Does Lending Bank Undercapitalization Affect Borrowers' Accounting Conservatism?

Abstract

This study examines the impact of a lending bank's undercapitalization on borrowing firms' accounting policy. To examine this, we use the introduction of AQR of Indian banks by the Reserve Bank of India (RBI) as a quasi-natural experiment. Indian AQR is unique due to its introduction in a non-crisis period without any capital backstop. Using the difference-in-differences method, we find that the borrowing firms of AQR exposed undercapitalized banks report less accounting conservatism due to the undercapitalization of banks and the increased cost of covenant violation. Further, the effect is more prominent in small and financially constrained firms. In addition, we find that a decrease in accounting quality leads to an increase in the cost of debt charged by the banks. However, a decrease in conservatism also provides relief to firms by reducing their probability of default. Overall, decreased firms' accounting conservatism results in decreased information quality.

Keywords: Asset Quality Review, Accounting Conservatism, Banking

1. Introduction

The importance of bank capital in preserving the stability and viability of financial institutions has been extensively documented in the literature (Berger & Bouwman, 2013; Diamond & Rajan, 2000). Banks experiencing capital inadequacies often employ various strategies to meet regulatory capital requirements. These strategies include issuing new equity (Admati et al., 2012; Berger et al., 2008; Dahl & Shrieves, 1990; Erkens et al., 2012) and engaging in what has been termed "zombie lending" (Caballero et al., 2008; Bruche & Llobet, 2014). Nevertheless, empirical research exploring the ramifications of undercapitalized banks on their borrowers' accounting practices remains scarce. We address this gap by exploiting an exogenous shock that eroded bank capital, leading to a shift from a well-capitalized to a poorly-capitalized banking environment. Primarily, we study how such a shift influences banks' incentives to demand higher or lower levels of accounting conservatism from their borrowers.

This study employs the Indian Asset Quality Review (AQR), a thorough banking cleanup operation carried out during relatively stable economic conditions. Before the AQR, banks' balance sheets were often burdened with restructured loans that obscured the true extent of non-performing assets[1] (NPA). Exploiting temporary forbearance rules led banks to suppress the actual quality of their assets (Mannil et al., 2024; Chari et al., 2021; Flanagan & Purnanandam, 2019). Raghuram Rajan, the incumbent governor of the Indian Central Bank, states, "*Forbearance is ostrich-like behavior, hoping the problem will go away. It is not realism but naiveté, for the lesson from across the world is that the problems only worsen as one buries one's head in the sand…… As we found banks reluctant to recognize problems, we decided not just to end forbearance but also to force them to clean up their balance sheets. The Asset Quality Review, initiated in 2015, was the first major exercise of this nature in India" (Rajan, 2017 pp. 115).*While the goal of the AQR was to make bank balance sheets that are clean and

[1] https://rbidocs.rbi.org.in/rdocs/Bulletin/PDFs/07SPAEDAC43052384566B9E9C690D66F94AE.PDF

adequately provisioned by March 2017 (Rajan, 2016), without having a capital backstop plan. The AQR procedure resulted in a substantial rise in gross NPA. The Gross NPA to total loans ratio increased from 4.6% before the AQR to 11.5% three years later. The detection of NPA and the absence of a capital backstop plan led to an exogenous shift from a well-capitalized to a poorly-capitalized banking environment (Kulkarni et al., 2019; Chopra et al., 2021). This decreased credit availability to the real economy and increased the prevalence of zombie lending, highlighting the ramifications of a poorly capitalized banking environment (Chopra et al., 2021; Mannil et al., 2024; Chari et al., 2021; Flanagan & Purnanandam, 2019).

In this study, we explore the consequences of the Indian AQR on undercapitalized banks' borrowers, mainly focusing on how it influences borrowers' incentives to recognize losses quickly—a key feature of conditional accounting conservatism. The AQR process involves the central bank appointing an auditor to conduct a comprehensive reassessment of several areas, including (1) compliance with loan classification regulations, (2) evergreening, and (3) the accuracy of assumptions regarding loan recoverability and any violations of debt covenants. Following this reassessment, auditors quantify the NPA of each bank and determine the required provisioning levels. Banks are then needed to reconcile the discrepancies between their reported figures and the results of the AQR, and to allocate additional funds as recommended by the AQR findings. This exogenous shock effectively reduces the capital reserves of the banks.

The divergence in the payoff structure between banks and borrowers can lead to conflicts of interest (Jensen & Meckling, 1976). Existing literature emphasizes that accounting conservatism can mitigate these agency conflicts in debt financing. This emphasis arises because adverse news affects the value of banks' claims more significantly than positive news due to the concave nature of their payoff structures (Watts, 2003; Guary & Verrecchia, 2006; Penalva & Wagenhofer, 2019). Moreover, the timely recognition of a loss can trigger an early

covenant violation or early warning signals, resulting in a transfer of control rights from shareholders to banks to protect their interests (Smith & Warner, 1979; Ball & Shivakumar, 2005; Zhang, 2008; Nikolaev, 2010; Christensen & Nikolaev, 2012). This enhances the loan recovery rate for creditors (Donovan et al., 2015). Consequently, banks generally enforce a higher degree of accounting conservatism, with non-compliance often resulting in increased borrowing costs for the firm (Ahmed et al., 2002; Francis & Martin, 2010; Bushman et al., 2011).

Nevertheless, the banks' requirement for accounting conservatism is not persistent; it varies as their motivation to monitor changes (Deng et al., 2018; Erkens et al., 2014; Gormley et al., 2012; Khurana & Wang, 2015; Tan, 2013). We anticipate that the AQR will alter banks' monitoring incentives, which in turn may affect the accounting conservatism of borrowers. Chopra et al. (2021) find that while banks reduced credit supply, they increased lending to zombie firms as a strategy to obscure bad assets from auditors in the post-AQR period. We argue that a strategy to obscure bad assets can motivate undercapitalized banks to relax the requirements of recognizing losses promptly rather than gain in the post-AQR period. This reduces the probability of debt covenant violation and subsequently reduces provisions and costly regulatory capital. To the extent that undercapitalized banks relax their demand for accounting conservatism, managers may become more inclined to adopt less conservative reporting practices. This is because accounting conservatism typically leads to lower reported earnings, which can negatively impact managers' compensation (Ahmed et al., 2002; García Lara et al., 2020; Watts, 2003).

However, the theoretical arguments related to bank lending standards literature suggest that bank lending standards can shift following a banking shock. Typically, banks become more conservative or adopt stricter lending standards after experiencing adverse shocks to their capital (Chava & Purnanandam, 2011; Murfin, 2012; Lo, 2014), such as the Indian AQR. For

example, Khan and Lo (2019) find that when banks incur capital losses in overseas business, their borrowers tend to increase accounting conservatism due to the banks' more rigorous monitoring and lending practices. This is consistent with the view that banks may compel borrowers to recognize losses promptly to mitigate further capital losses, lowering accounting conservatism. Whether the Indian AQR influences borrowers' accounting conservatism remains an empirical question.

The Indian AQR was a specialized audit commenced by central bank officials between August and December 2015. Every subsequent inspection follows the rules AQR sets; consequently, we include all of these reviews in our study. As a result, our sample period spans from 2013 to 2019. It is important to note that not all banks were subject to the AQR simultaneously. Therefore, we use a staggered Difference-in-Differences (DiD) approach with two-way fixed effects (firm and year fixed effects) (Baker et al., 2022). While the AQR was applied to all banks, provisions were only required if the difference between a bank's projected NPA and the NPA estimate made by the central bank-appointed auditors exceeded 15%[2]. One may argue that the AQR has a greater influence on the accounting conservatism of borrowers with considerable loans from AQR-exposed banks. To evaluate the extent of AQR-exposed banks' exposure to borrowers, we use loan-level data obtained from the Ministry of Corporate Affairs (MCA). Our staggered DiD analysis involves three years before the AQR and three years after its implementation. Our empirical tests examine the change in borrowers' accounting conservatism before and after the AQR and compare these changes between borrowers of AQR-exposed banks and other borrowers after controlling for concurrent variations in borrower-level characteristics. We follow Ball and Shivakumar (2005) and Khan and Watts (2009) to assess conditional accounting conservatism.

[2] According to Chopra et al. (2021), the average additional provisions, as a percentage of profit after tax, are 86%. As a result, the divergences that have been observed are economically significant.

The empirical results from the staggered DiD indicate that borrowers from AQR-exposed banks experience a significant reduction in accounting conservatism. Specifically, the decline in asymmetric loss recognition for these borrowers is economically meaningful, amounting to a decrease of approximately 112% relative to their accounting conservatism levels before the AQR. To reinforce our inferences, we conduct a cross-sectional analysis. These empirical findings reveal that borrowers exhibit reduced accounting conservatism accounting practices when nearing the breach of debt covenants and dealing with capital-constrained banks (i.e., banks with low capital levels before the AQR). This further strengthens our hypothesis that, following the AQR, undercapitalized banks are less able to allocate additional funds for loan loss provisions in response to covenant violations by borrowers. Consequently, exposed banks' demand for accounting conservatism decrease in the post-AQR period. We further find that exposed bank price incremental risk stems from reduced accounting conservatism by increasing borrowers' cost of debt. Specifically, a one standard deviation decrease in accounting conservatism (as measured by the *C_score*) results in a 1.21% increase in the cost of debt in the post-AQR period. This increase represents approximately 10% of the average cost of debt for firms borrowing from AQR-exposed banks.

