

# THE DIFFERENTIAL IMPACT OF PRIVATE AND PUBLIC DEBT ON ACCOUNTING CONSERVATISM

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## ABSTRACT

*The private and public debt markets differ in monitoring functions and covenant features. This paper empirically examines whether these differences impact accounting conservatism. Using a sample drawn from Loan Pricing Corporation's Dealscan, I find that firms report more conservatively in the years following the issuance of private debt than the years before. I also find that firms report more conservatively following initial public debt offerings (bond IPOs). However, there is no change in the degree of conservatism around seasoned bond offerings. I interpret the results as reflecting differences in monitoring functions of the private and public debt markets. The direct monitoring by private debt holders and the external monitoring including regulatory scrutiny in the context of bond IPOs are effective in enforcing accounting conservatism. The limited monitoring in the case of seasoned bonds fails to do so.*

**JEL:** M41, M42

**KEYWORDS:** Accounting Conservatism, Monitoring Function of Debt, Private Debt, Public Debt

## INTRODUCTION

The role of debt in financial reporting has been of great interest in the accounting literature. In this study, I differentiate the impact of private and public debt on accounting conservatism to shed light on the mechanism that drives firms' application of accounting conservatism. This research question is motivated by differences between private and public debt with respect to monitoring functions and covenant features.

Prior studies provide evidence that both private and public debt holders demand accounting conservatism (Ahmed et al., 2002; Beatty et al., 2008; Nikolaev, 2010). In addition, compared to private debt holders, public debt holders' demand for accounting conservatism might be stronger because their own monitoring is weaker and they do not have the protection of conservative covenants. On the other hand, enforcement of accounting conservatism is potentially conditional on an effective monitoring system including the use of maintenance covenants to gain control rights when situations arise, which is lacking for public debt holders. It is then an empirical question to examine whether the potentially stronger demand from public debt holders for conservatism drives more conservative reporting for firms that access the public debt market or their lack of effective monitoring fails to enforce more conservative reporting.

To identify the differential impact of the public and private debt markets on accounting conservatism, I take an incremental approach and examine the change in accounting conservatism subsequent to the issuance of new debt. Using a private debt sample drawn from Dealscan, I find that borrowing firms accelerate their recognition of bad news and delay their recognition of good news following the issuance of private debt. Using a public debt sample obtained from the SDC platinum, I do not find any change in reporting conservatism for the full sample. Because the external monitoring from the financial intermediaries such as credit rating agencies, auditors and underwriters and the regulatory scrutiny are stronger in the context of bond IPOs, I also test whether there is any difference in conservative reporting following the issuance of

bond IPOs and the seasoned bond offerings. I find that firms indeed report more conservatively following the issuance of bond IPOs. The result, however, does not hold following the issuance of seasoned bonds. Overall, the results support the interpretation that the direct monitoring by private debt holders and the external monitoring in the context of bond IPOs are effective in enforcing accounting conservatism. The limited monitoring in the case of seasoned bonds fails to do so. The rest of the paper is organized as follows. The next section is the literature review and development of the hypotheses, followed by a discussion of the research design and the sample selection procedure. The last two sections present the results and conclusion.

## LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

### The Debt Contracting Role of Conservatism

Several papers review various explanations for the existence of accounting conservatism (e.g. Watts 2003). Debt contracting is one of the most important. This line of research argues that debt contracting drives the existence and degree of conservatism. The debt market demands conservatism because debt holders have asymmetric payoffs – their payoffs are more sensitive to downside risk than upside gains. Consequently, debt holders are more concerned with the lower ends of the earnings and assets distributions, which are used to evaluate the creditworthiness of a business and its debt-repaying ability. Conservatism provides a timelier and more reliable estimate of the lower bound of a firm’s assets-in-place. Debt holders’ preference for conservatism also arises due to their concern over managers’ over-optimism engendered either by compensation incentives (the management’s compensation is dependent upon accounting numbers) or by corporate governance incentives (the potential to lose jobs because of poor financial performance makes the management tend to avoid reporting losses). Conservatism constrains managers from behaving opportunistically to increase their own welfare and the benefits of other claimholders.

