sample Type	Whole Sample (POB + GOB)		POB			GOB
			All POB	Forced	Voluntary	
Constant	−1.52 (−2.43)***	−0.75 (−1.79)**	−4.43 (−12.58)**	−3.65 (−8.01)**	2.26 (8.35)	1.45 (5.36)***
D_{TURNOVER}	−0.57 (−0.98)	—	−1.51 (−0.47)	−0.36 (−1.72)*	1.69 (1.47)	−0.72 (−1.25)
$D_{\text{TURNOVER}} \times D_{\text{FORCE}}$	—	0.61 (1.799)**	—	—	—	—
$D_{\text{TURNOVER_M\&A}}$	—	—	—	—	—	—
ΔLOANS	1.37 (1.35)	−1.12 (−0.57)	1.55 (1.47)	−0.74 (−0.68)	2.71 (1.33)	0.03 (0.15)
NCO	−1.14 (−1.21)	−0.79 (−1.00)	1.02 (1.83)**	0.92 (1.66)*	1.75 (3.35)***	−0.28 (−1.17)
NPL	1.45 (1.72)*	1.94 (1.35)	2.69 (2.19)***	1.46 (1.79)**	−0.95 (−1.59)	0.52 (1.70)*

Sample Type	Whole Sample (POB + GOB)		POB			GOB
			All POB	Forced	Voluntary	
ΔNPL	−0.65 (−1.53)	1.64 (1.68)*	−0.94 (0.00)	1.30 (1.51)	0.16 (1.19)	−1.10 (−1.48)
LLR	1.36 (1.56)	−1.42 (−1.51)	0.67 (2.22)***	−0.75 (−1.06)	1.35 (−2.65)***	1.57 (1.45)
Adj- R^2	0.0965	0.1352	0.1833	0.2007	0.1268	0.1667
Event obs.	151	151	79	37	42	72
Bank-year obs.	755	755	375	185	210	360
Control for year-effect	YES	YES	YES	YES	YES	YES

Source: The authors.

Notes: 1. *ChargeOff*: Charge off the bad loans scaled by total assets/*Total Asset*.

2. D_{turnover} : It is equal to 1 for $t = 0$ to 2 if a turnover exists and 0 for $t = -2$ to -1 . Accordingly, 151 CEO turnovers occurred across 36 banks, and among them are 72 and 79 cases for GOBs and POBs, respectively.

3. D_{FORCE} : It is equal to 1 if a turnover is a forced CEO turnover in POB and 0 otherwise. Among them, the forced and voluntary events are 37 and 42, respectively.

4. $D_{\text{turnover_M\&A}}$: It is equal to 1 for $t = 0$ to 2 if a turnover is derived from M&A activities exists and 0 for $t = -2$ to -1 . Accordingly, 11 cases are derived from M&A activities (shared 23.12% of all 37 forced cases).

5. The turnover events are identified from the articles in the press published in some of the major Taiwanese newspapers and journals, such as *Businessweek*, *Now-days* and *Wealth*. The financial ratios specifically related to the bank for the turnover cases are taken from TEJ.

6. The sample period ranges from 2002 to 2011.

7. Standard errors are adjusted by White heteroscedasticity-consistent and cluster effects in years.

8. Year dummies are included but are not reported to save space.

9. *t*-values are placed in parentheses. *, ** and *** are significant at the 10%, 5%, and 1% levels, respectively.

10. The bold characters show the coefficients of variables that we focus on.

Overall, forced CEO turnover takes a big bath in LLP and NPL because the performance of the new CEO is strictly evaluated. Thus, to demonstrate his/her relative performance, the new CEO should completely clear the past with the new performance. The turnovers of voluntary CEO increase the LLP but do not actively write off the NPL because the pressure on the new CEO is less than that on the CEO in a forced turnover. The appointed CEO in a GOB does not show a big bath in earnings or in asset quality.

