

# A Case Study On Big Bath Earnings Management With Large Shareholder Changes With A Focus On The Setting Of Loan Loss Allowances For A Savings Bank

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## ABSTRACT

*The management performance of a bank is highly affected by bad debt the bank has written off related to loan receivables. When this happens, discretionary action regarding the setting of the allowance for loan losses is enabled, through which the big bath phenomenon often occurs. The present study investigates this big bath phenomenon. In particular, it attempts to determine whether it occurs when the allowance for loan losses is set during a specific period of time – namely the period in which large shareholders change and the new shareholder brings a capital influx. An examination was carried out through a case analysis for a savings bank. Z Savings Bank was selected, and for comparison and analysis, similar savings banks were studied. From 2002 to 2014, large shareholders at Z Savings Bank changed four times. The analysis revealed that when individual-to-individual shareholder changes took place, the big bath phenomenon did not occur. However, in two cases, one in 2011 and the other in 2014, individual-to-company shareholder changes took place. In these two cases, management performance showed high variations, and it was confirmed that the typical big bath phenomenon occurred. According to the analysis, this was due to an environmental factor that caused distressed debts to be reflected at their maximum value. This was done via an inspection process that was triggered when the capital held by the large companies – both Korean and foreign – was brought in. Specifically, the bad debt being written off and the allowances for loan losses were intentionally exposed in the accounting in order to provide transparency when the shareholder changes took place. This phenomenon occurred because the Financial Supervisory Commission reinforced the obligatory allowance-setting rate to ensure the soundness of assets.*

**Keywords:** Big Bath; Large Shareholders; Earnings Management; Bad Debt Expense; Allowance For Loan Losses

## 1. INTRODUCTION

In earnings management, a CEO typically aims to maximize management performance to garner trust from a number of key persons. This improves his/her chances of reappointment. Alternatively, when management performance is aggravated, the CEO maximizes the repayment for the distressed debt and the loan receivables to reduce the overall financial performance (Yoon and Moon, 2005; Lee and Cheon, 1999). In addition, when a management power holder wants to take over a company, he/she lowers the remaining value in order to lower the negotiated take-over price (DeAngelo, 1986). A *big bath* is an accounting technique that reflects the troubled assets in an accounting year to disclose the potential poor economic status or profit size as it is. Its effect is that whereas the current profits (losses) are highly reduced (overly reported), future profits (losses) increase (decrease) (Lee et al., 2009). When the CEO changes, the bad debt is increased centering around the accounting process for doubtful accounts written off to reduce the operating income, ordinary income, and net income. On the other hand, the bad debt is reduced during the accounting period after the CEO changes to ultimately expand the management performance (Kim et al., 2012).

The big bath phenomenon described above occurs occasionally in the financial sector and in non-monetary institutions. When large shareholders change, a similar phenomenon appears. Essentially, a company whose shareholder portion increases attempts to decrease the reported profit in the year before the share increase, and a company whose shareholder portion decreases attempts to expand the reported profits in the accounting period before the share decrease. (Yi and Park, 2006). In addition, as the shares owned by foreign large shareholders increase, the earnings management of the company is affected. Thus, it has been found that earnings management tendencies have a significant relationship with the share rates of large shareholders and the share rates of foreign shareholders (Park, 2003).

This study attempts to verify whether the same phenomenon is shown in a non-monetary institution after the change of a large shareholder. Accordingly, it looks at how the big bath phenomenon appears in a savings bank, which is a non-monetary institution. It investigates the correlation between the big bath phenomenon and a large shareholder change, or between the big bath phenomenon and the variation in large shareholder share rates, and between the big bath phenomenon and the variation in foreign shareholder share rates. Generally, the management performance of a banking business is highly affected by the amount of bad debt it has written off related to loan receivables. With respect to the bad debt expenses that occupy a significant portion of operating expenses, it is possible that the bank has a certain amount of autonomy to take voluntary action (Kim et al., 2012). Thus, this study investigates the big bath phenomenon according to large shareholder changes in a foreign savings bank, focusing on loan loss allowances. The remainder of the paper is organized as follows. Chapter 2 reviews the related literature, Chapter 3 describes big bath-related cases for Z Savings Bank, and Chapter 4 discusses the results and suggestive points based on the case analysis.

## **2. THEORETICAL BACKGROUND AND LITERATURE REVIEW**

### **2.1 Large Shareholders and Earnings Management**

Company shareholder changes can be categorized as follows: from individual to individual, from individual to Korean domestic corporate body, or from individual to foreign corporate body. When a company experiences an increase in the shares of large shareholders, the reported profits in the year before the share increase are reduced (Lee and Park, 2006). This affects the level of earnings management of the company. When the share rate of large shareholders or foreign shareholders expand, companies manage their earnings in the direction that raises earnings (Park et al., 2009). A big bath occurs when the amount of earnings in excess of the general earnings management is intentionally lowered. This causes the net income to be highly reduced or the net loss to be overly reported. Thus, for companies, earnings management types can be classified into deficit avoidance companies and big bath companies (Kim et al., 2012).

In the U.S., company ownership is typically well dispersed into many shareholders. Thus, the agent problem usually occurs between the CEO and shareholders (Jensen and Meckling, 1976). Prior studies reported that in companies where ownership and management were less dispersed and the agency problem rarely occurred, the wealth of the shareholder increased (Warfield et al., 1995; Choi and Kim, 2001). However, in other studies, the share rate of the large shareholder or owner negatively affected the value of the company. For example, Klassens et al. (1999) explained that there was a possibility that an owner would hinder the profit of the external minority shareholder by reducing the dividend for an external minority shareholder, or by transferring the wealth to another corporate body that was within the controlling range of the owner, or by seeking private profits in order to maximize the wealth of the owner. That is, as the share rate of the large shareholder gets higher, the possibility also gets higher that the agency problem occurs between the large shareholder and the external minority shareholder. Porta et al. (1999) found that in nations where there was a higher tendency for the ownership structure to be focused on minor controlling shareholders, there existed weaker legal protection for the small number of investors. He argued that the possibility was much higher that in those countries, large shareholders would behave opportunistically to lower the profits of external minority shareholders. After all, if the largest shareholder moved in this opportunistic way, it would be possible for the largest shareholder to discreetly manipulate the profit of the company to achieve his/her own personal aims (Park, 2003).