Critics of using accounting conservatism in financial reporting to mitigate agency conflicts argue that the demand for conservatism from the debt markets can be realized through conservative adjustments to debt covenants. It is not necessary to introduce conservative bias in financial reporting. Beatty et al. (2008) consider the use of income escalator as one type of conservative adjustments to net worth covenant thresholds. Specifically, income escalator allows only a portion of positive income to increase covenant slack, but the full amount of losses to reduce covenant slack. Using a private debt sample, Beatty et al. (2008) find the use of income escalator is positively associated with conservatism in financial reporting. The result suggests that conservative adjustments in debt contracts and accounting conservatism are complements in their sample rather than substitutes. Using a public debt sample, Nikolaev (2010) finds that the reliance on covenants is positively associated with accounting conservatism, again suggesting the two are complements.

### Private Debt versus Public Debt: Monitoring and Covenants

Continuous review of financial reporting is an important component of debt holders’ monitoring system. They use it to evaluate the creditworthiness of a business and its debt paying ability. Many debt contracts have covenant restrictions that are also based on accounting numbers. Managers are often required to certify the accuracy of accounting information and to provide monthly or quarterly covenant compliance reports (FITCH IBCA 1999). The close monitoring of financial reporting by debt holders can then affect borrowers’ financial reporting behaviors including the application of accounting conservatism. Through close monitoring, lenders can enforce more conservative reporting as borrowers take on additional debt. Borrowers have to yield to the reporting demand if their financing structure is more debt-oriented. Otherwise, they could lose credibility with lenders, which in turn jeopardizes other lending relations and future credit accessibility.

Private debt and public debt differ in their monitoring functions. First, the investor base and liquidity of the two markets affect the incentives for monitoring. Private debt holders have more incentives to monitor because the lending is concentrated and the debt is more likely to be held to maturity. In contrast, public debt is held by diffuse creditors and their incentives to engage in monitoring are weak due to the “free rider” problem (Strahan, 1999). The incentive is further reduced when there is an active secondary market and investor holding is more transient (Armstrong, 2003). Private debt holders are also more efficient in monitoring. The majority of private debt is held by banks that are monitoring experts and have better information processing ability. They also have better access to a firm’s private information. They may request monthly internal financial statements. They can even require firms to provide weekly or daily updates on certain accounts (Standard & Poor’s, 2009; Wittenberg-Moerman, 2009).

Private and public debt contracts also differ in the use of accounting-based debt constraints. Private debt agreements typically have more negative financial covenants. FITCH IBCA (1999) reports that their sample of leveraged bank loan agreements on average contain 20 covenants, while the same issuers’ high-yield indentures have only 6 covenants on average. The financial covenants in private debt are set tightly and quarterly covenant compliance reports are required, giving private debt holders considerable control (Milken Institute, 2004). Dichev and Skinner (2002) find that private lenders set debt constraints just below the actual current value. Covenant violation occurs frequently. Such tight covenant restrictions and frequent violations of debt covenants suggest that lenders have significant power in enforcing their preferred managerial behaviors including the application of more conservative accounting. Public debt contracts, on the other hand, typically do not have financial covenants that require quarterly compliance. Even if they do, the covenants are set looser and technical violations are rare (Begley and Freedman 2004). The existence of accounting-based constraints in debt contracts, however, potentially has opposing effects on a firm’s financial reporting behaviors. On one hand, it is an important part of the monitoring system a debt holder could impose; on the other hand, it gives managers additional incentives to manage earnings upward with a purpose of avoiding covenant violations (DeFond and Jiambalvo, 1994; Dichev and Skinner, 2002)

### Development of Hypotheses

Based on prior research, it is unclear whether there is a change in the degree of conservatism around the issuance of private debt and if there is the direction of the change. First of all, if it is true that the debt market values conservatism and thus lowers cost of debt for firms reporting more conservatively, borrowing firms might voluntarily bond themselves to conservative reporting to reduce the cost of borrowing. It is then expected that this is done *ex ante* and borrowers will not become less conservative *ex post*. Zhang (2008) and Ahmed et al. (2002) propose that managers’ concern over reputation cost constrains them from deviating from their *ex ante* financial reporting commitment. Therefore, there will not be a significant change in the degree of conservatism around debt issuance.

