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**Debtholders’ Demand for Conservatism: Evidence from Changes in Directors’ Fiduciary Duties**

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ABSTRACT

Debtholders’ demand has been widely discussed as a key determinant of con- servatism but clear causal evidence is not yet established. Using a natural ex- periment setting, wherein a Delaware court ruled that the fiduciary duties of directors in near insolvent Delaware companies extend to creditors, we predict and find that firms subject to the ruling significantly increased their accounting conservatism. In addition, our results suggest that the increase in conservatism is more pronounced in near insolvent Delaware firms with stronger boards, confirming that the court ruling takes effect through the channel of the board of directors. Our results are robust to using alternative

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993

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measures of conservatism and near insolvency status, and controlling for potential confounding factors and other stakeholders’ demand for conser- vatism. Overall, our study provides empirical evidence to support the causal relation between debtholders’ demand and accounting conservatism previ- ously suggested in the literature, and offers some insights into the role of the board of directors in financial reporting.

**JEL codes:** M41; G34; K20

**Keywords:** Conservatism; fiduciary duties; near insolvency; board governance

# Introduction

Research on accounting conservatism posits that demand from lenders is the main reason why firms adopt conservative accounting policies (Watts [2003]). Supporting evidence for this conjecture is primarily based on doc- umented associations between conservatism and various characteristics of debt contracting (e.g., Ahmed et al. [2002], Ball and Shivakumar [2005], Beatty, Weber, and Yu [2008], Zhang [2008]), but most of them are not of a causal nature, raising the question of whether conservatism is indeed demanded by debtholders. Moreover, conservatism could also be excessive and thus inefficient for firms and even detrimental to debtholders, which appears to conflict with the presumption that debtholders would always demand conservatism. For instance, too much conservatism may result in tighter debt covenants leading to premature transfer of decision rights to debtholders, which might unduly constrain a firm’s investment and financ- ing policies (Leuz [2001]). Also, excessive conservatism may allow man- agers to create hidden reserves, which may be reversed in the future at the discretion of shareholders (Leuz [1998]). To help resolve this ambiguity on debtholder preferences, we exploit an important legal event to identify a causal link between debtholders’ demand and accounting conservatism.

A 1991 Delaware court in the ruling of *Credit Lyonnais Bank v. Pathe Communications* (hereafter “the court ruling”) expanded the scope of direc- tors’ fiduciary duties to include creditors when a Delaware incorporated firm is in the “vicinity of insolvency.” The fact that the court ruling had no judgment on financial reporting per se, combined with the natural event setting, which helps mitigate the issue of confounding factors, makes it possible to attribute any post-ruling change in conservatism by near insolvent Delaware companies to debtholders’ demand for conservatism.1

1 The idea is that the court ruling provides an exogenous change in fiduciary duties, which in turn should affect firms’ supply of conservative accounting. This exogenous variation allows us to identify debtholders’ demand for conservatism. If the shift in supply leads to no change in conservatism, this suggests that the demand for conservatism is either fully inelastic (which is implausible) or absent, which is the null for our tests.

We use a difference-in-differences research design to capture the dif- ferential post-ruling changes in financial reporting conservatism between firms near insolvency and away from insolvency and between firms incorpo- rated in and outside the State of Delaware. We employ a firm-year specific composite score as our main measure of conservatism and supplement it with the asymmetric timeliness models of Basu [1997] and Ball and Shiv- akumar [2006]. Overall, we find that, in the immediate period following the court ruling in 1991, financial reporting conservatism significantly in- creased for near insolvent Delaware firms. The results indicate that, in re- sponse to their increased fiduciary obligations to creditors, directors of firms subject to the court ruling influence managers to adopt more con- servative financial reporting.