Affiliated bankers on board and conservative accounting

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Abstract

We examine the tradeoff between having affiliated bankers on board and conservative accounting for mitigating debtholder-shareholder conflicts. We argue that affiliated bankers on board provide lenders with private information and control rights, thereby lowering debt-contracting demand for conservatism in public financial reports. We find that firms with affiliated bankers on board have lower conservatism in terms of asymmetric timeliness of earnings (Basu, 1997). We also show that the positive relation between conservatism and leverage/covenant intensity (LaFond and Watts, 2008; Nikolaev, 2010) does not exist for firms with affiliated bankers on board, suggesting that the presence of affiliated bankers on board lowers debt contracting demand for conservatism. Our evidence suggests that having affiliated bankers on board is an alternative, albeit costly, mechanism to conservatism/debt-contracting for mitigating debtholder-shareholder conflicts and provides indirect but powerful evidence in support of the debt-contracting motivation for conservative accounting.

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1. Introduction

Positive accounting theory posits that conservative accounting complements debt contracting in reducing the agency cost of debt (Watts and Zimmerman, 1986; Watts 2003a & b), and evidence supports this hypothesis (Ahmed et al., 2002; Beatty et al., 2008; Zhang, 2008; Nikolaev, 2010). While both theory and evidence suggests that conservative accounting in conjunction with debt contracting is an efficient mechanism for mitigating debtholder-shareholder conflicts, there could be other mechanisms—such as corporate governance structures—employed for this purpose. One particularly relevant governance structure is lender participation in management through board representation, i.e., having an affiliated banker on board.[1] Board representation mitigates debtholder-shareholder conflicts by providing lenders with better monitoring and greater control rights, thereby allowing them to protect their interests. The purpose of this paper is to examine how the presence of an affiliated banker on board—an alternative debt-oriented governance mechanism—is related to the extent of accounting conservatism.

We hypothesize that affiliated bankers on board could potentially reduce the demand for conservative accounting for the following two reasons. First, board representation provides timely private information to the affiliated banks with high verifiability, therefore allowing them to better monitor the borrower. The improved monitoring potentially reduces affiliated banks' reliance on debt contracting using financial statement information and thus lowers their demand

[1] We use the terms *affiliated (unaffiliated) banker on board* to describe a board member who is a top executive of a commercial bank that belongs to a syndicate that has (does not have) *a concurrent lending relationship* with the firm. Analogously, we also use the terms *affiliated bank* or *affiliated lender* to refer to the organization that employs the affiliated banker on board. However, *unaffiliated lender* refers to a lender that does not have a concurrent board tie with the firm. We also refer to the firm that has an affiliated banker on board as the *affiliated-banker-on-board firm*. Finally, we use syndicate membership as the basis for affiliation because under the principle of "collective action" the rights and responsibilities of syndicate members are inexorably tied together (Taylor and Sansone, 2007).

for conservatism. Second, board representation provides ongoing control rights to the affiliated banks through participation in the board's decision making. This increased control, in turn, reduces the need for the control transfer triggered by covenant violations and thus lowers affiliated banks' demand for conservatism. For these reasons, we hypothesize that the presence of an affiliated banker on board could potentially lower the demand for debt contracting and conservative accounting from the affiliated banks.

We acknowledge that the benefits of board representation accrue *directly* to only the affiliated banks. However, affiliated banks typically represent the most influential private lenders and therefore their preferences could have a strong influence on the firms' accounting choices.[2] In addition, there are externalities that should allow all lenders, affiliated and unaffiliated, to benefit from lender board representation. In particular, legal doctrine in the U.S. imposes *lender liability* on affiliated lenders who advance their own interests at the expense of other creditors (Kroszner and Strahan, 2001), suggesting that the affiliated lenders have incentives to protect the interests of also the unaffiliated lenders. Accordingly, the presence of an affiliated banker on board should reduce demand for conservative accounting from *all* lenders. For these reasons, the presence of an affiliated banker on board is expected to reduce the debt-contracting induced propensity for firms to engage in conservative accounting.

However, there are several reasons why affiliated bankers on board may also not lower the demand for accounting conservatism. First, affiliated bankers may be unwilling to exploit the advantages of board representation because of costs imposed both by lender liability and the conflicts of interest faced by banker-directors who have fiduciary duties to protect shareholder interests (Koszner and Stahan, 2001). Second, it is possible that affiliated bankers may use their

[2] In our sample, the affiliated bank's syndicate on average holds more than eighty percent of the private debt commitments and more than half of the total debt commitments of the affiliated-banker-on-board firms. Also, for half of these firms the affiliated bank's syndicate is the sole provider of private debt.

power to demand *more* conservative accounting in order to enhance lenders' renegotiation powers and also reduce their lender liability. Finally, it is also possible that other lenders may demand conservative accounting to protect themselves from the actions of the affiliated lenders, if they believe that lender liability alone does not provide adequate protection for their interests. For these reasons, whether the presence of affiliated bankers on board is associated with lower accounting conservatism is essentially an empirical question.

We construct a unique dataset of board ties and lending relationships between non-financial S&P1500 firms and commercial banks from 2000 to 2006. Our starting point is the S&P1500 firms that have loan information from Dealscan, financial information from Compustat, and market information from CRSP. We use biographic data from BoardEx to determine whether a director is an executive of a commercial bank. We manually check whether a bank is a commercial bank using FDIC's institution directory and Hoover's online. Lastly, we manually examine whether the commercial bank has a lending relationship with the firm using ownership data from the Federal Reserve's National Information Center. Our final sample comprises 6,481 firm-year observations over the period 2000-2006, of which 311 firm-years (5%) have an affiliated banker on board.

We measure accounting conservatism using the Basu (1997) model, which we extend by interacting all variables in the model with a dummy variable representing firm-years with an affiliated banker on board. We find that the coefficient measuring the asymmetric timeliness of losses versus gains is significantly lower for affiliated banker-on-board firms, suggesting that such firms have less conservative accounting than those without affiliated bankers on board. Further analysis suggests that there is no asymmetric loss recognition for affiliated banker-on-board firms, implying that these firms do not have conservative accounting. In contrast, we find

significant asymmetric loss recognition for firms without affiliated bankers on board, consistent with the prevalence of conservatism for the majority of the firms (Basu, 1997).

To control for confounding effects, we use a two-stage regression approach similar to Nikolaev (2010). In the first stage we orthogonalize the affiliated-bankers-on-board dummy—both separately and jointly—on three sets of control variables: (1) determinants of conservative accounting (LaFond and Watts, 2008); (2) determinants of bankers on board (Kroszner and Strahan, 2001); and (3) other corporate governance characteristics (Ahmed and Duellman, 2007). In the second stage, we replace the affiliated-bankers-on-board dummy in our modified Basu regressions with the residuals from the respective first-stage regression.[3] In addition to controlling for confounding effects, we also employ a variety of alternative designs and specifications, including propensity score matching and a reduced sample time-series analysis for firms that have first-time bankers on board, as well using the Ball and Shivakumar (2006) method for measuring conservatism. Our primary result, that firms with affiliated bankers on board have significantly less conservative accounting, is robust to controlling for confounding effects and all the design variations.

We note that our hypothesis applies only to affiliated bankers on board. Unaffiliated bankers serve on boards primarily as financial experts (Booth and Deli, 1999), have little incentive to safeguard lender interests and therefore are unlikely to reduce the demand for conservative accounting. Consistent with our conjecture, we find that the negative association between bankers on board and conservative accounting exists only for affiliated bankers—firms with unaffiliated bankers on board are no less conservative than the firms without any bankers on board. These results suggest that the negative relation between having an affiliated banker on

[3] As argued in Nikolaev (2010), one can view the residual from the first stage as an instrument that is correlated with the affiliated banker dummy, but by construction uncorrelated with those control variables that could confound the relationship.

board and conservatism can be attributed to the concurrent lending relationship with the affiliated banker.

We provide corroborating evidence suggesting that the lower level of conservatism in affiliated-banker-on-board firms is associated with lower debt-contracting demand. We first show that the positive association between conservatism and leverage (LaFond and Watts, 2008)—the often cited evidence for the debt contracting demand of conservatism—does not exist for affiliated-banker-on-board firms. Then we demonstrate that firms with affiliated bankers on board use significantly fewer debt covenants and that the previously documented positive association between conservatism and the use of debt covenants (Nikolaev, 2010)—arguably the most direct evidence of the debt contracting demand for conservatism—also does not exist for the affiliated-banker-on-board firms. These results support our conjecture that affiliated bankers on board lower the debt-contracting motivated demand for conservative accounting.

We contribute to the literature in several ways. Our primary contribution is examining how accounting conservatism relates to alternative debt-oriented governance mechanisms. Ball et al. (2000) conjecture that greater banker participation in management may explain why accounting in code law countries is less conservative. We directly test the role of banker board representation on accounting conservatism and find that the presence of affiliated bankers on board is associated with significantly less conservative accounting. Our results suggest that firms trade-off affiliated bankers on board with debt contracting/conservative accounting to mitigate debtholder-shareholder conflicts, therefore providing powerful—albeit indirect—support for the debt-contracting motivation for conservative accounting. In fact, our finding of no conservative accounting for affiliated banker-on-board firms suggests that debt contracting demands are a primary factor behind the prevalence of accounting conservatism in the U.S. We note that the

majority of firms do not have affiliated bankers on board but have conservative accounting, suggesting that conservatism/debt-contracting is probably a more cost-effective alternative to affiliated bankers-on-board in mitigating debtholder-shareholder conflicts.

Also, our paper is the first to study the financial reporting implications of having bankers on board. While there is an extensive literature on the corporate finance consequences of bankers on boards (Byrd and Mizruchi, 2005; Guner et al., 2008), whether and how bankers on board affect financial reporting is yet unexplored. Therefore, our study contributes to the relationship-banking literature that examines the ramifications of lender participation in management, by exploring its effects on financial reporting.

Finally, our paper contributes to the broad literature examining the association between corporate governance factors and conservative accounting. For example, previous literature shows that accounting conservatism is related to various board characteristics (Ahmed and Duellman, 2007) and managerial ownership (LaFond and Roychowdhury, 2008). We complement this literature by identifying a debt-oriented governance characteristic that is related to conservatism, incremental to other corporate governance characteristics. Our study, therefore, contributes to understanding the tradeoffs in the optimal combination of debt governance mechanisms (Armstrong et al., 2009).

2. Motivation and hypothesis development

2.1 The costs and benefits of affiliated bankers on board

Many U.S. firms have bankers on their boards. For example, Santos and Rumble (2006) find that approximately 25% of non-financial S&P 500 firms have bankers on their boards. However, a large proportion of the bankers on board are *unaffiliated*, i.e., they represent banks that do not have a concurrent lending relationship with the firm (Kroszner and Strahan, 2001).

Ostensibly, unaffiliated bankers are on boards primarily because their financial expertise is valued by firms (Booth and Deli, 1999). Serving on boards, in turn, improves the bankers' knowledge and experience in addition to, of course, increased networking and influence (Mizruchi, 1996). Therefore, unaffiliated bankers on board are not expected to have a material influence on firms' relationship with their lenders.

Our focus is on *affiliated* bankers on board, i.e., those who represent banks with a concurrent lending relationship with the firm. Lender representation on the board increases the scope and dynamics of the firms' relationship with their lenders by allowing better monitoring and increased control from the affiliated bank. Having board representation enhances the monitoring role of the affiliated banks by increasing information flow from the borrower to the affiliated bank.[4] This in turn reduces borrower-lender information asymmetry, thus improving lending decisions and protecting lenders' interests in a timely manner (Kroszner and Strahan, 2001). In addition to superior monitoring, board representation also confers affiliated banks some degree of control over borrowers' decision making, thus preventing decisions that could decrease the value of debt. The benefits of improved monitoring and increased control from board representation reduces the agency costs of debt, which may be shared with borrowers through more favorable financing terms, such as increased availability of credit, greater flexibility in the lending terms and also probably lower borrowing costs.[5]

However, affiliated bankers on board impose significant costs on the borrowers. An obvious cost is the potential cutback in operation flexibility due to extra monitoring and control.

