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Accounting Quality and Loan Pricing: The Effect of Cross-country Differences in Legal Enforcement

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ABSTRACT

This study examines whether the strength of legal enforcement at the country level plays a role in the value-relevance of accounting quality for loan pricing determination, using an international sample of firms reporting under IFRS. The underlying hypothesis is that stronger vs. weaker enforcement should affect the informativeness of financial statements, due to their increased credibility, and thus results in a stronger influence of accounting quality on loan pricing, in case this information is considered more reliable by potential lenders. Evidence indicates that accounting quality is consequential for the determination of loan spread only in combination with the level of legal enforcement, and this only holds for the countries with stronger legal enforcement. This evidence indicates that financial statement quality information is value-relevant and has a significant impact on the determination of loan pricing only if this information is considered to be credible enough by loan providers in a country, and this is the case when legal enforcement is stronger.

1. Introduction

There exists significant research indicating that the quality and credibility of financial information is incorporated into the pricing of bank loans, (e.g. Bharath, Sunder, & Sunder, 2008; Costello & Wittenberg-Moerman, 2011; Graham, Li, & Qiu, 2008; Kim et al., 2011a). Accounting quality is expected to affect loan pricing by determining the easiness of the prediction of the future financial position of borrowing firms, their ability to repay their loans, or by influencing the level of information asymmetry between insiders and outsiders (Bharath et al., 2008; Graham et al., 2008). Relevant studies have used a single country setting by focusing on the US market, resulting in unavoidable endogeneity of the relevant findings. Another stream of research, at this point, has indicated that the quality and strength of institutional enforcement mechanisms across countries significantly affect loan pricing and contracting terms (Bae & Goyal, 2009; Qian & Strahan, 2007). This is because country-specific institutional factors are expected to relate to the protection of creditor property rights, as well as contract enforceability (Bae & Goyal, 2009), with strong corporate governance and legal enforcement institutions to be working in the form of correcting mechanisms for uncertainty between insiders and outsiders.

The scope of this paper is to investigate whether the strength of legal enforcement at the country level plays a role for the value-relevance of accounting quality with respect to loan pricing determination. It is expected that the strength and effectiveness of country-level legal enforcement will relatively affect the informativeness of financial statements, due to anticipated increased credibility, and, as a result, the way in which the firm-specific quality of financial statements is incorporated into loan pricing.

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Stronger vs. weaker enforcement at the country level is expected to relate to stronger influence of accounting quality (hereafter, AQ) on loan pricing, under the assumption that lenders will consider this information more reliable in order to project the future cash flows and the probability of default for borrowers. This is because AQ has been considered to be to a significant extent endogenously determined by national institutional factors, such as the strength of the legal system, or political factors that differ among countries (Ball, 2006). A vast amount of research has indeed shown the existence of systematic differences among countries with respect to the quality of corporate financial statements, attributable to differing levels of efficiency of local institutional mechanisms (Ahmed, Neel, & Wang, 2013). This research has reached the unanimous conclusion that accounting quality is generally higher in strong enforcement countries relative to weak enforcement countries (Bhattacharya, Daouk, & Welker, 2003; Burgstahler, Hail, & Leuz, 2006; Leuz, Nanda, & Wysocki, 2003). This is because the strength of legal enforcement at the country level has been shown to affect contract enforceability, and resulting private benefits and control that can be extracted by insiders, the level of protection offered to shareholders (Kanagaretnam, Lim, & Lobo, 2010; Leuz et al., 2003), and the proper use of discretion permitted by accounting rules (Burgstahler et al., 2006).

In relation to the above, as underlined by Bushman and Piotroski (2006), another stream of research has further observed significant cross-country variation in the value-relevance of accounting numbers (e.g. Ali & Hwang, 2000; Defond, Hung, & Trezevant, 2007; Francis, Khurana, & Pereira, 2003; Haw, Hu, Lee, & Wu, 2012; Hope, 2003; Land & Lang, 2002). In the absence of strong enforcement, even the highest quality accounting standards can be expected to make no difference to financial statement users, as they will not be enforced (Hope, 2003). The scope of this study is, therefore, to examine whether AQ is more (as opposed to less) value-relevant for the determination of loan pricing depending on the strength of legal enforcement and creditor protection across countries. The expectation is in favor of a stronger effect and increased value-relevance of AQ for loan pricing in case legal enforcement in a country is stronger, rather than weaker, as the strength of enforcement is assumed to have an effect on the way credit investors rely on reported accounting numbers, and this way shape the link between accounting quality and loan pricing.

