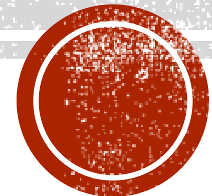
# FIN536 CORPORATE GOVERNANCE



Lecture 12 Creditors and Auditors

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# TODAY'S AGENDA

- Debt as a disciplinary mechanism
- Institutional lenders as corporate monitors
- Credit rating agencies
- International perspective
- Financial Reporting
- External Audit
- Case Study: The Satyam Scandal

# 1. DEBT AS A DISCIPLINARY MECHANISM

- The Existence of Corporate Debt
  - The existence of corporate debt creates three important corporate system monitors or devices:
    - Monitoring by institutional lenders
    - Debt, in and of itself, can be a disciplinary mechanism
    - Monitoring and debt ratings by credit agencies

# 1. DEBT AS A DISCIPLINARY MECHANISM

- Because interest payments represent obligations of the firm, debt actually imposes discipline on to the firm's management.
- Interest expense also discourages superfluous spending by management.
- Other covenants can be written into the debt contracts.
- In brief, debt potentially provides better protection to investors than equity.

# 1. DEBT AS A DISCIPLINARY MECHANISM

- Financial Covenants and Creditor's Rights
  - Contingent control by creditor

- Financial covenant (96.5%)
  - Coverage ratio (74.3%)
  - Debt to cash flow (57.5%)
  - Net worth/Tangible net worth (45.2%)
  - Liquidity-based (14.7%)
    - Current ratio, Quick ratio, Working capital

# 1. DEBT AS A DISCIPLINARY MECHANISM

- Covenant violations
  - Creditors receive termination and acceleration rights following negative performance

  - Limit the borrower's purchase of new assets, changes in control, the use of the borrowed funds, and the payment of dividends

# 1. DEBT AS A DISCIPLINARY MECHANISM

- Covenant violations
  - *Creditor Control Rights, Corporate Governance, and Firm Value* by Nini, Smith, and Sufi, RFS, 2012
  - Between 10% and 20% of firms report being in violation of a financial covenant in a credit agreement (1996-2008, non-fin. firms in U.S.)
  - Violations are followed immediately by
    - a decline in acquisitions and capital expenditures,
    - a sharp reduction in leverage and shareholder payouts,
    - an increase in CEO turnover.

# 1. DEBT AS A DISCIPLINARY MECHANISM

- Covenant violations
  - The changes in the investment and financing behavior of violating firms coincide with
    - amended credit agreements that contain stronger restrictions on firm decision-making;

  - The changes in the management of violating firms suggest that creditors also exert informal influence on corporate governance.

# 1. DEBT AS A DISCIPLINARY MECHANISM

- Covenant violations
  - Firm operating and stock price performance improve post-violation.
  - Actions taken by creditors increase the value of the average violating firm.

# 2. INSTITUTIONAL LENDERS AS CORPORATE MONITORS

- Relationship banking might be beneficial to the borrowing firm.
- However, getting favorable interest rates from banks often entails the firm having to expose private information to the bank.
- The firm may have to agree to numerous covenants to get the favorable rate.

# 2. INSTITUTIONAL LENDERS AS CORPORATE MONITORS

- Why didn't lenders raise a red flag during the recent corporate scandals?
  - Creditors and stock holders do not necessarily share the same objectives for the firm.
    - Creditor's claims have seniority over equity holder's claims.
    - If a financially strong firm is wasting money on executive perks, they will still be able to pay creditors.
    - Therefore, creditors may be less active in monitoring than stockholders.

# 2. INSTITUTIONAL LENDERS AS CORPORATE MONITORS

- Creditors may influence corporate governance in bankruptcy
  - Bankruptcy occurs when a firm cannot pay its debt and has more debt than assets.
  - In Bankruptcy, creditors are paid before shareholders receive any value and shareholders typically are wiped out.
  - If a firm wants to survive bankruptcy, managers must negotiate with creditors and the bankruptcy judge, which gives creditors some influence.