[4] The relationship banking literature characterizes banks as "delegated monitors" who act as information intermediaries between borrowers and other lenders (Diamond, 1984 & 1991).

[5] There is mixed evidence on whether bankers on board increase debt financing. Byrd and Mizruchi (2005) find that affiliated bankers on board are associated with lower debt ratios. However, Booth and Deli (1999) document that the presence of unaffiliated commercial bankers on the board is positively related to aggregate firm debt. Guner et al. (2008) find that when commercial bankers join boards, external funding increases (but the increased financing flows are to firms with good credit but poor investment opportunities).

More importantly, there is an inherent conflict of interest between the banker-directors' responsibility to further the interests of the banks that they represent and their fiduciary duty to protect shareholders' interests. Because of this, bankers on board could influence companies to take decisions aimed at ensuring lender wealth protection rather than shareholder wealth creation, for example by eschewing risky but lucrative projects.[6] In addition, having close ties with a lending bank could result in the bank exploiting its informational advantage into a pricing advantage and thus extracting rents from the borrowing company (Rajan, 1992).

Board representation also imposes considerable costs on the affiliated banks because of lender liability created by U.S. legal doctrine. Specifically, a senior lender that is active in company management prior to bankruptcy and shown to be protecting its own interests to the detriment of other creditors can lose its seniority during liquidation and can also be subject to liability claims from other creditors (Kroszner and Strahan, 2001). Lender liability makes board representation less attractive for affiliated banks. Because of these non-trivial costs to both the firm and the bank, affiliated bankers on board are rare in the U.S.—only about 6% of non-financial S&P 500 firms have affiliated bankers on board (Booth and Deli, 1999).

To summarize, affiliated bankers on board can play an important role in mitigating debtholder-shareholder conflicts through improved monitoring and control. However, board participation is costly to both borrowers and affiliated banks; therefore despite its myriad of benefits, the presence of affiliated bankers on corporate boards remains a relatively infrequent phenomenon in the U.S.

2.2 Affiliated bankers on board, debt contracting and accounting conservatism

[6] For example, Guner et al. (2008) find that investment bankers on boards are associated with larger bond issues and worse acquisitions, suggesting that bankers serve the interest of their banks at the cost of shareholders'.

Debt contracting reduces the agency costs of debt by transferring control to lenders through covenant violations and empowering them with the option to take protective actions (Jensen and Meckling, 1976). Conservative accounting facilitates debt contracting through timely loss recognition that triggers debt covenant violations when there is a material adverse change in default risk (Watts, 2003a&b; Zhang, 2008). For this reason, debt-contracting has been proposed as a major explanation for accounting conservatism (Watts, 2003 a&b; Ball, Robin and Sadka, 2008). Extant literature explores whether and how accounting conservatism mitigates debtholder-shareholder conflicts (Ahmed et al., 2002; Zhang, 2008) and how debt contracting shapes conservatism (Beatty et al., 2008; Nikolaev, 2010). However, the literature has rarely explored how conservative accounting relates to governance mechanisms, especially those that could also mitigate debtholder-shareholder conflicts. For this reason, Armstrong et al. (2009) call for research to understand the tradeoffs among alternative monitoring mechanisms, including monitoring by creditors.[7]

Prior literature has examined the relation between certain corporate governance characteristics and conservative accounting. For example, Ahmed and Duellman (2007) find that stronger boards use accounting conservatism to reduce agency conflicts with mangers, consistent with a monitoring role for accounting conservatism. LaFond and Roychowdhury (2008), in contrast, show that incentive alignment through higher managerial ownership can serve as an alternative to accounting conservatism. Both these papers focus on the *manager-owner* agency problem. However, given the central role of debt-contracting in the evolution of conservatism, it is important to understand how conservatism relates to *debt-oriented* governance mechanisms. i.e., mechanisms designed to ameliorate the *debtholder-shareholder* agency problem.

[7] "A more complete understanding of the tradeoffs among these various mechanisms, as well as among alternative monitoring mechanisms when information transparency is not achievable (e.g., equity incentives, monitoring by creditor, regulatory monitoring, etc.) could significantly advance the literature." (p.65, Armstrong et al. (2009)).

Accordingly, we examine how an important debt-oriented governance feature, i.e., the presence of an affiliated banker on the board, is associated with conservatism.

We argue that affiliated bankers on board could lower the demand for conservatism from affiliated banks because of improved monitoring and control. Board representation improves monitoring by providing affiliated banks access to internally used private information from the borrowers. Access to this private information offers various advantages for protecting lender interests over using debt contracts based on public accounting information. First, private information may be qualitative, richer in detail and more forward-looking than financial accounting information that is aggregated using various recognition criteria, such as reliability thresholds. Second, internally used private information is usually timelier in reflecting the latest economic news compared to periodic (quarterly) financial reporting data. Third, and more importantly, internally used private information is less subject to managerial manipulation than financial statement information, thus providing more reliable news, both good and bad. Accordingly, board representation provides access to rich, timely and unbiased private information to the affiliated bank, which lowers their demand for accounting conservatism.

Board representation also confers affiliated banks ongoing control rights through active participation in the board meetings. For example, banker-directors can veto business proposals that could harm lender interests, such as issuing new senior debt or increasing dividends.[8] In the absence of such ongoing control rights, lenders rely on covenant violations to trigger control transfers. However, covenant triggered control transfers are subject to incomplete contracting and accounting measurement choices. Also, covenant triggered control transfers typically occur *after* a material increase in credit risk, whereas ongoing control rights through board

[8] Theory also suggests that inter-locking provides general influence in addition to control. For example, Mintz & Schwartz (1985) developed a model of bank hegemony, in which banks exercise power not by controlling firms but by defining, through their routine actions, limits on the discretion of corporate managers.

participation allows the lender to *proactively* take preventive actions. Accordingly, we hypothesize that the ongoing control rights through affiliated bankers on board allow affiliated banks to protect their rights in a timelier manner than through debt covenants, thereby lowering their demand for debt contracting and conservatism.[9]

Arguments can be advanced for why affiliated bankers on board may not result in lower demand for conservatism from affiliated banks, thus lending tension to our hypothesis. It is possible that affiliated bankers on board maintain arm's length relationships with their borrowers because active monitoring or control is too costly. First, as board members, affiliated bankers have fiduciary responsibilities to protect shareholder interests. Second, active monitoring increases the risk of lender liability arising from aggrieved unaffiliated lenders (Kroszner and Strahan, 2001). If affiliated bankers forgo active monitoring and control due to the costs, we may observe no relation between affiliated bankers on board and conservative accounting. It is also possible that affiliated bankers may even demand more conservative accounting to enhance lenders' renegotiation power and lower lender liability, especially because conservative accounting may not be as costly to lenders as active monitoring and control. For these reasons, it is an empirical question whether the presence of affiliated bankers on board is associated with lower accounting conservatism.

2.3 Affiliated and unaffiliated lenders and the demand for conservative accounting

Thus far we have discussed how board representation could lower the demand for conservatism from the affiliated bank. However, public financial reports also serve the contracting needs of *unaffiliated* lenders, i.e., lenders that are not part of the affiliated bank's syndicate. If the debt contracting demands of these unaffiliated lenders significantly influences

[9] While we discuss monitoring and control separately, we emphasize that practically, monitoring and control are inseparable. In absence of the control right, either from board representation or covenant triggered control transfer, monitoring would not translate into actions that protect lender interests.

the firm's accounting, then we may not observe a lower level of conservatism even with the presence of an affiliated banker on board. For such a scenario not to occur, either of the following two conditions should be satisfied: (1) the demands of the unaffiliated lenders are not sufficient to influence the firm's accounting choices; or (2) unaffiliated lenders also demand less conservative accounting when there is an affiliated banker on board. We next discuss each of these conditions in order.

First, we note that it is possible that the demand for conservative accounting from unaffiliated lenders may not be sufficiently strong enough to influence the accounting choices of the firm. This is because affiliated bankers (or their syndicates) are arguably the most influential and the most activist lenders to the affiliated-banker-on-board firms. For example, we find that the affiliated bank's syndicate on average holds more than eighty percent of the private debt commitments and more than half of the total debt commitments of the affiliated-banker-on-board firms, and for half of these firms the affiliated bank's syndicate is the sole provider of the private debt and for a quarter of these firms the affiliated bank's syndicate provides almost 80% the firms' committed long-term debt (see Table 1 Panel C). Also, research finds that private lenders (such as banks) tend to be delegated monitors on behalf of all debtholders (Diamond, 1984, 1991; Berlin and Loeys, 1988) and also arguably the most activist lenders (Fama, 1985; Rajan, 1992; Gorton and Kahn, 1993). For these reasons, it is possible that the affiliated-banker-on-board firms may primarily cater to the demands of only the affiliated lenders, and therefore do not resort to conservative accounting because there is no demand from these lenders.

Second, we argue that having an affiliated banker on board could reduce the demands for conservative accounting from even the unaffiliated lenders. This could happen because there are externalities with banker board representation that could benefit unaffiliated lenders. First,

affiliated banks' actions may be observable by other lenders, who could then mimic the affiliated lenders' actions and protect their interests. For example, when affiliated lenders detect an increase in default risk and renegotiate loan terms, unaffiliated lenders can infer from this action and also renegotiate their loan terms.[10] Second, and more importantly, the monitoring and control from affiliated bankers could prevent the borrower from engaging in wealth transfer actions that are detrimental to all debtholders, affiliated or not. For example, the affiliated banker on board can veto a risky M&A project or a dividend increase, which would protect all existing debt. In fact, lender liability from legal doctrine ensures that affiliated banks risk loss of seniority and litigation if they use the advantages of board representation to further their own interests at the expense of unaffiliated lenders (Kroszner and Strahan, 2001). For these reasons, it is possible that the unaffiliated lenders may not demand conservatism even when they are influential enough to affect the firms' accounting choices.

Of course, to the extent that the unaffiliated lenders do not view lender liability as sufficient protection, affiliated bankers with board representation may not reduce the demand for conservatism from unaffiliated lenders. If the demands of these unaffiliated lenders are strong enough to influence the firms' accounting choices, then we may observe conservative accounting in affiliated-banker-on-board firms. Therefore, it is an empirical question whether the overall level of conservatism would be lower when there is an affiliated banker on board.

3. Sample and data

We construct a unique dataset of board ties and lending relationships between non-financial S&P1500 firms and commercial banks over the period of 2000 to 2006. We limit our sample to

[10] One can argue that the affiliated banks accrue the first mover advantage and mimicking protects the other lenders not in a timely fashion.

S&P1500 firms and to the period of 2000 to 2006 so that the manual collection of board ties and lending relationships is manageable. We limit our analysis to commercial banks to ensure that the *lending* relationship of an affiliated bank with a firm is the primary source of the affiliation, i.e., that an investment banking relationship is less likely to exist.

We begin by obtaining a list of firms that are shown to have outstanding bank loans on the DealScan database. To acquire financial and market information, we merge Dealscan with Compustat and CRSP using the link file used in Chava and Roberts (2008).[11] To identify banker-directors we use the following procedure. First, we merge the Dealscan/Compustat/CRSP combined sample with BoardEx (using CIK) and identify all the directors on the board of these sample firms. Second, we use biographic data from BoardEx to determine whether and at which firms the identified directors hold management positions (e.g., CEO, CFO). Finally, we use data from sources such as FDIC's institution directory and Hoover's online to determine whether a director's employer is primarily a commercial bank.[12]

We classify directors that are employed by commercial banks as being affiliated bankers if their bank belongs to a syndicate that has an outstanding loan agreement with the firm during the fiscal-year. Because Dealscan overwrites the history of a lender's parent and ultimate parent after mergers and a large number of commercial banks have been involved in mergers, we use ownership data from the Federal Reserve's National Information Center instead to determine whether a director's employer bank had an outstanding loan agreement with a firm.[13,14]

[11] We thank Sudheer Chava and Michael Roberts for sharing with us the Dealscan-Compustat link file.

[12] We exclude employers that are not primarily commercial banks. For example, we exclude firms that are primarily engaged in non-commercial banking activities (such as Merrill Lynch), but include commercial banking subsidiaries of diversified firms (such as GE capital).