6.3.3 CEO Turnovers as a Result of M&As

We further separate the 37 forced CEO turnovers with and without M&As. Accordingly, 11 cases are derived from M&A activities (shared 23.12% of all 37 forced cases), and most cases occurred from 2005 to 2006 when the ‘Big Bang’ of banking reform occurred in Taiwan. As mentioned, we hypothesise that the CEO turnover in M&A is typically a forced type and has the strongest motivation to take a big bath. Thus, we consider a new dummy variable of $D_{\text{TURNOVER_M\&A}}$, which is equal to 1 for an M&A case or 0 otherwise. In [Tables 5](#) and [6](#), the coefficients of $D_{\text{TURNOVER_M\&A}}$ are insignificant regardless of the dependent variables. Thus, we cannot find significant evidence to support H4.

Two possible reasons may explain this result. First, the five GOBs of CEO turnovers accounted for almost half of the total 11 M&A cases. However, these GOBs are excluded from our hypothesis because they are classified under voluntary changes by the government. Thus, the sample decreases considerably. Second, the M&A information lasts a long term even if, in the POB M&A cases, the managers of a new team are motivated to manipulate real activities before M&As to enhance their performance by the other form, that is, by the new board director and not only by the CEO turnover. Plausibly, new CEOs are not immediately appointed when M&As take place, as discussed in our case study.

6.4 Robust Results

6.4.1 Measurement of ‘Big’ Bath

Our approach to defining ‘big’ is motivated by the studies from the non-financial sector. Given that no clear definition of earnings bath is available in the banking literature, we define big bath as the condition when discretionary DLLP exceeds k times the standard deviation, where k is 1.5, 2 and 2.5. Moreover, we employed the logit model to examine the big bath.

This section captures the contents of the ‘big’ bath. We define a new big bath in earnings when DLLP exceeds the average and is 1.5 times of the standard deviation. We propose that the big bath in earnings indicates that a new CEO turnover sufficiently increases DLLP. Conventional linear model discusses only the linear response of DLLP to earnings before provisions and taxes (EBPT). Using DLLP to illustrate the big bath in earnings is specified as follows:

$$BigBath = \begin{cases} 1 & DLLP > \mu_{DLLP} + k \times \sigma_{DLLP} \\ 0 & otherwise \end{cases} \tag{3}$$

$$Pr ob(BigBath_{i,t} = 1) = \beta_0 + \beta_1 D_{TURNOVER_{i,t}} + Control + \varepsilon_{i,t} \tag{4}$$

where *BigBath* is a dummy variable that is equal to one if DLLP exceeds the mean and *k* times of its standard deviation. The term μ_{DLLP} is the 5-year average of DLLP (*t* = −2 to 2) and σ is the standard deviation of DLLP. *k* is a set consisting of 1, 1.5 and 2 used to examine the robustness of the estimated results. We also used *ChargeOff* to define the big bath in asset quality to examine the same issue.

Once we emphasise that only the ‘sufficiently large’ amounts of DLLP meet our definition of ‘big’ bath, only the forced CEO sample is likely to be used because the observed data where samples with sufficiently large amounts of DLLP (*BigBath* = 1) are likely the forced CEOs. In our sample, among the 79 POB turnovers, 38 cases, which are all forced CEO turnovers, fulfil the requirement of the ‘big’ bath defined in Equation (3). Alternatively, the turnover samples that generate small amounts of DLLP (*BigBath* = 0) are possibly voluntary CEO and GOB turnovers.

Table 7 shows the results of the logistic regression using the POB turnover events and one standard deviation for the concept of ‘big’. Again, we redefine the big bath for DLLP and *ChargeOff*. Moreover, we create a new interaction term $D_{TURNOVER} \times D_{FORCE}$, which is equal to 1 for forced turnovers or 0 for voluntary and GOB turnovers. The coefficient of this new interaction term is significant at the 10 per cent level for DLLP and *ChargeOff* regressions. Thus, forced CEO turnovers indeed generate a big bath.

