



Corporate governance and default prediction: a reality test

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ABSTRACT

Default prediction has commanded the attention of researchers for at least 50 years. This paper addresses several testable hypotheses regarding the relations between corporate governance and default prediction. We employ the conventional logistic regression to provide empirical evidence from U.S. default data over the period of 2000 to 2015. Empirical results are consistent with the following notions: First, default firms are associated with high ownership concentration, low shareholder rights, low financial transparency and disclosures, and less board effectiveness. Second, in-sample and out-of-sample tests support the incremental contribution of corporate governance information on default prediction, when compared with the models involving just financial information.

KEYWORDS

Corporate governance; default prediction; accounting information; market information

JEL CLASSIFICATION

C01; G21; C34; G34; C87

1. Introduction

Managing and measuring credit risk is a core activity for banks. The key parameter to quantify credit risk is default probability.¹ However, default probability is difficult to estimate because defaults occur relatively infrequently. The difficulty in predicting corporate failure has posed a long-standing problem in credit risk research. The importance of financial information for estimating default probability has been well documented in the literature. Recent studies pay attention to non-financial information, such as corporate governance, and point out non-financial information may improve accuracy of default probability estimation.

Financial information for estimating default probability could be grouped into two categories: accounting information suggested by Altman's (1968) model: and market information involved in Merton's (1974) model. The former seeks to estimate default probability of corporate borrowers based on their accounting-based information (e.g. Beaver 1966; Altman, 1968; Ohlson 1980). The latter predicts corporate failure based on the information of their equity prices (e.g. Vassalou and Xing 2004; Hillegeist et al. 2004; Du and Suo 2007; Bharath and Shumway

2008; Campbell, Hilscher, and Szilagyi 2008). Each type of financial information has limitations. The past performance reported in a firm's accounting reports may not be informative for predicting the future. Moreover, accounting manipulation behaviours by managers may damage financial reporting quality (Agarwal and Taffler 2008). Market information may show up-to-date information about the company which are not yet reflected in the accounting ratios, but only if markets are efficient. Accordingly, recent studies stress the importance of corporate governance and consider it as an alternative non-financial information source for bankruptcy prediction.

Extensive studies document that corporate governance is a key factor for corporate management decisions and thus influences corporate performance. Goktan, Kieschnick, and Moussawi (2006) argue if corporate governance affects company performance, the attributes of corporate governance also ensure the survival of the company. Although some studies have tested the effect of corporate governance on bankruptcy prediction (e.g. Daily and Dalton 1994a, 1994b; Gales and Kesner 1994; Simpson and Gleason, 1999, 1998; Elloumi and

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¹Under the Basel requirements, banks need to link the capital requirements of the bank to the individual level of credit risk.