# 3. CREDIT RATING AGENCIES

- Credit rating agencies rate bonds for potential bond investors.
- A rating grade informs investors about the risk of a bond.
- Most credit rating agencies are paid by the companies they rate – not by the investors who use the ratings.

# 3. CREDIT RATING AGENCIES

- The Ratings
  - To assess the credit worthiness of companies, the credit agencies employ financial analysts who review public financial statements issued by the companies.
  - Companies can reveal non-public information to the agencies.
  - Ratings are separated into investment grade and non-investment grade

# 3. CREDIT RATING AGENCIES

- Ratings of Bond Safety and Example Bond Yields

| | Moody's Rating | S&P's Rating | Example Bond Yield, % |
|---|---|---|---|
| Best Quality | Aaa | AAA | 6.4 |
| High Quality | Aa | AA | 6.9 |
| Upper Medium Grade | A | A | 7.1 |
| Medium Grade | Baa | BBB | 7.8 |
| Non-Investment Grade | Ba | BB | 9.9 |
| Highly Speculative | B | B | 10.5 |
| Defaulted | Caa to C | CCC to D | 20 to 90 |

# 3. CREDIT RATING AGENCIES

- Rating System
  - The higher the bond rating, the lower the interest rate the firm has to pay investors.
  - The ratings have historically been good predictors of the default potential of a debt issuer.
  - Each downgrade signals to investors that the bonds are becoming riskier.

# 3. CREDIT RATING AGENCIES

- Criticisms
  - Rating agencies are paid by the companies they rate, which is a conflict of interest.
  - Rating agencies also have become consultants to the companies they rate, which is another conflict of interest.
  - Rating agencies are slow to downgrade ratings causing dramatic mistakes (where bankrupt firms still have high ratings).

# 3. CREDIT RATING AGENCIES

- The credit rating crisis of 2007 and 2008
  - Rating Shopping
    - issuers shop around among rating agencies for the highest rating
    - which might have led to inflated ratings of structured finance products
  - Model Error
    - underestimation of default correlation across firms or households

# 3. CREDIT RATING AGENCIES

- Example – WorldCom
  - WorldCom issued an American record $11.9 billion of bonds, of which $10.1 billion was new financing in May of 2001.
  - Standard & Poor's rated the massive debt issue investment grade, with a BBB+ (Moody's rated it A3).
  - In May 2002, the credit agencies downgraded WorldCom debt to junk-bond status.
  - The agencies' initial seal of approval on the giant bond issue seems hard to believe.

# 3. CREDIT RATING AGENCIES

- Example - Enron's Credit Rating
  - Investment banks had raised capital for Enron's offshore partnerships and invested their own money.
  - They knew that if the credit rating agencies were to downgrade Enron to junk status, at least $3.9 billion in debt repayment would immediately be required and Enron would be forced to declare bankruptcy.
  - The banks asked the credit agencies to delay downgrading Enron to junk to bide time to look for additional capital.

# 3. CREDIT RATING AGENCIES

- Example - Enron's Credit Rating
  - Instead of communicating this enormous risk to bondholders, the agencies waited.
  - A month later, Enron filed for bankruptcy.
  - The credit agencies downgraded the bonds only days before.
  - Did the credit agencies do their job in warning bondholders?

# 4. INTERNATIONAL PERSPECTIVE

- Japan's main bank system
  - Japan is a developed market whose firms rely heavily on bank debt.
  - Usually, each Japanese firm has a "main bank."
  - These main banks usually own equity and place its own personnel into important management positions of their client firms.
  - Therefore, such bank-reliant firms have few conflicts among creditors, shareholders, and management.

# 4. INTERNATIONAL PERSPECTIVE

- Criticisms of the "Main Bank" System
  - Banks might encourage client firms to pursue profit stabilization rather than profit maximization.
  - When banks experience financial difficulties, then their client firms will also suffer.

# 4. INTERNATIONAL PERSPECTIVE

- Creditor Rights Around the World
  - Creditors may also be protected by the legal system.