Second, the costs of being conservative might prevent firms from reporting more conservatively *ex ante*. The managers of borrowing firms might be against conservatism because (1) conservatism leads to accelerated covenant violation (Zhang 2008); (2) managers have limited horizon and their compensation is tied to their current reported levels of income (Watts 2003); (3) conservatism increases earnings volatility (Givoly and Hayn 2000) but income smoothness is preferred by managers (Graham, Harvey and Rajgopal 2005); and (4) equity holders have other reporting preferences (Ball and Shivakumar 2008). However, with an increase in the level of debt, firms become more debt-oriented and the agency conflict between debt holders and owners/managers becomes more severe. Given conservatism is a preferred reporting mechanism for the debt market, *ex post* debt holders might force firms to report more conservatively through their monitoring mechanism, although borrowers might have other reporting preferences. This hypothesis assumes that the debt market has an effective monitoring and enforcement mechanism.

Third, the debt covenant hypothesis suggests that firms might also report less conservatively following debt issuance. Because the probability and cost of covenant violation are higher for firms with an increase in their debt level, firms have more incentives to make income-increasing accounting choices to avoid covenant violation, which is in direct contrast with conservatism that delays recognition of gains and accelerates recognition of losses when uncertainty is involved.

The private debt market has a strong monitoring function including the use of accounting-based covenants, but on the other hand, the existence of accounting-based constraints is more prevalent in private debt contracts and therefore the debt covenant hypothesis is more relevant. It is an empirical issue then to investigate whether there is a change in the degree of conservatism around the issuance of private debt, and if there is, which direction the change is. I present the following hypothesis in the null form:

*H1: There is no change in a firm's conservative reporting following the issuance of private debt.*

The monitoring function of the public debt market is weaker. The external monitoring from financial intermediaries such as rating agencies is also expected to be weaker than direct monitoring from banks. Therefore, if it is indeed the monitoring function of the debt market that makes borrowers report more conservatively, I expect the change toward being more conservative following debt issuance to be weaker for the public debt sample, hence the following hypothesis:

*H2: Any change towards being more conservative in financial reporting is weaker for firms getting public debt than firms borrowing from the private debt market.*

There are also significant differences between bond IPOs and seasoned bond offerings. The external monitoring from rating agencies, auditors and underwriters are expected to be stronger for initial bond offerings than subsequent bond issuance. The initial issuance is also subject to more regulatory scrutiny. Therefore, I expect the impact of bond IPO issuance on the enforcement of accounting conservatism is stronger than the issuance of seasoned bonds. I then have the following hypothesis:

*H3: Any change towards being more conservative in financial reporting is stronger for the bond IPO sample than the seasoned bond sample.*

## RESEARCH DESIGN AND SAMPLE SELECTION

The tests are to compare the reported level of conservatism three years before and after debt issuance. The measure of conservatism is calculated from the model developed in Basu (1997). Basu (1997) operationalizes this interpretation of conservatism by running an earnings-return regression with earnings as the dependent variable. Return is taken as a proxy for news, and earnings are expected to reflect bad news (negative return) more quickly than good news (positive return). The following model is used:

$$Earnings = \alpha + \beta_1 DR + \beta_2 Return + \beta_3 Return * DR + \varepsilon \quad (1)$$

