Journal of Accounting and Economics 59 (2015) 80–104

Contents lists available at ScienceDirect

Journal of Accounting and Economics

journal homepage: www.elsevier.com/locate/jae

Do financial market developments influence accounting practices? Credit default swaps and borrowers' reporting conservatism ☆

Xiumin Martin [a], Sugata Roychowdhury [b,*]

[a] Washington University, St. Louis, USA
[b] Boston College, USA

ARTICLE INFO

Article history:
Received 22 January 2014
Received in revised form
4 September 2014
Accepted 12 September 2014
Available online 13 October 2014

JEL classification:
G1
G2
G21
G30
M40
M41
M44

Keywords:
Credit default swaps
Timely loss recognition
Conservatism
Financial market developments
Lender monitoring

ABSTRACT

This paper investigates whether the initiation of trading in credit default swaps (CDSs) on a borrowing firm's outstanding debt is associated with a decline in that firm's reporting conservatism. CDS investments can modify lenders' payoffs on their loan portfolios by providing insurance on negative credit outcomes. The onset of CDS trading reduces lenders' incentives to continuously monitor borrowers and also their demand that borrowers report conservatively. Additionally, borrowers expect CDS-insured lenders to be more intransigent in renegotiations triggered by defaults and covenant violations. Since conservatism can trigger earlier covenant violations, borrowers have heightened incentives to report less conservatively in the post-CDS period. Using a differences-in-differences research design, we observe a decline in borrowing firms' reporting conservatism after CDS trade initiation. This effect is more pronounced when reputation costs lenders face from reducing monitoring are lower, when debt contracts outstanding at the time of CDS trade initiation have more financial covenants, and when lenders who monitor borrowers more regularly in the pre-CDS period enter into CDS contracts to hedge their credit exposures.

☆ This paper has benefited immensely from comments by Guojin Gong. This paper has also benefited from comments by Richard Frankel, Ewa Sletten, Ross L. Watts, Regina Wittenberg-Moerman, Jerry Zimmerman (editor), an anonymous referee, workshop participants at Arizona State University, Columbia University, London Business School, George Mason University, Georgetown University, Georgia State University, New York University, Pennsylvania State University, Washington University at St. Louis, University of Maryland, UCLA, University of Missouri at St. Louis, Dartmouth University, Singapore Management University, University of Texas at Dallas, and participants at the American Accounting Association conference, the Nick Dopuch conference at Washington University, the University of Minnesota Empirical Accounting Research Conference, Harvard University, Yale School of Management Conference on Accounting and the Financial Crisis, and CAPANA Conference. All remaining errors are ours.

* Corresponding author.
E-mail addresses: xmartin@wustl.edu (X. Martin), sugata.roychowdhury@bc.edu (S. Roychowdhury).

http://dx.doi.org/10.1016/j.jacceco.2014.09.006

1. Introduction

This paper investigates the influence of financial developments in the capital markets on accounting practices. Financial market developments can affect the payoffs and incentives of existing contractual parties to the firm. Since contractual considerations can influence accounting practices (Watts and Zimmerman, 1986), an altered contractual environment can potentially induce changes in these practices. The financial market innovation we focus on is credit default swaps (CDSs), widely used in recent times to manage lenders' credit risk exposures and their regulatory capital. The accounting practice we study is conservatism, in the context of the borrower–lender relationship. Our primary interest is in examining whether the advent of CDS trade initiation on a firm's outstanding debt is associated with a change in that firm's reporting conservatism.

The credit default swap is a contract in which the buyer, generally called the protection buyer, makes a series of payments to the seller, generally called the protection seller. In exchange, the protection buyer receives a payoff from the protection seller if a credit instrument (such as a loan or a bond) goes into default or experiences any other “credit event” specified in the CDS contract (such as restructuring, bankruptcy, or credit-rating downgrade). By acquiring a CDS contract, the protection buyer transfers the credit risk associated with its investment (such as a loan or a bond) to the protection seller, while retaining legal ownership of the investment. The risk-shifting via CDS contracts allows lenders, particularly banks, to better manage their regulatory capital since the risk weight assigned to a loan can be based on the credit rating of the counter-party in the CDS contract rather than the original borrower.[1] As an example, AIG discloses in its Annual Report that $150 billion of its notional CDSs outstanding at the end of 2009 reflected contracts it wrote to provide regulatory capital relief to financial institutions for their corporate loans (Saretto and Tookes, 2013). The overall CDS market has grown tremendously in recent years, with the notional amount increasing from $180 billion in 1998 to $57 trillion at the end of June 2008 (Stulz, 2010).[2]

