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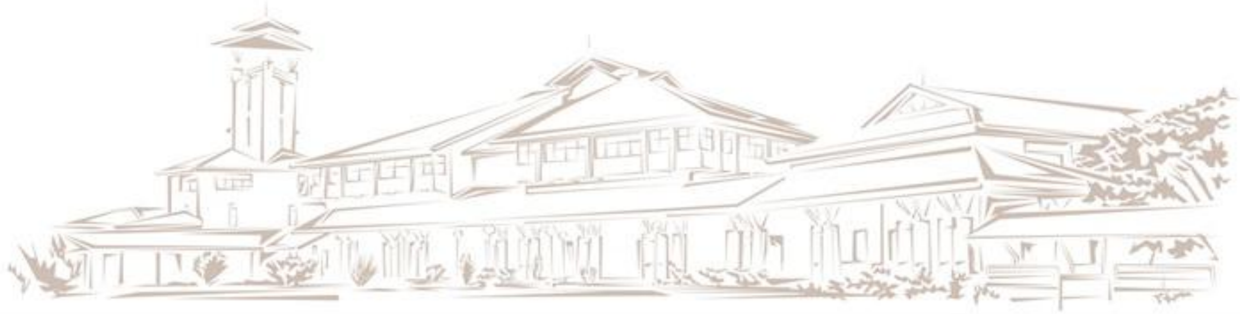

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Owner's financial expertise and Resubmitted Approved Loan Proposal in the Indian banks at the loan inception stage.

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IIMK WORKING PAPER

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Abstract

We empirically evidenced that the owner's financial expertise is different and comparatively less with respect to resubmitted approved loan proposal in the Indian banks at the loan inception stage, with proper control for resubmission and non-resubmission of loan proposals at the time of approval of these loans using primary data sample of 575 corporate accounts spread over a period of 15 years collected from Indian banks. The finding of this study implies that borrowers with comparatively less promoter's financial expertise in self-interest will avoid violating core covenants at the inception stage of a loan to get the loans approved. There is evidence of earnings management with respect to resubmitted loan proposal which are approved. Banks should take this information into account while disbursing loan and framing credit policies.

Key words: Owner's financial expertise, earnings management, corporate governance, loan covenants

JEL classification: G32, M41

1.1 Introduction

The most important issue in corporate governance reforms is to reduce the agency costs. One such indicator of agency cost is the earnings management (Klein, 2002). Empirical studies in the developed economy show that company board characteristics influence earnings management.[1] This is also related to borrowings from the market and the banks. With respect to borrowings from banks, literature evidenced financial accounting policy is dependent on the existence and tightness of accounting rules in loan covenants.[2] It is based on the concept that managers in self-interest make use of accounting choice to avoid breaching loan covenants and thus, there is earnings management. This is known as the debt covenant hypothesis (DCH).

Our study is based on this concept. The objective of this paper is to examine the relationship between the owner's financial expertise with respect to a loan account and earnings management at the loan inception stage in Indian Banks. Still the question remains why we are interested in the owner's financial expertise. The answer lies in the theory of upper echelons (Hambrick and Mason, 1984, Hambrick, 2007). The theory envisages that owners and manager's culture and characteristics can influence their decision making. In the recent past, this has led to examining several new empirically evidenced determinant of accounting choices related to owners and managers specific factors. Some of these include CEO reputation (Francis et al. 2008), superstar CEOs (Malmendier and Tate, 2009), managerial ability (Demerjian et al. 2013) and CEO financial expertise during IPO (Gounopoulos and Pham, 2016). All these findings have one thing in common. These are related to listed firms in US and impact the quality of financial report. And, nothing is known about these factors in the private sector firms going for debts. Another complementary theory is the proprietary information effect which talks about the decision rights and evidences the negative relation with divergence of financial information (Fan and Wong, 2002). These are the basis of our hypothesis development.