To capture changes in the reported level of conservatism, I adjust the model with a *Post* indicator variable. To be specific, the following model is used:

$$Earnings = \alpha + \beta_1 DR + \beta_2 Return + \beta_3 Return * DR + \beta_4 Post + \beta_5 DR * Post + \beta_6 Return * Post + \beta_7 Return * DR * Post + \varepsilon \quad (2)$$

*Earnings* is defined as annual earnings per share scaled by price per share at the beginning of the fiscal year. *Return* is fiscal year buy-and-hold return. *DR* is an indicator variable that equals 1 if *Return* is less than 0, and 0 otherwise. *Post* is an indicator variable that takes on the value of 1 if a year is after the debt issuance

year and 0 otherwise. The issuance year is not included in the analyses. All variables are for firm  $i$  and period  $t$ .  $\alpha$ , the intercept is expected to be positive according to Basu (1997) because it captures realized gains reflecting previous good news.  $\beta_2$  represents the sensitivity of earnings to good news and is expected to be positive.  $\beta_3$  captures the incremental response of earnings to bad news over good news and it is expected to be positive for conservative reporting. The incremental sensitivity of earnings to bad news over good news after the debt is issued is  $\beta_3 + \beta_7$ . If firms report more conservatively following the debt issuance,  $\beta_7$  is expected to be positive, meaning that firms further accelerate the recognition of bad news. The sensitivity of earnings to good news following debt issuance is  $\beta_2 + \beta_6$ . If conservatism is also reflected as further delay of recognizing unrealized gains,  $\beta_6$  is expected to be negative.

I obtain the private debt sample from Loan Pricing Corporation's Dealscan. The sample selection procedure starts with all facilities in the Dealscan database for the period from 1987 to 2005, totaling 157,717 observations. I keep one deal for each firm each year, which results in 26,022 deals. Of these deals, 22,630 have necessary borrowers' attribute available through COMPUSTAT. I truncate deals with borrowers' return and earnings per share (EPS) scaled by the prior year closing price being in the top and bottom 1% to reduce the effect of outliers on the regression results, leaving 20,773 deals. To improve comparability, I test the hypotheses using a constant sample. The constant sample is constructed to include only deals whose borrowers have all seven years data (3 years before, the issuance year and 3 years after) available. The final sample consists of 8,774 deals, representing 2,863 different borrowing firms.

I use Securities Data Company's SDC platinum to identify all non-convertible public debt issued from 1970 to 2005. A bond IPO is identified as the first issuance of public debt by each firm in the SDC platinum. I have a total of 6,296 bond IPOs. Similar to the private debt sample, I construct a constant sample that must have seven years data available (3 years before, the issuance year and 3 years after), which yields 890 bond IPOs. To construct the seasoned bond sample, I keep only one deal for each firm each year excluding the bond IPO. For this sample I again require that financial data should be available for all seven years of interest. After deleting deals with borrowers' return and earnings per share scaled by the prior year close price being in the top and bottom 1%, the final constant sample of seasoned bonds has 1,968 deals, representing 579 unique firms.

## RESULTS AND DISCUSSION

Table 1 presents the descriptive statistics for the private debt sample, the bond IPO sample and the seasoned bond sample. Comparison of the medians shows that firms in the seasoned bond sample are, on average, much larger (median total assets are \$7,947 million vs \$1,100 million for the private debt sample and \$1,628 for the bond IPO sample). The other financial attributes of the private debt and seasoned bond samples are comparable. Median market to book is around 2, leverage around 23%, ROA about 4%, earnings per share scaled by price around 0.06 and fiscal year return about 12%. The Bond IPO sample has lower market to book ratio (1.575). Table 2 also shows that the additional borrowings in the samples are economically important for the borrowing firms. The median deal size in the private debt sample is \$150 million, representing about 13% of total assets and about 59% of total long-term debt for a firm. The median deal size of the bond IPO is \$100 million, representing about 6.6% of total assets and 34.9% of total long-term debt. The materiality of the deals makes it possible that a firm might change its reporting practice for the purpose of debt contracting.