Our empirical results indicate that the demand for accounting conservatism among AQR-exposed banks decreases post-AQR. This raises a critical question: Are exposed banks employing alternative constraints on borrowers to offset the effect of reduced accounting conservatism? This question is vital because a reduction in accounting conservatism can increase bank fragility. Consequently, banks must impose alternative constraints on borrowers to mitigate the risks associated with lower accounting conservatism. Our study primarily emphasizes the impact of bank governance through the lens of tunneling, where corporate resources are diverted by controlling owners for personal gain at the expense of outside shareholders (Khanna & Palepu, 2000; La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2000;

La Porta, Lopez-de-Silanes, & Shleifer, 1999; Friedman, Johnson, & Mitton, 2003; Djankov, La Porta, Lopez-de-Silanes, & Shleifer, 2008). Prior studies suggest that tunneling can diminish a firm's value, hinder market growth, and even aggravate financial crises (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2002; Friedman et al., 2003). In emerging economies, controlling owners frequently use related party transactions (RPTs) as a mechanism for tunneling (Gopalan, Nanda, & Seru, 2007; Nenova, 2005; Gopalan et al., 2023). However, not every RPT is used for misappropriation. When market mechanisms like product and capital markets are undeveloped, RPTs, such as vertical integration and internal capital markets, can efficiently remedy market weaknesses (Khanna and Palepu, 2000). The existing literature distinguishes between two types of RPTs: those driven by business needs (efficient contracting hypothesis) and those motivated by opportunistic behavior (shareholder expropriation hypothesis) (Ryngaert & Thomas, 2012; Kohlbeck & Mayhew, 2010, 2017; Jiang, Tian, & Zhou, 2021). Based on this viewpoint, we anticipate that business-related RPTs, which offset market shortages, will unlikely decrease in the post-AQR period since eliminating these transactions would be costly and unfeasible. Opportunistic RPTs, on the other hand, are predicted to decline since they reduce business value and raise the danger of insolvency. Therefore, AQR-exposed banks impose constraints on borrowers to involve in opportunistic RPTs. We categorize RPTs into business and opportunistic by following Kohlbeck and Mayhew (2010, 2017) and Kohlbeck et al. (2022). Our empirical results support our prediction. We observe a substitution effect between opportunistic RPTs and accounting conservatism. Specifically, a one standard deviation decrease in accounting conservatism (as measured by the *C_score*) is associated with an approximately 8.2% reduction in opportunistic RPTs relative to the average level of opportunistic RPTs among firms borrowing from exposed banks.

Our study improves our understanding of how undercapitalized banks can ease their constraints. While prior studies extensively document the importance of bank capital on banks'

financial stability (Berger & Bouwman, 2013; Diamond & Rajan, 2000) and the strategies banks use to offset the effect of undercapitalization (Admati et al., 2012; Caballero et al., 2008), there is a notable gap in the literature how bank undercapitalization affect borrowers' accounting practices. The study employs the Indian AQR as a natural experiment to analyze the effects of a significant exogenous shock on banking capital. By focusing on the AQR's impact, which led to a substantial increase in NPAs and a shift from well-capitalized to poorly-capitalized banking environments, this study offers new empirical evidence on how such shifts influence the accounting conservatism of borrowing firms. The study also contributes to the literature on bank lending standards by providing empirical evidence on how capital shocks influence banks' monitoring incentives and lending practices (see Khan and Lo, 2019). It highlights the paradox where, contrary to expectations, banks may relax their demand for accounting conservatism to avoid recognizing losses and reduce regulatory capital requirements, thereby impacting borrowers' reporting practices.

2. Hypothesis Development

Banks capital plays a role of cushion towards any economic and financial shock. Regulatory landscape (BASEL norms) for banks also revolves around the bank capital because it decides the risk-taking avenues for the banks. For example, Admati and Hellwig (2014) advocates high banks capital to forestall any future financial crisis because more capital reduces the more hazard problem and increases the skin in the game. Therefore, undercapitalization of banks can create incentive for banks to indulge in risk-shifting activities and increase moral hazard. Literature uncovered the repercussions of undercapitalization of banks like zombie lending, evergreening, risk-shifting (Bonfim et al., 2023; Blattner et al., 2023; Chopra et al., 2021; Acharya et al., 2022). Due to concave payoff structure of creditors (banks), borrowers' timeliness of loss recognition (accounting conservatism) in financial statements, provides an

early signal of distress and increase recovery rate for banks in case of default (Nikolov, 2010). Therefore, demand of conservative reporting from borrower can be considered as important monitoring tool by banks.

Further, literature suggest that borrower conservative reporting and disclosures may change due to banking policy changes, competition, and financial crisis (Khan and Lo, 2019; Gormley et al., 2010; Hou et al., 2023; Lo, 2014; Martin and Roychowdhury, 2015). It can guide us that undercapitalization of banks may led to increase and decrease in conservative reporting by borrowing firms.

Traditionally, accounting conservatism is defined as anticipating all losses but no gains. Specifically, conservatism is defined as differential verifiability or asymmetric recognition of good news (profit) versus bad news (losses) (Watts, 2003; Basu, 1997; Ball and Shivakumar, 2005). Accounting conservatism is an important contracting mechanism for debt contracting to reduce the agency problem between the debtholder and shareholders. Asymmetric timely loss recognition than profits facilitate the role of 'trip wires' or signaling. It also provides early transfer of control to debtholders in case of distress (Zhang, 2008; Aghamolla and Li, 2018). Further, it provides the lower bound of net asset value to assess the repayment ability of borrowers. Accounting conservatism also increases the efficiency of covenants used in debt contracts. Which further improves the efficiency of debt contracts through renegotiations. There are many studies on accounting conservatism and how it is affected by the political environment, legal institutions, debt enforcement, taxation rules, banking environment, financial markets development, institutional framework, crisis, and managerial risk-taking (Zhang, 2008; Aghamolla and Li, 2018; Khan and Lo, 2019; Gormley et al., 2012; Martin and Roychowdhury, 2015).

However, undercapitalization of banks and borrowing firms conservative reporting is not studies well in the literature. AQR intervention by RBI as capital shock to bank in non- crisis period, as exogenous shock can help us minimize sample selection problem and identification issues. AQR is a unique banking intervention that uncovered hidden NPA and decrease the capital of banks in the non-crisis period. Further, it also changes the debt contracting environment, which affects the conservatism demand and supply as a joint effect. Both sides of the argument can be inferred from the literature on how AQR will affect the borrowing firms' accounting conservatism. One side suggests that banks that suffered capital loss will become better monitors and will scrutinize borrowers more. Khan and Lo (2019) suggest that banks that suffered capital loss due to foreign exposure and crisis, will increase the scrutiny for the local borrowers and lead to an increase in accounting conservatism of firms. Banks such as "Burnt Child, Dreads the Fire", which are forced to recognize losses under AQR, will ask for more accounting conservatism from the borrowing firms.

However, another side of the argument suggests that if banks are intransigent to renegotiation or restructuring of loans, borrowing firms will do less conservative reporting to avoid covenant violation (Martin and Roychowdhury, 2015). Under AQR restructuring of loans was not allowed by RBI, which will led to decrease accounting conservatism by the borrowing banks. Further, undercapitalized banks with limited liability will engage in risk shifting by writing loose debt contracts with high interest, which, in effect, may reduce accounting conservatism (Hoshi and Kashyap, 2010; Peek and Rosengren, 2005; Murfin, 2012; Acharya et al., 2022). Since maintaining regulatory capital is a costly affair, banks will also be reluctant to recognize NPA or take action on covenant violation because it will deteriorate capital and invite more regulatory action in the form of prompt corrective action (Plosser and Santos, 2024). Since, there is incentive for banks to demand less conservative reporting from borrowers, firms will also reduce accounting conservatism.

Furthermore, Firms will also reduce the conservatism because the strict regulatory audit will increase the probability of liquidation and loss of compensation and private benefits.

Chopra et al. (2021) argue that AQR exposed banks faced capital shock and engaged in risk-shifting with an increase in zombie lending. They also find that AQR exposed banks reduced lending supply to firms. Hence, AQR banks may not have negotiation power over borrowing firms and have an incentive not to recognize any further losses. This makes us believe that a joint effect of the intransigent nature of AQR banks, risk shifting, avoiding recognition of losses by banks, and fear of covenant violation by firms will lead to a decrease in accounting conservatism of financial reporting of borrowing firms. Accordingly, we examine the following hypothesis:

H1: ***Asset Quality Review of banks changes the accounting conservatism of borrowing firms compared to other firms.***

3. Research Design

3.1 Data and Sample

We collected bank firm loan level data from the Ministry of Corporate Affairs (MCA). MCA maintains Index of Charges database, where each creditor is required to register the charge against the assets of the borrowing firms (Chopra et al., 2021). We manually extracted data for the listed firms superset of Centre for Monitoring Indian Economy (CMIE) Prowess Dx using the CIN number. Table 17 also provides the snapshot format of MCA data, which contains the amount, date of loan creation, settlement, branch address, and bank name. Loan level transaction database help us to better identify the AQR exposure for the firms. We created firm-level AQR_EXP variable by using outstanding loan amount for each bank and firm pair.

