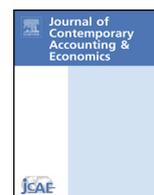


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The effect of commercial banks' internal control weaknesses on loan loss reserves and provisions

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ABSTRACT

This study examines whether the material internal control weaknesses (ICW) of commercial banks affect loan loss reserves and provisions. Bank regulators have been keen to improve the internal control procedures of banks in order to obtain accurate estimates of loan loss exposures. *GAO (1991, 1994)* reports that loan-loss reserves are often determined based on historical loss rates even for large loans, rather than individual loan impairment assessments, and the reported loan loss reserves include substantial amounts of supplemental reserves that are not linked to the loan loss exposure. We expect and find that banks with material ICW have, on average, higher loan loss reserves and provisions in years of ICW than those without ICW. We also find that ICW banks with successful remedial actions no longer have higher levels of loan loss reserves or provisions in the next year, while banks that report material ICW in both the current and following year continue to have significantly higher amounts of loan loss reserves and provisions in the next year.

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1. Introduction

The effectiveness of banks' internal control has been under the scrutiny of regulators since as early as 1991.¹ GAO reports of 1991 and 1994 document that many failed banks had inaccurate loan loss reserves and provisions due to poor internal control procedures, distorting their financial statements. Loan loss reserves are the estimated amount of the bank's loss exposure to cover uncollectible outstanding impaired loans. Loan loss provisions are an expense necessary to adjust the loan loss reserves. Loan loss reserves are the single largest component of bank accruals, and commercial bank loan portfolios are typically ten to fifteen times larger than their equity (*Altamuro and Beatty, 2010; Wahlen, 1994*). Therefore, loan loss reserves and provisions provide critical information about credit risk exposures to the clients and investors of banks. In line with regulatory attention to internal control effectiveness and its relation to loan loss reserves, we investigate whether material internal control weaknesses (ICW) are systematically associated with loan loss reserves and provisions of banks, and whether the following remedial actions affect them in the year after the material ICW report.

After a number of banks failed in the 1980s, the Federal Deposit Insurance Corporation (FDIC) passed the Federal Deposit Insurance Improvement Act (FDICIA) in 1991, requiring that the management of banks with more than \$500 million in assets evaluate the effectiveness of their internal controls processes of financial reporting and that the banks' external auditors attest to the effectiveness of the banks' internal control structure. However, banks continued to suffer from internal control problems related to corporate governance and financial reporting, and rocked the financial markets again in the early 2000s,

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¹ Bank regulators include the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), the Federal Reserve Board (FRB), and the Office of Thrift Supervision (OTS).

resulting in a significant loss of investor confidence in U.S. businesses and auditing firms.² To regain investors' trust, the Securities and Exchange Commission (SEC) enacted the Sarbanes–Oxley Act (SOX) in 2002, imposing stricter corporate governance measures on not only banks but also all other public firms with assets greater than \$75 million. In particular, Section 404 (b) of the SOX requires public firms to evaluate and report on the effectiveness of their internal control attested by independent auditors, and as a result the ICW data have become readily available. More recently, the Federal Reserve has performed a sweeping review of its bank supervision on internal control and how much loan loss reserves banks must maintain, after the 2007–2008 financial crisis (Ryan, 2014). As a result, the Dodd–Frank Wall Street Reform and Consumer Protection Act has been enacted in 2010.

Although there is a dearth of accounting studies on internal control issues and loan loss estimation among banks, Altamuro and Beatty (2010) investigate whether the internal control regulations of the FDCIA improve the validity of loan loss provisions. They compare banks affected by the FDCIA with total assets greater than \$500 million to banks unaffected by the regulation. However, it is possible that some banks with total assets greater than \$500 million do not have material ICW. Our study extends Altamuro and Beatty (2010) by comparing loan loss estimates between the banks that actually report material ICW and those with no ICW in order to understand the role of material ICW in loan loss estimation. Therefore, our study connects the current literature on ICW with the existing literature on loans loss.

