

Contents lists available at [ScienceDirect](#)

Journal of Contemporary Accounting & Economics

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

Finance company failure in New Zealand during 2006–2009: Predictable failures?

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ARTICLE INFO

Article history:

Received 30 August 2013

Accepted 29 September 2014

Available online 31 October 2014

Keywords:

Finance company failure

Failure prediction

New Zealand

ABSTRACT

Over 31 finance companies (non-bank deposit takers) failed in New Zealand over the 2006–2009 period. With an estimated loss of over NZ\$3 billion, there was public outcry and a parliamentary inquiry into the causes of the failures, but few have asked if this was a predictable event. We find that failed finance companies have lower capital adequacy, inferior asset quality, more loans falling due, higher earnings and lower cash flows. Furthermore, failed companies have a longer audit lag and some trustees appear to have a greater percentage of failed firms than others. Our logistic model can successfully classify failure one year before for 88.7% of companies. Our logistic model (neural network) can also correctly classify up to 87.5% (83.3%) of a holdout sample. Our results are of interest to regulators and practitioners, as we show that publicly available data could distinguish between failed and non-failed finance companies.

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1. Introduction

During 2006–2009, over 31 finance companies failed in New Zealand.¹ This large number of failures resulted in a public outcry, a parliamentary inquiry, civil actions and criminal prosecutions and convictions, as well as raising concerns over the quality of financial reports, audits and trustees (Allison, 2012). The New Zealand Parliament's [Commerce Select Committee \(2011\)](#) inquiry put losses at over NZ\$3 billion, impacting between 150,000 and 200,000 depositors (in a country where total share market capitalisation is approximately NZ\$75 billion²).

In response, this paper uses publicly available information to determine if these failures were a predictable event, despite the documented short-comings of financial disclosures and fraudulent actions that have subsequently emerged. This research is of importance to directors, regulators, auditors, financial advisers and the broader public, and directly addresses issues related to general confidence in accounting information and New Zealand capital markets.

Finance companies in New Zealand operate within a niche credit market catering to higher-risk borrowers and are typically unlisted private companies. Finance companies can be generalised as lending for consumer retail or motor vehicle purchases, property development or commercial finance. Finance companies are the most significant non-bank deposit-taking institutions in New Zealand and are a major part of the economy ([Commerce Select Committee, 2011](#)). Finance companies

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¹ Our sample includes a broad range of firms known to the public as finance companies.

² NZX market data available at <https://www.nzx.com/markets/NZSX>; retrieved 23/7/2013.

offer higher interest rates than major banks and, when combined with advertising campaigns often fronted by celebrities, can be viewed as an attractive investment by unsophisticated investors, although sometimes falsely so.

We examine 31 failed finance companies and 31 companies that did not fail over the 2005/06–2008/09 financial years with the same industry subcategories. We focus on this period due to the large number of failures and the announcement of an opt-in government guarantee scheme on 12 October 2008, with a broader extension announced on 25 August 2009. In addition, non-bank deposit takers (e.g. finance companies) became subject to further requirements in terms of risk management programmes in September 2009; credit rating requirements in March 2010; and capital adequacy, related party exposures, liquidity and governance requirements in December 2010 (Barker and Javier, 2010). Thus there was considerable change in the institutional setting in 2010 that may have altered both financial and non-financial ratios of finance companies.

We first compare differences in financial ratios based on the CAMEL (capital adequacy, asset quality, management competence, earnings and liquidity) framework used for assessing banks' overall condition. We find that failed companies have higher leverage, greater impairment expenses and more short-term assets relative to short-term liabilities. Next, we consider differences in non-financial information that can measure agency costs (agency-related variables). We find that failed finance companies are more likely to have a longer audit lag and be associated with a particular trustee company.³ There is also some evidence that failed companies make more related party lending and are younger. In terms of classification accuracy, our purely CAMEL ratio-based model can accurately categorise 80.6% of companies one year before failure, suggesting that reported financial information is useful in assessing finance companies' financial stability. Our regression analysis also finds that failed companies have higher earnings but lower cash flows, which is suggestive of some accrual management. Including agency-related information supplements CAMEL ratios by improving the classification of failure to 88.7%. We also find similar results when we perform a bootstrapping procedure on our regression analysis.

Next, we create a holdout sample by rerunning our logistic regression analysis on observations from 2005 to 2007 and then test our models predictive ability on failures in 2009. Our three main models (CAMEL, agency-related and combined) correctly classify between 79.2% and 87.5% of the pseudo holdout sample, suggesting our model is useful as an early warning signal. When we run a neural network, we also correctly classify 83.3% of the holdout sample. Furthermore, neural network results show that liquidity, measured as the proportion of short-term assets less the proportion of short-term liabilities, is the most important variable, followed by cash flows and audit lag.

We also do a variety of post-sample-period analysis. Since the end of our sample period, there have been further failures in the finance industry in New Zealand. Thus our non-failed sample is contaminated with six future (i.e. out-of-sample period) failures. Results are robust to both the inclusion and exclusion of these companies. We also find that failed finance companies that have had legal proceedings against them (either by regulators or civil proceedings) are not significantly different from other finance companies, and that our models can correctly classify these companies at similar levels of accuracy to the overall sample.

We find evidence consistent with the increase in regulatory requirements on finance companies in New Zealand (Barker and Javier, 2010). In contrast to media suggestions that some financial companies accounts were unreliable and contained errors of judgment (e.g. Dann, 2008; Parker, 2010), we find that publicly available financial information can distinguish between failed and non-failed companies one year prior to failure. This is important, as our research suggests that warning signals were available prior to the failure of these companies. Our paper is also one of the first to emphasise the importance of trustees in a supervisory role. We also add to the broader failure prediction literature by focusing on niche private deposit-taking companies.

The remainder of this paper proceeds as follows. Section 2 provides background information and develops the hypotheses. Section 3 outlines the research method, and results are discussed in Section 4. Conclusions are presented in Section 5.

2. Background and hypothesis development

2.1. New Zealand finance company sector failures

The non-bank finance sector in New Zealand grew rapidly in the decade before 2006 due to low barriers to entry and strong growth in the property market (KPMG, 2007). Property developers often used finance companies for riskier 'mezzanine' finance to fund requirements over and above their first mortgage from a major bank. As the major banks in New Zealand expanded their own lending portfolios, finance companies moved into lending to more risky clients. This included financing consumer purchases of used cars and household appliances, without rigorous internal controls to assess the ability to recoup the principal lent, let alone interest payments (Commerce Select Committee, 2011).

However, the higher risk of finance companies' loan portfolios was not clear to the general investing public (Commerce Select Committee, 2011). Finance companies only offered a minimally higher interest rate on deposits and sought to downplay any differences between themselves and the major banks. Lally and Prasad (2013) find that finance companies did not offer a high enough interest rate to compensate for greater default risk. Furthermore, finance companies aggressively marketed themselves to the general investing public using high profile celebrities. This resulted in a large number of

³ Our focus is on establishing a prediction model. The regulatory environment has also changed since our study. For these reasons, we do not name the trustees as there could be valid explanations for the differences we find.

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