  - Credit right index (“*Law and Finance*” by LaPorta et al.)
    - No automatic stay on the assets in reorganization
    - Secured creditors get paid first
    - Restrictions for going into reorganization
    - Management is replaced in reorganization

# 4. INTERNATIONAL PERSPECTIVE

- Creditor Rights Around the World

| Country | Creditor Rights | Country | Creditor Rights |
|---|---|---|---|
| Australia | 1 | Nigeria | 4 |
| Canada | 1 | Pakistan | 4 |
| Hong Kong | 4 | Singapore | 4 |
| India | 4 | South Africa | 3 |
| Ireland | 1 | Sri Lanka | 3 |
| Israel | 4 | Thailand | 3 |
| Kenya | 4 | U.K. | 4 |
| Malaysia | 4 | U.S. | 1 |
| New Zealand | 3 | Zimbabwe | 4 |
| | **English-origin average** | | **3.11** |

# 4. INTERNATIONAL PERSPECTIVE

- Creditor Rights Around the World

| Country | Creditor Rights | Country | Creditor Rights |
|---|---|---|---|
| Argentina | 1 | Italy | 2 |
| Belgium | 2 | Mexico | 0 |
| Brazil | 1 | Netherlands | 2 |
| Chile | 2 | Peru | 0 |
| Colombia | 0 | Philippines | 0 |
| Ecuador | 4 | Portugal | 1 |
| Egypt | 4 | Spain | 2 |
| France | 0 | Turkey | 2 |
| Greece | 1 | Uruguay | 2 |
| Indonesia | 4 | **French-origin average** | **1.58** |

# 4. INTERNATIONAL PERSPECTIVE

- Creditor Rights Around the World

| Country | Creditor Rights | Country | Creditor Rights |
|---|---|---|---|
| Austria | 3 | | |
| Germany | 3 | Denmark | 3 |
| Japan | 2 | Finland | 1 |
| South Korea | 3 | Norway | 2 |
| Switzerland | 1 | Sweden | 2 |
| Taiwan | 2 | **Scandinavian-origin** | **2.00** |
| **German-origin avg.** | **2.33** | | |

# 1. FINANCIAL REPORTING

- Accurate financial reporting is important for
  - corporate monitoring system
  - the efficiency of capital markets and the proper valuation of securities
  - an informed evaluation of strategy, business model, and risk
  - structuring compensation packages and awarding performance-based compensation

# 1. FINANCIAL REPORTING

- It is the role of the audit committee to help to ensure the accuracy of reports:
  - Sets parameters for quality, transparency, and controls.
  - Hires external auditor to test for misstatement.

- To ensure that its work is free from management influence:
  - All committee members must be independent
  - All member must be "financially literate"
  - One member must be a "financial expert"

# 1. FINANCIAL REPORTING

- A publicly held company is required to file the three main financial statements with the SEC:
  - Income statement, balance sheet, and statement of cash flows

- A firm also needs to report profits or losses to the IRS and determine the tax liability

# 1. FINANCIAL REPORTING

- Problems that may occur in Accounting
  - Unintentional errors are possible
    - Miscalculation
    - Applying an expense to the wrong accounting ledger
  - Requirement for judgments
  - Accountants could perpetuate fraud

# 1. FINANCIAL REPORTING

- The changing role of accounting: Managing earnings
  - Old role: simply providing information to insiders and outsiders
  - New role: being profit centers and are asked to increase profits through application of accounting methods.
  - Managing earnings to:
    - Meet internal target and external targets
    - Window dress
    - Smooth income