One line of ICW literature focuses on the impact of ICW on the cost of capital (Ashbaugh-Skaife et al., 2009; Beneish et al., 2008; Hammersley et al., 2008; Kim et al., 2011; Ogneva et al., 2007). Ogneva et al. (2007) find no significant relationship between ICW and the cost of equity. Ashbaugh-Skaife et al. (2009), however, report that ICW increases the cost of capital and that the cost of capital significantly decreases after remedial actions for ICW. Another line of ICW literature investigates characteristics of ICW firms (Ashbaugh-Skaife et al., 2009; Chan et al., 2008; Doyle et al., 2007; Ge and McVay, 2005; Krishnan and Visvanathan, 2007).³ ICW firms tend to be younger, less profitable, and in the midst of rapid growth. They tend to have more complex operations, recent changes in organizational structure, more accounting risk exposure, fewer resources, or a lower return–earnings relationship, compared to their counterparts.

Prior studies on loan loss reserves usually focus on bank managers' incentives to use loan loss estimation. Loan loss reserves may be used in income smoothing (Ahmed et al., 1999; Kanagaretnam et al., 2003, 2004; Kilic et al., 2013). When earnings are poor, managers can draw down the allowances for loan loss to reduce loan loss provisions and, as a result, increase earnings. Chen et al. (2005) document that determinants of loan loss reserves include nonperforming loans, loan interest rates, and loan loss charge-offs. However, they do not look into the quality of the loan loss review process and the resulting ICW reports as another determinant. To investigate these aspects, we posit that banks with material ICW have lower quality internal loan loss review processes than their counterpart.

Banks have to follow the Statement of Financial Accounting Standards (SFAS) No. 114 *Accounting by Creditors for Impairment of a Loan* and the SFAS No. 5 *Accounting for Contingencies* for their loan loss estimations (Chen et al., 2005). The SFAS No. 114 requires that banks determine which loans are impaired and assess the degree of impairment according to their internal evaluation process. The SFAS No. 5 provides the fundamental recognition criteria for loan losses. Due to the diversity and subjectivity of internal loan loss evaluation methods, the reported loan loss reserves and provisions often lack reliability, tainting the transparency of financial statements of banks. In our first hypothesis, we investigate whether banks with material ICW are more likely to misrepresent loan loss reserves and provisions.

Regulators believe that banks need to use individual loan assessments especially for large impaired loans (GAO, 1994). A high quality internal control system is imperative for accurate estimation of loan loss exposure, as individual loan assessments require an in-depth understanding of loan payment history, collaterals, and other relevant information. However, banks commonly use historical loss rates to evaluate loan loss risk and often keep excessive supplemental reserves. Supplemental reserves are set aside in addition to the reserves that are estimated from the loan loss assessment, and they are used to avoid negative reserves adjustments, appease regulators, or follow historical loss rates (GAO, 1994).⁴ Unjustified supplemental reserves can be used to manage earnings and distort future loan loss estimation, resulting in more room for error and manipulation.⁵ Thus, we expect that banks with material ICW tend to misrepresent their loan loss estimates and have excessive supplement reserves. It is because they have less pressure to provide legitimate justifications of the estimates and excessive reserves.⁶ In order to test the first hypothesis, we compare loan loss reserves and provisions between banks with material ICW and banks without ICW. We construct our matching samples based on firm size and return on assets for each year. We find that banks with material ICW indeed have significantly greater amounts of loan loss reserves and provisions than the control sample. Our results remain robust even after controlling for the self-selection bias and endogeneity.

² Examples of accounting fraud in the early 2000s include the cases of Enron, Tyco and WorldCom, among others.

³ Krishnan and Visvanathan (2007) report that ICW firms have a higher number of meetings of the audit committee, fewer “financial experts” on the audit committee, more auditor changes, and a greater number of prior restatements, compared to the firms with no ICW. Chan et al. (2008) find that ICW firms under Section 404 have more positive and absolute discretionary accruals than the control firms.

⁴ Supplemental reserves range from 30% to 70% of total reported loan loss reserves (GAO, 1994).

⁵ Although banks claim that supplemental reserves are established to cover possible losses from bad loans, loan grading errors, and economic conditions, excessive supplemental reserves can also be used to distort the current risk exposure of a bank, as previously reserved amounts can absorb the impairment of loan values in the current period without increasing loan loss reserves or provisions.

⁶ Because of the periodic examinations by regulators such as the FDIC and the State Banking Authorities, banks with material ICW are less likely to lower loan loss reserves aggressively without proper justification.

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