Further, we collected data from the Centre for Monitoring Indian Economy (CMIE) Prowess Dx about the firm identity, stock returns, and financial statements of firms and banks. Prowess covers both listed and unlisted firms. In the primary model, we used both listed and unlisted

firms. Although firm bank relationship data for unlisted firms are very limited, we used listed firms for another model. Our sample period is from 2013 to 2019. We limit our sample till 2019 because of COVID-19, and other regulatory changes occur after that period. Due to COVID-19, banks were provided flexibility or asked not to recognize NPA and provide a moratorium on loans, provisions for insolvency law were suspended among many other things, which makes the effect of AQR very limited and opaque. Our final sample consists of 19559 observations after cleaning for missing variables. Treatment period (AQR) observations are 5256. Never treated and pre AQR period observations are 13849. Probability of default data collected from Credit Research Initiative, National University of Singapore (CRI NUS).

3.2 Measurement of Accounting Conservatism

We measure the accounting conservatism following Ball and Shivakumar (2005), which measure the speed of recognizing bad news compared to good news through the relationship of accruals and cashflow:

$$\boldsymbol{ACC_{it} = \beta_0 + \beta_1\ DCFO_{it} + \beta_2\ CFO_{it} + \beta_3\ DCFO_{it} \times CFO_{it} + \epsilon_{it}} \quad \textbf{(1)}$$

Where ACC_{it} is the measure of accruals for Year *i* and firm *t,* calculated as Net profit – Net Operating Cashflow scaled by average total assets. CFO_{it} is a measure of operating cash flows, derived from the cash flow statement of the firms and scaled by the average total assets. $DCFO_{it}$ is a dummy variable equal to 1 if CFO_{it} is negative and 0 otherwise. $\boldsymbol{\beta_2}$ measures the timely recognition of accruals for positive cashflows, while $\boldsymbol{\beta_3}$ reflect the incremental timely recognition of accruals given negative cash flows. Further, we also calculated Khan and Watts (2009) C_Score model for alternatively measuring and validating our results. C_Score is based on Basu (1997) model, which was devised to capture the asymmetric timeliness of earnings implied by accounting conservatism. C_Score measures the incremental timeliness of bad news (Khan and Watts, 2009).

3.3 Identification Strategy

We use the Staggered Difference in Difference (DiD) regression combined with Ball and Shivkumar (2005) model for the causal inference and minimize the self-selection bias. We used the following regression equation, which is an expanded version of equation (2):

$$\boldsymbol{ACC_{it} = \beta_0 + \beta_1 \times DCFO_{it} + \beta_2 \times CFO_{it} + \beta_3 \times DCFO_{it} \times CFO_{it} + \beta_4 \times AQR\_EXP_{it} + \beta_5 \times DCFO_{it} \times AQR\_EXP_{it} + \beta_6 \times CFO_{it} \times AQR\_EXP_{it} + \beta_7 \times DCFO_{it} \times CFO_{it} \times AQR\_EXP_{it} + \beta \times X_{it} + \beta \times X_{it} \times DCFO_{it} + \beta \times X_{it} \times CFO_{it} + \beta \times X_{it} \times DCFO_{it} \times CFO_{it} + + \delta_i + \eta_t + \gamma_{jt} + \epsilon_{it}} \quad \textbf{(2)}$$

Where $ACC_{it,}$ $DCFO_{it}$, and CFO_{it} are the same defined as earlier in equation (1). Following Chopra et al. (2021), we created AQR_EXP_{it} as firm-level indicator equal to 1 if firm have above median AQR Bank Exposure and other wise zero. AQR_EXP is weighted average exposure of divergence of banks of borrowing firm *i*, where weights are pre AQR average outstanding loan amount with the particular bank. RBI issued a circular in which it mandates the banks to disclose the divergences in annual report if any bank cross the 15% limit of divergence of RBI estimate and bank estimate and make provisions accordingly.[3] All the AQR exposed banks did not breach the AQR exposure limit in single year. Some banks breached the limit in 2017 and continued the breach till 2019, while some breached the limit in 2018 or 2019. So, with the assumption that once exposed, banks will make disciplining effect on borrowers to avoid the breach of limit and cost attached with it, which means firms will remain in AQR exposure once exposed to AQR for subsequent two years. AQR of the bank is exogenous to firms accounting practices because it was a regulatory shock that affected the bank primarily and required changes at bank-level practices and provisioning. Our primary interest coefficient is $\boldsymbol{\beta_7}$ which measures the change in timely loss recognition of borrowing firms due to lending bank AQR. Firm-level attributes may confound the banks' AQR effect, so we included three

[3] https://rbi.org.in/SCRIPTS/BS_CircularIndexDisplay.aspx?Id=10932

control variables and their interactions with CFO and DCFO and CFO x DCFO, which is Size, as measured by the natural log of average total asset, Growth, measured by sales growth and leverage is total borrowing scaled by the average total asset.

Further, we use various fixed effects to improve our estimation of AQR. First, we included the Firm fixed effect $\boldsymbol{\delta_i}$, to control for time-invariant firm-level heterogeneity. Firm fixed also generates the estimate of accounting conservatism within the firm. Year fixed effect $\boldsymbol{\eta_t}$ captures the economy level time varying changes, which reduces the possibility that our estimates are confounded by the economy wide other changes. Further, we also control for time varying industry-level unobserved heterogeneity by including the Industry*Year Fixed effect $\boldsymbol{\gamma_{jt}}$ because bank lending practices and regulations sometimes differ by industry and developments at the industry level. Standard errors are clustered at the firm level to correct for heteroskedasticity.

4. Results and Discussion

4.1 Summary Statistics

Table 2 presents the descriptive statistics of borrower firms. The average CFO level is 0.05, which is also similar for treatment and control firms. We used three standard control variables for accounting conservatism- Size, Growth, and Leverage. Two different groups of firms may have different characteristics, which would lead to different reactions to shock, raising questions about the suitability of the control group as a counterfactual for treatment. Differences in Size, Growth, and Leverage for Pre AQR and AQR periods may also create covariate balancing problem. However, on average firms in the Pre-AQR period have similar size but higher leverage and growth.

4.2 Main Results

Table 3 reports the results for main baseline regression results. Our main interest is $\boldsymbol{\beta_7}$, which is the coefficient of DCFO*CFO*AQR_EXP, which represents the effect of AQR on

borrowing firms' accounting conservatism. Column 1 shows that accounting conservatism of borrowing firms decreases dues to AQR of banks, without any control variables and their interactions, and industry*year fixed effect. Further, we find consistent results after adding control variables, firm fixed effect, and industry*year in columns 2, and 3, respectively. The estimated coefficient varies around -0.18, which is statistically significant at the 5% level, which is consistent with our hypothesis that the AQR of banks leads to a decrease in accounting conservatism (timely loss recognition) of borrowing firms. Furthermore, economic significance can be implied from the decrease in timely loss recognition, which is 18% of the overall association between ACC and CFO. Moreover, compared to pre-AQR period decrease in conservatism is 112% (-0.173/0.154). Borrowing firms have decreased accounting conservatism because their banks under AQR are unwilling to recognize any more losses and cannot renegotiate or restructure the loans under AQR. We further verify our results by removing the firms that borrowed from banks that do not breach the AQR divergence limit as a control group. Although these firms may be systematically different and not suitable control group, some studies suggest verifying the results with and without these firms (Naaraayanan and Wolfenzon,2024). Therefore, we remove the observations of firms that did not borrow from any AQR bank because these firms might be systematically different, are reported in Table 4. Results are not only similar to table 3 but also high coefficient value with 1% statistically significant level.

We believe that Ball and Shivkumar (2005) measure of accounting conservatism is a more suitable proxy in our setting because of both public and private companies in the sample. However, to ensure that our findings are not specifically because of measure, we also use an alternative proxy of accounting conservatism, C_Score (Khan and Watts, 2009). C_Score also provides flexibility in examining how a decrease in accounting conservatism affects other firm-level characteristics and cross-sectional analysis. C_score is return based proxy. Table 6 reports

the C_score and AQR Bank results, which are similar to the main model in direction and significance level. The result suggests that borrowing firms decrease the speed of recognizing the bad news after banks face AQR. Furthermore, we validate the parallel trend assumptions fir DiD in table 5 and figure 1 (A &B), Column (1), (2) and (3) reports the result for full sample, while column (4), (5) and (6) we excluded never treated observations. Findings suggest there is parallel trend in pre period between AQR exposed and not exposed firms. if we use only one dummy for treatment period rather than expanded period wise post dummy, we find qualitatively similar results.

Overall, our findings suggest that when lending banks face AQR exposure, become undercapitalized and intransigent to restructuring and renegotiation, borrowing firms will reduce their accounting conservatism.

