FINANCIAL STATEMENT COMPARABILITY AND DIRECTORS' AND OFFICERS' INSURANCE COVERAGE

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Abstract

This study examines the effect of financial statement comparability on directors' and officers' (D&O) insurance coverage. Using a comprehensive sample of firms listed in the Taiwan capital markets, we find that the more comparable a firm's financial statements are to its peers', the less D&O insurance coverage the firm would purchase. The results remain robust after addressing potential concerns related to omitted variables, reverse causality, and sample selection bias. Consistent evidence emerges when we conduct change analyses and employ alternative measures of financial statement comparability. Furthermore, we document that higher comparability reduces abnormal D&O insurance coverage. Taken together, our findings suggest that enhanced financial statement comparability mitigates agency costs, as reflected in lower D&O insurance coverage, thereby benefiting shareholders.

Keywords: D&O Insurance, Financial Statement Comparability, Agency Cost

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1. INTRODUCTION

In this paper, we explore the relation between the comparability of financial statements and a specific type of agency cost measured by directors' and officers' (D&O) insurance coverage. The Financial Accounting Standards Board (FASB) (1980) defines comparability as a quality of accounting information that allows users to identify similarities and differences between two sets of economic phenomena. By using peer firms as benchmarks, comparability improves users' ability to interpret financial statement items and make more informed economic decisions.

The significance of financial statement comparability in capital markets has garnered increasing attention in recent years. Most extant studies focused primarily on its benefits (De Franco et al., 2011; Kim et al., 2013; Kim et al., 2016; Habib et al., 2017; Chen et al., 2018; Choi et al., 2019; Ahn et al., 2020; Kim et al., 2021; Nam & Thompson, 2023; Peng et al., 2024) and its determinants (Francis et al., 2014; Chen et al., 2020; Ege et al., 2020; Endrawes et al., 2020; Imhof et al., 2022; Afzali, 2023; De Franco et al., 2023; Borghesi et al., 2024; Francis et al., 2024). Other recent studies have inspired our inquiry into whether financial statement comparability can mitigate agency costs. For example, greater financial statement comparability has been shown to lower the cost of equity capital (Imhof et al., 2017) and cash holding (Habib et al., 2017). Kim et al. (2021) further found that financial statement comparability leads to increased cash holdings and capital expenditures, thereby improving investment efficiency. Expanding on this literature, we predict

that higher financial statement comparability enhances the information environment and thereby reduces agency costs reflected in lower D&O insurance coverage.

According to agency theory, the principal's monitoring expenditures represent agency costs (Jensen & Meckling, 1976). Monitoring involves the principal's efforts to control the agent's behavior through mechanisms such as budget restrictions, compensation policies, and operating rules. We assert that D&O insurance coverage constitutes a form of agency cost for three reasons. First, firms incorporate D&O insurance into compensation contracts to shield directors and officers from personal liability and to attract high-quality managerial talent (Wynn, 2008). Second, D&O insurance serves a governance function by subjecting the insured, coverage limits, and deductibles to external scrutiny (O'Sullivan, 1997). Third, the purchase of D&O insurance reflects inherent conflicts of interest between managers and shareholders, as the insurance protects managers against shareholder litigation for actual or alleged wrongful acts (Donelson et al., 2021).

Taiwan provides an ideal setting for our analysis. The region hosts globally recognized high-tech industrial clusters such as Taiwan Semiconductor Manufacturing Company and United Microelectronics Corporation. To protect directors and officers from personal liability, the Taiwan government amended the Company Act in 2018 to formally regulate D&O insurance. Following this amendment, both the Taiwan Stock Exchange (TWSE) and Taipei Exchange (TPEx) mandated listed firms to purchase D&O insurance, resulting in additional agency costs due to insurance expenditures.

Our research, involving data collection from the Market Observation Post System (MOPS) and the Taiwan Economic Journal (TEJ) database from 2013 onward, has led to significant findings. We measure each firm's degree of financial statement comparability using the methodology of De Franco et al. (2011). The empirical results reveal a negative and significant association between financial statement comparability and D&O insurance coverage. This finding remains robust after controlling for omitted-variable bias, reverse causality, and sample-selection concerns. The result is also consistent in change analyses and when using alternative comparability measures. Furthermore, we emphasize the crucial importance of distinguishing between normal and abnormal D&O insurance coverage based on the models of Core (1997) and Lin et al. (2013). Our findings show that higher comparability reduces abnormal coverage, suggesting a more substantial effect on excessive agency costs.

