DO FIRMS BENEFIT FROM PERSISTENT COMMITMENT TO ACCOUNTING CONSERVATISM? POSITIVE EMPIRICAL EVIDENCE FROM CROSS-SECTIONAL AND LONGITUDINAL ANALYSIS

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dx.doi.org/10.18374/JABE-24-2.5

ABSTRACT

When firms adopt conservative accounting practices on a long-term basis, their goal is to provide assurance on the dependability and verifiability of their financial results not only to the firms' shareholders but also to the lending institutions. This practice is often called accounting conservatism and it refers to the systematic understatement of net asset values by firms with the objective of obtaining loans on favorable terms from lenders when firms need additional funding. In the literature theoretical arguments are presented, justifying the implicit assumption that firms do persist in their commitment to their conservative accounting practices, and they do not act opportunistically after receiving significant funding from the capital markets either through the public offering of shares or bonds or directly from the lending institutions in the form of loans at low interest rates. However, there is no empirical evidence that firms' accounting conservatism is, indeed, persistent. In this paper, we propose three hypotheses about the benefits accruing to the firms that adopt conservative accounting practices. Using time-series data from more than a thousand firms collected from Dealscan and Compustat, we perform a cross-sectional analysis and a longitudinal or panel-data analysis. We present test results related to our hypotheses that lenders consider borrowers' persistent accounting conservatism in making interest rate decisions, and that borrowers do not lower their level of accounting conservatism after obtaining the necessary funding. Our findings provide empirical evidence validating the critical or implicit assumption found in the literature that firms tend to maintain their accounting conservatism because of the potential detrimental market consequences for reneging on their commitment and the influence of corporate governance structures that limit managers' opportunistic behavior.

Keywords: *accounting conservatism; loan contracts; opportunistic behaviors*

1. INTRODUCTION

As is commonly understood, accounting conservatism refers to the systematic understatement of net asset values by firms with the goal of obtaining loans on favorable terms from lenders when firms need additional funding. Of course, the managers of firms have the advantage of access to asymmetric information when it comes to the recognition and announcement of gains and losses. It is in the best interest of lenders to make loans to firms with a higher credit rating and lower default risk. But how can lenders reliably assess the default risk without access to information about the financial affairs of the firms? Accounting conservatism is the vehicle through which firms provide assurance to the lenders on the dependability and verifiability of their financial results, thereby mitigating the disadvantages experienced by the lenders because of the asymmetric information (Basu 1997; Watts 2003a). Research on accounting conservatism provides theoretical insights in terms of the information asymmetry and agency cost problems in capital markets. In particular, the contracting perspective holds that accounting conservatism reduces moral hazard issues and opportunistic behaviors resulting from the information asymmetry between firms and diverse stakeholders. Accordingly, research adopting this perspective posits that accounting conservatism leads to improvements in investors' asset allocation decisions and managers' compensation contracts by mitigating information asymmetry and reducing agency costs (Watts 2003a, 2003b).

In general, it is expected that accounting conservatism enhances the mutual trust and welfare of all participants involved in the loan contract. Lenders have an asymmetric payoff structure with regard to their