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Borrowing capacity and earnings management: An analysis of private loans in private firms

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ABSTRACT

This empirical study investigates whether borrowers manage earnings to ameliorate their accounting portrait and to achieve a better borrowing capacity in the private loan market. We analyse the impact of borrowers' earnings management activity on the amount and costs of their private loans both at the time of lending (ex post earnings management) and before a lending agreement is made (ex ante earnings management). We test our hypothesis on a panel sample of 465 small and medium-sized private corporations from the debt-dependent southern EU economies of Italy, Portugal and Spain over the 2002–2012 period. Using a generalized method of moments (GMM) model to control for endogeneity, we find that the discretionary earnings management activity of borrowers favours larger loan amounts, both ex post and ex ante. By contrast, we find no impact of borrowers' earnings management activity on the costs of loans. Interestingly, we find that the relationship between earnings management and firms' borrowing capacity is not significant before the enactment of the Basel II regulation; however, in the period following its enactment, we find a positive and systematic impact of earnings management (both ex post and ex ante) on the amount of bank loans, as well as some positive impact on the costs of bank loans. Our results indicate that borrowers manage earnings to signal better quality to lenders and to ameliorate their borrowing capacities, regardless of the excessive costs of doing so. In addition, we find that the introduction of the Basel II rules likely strengthened this tendency. The findings of this research should alert bank regulators to the feasibility of an unintended economic consequence of rigid discipline with respect to bank risk taking—namely, reducing borrowers' transparency may lead to less prudent assessments of borrowers' creditworthiness.

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1. Introduction

Firms provide information through financial reporting. Borrowers reduce information asymmetry with lenders by improving their financial reporting, e.g., by using more sophisticated accounting methods (Cassar et al., 2015), to signal the superior quality of their projects (Jaffee and Russell, 1976) and to increase access to debt financing and lower interest rates (Cassar et al., 2015).

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Previous studies have reported that credit approval decisions are based on accounting information (Cassar et al., 2015; Petersen and Rajan, 1994), credit scores (Cassar et al., 2015; Petersen, 2004) and other general background data (Berger and Udell, 2006). Recently, since the enactment of the Basel II regulations on bank risk assessments, lenders have been instructed to prefer accounting information and credit scores relative to other sources of information in assessing borrowers' creditworthiness (Petersen, 2004). In a context in which accrual accounting and financial reporting are mandatory for small and medium-sized borrowers, accounting information thus assumes another important role because it primarily drives credit scores.

Although previous studies document the relevance of these sources of information in the credit approval process, none of them measures the influence of the quality of earnings on this process. This study partially fills this gap by focusing on the relationship between small and medium-sized private borrowers' creditworthiness and their earnings management activity, which is one of the measurement techniques used in investigations of the quality of earnings.

Scholars often study the incentives for discretionary earnings management in public firms. Discretionary accounting behaviour is generally justified as managers' attempts to circumvent financial market investors' negative responses to bad news. As private firms are blind to market performance, their earnings management derives from reporting incentives that differ from those in public firms, which are mainly market-related incentives. Notwithstanding the massive presence of private firms in today's economy, the literature documenting the existence and motivation of discretionary accounting in private firms remains sparse.

This study investigates whether private borrowers manage earnings to ameliorate their borrowing capacity in the private loan market. We analyse the impact of discretionary earnings management behaviour on the amount and costs of loans, and we empirically test our hypothesis on a panel sample of 465 small and medium-sized private borrowing firms in Italy, Portugal and Spain, which are southern EU economies that are based on bank loan-dependent small and medium-sized enterprises, over the 2002–2012 period, which covers the periods both before and after the 2008 enactment of the Basel II regulation on risk assessment in banks. Using a generalized method of moments (GMM) model that controls for endogeneity, we show that the positive relationship between the borrower's earnings management activity and its borrowing capacity is strengthened after the introduction of the Basel II regulation. In particular, we find that a larger loan amount is systematically associated with borrowers' earnings management activity both at the time of lending (ex post earnings management) and before the lending agreement is made (ex ante earnings management). Moreover, surprisingly, we find no or positive significant impact of earnings management behaviour on the costs of loans, which signals that the strictness of the credit crunch has led small and medium-sized business borrowers to seek larger loan amounts despite the eventuality of excessive interest rates. These findings are economically significant and robust to different testing methodologies.

The results of this paper differ from previously documented results for the US public loan market (Ahn and Choi, 2009), but they support other research (Bushman and Williams, 2012) that suggests that the enforcement of risk assessment regulations has unintended detrimental effects on lenders' earnings quality. Thus, despite the intended purpose of Basel II to mitigate bank risk taking, in times of crisis in debt-dependent countries such as Italy, Portugal, and Spain, managers of unlisted borrowing firms manage earnings to ameliorate their firm's image and to increase their firm's borrowing capacity. Such an outcome likely reflects an unintended consequence of the hard technology-based discipline of Basel II. Interestingly, the finding that earnings management has no impact on the cost rate of loans demonstrates that borrowers manage earnings to signal the firm's better quality to obtain an increase in the amount of loans and to improve their creditworthiness, regardless of the costs of doing so.

Our study's contributions to the literature are manifold. First, this study answers calls for research on the understudied topic of the unintended economic consequences of regulation (Brüggenmann et al., 2013) by discussing an unintended and detrimental consequence of the Basel II rules on risk assessment in banks on the quality of borrowers' accounting. In this way, this study joins that of Bushman and Williams (2012), who similarly document the unintended and detrimental consequences of such regulations on the quality of lenders' accounting. Second, this study shows the relevance of lending agreements as an incentive for earnings management in small and medium-sized enterprises by providing a case from the private loan market, which extends the research of Ahn and Choi (2009) in the context of the public loans of public firms. This study also adds to the work of Cassar et al. (2015), who document that small, private borrowers in the US achieve better borrowing capacity by using certain signals to reduce information asymmetry with the lender; one such information cue is the voluntary adoption of accrual accounting (which generally ameliorates the quality of accounting and serves as an indicator of accounting sophistication). In this study, we document that earnings management (which generally deteriorates the quality of accounting) can help borrowers achieve a better borrowing capacity in countries where accrual accounting is mandatory. Third, we provide evidence that earnings management activity may be costly for firms because borrowers manage earnings to obtain larger bank loans, regardless of their excessive cost. From this perspective, this study stands alongside that of Cassar et al. (2015), who find that firms that provide less sophisticated accounting information suffer from higher interest rates for bank loans. Additionally, this study supports Erickson et al.'s (2004) finding that when managers allegedly overstate their earnings, they do not manipulate their tax costs, thus rendering earnings management expensive in terms of taxation. Moreover, we answer relevant calls for further research, as both lending contracts (Dechow et al., 2010) and private corporations (Kosi and Valentincic, 2013) are potentially fruitful but under-investigated areas for examinations of earnings management. Finally, because we provide an empirical test to support several theoretical studies that predict the feasible effects of Basel II on borrowing firms, our findings may be of substantial interest to bank regulators, who should consider the feasibility of such unintended economic consequences when adopting rigid discipline in the evaluation of borrowers' creditworthiness.

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