This study contributes to the literature by presenting new empirical evidence on agency costs in practice. Agency theory suggests that agency costs stem from information asymmetry; therefore, enriching this framework necessitates exploring diverse empirical contexts. In contrast, previous research indicates that financial statement comparability can alleviate agency frictions in capital markets (Fang et al., 2016; Habib et al., 2017; Imhof et al., 2017). We build on this research by demonstrating a novel finding that greater financial statement comparability is linked to lower D&O insurance coverage, a unique contribution to the field.

Our findings also carry significant practical benefits for corporate governance and insurance practices. For firms, financial statement comparability can be a helpful guide in determining optimal D&O insurance coverage. Cao and Narayanamoorthy (2014) argue that D&O insurance coverage accurately reflects litigation risk; therefore, understanding its connection to financial statement comparability can help firms in making more efficient insurance decisions. For insurers, financial statement comparability can improve pricing efficiency and reduce abnormal coverage. Boyer and Stern (2012) suggest that insurers can develop technologies to translate observable policyholder characteristics into risk assessments. As a result, firms with higher financial statement comparability demonstrate higher reporting quality, enabling insurers to evaluate firm risk and economic condition better, and potentially leading to lower D&O insurance premiums.

The remainder of this paper proceeds as follows. Section 2 reviews related literature and presents the main hypothesis. Section 3 describes research methodology. Section 4 presents empirical results. Section 5 concludes.

2. LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

2.1. Financial statement comparability

According to the contracting view, an organization represents a nexus of contracts among various stakeholders. For these contracts to function effectively, financial statement information serves as a critical mechanism to bridge information gaps across contracting parties. Givoly et al. (2010) argue that the demand for financial information arises primarily from contractual arrangements. Similarly, Kothari (2000) notes that market participants seek high-quality financial information because it mitigates information asymmetry between insiders and outsiders. High-quality financial reporting can also reduce the cost of capital and stock price volatility. Consequently, recent research has increasingly emphasized enhancing the qualitative characteristics of accounting information, particularly financial statement comparability.

De Franco et al. (2011) provide the first large-sample empirical evidence on the effects of financial statement comparability in capital markets. They document that greater comparability benefits sell-side analysts by lowering information acquisition costs and increasing both the quantity and quality of information available for firm valuation. Extending this line of inquiry, Kim et al. (2013) and Kim et al. (2016) investigate the implications of comparability in the debt and equity markets. Kim et al. (2013) find that higher comparability improves the accuracy of investors' valuation judgments and reduces firms' cost of capital, while Kim et al. (2016) show that comparability discourages managerial bad-news hoarding and reduces investors' perceptions of future crash risk.

Further studies examine the role of financial statement comparability in mergers and acquisitions. Chen et al. (2018) find that acquirers make more profitable acquisition decisions when

target firms' financial statements are more comparable. Duong and Truong (2021) extend their analysis over a longer sample period and report consistent evidence. Similarly, Kim et al. (2021) highlight the role of comparability in improving firms' resource allocation, showing that it mitigates both underinvestment and overinvestment.

Taken together, prior research suggests that financial statement comparability enhances capital market efficiency by facilitating the optimal allocation of resources and improving the informativeness and credibility of accounting information. In doing so, financial statement comparability strengthens market participants' valuation accuracy and the overall quality of financial decision-making.

2.2. Directors' and officers' insurance

Core (1997) explains that D&O insurance reimburses the legal expenses incurred by directors or officers in defending or settling lawsuits related to their service to the firm, provided they acted honestly and in good faith. This insurance, as noted by Donelson et al. (2021), serves as a crucial tool for firms, often purchasing it to protect managers from litigation initiated by shareholders, competitors, or regulators for a wide range of actual or alleged wrongful acts. It can serve as a safeguard for managers against unintentional mistakes, thereby fostering a sense of security and confidence in their roles. However, it may simultaneously create additional agency costs borne by shareholders (Donelson et al., 2021).