[13] For example, FleetBoston was acquired by Bank of America in 2004 and DealScan codes all FleetBoston loans to be from Bank of America even before 2004. Thus, we would misclassify a firm with an unaffiliated banker from Bank of America on board as having an affiliated banker, even though there was no lending relationship between the firm and Bank of America at that time.

After imposing additional data requirements for control variables, our final sample comprises of 6,481 firm-year observations, representing 1,293 firms. Out of these, 311 firm-years have a director who is an affiliated banker.

4. Measuring and modeling affiliated bankers on board

4.1 Measuring affiliated banker on board

We classify a firm as having an affiliated banker on board if one of its directors is an executive of a commercial bank that belongs to a syndicate that the firm has a lending relationship with during the fiscal year. For each firm year, we define a dummy variable, *Affiliated Banker*, that takes the value of 1 if the firm has an affiliated banker on board in that year, and zero otherwise.

If one of the firm's directors is an executive of a commercial bank that the firm does not have a lending relationship with, we classify the firm as having an unaffiliated banker on board. For each firm year, we define a dummy variable, *Unaffiliated Banker*, that takes the value of 1 if the firm has an unaffiliated banker on board, and zero otherwise.

4.2 Determinants of affiliated bankers on board

To control for the confounding effects, we first model affiliated bankers on board as a function of various control variables. To ensure that the hypothesized relation between affiliated banker and conservatism is not driven by firm characteristics that affect conservatism, we first control for the determinants of conservatism including the conventional determinants (LaFond and Watts, 2008) and other board characteristics that are shown to be related to conservatism (Ahmed and Duellman, 2007). In addition, to ensure that our hypothesized relation is not driven

[14] Because of the complicated mergers and acquisition history in the banking industry, we cross-check the ownership data from Federal Reserve National Information Center with other information sources such as companies' own websites.

by firm characteristics that influence the presence of affiliated bankers on boards, we also control for the known determinants of affiliated bankers on boards (Kroszner and Strahan, 2001).

4.2.1 Conservatism Determinants

The conventional determinants of conservatism include leverage, market to book, and probability of litigation (LaFond and Watts, 2008). Leverage is frequently used to proxy for the debt contracting demand for conservatism, as lenders from highly levered firms may demand more conservative accounting. Leverage can have either a negative or a positive relation with the presence of an affiliated banker on board. On the one hand, highly levered firms may benefit more from the banking relationships, increasing the probability of having a banker on board. On the other hand, firms with higher leverage may have greater lender liability, thus discouraging affiliated bankers from serving on the board. We measure leverage as the sum of long-term and short-term debt scaled by total assets.

Market-to-book (*MB*) is often used to proxy for the understatement of net assets. Roychowdhury and Watts (2008) document a negative association between market-to-book and short-period asymmetric timeliness. We argue that firms with high market-to-book, i.e. growth potential, may rely more on external financing and benefit from banking relationships, thereby increasing the probability of having an affiliated banker on board. We measure market-to-book as market value of equity divided by book value of equity.

Probability of litigation (*Problit*) captures the demand for conservatism arising from litigation risk and firms with higher litigation risk are expected to be more conservative. We argue that, if high litigation risk results from high information asymmetry, then the banking relationships can provide a certification role that mitigates the information asymmetry (Byrd and Mizruchi, 2005). However, high litigation risk also increases the affiliated bankers' exposure to

lender liability, thereby lowering the likelihood of having a banker on board. We measure probability of litigation based on the Rogers and Stocken (2005) litigation risk prediction model.

4.2.2 Board Characteristics

The second group of control variables includes other board characteristics that are shown to be correlated with conservatism. Controlling for these board characteristics ensures that any association between affiliated bankers on board and conservatism is not driven by these correlated board characteristics. Ahmed and Duellman (2007) argue that the following board characteristics capture board independence and monitoring incentives, thus having a positive relation with conservatism. Specifically, we control for the following board characteristics.

BOARD INDEPENDENCE (*Board independence*): a more independent board is more likely to have outside directors such as affiliated bankers on board. We measure board independence using the number of outside directors divided by the total number of directors.

BOARD SIZE (*Board size*): larger boards offer specialization and thus are more likely to include directors with special expertise such as affiliated bankers on board. We measure board size using the natural log of the total number of directors.

CEO/CHAIRMAN SEPARATION (*CEO/Chair separated*): prior literature has established that the separation of the CEO and chairman role enhances board independence (Jensen, 1993) and thus increases the likelihood of having outside directors such as affiliated bankers. We define this dummy variable to be one if the CEO is not the chairman of the board.

Following Ahmed and Duellman (2007), we also control for the following alternative governance proxies: (1) AVERAGE DIRECTORSHIPS, which equals the total number of directorships held by the board scaled by the total number of directors; (2) OUTSIDE DIRECTOR OWNERSHIP, which equals common shares held by outside directors scaled by total common shares

outstanding; (3) *Inside director ownership*, which equals the common shares held by inside directors scaled by total common shares outstanding; (4) *Institutional Ownership*, which equals the common shares held by institutional investors scaled by total common shares outstanding; and (5) *G-index*, which equals the governance index of 24 governance provisions as estimated in Gompers et al. (2003).

4.2.3 Determinants of affiliated bankers on board

The third group of control variables includes determinants of bankers on board proposed by the finance literature, such as volatility, size, PP&E, commercial paper access, and capital structure (Kroszner and Strahan, 2001).

VOLATILITY (*Stdv Ret*): firms with higher volatility face a stronger information asymmetry problem in external financing, thus having a greater demand for affiliated bankers on board. At the same time, firms with higher volatility might have higher lender liability in distress; thereby discouraging affiliated bankers to serve on the board. We measure firm volatility using the standard deviation of monthly stock returns.

FIRM SIZE (*Log(Assets)*): larger firms usually have larger boards and are thus more likely to have outside directors such as affiliated bankers. However, larger firms have better access to external financing and thus a lower demand for banking relationships. We measure firm size using the natural log of total assets.

PROPERTY, PLANT AND EQUIPMENT (*PPE*): firms with fewer tangible assets are more opaque and may have difficulties in obtaining debt financing, thus, they have a higher demand for banking relationships. However, firms with fewer tangible assets also have higher lender liability, leading to a lower likelihood of having affiliated bankers on board. We measure tangibility as PP&E deflated by total assets.

COMMERCIAL PAPER ACCESS (*Rating*): firms that have access to commercial paper have a less expensive alternative to bank loans, and therefore a lower demand for affiliated bankers on board. These firms, however, also tend to be financially healthy and thus have lower lender liability, which could lead to a higher likelihood of having affiliated bankers on board. We measure access to commercial paper using the existence of a commercial paper rating.

CAPITAL STRUCTURE (*Short-term debt*): A significant portion of the short-term debt could be the bank loan that is due within a year, or close substitute to it. Thus, short-term leverage proxies for the value of bank loans to the firm. Firms with higher current liabilities are thus expected to benefit more from banking relationships. At the same time, firms with higher leverage also have higher lender liability, which predicts a lower likelihood of affiliated bankers on board. We measure short-term leverage ratio as current liabilities divided by total liabilities.

In addition to these determinants used in Kroszner and Strahan (2001), we include the bankruptcy probability (*Pr(Bankrupt)*) as an additional control. Bankruptcy risk makes it more likely that affiliated bankers are concerned about lender liability. Therefore, we expect bankers to less likely serve on boards of firms that have a higher bankruptcy probability. We measure bankruptcy probability based on Shumway (2001).

4.3 Descriptive statistics

Table 1 Panel A reports descriptive statistics on the primary measures used in our analyses. Our variable of interest, *Affiliated Banker*, has a mean of 4.8%, indicating that 4.8% of our sample firm-years have an affiliated banker on board. Prior literature presents a rather large variation in this percentage due to the difference in sample firms, sample periods, and definitions of "affiliation" and "banks". For example, Booth and Deli (1999) report that 6% of their sample firms have affiliated bankers on board, while Kroszner and Strahan (2001) report 20%. Because

of these reasons, it is difficult to compare the proportion of affiliated bankers in our sample with that of the previous literature.[15] We also find that 11% of our sample has a banker—affiliated or unaffiliated— on board, suggesting that 6.2% of our sample firms have an unaffiliated banker on board. Our proportion of banker-on-board is also lower than that reported in the prior literature because of differences in definition and sample.[16]

Panel B of Table 1 presents the descriptive statistics on the importance of the affiliated debt. We observe that affiliated banks/private debt has a mean of 82.7% and a median of 100%, suggesting that the affiliated banks are the most important private debtholders for affiliated-banker-on-board firms. In terms of its proportion in the total committed long-term debt, affiliated debt is still quite significant, on average accounting for 53.3% of the total committed long-term debt of a firm.[17] The third quartile of this ratio is 0.799, indicating that for a quarter of the affiliated-banker-on-board firms the affiliated banker represents almost 80% of the total long-term debt capacity. We also report that affiliated debt accounts for 20% of the total assets on average, representing a significant player in the overall capital structure of a firm.

Table 1 Panel C presents Pearson correlation coefficients of the main measures. We find that *Affiliated Banker* is positively correlated with leverage, consistent with more highly levered

[15] Our percentage is lower than that reported in Kroszner and Strahan (2001) for a variety of reasons. For example, we use S&P 1500 firms over 2000-2006, while they include only S&P 500 firms for the year 2000. In addition, we require affiliated banks to have a concurrent lending relationship with the firm, while they also include past lending relationships. If we confine our sample to the S&P 500 for the year 2000 and also include past lending relationships, we find that 14% of firm-year observations have affiliated bankers on board. The remaining difference is because Kroszner and Strahan (2001) also include non-commercial bankers (e.g., investment bankers).

[16] Santos and Rumble (2006) find that in the year 2000, 25% of non-financial S&P500 firms have a banker (not restricted to commercial bankers) on their board. If we restrict our sample to S&P 500 firms in the year 2000, then 19% of our observations have commercial bankers on board.

[17] We measure total committed long-term debt as the sum of debentures, notes, and convertible debt as reported by Compustat, plus the total syndicated loan amount from Dealscan. We use this deflator to capture the debt capacity of the firm. Note that the item "notes" reported by Compustat contains the revolving bank notes and to the extent that these revolving notes overlap with Dealscan loans, we underestimate the importance of affiliated debt by inflating the denominator.

firms having a higher demand for banking relationships.[18] We also find that *Affiliated Banker* is negatively correlated with volatility, suggesting that firms with volatile operations have a higher conflict of interest and higher lender liability and these costs outweigh the benefits of having affiliated bankers on board. In addition, we observe positive correlations between *Affiliated Banker* and log(Assets), PPE, and commercial paper rating, suggesting that larger firms, firms with more tangible assets, and firms with commercial paper access have a lower cost (i.e. lender liability) of having affiliated bankers on board. In terms of other board characteristics, we observe that affiliated bankers on board are correlated with more independent boards, larger boards, higher outside directorships, lower insider director shareholdings, lower institutional ownership, and higher G-index. This is consistent with (1) larger boards, more independent boards, boards with more outside directorships being more likely to have outside directors such as affiliated bankers; (2) banker directors being a substitute for monitoring by institutional investors, and (3) banker directors being associated with weaker shareholder rights.

4.4 Comparing Firms with and without affiliated bankers on board

Table 2 Panel A compares the sample firms with affiliated banker on board to those without. We find that affiliated-banker-on-board firms have significantly higher earnings, lower incidence of negative returns, lower volatility, larger size, higher PP&E, and more access to commercial paper, which is consistent with affiliated-banker-on-board firms generally being healthier and having better credit. We also show that affiliated-banker-on-board firms have higher leverage than non-affiliated-banker-on-board firms, suggesting that firms that are more indebted have stronger incentives to build banking relationships. Lastly, we observe that affiliated-banker-on-board firms have more independent boards, larger boards, more outside

[18] While the literature provides mixed evidence on how bankers on board (affiliated and unaffiliated together) is related to leverage (footnote 6), our evidence suggests that the presence of *affiliated* bankers on board is positively correlated with leverage, probably because highly levered firms benefit more from the banking relationship.

directorships, lower inside director ownership, lower institutional ownership and higher G-index. These differences reinforce the correlations documented in the previous section.