# 1. FINANCIAL REPORTING

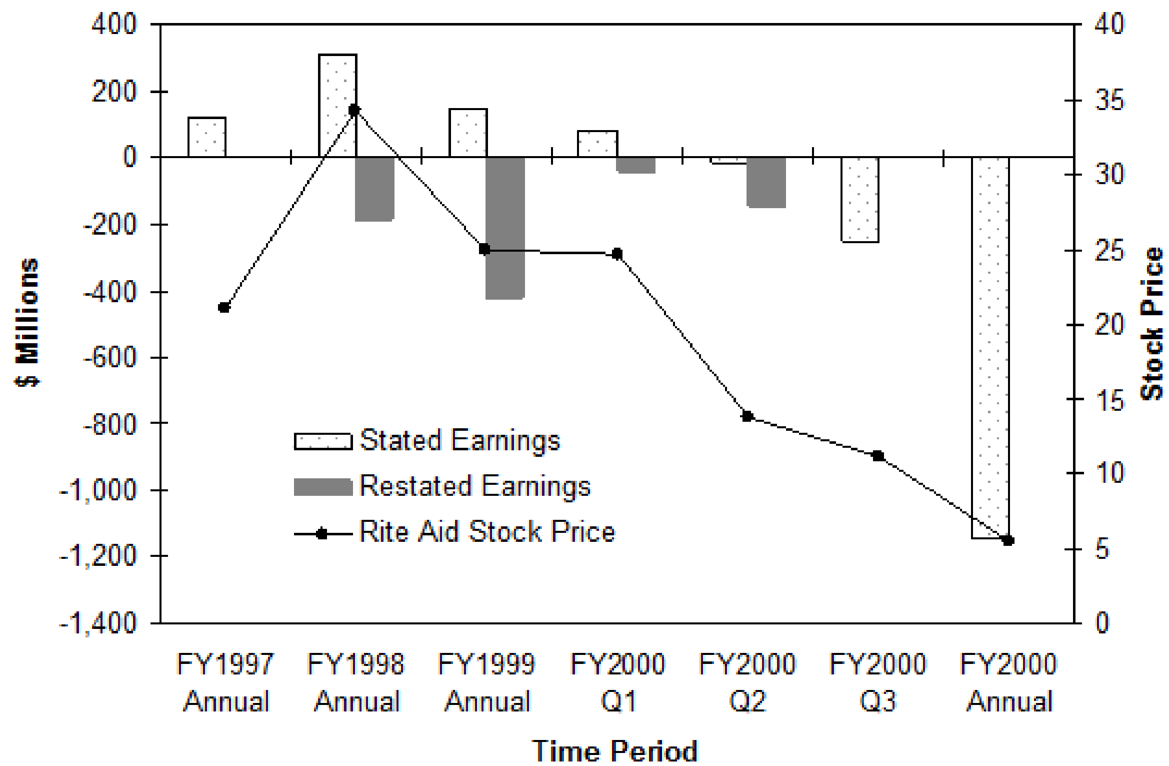
- Internal and External Targets
  - Accountants may feel pressure to meet internal targets and external targets because
    - Meeting internal targets may lead to a raise or a bonus for the CEO and other managers.
    - Meeting external targets to avoid stock price fall.

# 1. FINANCIAL REPORTING

- From Manipulation to Fraud
  - One important question: How much can companies manipulate accounting figures before they cross the line into fraud? Where is the line?
  - Accounting departments are pressed to make up shortfalls and even cross the line into fraud.
  - Recent examples of alleged accounting fraud:
    - WorldCom, Enron, Rite Aid, Adelphia, and Tyco

