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Continuous reporting benefits in the private debt capital market

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ABSTRACT

The study is an experiment, administered over the Internet, measuring the effect that continuous reporting has on a company's ability to secure private debt capital. Specifically, we test whether commercial loan officers would be more willing to increase the probablity of loan acceptance to a mid-sized company operating in a continuous reporting environment than they would a company that operates in a traditional reporting environment. We find that high risk companies providing financial information to the lender on a daily basis have a higher probability of loan acceptance than do companies providing financial information to the lender on a quarterly basis. We did not find any results for low risk companies, suggesting the potential benefits of continuous reporting might not accrue to those type companies. The results were robust for both new and existing banking relationship scenarios. We did not find any results for the interest rate variable. The results of this study have significant implications for companies determined to be high risk. Commercial loans are the life-support for many companies, and failure to secure a line-of-credit could have devastating consequences for these high-risk companies.

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1. Introduction

The private debt market is the primary source of external funds for most small and mid-sized companies. Failing to secure private debt can be devastating for these companies because public debt and equity markets are not accessible. To complicate matters, frictions such as information asymmetry limit

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funds from flowing to some companies with positive growth opportunities that might otherwise secure the funds. Implementing mechanisms that mitigate the existing frictions to a level necessary to secure financing is in the best interests of these small and mid-sized companies. One possible alternative in minimizing information asymmetry is for companies to agree to provide additional information, ex-post, and to allow the commercial lender increased monitoring capabilities.

The traditional commercial lending reporting arrangement usually consists of the lender receiving quarterly debt covenant compliance reports and annual audited financial statements. The potential exists today for the lender to receive continuously (e.g., weekly, daily, real-time) updated debt covenant information from the borrower. For those companies with no viable alternative to external funds, moving toward continuous reporting (CR) might increase the probability of securing funds (and perhaps lower the cost of those funds) by mitigating frictions caused by information asymmetry. The purpose of our study is to test whether CR provides such benefits.

Some argue that there will be some level of external continuous reporting and monitoring in the near future (Vasarhelyi and Greenstein, 2003). Hunton et al. (2003) believe that the demand for continuous reporting is already intense and that, if the accounting profession lags behind in meeting this demand, third-party information seekers (from lenders to investors) will find alternate providers.

Simply stated, CR means “making digitized information available through electronic channels simultaneously with its creation,” (Elliott, 2002, 140). With today's enterprise systems, many businesses are capturing transactions continuously, making CR of those transactions both possible and relatively easy (Alles et al., 2002). We are examining the potential benefits of companies continuously reporting debt covenant information to external information users (i.e., commercial lenders).

Lenders expose themselves to significant risk in extending credit to companies. The ability to monitor the health of the borrower is paramount. Inaccurate, biased and/or untimely information received from the borrower may hinder the ability of the lender in making correct decisions regarding the outstanding debt and the borrower. CR creates the potential for continuous monitoring of a customer's compliance with debt covenants. The continuous monitoring allows the lender the opportunity to call the loan in a timelier manner in order to mitigate loan losses. In other words, the increased disclosures provide lenders a tool to better manage default risk and result in the lender's willingness to offer credit to the borrower and do so, perhaps, at an interest rate lower than would be offered outside the CR environment.[1] The motivation for the borrower to increase company disclosures (i.e., allow the continuous reporting of its accounts) would be increased availability of funds and/or the reduction in the cost of securing debt.

In response to the calls of both the CICA/AICPA and the academic community to investigate implications of real-time financial reporting (Hunton et al., 2004; Vasarhelyi et al., 2004; O'Donnell and David, 2000; Sutton, 2000; CICA, 1999), we conduct an experiment where commercial lenders are asked to determine the probability that a company will secure a line-of-credit from their institution. We also have the commercial lenders assign an interest rate, assuming the loan application is ultimately approved. We manipulate the reporting frequency that will be made available to the lender (traditional/CR) and the company's risk level (high/low). We also examine the duration of the credit relationship between the company and the lender (new/five years) to investigate whether it impacts the utility of CR.

We find that high risk companies (as identified by the commercial lender) providing financial information to the lender on a daily basis have a higher probability of loan acceptance than do companies providing financial information to the lender on an quarterly basis. We find reporting frequency did not impact the loan approval decision for low-risk companies, as the loan approval probability was extremely high for this group. Additionally, we find the interest rate charged on the loan is not affected by reporting frequency.

Our study contributes to the CR empirical literature by examining the potential benefits and uses of CR for external stakeholders (e.g., loan officers). While the technology exists for CR, the likelihood of widespread adoption for CR, especially for external stakeholders, remains remote until research determines whether any incremental value exists in its use. Our study, along with future studies, can assist in determining the domains where that incremental value exists for CR from an external stakeholder

[1] This disclosure/cost of capital relationship has been documented with regard to the cost of equity capital, where an inverse relationship was found between *amount of information disclosure and cost of equity capital* under certain conditions (Botosan, 1997; Botosan and Plumlee, 2002; Gelb and Zarowin, 2002).

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