Table 1: Descriptive Statistics

<b>Panel A: The Private Debt Sample</b>					
Variable	N	Mean	Median	75%	25%
<i>Size (in millions)</i>	52,640	9,195	1,100	4,409	270
<i>Market to book</i>	52,572	2.842	1.926	3.054	1.275
<i>Leverage</i>	52,591	0.242	0.223	0.348	0.101
<i>ROA</i>	52,640	0.031	0.039	0.071	0.012
<i>Earnings</i>	52,644	0.034	0.056	0.083	0.025
<i>Return</i>	52,644	0.17	0.106	0.364	-0.129
<i>Deal month</i>	46,782	39	36	60	12
<i>Deal size (in millions)</i>	52,638	397	150	380	45
<i>Deal size/long term debt</i>	49,739	22.567	0.590	1.475	0.231
<i>Deal size/total assets</i>	52,634	0.235	0.130	0.272	0.055
<b>Panel B: The Bond IPO Sample</b>					
Variable	N	Mean	Median	75%	25%
<i>Size (in millions)</i>	5,340	11,326	1,628	4,773	561
<i>Market to book</i>	5,338	1.988	1.575	2.336	1.076
<i>Leverage</i>	5,311	0.233	0.212	0.342	0.099
<i>ROA</i>	5,339	0.043	0.041	0.066	0.014
<i>Earnings</i>	5,340	0.077	0.075	0.109	0.05
<i>Return</i>	5,340	0.145	0.103	0.324	-0.086
<i>Deal month</i>	5,340	174	122	304	86
<i>Deal size (in millions)</i>	5,340	190	100	200	40
<i>Deal size/long term debt</i>	5,230	1.304	0.349	0.739	0.152
<i>Deal size/total assets</i>	5,340	0.109	0.066	0.122	0.025
<b>Panel C: The Seasoned Bond Sample</b>					
Variable	N	Mean	Median	75%	25%
<i>Size (in millions)</i>	11,804	37,231	7,947	22,309	2,937
<i>Market to book</i>	11,794	2.937	2.026	3.072	1.477
<i>Leverage</i>	11,804	0.250	0.237	0.345	0.133
<i>ROA</i>	11,804	0.040	0.035	0.062	0.012
<i>Earnings</i>	11,806	0.064	0.065	0.089	0.044
<i>Return</i>	11,806	0.153	0.129	0.314	-0.038
<i>Deal month</i>	11,806	145	122	146	61
<i>Deal size (in millions)</i>	11,806	278	150	300	88
<i>Deal size/long term debt</i>	11,777	0.270	0.105	0.241	0.035
<i>Deal size/total assets</i>	11,804	0.042	0.021	0.051	0.006

Table 1 presents the descriptive statistics of the private debt sample, the bond IPO sample and the seasoned bond sample. Size is total assets. Market to book is the market value of equity divided by the book value of the equity. Leverage is long-term debt divided by total assets. ROA is net income divided by total assets. Return is fiscal year buy-and-hold return. Deal month is the length of the deal in months. Deal size is the borrowing amount of the deal in millions. Deal size/long term debt is the size of the deal divided by total long-term debt. Deal size/total assets is the size of the deal divided by total assets.

The results of testing hypothesis 1 regarding changes in conservatism around private debt issuance are reported in Table 2. For comparison purpose, I also present the results using the Basu basic model (model 1). The sign and magnitude of the intercept (+ 0.052), coefficients for good news (+ 0.011) and incremental sensitivity of bad news to good news (+ 0.251) are all consistent with Basu (1997). Overall, the results

show that the samples are representative and confirm that bad news is reflected more quickly in earnings than good news, as predicted by the conservatism literature.

