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## Disclosures of material weaknesses by Japanese firms after the passage of the 2006 Financial Instruments and Exchange Law

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### ABSTRACT

We investigate the disclosures of material weaknesses in internal control mandated for Japanese firms under the 2006 Financial Instruments and Exchange Law. We find that the presence of a material weakness is more likely for firms that are younger, have better growth prospects, have a volatile operating environment, are financially constrained, and have weak governance structures. We examine the role of Japan's main banks in this process and find that the likelihood of a material weakness is higher for firms with stronger links with their main banks. We also show that the financial health of the main banks themselves—proxied for by the banks' BIS ratios and bad loan ratios—increases the likelihood of a material weakness in affiliated firms. This paper provides novel insights into the determinants of material weaknesses of Japanese firms since the passage of the law. Results from this study contribute to the literature on material weaknesses and relationship banking.

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### 1. Introduction

We investigate the determinants of material weaknesses in internal control over financial reporting disclosed by Japanese firms after the enactment of the Financial Instruments and Exchange Law (FIEL) that was put forth by the Financial Services Agency (FSA)<sup>1</sup> and passed by the National Diet of Japan on June 7, 2006. It took effect on September 30, 2007 and is informally referred to as “J-SOX.”<sup>2</sup> Under J-SOX provisions, executive officers of listed companies are required to evaluate their company's internal control over financial reporting. The results of the internal report are audited and certified by independent accountants and then filed with the FSA. If an internal control deficiency is present, it is classified into “material weakness” or other “deficiency” according to its impact on financial reporting. Under J-SOX, a “material weakness” is a “con-

trol deficiency that has a reasonable possibility of having a material effect on financial reporting” (FSA, 2007, p. 34). If any material weakness is identified in the company's internal control, then it must be stated in the internal audit report. To determine whether a control deficiency constitutes a material weakness, the firm's management must evaluate it based on both quantitative and qualitative aspects. Quantitatively, a weakness may be considered material if the effect of the misstatement exceeds 5% of consolidated pre-tax income (FSA, 2007).

This study relies on newly available data on the Japanese firms that have disclosed such weaknesses as a result of FIEL. Our sample is comprised of 75 firms that reported a total of 83 material weaknesses during the 2008 and 2009 fiscal years.<sup>3</sup> We investigate whether material weaknesses in internal control are associated with the strength of internal and external governance, as measured by variables related to auditors, stock ownership by the CEO, board, and foreign and institutional investors. We find that firms with weaker governance structure are more likely to report material weakness. We examine also whether material weakness is associated with a firm's size and age, complexity of operations measured by the number of business segments, short-term and long-term growth proxied for by sales growth and the market-to-book ratio, riskiness measured by equity volatility, and profitability measured by return on assets. We find that the presence of material weakness

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<sup>1</sup> The FSA's role in Japan is comparable to that of the Securities and Exchange Commission in the United States.

<sup>2</sup> FIEL came as an amendment to the Japanese Securities and Exchange Law of 1943 and was introduced as a response to a series of financial reporting misstatements and incidents of accounting fraud. As part of the FIEL, a set of mandates were established targeting reliability and transparency of corporate disclosure. The purpose of J-SOX is to restore confidence in the Japanese securities market by strengthening internal controls and requiring timely and accurate reporting of financial information. The new framework was designed to closely replicate the US Sarbanes–Oxley Act (US-SOX) of 2002, specifically Sections 302 (Corporate Responsibility for Financial Reports) and 404 (Management Assessment of Internal Controls).

<sup>3</sup> Compliance with the J-SOX requirements is effective for fiscal years commencing on or after April 1, 2008; since the fiscal year for most Japanese companies ends on March 31, the first reports appeared on March 31, 2009.

is more likely for firms that are younger, rapidly growing, have a volatile operating environment, and are financially constrained. These findings echo studies that focus on the US market, such as Doyle et al. (2007a,b) and Ashbaugh-Skaife et al. (2007).

A unique feature of the Japanese economy is the traditionally close ties of Japanese firms with a so-called “main bank,” which is typically a bank that is the primary lender to the firm. While the US is a market-driven economy, Japan is largely a bank-centered economy. Japanese firms rely more on bank debt than do firms in the US, and bond financing in Japan is becoming important only recently. In the main bank system, the bank possesses private soft information regarding the firm that is unavailable to outsiders. The main bank typically also holds the first or second largest equity position in each of the member firms. When a firm is financially distressed, the main bank is expected to intervene and provide financial assistance. The dual status of a main bank as a lender and shareholder gives it the role of a delegated monitor, thus mitigating the agency problem between the managers and the firm’s owners (Prowse, 1990). On the other hand, a number of studies on relationship banking have documented that close ties with a bank jeopardizes a firm’s profitability and growth (e.g., Weinstein and Yafeh, 1998; Agarwal and Elston, 2001; Wu and Xu, 2005; Peek and Rosengren, 2005). While the relationship with a main bank reduces the cost of financial distress in the short run, it may increase moral hazard and hurt firms in the long run (e.g., Wu and Xu, 2005). Weak firms are almost guaranteed financing by their main banks during times of distress. This means that banks may continue to provide financial assistance to firms whose financial fragility would otherwise warrant bankruptcy or restructuring—a phenomenon described as “zombie lending” by Caballero et al. (2008). Many bank lending decisions are guided by the perceived national duty of banks to support troubled firms, rather than being a result of the careful credit risk analysis performed in the US (Peek and Rosengren, 2005).