Table 7. Robust Testing: Big Bath in Earnings and Asset Quality: Logistic Regression		
Variables	Big Bath in DLLP	Big Bath in Charge-off
	DLLP = 1, if $DLLP > \mu_{DLLP} + k \times \sigma_{DLLP}$ (k = 1)	ChargeOff = 1, if $Chargeoff > \mu_{charge-off} + k \times \sigma_{charge-off}$ (k = 1)
Constant	−4.41 (−14.91)***	−9.05 (−17.08)***
$D_{TURNOVER}$	0.09 (1.42)	1.41 (1.06)

Variables	Big Bath in DLLP	Big Bath in Charge-off
	$DLLP = 1, \text{ if } DLLP > \mu_{\sigma} + k \times \sigma \quad (k = 1)$	$ChargeOff = 1, \text{ if } Chargeoff > \mu_{\sigma} + k \times \sigma \quad (k = 1)$
$D_{TURNOVER} \times D_{FORCE}$	1.35 (1.91)**	0.99 (1.71)*
$\Delta LOANS$	−0.05 (−1.16)	−0.37 (−1.25)
NCO	0.22 (1.73)*	—
NPL	1.04 (1.68)*	0.06 (1.53)
ΔNPL	−0.65 (−1.27)	0.17 (1.01)
LLR	2.45 (1.39)	−2.19 (−1.55)
Adj- R^2	0.1975	0.1212
Sample variables	190 (= 38 events # 5 years)	190

Source: The authors.

Notes: 1. μ_{DLLP} : the 5-year average of DLLP ($t = -2$ to 2); DLLP and charge-off are scaled by total assets.

2. The explained variables are the same as those used in [Table 5](#).

3. t -values are reported in parentheses. *, ** and *** are significant at the 10%, 5%, and 1% levels, respectively.

4. The bold characters show the coefficients of variables that we focus on.

6.4.2 Big Bath in First Year

Choi, Kwak, and Choe ([2014](#)) demonstrated that a big bath in earnings is often observed in the first year of CEO appointment (also see [Dechow & Sloan, 1991](#); [Murphy & Zimmerman, 1993](#); [Pourciau, 1993](#); [Reitenga & Tearney, 2003](#)). Thus, we reset our dummy variable $D_{TURNOVER}$ to 1 in $t = 0$ and 0 in $t = -1$. [Table 8](#) presents the estimated results, which still support the aforementioned findings. The forced private CEO turnovers significantly create a big bath via LLP/TA, but CEO turnovers of GOB do not. However, $ChargeOff/TA$ is insignificant and is not reported in this study.

Table 8. Robustness Testing: Earnings Bath (Turnover Event = 1 year)

Sample Group (Independent Variables)	Whole Sample (POB + GOB)		POB			GOB
			All POB	Forced	Voluntary	
Constant	4.675 (5.75)***	1.35 (4.93)***	−2.25 (−3.11)***	4.36 (1.69)*	1.17 (1.87)**	−3.30 (−4.75)***
D_{TURNOVER}	0.89 (1.16)		−1.25 (−1.43)	1.40 (2.34)***	0.75 (1.68)*	−0.95 (−1.26)
$D_{\text{TURNOVER}} \times D_{\text{FORCE}}$		0.61 (1.83)**				
Δ_{LOANS}	−0.97 (−1.50)	−1.13 (−1.06)	1.25 (1.71)*	1.12 (0.65)	−0.87 (−1.64)	1.75 (1.49)
NCO	1.35 (1.14)	−0.72 (−1.06)	1.12 (1.35)	1.25 (0.95)	2.39 (1.80)**	−1.64 (−1.38)
NPL	−2.67 (1.54)	0.95 (1.25)	1.64 (1.42)	−0.38 (−1.22)	0.64 (1.53)	−1.38 (−1.73)*
ΔNPL	−1.38 (−0.24)	0.68 (1.20)	2.68 (1.50)	−0.36 (−1.75)*	1.04 (0.00)	1.27 (1.36)
LLR	1.24 (1.15)	−1.17 (−1.03)	0.38 (1.39)	0.75 (1.71)*	1.11 (1.58)	−0.64 (−1.12)
Adj- R^2	0.2458	0.2575	0.2836	0.3754	0.3129	0.2850
Event obs.	151	151	79	37	42	72
Bank-year obs.	1057	1057	553	259	294	504
Control for year	YES	YES	YES	YES	YES	YES

Source: The authors.