The *Post* indicator variable allows us to compare the degree of conservatism across periods.  $\beta_6$ , the coefficient for the incremental sensitivity of earnings to good news, is significantly negative (-0.014) while  $\beta_7$ , the coefficient on *Return\*DR\*Post* is positive 0.146, highly significant. The results indicate that firms further delay their recognition of good news and accelerate their recognition of bad news following the issuance of private debt. This supports the argument that financial reporting becomes more conservative following private debt contracting.

I further break down the full sample into an investment grade sub-sample and a leveraged sub-sample. I have this segregation because a few papers document differences in earnings management behaviors around the issuance of these two types of debt (e.g. Anthony et al., 2009). Following the definition of Standard & Poor's, 125 basis points are used as the cutoff point for the segregation. For both the investment-grade and leveraged sub-samples, I find that the coefficient on *Return\*Post* is significantly negative, suggesting that firms further delay their recognition of good news. The coefficient on *Return\*DR\*Post* is significantly positive for both sub-samples (0.105 and 0.180), suggesting that firms further accelerate their recognition of bad news. Overall, firms report more conservatively following the issuance of both investment-grade and leveraged private debt.

Table 2: Changes in Accounting Conservatism around Private Debt Issuance

Variable	Full		Investment Grade		Leveraged	
	Model 1	Model 2	Model 1	Model 2	Model 1	Model 2
<i>Intercept</i>	0.052***	0.054***	0.057***	0.059***	0.037***	0.039***
<i>DR</i>	0.009***	0.004	0.001	-0.003	0.011**	0.007
<i>Return</i>	0.011***	0.018***	0.024***	0.026***	0.011***	0.017***
<i>Return*DR</i>	0.251***	0.176***	0.128***	0.063***	0.265***	0.186***
<i>Post</i>		0.004*		0.004**		0.003
<i>DR*Post</i>		0.008**		0.003		0.010
<i>Return*Post</i>		0.014***		0.007**		0.011*
<i>Return*DR*Post</i>		0.146***		0.105***		0.180***
Adj R <sup>2</sup>	7.36%	7.99%	8.26%	9.13%	6.98%	7.81%

Table 2 presents the results of testing whether there is a change in conservatism around private debt issuance. The sample is further broken down to two subsamples: investment-grade loans and leveraged loans. The dependent variable is Earnings defined as annual earnings per share scaled by price per share at the beginning of the fiscal year. Return is fiscal year buy-and-hold return. DR is an indicator variable that equals 1 if Return is less than 0, and 0 otherwise. Post is an indicator variable that takes on the value of 1 if the year is after the debt issuance year and 0 otherwise. The issuance year is not included in the analyses. \*, \*\*, \*\*\* are used to indicate significance at the 10, 5 and 1 percent levels respectively.

To further test the hypothesis that it is the monitoring mechanism from the debt market that drives more conservative reporting, I use SDC platinum to identify new bond market issues and compare the public debt samples with the private debt samples (H2). Table 3 presents the results using the full public debt sample (the first two columns). Contrary to the private debt results, the coefficients on *Return\*Post* and *Return\*DR\*Post* are not statistically significant, meaning there is no change in the reported level of conservatism around the issuance of public debt. This is consistent with the notion that the monitoring function of the public debt market is weaker. I also break down the full sample into an investment-grade bond sample and a high-yield bond sample. I find that the coefficient on *Return\*DR\*Post* is significantly positive for the investment-grade sub-sample, suggesting an increase in accounting conservatism. For the high-yield sub-sample, the coefficients on *Return\*Post* is significantly positive, suggesting high-yield bond issuers engage in aggressive reporting and accelerate their recognition of gains.