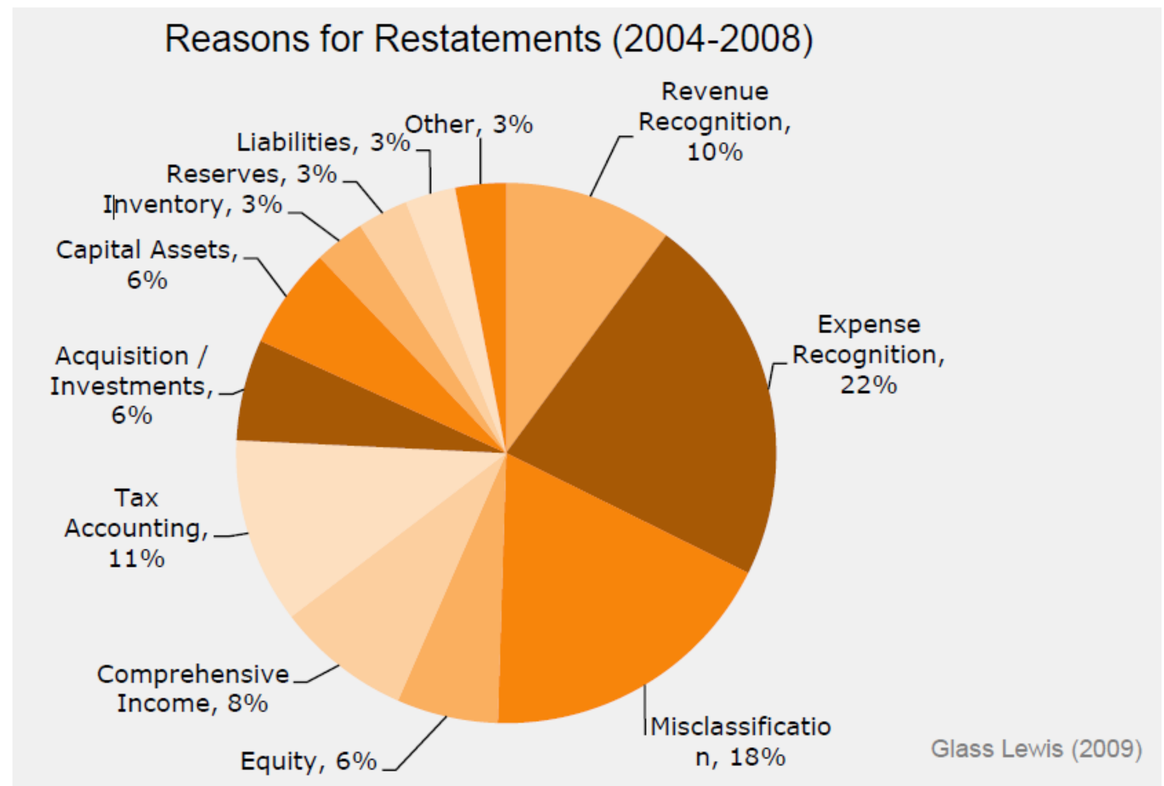
# 1. FINANCIAL REPORTING

- From Manipulation to Fraud
  - Rite Aid



# 1. FINANCIAL REPORTING

- Financial Restatements
  - A restatement occurs when a material error is found in the company's previously published financials. 200 to 500 U.S. public companies restate each year.



# 1. FINANCIAL REPORTING

- Reasons for Restatements
  - A restatement can occur because of human error, aggressive accounting, or fraud.
  - The reasons for restatement have implications on the quality of controls in the company and the steps needed to remedy.

# 1. FINANCIAL REPORTING

- Internal auditors
  - Oversee the firm’s financial and operating procedures
  - Check the accuracy of the financial record-keeping
  - Implement improvements with internal control
  - Ensure compliance with accounting regulations
  - Detect fraud

# 1. FINANCIAL REPORTING

- WorldCom Inc.
  - Gene Morse stared at an accounting entry for $500 million in computer expenses.
    - No invoices or documentation
    - Took his discovery to his boss
  - One month later, they had unearthed $3.8 billion in misallocated expenses and phony accounting.
    - accounting fraud turned out to be the largest in corporate history.
    - Sent WorldCom into bankruptcy

# 2. EXTERNAL AUDIT

- The external audit assesses the validity and reliability of publicly reported financial information.

- Because management is responsible for preparing financial reports, shareholders expect an objective third party to provide assurance that the information is accurate.

# 2. EXTERNAL AUDIT

- External Auditors
  - Review the firm's financial statements and its procedures for producing them to attest to the fairness of the statements

  - The auditors might:
    - Conduct interviews with the firm's employees
    - Make their own observations of the firm's assets
    - Check sample balance-sheet transactions
    - Confirm with the firm's customers and clients
    - Conduct their own financial statements analysis

# 2. EXTERNAL AUDIT

- Independent Auditors Report
  - External auditors must ensure the accuracy of the firm's financial information for shareholders
  - Big Four:
    - PriceWaterhouseCoopers
    - Deloitte & Touche
    - Ernst & Young
    - KPMG

# 2. EXTERNAL AUDIT

- Despite public expectations, it is not the explicit objective of the audit to identify fraud.