From the agency theory perspective, D&O insurance represents an agency cost because it weakens the disciplinary effect of potential litigation. Lin et al. (2022) argue that D&O insurance coverage, by absorbing defense costs and potential damages, diminishes the deterrence effect of shareholder lawsuits (Baker & Griffith, 2010), heightens information risk (Chen et al., 2016; Weng et al., 2017), and exacerbates inefficient investment behavior (Li & Liao, 2014), thereby generating managerial moral hazard. Empirically, Wang and Chen (2016) document a negative association between D&O insurance coverage and the sensitivity of directors' compensation to firm performance, implying weakened incentive alignment. Consistent with this view, Weng et al. (2017) find that higher levels of D&O coverage are associated with an increased likelihood of financial restatements, suggesting that managers may adopt more aggressive accounting policies when their personal legal exposure is reduced.

In contrast, other studies contend that D&O insurance can mitigate agency conflicts and reduce agency costs. Cao and Narayanamoorthy (2014) examine how insurers incorporate financial reporting concerns into pricing and find that insurance premiums increase following financial restatements, indicating that insurers effectively price reporting risk. Yuan et al. (2016) further show that D&O insurance can strengthen corporate governance mechanisms and thereby reduce the risk of a stock price crash. Similarly, Hwang and Kim (2018) document that D&O insurance enhances firm value by facilitating the conversion of growth opportunities into realized performance. They suggest that D&O insurance alleviates firms' underinvestment tendencies by reducing managerial risk aversion.

Taken together, the literature presents two competing views of D&O insurance. On one hand, it can function as a governance tool that enhances monitoring and risk sharing; on the other hand, it may serve as a protective shield that weakens disciplinary mechanisms and increases managerial opportunism. The net effect of D&O insurance, therefore, depends on the balance between its governance benefits and the moral hazard it potentially introduces.

2.3. The impact of financial statement comparability on directors' and officers' insurance coverage

High financial statement comparability in a firm creates a transparent informational environment for shareholders and stakeholders, enabling a better understanding and evaluation of the firm's operations. This enhanced comparability plays a crucial role in reducing information asymmetry between managers and shareholders, thereby mitigating agency problems. As per agency theory, lower information asymmetry leads to lower agency costs, underscoring the importance of our research topic.

In the context of D&O insurance, the amount of coverage purchased represents an observable manifestation of agency costs borne by shareholders. Firms must assess the litigation risk faced by directors and officers to determine the appropriate level of coverage. When financial statement comparability is higher, managers are likely to be more capable of accurately conveying firm performance (Lin et al., 2021). This allows stakeholders to assess managerial decisions and outcomes better, even when these decisions lead to unfavorable results. Consequently, reduced information asymmetry should lessen perceived litigation risk against directors and officers. All else equal, firms with higher financial statement comparability are expected to purchase D&O insurance with lower coverage limits. We therefore predict that financial statement comparability is negatively associated with D&O insurance coverage[1]. Formally, we state our main hypothesis as follows:

H1: Financial statement comparability is negatively associated with D&O insurance coverage.

3. RESEARCH METHODOLOGY

3.1. Empirical model

To test our main hypothesis, we estimate the following regression model:

$$DOCOV_{it} = a_0 + \beta_1 COMP_{it} + \beta_2 BRF_{it} + \beta_3 CGF_{it} + IND + YEAR + \varepsilon_{it} \quad (1)$$

[1] A better measure of the cost of D&O insurance is the amount of premium the firm pays the insurer for the D&O insurance. Unfortunately, such data are not available. However, we argue that when D&O insurance coverage is the same, a firm that has higher financial statement comparability would pay a lower premium to the insurer. Core (1997) posits that the insurance market has little adverse selection problem. Insurers with a better informational environment, when a firm's comparability is high, can better assess their risk exposure and, therefore, will likely charge a lower premium for D&O insurance coverage.

where:

$DOCOV_{it}$: The D&O insurance coverage of firm *i* in year *t*.

$COMP_{it}$: The financial statement comparability of firm *i* in year *t*.

BRF_{it}: The business risk factors of firm *i* in year *t*.

CGF_{it}: The corporate governance characteristics of firm *i* in year *t*.

Our primary variable of interest is β_1. We expect β_1 to be negative and statistically significant, indicating that higher financial statement comparability is associated with lower D&O insurance coverage. Following Core (2000) and Boyer (2014), we include controls for business risk factors and corporate governance characteristics, both of which may influence the level of D&O insurance coverage and thus mitigate potential omitted-variable bias. The business risk factors include firm size (*SIZE*), debt ratio (*LEV*), firm performance (*ROA*), and firm growth (*MTB*). The governance factors encompass board size (*BS*), the independent director ratio (*INDR*), whether the firm is audited by Big Four auditor firms (*BIGN*), whether the firm has a going concern option (*GCO*), and whether the firm engages an auditor industry expert (*AUDEXP*).