4.5 Multivariate regression of affiliated bankers on board on its determinants

We use logit regressions to model the presence of affiliated bankers on boards as a function of various determinants (discussed in Section 4.2). To observe how different groups of controls affect *Affiliated Banker* differently, we separately regress *Affiliated Banker* on different groups of controls and then combine all controls into a full model. In Model (1), we include the basic conservatism determinants, i.e., market to book, leverage, and probability of litigation, and the affiliated-banker-on-board determinants:

$$Affiliated\ Banker = \alpha_0+\alpha_1 MB+\alpha_2 Leverage+\alpha_3 Problit+\alpha_4 Pr(Bankrupt)+\alpha_5 Stdv\ Ret+\alpha_6 Stdv\ Ret^2+ \alpha_7 Log(Assets)+ \alpha_8 PPE+ \alpha_9 Rating+ \alpha_{10} Short\ term\ debt + \varepsilon \quad (1)$$

In Model (2), we include the basic conservatism determinants and the board characteristics:

$$Affiliated\ Banker=\alpha_0+\alpha_1 MB+\alpha_2 Leverage+\alpha_3 Problit+\alpha_4 Board\ independance+\alpha_5 Log(Board\ size) + \alpha_6 CEO/Chair\ separated+ \alpha_7 Avg\ directorship+ \alpha_8 Inside\ director\ ownership+ \alpha_9 Outside\ director\ ownership+ \alpha_{10} Institutional\ ownership+ \alpha_{11} Gindex + \varepsilon \quad (2)$$

Model (3) is the full model with all control variables included:

$$Affiliated\ Banker = \alpha_0+\alpha_1 MB+\alpha_2 Leverage+\alpha_3 Problit+\alpha_4 Pr(Bankrupt)+\alpha_5 Stdv\ Ret+\alpha_6 Stdv\ Ret^2+ \alpha_7 Log(Assets)+ \alpha_8 PPE+ \alpha_9 Rating+ \alpha_{10} Short\ term\ debt+\alpha_{11} Board\ independence +\alpha_{12} Log(Board\ size) + \alpha_{13} CEO/Chair\ separated+ \alpha_{14} Avg\ directorship+ \alpha_{15} Inside\ director\ ownership+ \alpha_{16} Outside\ director\ ownership+ \alpha_{17} Institutional\ ownership+ \alpha_{18} Gindex + \varepsilon \quad (3)$$

Table 2 Panel B reports the results from these regressions. We do not find market to book, leverage, and probability of litigation to be significantly related to affiliated bankers on board. This finding alleviates the concern, to some extent, that affiliated bankers on board and conservatism are endogenously determined by these firm characteristics. Model (1) includes the

determinants of affiliated bankers on board. Consistent with Kroszner and Strahan (2001), we find that *Affiliated Banker* is positively associated with volatility, firm size, PP&E, and commercial paper access and negatively associated with the squared volatility.[19] Model (2) includes other board characteristics used in Ahmed and Duellman (2007). We find that *Affiliated Banker* is positively associated with board size, and negatively associated with insider director share holdings and institutional ownership. This is consistent with larger boards being more likely to have outside directors with special expertise such as commercial banking; firms with higher insider director share holdings consider extra monitoring from affiliated bankers to be more costly; and affiliated bankers on board is potentially an alternative monitoring mechanism to institutional holdings. In Model (3), all of these aforementioned variables remain significant except for board size. Overall, we find that the presence of affiliated bankers on board is the result from a trade-off between the benefits and costs as captured by volatility, size, etc.; and is also associated with some other board characteristics and governance mechanisms.

5. Affiliated bankers on board and conservatism

5.1 Measuring conservatism

We define conservatism as differential verifiability required for the recognition of gains vs. losses. We adopt this definition because theory suggests that asymmetric loss recognition provides lenders with a verifiable lower bound of net asset values to monitor borrowers' ability to pay (Watts, 2003a). In addition, empirical evidence also shows that asymmetric loss recognition provides contracting benefits to both lenders and borrowers (Zhang, 2008).

[19] Note that the sign of volatility changes from negative in the simple correlation table to positive in the multivariate regression, possibly due to the non-linearity in its relationship with affiliated banker on board.

Following this definition, we measure conservatism using the asymmetric loss recognition coefficient from Basu (1997):

$$Earnings = \alpha_0 + \beta_1 D(Ret<0) + \beta_2 Ret + \beta_3 Ret \times D(Ret<0) + \varepsilon \quad (4)$$

where *Earnings* is earnings before extraordinary items of firm *i* in fiscal year *t* deflated by market value of equity at the beginning of year *t*, *Ret* is the 12-month return of firm *i* over the fiscal year *t*, and *D(Ret <0)* is a dummy variable equal to one if *Ret<=0* and zero otherwise. In this regression, the timeliness of earnings in incorporating economic gains (losses) is captured by β_2 ($\beta_2 + \beta_3$), and the asymmetric loss recognition is captured by β_3.

5.2 Basic Regression model

To test the relation between affiliated bankers on board and asymmetric loss recognition, we expand the Basu (1997) model to further incorporate the effect of affiliated banker on board. Specifically, we estimate the following model (hereafter, the "basic model"):

$$Earnings = \alpha_0 + \beta_1 D(Ret<0) + \beta_2 Affiliated\ Banker + \beta_3 D(Ret<0) \times Affiliated\ Banker + \beta_4 Ret + \beta_5 Ret \times D(Ret<0) + \beta_6 Ret \times Affiliated\ Banker + \beta_7 Ret \times D(Ret<0) \times Affiliated\ Banker + \varepsilon \quad (5)$$

A negative β_7 indicates that affiliated-banker-on-board firms have lower asymmetric loss recognition than non-affiliated-banker-on-board firms.

Table 3 presents our main results on the association between affiliated banker on board and asymmetric loss recognition. Panel A of Table 3 reports the results from estimating the basic model without controls, i.e., model (5). We find a significantly negative β_7, suggesting that affiliated-banker-on-board firms have lower asymmetric loss recognition than non-affiliated-banker-on-board firms.

For the ease of interpretation, in Panel B of Table 3 we reconstruct the coefficients of timely loss recognition, timely gain recognition, and asymmetric loss recognition from the regression results in Panel A. For non-affiliated-banker-on-board firms, β_4 ($\beta_4 + \beta_5$) captures

timely gain (loss) recognition. We use two measures to evaluate the asymmetric timely loss recognition. The first measure is timely loss recognition minus timely gain recognition, β_5. The second measure is timely loss recognition divided by timely gain recognition, $(\beta_4+ \beta_5)/\beta_4$. Both measures indicate that non-affiliated-banker-on-board firms exhibit significant asymmetric timely loss recognition. For example, $(\beta_4+ \beta_5)/\beta_4$ is 14.74, suggesting that non-affiliated-bank firms recognize bad news almost 15 times more timely than good news in contemporaneous earnings.

For affiliated-banker-on-board firms, $\beta_4 + \beta_6$ ($\beta_4+ \beta_5 + \beta_6+ \beta_7$) represents timely gain (loss) recognition. We find significant timely loss recognition as well as gain recognition for affiliated-banker-on-board firms. Specifically, the timely loss recognition is 0.071 ($p<.05$) and the timely gain recognition is 0.061 ($p<.01$) for affiliated- banker firms. While timely loss recognition is greater than timely gain recognition, the two measures of asymmetric loss recognition (i.e., the difference and the ratio) are both insignificant. For example, $(\beta_4+ \beta_5)/\beta_4$ is 1.169 and insignificant, suggesting that affiliated-bank firms are almost equally timely to recognize bad and good news in contemporaneous earnings.

Formally tests of the difference indicate that affiliated-banker-on-board firms exhibit significantly lower timely loss recognition, higher timely gain recognition, and lower asymmetric loss recognition than non-affiliated-banker-on-board firms. For instance, the ratio difference in the asymmetric loss recognition between affiliated-banker-on-board and non-affiliated-banker-on-board firms is -13.571 ($p<.01$). This difference is economically significant: while non-affiliated-banker-on-board firms are around 15 times more timely to recognize bad news than good news in earnings, affiliated- banker firms show no evidence of asymmetric timeliness.

5.3 Adding controls using a two-stage regression

To control for the confounding effects, we adopt a two stage regression methodology similar to Nikolaev (2010). In the first stage, we orthogonalize the *Affiliated Banker* dummy on the three sets of control variables in Model (1) to (3) that were introduced in Section 4.2. In the second stage regression, we replace the *Affiliated Banker* dummy in Model (5) with the residuals from Model (1) – (3). Compared to adding these controls to the basic model, the two-stage specification mitigates the multicollinearity introduced by the double and triple interactions among multiple control variables, return, and negative return dummy.[20] Specifically we estimate the following model:

$$Earnings = \alpha_0 + \beta_1 D(Ret<0) + \beta_2 Residual + \beta_3 D(Ret<0) \times Residual + \beta_4 Ret + \beta_5 Ret \times D(Ret<0) + \beta_6 Ret \times Residual + \beta_7 Ret \times D(Ret<0) \times Residual + \varepsilon \quad (6)$$

Panel C of Table 3 presents the regression results of the second stage regressions. Note that the first-stage regressions are reported in Table 2 Panel B. Recall that we have three models that alternate between different sets of controls. Consistent across all three first-stage models, we find a significantly negative β_7 in the second stage regression, indicating lower asymmetric loss recognition for affiliated-banker-on-board firms than for non-affiliated-banker-on-board firms. We do not repeat the coefficient reconstruction as in Table 3 Panel B because the residual is a continuous variable that does not have the same natural interpretation as the *Affiliated Banker* dummy.

Overall, the results from both the basic model without controls and the two-stage model with controls suggest that firms with affiliated bankers on board exhibit significantly—both statistically and economically—lower asymmetric loss recognition, consistent with lenders' board representation lowering the debt contracting motivated demand for conservatism.

5.4 Alternative specifications

[20] The average VIF for the one stage all-inclusive regression is 1,290, and it reduces to 2.4 in this two-stage specification.

Table 4 presents four alternative specifications to evaluate the robustness of our primary results. First, we replace the two-stage specification with a one-stage all-inclusive regression, in which we include all control variables and their double and triple interactions with return and the negative return dummy. Panel A of Table 4 reports the regression coefficients on the main terms. Despite severe multicollinearity, we still find a significantly negative β_7 (-0.096, p=0.028), indicating that affiliated-banker-on-board firms exhibit lower asymmetric loss recognition than non-affiliated-banker-on-board firms.

Second, we use a propensity score matching technique in the first stage to minimize the impact of covariates on the dependent variable and enhance our ability to draw causal inference (Armstrong, Jagolinzer, and Larcker, 2010). Specifically, we match affiliated-banker-on-board and non-affiliated-banker-on-board firms on their propensity to have affiliated bankers on board. The propensity score is calculated as the predicted value from Model (3), the full model, in Panel B of Table 2. The matching procedure reduces our sample from 6,481 to 1,101. Untabulated results indicate that the covariates are balanced between affiliated-banker-on-board and non-affiliated-banker-on-board firms after the matching procedure. We repeat our basic regression on this reduced balanced sample. Again, we find a significantly negative β_7 (-0.116, p=0.013), suggesting that affiliated-banker-on-board firms have lower asymmetric loss recognition than non- affiliated-banker-on-board firms.

Third, we identify a reduced sample to conduct a change specification. We only keep the years when the *Affiliated Banker* dummy switches from zero to one. The *Affiliated Banker* dummy is defined to be zero in the year before and switches to one in the year of the change. We repeat our basic regression on this change sample and again find a negative and significant β_7 (-0.235, p=0.00), suggesting that the inclusion of an affiliated banker on board has an immediate

effect on lowering asymmetric loss recognition. The results from this test further point the causality to the direction that affiliated bankers on board reduce the demand for conservatism.