Investments in CDS contracts by banks can potentially have an influence on the reporting practices of those clients. Upon granting a loan, lenders generally face an asymmetric payoff on their investment: if the borrowing firm remains solvent, lenders receive their principal and earned interest, while bankruptcy entitles them to the orderly liquidation value of the borrower. The literature argues that this asymmetric payoff underlies lenders' demand for conservatism in the financial statements of borrowers (Watts and Zimmerman, 1986; Watts, 2003). Under conservative reporting, which requires stricter verification standards for recognizing good news in earnings relative to bad news, the book value of a firm provides lenders with a lower-bound estimate for the firm's orderly liquidation value. Ensuring that borrowers do not deviate from conservative reporting practices post-loan-initiation arguably requires continuous monitoring by lenders over the life of the loan. Indeed, continuous lender monitoring, in particular by banks, seems to be a salient feature of the traditional lender–borrower relationship (Gorton and Khan, 1993; Roberts and Sufi, 2009; Acharya et al., 2014).

The availability of CDS contracts alters lenders “downside” payoffs and can thus influence the lender–borrower relationship. In the event of borrower insolvency (in practice, any pre-specified credit event in the CDS contract), lenders are now entitled to settlement payouts from CDS sellers. Coverage from a CDS contract thus reduces the asymmetry in the payoffs to lenders' claims, and provides them greater bargaining power upon the occurrence of pre-specified credit events such as defaults and violations (Bolton and Oehmke, 2010). Lenders' less asymmetric claim structure post-CDS, and their higher bargaining power in renegotiations, potentially diminish their reliance on continuous monitoring to protect the value of their claims and relatedly, their demand for conservatism in borrowers' financial reports. Furthermore, lenders' reduced reliance on continuous monitoring is expected to be accompanied by higher intransigence on their part in renegotiations with borrowers who experience credit events (Fink, 2004; Hu and Black, 2006; Bolton and Oehmke, 2010; Stulz, 2010; Subrahmanyam et al., 2014). Since conservative accounting policies are associated with earlier covenant violations (Zhang, 2008; Nikolaev, 2010), borrowers have increased incentives to report less conservatively after CDS trade initiation, because they anticipate tougher renegotiations if they trigger covenant violations. The joint effect of borrowers' incentives to avoid renegotiations and lenders' incentives to avoid monitoring costs can lead to less conservative reporting by borrowers after CDS trade initiation.

A post-CDS reduction in borrowers' reporting conservatism need not necessarily be a foregone conclusion as it can make third parties such as CDS sellers apprehensive about borrowers' credit quality. Note that CDS sellers do not own control rights with respect to the underlying loan and typically eschew any direct contractual involvement with borrowers. Nevertheless, it is possible that lenders maintain their demand for conservatism, to avoid reputation costs (for example, with CDS sellers) arising from negative credit event realizations that are attributed to their reduced monitoring of financial statements. Further, it may be difficult for borrowers to deviate from past conservatism for the sake of maintaining reporting consistency. Other stakeholders to the firm unprotected by CDS investments, such as shareholders and lenders, may step up their monitoring to ensure that borrowers continue to report conservatively. These alternative scenarios illustrate the importance of empirically investigating changes in borrowers' reporting conservatism upon CDS trade initiation.

[1] BASEL II states that guarantees issued by or protection provided by entities with a lower risk weight than the counterparty exposure is assigned the risk weight of the guarantor or protection provider.

[2] The size of the CDS market fell sharply in the second half of 2008 in the wake of the financial crisis, but was still high at $41 trillion at the end of 2008. The Bank for International Settlements (BIS) has statistics on the CDS market since the end of 2004 based on survey data. See http://www.bis.org/statistics/derstats.htm.