3.2. Variable definition

3.2.1. Directors' and officers' insurance measurement

Following Lin et al. (2013), we measure D&O insurance coverage (*DOINS*) as the coverage limit of a firm's D&O insurance policy scaled by the firm's market value of equity at the end of the fiscal year. Donelson et al. (2021) document that higher D&O insurance coverage is positively associated with accounting-related agency costs. Accordingly, a higher level of D&O insurance coverage implies that a firm bears greater agency costs.

3.2.2. Financial statement comparability

We measure financial statement comparability (*COMP*) using the model developed by De Franco et al. (2011), which captures the similarity between two firms' accounting systems in mapping economic events into financial statements (Kim et al., 2016). Specifically, we estimate the following firm-level time-series regression using sixteen quarters of data for each firm-year:

$$Earnings_{it} = a_{it} + \beta_i Return_{it} + \varepsilon_{it} \quad (2)$$

where:

- $Earning_{it}$: Quarterly net income before extraordinary items divided by the beginning of period market value of equity of firm *i* in quarter *t*;
- $Return_{it}$: Quarterly stock return of firm *i* in quarter *t*;
- ε_{it}: The residual of firm *i* in period *t*.

The estimated coefficients α_i and β_i represent firm *i's* accounting function that maps economic events into reported earnings. Similarly, α_i and β_i represent the accounting function of firm *j* within the same industry. To assess the similarity between the accounting systems of firms *i* and *j*, we assume that both firms experience identical economic events and then compute each firm's predicted earnings under both accounting functions as follows:

$$E(Earnings_{iit}) = \hat{a}_i + \hat{\beta}_i Return_{it} \quad (3)$$

$$E(Earnings_{jit}) = \hat{a}_i + \hat{\beta}_i Return_{jt} \quad (4)$$

$E(Earnings)_{iit}$ denotes firm *i's* predicted earnings based on its own accounting parameters, while $E(Earnings)_{jit}$ represents firm *j's* predicted earnings using firm *i's* stock returns. Finally, we compute the comparability between firms *i* and *j* as the negative average absolute difference between the predicted earnings derived from the two accounting systems:

$$COMP_{ijt} = -\frac{1}{16} \times \sum_{t-15}^{t} \left| E(Earnings_{iit}) - E(Earnings_{jit}) \right| \quad (5)$$

A higher (less negative) value of $COMP_{ijt}$ indicates greater similarity and hence higher comparability between firms *i* and *j*.

Following prior research, we aggregate firm-pair comparability to the firm-year level using three measures: *COMPIND*, the mean comparability between firm *i* and all other firms in the same industry-year; *COMPT4*, the average comparability with firm *i's* four most comparable peers in the same year; and *COMPT10*, the average comparability with firm *i's* 10 most comparable peers in the same year (Kim et al., 2016; Imhof et al., 2017).

3.3. Data collection

We obtain financial and firm-specific data from the TEJ database and the MOPS. Panel A of Table 1 summarizes the sample selection procedure. The initial sample consists of 13,115 firm-year observations. After excluding firm-years with missing data for control variables and those without D&O insurance coverage, the final sample comprises 9,111 firm-year observations for the period 2013–2022. Panel B of Table 1 reports the annual distribution of the sample. Consistent with Taiwan's regulatory change mandating D&O insurance purchases beginning in 2019, the number of firms with active D&O insurance policies increased by 1,132 in that year. To mitigate the influence of extreme values, all financial variables are winsorized at the top and bottom one percent of their respective distributions.

Table 1. Sample selection process and sample distribution

Panel A. Sample selection			
Initial sample collection			13,115
Exclude			
The firm is missing in the control variable			(125)
Firm without the purchase of D&O insurance			(3,879)
Final analysis sample			9,111
Panel B. Sample distribution based on year			
Year	***Freq.***	***Percent***	***Cum.***
2013	564	0.062	0.062
2014	606	0.067	0.128
2015	664	0.073	0.201
2016	721	0.079	0.280
2017	839	0.092	0.373
2018	970	0.106	0.479
2019	1,132	0.124	0.603
2020	1,194	0.131	0.734
2021	1,205	0.132	0.867
2022	1,216	0.133	1.000
Total	9,111	100%	