## **2.2 Foreign Shareholder and Earnings Management**

It has only been around 15 years since foreign investment started in earnest in Korea. However, as the shares of foreign shareholders gradually increased in the Korean market, the stability of the market increased (Song and Park, 1998). According to the increase of foreign shares, the following positive and negative aspects have been observed. In general, foreigner shareholders have primarily focused on long term rather than short term investments. They have emphasized intrinsic value according to investment techniques developed in advanced countries. They have participated in the management of companies they have invested in more actively to monitor the CEO. This has allowed them to restrain the CEO's intention to manage earnings opportunistically (Kim and Bae, 2006).

Accordingly, as foreign investment share rates have increased, the accounting conservatism of the company has been reinforced (Kim and Bae, 2006). However, these investors have tended to invest in companies that rarely engaged in discreet activities (An et al., 2005). Most studies have reported that foreign investment has contributed to the relief of information asymmetry in terms of accounting information (Ryu, 2008). However, recent foreign investors have shifted their focus toward short term rather than long term investments in Korean companies (Lee et al., 2012). In connection with this shift, events hindering the transparency of the company and its long term growth have emerged. This has created a side effect; long term company growth has been hindered due to the outflow of enormous funds, and the transparency of the company has not been expanded. In addition, many cases have occurred in which big baths were induced to take over Korean domestic companies at lower prices. Subsequently, either liquidated dividends were paid out within short periods of time, or companies that were taken over were sold again, followed by foreign investor withdrawal. These cases have shown that foreign investors can hinder the long term growth of Korean domestic companies.

Companies with higher profits can sell shares at higher prices. Thus, if foreign investors want to maximize earnings obtained from re-selling shares within a short term, there is a higher possibility that companies with high foreign shareholder rates will manage their earnings in a direction that promotes higher earnings. Further, with respect to new stock listings and the selling of stocks, companies will manage their earnings in a direction that increases profits in an effort to maximize the prices of stocks on sale (Teoh et al., 1998; Park et al., 2009).

As the foreign share rate increases, earnings management based on the actual activities of the company will decrease on average (Kim et al., 2012; Lee and Kang, 2004). This happens because foreign investors who desire relatively long and stable investments based on excellent information collection and analyses will work to reduce the earnings management of CEOs who try to achieve private goals by using internal information. Further, the restraint effect of this type of real earnings management is often attributable to the role of foreign large shareholders holding more than 5 % of the share rates of the relevant companies. This is because these shareholders can have greater long, actual effects on the decision-making of the company than the usual foreign minority shareholders can (Kim et al., 2012). Meanwhile, in situations where reported profits are reduced, as foreign investor share rates increase, the level of earnings management increases (Lee and Kang, 2004).

On the other hand, in cases in which a foreign shareholder is the largest shareholder of a relevant company, the company will report more profit than the actual profit by using the actual company activity. This shows that when a foreign investor acquires more than a certain share rate to play a more positive role in raising the value of the company and, as a result, becomes the largest shareholder, he/she might approve of decision-making that contradicts the value of the company (Kim et al., 2012). In addition, companies generally increase their earnings management in a direction that raises profits as the share rates of the large shareholders and foreign shareholders increase. On the contrary, with respect to moving in a direction that reduces profits, there are no differences between the share rates of large shareholders and foreign shareholders (Park et al., 2009).

## **2.3. Financial Institution Earnings Management**

The following case study explores the big bath phenomenon as it occurred during changes in large shareholders at Z Savings Bank. This case study takes into consideration a number of prior studies carried out on the big bath phenomenon during large shareholder changes as well as on earnings management for savings bank businesses.

Regarding company earnings management, studies on particular situations and strategies have been conducted from multiple angles.

Regarding prior studies on financial institution earnings management, Ma (1998) insisted on earning smoothing by using a set amount for loan loss allowances based on panel data for U.S. banks. After carrying out the related analyses, U.S. banks reported earnings smoothing via the set amount of loan loss allowances. McNichols and Wilson (1998) also looked into how banks performed earnings management via a set amount of loan loss allowances. In their study, they analyzed 10 return on asset- (ROA-) based portfolios to prove that banks performed earnings management. In doing so, they also showed that there existed a significant relationship between the discretionary factors of the set amount of loan loss allowances and the portfolio order. Choi (2003) revealed that Korean banks increased or decreased their reported profits by using loan loss allowances. Moon (2004) insisted that the discretion of the CEO had a greater effect in the recognition of bad debt expenses related to loan receivables. Moon's analysis found that when earnings before management were higher (or lower), bad debt expenses were additionally recognized at the end of the accounting period. The bad debt expenses were higher or lower than the actual case for earnings smoothing. Ultimately, it seems clear that the degree to which a company writes off doubtful accounts is related to that company's loan receivables.

Bad debt expenses in the banking sector have the most influence on financial numerical values. Kim et al., (2012) analyzed the big bath phenomenon during CEO changes based on accounting processes used to write off bad debts. They showed that in a year when a manager changed, either greater bad debt expenses were created or other costs increased such as restructuring costs. In addition, the operating income and net income decreased significantly compared to the years before and after the change. This coincided with a strong improvement in management performance in the following year. This can be interpreted as the big bath phenomenon. By studying the loan receivables and loan loss allowances for each accounting year, it was clear that when the CEO changed, compared to other similar banks, the increased width of the rate of loan loss allowances was highly significant. When the rate of allowances for bad debts increased, it was determined that there was an increased tendency for bad debt expenses.

Ji and Park (2006) studied the big bath phenomenon as it related to savings banks. They found that the manager of a mutual savings bank artificially adjusted the capital adequacy ratio for risk-weighted assets by using loan loss allowances. If the capital adequacy ratio before adjustment was lower than the numerical value reported to the Financial Supervisory Commission in the prior term, Ji and Park deemed that the manager would feel compelled to adjust the capital adequacy ratio. They then investigated whether this was carried out via loan loss allowances. They concluded that when the capital adequacy ratio before adjustments was lower than expected levels, the manager reduced the setting rate for the loan loss allowances. Thus, Ji and Park argued that Korean savings banks adjusted their loan loss allowances in order to control their capital adequacy ratios.