5. Mechanism at work

Now the question arises what are possible channels due to which borrowing firms reduce accounting conservatism, i.e., undercapitalization of banks and fear of covenant violation by firms due to the intransigent nature of banks after AQR, are working in reducing the accounting conservatism. So, we explore the channels underlying the effect of banks' AQR and borrowing firms' accounting conservatism. We first test how the undercapitalization of banks affects the borrowing firm's accounting conservatism. Banks under AQR were forced to recognize the losses, which led to undercapitalization. Undercapitalized banks have an incentive to do risk shifting and zombie lending (Acharya et al., 2022; Chopra et al., 2021) and avoid recognizing losses. Plosser and Santos (2024) banks in pursuance of maintaining the regulatory capital will let go profitable activity. Similarly, banks can demand low conservative financial statement, which can reduce their provisioning requirement.

To test the undercapitalization of banks, we divided banks based on median Capital to Risk Weighted Ratio (CRAR) in pre AQR period. We categorized firms borrowing from any bank

which have CRAR less than median as Low CRAR category otherwise High CRAR. We find significant reduction in accounting conservatism for firms which borrowed from low CRAR banks in table 8 columns (1) and (2). While firms borrowing from high CRAR banks are not showing any reduction in accounting conservatism. Which verifies that undercapitalization of banks lead to reduction in accounting conservatism of firms.

Further, the increased cost of covenant violation due to AQR can also be the operating mechanism for a decrease in accounting conservatism by borrowing firms. After AQR, banks were intransigent to renegotiation and restructuring of loans because restructuring of loans was prohibited during that period. RBI also initiated borrower-level banking loan exposure data, CRILC, used for AQR and other regulatory purposes. So, if a borrower violates or defaults on a covenant with one bank, it can increase the cost for every other bank in the system and affect their provisions. Therefore, we investigate that firms with a high probability of covenant violation are more likely to reduce their accounting conservatism than firms with a low probability of covenant violation. We use various proxies for the classification of the probability of covenant violation, which is also used for characterizing zombie firms. For brevity, we report the Interest coverage ratio (ICR) results in Table 7. We divide firms into two categories firms near to covenant violation and distant to covenant violation on the basis of ICR. Firms near to covenant violation if the firms, interest coverage ratio is less than one in the Pre-AQR period (2016) and distant to covenant violation if ICR is more than one in the Pre-AQR period. We find a statistically significant decrease in accounting conservatism for firms near covenant violations. While accounting conservatism also decreases for other firms, the effect is small in magnitude, and statistically insignificant. We further divide the sample on the basis of increase and decrease in debt. Table 9 reports the result that firms which are increasing bank debt are reducing accounting conservatism, which basically suggest that decreasing

conservatism also helped the firms getting more bank funding to avoid the covenant violation and evergreening.

Based on the above finding, we can suggest that both mechanisms are at work and jointly determined the decrease in accounting conservatism.

6. Cross-Sectional Analysis

It is possible that a decrease in borrowing firms' accounting conservatism due to AQR prominently affected firms with certain different characteristics, such as group firms, small-size firms, and financially constrained firms. Cross-sectional analysis shows which firms are more sensitive to bank AQR. We report the results for small and large firms, divided based on quantiles, in Table 11. We find that small firms reduce accounting conservatism due to AQR. The coefficient of interest AQR_EXPx DCFO x CFO is statistically significant and consistent with previous literature that financially constrained small firms will avoid covenant violation by decreasing the accounting conservatism. However, group affiliated firms have access to the internal capital market and are less financially constrained, they may not fear covenant violation and distort the accounting quality. Group firm also more likely to do indirect evergreening (Kashyap et al., 2023). We find similar results in Table 10 that group firms significantly reduce accounting conservatism.

7. Cost Benefit Trade off

Decreases in accounting conservatism have benefit and cost attached with it. We find that decreased conservatism and AQR Exposure will decrease probability of default. Table 14 reports regression result for how AQR Exposure and the decrease in accounting conservatism (C_Score) affect the probability of default of the firm. Dependent variable Probability of default for 12 and 24 months. Probability default data collected from Credit Reseacrh Inititative, National University of Singapore (CRI NUS). The coefficient of interest is

interaction term C_Score x AQR_EXP, which shows how the AQR of banks and the resulting decrease in accounting conservatism increase the probability of CIRP filling. C_Score x AQR_EXP is positive and statistically significant at a 5% level and consistent after using all control variables, Year fixed effect, and Industry fixed effect in columns 1 to 4.

AQR exposed banks were giving leeway for conservatism reporting to firms while ensuring that tunneling and private benfit of managers should decrease. RPT is major source of tunneling by the managers and insiders. We find that decrease in conservatism of exposed firms reduce the opportunistic RPT only, while business RPT and total RPT are no decreasing. Table 15 reports the result for the same. We also find that decrease in accounting conservatism increase the cost of debt of firms. Table 16 reports the result, negative and statistically significant coeffiencet for C_Score x AQR_EXP, suggest that decreasing accounting conservatism result in increased cost of debt.

8. Robustness

To avoid covariate mismatch problem, we used entropy balanced weight based regression (Hainmueller, 2012). Entropy balancing method retain full sample and sufficient power to reduce coefficient bias (McMullin & Schonberger, 2020). We report entropy bases staggered DiD result in table 12. Results are qualitatively similar to baseline regression.

We further conducted Placebo test for baseline staggered DiD results. In table 13, column (1) and (2), we changed the shock period to 2015 onwards, we run the DiD regression in pre-period (2013-2016) and find no significant effect. In column (3) and (4), randomly placebo treatment firms are selected in year 2015 and we find no significant effect in pre period DiD regression. These finding suggest that AQR conducted by RBI was exogenous.

We further test our results on the firms filling for CIRP under Insolvency and Bankruptcy Code, 2016. We find these bankrupt firms also reduce accounting conservatism, however it does not affect their probability of default and bankrupt firm insiders also increase tunneling through

opportunistic RPT after bank is exposed to AQR, because it is more likely they will lose control over the firm. Results for the bankrupt firm analysis is available in online appendix.

9. Conclusion

AQR, as a unique policy intervention in the non-crisis period, has affected the banks and economy very differently than the crisis period and interventions thereafter. In this study, we examine the effect of banks' AQR on the borrowing firms' accounting quality. We find that the AQR of banks decreases the accounting conservatism of borrowing firms due to undercapitalization and increased cost of covenant violation. Further, the effect is more prominent in small, standalone, and financially constrained firms. This decrease in accounting quality leads to a decrease in the probability of default, a reduction in private benefits for managers, and increased cost of debt. A decrease in accounting conservatism may hamper information quality and reduce the recovery rates for lenders. The study suggests that AQR may have far more unintended effects on borrowing firms and the real economy than policymakers have devised for it.

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Table 1 Variable Definition

Variables	Description	Source
AQR_EXP	The dummy variable equals one if the firm's exposure to AQR is above the median and subsequent years of exposure and zero otherwise. The firm's exposure to AQR is the weighted average of lenders' exposure using weights of pre AQR average outstanding loan amount of the firm with the lender.	MCA
ACC	(Net profit-Net operating cash flow)/Average Total Assets	CMIE
CFO	Net Operating Cash Flow/ Average Total Assets	CMIE
DCFO	The dummy variable equals to 1 if the CFO is negative and 0 otherwise	CMIE
Size	Natural Log of Average Total Assets	CMIE
Leverage	Borrowing/Average Total Assets	CMIE
Growth	Sales Growth	CMIE
PD_12	Probability of Default for the next 12 months based on the distance to the default model	CRI NUS
PD_24	Probability of Default for the next 12 months based on the distance to the default model	CRI NUS
Opportunistic RPT	Opportunistic Related Party Transactions are classified based on (Kohlbeck and Mayhew, 2017)	CMIE
Business RPT	Total Business Related Party Transactions are classified based on (Kohlbeck and Mayhew, 2017)	CMIE
Total RPT	Total Related Party Transactions are classified based on (Kohlbeck and Mayhew, 2017)	CMIE
Interest Rate	Interest Expense/Total borrowing	CMIE
Profitability	PBIT/Average Total Asset	CMIE
Age	ln(1+(year-incorporation year)	CMIE

Table 2 Descriptive Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max	Obs	Mean	Std. Dev.	Min	Max	Obs	Mean	Std. Dev.	Min	Max
	Panel A: Full Sample					Panel A: AQR Firms					Panel C: Firms Without AQR				
Size	19105	7.641	2.007	3.264	13.024	5256	7.757	1.964	3.264	13.024	13849	7.598	2.022	3.264	13.024
Leverage	19105	0.371	0.351	0.001	2.438	5256	0.343	0.333	0.001	2.438	13849	0.382	0.357	0.001	2.438
Growth	19105	0.156	0.712	-0.879	5.334	5256	0.144	0.65	-0.879	5.334	13849	0.16	0.734	-0.879	5.334
CFO	19105	0.05	0.11	-0.364	0.368	5256	0.05	0.106	-0.364	0.368	13849	0.051	0.111	-0.364	0.368
ACC	19105	-0.034	0.127	-0.523	0.406	5256	-0.029	0.126	-0.523	0.406	13849	-0.036	0.127	-0.523	0.406
PD_12	13542	0.042	0.06	0	0.365	3826	0.047	0.069	0	0.365	9716	0.04	0.056	0	0.365
PD_24	13542	0.021	0.033	0	0.205	3826	0.024	0.038	0	0.205	9716	0.02	0.031	0	0.205
Opportunistic RPT	17693	0.035	0.1	0	0.714	4964	0.041	0.109	0	0.714	12729	0.033	0.096	0	0.714
Business RPT	17693	0.184	0.339	0	2.111	4964	0.168	0.316	0	2.111	12729	0.19	0.347	0	2.111
Total RPT	17693	0.228	0.394	0	2.495	4964	0.219	0.376	0	2.495	12729	0.231	0.401	0	2.495
Profitability	19105	0.068	0.102	-0.358	0.369	5256	0.07	0.107	-0.358	0.369	13849	0.067	0.101	-0.358	0.369
Age	19105	3.321	0.592	0.693	5.056	5256	3.389	0.562	1.099	5.056	13849	3.295	0.601	0.693	5.037
Interest rate	18249	0.129	0.196	0.001	1.714	5043	0.135	0.215	0.001	1.714	13206	0.126	0.189	0.001	1.714