Table 3: Changes in Accounting Conservatism around Public Debt Issuance

Variable	Full		Investment Grade		High Yield	
	Model 1	Model 2	Model 1	Model 2	Model 1	Model 2
<i>Intercept</i>	0.059***	0.064***	0.060***	0.064***	0.041***	0.049***
<i>DR</i>	0.003*	-0.001	0.002	0.000	-0.006	-0.029*
<i>Return</i>	0.051***	0.046***	0.049***	0.048***	0.072***	0.045***
<i>Return*DR</i>	0.066***	0.058***	0.053***	0.036***	0.065*	0.079
<i>Post</i>		-0.009***		-0.008***		-0.015
<i>DR*Post</i>		0.007**		0.003		0.052**
<i>Return*Post</i>		0.008*		0.000		0.058**
<i>Return*DR*Post</i>		0.014		0.032***		-0.018
Adj R <sup>2</sup>	11.73%	12.05%	11.62%	12.22%	12.85%	13.67%

Table 3 presents the results of testing whether there is a change in conservatism around public debt issuance. The sample is further broken down to two subsamples: one has only public debt of investment grade and the other has only public debt of high yield. The dependent variable is Earnings defined as annual earnings per share scaled by price per share at the beginning of the fiscal year. Return is fiscal year buy-and-hold return. DR is an indicator variable that equals 1 if Return is less than 0, and 0 otherwise. Post is an indicator variable that takes on the value of 1 if the year is after the debt issuance year and 0 otherwise. The issuance year is not included in the analyses. \*, \*\*, \*\*\* are used to indicate significance at the 10, 5 and 1 percent levels respectively.

To test H3, I first run the regression using the bond IPO sample and then the seasoned bond sample. Table 4 presents the results for the bond IPO sample. The coefficients on *Return\*Post* is not significant, but the coefficient on *Return\*DR\*Post* is significantly positive, meanings firms further delay the recognition of bad news. The level of conservatism increases following the issuance of bond IPOs. The results hold for the full bond IPO sample as well as the investment grade sub-sample. On the other hand, I do not find any change in the degree of conservatism following the issuance of seasoned bonds. As shown in Table 5, the results of no change hold for both the full seasoned bond sample and the sub-samples broken down into investment-grade and high-yield bonds. Therefore, the result of being more conservative following the issuance of investment grade bonds reported in Table 3 is driven by bond IPOs. Table 4 and 5 also indicate there is no change in reported levels of conservatism following the issuance of high-yield bonds. Overall, the results suggest that external monitoring from financial intermediaries is stronger around the initial public debt offerings compared with the subsequent offerings.

Table 4: Changes in Accounting Conservatism around the Initial Public Debt Offerings

Variable	Full		Investment Grade		High Yield	
	Model 1	Model 2	Model 1	Model 2	Model 1	Model 2
<i>Intercept</i>	0.079***	0.082***	0.079***	0.082***	0.066***	0.074***
<i>DR</i>	0.003	-0.006	0.002	-0.010**	-0.005	0.003
<i>Return</i>	0.041***	0.044***	0.044***	0.042***	0.049***	0.063***
<i>Return*DR</i>	0.131***	0.054***	0.078***	0.005	0.253***	0.185**
<i>Post</i>		-0.005		-0.006		-0.009
<i>DR*Post</i>		0.014*		0.020***		-0.022
<i>Return*Post</i>		-0.009		0.004		-0.049
<i>Return*DR*Post</i>		0.130***		0.120***		0.130
Adj R <sup>2</sup>	9.42%	10.05%	9.31%	9.99%	12.75%	13.98%

Table 4 presents the results of testing whether there is a change in conservatism around bond IPO issuance. The sample is further broken down into two subsamples: one has bond IPOs of investment grade and the other has bond IPOs of high yield. The dependent variable is Earnings defined as annual earnings per share scaled by price per share at the beginning of the fiscal year. Return is fiscal year buy-and-hold return. DR is an indicator variable that equals 1 if Return is less than 0, and 0 otherwise. Post is an indicator variable that takes on the value of 1 if the year is after the debt issuance year and 0 otherwise. The issuance year is not included in the analyses. \*, \*\*, \*\*\* are used to indicate significance at the 10, 5 and 1 percent levels respectively.



