

DOCTORAL THESIS

Essays on economic consequences of inside director reputation

Tian, Zhimin

Date of Award:
2014

[Link to publication](#)

General rights

Copyright and intellectual property rights for the publications made accessible in HKBU Scholars are retained by the authors and/or other copyright owners. In addition to the restrictions prescribed by the Copyright Ordinance of Hong Kong, all users and readers must also observe the following terms of use:

- Users may download and print one copy of any publication from HKBU Scholars for the purpose of private study or research
- Users cannot further distribute the material or use it for any profit-making activity or commercial gain
- To share publications in HKBU Scholars with others, users are welcome to freely distribute the permanent URL assigned to the publication

Abstract

This study consists of two essays. The first essay investigates whether non-CEO inside director reputation matters in bank loan contracting. Reputable inside directors (RIDs) can improve borrowers' financial reporting quality and reduce agency risk in loan contracting. Based on regression analysis of 5,104 loan facilities during 1999-2007 in the U.S., I find that borrowers with reputable inside directors enjoy lower loan interest rate and a smaller number of restrictive covenants, and are less likely to have the loans secured by collateral, compared with borrowers without RIDs. The results still hold after I control for CEO reputation, and address the endogeneity of RIDs and the joint determination of various loan contracting terms. These findings shed new light on the impact of director-level reputation in the context of bank loan market.

The second essay investigates whether non-CEO inside directors with reputation incentives affect the effectiveness of a firm's internal control over financial reporting. Internal control effectiveness is an important indicator of financial reporting quality. Using a large sample of 7,352 firm-year observations from 2004 to 2012, I find that firms with RIDs are less likely to have reported internal control weaknesses (ICWs). I also find that RIDs have a more pervasive impact on account-level ICWs than company-level ICWs. Empirical results also demonstrate that the association between RIDs and ICWs is more pronounced for firms with lower audit quality, higher CEO entrenchment, and higher cost of misreporting. Further test shows that RIDs can help to improve earnings quality through mitigating ICWs. The study results still hold after I control for CEO reputation, employing alternative proxies and estimation methods, and address the potential endogeneity problems of RIDs. The study findings add to the few empirical studies examining the determinants of ICWs and have corporate governance policy implications for regulators by supporting the desirable role of inside directors in terms of efficient contracting.

ACKNOWLEDGEMENTS

I am most grateful to my principal supervisor, Professor Zhijun Lin, Head of the Department of Accountancy and Law of Hong Kong Baptist University, for his invaluable guidance, insightful comments, and continued supports. Professor Lin has been supportive since my MPhil studies. He helped me to develop my thesis and overcome different hardships during the five years' MPhil and PhD studies. Without his supports and encouragements, it will not be possible for me to finish the two essays of my thesis in three years. There are no words to express the full measure of my gratitude.

I wish to thank Professor In-Mu Haw and Dr. Byron Song, for their valuable comments and suggestions during various phases of this thesis. Professor In-Mu Haw has supported me not only through his insightful comments, but also from his guidance on how to enrich the whole life and how to become a helpful teacher in the future. I'm also very thankful to Dr. Byron Song for his insightful suggestions and guidance throughout the years. Dr. Byron Song helped me to identify research ideas and also gave me a lot of suggestions on research methodology.

I would like to express my gratitude to all the external and internal examiners on my thesis. They are Dr. Peter Chen, Professor Benjamin Tai, Dr. Raymond Chan, and Dr. Bingbing Hu. They gave me valuable comments to further improve my thesis. Also I deliver my thanks to all the staff members and PhD students at

the Department of Accountancy and Law of Hong Kong Baptist University for their encouragements and assistances.

Last but not the least, I am deeply grateful to my parents Shulin Tian and Yunxiang Sun for their love. Without their help in taking care of my daughter and the whole family, I am not able to commit myself into my thesis. I am thankful to my elder brother Zhigang Tian for his encouragement and guidance throughout these years. I am especially grateful for my husband Ze Sun for his spiritual supports. He has always supported me to do what I want to do. He is the reason why I have the courage to move on whenever I meet with difficulties. Finally, my thanks also go to my daughter Mia Sun. Her beautiful smile inspires me to work in a good humor.

Table of Contents

DECLARATION	i
Abstract.....	ii
ACKNOWLEDGEMENTS	iii
Table of Contents.....	v
List of Tables	viii
Overall Highlight	1
Essay One: Does Director-Level Reputation Matter? Evidence from Bank Loan Contracting.....	7
1 Introduction.....	7
2 Literature review and hypothesis development	13
2.1 Inside director reputation and bank loan contracting	13
2.2 Comparison of inside director reputation and CEO reputation.....	16
3 Research design and data.....	17
3.1 Measurement of inside director reputation	17
3.2 Bank loan contracting features.....	18
3.3 Empirical model.....	19
3.4 Data.....	23
3.5 Descriptive statistics	25
4 Empirical results	27
4.1 Main results.....	27
4.1.1 RID and loan spread: test of H1	27
4.1.2 RID and nonprice terms: test of H2 and H3	28
4.1.3 RID versus RCEO on bank loan contracting: test of H4	30
4.2 Robustness tests	31
4.2.1 Joint determination of loan terms: IV framework estimation.....	31
4.2.2 Endogeneity of inside director reputation.....	35
4.2.3 Controlling for firm-level governance.....	37

4.2.4	Effect of busy director	37
4.2.5	Deal-level analyses	38
5	Conclusion	39
	Appendix: Definition of Variables.....	41
	References.....	44
	Essay Two: Reputable Inside Directors and Internal Control Effectiveness.	67
1	Introduction.....	67
2	Literature review and hypotheses development	73
2.1	Prior literature on internal control effectiveness	73
2.2	Reputation incentives of inside directors and internal control effectiveness .	75
2.3	Company- versus Account-Level Material Weakness	78
2.4	Comparison of inside director reputation and CEO reputation.....	79
2.5	Role of audit quality, CEO entrenchment, and cost of misreporting	81
2.5.1	Role of audit quality	81
2.5.2	Role of CEO entrenchment.....	82
2.5.3	Role of cost of misreporting	83
3	Research Design	84
3.1	Model specification.....	84
4	Sample and data.....	90
5	Empirical results	93
5.1	Main results.....	93
5.1.1	Inside director reputation and ICWs: test of <i>H1</i>	93
5.1.2	Account-level ICWs and company-level ICWs: test of <i>H2</i>	95
5.1.3	Comparison between RID and CEO reputation: test of <i>H3</i>	96
5.1.4	Effect of audit quality: test of <i>H4a</i>	96
5.1.5	Effect of CEO entrenchment: test of <i>H4b</i>	97
5.1.6	Effect of cost of misreporting: test of <i>H4c</i>	97
5.2	Endogeneity issues.....	98
5.2.1	Propensity score matching.....	98

5.2.2	Reverse causality: change/remediation analysis.....	100
5.3	Robustness tests	101
5.3.1	Effect of RIDs on earnings quality	101
5.3.2	Corporate governance control index.....	103
5.3.3	Alternative measures for firm-specific controls	104
5.3.4	Effect of SOX 302 reports	105
5.3.5	Effect of regulation on non-accelerated filers.....	106
5.3.6	Alternative partitioning methods for H4.....	106
6	Conclusion	107
	Appendix: Variable Definition	109
	Reference:	112
	CURRICULUM VITAE.....	144