Journal of Banking & Finance 33 (2009) 425–434

Contents lists available at ScienceDirect

Journal of Banking & Finance

journal homepage: www.elsevier.com/locate/jbf

The role of bank monitoring in corporate governance: Evidence from borrowers' earnings management behavior

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ARTICLE INFO

Article history:
Received 14 January 2008
Accepted 30 August 2008
Available online 6 September 2008

JEL classification:
G21
G34
M41

Keywords:
Bank monitoring
Bank loans
Corporate governance
Earnings management

ABSTRACT

In this paper, we examine the corporate governance role of banks by investigating the effect of bank monitoring on the borrowers' earnings management behavior. Our analyses suggest that a borrowing firm's earnings management behavior generally decreases as the strength of bank monitoring increases. The strength of bank monitoring is measured as (1) the magnitude of a bank loan, (2) the reputation (rank) of a lead bank, (3) the length of a bank loan, and (4) the number of lenders. These results imply that bank monitoring plays an important role in the corporate governance of bank-dependent firms. We further examine other bank loan characteristics (collateral, refinancing, loan types, and loan purposes) and their effects on borrowers' earnings management behavior. Our analyses show that collateral and loan types are significantly associated with borrowers' earnings management behavior while refinancing and loan purposes have no association.

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1. Introduction

In this paper, we examine the corporate governance role of banks in the US. Specifically, we examine the effect of *bank monitoring* on a borrowing firm's earnings management behavior. A large volume of literature in financial economics explores how banks perform their unique roles and how firm-bank relationships affect a firm's business (e.g., Diamond (1984), Fama (1985), Rajan and Winton (1995) and Vesala (2007)). Despite a number of theoretical discussions on bank monitoring, however, little empirical evidence is provided about their role (Shleifer and Vishny, 1997). The main purpose of this paper is to empirically examine the effectiveness of bank monitoring by using the direct measure of a borrower's moral hazard problem (i.e., earnings management).

Banks perform governance activities such as monitoring and screening. Among these activities, monitoring is considered as one of the bank's most distinctive and important activities (Freixas and Rochet, 1997). In general, the purpose of bank monitoring is to reduce a bank's credit risk by preventing the opportunistic behavior of a borrower (*moral hazard*).[1] Moral hazard occurs after a bank loan is made due to information asymmetries between banks and firms. Diamond (1984) and Fama (1985) focus on banks' information generating abilities and show why financial intermediaries, especially banks, have advantages in performing a monitoring function. They argue that banks perform monitoring activities at lower costs because (i) banks are delegated monitors (Diamond), and (ii) banks have informational advantages (Fama).

As stated above, despite the theoretical developments, little empirical evidence exists that determines whether bank monitoring is successful. The lack of empirical evidence stems from the lack of a measurement of the borrowers' opportunistic behavior and from the lack of large sample data on bank loans and firm-bank relationships. We directly measure a firm manager's opportunistic behavior by using *earnings management* as measured by discretionary accrual models. Importantly, the degree of earnings management is directly related to the qualitative measures of credit risk, such as the integrity and competency of a business borrower's management. The close relation of earnings management measures to the qualitative measures of credit risk shows why a bank cares about a firm manager's financial reporting behavior while monitoring its borrowers. Therefore, we predict a negative relationship between a firm's earnings management and the strength of bank monitoring.

Unlike prior research on US firm-bank relationships, which focuses on small firms (e.g., Petersen and Rajan (1994) and Berger and Udell (1995)), our research focuses on all bank loan data

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[1] Credit risk is the risk that a borrower will fail to repay loans and interest as agreed. It is the most visible risk facing bank managers and one of the primary causes of bank failure.

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doi:10.1016/j.jbankfin.2008.08.013

available from the *DealScan* database during 1988–2001. These data incorporate both large and small firms. The empirical analyses are based on 1063 firms and 3260 firm-year observations. Earnings management is measured by signed discretionary accruals. The strength of bank monitoring is measured by (1) the magnitude of a bank loan, (2) the reputation (rank) of a lead bank, (3) the length of a bank loan, and (4) the number of lenders.

Consistent with the main hypotheses, the empirical results show that a borrowing firm's earnings management generally decreases as the strength of bank monitoring increases. Specifically, a firm's earnings management deceases as the magnitude of a bank loan increases and the length of a bank loan increases. In addition, earnings management is significantly lower for a firm with a bank loan from a ranked lead bank than for a firm with a bank loan from a non-ranked lead bank. However, the number of lenders is not significantly associated with a firm's earnings management. These findings indicate that bank monitoring plays an important role in the corporate governance of bank-dependent firms. This research further examines the effect of deposit relationships on the borrower's earnings management behavior, and finds no significant relationship between the overall cash amounts of borrowers and the borrowers' earnings management behavior. Finally, this research examines other bank loan characteristics such as collateral, refinancing, loan types, and loan purposes, and their relations to a firm's earnings management. The analyses show that collateral and loan types are significantly associated with a firm's earnings management behavior while refinancing and loan purposes have no association.