Table 5: Changes in Accounting Conservatism around Seasoned Bond Offerings

Variable	Full		Investment Grade		High Yield	
	Model 1	Model 2	Model 1	Model 2	Model 1	Model 2
<i>Intercept</i>	0.059***	0.063***	0.059***	0.064***	0.040***	0.045***
<i>DR</i>	0.002	0.001	0.001	0.000	-0.004	-0.018
<i>Return</i>	0.049***	0.046***	0.047***	0.044***	0.083***	0.068***
<i>Return*DR</i>	0.061***	0.063***	0.052***	0.051***	0.062	0.086
<i>Post</i>		-0.009***		-0.009***		-0.017
<i>DR*Post</i>		0.003		0.001		0.032
<i>Return*Post</i>		0.006		0.004		0.038
<i>Return*DR*Post</i>		-0.004		0.002		-0.045
Adj R <sup>2</sup>	11.00%	11.43%	10.83%	11.44%	12.89%	12.61%

Table 5 presents the results of testing whether there is a change in conservatism around the issuance of seasoned bonds. The sample is further broken down to two subsamples: one has only seasoned bonds of investment grade and the other has only seasoned bonds of high yield. The dependent variable is Earnings defined as annual earnings per share scaled by price per share at the beginning of the fiscal year. Return is fiscal year buy-and-hold return. DR is an indicator variable that equals 1 if Return is less than 0, and 0 otherwise. Post is an indicator variable that takes on the value of 1 if the year is after the debt issuance year and 0 otherwise. The issuance year is not included in the analyses. \*, \*\*, \*\*\* are used to indicate significance at the 10, 5 and 1 percent levels respectively.

## CONCLUSION

This paper examines the differential impact of public and private debt on accounting conservatism, using a private debt sample drawn from Dealscan and a public debt sample obtained from the SDC platinum. An incremental approach is used to examine whether firms increase their degree of accounting conservatism following an increase in debt levels resulting from the issuance of private debt, bond IPOs and seasoned bonds. I find that firms report more conservatively following the issuance of private debt. They also report more conservatively following the issuance of bond IPOs. But I do not find that firms change their degree of accounting conservatism following the issuance of seasoned bonds. I attribute the results to the monitoring effectiveness of the debt market. The debt market demands conservative reporting. The direct monitoring of the private debt holders including the use of accounting-based constraints is strong for the private debt market and therefore I find a positive relation between an increase in debt levels and an increase in accounting conservatism. The external monitoring from the financial intermediaries is also strong in the context of bond IPOs. I therefore also find a positive relation using the bond IPO sample. In the case of seasoned bonds, however, the monitoring function is weak for the diffuse holders of public debt and the external monitoring is also not very strong and thus there is no change in accounting conservatism.

This paper contributes to the stream of research on the role of debt in financial reporting. It provides evidence that changes in conservatism around debt issuance differ between private debt, bond IPOs and seasoned bonds. There are two key differences between this paper and prior studies. First, this paper recognizes the cost of conservatism to managers and considers the importance of having an effective monitoring system in place for debt holders to enforce conservatism. Second, this paper differentiates the impact of public and private debt on firms' financial reporting. This distinction is important because it has long been recognized that monitoring functions and covenant restrictions imposed in debt agreements of the two markets are very different. Our paper also has practical implication for standard setting. Standard setters leave conservatism off the list of qualitative characteristics of reporting because it clashes with concepts like neutrality. The primary users of financial statements as capital providers, however, include both equity investors and creditors. Given the importance of accounting conservatism in debt contracting, especially for public debt holders, the move away from conservatism might have a negative effect on the credit supply by the public debt market.

One caveat about our analysis is that the use of the incremental approach does not consider the effect of the existing debt level and mix, which could be an extension of this research. Another potentially fruitful direction of future research is to study how the move away from conservatism in accounting standards could affect debt holders' use of accounting information and what compensating mechanism has been adopted by managers and creditors to mitigate the potential negative effect.

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