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How does managerial opportunism affect the cost of debt financing?

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A B S T R A C T

Using managerial entrenchment and earnings management activities to proxy for managers' opportunism, this paper explores the effect of the managers' behaviour on the cost of debt financing. The study shows that low levels of managerial opportunism result in firms enjoying lower corporate bond costs and higher credit ratings. Moreover, the findings suggest that higher bond costs and lower credit ratings are generally associated with income-increasing earnings management activities.

I further investigate the impact of major changes in the regulation on the "monitoring role" of the debt market actors (i.e. bondholders and rating agencies). Taking the Sarbanes-Oxley Act adoption as major shift in the regulation in the USA, I find strong evidence that the dramatic changes required by this Act have enhanced this "monitoring role" since managerial opportunism seems to be severely punished (only) after the enactment of the Act.

1. Introduction

Despite the growing size of the corporate bond market, particularly in the U.S., only few researches have studied the impact of governance on bondholders' wealth. For example, Sengupta (1998) finds that the cost of debt is negatively affected by the quality of disclosure. Anderson et al. (2003) observe that ownership concentration in the hands of the founding family reduces the agency cost of debt. Also, Bhojraj and Sengupta (2003) explore the effect of institutional ownership and outside directors on bond ratings and yields. Their results point to lower bond costs and higher bond ratings for firms with greater institutional ownership, and a larger proportion of outside directors. Ashbaugh et al. (2006) document that credit ratings are positively affected by the quality of financial transparency and by board independence, ownership and expertise. Boubakri and Ghouma (2010) study the effect of governance on debt financing costs in a multinational sample of firms. They find strong evidence that the voting/cash-flow rights wedge and family control have a positive effect on bond yield-spreads, and a negative effect on bond ratings. Aman and Nguyen (2013) find similar findings for a sample of Japanese firms.

When they invest their money, debtholders face two major risks: the expropriation risk by major shareholders, and the opportunistic behaviour of the firm's managers. The first risk exists when the ownership structure of the firm is dominated

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by one or some controlling shareholders who hold control beyond their ownership stake. As regards the second risk, financial theory suggests that management behaviour can exacerbate the default risk of the firm. The "managerial" firm defined by Berle and Means (1932) is characterized by a separation between ownership and control. This type of firm was later analyzed by Jensen and Meckling (1976). Within this firm, managers are not perfect agents for shareholders because they may adopt a non value-maximizing behaviour. For example, they can entrench themselves by undertaking specific-investments that have a higher value only if they stay in the firm, investing in projects in which they have experience, no matter what their impact on shareholders value is, and making the firm's contracts as implicit as possible (Shleifer and Vishny, 1989). This makes managers very costly to replace. Moreover, managers can use their discretion in reporting financial information. Indeed, they may use their judgment in estimating losses from bad debts, or even in shifting expenditures and gains between periods (Kieschnik and Urcan, 2006; Chin et al., 2005).

Although this handful of studies bridges the literature on debt markets and corporate governance, there are still relevant questions that need to be addressed. For example, how do bond market actors react to an opportunistic managerial behaviour? Do they play a determinant role in designing the corporate governance, or do they act passively? Does this role, if any, interact with the legal/regulatory environment of the firm? In other words, do changes in the regulatory environment lead to changes in the role and perception of these actors?

This paper seeks to empirically highlight the potential effect of managerial opportunism on the debt financing costs for a sample of U.S. companies. The main goal is to firstly assess the perceptions of bondholders and rating analysts (the most important players in bond markets) about management misbehaviour, and secondly to investigate the impact of regulation changes on these perceptions. The assessment of the perceptions of bondholders and rating agencies reflects, among other things, whether these two market actors are aware of (and price) the risk of managerial opportunism. An affirmative answer to this question should be interpreted as an indication of effective monitoring by these actors in the firm's corporate governance. In the first part of the empirical analysis, I examine the impact of managerial opportunism on the costs and the ratings of publicly traded U.S. bonds. Unlike prior studies (namely Bharath et al., 2004, 2008; Bradley and Chen, 2011; Aman and Nguyen, 2013, etc.), I measure managerial opportunism along two dimensions; managerial entrenchment and earnings management activities. Both are a natural manifestation of a misleading conduct of managers and prior studies have shown their negative impact on firms' performance (Gompers et al., 2003; Bebchuk et al., 2009; Teoh et al., 1998a,b; DuCharme et al., 2001, 2004; Xie, 2001, among others). Using a sample of American corporate bonds issued between 1995 and 2006, I find strong evidence that firms with less entrenched managers enjoy lower corporate bond costs and higher credit ratings. As for the second dimension of managerial opportunism –i.e. earnings management activities-, I find that bondholders generally charge higher bond costs, while rating analysts assign lower ratings for firms that inflate their earnings (income-increasing earnings management). For income-decreasing earnings management activities (i.e. firms with negative abnormal accruals), I do not find a similar pattern. I interpret this finding by the fact that increasing income activities through abnormal accruals is more likely to reflect an opportunistic behaviour. Indeed, managing earnings downward, unlike income increasing activities, is more likely to take place when the firm has generated substantial profits, and generally aims to make earnings appear more stable. Moreover, it allows managers to make more reserves (profits) for the future. Inflating income, however, is more of an indication of poor current performance, and reflects an attempt by managers to camouflage it.

In the second part of the empirical analysis, I investigate the effect of changes in the legal/regulatory environment on the perceptions of bondholders and rating agencies. I particularly focus on the Sarbanes-Oxley Act (here-after SOX), considered as one of the most important business reforms since the Securities Exchange Act of 1934. I find that, after SOX, both bondholders and rating analysts become more aware of the risk of opportunistic behaviour by managers. Mainly, in the post-regulation change period (SOX), bondholders charge higher costs and rating agencies assign lower ratings to firms with more entrenched management. Furthermore, bondholders react only to income-increasing earnings management activities by rising bonds costs after the SOX passage only. As regards rating agencies, they appear to assign lower ratings for firms that inflate their abnormal accruals for both the pre- and the post-SOX periods, while they seem to "value" income-decreasing earnings management activities particularly after SOX.

The overall findings point to a two-sided story: On the one hand, debt markets (via bondholders and rating agencies) effectively act as an "external monitor" of managers. On the other hand, the SOX enactment contributes (at least partially) to the effectiveness of bond markets as monitors.

The paper contributes to the existing literature in many ways. Our findings contribute to our understanding of the role of the debt market in the economy through the study of the perceptions of its actors. Further, the results indirectly assess the effectiveness of SOX. While previous studies analyze the impact of SOX on the existence of misbehaviour activities (comparison of some patterns before and after SOX enactment), I investigate whether SOX induced changes in the perceptions of some governance actors such as bondholders and credit rating agencies. I find strong support for the effectiveness of SOX in improving the control exerted by these actors on the firm's managers.

The rest of the paper proceeds as follows. Section 2 presents the theoretical framework and develops the hypotheses. Section 3 describes the methodology used and presents some descriptive statistics. Section 4 discusses the empirical findings while section 5 concludes.