This study empirically looks at the owner financial expertise in private firms which have applied for loans in Indian Banks at the inception stage. The implications are in NPA and credit policies for policy advisors, makers and regulators to understand the causes of this low quality of financial report. The corporate governance literature in this aspect is on US because of availability of data (Bushman and Smith, 2001). Yet there is no literature on the relationship between the owner's financial expertise in a loan account and earnings management with focus at the loan inception stage. Further, banks in different markets are different. Hence, the paper is in the Indian context in Indian Banks. This is more important from the evidence that earnings opacity is on the higher in developing economies accounted for by earnings management (Bhattacharya et al., 2003). This study will contribute to literature on corporate governance and financial reporting with policy implications in the Indian context. We start with loans from the banks and earning management, then on earning management and owner's financial expertise.

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[1] See Dechow et al., 1996; Peasnell et al., 2001; Klein, 2002

[2] See Press and Weintrop, 1990; Begley, 1990; Citron, 1992a; Duke and Hunt, 1995

Watts and Zimmerman (1978, 1986) using Positive Accounting Theory (PAT) approach shows that accounting numbers have been found to play a role in debt agreements[3]. One of the hypotheses developed to support PAT is DCH. DCH states that if a firm is close to breach the accounting based loan covenants; the manager in self-interest will more likely increase the firm's current earnings to reduce costs of technical default in a loan contract by choosing an accounting method. This hypothesis attempts to explain firm's accounting policy on the basis of the financial loan covenants existence. It assumes manager's decision is based on the potential effects on loan covenants. It assumes loan covenant breach is costly (Watts and Zimmerman, 1990). On the other hand, Allen et al. (2007) in the Indian banking system evidences that the borrower's selection is through a severe screening process. The borrowers complain of high standards. This leads to borrowers submitting and resubmitting their financials, more than once, to a number of local banks or to multiple banks in a locality, for loan approvals. Usually, these resubmissions also include unaudited financials till loans are approved. The question then arises with respect to resubmission of loan proposal is with respect to incidence of debt covenant hypothesis (DCH) that is managers in self-interest make use of accounting choice to avoid breaching benchmark loan covenants to get the loan approved.

Similarly, the earnings management literature has two aspects in a loan contract: the bonus plan hypothesis of PAT where if a manager is rewarded for the firm's performance, the managers in self-interest will more likely increase the firm's current earnings by choosing an accounting method. And, the DCH where the loan covenants require that a firm maintain specified accounting figures including earnings. These covenants generate incentives for a firm's manager to get a loan approved. We find that both the aspects mentioned above are interlinked in earnings management particularly at the inception of a loan. The hypothesis also predicts that earnings management may be used not only to avail a loan but also at a lower cost at the loan inception stage (Baag and Banerjee, 2013).

With respect to DCH and earnings management, a firm at the inception stage of a loan may increase the earnings to show that the firm is less risky and get the loan approval with a better price. Francis et al. (2005) finds that better ratings loans are priced low. A financially liquid tight firm will have more incentives to increase the earnings. This is also supported by the pecking order theory of capital structure (Myers and Majluf, 1984), where in a developing nation; banks are the best source of access to private debt. The borrowers applying for a loan and in a financially liquid tight position will opt for the DCH option to have access to loan finance, by just exceeding the minimum thresholds based on the core accounting covenants through which banks evaluate the capacity of the borrower to pay back the loans.

In the earnings management literature, Das and Shroff (2002) find that a distress firms uses leverage to inflate earnings. With respect to bank, Francis et al. (2005) find that banks are able to

[3] This approach is based on the descriptive theories and empiricism, and has dominated since the 1970s (Gaffikin, 2006). PAT is considered an extension of Friedman (1953) positive theories of economics.

see through managed earnings. Janes (2003) evidences are against it. Baag and Banerjee (2013) empirically evidenced the debt covenant hypothesis with respect to resubmitted approved loan proposal in the Indian banks at the loan inception stage. There is evidence of earnings management with respect to resubmitted loan proposal which are approved, in the Indian context. Thus, borrowers in self-interest will avoid violating core covenants at the inception stage of a loan to get the loan approved. The present study has used a unique primary hand collected data set; with respect to private loan agreements. The study will have important implications for the Indian banks as banks use both quantitative and qualitative information of the borrower while approving a loan.