Figure1: Parallel Trends

Figure 1(A) : Parallel trend

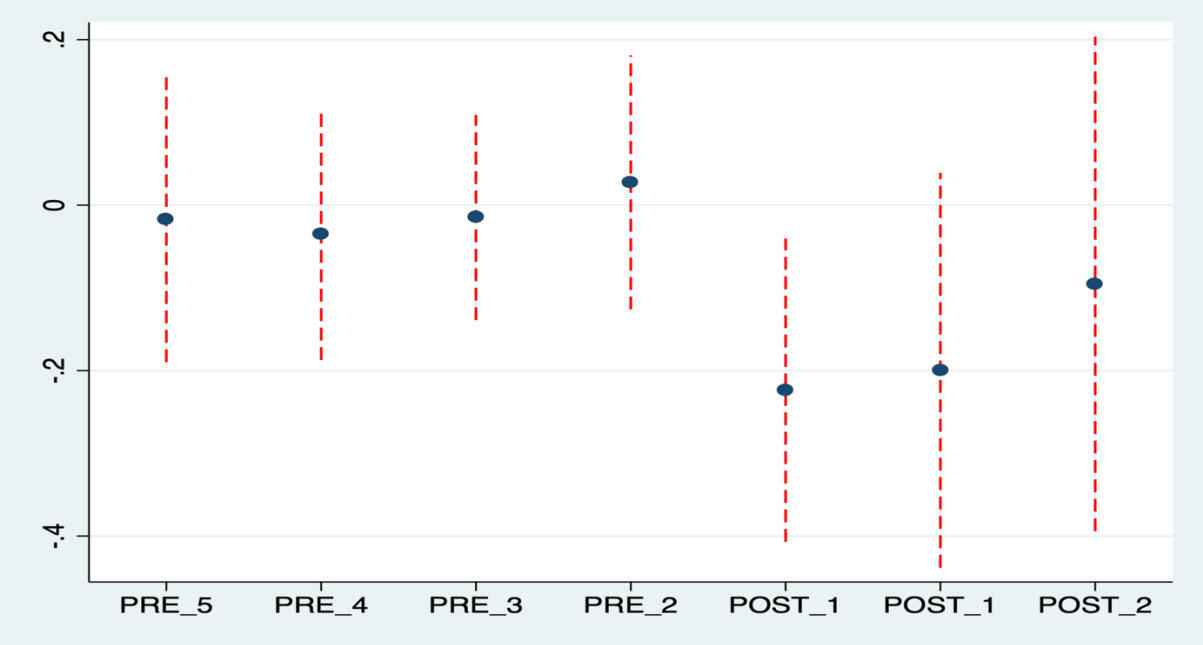

Figure 1(B) : Parallel trend wih C_Score

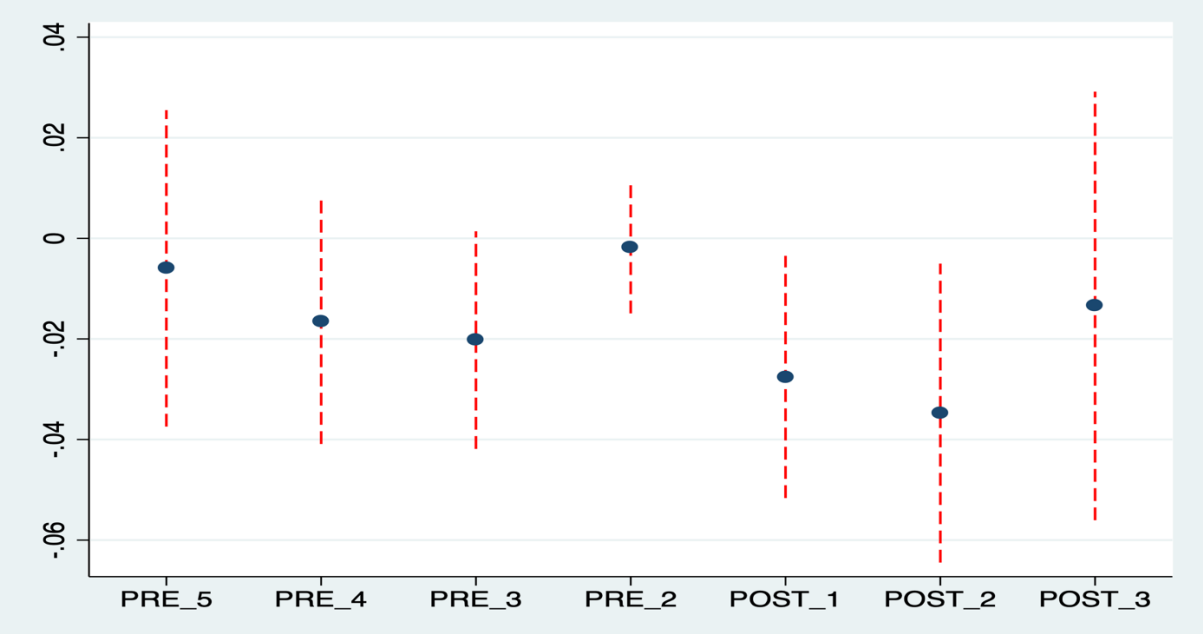

Table 3: Main Baseline Regression Result

This table reports the result of a regression equation (2) based on Ball and Shivkumar (2005). The dependent variable is ACC. Our coefficient of interest is the interaction term DCFO*CFO*AQR_EXP, which captures the effect of bank AQR on firm-level asymmetric timely loss recognition. Control variables include Size, Growth, and Leverage and their interactions with CFO, DCFO, and CFO*DCFO. All variables are defined in table 1. Standard errors are given in parenthesis and clustered at the firm level. *, **, and *** represent the statistical significance level at 10%, 5%, and 1%, respectively.

	(1)	(2)	(3)
VARIABLES	ACC	ACC	ACC
CFO	-0.915***	-1.149***	-1.147***
	(0.017)	(0.072)	(0.073)
DCFO	-0.000	-0.014	-0.012
	(0.003)	(0.012)	(0.012)
DCFO*CFO	-0.059*	0.154	0.145
	(0.032)	(0.134)	(0.131)
AQR_EXP	-0.021***	-0.018***	-0.019***
	(0.004)	(0.004)	(0.004)
AQR_EXP*CFO	0.205***	0.167***	0.173***
	(0.033)	(0.033)	(0.034)
AQR_EXP*DCFO	0.008	0.008	0.009
	(0.006)	(0.006)	(0.006)
AQR_EXP*DCFO*CFO	-0.196***	-0.173**	-0.189***
	(0.073)	(0.070)	(0.069)
Constant	0.013***	0.017	0.019
	(0.002)	(0.031)	(0.031)
Control Variables and Interactions	No	Yes	Yes
Year Fixed Effect	Yes	Yes	Yes
Firm Fixed Effect	Yes	Yes	Yes
Industry*Year Fixed Effect	No	No	Yes
Observations	19,105	19,105	19,063
R-squared	0.738	0.751	0.759

Table 4: Main Baseline Regression Result

This table reports the result of a regression equation (2) based on Ball and Shivkumar (2005). The dependent variable is ACC. Our coefficient of interest is the interaction term DCFO*CFO*AQR_EXP, which captures the effect of bank AQR on firm-level asymmetric timely loss recognition. Control variables include Size, Growth, and Leverage and their interactions with CFO, DCFO, and CFO*DCFO. All variables are defined in table 1. Standard errors are given in parenthesis and clustered at the firm level. We remove never-treated firm-bank observations for better identification. *, **, and *** represent the statistical significance level at 10%, 5%, and 1%, respectively.

