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The role of accruals quality in the access to bank debt

Pedro J. García-Teruel [a,*], Pedro Martínez-Solano [a,1], Juan Pedro Sánchez-Ballesta [b,2]

[a] Dep. Management and Finance, Faculty of Economics and Business, University of Murcia, Murcia, Spain
[b] Dep. Financial Economics and Accounting, Faculty of Economics and Business, University of Murcia, Spain

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ABSTRACT

This work analyses the effect of accruals quality in the access of firms to bank debt in a panel data of SME Spanish firms. The results show a positive association between accruals quality and bank debt, even when controlling for other determinants of bank debt and for possible endogeneity between bank debt and accruals quality, which suggests that higher precision of earnings reduces information asymmetries with banks and favors the access of firms to bank loans.

1. Introduction

This paper studies whether earnings of higher quality, i.e., more precise earnings with respect to cash flows, help firms to reduce information asymmetries with banks, and thus allow them access to bank debt. The role of asymmetric information in bank debt contracting is an aspect of special interest in accounting and finance literature. In the presence of this market imperfection, financial institutions face adverse selection and moral hazard problems that make the assessment of the investment projects of their borrowers and the monitoring of their opportunistic behaviors difficult. As a consequence, firms with higher information asymmetry obtain less financing from financial institutions.

This concern becomes especially important in the case of small and medium sized firms (SMEs). Given both their higher levels of asymmetric information (Berger and Udell, 1998) and their more debt-related agency conflicts (Smith and Warner, 1979) with respect to big firms, SMEs have more difficulties in accessing capital markets and obtaining financing (Titman and Wessels, 1988). In order to mitigate problems associated with their higher risk and asymmetric information, lenders demand higher returns and establish stronger contracting conditions for these firms.

Previous research has focused on the impact of asymmetric information as a determinant of bank debt from various points of view. The main findings of these studies are that bank debt is preferable to public debt when asymmetric information is present, due to the monitoring role that banks may play on the borrower (Johnson, 1997; Anderson and Makhija, 1999; Hooks, 2003; Denis and Mihov, 2003; among others); banking relationships are also valuable in obtaining bank financing, because of the information generated about the borrowers' financial prospects (Petersen and Rajan, 1994; Berger and Udell, 1995; among others); finally, firm reputation may also reduce asymmetries (Diamond, 1991). On the other hand, precision of earnings has been shown to be a factor that, by reducing the information risk faced by lenders, improves debt contracting terms, such as the cost of debt financing (Francis et al., 2005), the debt maturity structure of firms, and the likelihood of providing collateral (Bharath et al., 2008).

Based on this previous research on the debt contracting consequences of earnings quality, this study focuses on the effects of accounting information quality on access to bank debt. We argue that more precise earnings mitigate adverse selection costs by reducing information asymmetries (information risk) between the firm and the bank. As a consequence, we expect those firms with higher earnings quality to have easier access to bank loans.

In order to test our hypothesis we consider several accruals quality proxies (Dechow and Dichev, 2002; McNichols, 2002; Ball and Shivakumar, 2006) and test their effect on bank debt in a sample of Spanish SMEs. Spanish SMEs provide an excellent setting for the purpose of our study for several reasons. First, Spain has a

* Corresponding author. Tel.: +34 868887828; fax: +34 868887537.
E-mail addresses: pjteruel@um.es (P.J. García-Teruel), pmsolano@um.es (P. Martínez-Solano), juanpsb@um.es (J.P. Sánchez-Ballesta).
1 Tel.: +34 868883747; fax: +34 868887537.
2 Tel.: +34 868883807; fax: +34 868887794.

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banking oriented financial system where financial resources are channelled fundamentally by financial institutions (Schmidt and Tyrell, 1997), and where, in contrast to other European countries, the development of capital markets has been led by banks (Gallego et al., 2002). Thus, bank loans constitute almost the only source of external funds for Spanish SMEs, which, besides, present higher asymmetric information than their counterparts in the wealthier northern European countries (Mulhern, 1995). Additionally, transaction-based lending in Spain is mainly focused on financial statements because others transaction-based lending technologies that exist in the UK and the US market, such as credit scoring and asset-based lending, are not available in Spain (Carbó-Valverde et al., 2009).

Our results show a positive association between our proxies of accruals quality and bank debt, which suggests that the precision of earnings reduces information asymmetries between the firm and the bank in our institutional context. These findings provide valuable insights for managers since they suggest that by improving the quality of earnings firms can enhance their availability of debt financing. The paper is organized as follows: in the second section we present previous literature on the determinants of bank debt. The third section describes sample and data. The fourth section covers the research design. Results are discussed in the fifth section, and concluding comments end the paper.