The focus of our study is on the characteristic of the owner's financial expertise based on the behaviour of the firm at the loan inception stage with an objective to empirically provide evidence on the relationship between owner's financial expertise and earnings management based on validity of the debt covenant hypothesis with respect to resubmitted loan application at inception stage of loan. This gains importance from the evidence that owners' culture and characteristics can influence their decision making that have impacted the quality of financial reporting and availability of such data which is based on the concept of control.[4]

We empirically evidenced that the owner's financial expertise with respect to resubmitted approved loan proposal in the Indian banks at the loan inception stage, is different with proper control for resubmission and non-resubmission of loan proposals at the time of approval of these loans using Mann-Whitney U test. The finding of this study implies that borrowers with lower owner's financial expertise and unsecured loan in their control in self-interest will avoid violating core covenants at the inception stage of a loan to get the loans approved. There is evidence of earnings management with respect to resubmitted loan proposal which are approved. Banks should take this information into account while disbursing loan and framing credit policies in such a way that it should in context with the institutional environment.

1.2 Literature Review

An important aspect of loan contracts is the accounting rules (AR). Accounting numbers are used in loan covenants subject to the accounting methods that are acceptable to the AR and the allowed flexibility in choosing such accounting methods under the AR (Frost and Bernard, 1989). Since breaching of loan covenants is assumed to be costly (Bratton, 2006), borrowers choose an accounting method within the AR that improves the financial statement in such a way that the accounting numbers avoid breaching loan covenants. In the literature, we find that loan covenants efficiently deal with the conflict between a bank and the borrower, even though these are costly (Smith and Warner, 1979). In the literature, we find PAT as one approach that explains firm's choice of accounting method. PAT objective is explaining and predicting phenomena of accounting practice rather than prescribing solutions to accounting problems. In the literature, we

[4] See Fan and Wong, 2002; Coffee, 2005; Hambrick, 2007

find that manipulating accounting numbers for incentives by managers has been defined as earnings management (Healy and Wahlen, 1998).

Earnings management reduces transparency in a financial report by a firm but it is the theory of the firm's costly contracting approach which gives value to the earnings. This approach is based on how much the outsiders are aware of the true earnings of the firm without the financial information. If this information has nothing to offer, then earnings will serve no purpose. This approach signifies that earnings management behaviour is opportunistic and is based on economic consequences. Thus, the firm will manage its earnings to avoid breaching loan covenants, ex ante; it will be to get the loan approved (Baag and Banerjee, 2013). In the earnings management literature, we find evidence that firms manage earnings before breach of loan covenants (Defond and Jiambalvo, 1994). But this pertains to ex post loan disbursement period and the only empirical literature on the loan inception stage is by Baag and Banerjee (2013).

The implication of the literature show that managers at the inception of loan stage may use earnings management to avoid rejection of the loan as the cost of rejection are too high by just exceeding the minimum benchmark needed, which are based on the core accounting numbers, which in turn are used in the core covenants as benchmark covenants through which banks evaluate the capacity of the borrower to pay back the loans. The incentives are more when the firm needs finance, and bank being a cheaper source of finance is preferred more. This view supports the debt covenant hypothesis.

In the property rights literature, causes of governance are well analysed with respect to law, legal rights, customs and social factors. It gives rights with respect to control, decisions, earn and transfer of authority[5]. The proprietary information effect which talks about the decision rights allows the owner with specific knowledge of the firm to limit the disclosure of information to have advantage over its competitors and avoid monitoring and reduce corporate transparency (Jensen and Meckling, 1992; Christie et al., 2002). This approach also agrees with one of the PAT hypothesis: The political cost. This evidences the negative relation with divergence of financial information. Similarly, reputation is important for firms that seek external finance at cheaper costs (Gilson and Gordon, 2003) and can engage in earnings manipulation (Fan and Wong, 2002) and also, association with business groups including negative spillovers and reputations (Masulis et al., 2009).