Finally, we use an alternative measure of asymmetric loss recognition from the Ball and Shivakumar (2006) model:

$$Accruals = \alpha_0 + \beta_1 D(\Delta CF<0) + \beta_2 \Delta CF + \beta_3 \Delta CF \times D(\Delta CF<0) + \varepsilon \quad (7)$$

where *Accruals* is income before extraordinary item minus cash flow from operating activities deflated by average total assets, ΔCF is the annual change of operating cash flow scaled by average total assets, and $D(\Delta CF<0)$is a dummy variable equal to one if $\Delta CF<=0$ and zero otherwise. In this regression, the sensitivity of accruals to good (bad) news is captured by β_2 ($\beta_2 + \beta_3$), and the asymmetric loss recognition is captured by β_3. The advantage of this measure is that it does not rely on stock returns to measure economic news. We then estimate the following regression:

$$Accruals = \alpha_0 + \beta_1 D(\Delta CF<0) + \beta_2 Affiliated\ Banker + \beta_3 D(\Delta CF<0) \times Affiliated\ Banker + \beta_4 \Delta CF + \beta_5 \Delta CF \times D(\Delta CF<0) + \beta_6 \Delta CF \times Affiliated\ Banker + \beta_7 \Delta CF \times D(\Delta CF<0) \times Affiliated\ Banker + \varepsilon \quad (8)$$

Table 4 Panel B reports the regression results of this alternative measure and again we find a significantly negative β_7 (-0.667, p=0.023). This suggests that our results are not driven by any peculiarities of the Basu model.

In summary, we find strong and consistent results that the presence of affiliated bankers on board is negatively associated with conservatism in all four alternative specifications, reinforcing our primary finding that lenders' board representation lowers the debt-contracting motivated demand for accounting conservatism.

6. Affiliated banker vs. unaffiliated banker on board

We argue that to protect their interests, affiliated bankers have strong incentives to monitor the firm through private communication and control rights, thus lowering the demand for conservatism in public financial reports. However, as we note earlier, such incentives do not exist for unaffiliated bankers because they do not hold any stakes in the firm and they serve on the board mainly to provide financial market related expertise (Kroszner and Strahan, 2001). If it is the lending relationship that drives the lower demand from conservatism, then we do not expect unaffiliated bankers to have a similar negative association with conservatism. To test this conjecture, we define a *Unaffiliated Banker* variable to be one if there is an unaffiliated banker on board, i.e., a banker-director from a bank that does not have a lending relationship with the firm, zero otherwise. We drop firms that have both affiliated and unaffiliated bankers on board. Then we run the following regression:

$$\begin{aligned} Earnings = {} & \alpha_0 + \beta_1 D(Ret<0) + \beta_2 Affiliated\ Banker + \beta_3 Unaffiliated\ Banker + \beta_4 D(Ret<0) \times Affiliated\ Banker \\ & + \beta_5 D(Ret<0) \times Unaffiliated\ Banker + \beta_6 Ret + \beta_7 Ret \times D(Ret<0) + \beta_8 Ret \times Affiliated\ Banker \\ & + \beta_9 Ret \times Unaffiliated\ Banker + \beta_{10} Ret \times D(Ret<0) \times Affiliated\ Banker \\ & + \beta_{11} Ret \times D(Ret<0) \times Unaffiliated\ Banker + \varepsilon \end{aligned} \quad (9)$$

Table 5 reports regression coefficients reconstructed from this regression. We find that firms without any banker on board exhibit significant timely loss recognition, i.e., their asymmetric timeliness coefficient is 0.170 (p=0.00). Consistent with our previous findings, the firms with affiliated banker on board do not display significant asymmetric loss recognition (their coefficient is 0.013 and insignificant). In contrast, firms with unaffiliated bankers on board have a positive and significant asymmetric loss recognition coefficient (0.266, p=0.00). Formal tests of the differences indicate the following. First, firms with affiliated bankers on board display significantly less asymmetric loss recognition than firms without any banker on board.[21]

[21] In Panel B of Table 3 the non-affiliated-banker-on-board firms include unaffiliated-banker-on-board-firms and no-banker-firms, while in Table 5 we separate these two groups and formally test the difference across the three groups: no-banker firms, affiliated-banker-on-board firms, and unaffiliated-banker-on-board firms.

Second, firms with unaffiliated bankers on board are no different than firms without any bankers on board in their asymmetric loss recognition. Lastly, firms with unaffiliated bankers on board have a significantly higher asymmetric loss recognition coefficient than firms with affiliated bankers on board. These results lend support to the notion that the lower demand for conservatism/debt contracting is driven by the lending relationship, which promotes private communication and control from the affiliated bank.

7. Affiliated bankers on board and the debt-contracting demand for conservatism

In Section 5 we show that affiliated bankers' board representation is associated with lower levels of conservatism. We acknowledge that a lower level of conservatism is indirect evidence of lower contracting demand for conservatism. In this section, we conduct arguably more direct tests of the proposition that the lower conservatism associated with affiliated-banker-on-board firms arises because of lower debt-contracting demand in such firms. Prior literature has inferred debt contracting demand for conservatism by documenting (1) a positive association between conservatism and leverage (LaFond and Watts, 2008); and (2) a positive association between conservatism and debt-covenant-intensity (Nikolaev, 2010). Accordingly, we test our proposition that affiliated bankers on board reduce the demand for debt-contracting motivated demand for conservatism by examining whether the presence of an affiliated banker on board moderates the relation between leverage/debt-covenant-intensity and conservative accounting.

6.1 Affiliated bankers on board and the relation between conservatism and leverage

LaFond and Watts (2008) show that the extent of accounting conservatism increases in financial leverage, which is consistent with the debt-contracting demand for conservative accounting. We argue that if the presence of affiliated banker on board lowers conservatism

through lower debt contracting demand, then the previously documented positive relation between conservatism and leverage should be weaker for the affiliated-banker-on-board firms. To test this conjecture, we partition the sample on two dimensions: (1) affiliated-banker-on-board vs. other firms; and (2) low vs. high leverage. We define a variable *High Leverage* equal to one if the proportion of the firm's long-term debt in total assets is in the top tircile, and zero otherwise.

Panel A of Table 6 presents descriptive statistics on the leverage partition. We report that the mean leverage for the firms in the low leverage tircile is 0.047 while the mean leverage for the firms in the high leverage tircile is 0.407. In Panel B of Table 6 we report the number of observation in each two-way partition and test whether having affiliated bankers on board is associated with more highly leveraged firms. We document that for firm-years without affiliated bankers on board, 51% have low leverage and 49% have high leverage observations. However, for firm-years with affiliated bankers on board, only 35% have low leverage and 65% have high leverage; a χ^2 test suggests that these two frequencies are significantly different from the expected level (p=0.00). This result is consistent with our descriptive statistics in Table 2, suggesting that firms with high leverage face stronger demand from debtholders for protection and thus are more likely to benefit from the close lending relationship.

To test how the relation between conservatism and leverage changes with the presence of affiliated bankers, we add the leverage dummy to model (5) and estimate the following regression:

$$\begin{aligned} Earnings = {} & \alpha_0 + \beta_1 D(Ret<0) + \beta 2 Affiliated\ Banker + \beta_3 High\ Leverage + \beta_4 D(Ret<0) \times Affiliated\ Banker + \\ & \beta_5 D(Ret<0) \times High\ Leverage + \beta_6 Ret + \beta_7 Ret \times D(Ret<0) + \beta_8 Ret \times Affiliated\ Banker + \beta_9 Ret \times High \\ & Leverage + \beta_{10} Ret \times D(Ret<0) \times Affiliated\ Banker + \beta_{11} Ret \times D(Ret<0) \times High\ Leverage + \\ & \beta_{12} Ret \times D(Ret<0) \times High\ Leverage \times Affiliated\ Banker + \varepsilon \end{aligned} \quad (10)$$

We report the results of estimating Equation (10) in Panel C of Table 6. To ease the interpretation, we only report reconstructed asymmetric-timeliness regression coefficients in a 2×2 table, where affiliated banker-on-board and leverage are the two dimensions.[22] The bottom row of Table 6 reports asymmetric timeliness coefficients partitioned on the affiliated banker-on-board dimension, which replicates our main analysis in Table 3 Panel B and confirms that affiliated-banker-on-board firms have significantly lower conservatism. The last column, on the other hand, reports asymmetric timeliness coefficients partitioned on the leverage dimension, which replicates the LaFond and Watts (2008) analysis and finds consistent evidence, i.e., firms with higher leverage exhibit higher levels of conservatism than firms with low leverage (0.246 vs. 0.114).

The three top (left) rows (columns) in Panel C of Table 6 presents the asymmetric timeliness coefficients for the two-way partition with the corresponding differences. The first column reports the partition by High/Low leverage for non-affiliated-banker-on-board firms. We observe that for these firms, higher leverage is associated with a markedly higher level of asymmetric loss recognition—the asymmetric loss coefficient for high leverage firms (0.248) is more than twice that of the low leverage firms (0.115) and the difference (0.132) is significant at better than the 0.01 level. The third column presents the same high/low leverage partition for the affiliated-banker-on-board firms. For these firms, we find no evidence of asymmetric loss recognition for either the high or the low leverage partitions and there is no significant difference across the low/high leverage partitions. Also the difference-in-difference coefficient (i.e., the

[22] Take the third column of "Affiliated Banker" as an example. The cell Affiliated Banker/Low Leverage reports the estimated value of $\beta_7 + \beta_{10}$, the cell Affiliated Banker/High Leverage reports the estimated value of $\beta_7 + \beta_{10} + \beta_{11} + \beta_{12}$, and the cell Affiliated Banker/ Δ Leverage is simply the difference between the cell above and below: $\beta_{11} + \beta_{12}$. In addition, the highlighted cell "Δ Affiliated Banker / Δ Leverage" reports the estimated β_{12} from the regression above, which captures the difference (in the level of conservatism between High Leverage and Low Leverage) in the difference (between Affiliated Banker and No Affiliated Banker).

difference between the affiliated-banker-on-board and other firms, for the difference in asymmetric loss recognition across the high/low leverage) is 0.102 and statistically significant.

Overall we find that, once a firm has an affiliated banker on board, the normal positive association between leverage and conservatism ceases to exist, suggesting that higher leverage does not appear to create a debt-contracting demand for conservatism, potentially because lenders in such firm are less reliant on the monitoring and control provided through conservative accounting.[23]

6.2 Affiliated bankers on board and the use of debt covenants in loan contracts

While leverage captures the overall demand for monitoring and control from debtholders, the complementarity between conservatism and the use of debt covenants is more direct evidence that the demand for conservatism arises from debt contracting (Nikolaev, 2010). Accordingly, our second proxy for debt-contracting demand is debt covenant intensity, which we measure as the number of covenants in loan contracts. We examine whether the presence of affiliated bankers on board (1) is associated with covenant intensity; and (2) moderates the relation between covenant intensity and conservative accounting documented by Nikolaev (2010).

6.2.1 Affiliated bankers on board and the use of debt covenants

We start with the analysis on how lenders' board representation is related to the use of debt covenants in debt contracts. On one hand, the private communication and control right exercised by affiliated bankers could lower the demand for debt covenants (and therefore

[23] We report the results based on the dichotomous *Affiliated Banker* variable without controlling for the confounding effect, because the residual from a first-stage regression is a continuous variable that does not have the same natural interpretation as the *Affiliated Banker* dummy. Nevertheless, we control for the confounding effect by adding the predicted value of the *Affiliated Banker* from the first stage regression (model 3 in Table 2 Panel B) and its double and triple interaction terms with return and the negative return dummy in equation (10). We find that our results remain qualitatively the same. That is, we confirm that the positive association between conservatism and leverage exists only for non-affiliated-banker-on-board firms, not for affiliated-banker-on-board firms after controlling for confounding effects.

conservatism) in protecting affiliated lenders. On the other hand, affiliated bankers may find active monitoring and control too costly and therefore may still rely on debt covenants (and conservatism) to exercise monitoring and control. Therefore it is an empirical question whether the presence of affiliated bankers is related to the use of debt covenants.

We measure the use of debt covenants following Bradley and Roberts (2004). Specifically, we define covenant intensity of a bank loan contract as the sum of six dummy variables representing the existence of a debt issuance sweep covenant, an equity issuance sweep covenant, an asset sale sweep covenant, a dividend covenant, at least two financial covenants, and a secured covenant. [24] This measure ranges from zero (the least restrictive) to six (the most restrictive). Since these covenants are at the package level and firms may have multiple packages we aggregate the package data to the firm-level.[25] We define a firm-year to have high (low) use of debt covenants if its covenant intensity score is in the top (bottom) tercile.