	(1)	(2)	(3)
VARIABLES	ACC	ACC	ACC
CFO	-0.926***	-1.220***	-1.225***
	(0.018)	(0.080)	(0.079)
DCFO	-0.001	-0.029*	-0.022
	(0.003)	(0.015)	(0.015)
DCFO*CFO	-0.041	0.132	0.207
	(0.038)	(0.165)	(0.152)
AQR_EXP	-0.020***	-0.017***	-0.017***
	(0.004)	(0.004)	(0.004)
AQR_EXP*CFO	0.214***	0.170***	0.176***
	(0.034)	(0.033)	(0.034)
AQR_EXP*DCFO	0.008	0.009	0.009
	(0.006)	(0.006)	(0.006)
AQR_EXP*DCFO*CFO	-0.211***	-0.183**	-0.212***
	(0.075)	(0.072)	(0.069)
Constant	0.018***	0.066*	0.066*
	(0.002)	(0.036)	(0.036)
Control Variables and Interactions	No	Yes	Yes
Year Fixed Effect	Yes	Yes	Yes
Firm Fixed Effect	Yes	Yes	Yes
Industry*Year Fixed Effect	No	No	Yes
Observations	13,854	13,854	13,813
R-squared	0.730	0.747	0.760

Table 5: Parallel Trends

This table reports the result for parallel trends assumption of DiD based on regression equation (2). The dependent variable is ACC. In this model, the effect of AQR_EXP is time varying and takes the nomenclature of pre and post depending upon the pre and post-period of AQR. Since AQR divergence disclosure did not happen to all the banks in one period, pre and post takes the value 1 depending upon which firms' banks faced AQR disclosure in a given year. Control variables include Size, Growth, and Leverage and their interactions with CFO, DCFO, and CFO*DCFO. All variables are defined in table 1. Standard errors are given in parenthesis and clustered at the firm level. *, **, and *** represent the statistical significance level at 10%, 5%, and 1%, respectively.

	(1)	(2)	(3)	(4)	(5)	(6)
	Full Sample			Excluding Never Treated Firms		
VARIABLES	ACC	ACC	ACC	ACC	ACC	ACC
DCFO*CFO*PRE_5	-0.017	-0.001	0.014	-0.107	-0.084	-0.066
	(0.088)	(0.092)	(0.090)	(0.107)	(0.113)	(0.106)
DCFO*CFO*PRE_4	-0.035	0.003	0.019	-0.129	-0.080	-0.063
	(0.077)	(0.072)	(0.072)	(0.097)	(0.093)	(0.089)
DCFO*CFO*PRE_3	-0.015	-0.000	0.013	-0.101	-0.085	-0.054
	(0.063)	(0.063)	(0.064)	(0.086)	(0.086)	(0.079)
DCFO*CFO*PRE_2	0.027	-0.028	-0.018	-0.059	-0.117	-0.108
	(0.078)	(0.082)	(0.078)	(0.093)	(0.095)	(0.087)
DCFO*CFO*POST_1	-0.224**	-0.191**	-0.193**	-0.308***	-0.260**	-0.268***
	(0.094)	(0.092)	(0.090)	(0.114)	(0.114)	(0.103)
DCFO*CFO*POST_2	-0.200*	-0.181	-0.193*	-0.287**	-0.266**	-0.289**
	(0.122)	(0.115)	(0.112)	(0.132)	(0.125)	(0.117)
DCFO*CFO*POST_3	-0.095	-0.103	-0.135	-0.180	-0.188	-0.206
	(0.152)	(0.146)	(0.152)	(0.161)	(0.155)	(0.159)
Constant	0.011***	0.015	0.017	0.017***	0.061*	0.061*
	(0.003)	(0.031)	(0.031)	(0.004)	(0.036)	(0.036)
Control Variables and Interactions	No	Yes	Yes	No	Yes	Yes
Year Fixed Effect	Yes	Yes	Yes	Yes	Yes	Yes
Firm Fixed Effect	Yes	Yes	Yes	Yes	Yes	Yes
Industry*Year Fixed Effect	No	No	Yes	No	No	Yes
Observations	19,105	19,105	19,063	13,854	13,854	13,813
R-squared	0.739	0.752	0.760	0.732	0.748	0.761

Table 6: C_Score and AQR Bank

This table reports the result for the DiD regression, where the dependent variable is C_Score based on Khan and Watts (2009), which is a measure of timeliness in recognizing bad news. Our coefficient of interest is AQR_EXP. Control variables include Size, Leverage and Growth. All variables are defined in table 1. Colum 3 and 4 report the results, for yearly expanded AQR period. Standard errors are given in parenthesis and clustered at the firm level. *, **, and *** represents the statistical significance level at 10%, 5% and 1% respectively.

	(1)	(2)	(3)	(4)
VARIABLES	C_Score	C_Score	C_Score	C_Score
AQR_EXP_PRE_5			-0.006	0.005
			(0.016)	(0.016)
AQR_EXP_PRE_4			-0.017	-0.008
			(0.012)	(0.012)
AQR_EXP_PRE_3			-0.020*	-0.017
			(0.011)	(0.011)
AQR_EXP_PRE_2			-0.002	-0.004
			(0.007)	(0.007)
AQR_EXP_POST_1			-0.028**	-0.023*
			(0.012)	(0.012)
AQR_EXP_POST_2			-0.035**	-0.040***
			(0.015)	(0.015)
AQR_EXP_POST_2			-0.013	-0.022
			(0.022)	(0.021)
AQR_EXP	-0.024**	-0.023**		
	(0.011)	(0.011)		
Size	-0.069***	-0.059***	-0.069***	-0.059***
	(0.014)	(0.014)	(0.014)	(0.014)
Leverage	1.531***	1.531***	1.530***	1.530***
	(0.031)	(0.032)	(0.031)	(0.032)
Growth	-0.009*	-0.008	-0.009*	-0.008*
	(0.005)	(0.005)	(0.005)	(0.005)
Constant	0.124	0.040	0.131	0.045
	(0.108)	(0.108)	(0.108)	(0.108)
Year Fixed Effect	Yes	Yes	Yes	Yes
Firm Fixed Effect	Yes	Yes	Yes	Yes
Industry*Year Fixed Effect	No	Yes	No	Yes
Observations	13,060	13,016	13,060	13,016
R-squared	0.770	0.793	0.770	0.793

Table 7: Firms Probability of Covenant Violation and Accounting Conservatism

This table reports the result of a regression equation (2) based on Ball and Shivkumar (2005). The dependent variable is ACC. Our coefficient of interest is the interaction term DCFO*CFO*AQR_EXP, which captures the effect of bank AQR on firm-level asymmetric timely loss recognition. Control variables include Size, Growth, and Leverage and their interactions with CFO, DCFO, and CFO*DCFO. All variables are defined in table 1. Standard errors are given in parenthesis and clustered at the firm level. Column 1 and 2 shows the results for firms ICR<1in 2016, and column 3 and 4 shows the results for firms ICR>1in 2016. *, **, and *** represents the statistical significance level at 10%, 5% and 1% respectively.

	(1)	(2)	(3)	(4)
	ICR<1		ICR>1	
VARIABLES	ACC	ACC	ACC	ACC
CFO	-1.257***	-1.283***	-1.167***	-1.158***
	(0.157)	(0.165)	(0.075)	(0.076)
DCFO	-0.003	0.006	-0.022*	-0.020
	(0.028)	(0.030)	(0.013)	(0.012)
DCFO*CFO	0.490	0.462	0.023	0.024
	(0.340)	(0.337)	(0.139)	(0.128)
AQR_EXP	-0.047***	-0.057***	-0.008**	-0.008**
	(0.011)	(0.011)	(0.003)	(0.003)
AQR_EXP*CFO	0.412***	0.481***	0.113***	0.119***
	(0.104)	(0.106)	(0.029)	(0.029)
AQR_EXP*DCFO	0.009	0.012	0.010	0.010
	(0.014)	(0.015)	(0.006)	(0.006)
AQR_EXP*DCFO*CFO	-0.496***	-0.645***	-0.039	-0.049
	(0.181)	(0.180)	(0.074)	(0.074)
Constant	-0.084	-0.102	0.075**	0.079***
	(0.091)	(0.093)	(0.029)	(0.030)
Control Variables and Interactions	Yes	Yes	Yes	Yes
Year Fixed Effect	Yes	Yes	Yes	Yes
Firm Fixed Effect	Yes	Yes	Yes	Yes
Industry*Year Fixed Effect	No	Yes	Yes	Yes
Observations	3,881	3,800	12,936	12,893
R-squared	0.614	0.652	0.816	0.824

Table 8: Banks Capital Adequacy Ratio and 'Firms' Accounting Conservatism

This table reports the result of a regression equation (2) based on Ball and Shivkumar (2005). The dependent variable is ACC. Our coefficient of interest is the interaction term DCFO*CFO*AQR_EXP, which captures the effect of bank AQR on firm-level asymmetric timely loss recognition. Control variables include Size, Growth, and Leverage and their interactions with CFO, DCFO, and CFO*DCFO. All variables are defined in table 1. Standard errors are given in parenthesis and clustered at the firm level. Column 1 and 2 shows the results for firms which borrowed from Low CRAR banks and column 3 and 4 shows the results for firms High CRAR banks. *, **, and *** represents the statistical significance level at 10%, 5% and 1% respectively.