Notes: 1. DLLP: Discretionary LLP/total assets.

2. D_{TURNOVER} : It is equal to 1 for $t = 0$ to 1 if a turnover exists and 0 for $t = -2$ to -1 . Accordingly, 151 CEO turnovers occurred across 36 banks, and among them are 72 and 79 cases for GOBs and POBs, respectively.

3. D_{FORCE} : It is equal to 1 if it is a forced CEO turnover in POB and 0 otherwise. Among them, the forced and voluntary events are 37 and 42, respectively.

4. The turnover events are identified from the articles in the press published in some of the major Taiwanese newspapers and journals, such as *Businessweek*, *Now-days* and *Wealth*. The financial ratios related the bank-specific variables for the turnover cases are taken from TEJ.

5. The sample period ranges from 2002 to 2011.

6. Standard errors are adjusted by White heteroscedasticity-consistent and cluster effects in years.

7. Year dummies are included but are not reported to save space.

8. t -values are placed in parentheses. *, ** and *** are significant at the 10%, 5%, and 1% levels, respectively.

9. The bold characters show the coefficients of variables that we focus on.

7. Conclusions

This study adds new empirical evidence to the earnings management literature by considering the big bath in earnings and asset quality. The literature typically discusses loss avoidance, earnings smoothing, and earnings aggressiveness. Few studies investigate the big bath in earnings, but fewer studies discuss the issue of asset quality in the banking sector. We argue that using LLP to examine the big bath in earnings may not fully reflect the concept of relative performance. In the banking sector, asset quality and earnings are equally important as the performance measures. Dismissed CEOs may exaggerate the quality of assets and therefore use loose standards to evaluate NPL, which can be lowered superficially. By contrast, incoming CEOs are inclined to classify all suspicious assets into NPL by using strict definitions to classify five types of bank assets. By doing so, only high-quality assets are left in the banks and all suspicious assets are classified as NPLs and will be written off soon. Thus, NPL exhibits a structural upward shift after CEO turnovers. However, a high NPL leads to tension between incoming CEOs and outsiders, such as supervisors and shareholders, because high NPL implies poor management. Thus, new CEOs will write off the bad assets with the accumulated LLP.

Our hypothesis for earnings management by incoming CEOs in banks represents a variant of the big bath hypothesis, which explains earnings management by incoming CEOs of firms. Although the compensation of a CEO, when tied with performance, motivates a big bath ([Burgstahler, Hail, & Leuz,](#)

[2006](#); [Conyon & Hec, 2012](#); [Healy, 1985](#)), we argue that managerial risk aversion may lead to earnings management in banks because of the informational opacity of bank operations. Our results contribute to the literature by stating that the big bath in earnings and asset quality in banking typically occurs when a forced CEO turnover exists in POB. However, a voluntarily appointed CEO shows a big bath in earnings but not in asset quality. The appointed CEO in GOB does not show a big bath in earnings or in asset quality. Newly appointed CEOs after M&As do not take a big bath in earnings and asset quality. Thus, H1, H2 and H3 are supported, but not H4. Future studies are proposed to consider the likelihood of the CEO turnover increasing the bank risk-taking behaviour, which is a new research direction suggested by Chen et al. ([2013](#)).

Some specific public policy recommendations arising out of our study are as follows. First, the appointed CEOs will probably engage swiftly in big bath accounting when their predecessor had a forced dismissal. In this case, the new CEO can easily blame the dismissed CEO for underperforming in the year of the CEO change and manage earnings downwards to the detriment of his predecessor. Based on the reputational and compensation concerns, CEOs expect that the compensation motivation will strengthen, and they only have a short period to prove themselves and that they should already manage earnings upwards in the first year of their tenure. Furthermore, the widely held belief is that excessive or discretionary risk-taking caused the recent financial crisis, and the compensation incentives encourage CEOs to manipulate the behaviour of earnings management ([Low, 2009](#)). Banking is intrinsically an opaque activity, and thus the design of banking CEO compensation structure should be considered the possible incentives for the bath-taking behaviour.