Overall, the present study differentiates itself from other studies in four important ways. First, whereas previous studies were conducted only in the financial sector, this study focuses on savings banks, which are non-monetary institutions. Second, it distinguishes between savings banks that experienced foreign capital influxes from cases in which savings banks were taken over via domestic capital. Third, while previous studies looked at the big bath phenomenon specifically during CEO changes, this study focuses on periods in which large shareholders are changed. Fourth, a Korean native savings bank is compared with a savings bank into which overseas capital was invested.

### **3. CASE STUDY**

#### **3.1 Case Selection Process and Current Status of Savings Bank Business**

This study selected Z Savings Bank, which was a recipient of the initial influx of Western capital investments. From around 15 years ago, foreign capital began pouring into savings banks. A greater amount of capital came from foreign sources than from large Korean companies due to the negative image that Korean companies had cultivated. If funds were raised at the low interest rates, the funds could be operated at higher interest rates in Korea. This resulted in high profits. However, Korean financial companies remained passive with respect to financial businesses for ordinary individuals because they did not want to be seen as loan sharks.

In this financial environment, once it received Western capital, Z Savings Bank compared well against companies relying on Korean capital inflows in terms of transparent sales and finance performance. With this in mind, the present authors have attempted to explore the big bath phenomenon in the current market by comparing the two case types: (a) cases in which the financial performance of the relevant year was highly aggravated whenever a large shareholder changed, and (b) cases in which the financial performance of the next year was highly improved.

The case study focused on the years running from 2005 to 2015, though it also specifically looked at the four cases over the last decade in which large shareholders changed. First, in April 2005, a large shareholder changed from an individual to another individual. Next, in September 2010, ABC Corporation (a Korean firm) engaged in a 100 % takeover. Afterwards, in October 2013, XYZ Group, a Western capital firm, took over Z Savings Bank in Korea. Particularly in 2010 and 2013, during the processes in which capital came in from a large Korean company and large foreign company, management aggravation intensified. The present study has endeavored to consider these variations and analyze the extent to which the changes in shareholders and foreign capital inflow affected the bank's earnings management.

Savings banks attract their base by differentiating themselves from big banks and targeting local businesses and ordinary households and individuals. In Korea, these banks adhere to the rules covered by a presidential decree that was enacted on August 3<sup>rd</sup>, 1972 as a part of urgent financial measures designed to encourage stability and economic growth. This decree included laws on mutual savings and financing companies, and they were intended to allow public financial institutions to operate private financial markets. In fact, private financial markets needed restrictions; at the time, they were chaotic. Thus, the changes sought to establish sound credit order and protect traders. The primary businesses involved in this included mutual savings businesses as well as businesses that provided the installment of credit, micro credit via amortization, and bill discounting for credit union members or individuals paying in installments. The laws governing mutual savings and financing companies were amended into a mutual savings bank law in March 2001. Consequently, mutual savings and financing companies changed their firm names into mutual savings *banks* in 2002. A mutual savings bank uses an integrated account number system through a network provided by the Korea Financial Telecommunications and Clearings Institute, and its interest and lending rates are somewhat higher than those of general banks.

The government began expelling these savings banks in the first half of 2011. A primary reason for this was the issue of supervision. These banks were designed to serve as financing institutions for ordinary individuals while performing the role of a large investment bank. However, they remained at the level of financing institutions for ordinary individuals, and this put them squarely into a supervision dead zone. Subsequently, after 2011, savings banks underwent enormous restructuring. The resulting Korean financing companies were passive with respect to offering finance services for ordinary individuals for fear of being labeled loan sharks. This situation resulted in significant encroachment in the loan and savings bank market for ordinary individuals by Japanese finance capital. In particular, Japanese capital providers rapidly entered the Korean savings bank sector to take the lead in the Korean savings bank market.

### **3.2 Loan Loss Allowances and Earnings Possibilities**

When Korea complied with the Korea-Generally Accepted Accounting Principles (K-GAAP), the higher amount between the lowest savings rate (as defined by a detailed enforcement of bank supervision operations) and the experienced loss rate (based on expected losses) was added up to determine loan loss allowances.

Thus, savings banks classified the soundness of their loan receivables according to five steps –normal, problematic, fixed, doubtful of collection, and probable loss. They did this by taking into account the ability of the debtor to repay the debt and the debtor's financial transaction details during the process in which loan loss allowances were set. In this way, after a savings bank enacted this classification system for asset soundness, it added up its loan loss allowances, which were higher than the minimum savings rate, for each classification to reflect these considerations in their financial statements.

Savings banks run into problems due to lower levels of reliability and the lack of robust business models. Their competitiveness continues to worsen, and savings banks that have fallen into capital encroachment by distressed debt due to project financing (PF) through the re-assessment of assets have repeatedly experienced management aggravation. Ownership and governance structure problems have emerged, including governance structures centering on individual large shareholders with low social credit related to capital strength. In addition, governance structure is centered on large shareholders, who can be despotic. Their actions include irregular involvement in management, resulting in no clear divisions between ownership and management. For these reasons, savings banks have developed structures in which management could not easily be checked via internal controls or outside directors and auditors.

12 of 16 savings banks whose businesses were suspended in the past underwent conversions into private safes for large shareholders via illegal activities. These banks were pushed into giving high risk loans, including credit loans to individuals with low credit scores, as well as PF loans. Despite the high levels of risk, savings banks did not have sufficient risk management systems in place. Furthermore, as loan competitions between banks worsened after the Asian financial crisis in 1997, a large number of traditional customers such as small and medium sized businesses and single individuals cancelled their accounts. This weakened the overall sales base, causing banks to look for alternative solutions. They expanded their loan services and sought out new individuals and service businesses by invoking new financial liberalization measures. These measures included a reduction in the levels of capital requirement for large companies and the removal of restrictions regarding the approval of loans to businesses that were deemed risky. Ultimately, savings banks failed to develop their own unique business models due to the strong competition coming from financial institutions and the rapid changes to the financial regulation environment. Instead, they relied on deregulation, and they were operated with too much importance given to high risk, high profit assets, including real estate PF loans and real estate funds.