The upper echelons theory suggests that managerial experiences like formal education and functional track can affect managers' interpretations of the situations that impact their decision making (Hambrick and Mason 1984, Hambrick 2007). Empirical studies have shown that managerial heterogeneity has significant explanatory power for corporate decisions and performance (Graham et al. 2013). Recent research has examined the experience of CEOs. Custodio and Metzger (2014) provide evidence that CEOs' past financial expertise influences

[5] See Coase, 1960; Demsetz, 1964; Alchian, 1965, 1977; Cheung, 1970, 1983; Eggertsson, 1990

firm's financial policies such as cash holdings, leverage, and payout policies. At the same time, Bamber et al. (2010) argue that idiosyncratic differences in managers play a significant role in firms' voluntary financial disclosure choices. Francis et al. (2008) report a negative association between earnings quality and CEO reputation which is measured by press coverage. They argue the reason for this correlation is because firms with poor earnings quality tend to hire reputed CEOs for the expertise that they can bring to the firm, rather than CEOs taking actions to manipulate earnings to influence market perceptions. Demerjian et al. (2013) evidences managerial expertise associated with greater earnings quality represented by fewer subsequent restatements. Jiang et al. (2013) find evidence that the appointment of financially experienced CEOs reduces real earnings management.

Further, the owner's financial expertise with deeper understanding of financial and accounting issues and structures contribute to the quality of financial reporting. They set the quality from the top and influence the decisions of managers (Feng et al. 2011). This is further supported by the theory of top management teams (Bunderson and Sutcliffe 2002) which evidences that the common functional background facilitates the communication among top management team members. Therefore, a owner with financial expertise will be able to monitor effectively to strengthen the firm's accounting policies. Their affiliation with professional organisations require adherence to ethical codes of conduct, to effectively develop good accounting policies and effectively communicate financial information (Custodio and Metzger, 2014). According to upper echelons theory, owners with financial experience will draw on their prior work experience when making accounting decisions. Therefore, we expect that financial expert owners will be more capable of monitoring the accounting process and providing higher quality financial statements. Based on existing theories and empirical evidence, we predict that firms with financial expert owners will exhibit lower earnings management. Thus, we are extending this theory to the loan inception stage with respect to availing loans from banks. We investigate whether owner's financial expertise with respect to resubmitted approved loan proposal in the Indian banks at the loan inception stage, is different with proper control for resubmission and non-resubmission of loan proposals at the time of approval of these loans. We gather the biographies of all owners in our primary sample. We define financial expert as those having past experience in the financial sector or in a financial job or with some financial education. We also look at the diversity of this experience.

1.3 Hypotheses

Based on the above arguments, we hypothesize that the loan proposal which had not been resubmitted and got approved are able to capture the existence of the owner's financial expertise compared to the resubmitted and approved loan.. The null hypothesis for the test is that there exists no relation between loan covenant restrictions level and owner's financial expertise. The alternative hypothesis is that borrowers with less owner's financial expertise in self-interest will avoid loan covenant violations to get the loans approved.

1.4 Sample Data

Our sample is more representative of firms in the Indian context and helps to evidence the owner's financial expertise in bank loans at inception stage as such data availability quite often not easy to track (Lins, 2003). In this study, we have used 575 accounts data collected from three public sector banks in India for studying the relationship between owner's financial expertise and not resubmitted loan applications that were sanctioned and compared to a control group of accounts which had resubmitted the loan applications. We have used the same sample of primary data used by Baag and Banerjee (2013). One of the characteristic of this data is that there is evidence of earnings management at the loan inception stage with respect to the resubmitted loan. We name the group which had not resubmitted the loan applications as the Group-Yes OFE (GY) and the control group which did resubmit the loan application as Group-No OFE (GN). Our sample data includes 275 GN accounts and 300 GY accounts covering a period of 2001-2015 and two types of accounts, first, only owner's experience and second, owner's experience and professional education if any. The process of identifying the GN accounts are as follows: We went through the credit file of the accounts to find evidence of resubmission through loan forwarding applications, notes by the banks employee and personal interactions with the bank officers.