4. EMPERICAL RESULTS

4.1. Descriptive statistics and correlation

Table 2 presents the descriptive statistics for the variables used in the analysis. The mean value of *DOCOV* (D&O insurance coverage) is 0.069, indicating that, on average, the D&O insurance coverage amounts to approximately 6.9% of firms' market value of equity. The mean values of the three comparability measures *COMPIND*, *COMPT4*, and *COMPT10* are -2.753, -0.400, and -0.562, respectively, consistent with the magnitudes reported in Imhof et al. (2017). The mean leverage ratio (*LEV*) is 0.422, suggesting that, on average, firms finance about 42% of their assets with debt. Regarding audit characteristics, 89.2% of the sample firms engage a Big Four audit firm (*BIGN*), which is comparable to the proportion reported by Lin et al. (2019). In addition, 2.6% of the sample firms employ an auditor with industry expertise (*AUDEXP*). Collectively, these descriptive statistics indicate that our sample primarily consists of large, well-audited firms operating in Taiwan's capital market during the 2013–2022 period.

Table 2. Descriptive statistics

Variables	*Mean*	*SD*	*P25*	*P50*	*P75*
$DOCOV_{it}$	0.069	0.096	0.015	0.036	0.080
$COMPIND_{it}$	-2.753	2.451	-2.700	-2.063	-1.746
$COMPT4_{it}$	-0.400	1.053	-0.336	-0.145	-0.065
$COMPT10_{it}$	-0.562	1.228	-0.509	-0.225	-0.100
$SIZE_{it}$	8.373	1.443	7.328	8.206	9.226
LEV_{it}	0.422	0.180	0.283	0.426	0.550
ROA_{it}	0.029	0.080	0.002	0.034	0.069
MTB_{it}	1.686	1.302	0.893	1.285	1.984
BS_{it}	7.617	2.051	7.000	7.000	9.000
$INDR_{it}$	0.320	0.123	0.286	0.333	0.400
$BIGN_{it}$	0.892	0.310	1.000	1.000	1.000
GCO_{it}	0.006	0.077	0.000	0.000	0.000
$ADEXP_{it}$	0.026	0.159	0.000	0.000	0.000
Obs.	9,111				

Note: Variable definition: $DOCOV_{it}$: The D&O coverage ratio of firm i in period t; $COMPIND_{it}$: The mean value of financial statement comparability of firm i in period t; $COMPT4_{it}$: The average of firm i's four highest comparability in period t; $COMPT10_{it}$: The average of firm i's 10 highest comparability in period t; $SIZE_{it}$: The natural log of the market value of firm i in period t; LEV_{it}: The debt ratio of firm i in period t; ROA_{it}: The ROA of firm i in period t; MTB_{it}: The market to book ratio of firm i in period t; BS_{it}: The board size of firm i in period t; $INDR_{it}$: The percentage of independent directors of firm i in period t; $BIGN_{it}$: A dummy variable that takes a value of 1 if a firm has a Big 4 auditor in period t and 0 otherwise; GCO_{it}: A dummy variable that takes a value of 1 if a firm has a going concern option in period t and 0 otherwise; $AUDEXP_{it}$: A dummy variable that takes a value of 1 if a firm has an auditor expert in period t and 0 otherwise.

Table 3 reports the Pearson correlation matrix of the variables used in this study. As preliminary support to our main hypothesis, the table shows that financial statement comparability is negatively and significantly correlated with D&O insurance coverage; that is, higher financial statement comparability is associated with lower D&O insurance coverage. The highest correlation coefficient among the independent variables is -0.513, while all other pairwise correlations are below 0.50, suggesting that multicollinearity is not a serious concern in our regression analyses.