In terms of policy and system, deregulation was permitted in order to (a) raise the competitiveness of adequately functioning savings banks, and (b) serve as a catalyst for the restructuring of poorly performing savings banks. The plan backfired; deregulation resulted in lax morals and a forced expansion of outer forms. Moreover, although ownership was concentrated among a small number of people, savings banks provided the same level of benefit from deposit insurance as regular banks did. There were some restrictions in place. Savings banks were required to have a BIS ratio of greater than 8 %, and only 8 % of their loans could be deemed substandard and below the ratio. Deregulation on loan limits were carried out, and under the new rules, savings banks were required to maintain real estate PF loan rates at below 30 % in order to check against excessive PF loans. Nevertheless, the savings banks pursued an expansion in terms of the accumulation of allowances, and with a strong real estate market in Korea, excessive PF loans and the forced form expansion continued. In addition, financial liberalization and deregulation trends caused looser supervision for savings banks compared to that for conventional banks. As a result, lengthy grace periods were bestowed on savings banks. This prevented timely correction measures from being enacted for poorly performing savings banks. M&As occurred to stabilize the financial market, but Korea still experienced an expansion in risky financial situations.

### **3.3 Case Analysis**

The Z Group holds a vast global network providing financial services in Korea, Britain, Spain, and Ireland. The group is centered in Australia, though it has also deployed businesses in Singapore and the U.S.. The main businesses of the Z Group include lending, advisory services, and asset management. It is also continuing its expansion into European and Asian markets. As of the end of June 2015, the Z Group manages assets of around 31 trillion won, and it has earned a reputation for customer reliability due to transparent, clean management.

#### *3.3.1 Large Shareholder Change in April 2005*

In 2005, the Korean economy showed a typical economic downturn, which was caused by a high slowdown in net exports. Accordingly, the Korean economy showed somewhat lower economic growth compared to the previous year. The depression continued to hit service businesses, and industrial production growth rates dropped into single digits. Exports, the diffusion index, and other leading economic indicators continued slowing down as domestic businesses slumped. At the same time, inventories increased.

Z Savings Bank changed its large shareholder and then took charge of management on April 1, 2005. When the change occurred, no significant variations emerged in terms of accounting ratios such as bad debt expenses, loan loss allowances, or credit loss provision rates. Thus, in this case, where an individual-to-individual change of large shareholders occurred, the big bath phenomenon did not occur.

Table 1 shows financial data as of June 30, 2004, June 30, 2005, and June 30, 2006. It is clear that the big bath phenomenon did not occur. In the year of change, loan receivables increased and loan loss allowances decreased compared to the year prior. Consequently, the loan loss allowance rate and credit loss provision rate decreased from 4.08 % to 2.03 % and from 2.40 % to 0.65 %, respectively. The rate at which bad debts were written off also decreased from 18.14 % to 6.37 %. Consequently, operating income and net income increased compared to the previous year.

**Table 1.** Financial Highlights for Z Savings Bank

Classification	(Unit: million won, %)		
	2004.6.30. (Year prior)	2005.6.30. (Year of change)	2006.6.30. (Year following)
Loan receivables (a)	37,045	40,032	91,234
Allowance for loan losses (b)	1,511	813	1,432
Rate of allowance for loan losses (b/a)	4.08	2.03	1.57
Rate of provision for credit losses	2.40	0.76	0.78
Operating revenue (c)	4,907	4,787	10,003
Operating expenses	4,358	3,805	6,517
Bad debt expenses (d)	890	305	715
Rate of bad debts written off (d/c)	18.14	6.37	7.15
Operating income (loss)	549	981	3,487
Net income (loss)	609	971	2,529

**Note:** Rate of allowance for loan losses = Ending balance of allowance for loan losses / Ending balance of loan receivables

Rate of provision for credit losses = Provision for credit losses / Ending balance of loan receivables

Rate of bad debts written off = Bad debt expenses / Operating revenue

### 3.3.1.1 Comparison with Other Savings Banks

Currently, there are 79 savings banks in Korea. The present authors randomly selected two from the top eight (in terms of asset size) for comparison and analysis. Specifically, the authors were interested to see whether either of the two banks experienced a big bath in the same accounting year (2005).

As can be seen in Table 2, J Savings Bank, showed a decrease in its loan loss allowance rate from 4.92 % to 4.72 % in the year the large shareholder changed at Z Savings Bank. Decreases also occurred for the credit loss provision rate and the bad debt write-off rate from 23.58 % to 20.51 % and from 3.16 % to 2.24 %, respectively. Loan receivables were 541.6 billion won in 2006, a 17.71% increase over the year of change. Loan loss allowances were 25.7 billion won in 2006, a 18.43 % increase over the year of change. When considering the year right after the change, loan receivables increased, but loan loss allowances and bad debt expenses did not show significant variations.

In the case of K Savings Bank, in 2005, loan receivables increased 27 % over the prior year, while loan loss allowances increased 56 %. Thus, the loan loss allowance rate rose by 1.16 % from 4.91 % to 6.07 %. The credit loss provision rate and the bad debt write-off rate increased from 1.52 % to 2.08 % and from 11.12% to 18.07 %, respectively. In the year of change, operating expense increased by which operating income rapidly decreased, and finally the business performance shows net income, 2.5 billion won, which was produced by 70% reduced compared to the year right before change. The big bath phenomenon did not occur.