2. Theoretical background

2.1. Asymmetric information and bank debt

The presence of asymmetric information between borrower and lender is traditionally used by the financial literature to explain why capital does not always flow to firms with profitable investment opportunities (Stiglitz and Weiss, 1981). In this situation, creditors face adverse selection and moral hazard problems when granting credit. According to previous literature, banks are more effective in monitoring borrowers than other lenders, e.g., public debtholders, due to their closer relationship with the firms (Fama, 1985; Houston and James, 1996; Blackwell and Kidwell, 1988; Diamond, 1984, 1991) and their ability to design and redesign contracts according to the characteristics of the borrower (Bharath et al., 2008). This better monitoring of borrowers aligns the interests of management and shareholders and limits moral hazard problems related to underinvestment (Myers, 1977), unprofitable investments (Hoshi et al., 1991), and asset substitution (Jensen and Meckling, 1976). Moreover, bank debt may also reduce information asymmetries with respect to public debt because bank financing signals positive information about a firm's credit quality and thus enhances the reputation of the firm (Diamond, 1991; Yosha, 1995). Actually, empirical studies focused on Anglo-Saxon markets have shown how information asymmetry influences the access of the firm to bank debt, and that firms with higher asymmetric information use more bank debt than public debt (Johnson, 1997; Anderson and Makhija, 1999; Hooks, 2003; Denis and Mihov, 2003, among others).

However, in contrast to the well developed capital markets in the US or UK, the financial system of continental European countries, and particularly Spain, is banking oriented (Schmidt and Tyrell, 1997) where most resources are channelled via banks. In fact, Spanish listed firms which are able to issue public debt rely mainly on bank debt, and public debt represents only 6.3% of all their debts (Cuñat, 1999). Accordingly, Spanish small and medium sized firms deal exclusively with financial intermediaries. In this context, the reduction of information asymmetry facilitates access to bank debt, as shown by recent studies focused on Continental countries dominated by private debt providers (De Andrés Alonso et al., 2005). Thus, we expect that in bank-based financial systems firms may improve their access to bank debt by reducing informational asymmetries.

2.2. Accruals quality and access to bank debt

Lending technologies used by financial institutions have important effects on SME credit availability. Financial statement lending is a transaction technology based on the strength of the borrower's financial statement. Banks use this accounting information in order to estimate the expected future cash flows of the borrowers, and then assess their repayment capacity (Berger and Udell, 2006). Financial statements are, therefore, an important source of information in mitigating the problems associated with borrower risk and asymmetric information: the higher the quality of this information, i.e., the more accurate the precision of earnings to capture future cash flows, the lower the information risk of the firm, because the lender can better estimate the future cash flows of the firm with which the loans will be repaid.

Previous research has verified that accruals increase the ability to predict future cash flows (Dechow, 1994) and that the reduction of information risk due to higher accruals quality influences contract terms, such as interest cost, collateral and debt maturity (Francis et al., 2005; Bharath et al., 2008). Based on the results of these papers and on the negative association between information asymmetry and bank debt in private debt contexts, we establish the hypothesis that this reduction of information risk may influence not only the contract terms of the loans but also the access of the firm to these loans.

2.3. Other determinant factors of bank debt

The literature on bank debt shows that factors such as size and age are proxies of asymmetric information and firm's reputation that influence the levels of bank debt because of the information they generate about the financial expectations of the borrowers (Diamond, 1991; Petersen and Rajan, 1994; Berger and Udell, 1995). Larger and older firms present lower levels of asymmetric information and have better reputations (Berger and Udell, 1995), so it is expected they use more public debt than companies with higher levels of asymmetric information (Denis and Mihov, 2003). However, as De Andrés Alonso et al., 2005 point out, in civil law countries most firms, even large ones, rely almost exclusively on bank-borrowed funds, so the access to these funds in these contexts is negatively associated to information asymmetry. This association should be stronger when focusing on small and medium sized enterprises since they cannot get funds through bond issue in public markets. Moreover, in the case of Spanish firms, bank loans are their only source of external finance in practice (García-Marco and Ocaña, 1999). In this situation access to bank debt depends on the adverse selection and moral hazard problems due to the asymmetric information faced by lenders. Therefore, a positive association of size and age with bank debt is expected.

Additionally, firms with higher growth opportunities are more likely to exhaust internal funds and consequently this would lead to use more debt. This suggests a positive relationship between growth opportunities and debt, as Michaelas et al. (1999) find for U.K. SMEs. Nevertheless, firms with growth opportunities may face an underinvestment problem because some of the returns of the investment go to creditors, so by reducing debt firms may avoid the agency costs of debt between shareholders and debtholders. Heyman et al. (2008) also point out that firms with growth opportunities present higher expected costs of financial distress, so they will use equity to finance their projects instead of debt. These arguments suggest a negative relationship of growth opportunities and leverage, which is consistent with previous empirical evidence for