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# The Impact of Corporate Governance and Fair Value Accounting on Debt Contracts

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**Abstract:** This paper investigates the theoretical relationship between corporate governance, fair value accounting, and debt contracts. It primarily examines the individual impacts of corporate governance and fair value accounting on debt contracts, while also exploring the influence of corporate governance on fair value accounting. The study emphasizes the importance of considering the interests and legal status of creditors in the context of debt contracts. The findings indicate that strong corporate governance can reduce the likelihood of debt default and that the company's restructuring costs in the event of a default determine whether improved corporate governance will increase or decrease debt costs. Additionally, the study reveals that the strength of corporate governance affects the value relevance of fair value accounting. However, the impact of fair value accounting on debt contracts is not inherently positive or negative; for instance, companies may use fair value adjustments with manipulative intent to enhance performance. Ultimately, the research highlights that discussions about corporate governance should not prioritize shareholder interests exclusively but also consider the legitimate position of creditors.

**Keywords:** Corporate governance; Debt contracts; Debt default; Fair value accounting

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## 1. Introduction

Creditors are a significant group of stakeholders in a company, yet under corporate governance mechanisms, their interests are often overlooked and, in many cases, may be undermined. This paper theoretically investigates the influence of corporate governance and fair value accounting on debt contracts. Firstly, it explores how corporate governance specifically impacts debt contracts by examining a dynamic model in which equity holders weigh the pros and cons of opting for debt default versus recapitalizing the company. The findings indicate that corporate governance plays a crucial role: all else being equal, companies are more likely to default when poorly managed than when well managed. Whether improved corporate governance increases or decreases the cost of debt depends on the restructuring costs the company faces in the event of default.

Secondly, this paper discusses the impact of corporate governance on fair value accounting. A company's level of corporate governance and institutional environment affect the value relevance and implementation

effectiveness of fair value accounting. The paper then delves into the influence of fair value accounting on the design of debt contracts, particularly in the context of SFAS 159. By examining debt contracts before and after the implementation of SFAS 159, the study assumes that changes in the usefulness of accounting brought about by the expansion of fair value will alter the contract equilibrium. The findings suggest that the influence of fair value accounting on debt contracts is neither wholly positive nor negative. When there are greater incentives and opportunities for manipulation, fair value accounting can reduce the usefulness of debt contracts.

In conclusion, while poor corporate governance may lower the cost of debt, good corporate governance remains essential, serving as the company's core competitive advantage. Additionally, it is far more important to place creditors in a legitimate position and protect their interests, rather than focusing solely on reducing the cost of debt.

## 2. Corporate governance and debt contracts

Good corporate governance can reduce the risk of debt default, but it does not necessarily lower the cost of debt. Stronger governance does not automatically lead to cheaper debt, especially when the restructuring costs in default are less than the cost of the debt. In such cases, effective governance may actually increase the cost of debt because debt default aims to maximize the value of equity holders, often at the expense of creditors.

Corporate governance plays a key role in defaults. When governance is weak, outside shareholders typically hold fewer shares in the company than they do under strong governance. Consequently, these external shareholders are less inclined to restructure the company, making the company more likely to default when poorly governed. It was predicted that corporate governance's impact on debt cost would vary, with improvements either increasing or decreasing debt costs depending on the company's restructuring costs in the event of default.

This demonstrates that shareholders do not always favor strong corporate governance. In situations where governance is poor, shareholders and management have greater control over whether to default on the debt, as well as more opportunities to manipulate earnings and select accounting methods to suit their needs. This scenario benefits both management and shareholders: if restructuring costs in the event of a default are low, they may opt for default while using fair value accounting to manipulate financial statements. This allows management to adjust performance figures and permits shareholders to claim part of the creditors' interests. The next section touches on this issue, demonstrating how, under circumstances of greater manipulation incentives, fair value accounting reduces the effectiveness of debt contracts. This concept will be explored further in **Section 4**.

Although poor corporate governance may sometimes lower debt costs, good corporate governance is undeniably more critical in the long term. Satisfying shareholders at the expense of creditors, especially during financial distress, is shortsighted. Default also introduces unnecessary restructuring costs. An alternative approach is debt contract renegotiation, which research suggests can help address unnecessary default costs and may be incentive-compatible in times of financial stress [1]. The Coase theorem supports this idea, indicating that the surplus created by renegotiation would likely benefit all parties, even if it occasionally increases transaction costs associated with transfers of benefit.

## 3. Corporate governance and fair value measurement

Mănoiu and Damian mentioned that the value correlation of fair value in financial statements is influenced by corporate governance mechanisms and highlight that, as corporate governance structures improve, fair value

measurement can become the preferred model [2].