**Table 2.** Financial Highlights of Two Other Savings Banks

		(Unit: million won, %)		
Classification		2004.6.30. (Year prior)	2005.6.30. (Year of change)	2006.6.30. (Year following)
J Savings Bank	Loan receivables (a)	369,105	460,804	541,561
	Allowance for loan losses (b)	18,157	21,754	25,717
	Rate of allowance for loan losses (b/a)	4.92	4.72	4.75
	Rate of provision for credit losses	3.16	2.24	2.82
	Operating revenue (c)	49,526	50,397	61,772
	Operating expenses	45,640	46,910	55,488
	Bad debt expenses (d)	11,677	10,337	15,277
	Rate of bad debts written off (d/c)	23.58	20.51	24.73
	Operating income (loss)	3,886	3,487	6,284
	Net income (loss)	4,140	2,872	4,766
K Savings Bank	Loan receivables (a)	339,732	430,201	575,668
	Allowance for loan losses (b)	16,692	26,093	15,954
	Rate of allowance for loan losses (b/a)	4.91	6.07	2.77
	Rate of provision for credit losses	1.52	2.08	0.01
	Operating revenue (c)	46,288	49,435	66,594
	Operating expenses	38,470	46,814	44,882
	Bad debt expenses (d)	5,174	8,934	32
	Rate of bad debts written off (d/c)	11.12	18.07	0.05
	Operating income (loss)	7,818	2,622	21,713
	Net income (loss)	8,048	2,468	24,007

**Note:** Rate of allowance for loan losses = Ending balance of allowance for loan losses / Ending balance of loan receivables  
 Rate of provision for credit losses = Provision for credit losses / Ending balance of loan receivables  
 Rate of bad debts written off = Bad debt expenses / Operating revenue

Table 3 compares the three savings banks. In the case of Z Savings Bank, the bad debt write-off rate slightly increased. For J Savings Bank, the bad debt write-off rate maintained the same level as in the year prior, but for K Savings Bank, the rate declined steeply.

When looking at the loan loss allowance rate for Z Savings Bank, the rate during the year of change was lower than the year prior. In the year following the change, it continued to decline. The credit loss provision rate declined steeply in the year of change compared to the year prior. On the contrary, for J Savings Bank, the loan loss allowance rate did not change significantly through the three-year period. The credit loss provision rate decreased in the year of change compared to the year prior, and it increased in the year following. For K Savings Bank, when looking at the loan loss allowance rate and the credit loss provision rate, loan receivables increased due to the enhanced business performance in the year of change compared to the year prior. The bank's operating income and net income dropped steeply from the prior year.

**Table 3.** Savings Bank Comparison

		(Unit: %)		
Classification		2004.6.30. (Year prior)	2005.6.30. (Year of change)	2006.6.30. (Year following)
Rate of Bad Debt Written Off	Z Savings Bank	18.14	6.37	7.15
	J Savings Bank	23.58	20.51	24.73
	K Savings Bank	11.12	18.07	0.05
Rate of allowance for loan losses	Z Savings Bank	4.08	2.03	1.57
	J Savings Bank	4.92	4.72	4.75
	K Savings Bank	4.91	6.07	2.77
Rate of provision for credit losses	Z Savings Bank	2.40	0.76	0.78
	J Savings Bank	3.16	2.24	2.82
	K Savings Bank	1.52	2.08	0.01



*3.3.2 Large Shareholder Change in September 2010*

In 2010, the global economy was in a recovery phase. This recovery had started in the second half in 2009, and it was clearly gaining steam in the following year. Economic stimulus packages for 2010 exceeded those of 2009, and in the E.U., measures introduced in 2009 to stimulate the economy were now being fully carried out. Korea responded strongly to this trend, and at a 6.5 % growth rate, showed the most rapid recovery among all OECD nations. The national income per person exceeded 20,000 dollars, and Korea ranked 7<sup>th</sup> globally in terms of exports. Overseas media outlets and a number of international organizations pointed to Korea as textbook case in recovering from an economic crisis. In particular, in November 2010, Korea successfully hosted a G20 summit conference, enabling the country to significantly enhance its international status.

In 2011, PF rates and real estate loan rates related to savings banks increased sharply. This introduced a very real risk of a high number of bankruptcies. Early in 2011, the Financial Supervisory Commission imposed business suspensions on several savings banks. This resulted in a bank run fad across the entire savings bank sector. Savings banks became less reliable, and they lacked the capability to develop solid credit estimation systems and perform adequate credit risk management. This also limited their ability to expand their supply of services (Lee, 2012). In this situation, savings bank competitiveness was continuously aggravated. Thus, the Financial Supervisory Commission reinforced the role of the savings bank as the financial institution for ordinary people. They did this through policies to handle finances, and they allowed loan companies to take over savings banks. Regulations were also relaxed to pave the way for a more diversified range of businesses.

In September 2010, a Korean firm, ABC Corporation, took over 100% of the shares of Z Savings Bank. Table 4 shows the financials in the year right before the large shareholder change and in the year right after. The loan loss allowance rate during the year of changed increased by 1.51%. The credit loss provision rate was 3.52 %, a 2.34 % increase from the 1.18 % rate during the year prior. When the bad debt expense rate was compared to the operating income, there was a 3.5-fold increase from 9.43 % in 2009 to 32.99 % in 2010. This is the big bath phenomenon. Management attempted to dispose of as many distressed debts as possible during the accounting year in which a large shareholder changed. The reason for this centered on the takeover price. Essentially, management sought to minimize the remaining value of the company in order to influence the price paid by the new shareholder. Accordingly, a company that was creating a net income prior to the takeover was converted into a company with a sharply rising deficit. However, in the year following the shareholder change, the credit loss provision rate and the doubtful account write-off rate returned to the conventional values that existed prior to the shareholder change. Ultimately, although aftereffects of the big bath phenomenon persisted, the deficit began to drop dramatically. Previous studies have indicated that a change in the largest shareholder (i.e. a significant variation in the governance structure within the company occurs) has a direct influence on the earnings management of the CEO (Kim, 2010). As such, it is not surprising that the big bath phenomenon occurred for Z Savings Bank when a large shareholder changed.