Table 3. Pearson correlation

Variables	$DOCOV_{it}$	$CompIND_{it}$	$CompT4_{it}$	$CompT10_{it}$	$SIZE_{it}$	LEV_{it}	ROA_{it}	MTB_{it}	BS_{it}	$INDR_{it}$	$BIGN_{it}$	GCO_{it}	$ADEXP_{it}$
$DOCOV_{it}$	1.000												
$CompIND_{it}$	-0.192***	1.000											
	(0.000)												
$CompT4_{it}$	-0.135***	0.627***	1.000										
	(0.000)	(0.000)											
$CompT10_{it}$	-0.157***	0.657***	0.982***	1.000									
	(0.000)	(0.000)	(0.000)										
$SIZE_{it}$	-0.513***	0.133***	0.112***	0.123***	1.000								
	(0.000)	(0.000)	(0.000)	(0.000)									
LEV_{it}	0.022*	-0.146***	-0.123***	-0.142***	0.085***	1.000							
	(0.064)	(0.000)	(0.000)	(0.000)	(0.000)								
ROA_{it}	-0.338***	0.205***	0.140***	0.171***	0.427***	-0.177***	1.000						
	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)							
MTB_{it}	-0.053***	-0.072***	0.008	0.001	0.254***	0.018	0.187***	1.000					
	(0.000)	(0.000)	(0.526)	(0.943)	(0.000)	(0.121)	(0.000)						
BS_{it}	-0.173***	0.051***	0.034***	0.028**	0.415***	0.052***	0.099***	0.035***	1.000				
	(0.000)	(0.000)	(0.004)	(0.018)	(0.000)	(0.000)	(0.000)	(0.003)					
$INDR_{it}$	0.010	0.020*	0.058***	0.057***	-0.047***	-0.012	-0.046***	0.049***	0.186***	1.000			
	(0.390)	(0.100)	(0.000)	(0.000)	(0.000)	(0.296)	(0.000)	(0.000)	(0.000)				
$BIGN_{it}$	-0.029**	0.073***	0.084***	0.093***	0.171***	-0.019	0.102***	0.004	0.065***	0.044***	1.000		
	(0.015)	(0.000)	(0.000)	(0.000)	(0.000)	(0.119)	(0.000)	(0.735)	(0.000)	(0.000)			
GCO_{it}	0.129***	-0.122***	-0.116***	-0.129***	-0.118***	0.093***	-0.205***	0.149***	0.041***	-0.010	-0.086***	1.000	
	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.001)	(0.386)	(0.000)		
$ADEXP_{it}$	-0.046***	-0.007	0.007	0.002	0.221***	0.042***	0.050***	0.041***	0.151***	-0.027**	0.048***	0.011	1.000
	(0.000)	(0.570)	(0.535)	(0.889)	(0.000)	(0.000)	(0.000)	(0.001)	(0.000)	(0.023)	(0.000)	(0.375)	

*Note: * p < 0.10, ** p < 0.05, *** p < 0.01.*

4.2. Regression result

4.2.1. The result of financial statement comparability on directors' and officers' insurance

Table 4 reports the main regression results examining the effect of financial statement comparability on D&O insurance coverage. Model A presents the baseline ordinary least squares (OLS) estimates from Eq. (1). Across all three specifications, the coefficient on COMP is negative and statistically significant, regardless of whether comparability is measured using the mean value of all peer-firm scores (*COMPIND*, Column (1)), the average of the four most comparable peers (*COMPT4*, Column (2)), or the average of the 10 most comparable peers (*COMPT10*, Column (3)). These results indicate that higher financial statement comparability is associated with lower D&O insurance coverage, consistent with the notion that enhanced comparability mitigates information asymmetry and reduces agency costs. Accordingly, the hypothesis is supported.

Model B of Table 4 re-estimates Eq. (1) using firm fixed effects to address potential concerns about time-invariant unobservable factors that may bias the estimates (Adams & Ferreira, 2009; Kim et al., 2011; Lin et al., 2021). The results remain qualitatively unchanged. The coefficients at *COMP* continue to be negative and significant at conventional levels. This robustness suggests that the documented relationship is not driven by omitted firm characteristics, thereby reinforcing the conclusion that financial statement comparability reduces D&O insurance coverage.

Table 4. Regression result of financial statement comparability on directors' and officers' coverage