- Instead, the objective is to express an opinion on whether statements comply with accounting standards. Auditors express an "unqualified opinion" if it finds no reason for concern

# 2. EXTERNAL AUDIT

- External Audit Process
  - Audit preparation: Determine scope of audit. Identify areas requiring special attention.
  - Review estimates and disclosure: Sample key accounts. Test managerial assumptions. Independently verify estimates.
  - Fraud evaluation: Review opportunity for fraud. Examine incentives for fraud. Use "professional skepticism."
  - Assess internal controls: Examine design. Identify weaknesses. Focus on key accounts and unusual transactions.
  - Conclude: Review findings with audit committee. Express an opinion to accompany the financial statements

# 2. EXTERNAL AUDIT

- Audit Quality
  - Given the importance of the audit, much attention has been paid to factors that might impact audit quality.
  - Potential issues include:
    - Industry consolidation
    - Conflict when auditor provides non-audit services
    - Conflict when former auditor is hired as CFO
    - Auditor rotation
  - What impact, if any, do each of these have on the likelihood of future restatement or fraud?

# 2. EXTERNAL AUDIT

- Industry Consolidation
  - Currently there are only four (the "Big Four") major accounting firms

  - Pros
    - Scale of audit firms matches the scale of companies
    - Expertise by industry and region
    - Expertise by function (tax, audit, systems, etc.)
  - Cons
    - Inadequate number of firms to choose among
    - Decreased competition might lead to increased fees

# 2. EXTERNAL AUDIT

- Industry Consolidation (Gao 2008)
  - 60% of large companies believe there is an inadequate number of audit firms. Fewer than 25% of small companies believe this.
  - Audit fees have risen, but this is likely due to greater cost of compliance with SOX, greater scope, more expensive personnel.
  - Splitting up Big Four would reduce expertise and decrease quality.

# 2. EXTERNAL AUDIT

- Non-Audit Services
  - Sarbanes Oxley prohibits auditors from performing certain non-audit services (auditors as consultants)

  - Pros
    - Reduces potential conflict of interest
    - Might improve auditor independence
    - Company cannot “retaliate” if it disagrees with auditor
  - Cons
    - Auditor has expertise in company procedures
    - Might be cheaper for company

# 2. EXTERNAL AUDIT

- Non-Audit Services (Romano 2005)
  - No evidence that this practice hurts audit quality (measured by abnormal accruals, earnings conservatism, failure to issue qualified opinion, or future restatement).

  - Congress did not take into account this disconfirming evidence, even though it was widely understood at the time.

# 2. External Audit

- Former Auditor as CFO
  - A company might decide to offer a job in finance, treasury, or internal audit to a member of the external auditing team.

  - Pros
    - Auditor is familiar with company and its procedures
    - Company is familiar with auditor working style
    - Reduces both hiring costs and risk of failure
  - Cons
    - Auditor might have allegiance to former employer
    - Auditor knows internal controls, might facilitate fraud

# 2. EXTERNAL AUDIT

- Former Auditor as CFO
  - Mixed evidence (Dowdell and Krishnan 2004, Geiger, North, and O'Connell 2005)

  - Some studies find decrease in earnings quality when company hires former auditor as CFO.
  - Others find no relation between source of hire and earnings quality.

# 2. EXTERNAL AUDIT

- Auditor Rotation
  - Auditor rotation is the practice of periodically changing external audit firms.

  - Pros
    - New auditor might be more independent
    - New auditor has fresh perspective
  - Cons
    - Costly to change audit firms or audit teams
    - New auditor has a steep learning curve

# 2. EXTERNAL AUDIT

- Auditor Rotation
  - Very little evidence that auditor rotation is cost-effective or that it improves audit quality.
  - However, auditor resignation (auditor quits because of disagreement with management) might be a warning sign of fraud.
  - Cameran, Merlotti, and Di Vincenzo (2005); Whisenant, Sankaraguruswamy, and Raghunandan (2003)