Panel A of Table 7 presents descriptive statistics on the use of debt covenants. We report that 2,139 firm-years fall into the low covenant tercile, with no covenant or only one covenant (out of six) used. In contrast, 1,957 firm-years are in the high covenant tercile, having between four to six covenants in their loan contracts. In Panel B of Table 7 we test whether the variation in the covenant usage is a function of having affiliated bankers on board. We document that for firm-years without affiliated bankers on board, 51% have low covenant usage and 49% have high covenant usage. However, for firm-years with affiliated bankers on board, 79% have low covenant usage and only 21% have high covenant usage; a χ^2 test suggests that these two frequencies are significantly different from the expected level (p=0.00). This result is particularly

[24] Most covenants are at the package level except the collateral covenant which is at the facility level. We define a loan package to have the collateral covenant as long as one of the facilities has the collateral covenant.

[25] This implies that if any of the packages has a particular covenant type, the dummy variable for that type of covenant is coded as being equal to one.

salient given that affiliated-banker-on-board firms usually have a higher leverage (Table 2 and Table 6 Panel B), which would normally predict higher covenant usage.[26] The lower usage of covenants by firms with affiliated bankers on board provides corroborating evidence that the lower conservatism for such firms is associated with lower debt-contracting demand.[27]

6.2.2 Affiliated bankers on board and the link between conservatism and debt covenants

Nikolaev (2010) documents that firms that rely more heavily on debt covenants (i.e., have greater covenant intensity) use more conservative accounting. These results suggest that conservatism complements debt covenants in protecting lender interests, i.e., conservatism is important for the effective functioning of debt covenants. If lender board representation provides an alternative mechanism to protect lender interests, then firms with affiliated bankers on board should rely less on the effectiveness with which debt covenants protect lender interests. Therefore, as conservative accounting exists to enhance covenant effectiveness, affiliated-banker-on-board firms should display less of an association between conservatism and debt covenant intensity.

Accordingly, we formally test how the relation between conservatism and debt covenants changes with the presence of affiliated bankers. Specifically, we conjecture that the positive relation between debt covenant intensity and conservatism should be weaker for firms with affiliated bankers on board. To test this conjecture, we add the covenant variable to model (5) and estimate the following regression:

$$Earnings = \alpha_0+\beta_1 D(Ret<0)+ \beta_2 Affiliated\ Banker +\beta_3 High\ Covenants +\beta_4 D(Ret<0)\times Affiliated\ Banker+ \beta_5 D(Ret<0)\times High\ Covenants +\beta_6 Ret + \beta_7 Ret\times D(Ret<0) + \beta_8 Ret\times Affiliated\ Banker + \beta_9 Ret\times High$$

[26] Using Dealscan/Compustat merged data, we find a positive and significant correlation (0.07) between leverage and the use of covenants for all firms.

[27] As noted earlier, the use of debt covenants is more direct evidence of the demand for debt contracting, while leverage has the broad notation of the overall demand for monitoring and control from lenders. The seemingly inconsistency between high leverage and low covenant for affiliated-banker-on-board firms is thus consistent with that such firms have higher overall demand for monitoring and control from lenders, but the demand is not satisfied through the use of more restrictive covenants, but through the close monitoring and control from affiliated lenders.

$$Covenants + \beta_{10}Ret\times D(Ret<0)\times Affiliated\ Banker + \beta_{11}Ret\times D(Ret<0)\times High\ Covenants + \beta_{12}Ret\times D(Ret<0)\times High\ Covenants \times Affiliated\ Banker + \varepsilon \quad (11)$$

To ease the interpretation, in Panel C of Table 7, we once again report reconstructed coefficients from the above regression into a 2×2 table representing the affiliated-banker-on-board and covenant-intensity dimensions. The last row of Table 7 Panel C reports asymmetric timeliness coefficient partitioned based only on the affiliated banker dimension, which is a replication of our main analysis in Table 3.[28] The last column, on the other hand, presents asymmetric timeliness coefficient partitioned only on High/Low covenants, which is a replication of Nikolaev (2010).[29] We find that firms with high use of covenants exhibits higher level of conservatism than firms with low use of covenants (0.196 vs. 0.120), and the difference is again significant (0.076, p=0.040). This is consistent with the finding in Nikolaev (2010) that conservatism improves the effectiveness of debt covenants in protecting lender interests.[30]

The three top (left) rows (columns) in Table 7 Panel C presents the asymmetric timeliness coefficient based on the two-way partition and the corresponding differences. The first column reports the partition by High/Low use of covenants for the non-affiliated-banker-on-board firms. We observe that for these firms, high covenant usage is associated with higher asymmetric loss coefficient (0.200) than low covenant usage (0.122) and the difference of 0.077 is significant at the 0.04 level. The third column presents the same partition for affiliated-banker-on-board firms. Interestingly, for these firms there is no evidence of significant asymmetric loss recognition for

[28] This partition repeats the estimation of model (5) on a smaller sample that excludes the middle tertile of the covenant index following our definition of the high and low covenant dummy variable. The sample difference causes some negligible difference between the coefficients in Table 5 Panel C and those in Table 3 Panel B.

[29] To replicate Nikolaev (2010), we replace the banker dummy in model (5) with the high covenant dummy. Specifically, we estimate the following regression. $Earnings = \alpha_0 + \beta_1 D(Ret<0) + \beta_2 High\ Covenants + \beta_3 D(Ret<0) \times High\ Covenants + \beta_4 Ret + \beta_5 Ret \times D(Ret<0) + \beta_6 Ret \times High\ Covenants + \beta_7 Ret \times D(Ret<0) \times High\ Covenants + \varepsilon$. The cell All/Low Covenants is the estimated β_5 and the cell All/High Covenants is the estimated $\beta_5 + \beta_7$ from this regression.

[30] We note that while Nikolaev (2010) uses bond covenants, we use bank loan covenants because we study bankers on board and bank loans are directly tied to bankers' incentives. Our finding of a positive association between conservatism and loan covenants complements Nikolaev (2010).

either the low or the high covenant intensity partitions, and the difference between these partitions is also not significant. The difference-in-difference coefficient (-0.098) is both economically and statistically significant, suggesting that the normal positive relation between covenant intensity and conservatism reported by Nikolaev (2010) is absent in the affiliated bankers-on-board firms. These results indicates that when there are affiliated bankers on board, the use of conservatism in accounting is no longer responsive to the use of debt covenants, ostensibly because such firms are less reliant on the effectiveness of the covenants.

Overall, our evidence suggests that the lower level of conservatism in affiliated-banker-on-board firms is accompanied by lower use of debt covenants. More interestingly, the previously documented positive association between conservatism and leverage/debt covenants vanishes for the affiliated-banker-on-board firms.[31] These results are consistent with our conjecture that affiliated bankers on board reduce the debt-contracting motivated demand for conservatism.

8. Conclusion

We examine the tradeoff between having affiliated bankers on the board and conservative accounting for mitigating debtholder-shareholder conflicts. We first document that firms with affiliated bankers on board have less conservative accounting, i.e., their earnings exhibit significantly less asymmetric timeliness (Basu, 1997) than firms without affiliated bankers on board. These results are robust to including a wide range of control variables, using a change analysis, propensity score matching, and an alternative measure of conservatism (Ball and

[31] Similarly to the leverage analysis, we report the results based on the dichotomous *Affiliated Banker* variable. However, we find that our results remain qualitatively the same after controlling for the predicted value of the *Affiliated Banker* from the first stage regression (model 3 in Table 2 Panel B) and its double and triple interaction terms in equation (11). Specifically, we confirm that the positive association between conservatism and covenants exists only for non-affiliated-banker-on-board firms and not for affiliated-banker-on-board firms after controlling for the confounding effects.

Shivakumar, 2006). Additionally, we show that when there are affiliated bankers on board, borrowers are subject to less debt covenants, and the previously documented positive association between conservatism and leverage/covenants (LaFond and Watts, 2008; Nikolaev, 2010) disappears. We interpret this evidence as affiliated bankers on board reducing the debt contracting demand for conservatism.

We are the first to examine the tradeoff between conservatism (in conjunction with debt contracting) and affiliated bankers on board, two debt-oriented monitoring mechanisms. The negative relation between conservatism and another debt-oriented monitoring mechanism attests the debt-contracting explanation for conservative accounting. However, we note that given the cost of having affiliated bankers on board, it is not a prevalent phenomenon in the U.S.; therefore conservative accounting/debt contracting is a low cost alternative to mitigate the debtholder-shareholder conflict and as a result is more prevalent in practice. Our paper is also the first to examine the financial reporting implications of having affiliated bankers on board, an important yet under-examined governance mechanism. The results in this paper improve our understanding of the optimal governance design to address the debtholder-shareholder conflict, and highlight the need to further study the tradeoffs among various monitoring mechanisms (Armstrong et al., 2010).

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TABLE 1

Panel A. Descriptive Statistics of Main Measures

	N	Mean	Std Dev	Q1	Median	Q3
Affiliated Banker	6,481	0.048	0.214	0.000	0.000	0.000
Unaffiliated Banker	6,481	0.064	0.244	0.000	0.000	0.000
Earnings	6,481	0.038	0.111	0.028	0.052	0.072
Ret	6,481	0.174	0.500	-0.085	0.117	0.346
D(Ret <0)	6,481	0.346	0.476	0.000	0.000	1.000
ΔCF	6,481	0.011	0.070	-0.019	0.009	0.040
D(ΔCF<0)	6,481	0.408	0.491	0.000	0.000	1.000
MB	6,481	4.629	70.720	1.646	2.379	3.696
Leverage	6,481	0.227	0.160	0.093	0.226	0.339
Problit	6,481	0.012	0.019	0.004	0.007	0.012
Pr(Bankruptcy)	6,481	0.002	0.009	0.000	0.001	0.002
Stdv Ret	6,481	0.118	0.059	0.078	0.104	0.143
Stdv Ret^2	6,481	0.017	0.020	0.006	0.011	0.020
log(Assets)	6,481	7.708	1.448	6.639	7.546	8.648
PPE	6,481	0.302	0.221	0.128	0.240	0.440
Rating	6,481	0.124	0.330	0.000	0.000	0.000
Short-term debt	6,481	0.056	0.086	0.001	0.021	0.077
Board independence	6,481	0.680	0.150	0.571	0.700	0.800
log(Board size)	6,481	2.375	0.341	2.079	2.398	2.639
CEO/Chair separated	6,481	0.922	0.268	1.000	1.000	1.000
Avg directorships	6,481	1.217	0.851	0.615	1.000	1.625
Inside director ownership	6,481	0.051	0.116	0.002	0.009	0.040
Outside director ownership	6,481	0.009	0.049	0.000	0.001	0.004
Institutional ownership	6,481	0.749	0.194	0.624	0.763	0.878
G-index	6,481	9.416	2.546	8.000	9.000	11.000

Descriptive statistics are based on a sample of 1,293 non-financial S&P 1500 firms from 2000-2006 (6,481 firm-year observations). *Affiliated Banker* is an indicator variable equal to 1 when a firm has an executive from an affiliated commercial bank on its board, and 0 otherwise; *Unaffiliated Banker* is an indicator variable equal to 1 when a firm has an executive from an unaffiliated commercial bank on its board, and 0 otherwise; *Earnings* equals income before extraordinary items scaled by prior year's market value of equity; *Ret* equals fiscal year stock returns; *D(Ret < 0)* is an indicator variable that is equal to 1 when *Ret* is negative, and 0 otherwise; *Accruals* equals income before extraordinary items minus cash flow from operating activities scaled by average total assets; ΔCF equals annual change in cash flow, scaled by average total assets; *D(ΔCF<0)* is an indicator variable that equals 1 when *ΔCF* is negative, and 0 otherwise; *MB* equals market value of equity divided by book value of equity; *Leverage* equals sum of long-term debt and the current portion of long-term debt scaled by total assets; *Problit* is the probability of litigation from Rogers and Stocken (2005); *Pr(Bankruptcy)* is the probability that a firm will go bankrupt and is based on Shuman (2001); *Stdv Ret* is standard deviation of monthly stock returns over the prior 3 years; *Stdv* Ret^2 equals the square of *Stdv Ret*; *log(Assets)* equals the natural logarithm of total assets; *PPE* is property plant & equipment scaled by total assets; *Rating* is an indicator variable that equals 1 when a firm has a commercial paper rating, and 0 otherwise; *Short-term debt* equals short-term debt scaled by total debt; *Board independence* equals the number of outside directors scaled by total number of directors; *log(Board size)* is the natural log of the number of directors; *CEO/ Chair separated* is an indicator variable that equals 1 when the CEO is not chairman of the board, and 0 otherwise; *Avg directorships* equals the total directorships held by the board scaled by the total number of directors; *Inside director ownership* equals the common shares held by inside directors scaled by total common shares outstanding; *Outside director ownership* equals the common shares held by outside directors scaled by total common shares outstanding; *Institutional Ownership* equals the common shares held by institutional investors scaled by total common shares outstanding; *G-index* equals the governance index of 24 governance provisions as calculated in Gompers et al. (2003).