**Table 4.** Financial Highlights of Z Savings Bank

Classification	(Unit: million won, %)		
	2009.6.30. (Before change)	2010.6.30. (Year of change)	2011.6.30. (After change)
Loan receivables (a)	170,426	204,107	184,286
Allowance for loan losses (b)	5,599	9,807	12,443
Rate of allowance for loan losses (b/a)	3.29	4.80	6.75
Rate of provision for credit losses	1.18	3.52	1.43
Operating revenue (c)	21,243	21,772	23,109
Operating expenses	20,119	30,366	24,817
Bad debt expenses (d)	2,005	7,182	2,632
Rate of bad debt written off (d/c)	9.43	32.99	11.39
Operating income (loss)	(1,125)	(8,594)	(1,708)
Net income (loss)	963	(8,824)	(1,455)

**Note:** Rate of allowance for loan losses = Ending balance of allowance for loan losses / Ending balance of loan receivables

Rate of provision for credit losses = Provision for credit losses / Ending balance of loan receivables

Rate of bad debts written off = Bad debt expenses/ Operating revenue

3.3.2.1 Comparison with Other Savings Banks

Table 5 shows that in the case of J Savings Bank, the loan loss allowance rate increased slightly from 3.46 % in 2009 (the year right before the shareholder changed at Z Savings Bank) to 3.86 % in 2010. The operating revenue was 160.5 billion won in 2010, a slight reduction from the 162.5 billion won posted in 2009. Thus, the bad debt write-off rate did not change significantly. Bad debt expenses in 2010 were 31.3 billion won, just shy of the 31.9 billion won listed in 2010. Accordingly, the credit loss provision rate dropped slightly from 2.84 % in 2009 to 2.51 % in 2010.

As for K Savings Bank, in the year the large shareholder changed at Z Savings Bank (2010), loan loss allowances increased by 14.1 billion won (55.1 %) over 2009. In other words the loan loss allowance rate increased 1.04 % from 2.98 % to 3.93 %, and the credit loss provision rate also rose from 0.66 % to 1.38 %.

As for operating revenue, the loan receivables that were classified as normal in 2011 compared to the prior year were partly converted into problematic, fixed and doubtful of collection. The operating income was reduced by setting a large number of bad debt expenses related to the soundness of assets. Finally, regarding these bad debt expenses, a total of 14 billion won was posted in 2010, meaning that 8.1 billion won (137.28 %) added to the 5.9 billion won posted in 2009. The bad debt write-off rate increased 7.79 % from 4.62 % in 2009 to 12.41 % in 2010. Thus, the operating revenue was also 14 billion won, a 14.2 billion won reduction over the prior year.

Table 5. Financial Highlights of Two Other Savings Banks

		(Unit: million won, %)		
Classification		2009.6.30. (Before change)	2010.6.30. (Year of change)	2011.6.30. (After change)
J Savings Bank	Loan receivables (a)	1,123,547	1,244,380	1,347,812
	Allowance for loan losses (b)	38,871	48,076	50,046
	Rate of allowance for loan losses (b/a)	3.46	3.86	3.71
	Rate of provision for credit losses	2.84	2.51	1.92
	Operating revenue (c)	885,414	1,010,457	1,053,595
	Operating expenses			
	Bad debt expenses (d)	25,569	39,680	43,809
	Rate of bad debts written off (d/c)			
	Operating income (loss)	2.89	3.93	4.16
	Net income (loss)	0.66	1.38	0.56
K Savings Bank	Loan receivables (a)	2010.6.30	2011.6.30	2012.6.30
	Allowance for loan losses (b)	162,528	160,521	163,139
	Rate of allowance for loan losses (b/a)	144,010	149,496	149,698
	Rate of provision for credit losses	31,927	31,289	25,879
	Operating revenue (c)	19.64	19.49	15.86
	Operating expenses	18,518	11,026	13,441
	Bad debt expenses (d)	127,073	112,804	119,144
	Rate of bad debts written off (d/c)	99,041	97,971	99,270
	Operating income (loss)	5,876	14,001	5,336
	Net income (loss)	4.62	12.41	4.48

Note: Rate of allowance for loan losses = Ending balance of allowance for loan losses / Ending balance of loan receivables  
 Rate of provision for credit losses = Provision for credit losses / Ending balance of loan receivables  
 Rate of bad debts written off = Bad debt expenses / Operating revenue

Table 6 summarizes the comparison of the three banks. In the case of Z Savings Bank, the bad debt write-off rate in the year the large shareholder changed (2010) was 32.99 %. This marked a 23.56 % increase over the 9.43 % listed in 2009. However, in 2011, it decreased by a third. The credit loss provision rate was 3.52%, a 2.34 % increase over the 1.18 % posted in 2009. In 2011, it dropped to 1.43 %. When compared to Z Savings Bank, large financial changes were not observed in the two other banks for the same period.

In terms of the accumulation of preemptive loan loss allowances – a measure taken to protect against overall economic regression and a real estate slowdown – the rate of allowances for doubtful accounts actually increased. This shows that burdens were being incurred with respect to the economic status of the savings bank and its efforts to set allowances for distressed debts. Meanwhile, the loan loss allowances could be set as high as possible within the accounting period in which the deficit was created. Subsequently, in the following year, a big bath could be used to obtain reliability from the persons concerned. In fact, this phenomenon is common. Companies in this situation will attempt to dispose of a deficit with an accounting year, and then, in the following year, all expectations will be for a significant improvement in management performance. Overall, such efforts are channeled through loan loss allowances since the big bath phenomenon bases itself on obtaining a high level of management reliability from the persons concerned.