	(1)	(2)	(3)	(4)
	Low CRAR		High CRAR	
VARIABLES	ACC	ACC	ACC	ACC
CFO	-1.188***	-1.179***	-1.181***	-1.177***
	(0.087)	(0.089)	(0.117)	(0.119)
DCFO	-0.004	-0.001	-0.027	-0.023
	(0.016)	(0.016)	(0.020)	(0.020)
DCFO*CFO	0.287*	0.275*	0.112	0.106
	(0.164)	(0.164)	(0.224)	(0.212)
AQR_EXP	-0.021***	-0.023***	-0.011**	-0.013***
	(0.006)	(0.006)	(0.005)	(0.005)
AQR_EXP*CFO	0.213***	0.215***	0.112***	0.125***
	(0.049)	(0.050)	(0.042)	(0.042)
AQR_EXP*DCFO	0.016**	0.016**	0.001	0.004
	(0.008)	(0.008)	(0.009)	(0.009)
AQR_EXP*DCFO*CFO	-0.231**	-0.238**	-0.098	-0.135
	(0.097)	(0.098)	(0.102)	(0.100)
Constant	0.041	0.040	0.029	0.033
	(0.048)	(0.048)	(0.041)	(0.041)
Control Variables and Interactions	Yes	Yes	Yes	Yes
Year Fixed Effect	Yes	Yes	Yes	Yes
Firm Fixed Effect	Yes	Yes	Yes	Yes
Industry*Year Fixed Effect	No	Yes	Yes	Yes
Observations	8,832	8,771	8,812	8,758
R-squared	0.745	0.756	0.755	0.771

Table 9: Change in Debt and 'Firms' Accounting Conservatism

This table reports the result of a regression equation (2) based on Ball and Shivkumar (2005). The dependent variable is ACC. Our coefficient of interest is the interaction term DCFO*CFO*AQR_EXP, which captures the effect of bank AQR on firm-level asymmetric timely loss recognition. Control variables include Size, Growth, and Leverage and their interactions with CFO, DCFO, and CFO*DCFO. All variables are defined in table 1. Standard errors are given in parenthesis and clustered at the firm level. Column 1 and 2 shows the results for firms which increased the debt and column 3 and 4 shows the results for firms which decrease the debt. *, **, and *** represents the statistical significance level at 10%, 5% and 1% respectively.

	(1)	(2)	(3)	(4)
	Increase Debt		Decrease Debt	
VARIABLES	ACC	ACC	ACC	ACC
CFO	-1.111***	-1.118***	-1.177***	-1.167***
	(0.098)	(0.101)	(0.117)	(0.110)
DCFO	-0.008	-0.006	-0.065*	-0.070**
	(0.014)	(0.013)	(0.034)	(0.033)
DCFO*CFO	0.081	0.100	0.134	0.146
	(0.162)	(0.153)	(0.312)	(0.319)
AQR_EXP	-0.016***	-0.016***	-0.014**	-0.014**
	(0.005)	(0.005)	(0.006)	(0.006)
AQR_EXP*CFO	0.154***	0.159***	0.156***	0.155***
	(0.042)	(0.043)	(0.055)	(0.054)
AQR_EXP*DCFO	0.004	0.004	0.014	0.013
	(0.007)	(0.007)	(0.011)	(0.011)
AQR_EXP*DCFO*CFO	-0.161*	-0.186**	-0.093	-0.104
	(0.084)	(0.083)	(0.140)	(0.140)
Constant	-0.029	-0.024	0.113	0.109
	(0.038)	(0.038)	(0.073)	(0.074)
Control Variables and Interactions	Yes	Yes	Yes	Yes
Year Fixed Effect	Yes	Yes	Yes	Yes
Firm Fixed Effect	Yes	Yes	Yes	Yes
Industry*Year Fixed Effect	No	Yes	Yes	Yes
Observations	12,283	12,228	5,675	5,630
R-squared	0.783	0.792	0.786	0.808

Table 10: Group vs. Standalone Firms

This table reports the result of a regression equation (2) based on Ball and Shivkumar (2005). The dependent variable is ACC. Our coefficient of interest is the interaction term DCFO*CFO*AQR_EXP, which captures the effect of bank AQR on firm-level asymmetric timely loss recognition. Control variables include Size, Growth, and Leverage and their interactions with CFO, DCFO, and CFO*DCFO. All variables are defined in table 1. Standard errors are given in parenthesis and clustered at the firm level. Column 1 and 2 shows the results for Group firms, and column 3 and 4 shows the results for standalone firms. *, **, and *** represents the statistical significance level at 10%, 5% and 1% respectively.

	(1)	(2)	(3)	(4)
	Group Firms		Standalone Firms	
VARIABLES	ACC	ACC	ACC	ACC
CFO	-1.145***	-1.138***	-1.080***	-1.098***
	(0.113)	(0.112)	(0.123)	(0.128)
DCFO	-0.037*	-0.030	-0.004	-0.003
	(0.022)	(0.021)	(0.019)	(0.019)
DCFO*CFO	0.164	0.159	-0.058	-0.055
	(0.244)	(0.222)	(0.212)	(0.215)
AQR_EXP	-0.019***	-0.021***	-0.018***	-0.019***
	(0.006)	(0.006)	(0.005)	(0.006)
AQR_EXP*CFO	0.181***	0.188***	0.152***	0.164***
	(0.049)	(0.050)	(0.046)	(0.047)
AQR_EXP*DCFO	0.015*	0.016*	0.000	0.002
	(0.008)	(0.008)	(0.008)	(0.008)
AQR_EXP*DCFO*CFO	-0.262***	-0.277***	-0.131	-0.150
	(0.091)	(0.091)	(0.094)	(0.096)
Constant	0.106**	0.116***	-0.055	-0.056
	(0.043)	(0.043)	(0.043)	(0.044)
Control Variables and Interactions	Yes	Yes	Yes	Yes
Year Fixed Effect	Yes	Yes	Yes	Yes
Firm Fixed Effect	Yes	Yes	Yes	Yes
Industry*Year Fixed Effect	No	Yes	Yes	Yes
Observations	9,878	9,818	8,885	8,834
R-squared	0.750	0.764	0.754	0.767

Table 11: Small vs. Large Firms

This table reports the result of a regression equation (2) based on Ball and Shivkumar (2005). The dependent variable is ACC. Our coefficient of interest is the interaction term DCFO*CFO*AQR_EXP, which captures the effect of bank AQR on firm-level asymmetric timely loss recognition. Control variables include Size, Growth, and Leverage and their interactions with CFO, DCFO, and CFO*DCFO. All variables are defined in table 1. Standard errors are given in parenthesis and clustered at the firm level. Column 1 and 2 shows the results for Small firms, and column 2 and 3 shows the results for Large firms. Firms above median size in year 2016 is classified as large firms and below median small firms. *, **, and *** represents the statistical significance level at 10%, 5% and 1% respectively.

	(1)	(2)	(3)	(4)
	Small Firms		Large Firms	
VARIABLES	ACC	ACC	ACC	ACC
CFO	-1.062***	-1.045***	-1.121***	-1.133***
	(0.165)	(0.169)	(0.141)	(0.138)
DCFO	-0.056**	-0.054**	0.047	0.054*
	(0.023)	(0.023)	(0.029)	(0.031)
DCFO*CFO	-0.072	-0.107	0.756	0.819*
	(0.255)	(0.248)	(0.460)	(0.483)
AQR_EXP	-0.017***	-0.017***	-0.017***	-0.018***
	(0.006)	(0.006)	(0.005)	(0.005)
AQR_EXP*CFO	0.156***	0.169***	0.172***	0.169***
	(0.052)	(0.054)	(0.041)	(0.042)
AQR_EXP*DCFO	0.001	0.005	0.016*	0.016
	(0.008)	(0.008)	(0.009)	(0.010)
AQR_EXP*DCFO*CFO	-0.189**	-0.210**	0.032	-0.007
	(0.092)	(0.093)	(0.149)	(0.150)
Constant	0.010	0.029	0.069	0.053
	(0.038)	(0.039)	(0.048)	(0.048)
Control Variables and Interactions	Yes	Yes	Yes	Yes
Year Fixed Effect	Yes	Yes	Yes	Yes
Firm Fixed Effect	Yes	Yes	Yes	Yes
Industry*Year Fixed Effect	No	Yes	Yes	Yes
Observations	8,330	8,282	9,160	9,105
R-squared	0.774	0.785	0.700	0.717

Table 12: Entropy Based DiD

This table reports the result of a Entropy balanced regression equation (2) based on Ball and Shivkumar (2005). The dependent variable is ACC. Our coefficient of interest is the interaction term DCFO*CFO*AQR_EXP, which captures the effect of bank AQR on firm-level asymmetric timely loss recognition. Control variables include Size, Growth, and Leverage and their interactions with CFO, DCFO, and CFO*DCFO. All variables are defined in table 1. Standard errors are given in parenthesis and clustered at the firm level. Entropy balnced matched weights are used in this regression. *, **, and *** represent the statistical significance level at 10%, 5%, and 1%, respectively

	(1)	(2)	(3)
VARIABLES	ACC	ACC	ACC
CFO	-0.915***	-1.193***	-1.193***
	(0.016)	(0.078)	(0.078)
DCFO	0.001	-0.017	-0.014
	(0.003)	(0.014)	(0.014)
DCFO*CFO	-0.044	0.174	0.174
	(0.032)	(0.153)	(0.151)
AQR_EXP	-0.019***	-0.015***	-0.016***
	(0.004)	(0.004)	(0.004)
AQR_EXP*CFO	0.172***	0.135***	0.140***
	(0.033)	(0.032)	(0.032)
AQR_EXP*DCFO	0.005	0.006	0.007
	(0.006)	(0.006)	(0.006)
AQR_EXP*DCFO*CFO	-0.172**	-0.151**	-0.168**
	(0.072)	(0.069)	(0.069)
Constant	0.018***	0.059*	0.058*
	(0.002)	(0.033)	(0.033)
Control Variables and Interactions	No	Yes	Yes
Year Fixed Effect	Yes	Yes	Yes
Firm Fixed Effect	Yes	Yes	Yes
Industry*Year Fixed Effect	No	No	Yes
Observations	19,105	19,105	19,063
R-squared	0.737	0.753	0.761