The findings from this study contribute to the ongoing research on the corporate governance role of banks. Our work shows that bank monitoring is effective in constraining a firm manager's opportunistic reporting behavior, implying that banks play important roles in the corporate governance system. Unlike prior studies that mostly focus on the theoretical aspects of bank monitoring, we empirically measure the strength of bank monitoring by using four characteristics related to bank debt financing and examine the effectiveness of bank monitoring by investigating the association between the four measures and a borrower's earnings management. We also contribute to the literature on bank loans. Lee and Mullineaux (2004) state that there is little research on the size and structure of commercial lending syndicates. Farinha and Santos (2002) state that the literature on the number of bank lending relationships is still in its infancy and scant. With our research, we fill such gaps by examining the various structures of a bank loan including the magnitude of a bank loan and the number of lenders. Finally, we add to the literature on earnings management. The results from this study suggest that a firm's earnings management could be reduced by carefully designing a loan contract.

This paper proceeds as follows: Section 2 discusses the related literature. Section 3 develops the main hypotheses. Sections 4 and 5 presents our research design and empirical results. Section 6 discusses deposit relationships. Section 7 examines the association between other bank loan characteristics and earnings management. Section 8 discusses the economic significance. Finally, Section 9 concludes the paper.

2. Related literature

2.1. Earnings management behavior around debt financing

Borrowers have various incentives to engage in earnings management behavior before and after debt financing. Before loans are made, they have incentives to manage earnings to increase borrowing capacity (e.g., higher loan amounts, lower interest rates, and lower contracting costs). Banks typically approve loans to borrowers based on the borrowers' financial condition and collateral (Fraser et al., 2001; Mishkin and Eakins, 2003). Therefore, the terms of debt contracts are likely to be affected by profits and losses (i.e., income) of borrowers, providing strong incentives for *ex-ante* earnings management.

After loans are made, borrowers continue to have incentives to manage earnings. One reason for *ex-post* earnings management is to avoid debt covenant violations. Debt covenant violations generally result in negative consequences to the borrowers, including increases in interest rates, requests for early debt repayment, and additional restrictions on the borrowers' activities (Beneish and Press, 1993). Therefore, firms have incentives to reduce the probability of a covenant becoming binding through financial reporting choice (Begley, 1990). Dichev and Skinner (2002) find that when debt covenants are present in private lending agreements, they are set relatively tight, providing firms with incentives to manage their earnings.

2.2. The importance of earnings management behavior in credit risk assessment process

One of the main reasons why banks perform governance activities is to reduce credit risk. The *Comptroller's Handbook* of 2001 from The Office of the Comptroller of the Currency (OCC), US Department of Treasury, specifically states that "credit risk is the primary financial risk in the banking system and exists in virtually all income-producing activities". A borrower's financial condition and the integrity of its management are particularly important in evaluating a bank's credit risk during a loan period. Therefore, a bank typically uses qualitative measures (e.g., the caliber of the borrower's management) as well as quantitative measures (e.g., earnings) in order to evaluate credit risk for outstanding bank loans. For example, the credit risk evaluation process described in the OCC's Comptroller's Handbook includes the evaluation of the competency and integrity of a business borrower's management, as well as the borrower's current and expected financial condition. In their study of internal credit risk rating systems in large US banks, Treacy and Carey (1998) show that large banks in the US use both qualitative and quantitative measures to evaluate credit risk. They find that banks examine risk factors, such as the reliability of the borrower's financial statements, the quality of its management, and the borrower's financial condition. Importantly, they find that almost all internal credit risk rating systems cite the borrower's management as an important consideration in evaluating credit risk.

The extent of earnings management is directly related to the qualitative measure of credit risk (i.e., the integrity and competency of a business borrower's management and the reliability of the borrower's financial statements). Credit risk is an increasing function of the degree of earnings management. For instance, the more borrowers manage their own earnings, the lower the quality of management becomes, thus leading to a higher level of credit risk. Likewise, the low quality of management indicates that there are high levels of moral hazard problems.

2.3. The effectiveness of bank monitoring

As stated in the previous sections, borrowing firms have incentives to manage earnings around debt financing, and the firms' earnings management is important for banks' credit risk management. Therefore, banks perform monitoring activities to provide borrowers with incentives to avoid earnings management, thereby reducing credit risk. Compared to individual lenders and other specialized agencies including auditors, banks have comparative advantages in monitoring borrowers because of their low costs of delegation, economies of scale in monitoring, abilities to access inside information, etc. The banks' superior monitoring abilities have been the subject of many academic studies. Diamond (1984) develops the

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