In this paper, we account for this aspect of the Japanese economy directly, by including a set of variables related to a firm’s association with its main bank into our prediction model. We measure the strength of the relation using several proxy variables, that include the ratio of loans from the main bank, fraction of equity held by the main bank, and the number of main bank officers on the firm’s board. We study how, having accounted for governance-related covariates, main bank ties help predict the probability of reporting a material weakness. We find that the firms with strong ties with main banks are more likely to report a weakness in internal controls—a result consistent with the argument that relationship banking is detrimental to a firm.

In addition to studying the role that the strength of the affiliation of a firm with its main bank plays on internal control weaknesses, we explore whether the financial strength of the main bank itself is indicative of the characteristics of the internal control environment of the borrower firm. We use the BIS ratio, bad loan ratio, and compliance with the Basel capital requirements as proxies of the bank’s solvency. Our results reveal that firms that are more likely to report a material weakness financially are affiliated with weaker main banks.

This paper offers insights into the determinants of material weaknesses in Japanese firms and the role played by the main bank system. The findings of this study provide new evidence of the adverse implications of the bank-centered corporate system on the accounting efficiency of Japanese firms. The contributions of this paper add to a growing body of literature on accounting irregularities and have wider implications for relationship banking.

The remainder of this paper is organized as follows. Section 2 reviews relevant literature on material weakness and relationship lending. Section 3 discusses relevant institutional background. Section 4 develops testable hypotheses and explains the variables used in our empirical study. Section 5 describes the data, research

methodology, and presents our empirical findings. Section 6 offers concluding remarks.

## 2. Related literature

The papers summarized in this section are related to two streams of literature. The first stream is on material weaknesses and accounting irregularities. The second stream addresses relationship banking.

### 2.1. Material weakness

Our paper is related to a growing body of literature on the material weakness of internal controls and earnings restatements. Studies in this area focus on firms in the post US-SOX period. Regulators assert that the remediation of internal control weaknesses improves reliability of financial reporting and boosts shareholder confidence (e.g., Nicolaisen, 2004, 2005; Niemeier, 2004). Doyle et al. (2007b) examine determinants of internal control deficiencies for 779 firms that disclose material weaknesses during 2002–2005. They find that these firms tend to be smaller, younger, financially weaker, more complex, growing rapidly, or undergoing restructuring. Similar findings are reported by Ashbaugh-Skaife et al. (2007).

Material internal control weaknesses are also associated with a higher cost of equity. In this stream of research, Ashbaugh-Skaife et al. (2009) compare unaudited pre-SOX Section 404 disclosures and SOX 404 audit opinions to evaluate how changes in internal control quality affect risk and the cost of equity. They document that firms with internal control weaknesses also have higher idiosyncratic risk, systematic risk, and cost of equity. In a similar study, Ogneva et al. (2007) investigate the benefits of SOX with regard to cost of equity effects but find no clear association with internal control deficiencies.

Several studies have examined whether earnings restatements result in lower credit ratings. For instance, Elbannan (2009) and Doss and Jonas (2004) find that firms restating earnings have lower credit ratings. Along the same lines, Hammersley et al. (2012) find that firms that fail to improve their internal controls after having reported a weakness and that report another similar weakness in the second consecutive year, have lower bond ratings and pay higher audit fees, among other costs.

Burns and Kedia (2006) and Efendi et al. (2007) examine whether material weaknesses are related to executive compensation for US firms. They find a positive relation of the propensity to misreport to CEO compensation and also to the stock price sensitivity of different compensation components.

### 2.2. Relationship banking

This study is closely related to a stream of literature on relationship banking. Lending generates proprietary information to the lender about the borrower (e.g., Rajan, 1992; Lummer and McConnell, 1989).<sup>4</sup> The literature is divided regarding the impact of relationship lending on firm performance.

<sup>4</sup> The literature provides a number of definitions as to what constitutes relationship banking. Ongena and Smith (2000) describe bank relationship as “the connection between a bank and customers that goes beyond the execution of simple, anonymous, financial transactions.” Boot (2000) defines it as “the provision of financial services by financial intermediary that invest in obtaining customer-specific information, that is often proprietary in nature; and that evaluates the profitability of these investments through multiple interactions with the same customer over time and across products.” Following Berger and Udell (2002), “the lender bases its decisions in substantial part on proprietary information about the firm and its owner gathered through a variety of contacts over time.” The key message is that the bank possesses and utilizes private information on the financial position and prospects of the borrower firm.

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