Table 13:Placebo Test

This table reports the result of a regression equation (2) based on Ball and Shivkumar (2005) on pre period sample. The dependent variable is ACC. Our coefficient of interest is the interaction term PLACEBO_EXP*DCFO*CFO and PLACEBO_R_EXP*DCFO*CFO. Control variables include Size, Growth, and Leverage and their interactions with CFO, DCFO, and CFO*DCFO. Column (1) amd (2) treatment year is changed to 2015 and column (3) and (4) firms are randomly selected for treatment in year 2015. All variables are defined table 1. Standard errors are given in parenthesis and clustered at the firm level. Sample period for this regression is pre-period only (2013-2016). *, **, and *** represent the statistical significance level at 10%, 5%, and 1%, respectively

	(1)	(2)	(3)	(4)
VARIABLES	ACC	ACC	ACC	ACC
CFO	-1.132***	-1.137***	-1.106***	-1.107***
	(0.089)	(0.090)	(0.090)	(0.091)
DCFO	-0.007	-0.007	-0.007	-0.007
	(0.014)	(0.013)	(0.014)	(0.014)
DCFO*CFO	0.086	0.101	0.059	0.074
	(0.183)	(0.178)	(0.189)	(0.183)
PLACEBO_EXP	-0.000	0.000		
	(0.004)	(0.004)		
PLACEBO_EXP*CFO	0.045	0.045		
	(0.028)	(0.028)		
PLACEBO_EXP*DCFO	-0.003	-0.003		
	(0.006)	(0.006)		
PLACEBO_EXP*DCFO*CFO	-0.048	-0.044		
	(0.077)	(0.077)		
PLACEBO_R_EXP			0.002	0.001
			(0.004)	(0.004)
PLACEBO_R_EXP*CFO			-0.011	-0.012
			(0.032)	(0.032)
PLACEBO_R_EXP*DCFO			-0.009	-0.008
			(0.007)	(0.007)
PLACEBO_R_EXP*DCFO*CFO			-0.053	-0.056
			(0.083)	(0.082)
Constant	-0.126*	-0.116*	-0.103	-0.093
	(0.066)	(0.066)	(0.069)	(0.068)
Control Variables and Interactions	Yes	Yes	Yes	Yes
Year Fixed Effect	Yes	Yes	Yes	Yes
Firm Fixed Effect	Yes	Yes	Yes	Yes
Industry*Year Fixed Effect	No	Yes	Yes	Yes
Observations	10,563	10,540	10,123	10,093
R-squared	0.825	0.831	0.826	0.833

Table 14: Accounting conservatism and Probability of Default

This table reports the result for the DiDiD, where the dependent variable is PD_12 and PD_24. Our coefficient of interest is AQR_EXP*C_Score, which captures the effect decrease in timeliness of recognizing bad news of AQR exposed firms on the probability of default. Control variables include Size, Leverage, Growth and Profitability. All variables are defined table 1. Standard errors are given in parenthesis and clustered at firm level. *, **, and *** represents the statistical significance level at 10%, 5% and 1% respectively.

	(1)	(2)	(3)	(4)
VARIABLES	PD_12	PD_12	PD_24	PD_24
C_Score	0.004***	0.004***	0.008***	0.007***
	(0.001)	(0.002)	(0.003)	(0.003)
AQR_EXP	0.001	0.001	0.002	0.001
	(0.001)	(0.001)	(0.002)	(0.002)
AQR_EXP*C_Score	0.003**	0.002*	0.005**	0.005*
	(0.001)	(0.001)	(0.002)	(0.002)
Size	-0.001	-0.000	-0.000	0.000
	(0.001)	(0.001)	(0.002)	(0.002)
Leverage	0.017***	0.016***	0.030***	0.028***
	(0.004)	(0.004)	(0.007)	(0.007)
Growth	-0.001***	-0.001***	-0.002***	-0.002***
	(0.000)	(0.000)	(0.001)	(0.001)
Profitability	-0.066***	-0.065***	-0.118***	-0.116***
	(0.006)	(0.006)	(0.010)	(0.010)
Constant	0.023***	0.021**	0.037**	0.033**
	(0.008)	(0.009)	(0.015)	(0.016)
Year Fixed Effect	Yes	Yes	Yes	Yes
Firm Fixed Effect	Yes	Yes	Yes	Yes
Industry*Year Fixed Effect	No	Yes	No	Yes
Observations	12,381	12,332	12,381	12,332
R-squared	0.699	0.718	0.722	0.741

Table 15: Accounting conservatism and Related Party Transaction

This table reports the result for the DiDiD, where the dependent variable is Opportunistic RPT, Business RPT and Total RPT. Our coefficient of interest is AQR_EXP*C_Score, which captures the effect decrease in timeliness of recognizing bad news of AQR exposed firms on RPT. Control variables include Size, Leverage, Growth, Profitability, and Age. All variables are defined table 1. Standard errors are given in parenthesis and clustered at firm level. *, **, and *** represents the statistical significance level at 10%, 5% and 1% respectively.

VARIABLES	(1) Opportunistic RPT	(2) Opportunistic RPT	(3) Business RPT	(4) Business RPT	(5) Total RPT	(6) Total RPT
C_Score	-0.005	-0.006	-0.019	-0.022*	-0.023	-0.028*
	(0.004)	(0.004)	(0.012)	(0.013)	(0.014)	(0.015)
AQR_EXP	0.000	0.001	-0.018**	-0.020**	-0.016	-0.017*
	(0.003)	(0.003)	(0.009)	(0.009)	(0.010)	(0.010)
AQR_EXP*C_Score	0.007*	0.008*	0.006	0.008	0.013	0.017
	(0.004)	(0.005)	(0.011)	(0.012)	(0.013)	(0.014)
Size	-0.011**	-0.010**	-0.037***	-0.038***	-0.053***	-0.053***
	(0.004)	(0.004)	(0.014)	(0.014)	(0.015)	(0.015)
Leverage	0.033***	0.033***	0.048	0.067*	0.095**	0.110***
	(0.012)	(0.012)	(0.035)	(0.037)	(0.041)	(0.042)
Growth	0.004**	0.004**	0.013***	0.011**	0.017***	0.015***
	(0.002)	(0.002)	(0.005)	(0.005)	(0.005)	(0.005)
Profitability	0.034**	0.034**	0.141***	0.135***	0.196***	0.191***
	(0.013)	(0.014)	(0.045)	(0.045)	(0.051)	(0.052)
Age	-0.006	-0.020	-0.101	-0.085	-0.138	-0.148
	(0.021)	(0.023)	(0.071)	(0.077)	(0.092)	(0.102)
Constant	0.124	0.168**	0.798***	0.755***	1.073***	1.099***
	(0.076)	(0.079)	(0.273)	(0.288)	(0.344)	(0.370)
Year Fixed Effect	Yes	Yes	Yes	Yes	Yes	Yes
Firm Fixed Effect	Yes	Yes	Yes	Yes	Yes	Yes
Industry*Year Fixed Effect	No	Yes	No	Yes	No	Yes
Observations	12,502	12,450	12,502	12,450	12,502	12,450
R-squared	0.558	0.572	0.730	0.739	0.743	0.752

Table 16: Accounting conservatism and Interest rate

This table reports the result for the DiDiD, where the dependent variable is Interest Rate. Our coefficient of interest is AQR_EXP*C_Score, which captures the effect decrease in timeliness of recognizing bad news of AQR exposed firms on Interest rate. Control variables include Size, Leverage, Growth, Profitability, and Age. All variables are defined table 1. Standard errors are given in parenthesis and clustered at firm level. *, **, and *** represents the statistical significance level at 10%, 5% and 1% respectively.

	(1)	(2)
VARIABLES	Interest Rate	Interest Rate
C_Score	-0.018*	-0.016
	(0.010)	(0.010)
AQR_EXP	-0.006	-0.006
	(0.007)	(0.007)
AQR_EXP*C_Score	-0.034***	-0.029**
	(0.012)	(0.012)
Size	-0.012	-0.010
	(0.009)	(0.009)
Leverage	-0.305***	-0.309***
	(0.027)	(0.028)
Growth	0.001	0.003
	(0.004)	(0.004)
Profitability	0.007	0.007
	(0.029)	(0.030)
Constant	0.321***	0.304***
	(0.073)	(0.073)
Year Fixed Effect	Yes	Yes
Firm Fixed Effect	Yes	Yes
Industry*Year Fixed Effect	No	Yes
Observations	12,686	12,641
R-squared	0.516	0.531

Table 17: Sample MCA Data Format

Sr. No	SRN	Charge Id	Charge Holder Name	Date of Creation	Date of Modification	Date of Satisfaction	Amount	Address	Whether charge registered by other entity	Asset Holder Name
1	y12	xxx	Bank/NBFC	26/07/2022	13/05/2023	26/05/2024	4000XXXXX	XXXXXX		
2	y13	xxx	Bank/NBFC2							
3	y22	xxx	Bank/NBFC3							
4	y66	xxx	Bank/NBFC4							
1			Bank/NBFC							