According to Leuz (2010), from the moment IFRS have been widely adopted around the world, reporting standards no longer represent the main topic of interest, and there is need to shift attention towards – still pronounced – differences in the enforcement of reporting and disclosure rules. In this direction, this paper makes use of an initial international sample of firms with uniform accounting rules, from 25 European Union (EU) and non-EU countries, which had mandatorily adopted IFRS by 2005, with bank loan data available from LPC's Dealscan database. The sample period extends from 2005 to 2012, and the impact of AQ on loan pricing is examined by using loan spread as a relevant proxy. The focus on loan pricing is based on expectation that this particular loan term directly incorporates risk pricing expressed in monetary terms, while the effect of AQ on loan maturity and collateral requirements is examined in the course of robustness controls. The level of legal enforcement in a country is approximated through Kaufmann, Kraay, and Mastruzzi's (2010) index (Ahmed et al., 2013; Daske, Hail, Leuz, & Verdi, 2008; Houqe, van Zijl, Dunstan, & Waresul Karim, 2012; Wu & Zhang, 2014). In the basic model specification, AQ is defined by assessing the quality of accruals, i.e. the extent to which working capital accruals materialize and efficiently map into current, past and future cash flows (Dechow & Dichev, 2002; McNichols, 2002).

Evidence indicates that AQ negatively and significantly affects bank loan spreads, but only when taking the strength of legal enforcement in a country into account; more specifically AQ is observed to negatively and significantly affect loan spread, with the result to hold only combined with the level of enforcement, which is the case for stronger legal enforcement countries. When repeating the analysis for bank loans of similar quality, it is observed that this result on a significant and differing impact of AQ on loan pricing for stronger vs. weaker enforcement countries is mainly concentrated for non-investment grade or unrated loans, rather than investment grade ones. This result is interpreted as an indication that the effect of AQ on loan pricing is not generally significant, no matter what the strength of enforcement is, for issues which are of higher credit quality: for such issues, information asymmetries and the projection of future cash flow generation prediction and default probability should be expected to be less demanding, due to the already acceptable quality of the issues. However, in the case of non-investment grade or unrated issues, asymmetries between insiders and outsiders should be expected to be stronger, resulting in increased importance for the role of financial statement information in order to resolve these issues and derive loan pricing. Therefore, particularly in the case of these loans, it is observed that the efficiency of enforcement at the country level plays a significant role as to whether AQ is incorporated or not into loan pricing, in other words, whether borrowers consider it credible and informative enough so that it will affect pricing. This result is, therefore, not attributable to differences in the quality of debt between higher vs. lower enforcement institutional environments, and is further robust to a number of controls implemented, for example, for macroeconomic differences in the sample countries examined, the financial crisis of 2008, alternative definition of AQ, the presence of financial covenants, defining the strength of enforcement under more detailed country groupings, or excluding from the sample countries whose GDP generation ability is not accurately represented in terms of number of observations.

Finally, evidence indicates that AQ positively and significantly relates to loan maturity, but again only when taking the strength of legal enforcement in a country into account, while there is no significant differential impact of AQ observed (with and without accounting for the level of enforcement) on loan collateralization status. However, the result on the effect of AQ on loan maturity is considerably weaker in comparison to relevant results on loan spread, which is considered to be explainable taking into account that that loan spread, rather than other pricing terms, directly prices risk and translates it into monetary terms, in contrast to other loan terms forming the overall loan pricing terms and conditions 'package'.

This study focuses on the strength and quality of legal enforcement at the country level, which is expected to affect managerial incentives for producing lower vs. higher quality financial reports, by having a preventive as well as sanctioning role with respect to the misuse of such incentives (Ebner, Hottman, Teuteberg, & Zulch, 2015). The implicit assumption is that the concept of legal

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