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Does high-quality auditing decrease the use of collateral? Analysis from the perspective of lenders' self-protection

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ABSTRACT

We examine the association between audit quality and the use of collateral in a sample of Chinese firms from 2005 to 2011. Using the full sample, we document a negative relationship between audit quality and the use of collateral that is consistent with lenders' interests. We also show that audit quality and collateral are regarded as alternative means of reducing debt credit risk. Our conclusions are robust after using an auditor-switching test, the Heckman two-stage model and a propensity-score matching model to address endogeneity issues. China's institutional background is also considered. First, we find that in the group of firms in which large shareholders are able to control borrowers' activities, the substitution effects between collateral and audit quality are reduced when the degree of separation between large shareholders' control and ownership is high. Second, these substitution effects are greater when the borrowers' ultimate controller is a state-owned enterprise (SOE) rather than a non-state-owned enterprise (NSOE). Third, the differences in substitution effects between NSOEs and SOEs are smaller in areas with a high market-development index. We conclude that the substitution effects are smaller in high credit risk firms than in low credit risk firms.

1. Introduction

Bank loans play an important role in borrowers' external financing. Unlike developed foreign markets, China is undergoing economic transition, as its emerging equity market emerged as recently as 1990. In addition, its public

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bond market remains undeveloped, long-term bond financing makes up only a small proportion (less than 5%) of its long-term debt. Therefore, bank loans are still vital to corporate funding in China. Chen et al. (2010) and Chen and Xiao (2012) find that despite the significant growth of China's equity market, borrowers still rely overwhelmingly on banks to satisfy their need for capital.[1] Allen et al. (2005) show that the proportion of GDP comprised by bank loans is higher in China than in other developing countries. Moreover, as important intermediaries, banks are vital to the adjustment of the allocation of capital. They provide not only capital loans, but macroeconomic regulation. Chen and Li (2011) show that the industries involved in China's 5-year support plan have preferential access to capital and exhibit better performance than industries not involved in the plan. We know that bank loans are significant not only to borrowers but to policy makers, as they make a large contribution to the development of China's economy.

Collateral, together with interest rates, debt maturity and other covenants, is widespread in debt contracts. It is used to solve the moral-hazard and adverse-selection problems caused by information asymmetry (Bester, 1985; Chan and Kanatas, 1985; Boot et al., 1991). La Porta et al. (1998) argue that collateral is central to the relationship between lenders and borrowers. Collateral requirements arise from the agency problem that afflicts financial relationships, especially with regard to debt financing. Collateral is not only an ex-ante mechanism of interest alignment but an ex-post mechanism of control allocation, used to supervise borrowers and to minimize losses when a borrower defaults on a loan repayment (Aghion and Bolton, 1992).

External auditing is a useful mechanism of both corporate governance and external supervision. High-quality auditing can improve the quality of financial information (Becker and Defond, 1998; Francis et al., 1999; Teoh and Wong, 1993; Qi, 2004; Wu and Li, 2006), increase the transparency of accounting information (Chen and Wang, 2006) and decrease a company's capital costs (Khurana and Raman, 2004; Pittman and Fortin, 2004). In addition, many empirical studies show that when making decisions, lenders consider the quality of accounting information as well as several key financial measures (Chen et al., 2010; Rao and Hu, 2005; Goncharov and Zimmerman, 2007). The quality of accounting information also affects the usefulness of a debt contract (Lu et al., 2008). As important stakeholders, lenders can use high-quality external auditing to decrease credit risk.

However, there is a trade-off between the use of collateral and the necessity of high-quality auditing. Although collateral is determined ex-ante, it may incur the costs of screening and monitoring the pledged assets, as well as disposal expenses and losses due to the sale of specialized assets (Chen et al., 2012). External audit quality may be affected by many factors, such as the purchasing of audit opinion and the collusion of auditors with borrowers, which severely depreciate external audit quality. This is not in the interests of lenders. The question arises of whether lenders use the optimal means to control credit risk when designing debt contracts?[2] We focus on collateral in this study, on the grounds that the total number of bank loans is incapable of reflecting bank-loan restrictions, as bank loans can be divided into collateral, guarantor and credit loans according to their degree of restriction.[3] We believe that the use of collateral and guarantor loans more accurately reflects our expected relationships between lenders and borrowers, leading to more reliable results. Chen (2011) uses credit loans to examine the relationship between auditor reputation and borrowers' bank loans.

[1] Chen et al. (2012) show that the capital raised from banks each year ranged from RMB 1250 to RMB 3100 billion between 2001 and 2006, whereas the capital raised from the stock market during this period was only between RMB 30 and RMB 250 billion a year. Chen and Xiao (2012) calculate that the ratios of bank loans and capital raised from the equity market to GDP, and show that the proportion constituted by bank loans is 75 times greater than that of capital raised from the equity market.

[2] We regard collateral as a debt contract issue determined ex-ante, as borrowers use their assets or properties to pledge collateral. Compared with external auditing, collateral is a better way to prevent credit risk. However, neither collateral nor external audit is free of costs, and both have some problems. The aim of our study is to examine the degree to which lenders rely on audit quality, which is reflected in the reduction of collateral.

[3] Bank loans can be divided into the following categories, according to their level of restriction: collateral loans, guarantor loans and credit loans. Collateral involves two kinds of loans, namely pledged loans and mortgage loans. A guarantor loan is a loan for which a third party has joint or guaranteed liability, if the loan defaults. Mortgage loans are bank loans secured on the borrower's property or the property of the third party. Pledge loans are secured on the borrower's or third party's movable property or rights of claim. If the borrower defaults on the loan, the lender is permitted to dispose of the pledged or mortgaged properties to cover their losses and prevent credit risk. Therefore, we believe that collateral and guarantor loans, especially collateral loans are more effective in helping lender to avoid credit risk. We use the proportion of collateral loans in our main tests, and the proportion of collateral and guarantor loans in our sensitivity tests.