Advanced Science and Technology Letters
Vol.84 (Business 2015), pp.103-106
http://dx.doi.org/10.14257/astl.2015.84.21

The Impact of the Weakness of Internal Control Systems for Discretionary Allowance for Loan Losses

Soon-Mi Yu* and Hyun-Jung Kang*

*Department of Accounting, Gyeongsang National University,
504, Jinju-daero, Jinju 660-701, South Korea
E-mail: smyu@gnu.ac.kr

Abstract. In this paper, we predict that the weaker the internal control system, the easier the earnings management by savings banks. In this regard, the paper verifies whether savings banks, reporting weakness in their internal control systems, manage their earnings through their discretionary allowance for loan losses. The results show that savings banks with weak internal control systems are significantly more likely to use their discretionary allowance for loan losses. This suggests that the weaker the internal control system, the more likely the opportunistic earnings management by bank managers.

Keywords: Mutual Savings Bank, Weakness of Internal Control System, Discretionary Allowance for Loan Losses, Earnings Management

1 Introduction

Mutual savings banks provide petty loans for the working class, and they are smaller and have weaker internal control systems than commercial banks. Because their customers generally consist of various segments of the working class and small firms, the social impact of suspending mutual savings banks may exceed that of other types of banks. According to a statement in July 2014 by the Financial Supervisory Service, the large-scale restructuring of mutual savings banks now allows large lenders to take over insolvent savings banks. This paper analyzes managers' discretionary accounting decisions in Korea. More specifically, we predict that it is easier for the mutual savings banks with weak internal control systems to manage their earnings. Thus, we test whether the savings banks with weak internal control system have more opportunistic earnings management by bank managers using discretionary allowance for loan losses. Most of recent studies have generally emphasized financial institutions using allowances for loan losses for managing earnings or adjusting the capital adequacy ratio and only a few researches analyze financial institutions in terms of internal control systems. In this regard, this paper connects mutual savings banks' poor internal control system to their earnings control ability and contributes to the literature by providing further evidence of the relationship between internal control systems of mutual savings banks and their earnings management based on the provision for loan losses.

ISSN: 2287-1233 ASTL

2 Literature Review

[1] investigates how banks alter the timing and magnitude of transactions and accruals to achieve primary capital, tax, and earnings goals and hypothesize that, each year, bank managers try to minimize the combined cost of deviating from these goals as well as the cost of exercising discretion over five factors: loan-loss provisions, loan charge-offs, pension settlement transactions, miscellaneous gains and losses (e.g., gains and losses from the sale of investments or physical assets), and the issuance of new securities. Their study demonstrates that taking simultaneity into account is important for three of the five modeled choices, namely loan charge-offs, loan-loss provisions, and the decision to issue securities. [2] examine alternative underlying motives of bank manager to use loan-loss provisions (LLPs) to smooth reported income and find that for banks with good (poor) current performance and poor (good) expected future performance, managers save income for (borrow income from) the future by reducing (increasing) current income though LLPs. [3] examines opportunistic accounting decisions on LLPs by Korean banks for the 1995-2001 period and investigates whether banks with poor performance adjust their LLPs to manage earnings, and she finds that the lower the level of nondiscretionary current earnings, the less likely the bank is to pursue LLPs. Moon finds a significant positive relationship between nondiscretionary current earnings and LLPs and suggests the finding to provide support for the earnings management hypothesis, which posits that banks smooth their earnings over time. [4] examines whether mutual savings banks manage their reported earnings and BIS capital adequacy ratios by adjusting their bad-debt expenses and/or LLPs and shows that these banks are less likely to report bad-debt expenses if their profits in the current year are smaller than those of the previous year or the average. [5] examine the relationship between accruals quality and internal control by using 705 firms disclosing at least one material weakness from August 2002 to November 2005 and find such weaknesses to be generally related to poorly estimated accruals not realized as cash flow.