**Table 6.** Savings Bank Comparison

(Unit: %)

Classification		2009.6.30. (Year prior)	2010.6.30. (Year of change)	2011.6.30. (Year following)
Rate of Bad Debt Written Off	Z Savings Bank	9.43	32.99	11.39
	J Savings Bank	19.64	19.49	15.86
	K Savings Bank	4.62	12.41	4.48
Rate of allowance for loan losses	Z Savings Bank	3.29	4.80	6.75
	J Savings Bank	3.46	3.86	3.71
	K Savings Bank	2.89	3.93	4.16
Rate of provision for credit losses	Z Savings Bank	1.18	3.52	1.43
	J Savings Bank	2.84	2.51	1.92
	K Savings Bank	0.66	1.38	0.56

*3.3.3 Large Shareholder Change in October 2013*

In 2014, the Korean economy continued its gradual recovery centering on domestic consumption. This was in large part due to expansionary macroeconomic policies despite overseas difficulties, including the weak recovery of the global economy. The annual growth rate was recorded as 3.3 %, so the growth trend had expanded over the previous year. In particular, the contribution to growth provided by domestic consumption saw significant expansion (1.5 % to 2.8 %). Consumer prices rose 1.3 % for the year, an identical increase to that of the previous year. This was due to the stability of influential supply factors such as the stability of farm product prices according to the good weather and the decline of international oil prices. Due to the recovery of domestic consumption, income rose by 1.9 %, although exports received an even higher boost (2.3 %). Accordingly, the current account surplus was 89.22 billion dollars, the highest surplus ever recorded. Foreign exchange holdings were recorded at 363.3 billion dollars, a 17.1 billion dollar increase over the year prior.

In October 2013, Z Savings Bank was taken over by XYZ Group, a foreign mortgage company that not only dealt with renting equipment and vehicles, but also with consumption finance and mortgages for houses and commerce. XYZ Group was also a large issuer of large subprime residential mortgage back securities (RMBSes). [Table 7] shows the financials in the year right before the large shareholder changed (2013) and in the following year. In 2013, due a large improvement in sales, the loan loss allowance rate was 11.46 %, a 3.04 % increase over the 8.42 % posted in the first half of the year. The credit loss provision rate also saw a large increase from 0.17 % in 2012 to 4.93 % in 2013. Operating revenue in 2013 was 18.5 billion won, a 16.34 % increase over the 15.9 billion won the year prior. However, when the shareholder changed in 2013, bad debt expenses added up to 7.3 billion won, a 7.1 billion won increase over the 160 million won posted in 2012. This means that the typical big bath phenomenon appeared.

Finally, when the operating loss was created in the first half of the year, the operating deficit was highly expanded. This deficit continued right through to the year after the change.

In general, when faced with a takeover, companies set their maximum bad debt write-offs and maximum loan loss allowances based on their indirect liability and distressed debts. This is because when companies decide on the value

of a takeover, they are very sensitive regarding their net asset value. This value is produced by subtracting total debts from total assets. This means that during a merger process or during an actual inspection process prior to the shareholder change, the company is able to remove a sufficient amount of distressed debts. This is how the big bath phenomenon can come about via the setting of loan loss allowances.

This implies that bad debt write-offs and loan loss allowances are reflected as much as possible in the accounting in order to provide transparency in the year of a large shareholder change. This happens primarily because the Financial Supervisory Commission also reinforced an obligatory rate at which allowances are set in order to protect the soundness of assets. After a large shareholder changes, the large shareholder sometimes reduces the earnings management of the CEO by strengthening the monitoring of and efficient controlling of the decision-making of the CEO (Kim, 2010).

**Table 7.** Financial Highlights of Z Savings Bank

Classification	(Unit: million won, %)		
	2012.6.30. (Year prior)	2013.6.30. (Year of change)	2014.6.30. (Year following)
Loan receivables (a)	98,508	148,762	313,492
Allowance for loan losses (b)	8,294	17,045	7,019
Rate of allowance for loan losses (b/a)	8.42	11.46	2.24
Rate of provision for credit losses	0.17	4.93	1.89
Operating revenue (c)	15,948	18,552	29,894
Operating expenses	17,520	31,436	39,096
Bad debt expenses (d)	164	7,329	5,919
Rate of bad debts written off (d/c)	1.03	39.51	19.79
Operating income (loss)	(1,572)	(12,884)	(9,203)
Net income (loss)	(2,233)	(12,379)	(8,701)

**Note:**

Rate of allowance for loan losses = Ending balance of allowance for loan losses / Ending balance of loan receivables

Rate of provision for credit losses= Provision for credit losses / Ending balance of loan receivables

Rate of bad debts written off = Bad debt expenses / Operating revenue

**3.3.3.1 Comparison with Other Savings Banks**

As can be seen in [Table 8], in the case of J Savings Bank, loan loss allowances increased slightly from 4.58 % to 5.85 %, and the credit loss provision rate increased from 2.69 % from 4.01 %. The bad debt write-off rate dropped from 34.17 to 21.38 %. Accordingly, 9.8 billion won of the business deficit from the prior year was converted into a surplus for 2013. In conclusion, in the case of J Savings Bank, when comparing the year prior to the shareholder change and the year of the change, the credit loss provision rate and bad debt write-off rate both decreased.

For K Savings Bank, in the year the large shareholder changed at Z Savings Bank, loan receivables classified as fixed or doubtful of collection (in terms of their asset soundness) partly increased so that the loan loss allowance rate increased slightly from 3.54 % to 4.11 %, and the credit loss provision rate also increased slightly from 0.76 % to 1.32 %. The operating income partly declined compared to the year prior, and the bad debt write-off rate increased from 7.55 % to 13.91 % in the year of change. However, because operating expenses decreased, the operating income totaled 27.6 billion won, a 6.6 billion won jump over the year prior.

**Table 8.** Financial Highlights of Two Other Savings Banks

(Unit: million won, %)

Classification		2012.6.30. (Year prior )	2013.6.30. (Year of change )	2014.6.30. (Year following)
J Savings Bank	Loan receivables (a)	1,269,980	1,080,018	1,139,702
	Allowance for loan losses (b)	58,227	63,200	71,248
	Rate of allowance for loan losses (b/a)	4.58	5.85	6.25
	Rate of provision for credit losses	4.01	2.69	2.57
	Operating revenue (c)	148,947	131,218	123,229
	Operating expenses	162,058	121,367	99,622
	Bad debt expenses (d)	50,895	29,050	29,239
	Rate of bad debts written off (d/c)	34.17	21.38	23.73
	Operating income (loss)	(13,112)	9,851	23,607
Net income (loss)	(9,379)	7,848	17,321	
K Savings Bank	Loan receivables (a)	1,105,038	1,147,289	1,467,685
	Allowance for loan losses (b)	39,136	47,196	45,455
	Rate of allowance for loan losses (b/a)	3.54	4.11	3.10
	Rate of provision for credit losses	0.76	1.32	-
	Operating revenue (c)	111,854	108,480	123,708
	Operating expenses	90,850	80,871	80,530
	Bad debt expenses (d)	8,440	15,087	
	Rate of bad debts written off (d/c)	7.55	13.91	
	Operating income (loss)	21,004	27,609	43,179
Net income (loss)	12,304	25,658	34,766	