1.5 Outline

This study consists of two sections. The first section consists of five parts as introduction, literature review, hypothesis development, data and outline. The second section consists of methodology, method and results and conclusion along with the recommendation of future studies.

2.1 Research Methodology, Method and Results

This empirical study follows the decision-usefulness approach and uses the market based research type empirical study focusing on the methodical issues methodology, contract process of PAT and distribution of earnings methodology. Based on the debt covenant hypothesis of PAT, we use the Mann-Whitney U test to validate that the two groups: GY and GN are not same.

We use the objectives of the PAT of explanation and prediction to empirically validate that the two groups: GY and GN are not same. We use the statistical Mann-Whitney U test also known as the Wilcoxon two sample one tail test. To test the null hypothesis that there is no difference between these two groups, we use Mann-Whitney U test (one tail) on the whole sample to test whether our grouping variable is able to capture the existence of the promoter's contribution. Mann-Whitney U test is a non-parametric test which makes few assumptions of data typed used in a sample. These are sometimes also known as distribution free tests. It means we make no assumptions on the nature of distribution of data. It works by ranking the data (Noreen, 1989).

This ensures creation of null hypothesis that no difference exists between the groups. We present the results of our test in table 2.1 along with the mean ranks and the descriptive statistics.

The results of the test of null hypothesis that there is no difference between the two groups: GY and GN are presented in table 2.1. The tests show that the two groups based on owner's experience and owner's experience and education are significantly different. Thus, the null hypothesis that there is no difference between the two groups is rejected. The finding of this study implies that borrowers with less financial expertise and education in self-interest will avoid violating core covenants at the inception stage of a loan to get the loans approved. There is evidence of earnings management with respect to resubmitted loan proposal which are approved. Banks should take this information into account while disbursing loan and framing credit policies.

2.2 Conclusion

We used a primary sample data of 575 accounts from public sector banks with proper control for resubmission and non-resubmission of loan proposals at the time of approval of these loans. We used promoter's financial experience and promoter's financial experience and professional education to study its relation with the loans. We used Mann-Whitney U test. The study show that the two groups based on promoter's financial experience and promoter's financial experience and professional education are significantly different. The finding of this study implies that borrowers with less promoter's financial experience and promoter's financial experience and professional education in self-interest will avoid violating core covenants at the inception stage of a loan to get the loans approved. Banks should take this information into account while disbursing loan and framing credit policies. Future research could study this relation with respect loan renewals, enhancements and maintenance of these accounts as well as the management's choice of accounting method.

Table 2.1

Test results showing difference in groups: resubmitted and non-resubmitted and relation between non-resubmitted group and owner's financial experience and owner's financial experience and professional education

Restricted owner financial expertise attributes

Non-Resubmission	OFE	OFE+PE	success rate
Z statistics	-1.748	-4.367	2/2
p value	0.039**	0***	
Significant	Yes	Yes	
Mean Ranks			
Group-Yes	305.21	319.32	
Group-No	284.73	249.65	
Descriptive statistics			
Mean	7.45	8.65	
Std deviation	3.49	3.87	
Minimum	0.01	0.15	
Maximum	21.23	22.41	

Grouping variable yes/no

**Mann-Whitney U test (Wilcoxson two sample test)- one tail test: Null hypothesis -there is no difference in resubmitted and non-resubmitted groups. It is based on resubmission (dummy- 1 or yes) and non-resubmission (dummy- 0 or no) on covenant restriction

No of observations: yes= 300 and No = 275. Total observations = 575

** Success rate is based on P value < 0.05

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