Audit Report Delay, Debt Maturity Structure and Earnings Management

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Abstract
We examine the relation between Audit Report Delay, firms' debt maturity structures and the propensity to manage earnings. Our results indicate that (i) firms with more current debt are more susceptible to managing earnings, (ii) this relation is stronger for firms facing debt market constraints (those without investment grade debt) and (iii) auditor characteristics such as auditor quality and tenure help diminish this relation. Overall, our results indicate that earnings management by firms is influenced by the relative amount of short-term debt used in firms' capital structures.
Keyword: Audit Report Delay, Debt Maturity Structure and Earnings Management

1. Introduction

In their discussion of the classic agency problem Jensen and Meckling (1976) note that although the introduction of debt in the capital structure of the firm presents a new set of agency problems, the existence of debt helps to mitigate the agency costs of equity. Jensen (1980) discusses the reduction in equity-related agency costs brought about by the elimination of free cash flow resulting from an increase in the relative amount of debt financing. Additionally, certain types of lenders (e.g., banks) may provide a monitoring function for their borrowers, thereby further reducing the agency costs of equity.
Although lenders (such as banks) have the potential to enhance firm monitoring, Diamond (2004) shows that lenders avoid active enforcement of debt contracts when the enforcement costs outweigh the benefits. The absence of lender enforcement encourages borrower misconduct and leads to inefficient allocations of resources. He recommends the use of short-term debt to overcome lender passivity in enforcing debt contracts because short-term debt can provide better incentives to lenders to monitor borrowers. As illustrated in Flannery (1986) and in Diamond (1991) borrowing short-term comes with inherent liquidity risk. Firms may be denied renewals of short-term loans or repayment may be required before the maturity of their projects. The cascading effect of relatively early repayment and/or lack of renewals (hereafter referred to as debt runs) can lead to significant liquidity crises for borrowers, and can even cause bankruptcies. The threat of such possible debt runs induces lenders to monitor borrowers, and at least ex-ante provides borrowers with incentives not to misbehave.
Although the debt run scenario increases diligence on the part of lenders, it may also increase a very specific form of managerial misbehavior. For a debt run scenario to be probable borrowers must have sufficient amounts of debt