**Note:**

Rate of allowance for loan losses = Ending balance of allowance for loan losses / Ending balance of loan receivables

Rate of provision for credit losses= Provision for credit losses / Ending balance of loan receivables

Rate of bad debts written off = Bad debt expenses/ Operating revenue

Table 9 shows that for Z Savings Bank, the bad debt write-off rate in the year of change was 39.51%, a 38.48 % increase over the 1.03 % posted in the year prior. In the year right after change, it was 19.79 %. The credit loss provision rate was 4.93 %, a 4.76 % increase over the year prior when a 0.17 % was posted. It dropped to 1.89 % in the year after the change.

Overall, significant financial changes were not observed in the two other savings banks during the same period of time. This indicates that the big bath phenomenon occurs as a result of a change in large shareholders.

**Table 9.** Savings Bank Comparison

(Unit: %)

Classification		2012.6.30. (Year prior )	2013.6.30. (Year of change )	2014.6.30. (Year following)
Rate of Bad Debt Written Off	Z Savings Bank	1.03	39.51	19.79
	J Savings Bank	34.17	21.38	23.73
	K Savings Bank	7.55	13.91	-
Rate of allowance for loan losses	Z Savings Bank	8.4	11.46	2.24
	J Savings Bank	4.58	5.85	6.25
	K Savings Bank	3.54	4.11	3.10
Rate of provision for credit losses	Z Savings Bank	0.17	4.93	1.89
	J Savings Bank	4.01	2.69	2.57
	K Savings Bank	0.76	1.32	-

**IV. CONCLUSION**

Accounting manipulations within financial institutions are carried out in a variety of ways. Regarding the accumulation of loan loss allowances for the loan losses specifically related to loan receivables, it is highly possible

that a large shareholder or management power holder will exercise their discretionary rights. This is despite the fact that financial institutions should set their allowances for loan losses according to appropriate asset soundness classifications related to loan receivables as required by the Financial Supervisory Commission. In reality, it is very likely that management power holders will manipulate loan loss allowances for the purpose of adjusting reported profits or managing BIS capital adequacy ratios (Kang and Hwang, 2013).

Mutual savings banks are financial institutions for ordinary customers. These customers prefer mutual savings banks with high operating incomes, financial soundness, and stability. All of these characteristics can be verified via audit reports. By extension, customers will tend to avoid dealing with mutual savings banks with falling profits since they are deemed as poorly performing institutions. Therefore, the upper management within these banks will seek to enhance a positive image in multiple ways, including via the reporting of high earnings. When necessary, this can be achieved by carrying out a big bath and managing the BIS capital adequacy ratio. Manipulating loan loss allowances can be achieved discreetly, and this technique allows management to garner trust from the public.

This study analyzed this earnings management phenomenon through the bad debt expenses according to shareholder changes at Z Savings Bank, a non-monetary institution. J Savings Bank and K Savings Bank were selected for comparison. The big bath phenomenon, which occurred before and after large shareholder changes, was then analyzed by looking at the bad debt expenses and loan loss allowances.

According to the study results, when an individual-to-individual change of large shareholders occurred at Z Savings Bank, the financials were not significantly affected. However, when an individual-to-company (or individual-to-group) change of large shareholders occurred at the same bank, a strong big bath resulted. It should be noted that the individual-to-company (or individual-to-group) changes were accompanied by foreign capital inflows. The logic behind the big bath phenomenon in this case can be understood as follows. Before the savings bank receives large amounts of capital from a large Korean or foreign company, it attempts to find and reflect as many distressed debts as possible in its accounting. This is carried out using an inspection process, and it allows the bank to give the appearance of being transparent. All of this is done in the year prior to the shareholder change. However, once the new shareholder is in place, that shareholder begins monitoring and influencing the decision-making of the company. The shareholder uses this control to improve the financial aspects of the bank. In this way, the public is convinced that earnings management has been reduced. It also shows that the bank is abiding by the obligatory rate of allowance setting enforced by the Financial Supervisory Commission to protect asset soundness.

The results of this study imply the following. First, when a large individual-to-company shareholder changes, during the associated accounting period, earnings management is carried out using a big bath. Most companies want to show their financial performance on the premise of transparent management. With that in mind, companies are creating large deficits in a specific accounting period for a specific purpose. They are setting bad debt expenses and loan loss allowances to their maximum limits so that they can reflect the largest net loss possible within that accounting year.

Next, bad debt expenses and loan loss allowances are then used to conduct the desired earnings management. In particular, the financial institution sets its relevant loan loss allowances for its loan receivables by occasionally assessing the credit rating of the relevant company. When the residue value needed to determine a takeover value is calculated at the time the large shareholder changes, a sufficient amount of actual profit is reflected in the accounting. Therefore, it is seen as advantageous to utilize these bad debt expenses and loan loss allowances.

Third, in the year right after the large shareholder changes, management performance will be improved in order to garner trust from the persons concerned. The allowances were set via the bad debt rate from before the change took place, and now management will strive to achieve large improvements in financial performance. It will appear as though management has improved since the shareholders changed. When a reversal of loan loss allowances occurs, it will seem as though a great contribution has been made to the overall finances of the bank.

It should be noted that this study has certain limitations. It focused on an analysis of bad debt expenses and loan loss allowances. However, a more thorough analysis of earnings management would be useful. Such an analysis could include detailed factors such as the size of business profits, a recognition of the impairment of good will, and debt

ratios. Moreover, only three banks were compared and analyzed in the case analysis. This made it difficult to produce generalizations for the entire industry. As such, a study with a larger number of savings banks and relevant factors should be carried out in the future.

#### AUTHOR BIOGRAPHIES

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