Dixon emphasized that a key implication of corporate governance is that boards need to be fully aware of and actively involved in all aspects of the fair value estimation process. This includes assessing the risk of material misstatement and ensuring the adequacy of mandatory and explanatory disclosures [3]. Boards must also monitor management closely and maintain vigilance regarding management ethics, as fair value measurement relies significantly on management's discretion [4-6]. The information asymmetry between managers (agents) and investors (principals), coupled with conflicts of interest between the two groups, can lead to moral hazard in fair value accounting [7]. In such cases, managers may exploit the flexibility of fair value measurement, reducing the reliability of the information presented [8-10].

In the face of these agency risks, corporate governance can help mitigate conflicts of interest [11]. For instance, companies may include external auditors in their governance mechanisms, playing a key role in resolving agency conflicts by ensuring the reasonableness of fair value measurements (ISA 540) [12]. Additionally, boards of directors can prevent management from distorting transaction outcomes by designing effective compensation plans and adjusting the way managers are remunerated [13].

## 4. Fair value accounting and debt contracts

This section builds on the research findings of Demerjian *et al*. [14], who investigated the impact of fair value accounting on debt contracts within the context of SFAS 159. Their analysis compares debt contracts before and after the implementation of SFAS 159, which offers unique features enabling conclusions that were not possible in earlier analyses. First, debt contracts are both observable and accessible for most companies. Second, the cost of adjusting covenants in debt contracts to exclude fair value effects is low.

They began by comparing the net benefits and costs of potential contracts in response to fair value expansion. Assumptions were formulated and tested by examining debt contracts before and after the standard's application. The analysis is premised on the idea that changes in accounting usefulness due to fair value expansion alter the contractual equilibrium, revealing borrower and lender preferences through changes in debt contract terms.

Next, they explored modifications to the definition of financial contracts, the most likely response to SFAS 159. They discovered that only a small number of contracts explicitly excluded the effects of SFAS 159, indicating that most parties did not perceive fair value accounting as significantly detrimental to contractual usefulness. Moreover, most exclusions applied solely to liabilities, suggesting that under fair value accounting, liabilities are more likely to be scrutinized than assets.

The researchers then examined the cross-sectional determinants of excluding fair value estimates from contracts. Borrowers inclined to opportunistically use fair value accounting to reduce debt costs and extract wealth from creditors were more likely to exclude fair value estimates from contracts.

They also analyzed two scenarios where fair value accounting provides useful information for contracts. First, SFAS 159 may incentivize companies to opt for fair value accounting. One advantage is that SFAS 159 provides information on the effectiveness of a company's hedging activities, enhancing its ability to repay debt. Additionally, it reduces hedge accounting costs, facilitating hedging and aligning creditor and debtor interests. Second, fair value estimates may improve the relevance of accounting figures when contractual value is tied to monitoring the borrower's liquidity.

The key contributions of their study to the accounting literature include demonstrating how parties to debt contracts respond to fair value accounting. While adjusting debt contracts to exclude fair value effects

generally incurs low costs, these effects were not deemed harmful enough to justify exclusion. They concluded that fair value accounting's impact on debt contracts is nuanced. When measurement uncertainty exists, and opportunities for earnings manipulation are high, fair value may reduce the usefulness of debt contracts. Conversely, it can enhance their usefulness when hedging opportunities and measurement of liquidity are significant.

Moreover, fair value accounting's impact on debt contracts is subject to certain limitations. While measurement risk under fair value is higher, companies may still need to use fair value to enter into debt contracts. For instance, fair value measurement aids companies in financing debt when bank regulators require lenders to consider the reported carrying value of borrowers in lending decisions. In such cases, financially constrained companies may raise capital by reporting asset values higher than their actual worth, provided the assets are measured at fair value. Thus, financial constraints play a role in determining whether companies adopt fair value or historical cost measurement, with constrained companies often favoring fair value without regard for earnings management [15].

## 5. Conclusion

This paper explores the theoretical influence of corporate governance and fair value accounting on debt contracts. The research reveals that while good corporate governance can reduce the probability of debt default, it does not necessarily lower the cost of debt. Whether improved governance will increase or decrease debt costs depends on the restructuring costs in the event of default. Additionally, it is found that the strength of corporate governance influences the value relevance of fair value accounting. The impact of fair value accounting on debt contracts is not inherently positive or negative; for instance, when there are greater incentives and opportunities for manipulation, fair value accounting diminishes the usefulness of debt contracts.

However, even though poor corporate governance might reduce debt costs in some cases, it cannot be denied that good corporate governance and appropriate accounting measurement are far more critical to the long-term success of a company than sacrificing the interests of creditors to benefit shareholders. With the globalization of business and heightened competition, good corporate governance can become a company's primary advantage, significantly influencing the quality and usefulness of its accounting information. Furthermore, companies should ensure that creditors are placed in their legitimate position, especially in states of financial distress. The primary objective of governance decisions should be to protect creditors' fixed claims rather than to maximize shareholders' wealth [16]. Cowton emphasized that business ethicists who support the stakeholder viewpoint should recognize and pay greater attention to the status of creditors as a vital stakeholder group.

## Disclosure statement

The author declares no conflict of interest.

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