TABLE 1 (Continued)

Panel B. Descriptive Statistics of Affiliated Debt

Affiliated Debt/Private debt	311	0.827	0.299	0.720	1.000	1.000
Affiliated Debt/Total committed long-term debt	311	0.533	0.309	0.294	0.503	0.799
Affiliated Debt/Total assets	311	0.200	0.215	0.070	0.152	0.251

Descriptive statistics are based on the subsample of 311 firm years that there is an affiliated banker on board. *Affiliated Debt* is the total amount of the syndicated loan for which the affiliated banker represents (from Dealscan). *Private Debt* is the total syndicated loans for a firm (from Dealscan). *Total committed long-term debt* is the sum of convertible debt, debentures, notes (all from Compustat), and total syndicated loans (from DealScan).

TABLE 1 (Continued)

Panel C. Pearson Correlation Coefficients between Main Measures

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)	(17)	(18)	(19)	(20)	(21)	(22)	(23)	(24)
(1) Affiliated Banker																								
(2) Earnings	0.04																							
(3) Ret	0.00	0.15																						
(4) D(Ret <0)	-0.03	-0.19	-0.58																					
(5) Accruals	0.03	0.43	0.06	-0.07																				
(6) ΔCF	0.00	0.12	0.17	-0.13	-0.32																			
(7) D(ΔCF<0)	-0.01	-0.10	-0.13	0.14	0.23	-0.65																		
(8) MB	0.00	-0.06	0.07	-0.01	-0.01	0.03	-0.02																	
(9) Leverage	0.05	-0.04	-0.03	0.00	0.06	-0.06	0.04	0.05																
(10) Problit	-0.01	-0.16	-0.32	0.33	-0.14	-0.03	0.02	-0.01	-0.06															
(11) Pr(Bankruptcy)	-0.01	-0.25	0.26	-0.04	-0.06	0.03	0.02	0.14	0.12	-0.04														
(12) Stdv Ret	-0.08	-0.31	0.09	0.18	-0.21	0.02	0.03	0.02	-0.14	0.26	0.33													
(13) Stdv Ret^2	-0.07	-0.31	0.11	0.15	-0.21	0.01	0.03	0.02	-0.12	0.24	0.39	0.95												
(14) log(Assets)	0.12	0.12	-0.07	-0.02	0.10	0.00	-0.05	-0.01	0.33	0.19	-0.14	-0.34	-0.29											
(15) PPE	0.12	0.07	0.01	-0.06	-0.14	0.03	-0.05	-0.02	0.29	-0.11	-0.02	-0.20	-0.17	0.20										
(16) Rating	0.14	0.05	-0.07	0.00	0.04	-0.01	-0.02	0.01	0.08	0.10	-0.07	-0.25	-0.19	0.41	0.04									
(17) Short-term dbt.	0.01	-0.02	-0.06	0.04	0.08	-0.06	0.04	0.00	0.25	0.00	0.02	-0.09	-0.07	0.14	-0.02	0.16								
(18) Board ind.	0.05	0.01	0.03	-0.04	0.02	-0.04	0.03	0.02	0.13	0.01	0.04	-0.04	-0.03	0.17	0.07	0.13	0.05							
(19) log(Board size)	0.07	0.07	-0.11	0.01	0.08	-0.01	-0.02	-0.01	0.17	-0.01	-0.08	-0.41	-0.34	0.44	0.08	0.19	0.08	-0.04						
(20) CEO/Chair	-0.03	0.02	0.05	-0.05	0.06	-0.01	0.01	0.00	-0.08	-0.07	0.00	-0.07	-0.05	-0.06	-0.05	-0.06	-0.04	-0.11	0.08					
(21) Avg. dir.	0.06	-0.03	0.00	-0.01	0.00	-0.02	0.01	0.00	0.16	0.13	0.00	0.01	0.01	0.37	0.02	0.23	0.07	0.32	-0.08	-0.12				
(22) Ins. dir.own.	-0.04	0.02	0.01	0.01	0.03	0.01	0.01	0.00	-0.05	-0.03	0.01	0.03	0.02	-0.13	-0.04	-0.05	-0.01	-0.34	-0.01	0.03	-0.15			
(23) Outs. dir.own.	0.00	0.01	0.01	0.01	-0.01	0.01	0.00	0.00	0.02	-0.02	0.02	-0.01	-0.01	-0.05	-0.01	-0.01	0.01	0.00	0.02	-0.01	-0.02	0.05		
(24) Inst.own.	-0.08	0.08	0.05	-0.03	0.02	0.04	-0.03	0.00	-0.10	-0.11	-0.10	-0.03	-0.08	-0.13	-0.15	-0.19	-0.12	-0.01	-0.01	0.10	-0.10	-0.20	-0.04	
(25) G-index	0.06	0.06	-0.01	-0.05	0.05	-0.02	0.02	0.00	0.16	-0.08	-0.02	-0.20	-0.18	0.14	0.11	0.07	0.06	0.25	0.18	-0.04	0.12	-0.17	-0.02	-0.06

All measures are as defined in panel A. All correlation coefficients with an absolute magnitude larger than 0.02 are significant at $p < .05$ (two-tailed)

TABLE 2

Panel A: Descriptive Statistics Affiliated-banker-on-board versus Non-affiliated-banker-on-board Firms

	Affiliated Banker				
Variable	Yes	No	Difference	*t*-stat	*p*-value
Earnings	0.056	0.037	0.019	2.990	0.003
Ret	0.180	0.173	0.007	0.240	0.812
D(Ret <0)	0.286	0.349	-0.063	-2.280	0.023
Accruals	-0.049	-0.058	0.009	2.100	0.036
ΔCF	0.011	0.011	0.001	0.180	0.858
D(ΔCF<0)	0.395	0.409	-0.013	-0.460	0.647
MB	3.441	4.689	-1.248	-0.300	0.761
Leverage	0.266	0.225	0.041	4.410	0.000
Problit	0.011	0.012	-0.001	-0.900	0.369
Pr(Bankruptcy)	0.002	0.002	-0.001	-1.010	0.311
Stdv Ret	0.096	0.119	-0.023	-6.850	0.000
Stdv Ret^2	0.011	0.018	-0.006	-5.570	0.000
log(Assets)	8.483	7.669	0.815	9.750	0.000
PPE	0.420	0.296	0.124	9.750	0.000
Rating	0.325	0.114	0.210	11.080	0.000
Short-term debt	0.061	0.055	0.006	1.200	0.231
Board independence	0.712	0.678	0.034	3.880	0.000
log(Board size)	2.476	2.370	0.106	5.370	0.000
CEO/Chair separated	0.891	0.924	-0.033	-2.110	0.035
Avg directorships	1.429	1.206	0.223	4.520	0.000
Inside director ownership	0.030	0.052	-0.022	-3.260	0.001
Outside director ownership	0.009	0.009	0.000	0.110	0.916
Institutional ownership	0.681	0.752	-0.071	-6.350	0.000
G-index	10.122	9.381	0.741	5.020	0.000
Nobs	311	6,170			

All measures are as defined in panel A. *t*-statistics and two-sided *p*-values are computed using pooled variances.

TABLE 2 (continued)

Panel B: Logit Models Predicting Affiliated Banker on Board

VARIABLES	Model 1	Model 2	Model 3
Constant	-22.575	-6.765	-20.955
	(0.000)	(0.000)	(0.000)
MB	-0.015	-0.001	-0.008
	(0.473)	(0.815)	(0.611)
Leverage	-0.458	0.534	-0.863
	(0.647)	(0.524)	(0.413)
Problit	-5.261	-8.399	-6.090
	(0.364)	(0.164)	(0.335)
Pr(Bankruptcy)	4.366		0.005
	(0.820)		(1.000)
Stdv Ret	24.140		23.970
	(0.019)		(0.018)
Stdv Ret^2	-111.041		-103.559
	(0.024)		(0.024)
Log(Assets)	0.276		0.276
	(0.005)		(0.008)
PPE	2.657		2.673
	(0.000)		(0.000)
Rating	1.002		0.903
	(0.001)		(0.008)
Short-term debt	-1.155		-1.744
	(0.372)		(0.201)
Board independence		1.349	-0.533
		(0.202)	(0.567)
log(Board size)		1.500	0.107
		(0.000)	(0.784)
CEO/Chair separated		-0.213	-0.046
		(0.194)	(0.788)
Avg directorships		0.275	-0.034
		(0.014)	(0.781)
Inside director ownership		-5.088	-2.859
		(0.018)	(0.066)
Outside director ownership		0.205	1.072
		(0.886)	(0.174)
Institutional ownership		-2.807	-1.341
		(0.000)	(0.054)
G-index		0.081	0.073
		(0.090)	(0.150)
Industry Fixed-Effects	Yes	No	Yes
Observations	6,416	6,416	6,416
Pseudo R-squared	0.144	0.108	0.154

This table presents the results of logit regressions of the dummy variable of affiliated bankers on board on various control variables. Industry fixed-effects are 1-digit SIC code indicators. All other measures are as defined in panel A of Table 1. Models are estimated after dropping the top 1% of absolute standardized residuals. Two-sided *p*-values in brackets are computed using standard errors clustered at the firm-level.

TABLE 3

Conservatism and Affiliated Bankers on Board

$$Earnings = \alpha_0 + \beta_1 D(Ret<0) + \beta_2 Affiliated\ Banker + \beta_3 D(Ret<0) \times Affiliated\ Banker + \beta_4 Ret + \beta_5 Ret \times D(Ret<0) + \beta_6 Ret \times Affiliated\ Banker + \beta_7 Ret \times D(Ret<0) \times Affiliated\ Banker + \varepsilon$$

Panel A: Affiliated Bankers on Board and Conservatism – Regression Results

α_0	β_1	β_2	β_3	β_4	β_5	β_6	β_7	*Adjusted* R^2	*N*
0.053	0.004	-0.001	0.003	0.013	0.173	0.048	**-0.163**	0.156	6,416
(0.000)	(0.156)	(0.903)	(0.708)	(0.009)	(0.000)	(0.003)	**(0.000)**		

Panel B: Affiliated Bankers on Board and Conservatism – Reconstructed Coefficients

	(1) Timely loss recognition	(2) Timely gain recognition	(3) Asymmetric loss recognition	(4) Asymmetric loss recognition
	D(Ret <0)=1	*D(Ret <0)=0*	(1) – (2)	(1)/(2)
Affiliated Banker	$\beta_4+\beta_5+\beta_6+\beta_7$	$\beta_4+\beta_6$	$\beta_5+\beta_7$	$(\beta_4+\beta_5+\beta_6+\beta_7)/(\beta_4+\beta_6)$
Estimate	0.071	0.061	0.010	1.169
p-value	(0.017)	(0.000)	(0.746)	(0.754)
No Affiliated Banker	$\beta_4+\beta_5$	β_4	β_5	$(\beta_4+\beta_5)/(\beta_4)$
Estimate	0.186	0.013	0.173	14.740
p-value	(0.000)	(0.009)	(0.000)	(0.019)
Affiliated Banker – No Affiliated Banker				
Estimate	-0.115	0.048	**-0.163**	**-13.571**
p-value	(0.000)	(0.003)	**(0.000)**	**(0.021)**