3 Hypothesis

If a firm has a weak internal control system, then its managers are more likely to employ intentional misstatements in financial reporting for opportunistic earnings management [6] through LLPs because they need to meet BIS requirements for mutual savings banks. In addition, weak internal control from the defective segregation of duties can lead to some asset misappropriation and distort accounting records as a result of insufficient manpower and a lack of monitoring by controlling shareholders. Eventually, that weakness in mutual savings banks' internal control can increase discretionary LLPs. This suggests a positive relationship between this weakness in internal control and earnings management and leads to this paper's null hypothesis:

H: The material weakness of the internal control system is not related to the discretionary share of the allowance account.

4 Results

Table 1 shows the main results for the regression model. Firms reporting some material weakness show a higher discretionary share of the allowance account. The coefficient of IC is 0.013 and significant at the 1% level, providing support for the hypothesis that a firm with some material weakness in its internal control system is more likely to have managers reporting false statements and that savings banks can manage their accounts by using accounting estimates such as allowances for uncollectible debt to satisfy the BIS ratio, which is demanded by financial authorities. The coefficient of ALL_{t-1} is 0.219, which indicates that the larger the initial allowance, the larger the discretionary allowance. The coefficient of NPL_t is -0.066, which indicates that an increase in NPL_t reduces the nondiscretionary allowance. The coefficient of ΔNPL_{t+1} is -0.019 at the 1% level. When a firm expects an increase in NPLs in the next period, its nondiscretionary allowance also increases. Therefore, the firm's discretionary allowance is likely to decrease in the current period. The coefficient of Size is 0.002 and significant at the 5% level. The coefficient for profits before adjustments is 0.059, which provides support for the findings of previous studies suggesting that a firm with substantial profits before adjustments is likely to show an increase in the discretionary allowance for NPLs to reduce those profits. Finally, the coefficient for the BIS capital adequacy ratio and loans is not significant.

Table 1. Regression results for the discretionary provision for loan losses and the weakness of internal control systems for financial reporting (n: 586)

Variable	Sign	Coefficient	t-statistic
Intercept		-1.193	-1.214
IC	(+)	0.013	3.44***
ALL(t-1)	(+)	0.219	10.416***
NPL	(-)	-0.066	-5.12***
△ NPL(t+1)	(-)	-0.019	-2.60***
LOAN	(+)	-0.002	0.75
SIZE	(+)	0.002	2.19**
NI	(+)	0.059	2.20**
BIS	(-)	0.001	1.15
		F-value: 15.21	Adj: 0.179

5 Conclusions

This paper assumes that earnings management may be more likely used among savings banks with weak internal control systems and verifies this assumption by considering savings banks with weak internal control systems manage their earnings through the discretionary share of the allowance account. (DALL) The results show that those savings banks reporting some material weakness in their internal control systems have significant positive (+) effects on their discretionary share of the allowance account

References

1. Beatty, A., S. L. Chamberlain, and J. Magliolo: Managing financial reports of commercial banks: The influence of taxes, regulatory capital, and earnings, Journal of Accounting Research 33(Autumn), 231-261(1995)
2. Kanagaretnam K., Lobo G.J. and Yang D.H.: Managerial Incentives for Income Smoothing Through Bank Loan Loss Provisions. Review of Quantitative Finance and Accounting, 20, 63-80(2003)
3. Moon Hyun-Ju.: Earning Management by Banks through Specific Accruals Approach. Korea Accounting Review, 29(2), 111-131(2004)
4. Park Y.-H.: Earnings management by Mutual Saving Banks Using Bad Debt Expenses and/or Loan Loss Provisions, Journal of Taxation and Accounting, 6(2), 67-85(2005)
5. Doyle J. T., Ge W. and Mcvay S.: Accruals Quality and Internal Control over Financial Reporting. The Accounting Review 82(5), 1141-1170(2007)
6. Kim J.-K., Yu, S. M. and Kim, H. J.: Internal Control weaknesses over financial Reporting and Accruals Quality. Korean Accounting Journal, 18(4), 33-64(2009)

