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Private lenders' demand for audit

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ABSTRACT

We study clauses in private lending agreements requiring auditors to assure lenders of borrowers' compliance with financial covenants. Auditors are required under general purpose financial reporting to review covenant compliance. However, by informing lenders directly that they have no knowledge of default, auditors may increase their litigation risk. We find that auditor covenant compliance assurance clauses are significantly associated with more complex contractual adjustments to net income, the extent of reliance on accounting information in the contract, intangibility of borrowers' assets, the number of lenders and loan maturity. We provide novel evidence of the audit market enhancing efficient contracting.

1. Introduction

Accounting covenants are widely used in private lending agreements to mitigate conflicts of interest between shareholders and lenders. These covenants increase contracting efficiency by providing the basis for the optimal allocation of control rights when contracts are incomplete (Watts and Zimmerman, 1986; Roberts and Sufi, 2009a; Christensen and Nikolaev, 2012; Christensen et al., 2016).[1] Auditors are required to check borrowers' compliance with covenants in private lending agreements under GAAP. In particular, accounting and auditing standards require auditors to confirm the going concern assumption and to ensure the appropriate classification of debt as current or non-current, which entails checking covenant compliance. In addition to these standard obligations to verify compliance, however, auditors may offer a letter providing specific negative assurance directly to lenders by certifying that they have no knowledge of any default. What is unclear is whether this additional covenant compliance assurance occurs at random, or whether it can be explained by efficient

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[1] In contrast, accounting covenants are rarely used in public debt markets (e.g. Beatty et al., 2012).

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contracting. To date, the literature has been largely silent on the conditions under which lenders seek such assurance from auditors.[2] We seek to address this question in this paper.

The fact that auditors report on borrowers' covenant compliance directly to lenders may be economically important because of its effects on auditor liability. Under the GAAP regime, auditors are not liable to lenders because lenders are regarded as non-contractual third parties to standard audit arrangements. Nevertheless, auditors may become liable to third parties depending on whether auditors are aware that financial statements are to be used for particular purposes by known parties, and whether there is any conduct by the auditors linking them to third parties (Feinman, 2015). Because they require auditors to write to lenders to state they have no knowledge of any defaults on the covenants, auditor covenant compliance assurance clauses are likely to extend auditors' liability to lenders, even though there is no contract between them. This is because it will be more difficult for auditors to convince a court that they were not aware who they were reporting to and what their reports were to be used for.

We present novel descriptive evidence of auditors providing assurance to private lenders of borrowers' compliance with accounting covenants. If the standard GAAP regime is sufficient for lenders' needs, we do not expect to observe systematic associations between lenders' audit demands and borrower or loan characteristics. According to agency theory and the theory of incomplete contracting, information asymmetries and contracting efficiency should drive observed variation in lenders' demand for additional assurance. Agency theory predicts that covenants appear in debt contracts to reduce conflicts of interest between providers of equity and providers of debt (Jensen and Meckling, 1976; Smith and Warner, 1979). More recent insights based on the theory of incomplete contracting view accounting information as part of an efficient contracting regime, where financial covenants represent the contingency for the allocation of control rights (Christensen et al., 2016). We draw on these arguments and predict that lenders will demand auditor assurance of covenant compliance in an attempt to reduce agency problems and to enhance contracting efficiency. Such assurance involves reporting specifically to lenders on borrowers' compliance with the chosen set of contractual accounting definitions (Li, 2010). To test our predictions, we conduct a cross-sectional analysis of auditor covenant compliance clauses, using a large sample of private lending agreements retrieved from the SEC EDGAR archives for the period 1996 to 2012.

Around 35% of the 6,513 loan agreements in our sample are identified as containing an auditor covenant compliance assurance (CCA) clause. After adjusting for the total number of financial covenants in loan agreements, the use of CCA clauses is comparatively stable over our sample period. We do not find that the use of CCA clauses is concentrated among a few banks or industries–their use is widespread. When we explore the sources of the variation in the incidence of CCA clauses, our results are inconsistent with the idea that they are randomly distributed across private lending arrangements. In particular, in various empirical specifications, we find that private lenders' demand for independent assurance by auditors is stronger when accounting measurement rules depart more from GAAP, when agreements rely more on accounting data (either in the form of more accounting covenants or accounting-based performance pricing provisions), when borrowers have high levels of harder-to-verify intangible assets, and when there are more lenders in the loan syndicate.

The paper makes several contributions to the literature. First and foremost, it provides novel empirical evidence that in addition to their standard obligations under GAAP, auditors play a role in ameliorating information asymmetries and enhancing contracting efficiency between borrowers and lenders. In addition to the information they receive via standard general purpose financial statements, lenders also often demand direct assurance from auditors that borrowers have conformed to the negotiated measurement rules specified in the contract. These results are consistent with Li's (2010) conjecture that more extensive departures from GAAP rules involve higher monitoring costs for lenders and may help explain why debt contracts often contain comparatively few accounting ratios (Christensen et al., 2016).[3]

Our results contribute to the contracting literature by indicating that covenant compliance assurance by auditors is associated with borrower and loan characteristics. Furthermore, our findings suggest that when it is deemed optimal by contracting parties, auditor covenant compliance assurance may facilitate contracting on the basis of intangible assets that are harder to verify (Frankel et al., 2008). Our results also contribute to the agency literature by showing that the number of lenders in loan syndicates is positively associated with explicit requirements for auditor assurance of covenant compliance. This may be due to reduced monitoring effectiveness induced by large loan syndicates or because of higher renegotiation costs in the event of a misclassified covenant violation. Finally, and more broadly, our research contributes to the growing evidence on the importance and influence of private lenders as active participants in financial reporting and corporate governance mechanisms. Although several studies have examined the role of auditors in stock markets and public debt markets (e.g. Teoh and Wong, 1993; Mansi et al., 2004; Lou and Vasvari, 2013), evidence on their role in private debt markets remains scarce (Menon and Williams, 2016). This is in spite of reports that corporations raise more capital from banks than from public debt and equity markets combined (Ferreira and Matos, 2012; Nini et al., 2009; Sufi, 2007). Our findings thus contribute to the nascent literature demonstrating that banks exert influence over borrowers' corporate governance processes, even outside default states (Triantis and Daniels, 1995; Nini et al., 2012; Christensen et al., 2016).

[2] Though Watts (1977, footnote 31) and Watts and Zimmerman (1986) cite examples of private lending agreements containing clauses requiring auditors to offer assurance on covenant compliance.

[3] We do not study the magnitude of the additional costs associated with auditor CCA clauses. Identifying the costs from secondary data may be difficult for at least two reasons. First, the classification of the associated fees as audit or non-audit may be blurred in practice. Second, even though the additional audit costs may be high relative to the costs of contracting, they may be low (and thus hard to detect) relative to the fees paid for the main audit.