Panel C: Controlling for Determinants of Conservatism and Affiliated Banker in a two-stage regression

α_0	β_1	β_2	β_3	β_4	β_5	β_6	β_7	*Adjusted* R^2	*N*
Model 1									
0.054	0.004	0.000	0.002	0.013	0.171	0.017	**-0.102**	0.153	6, 416
(0.000)	(0.133)	(0.996)	(0.869)	(0.006)	(0.000)	(0.357)	**(0.009)**		
Model 2									
0.054	0.004	-0.002	-0.004	0.014	0.168	0.040	**-0.213**	0.156	6,416
(0.000)	(0.136)	(0.772)	(0.655)	(0.004)	(0.000)	(0.021)	**(0.000)**		
Model 3									
0.054	0.004	0.000	0.002	0.013	0.171	0.018	**-0.094**	0.153	6,416
(0.000)	(0.134)	(0.990)	(0.810)	(0.006)	(0.000)	(0.338)	**(0.018)**		

Panel A presents the results of a regression model that examines the relation between the presence of affiliated bankers on board and accounting conservatism using a Basu (1997) model. All measures are as defined in panel A of Table 1. Panel B presents the reconstructed coefficients of timely gain recognition, timely loss recognition, and asymmetric loss recognition for affiliated-banker-on-board firms and non-affiliated-banker-on-board firms. Two-sided *p*-values in brackets are computed using the Delta method. Panel C presents the results of second-stage regression models that use the residual from the logit models (Model 1- Model3) in panel B of Table 2 (expressed in terms of probability) as a measure for *Affiliated Banker*. All other measures are as defined in panel A of table 1. All models are estimated after dropping the top 1% of absolute studentized residuals. Two-sided *p*-values in brackets are computed using standard errors clustered at the firm-level.

TABLE 4
Conservatism and Affiliated Bankers on Board: Alternative Specifications

Panel A: Alternative specifications of the Basu (1997) model

$$Earnings = \alpha_0 + \beta_1 D(Ret<0) + \beta_2 Affiliated\ Banker + \beta_3 D(Ret<0) \times Affiliated\ Banker + \beta_4 Ret + \beta_5 Ret \times D(Ret<0) + \beta_6 Ret \times Affiliated\ Banker + \beta_7 Ret \times D(Ret<0) \times Affiliated\ Banker + \varepsilon$$

α_0	β_1	β_2	β_3	β_4	β_5	β_6	β_7	Adjusted R^2	N
Including all interactions in model (only main measures are reported)									
0.053	-0.043	-0.007	0.014	-0.162	-0.201	0.053	**-0.096**	0.361	6,416
(0.013)	(0.233)	(0.198)	(0.132)	(0.015)	(0.181)	(0.002)	**(0.028)**		
Match firms based on firm-characteristics									
0.053	0.009	-0.000	-0.001	0.040	0.126	0.021	**-0.116**	0.188	1,101
(0.000)	(0.129)	(0.953)	(0.903)	(0.000)	(0.000)	(0.216)	**(0.013)**		
Change model									
0.060	0.032	-0.005	-0.010	0.056	0.235	0.024	**-0.235**	0.521	93
(0.000)	(0.181)	(0.651)	(0.780)	(0.000)	(0.000)	(0.008)	**(0.003)**		

Panel B: Ball and Shivakumar (2006) model

$$Accruals = \alpha_0 + \beta_1 D(\Delta CF<0) + \beta_2 Affiliated\ Banker + \beta_3 D(\Delta CF<0) \times Affiliated\ Banker + \beta_4 \Delta CF + \beta_5 \Delta CF \times D(\Delta CF<0) + \beta_6 \Delta CF \times Affiliated\ Banker + \beta_7 \Delta CF \times D(\Delta CF<0) \times Affiliated\ Banker + \varepsilon$$

α_0	β_1	β_2	β_3	β_4	β_5	β_6	β_7	Adjusted R^2	N
-0.051	0.009	0.003	-0.020	-0.423	0.243	-0.013	**-0.667**	0.172	6,416
(0.000)	(0.000)	(0.554)	(0.007)	(0.000)	(0.000)	(0.866)	**(0.023)**		

Panel A presents the results of alternative specifications to examine whether our results are robust to (1) including all controls from model (3) and their interaction terms; (2) matching firms on their propensity of having affiliated bankers on board based on the full logit regression in panel B of table 2, where the difference in probability of having an affiliated banker between banker firms and matched firms is 0.01 or smaller (maximum 3 matches per banker firm); and (3) a change specification, in which the baseline is the year before a banker joins a firm's board, and the treatment is the year in which a banker joins a firm's board. Panel B presents the results of a regression model based on Ball and Shivakumar (2006) to examine whether our results also hold for alternative conservatism models. All measures are as defined in panel A of table 1. Models are estimated after dropping the top 1% of absolute studentized residuals. Two-sided *p*-values in brackets are computed using standard errors clustered at the firm-level.

TABLE 5

Conservatism and Unaffiliated Bankers on Board

$$Earnings = \alpha_0 + \beta_1 D(Ret<0) + \beta_2 Affiliated\ Banker + \beta_3 Unaffiliated\ Banker + \beta_4 D(Ret<0) \times Affiliated\ Banker + \beta_5 D(Ret<0) \times Unaffiliated\ Banker + \beta_6 Ret + \beta_7 Ret \times D(Ret<0) + \beta_8 Ret \times Affiliated\ Banker + \beta_9 Ret \times Unaffiliated\ Banker + \beta_{10} Ret \times D(Ret<0) \times Affiliated\ Banker + \beta_{11} Ret \times D(Ret<0) \times Unaffiliated\ Banker + \varepsilon$$

	Coefficients	Asymmetric Timeliness
No Banker	β_7	0.170 (0.000)
Affiliated Banker	$\beta_7 + \beta_{10}$	0.013 (0.699)
Unaffiliated Banker	$\beta_7 + \beta_{11}$	0.266 (0.000)
Affiliated Banker - No banker	β_{10}	-0.157 (0.000)
Unaffiliated Banker - No banker	β_{11}	0.096 (0.195)
Unaffiliated Banker - Affiliated banker	$\beta_{11} - \beta_{10}$	**0.253** **(0.002)**

This table presents the results of a regression model that examines whether the association between the presence of affiliated banker on board and conservatism is more pronounced for affiliated bankers than for unaffiliated bankers. The model is estimated after dropping firms that concurrently have affiliated bankers and unaffiliated bankers on board. We also drop the top 1% of absolute studentized residuals. Two-sided *p*-values in brackets are computed using standard errors clustered at the firm-level.

TABLE 6
Affiliated Bankers on Board and the Conservatism-Leverage Link

Panel A: Descriptive Statistics of Leverage

	Observations	Mean	Minimum	Maximum
Low Leverage	2,160	0.047	0.000	0.148
High Leverage	2,160	0.407	0.299	0.858

Panel B: Affiliated Bankers on Board and Leverage

	No Affiliated Banker	Affiliated Banker
Low Leverage	2,098	62
	(50.65%)	(35.23%)
High Leverage	2,044	114
	(49.35%)	(64.77%)
Test Statistic	$\chi^2 = 16.016$	p-value = 0.000

Panel C: Affiliated Bankers on Board and the Conservatism-leverage link

$$Earnings = \alpha_0+\beta_1 D(Ret<0)+ \beta 2 Affiliated\ Banker +\beta_3 High\ Leverage +\beta_4 D(Ret<0)\times Affiliated\ Banker+ \beta_5 D(Ret<0)\times High\ Leverage +\beta_6 Ret + \beta_7 Ret\times D(Ret<0) + \beta_8 Ret\times Affiliated\ Banker + \beta_9 Ret\times High\ Leverage + \beta_{10} Ret\times D(Ret<0)\times Affiliated\ Banker + \beta_{11} Ret\times D(Ret<0)\times High\ Leverage + \beta_{12} Ret\times D(Ret<0)\times High\ Leverage \times Affiliated\ Banker + \varepsilon$$

	Asymmetric Timeliness Coefficient			
	No Affiliated Banker	Δ Affiliated Banker	Affiliated Banker	All
Low Leverage	0.115	-0.137	-0.022	0.114
	(0.000)	(0.002)	(0.620)	(0.000)
Δ Leverage	0.132	**-0.102**	0.030	0.132
	(0.000)	**(0.006)**	(0.447)	(0.000)
High Leverage	0.248	-0.239	0.008	0.246
	(0.000)	(0.000)	(0.873)	(0.000)
All	0.179	-0.180	-0.001	
	(0.000)	(0.000)	(0.981)	

Panel A presents descriptive statistics of the Leverage indicator. Firm year observations are classified as High (Low) Leverage if their leverage is in the top (bottom) tercile. Leverage equals the sum of long-term debt and the current portion of debt scaled by total assets. Panel B provides a frequency distribution of High and Low Leverage firms based on whether firms have an affiliated banker on boards. Two-sided p-value is computed using a χ^2-test. Panel C reports the reconstructed asymmetric timeliness coefficient from a regression that examines whether the presence of affiliated bankers on boards affects the relation between conservatism and leverage. Models are estimated after dropping the middle tircile of leverage ratios and after dropping the top 1% of absolute studentized residuals. Two-sided p-values in brackets are computed using standard errors clustered at the firm-level.

TABLE 7
Affiliated Bankers on Board and Debt Covenants

Panel A: Descriptive Statistics of Debt Covenants

	Observations	Mean	Minimum	Maximum
Low Covenants	2,139	0.452	0	1
High Covenants	1,957	5.247	4	6

Panel B: Affiliated Bankers on Board and the use of Debt Covenants

	No Affiliated Banker	Affiliated Banker
Low Covenants	1,982	157
	(50.86%)	(78.89%)
High Covenants	1,915	42
	(49.14%)	(21.11%)
Test Statistic	$\chi^2 = 59.640$	p-value = 0.000

Panel C: Affiliated Bankers on Board and the Conservatism-covenants link

$$Earnings = \alpha_0+\beta_1 D(Ret<0)+ \beta 2 Affiliated\ Banker +\beta_3 High\ Covenants +\beta_4 D(Ret<0)\times Affiliated\ Banker+ \beta_5 D(Ret<0)\times High\ Covenants +\beta_6 Ret + \beta_7 Ret\times D(Ret<0) + \beta_8 Ret\times Affiliated\ Banker + \beta_9 Ret\times High\ Covenants + \beta_{10} Ret\times D(Ret<0)\times Affiliated\ Banker + \beta_{11} Ret\times D(Ret<0)\times High\ Covenants + \beta_{12} Ret\times D(Ret<0)\times High\ Covenants \times Affiliated\ Banker + \varepsilon$$

	Asymmetric Timeliness Coefficient			
	No Affiliated Banker	Δ Affiliated Banker	Affiliated Banker	All
Low Covenants	0.122	-0.099	0.023	0.120
	(0.000)	(0.076)	(0.664)	(0.000)
Δ Covenants	0.077	**-0.098**	-0.021	0.076
	(0.038)	**(0.014)**	(0.624)	(0.040)
High Covenants	0.200	-0.197	0.003	0.196
	(0.000)	(0.000)	(0.955)	(0.000)
All	0.160	-0.149	0.011	
	(0.000)	(0.003)	(0.812)	

Panel A presents descriptive statistics of a covenant index that is defined as the sum of six covenant indicators: collateral, dividend restriction, more than two financial covenants, asset sales sweep, equity issuance sweep, and debt issuance sweep. Firm year observations are classified as High (Low) Covenants if their covenant index score is in the top (bottom) tercile. Panel B provides a frequency distribution of High and Low Covenants firms based on whether firms have an affiliated banker on their corporate boards. Two-sided *p*-value is computed using a χ^2-test. Panel C the reconstructed asymmetric timeliness coefficient from a regression model that examines whether affiliated bankers on affect the relation between conservatism and the use of covenants. Models are estimated after dropping the middle tercile of covenant index scores and after dropping the top 1% of absolute studentized residuals. Two-sided *p*-values in brackets are computed using standard errors clustered at the firm-level.