Second, we find evidence in favour of the ‘big bath’ hypothesis, where the incoming CEO of a private bank is more likely to bring down earnings at the beginning of his/her tenure to create enough ‘room’ for showing strong performance. Therefore, making a distinction between routine and forced CEO resignations does matter. We predict that CEOs have incentives to manage earnings upwards in the last year of the final tenure and manage earnings upwards in the first full year after their appointment as CEO. These findings may have meaningful policy implications from a regulatory perspective to continue detecting the personal risk management that may account for earnings management by incoming CEOs of private banks.

Declaration of Conflicting Interests

The authors declared no potential conflicts of interest with respect to the research, authorship and/or publication of this article.

Funding

This study has been supported by the Ministry of Science and Technology (MOST) of Taiwan (Grant Number: 99-2410-H-260 -029 -MY2). The original title of the project is as The Risk Management of Bank Loan: “*The Determinants of LLP*” & “*The Resolutions of Problem Loans*”.

Acknowledgments

The authors are grateful for the helpful comments we received at several international annual academic meetings and are also most appreciative of the extremely constructive suggestions from an anonymous referee from the journal submission.

Footnotes

1. Studies on the new incoming CEO behaviour have attracted widespread attention recently. For example, to explain the financial crisis, Chen et al. ([2013](#)) postulate that new CEOs may be more risk-taking than others.

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2. They examined the intertemporal relationship between large asset write-downs (big baths) and information asymmetry.

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3. In each accounting period, a bank lists a certain amount, known as a provision for loan losses, which is designed to reflect these potential losses as a hypothetical expense. Then, the relevant amount can be listed as an asset on the balance sheets. This loan loss reserve (LLR) ensures that the bank has adequate money on hand to cover defaults. Although contributions to a LLR are listed on a bank’s income statement, the contributions are not an actual cash expense. Instead, the contributions simply reflect the necessary adjustments to the figures to ensure that adequate money is set aside. For details, refer to the accounting of banks in the work of Rose and Hudgins ([2012](#)).

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4. However, the timing and magnitude of certain commercial loan charge-offs may involve a degree of management judgment to determine when the loan loss is considered realized and to estimate the extent of expected recoveries. Elliott, Hanna and Shaw ([1991](#)) show that three issues, namely, timing, measurement and disclosure, are also relevant in the accounting for write-offs.

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5. For details of the Citicorp case, see Madura and McDaniel ([1989](#)), Griffin and Wallach ([1991](#)) and Elliott, Hanna, and Shaw ([1991](#)).

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6. Studies on loss avoidance have been conducted by Burgstahler and Dichev ([1997](#)), Bhattacharya et al. ([2003](#)), Shen and Chih ([2005](#)) and Jiang ([2008](#)); earnings smoothing can be found in the works of Kwan and O'Toole ([1997](#)), Ahmed et al. ([1999](#)), Cavallo and Majnoni ([2001](#)), Leaven and Majnoni ([2003](#)) and Kanagaretnam, Lobo, and Yang ([2004](#)); and earnings aggressiveness can be found in the works of Rangan ([1998](#)) and Ball, Kothari, and Robin ([2000](#)).

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7. In most cases, only the appointed CEOs can sign, which helps us decide the event year. However, in a few cases, the outgoing and incoming CEOs sign the annual report. Our view on these cases is that the new CEO has not gained total control yet, and therefore, the subsequent year counts as the first year when the new CEO is in control.

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8. It also means means that *DLLP* (and *ChargeOff*) is scaled is scaled by lagged one period of total assets because the scalar itself might be affected by the *DLLP* (and *ChargeOff*) activities in the year. Refer to Beatty et al. ([1995](#)), Ahmed et al. ([1999](#)) and Beatty et al. ([2002](#)) for the explanations of all variables.

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9. The 151 events that are grouped into 68 cases can be attributed to the general manager and 83 to the chairpersons.

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10. Fu-Chien Lo was appointed as the new chairman.

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11. This information is based on Taiwan’s Market Observation Post System, which records dates and reasons for the resignation of CEOs for listed firms. The names of the new and old CEOs are Pei-Hua Liang and Chao-ang Kao, respectively.

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