Variables	*Model A*			*Model B*		
	Column (1)	*Column (2)*	*Column (3)*	*Column (1)*	*Column (2)*	*Column (3)*
$Comp_{it}$	-0.004***	-0.007**	-0.007***	-0.001**	-0.004	-0.004*
	(0.000)	(0.018)	(0.006)	(0.028)	(0.120)	(0.068)
$SIZE_{it}$	-0.035***	-0.035***	-0.035***	-0.055***	-0.055***	-0.054***
	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)
LEV_{it}	0.020	0.023*	0.021*	0.004	0.004	0.004
	(0.101)	(0.073)	(0.091)	(0.855)	(0.849)	(0.848)
ROA_{it}	-0.136***	-0.149***	-0.145***	0.069**	0.069**	0.068**
	(0.000)	(0.000)	(0.000)	(0.019)	(0.019)	(0.022)
MTB_{it}	0.007***	0.007***	0.007***	0.013***	0.013***	0.013***
	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)
BS_{it}	0.003***	0.003***	0.003***	0.000	0.000	0.000
	(0.001)	(0.001)	(0.001)	(0.715)	(0.666)	(0.675)
$INDR_{it}$	0.007	0.010	0.010	-0.005	-0.004	-0.004
	(0.635)	(0.507)	(0.512)	(0.627)	(0.712)	(0.729)
$BIGN_{it}$	0.021***	0.021***	0.021***	-0.007	-0.006	-0.006
	(0.000)	(0.000)	(0.000)	(0.644)	(0.661)	(0.686)
GCO_{it}	0.024	0.025	0.023	0.035	0.034	0.034
	(0.415)	(0.396)	(0.434)	(0.156)	(0.163)	(0.169)
$ADEXP_{it}$	0.036**	0.037**	0.036**	0.014	0.014	0.014
	(0.019)	(0.018)	(0.020)	(0.248)	(0.243)	(0.242)
Constant	0.305***	0.317***	0.313***	0.509***	0.510***	0.504***
	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)
IND	YES	YES	YES	X	X	X
ID	X	X	X	YES	YES	YES
YEAR	YES	YES	YES	YES	YES	YES
Obs.	9,111	9,111	9,111	9,111	9,111	9,111
R^2	0.329	0.325	0.327	0.835	0.835	0.836
Adj. R^2	0.326	0.322	0.324	0.795	0.795	0.795
F	28.227	27.696	27.864	13.386	13.335	13.331

*Note: * p < 0.10, ** p < 0.05, *** p < 0.01.*

4.2.2. Control for the reverse causality problem

Prior research suggests that D&O insurance may influence firms' financial reporting behavior, raising concerns about potential reverse causality between D&O insurance and financial statement comparability (Chung & Wynn, 2008; Khan & Wald, 2015; Kim, 2015; Weng et al., 2017). For instance, Chung and Wynn (2008) document that higher D&O insurance coverage reduces managers' perceived legal liability, thereby encouraging less conservative financial reporting. Similarly, Weng et al. (2017) find that firms with higher D&O insurance coverage are more likely to restate their financial statements, implying that extensive coverage can weaken financial reporting discipline.

To mitigate this endogeneity concern, we employ a two-stage least squares (2SLS) approach. Following Groves et al. (1994) and prior accounting research that uses lagged values as internal instruments in 2SLS settings (Chang et al., 2006; Cheng et al., 2016), we use the lagged value of financial statement comparability as an instrumental variable. This choice reflects the notion that past comparability affects current comparability but is unlikely to directly influence current D&O insurance decisions beyond its impact through contemporaneous comparability.

The 2SLS regression results are reported in Table 5. Consistent with our baseline findings, the coefficient on financial statement comparability remains negative and statistically significant, indicating that firms with higher comparability purchase lower D&O insurance coverage. This result suggests that our main inference is robust to concerns about reverse causality, reinforcing the interpretation that higher comparability reduces agency costs reflected in D&O insurance coverage.

Table 5. Regression result of financial statement comparability on directors' and officers' coverage: 2SLS

Variables	*Column (1)*	*Column (2)*	*Column (3)*
$Comp_{it}$	-0.005***	-0.005***	-0.006***
	(0.000)	(0.010)	(0.001)
$SIZE_{it}$	-0.036***	-0.036***	-0.036***
	(0.000)	(0.000)	(0.000)
LEV_{it}	0.023***	0.027***	0.026***
	(0.002)	(0.000)	(0.001)
ROA_{it}	-0.120***	-0.141***	-0.137***
	(0.000)	(0.000)	(0.000)
MTB_{it}	0.006***	0.007***	0.007***
	(0.000)	(0.000)	(0.000)
BS_{it}	0.003***	0.003***	0.003***
	(0.000)	(0.000)	(0.000)
$INDR_{it}$	0.007	0.011	0.011
	(0.478)	(0.318)	(0.319)
$BIGN_{it}$	0.021***	0.020***	0.020***
	(0.000)	(0.000)	(0.000)
GCO_{it}	0.016	0.018	0.017
	(0.582)	(0.539)	(0.562)
$ADEXP_{it}$	0.040***	0.041***	0.041***
	(0.000)	(0.000)	(0.000)
Constant	0.292***	0.302***	0.294***
	(0.000)	(0.000)	(0.000)
IND	YES	YES	YES
YEAR	YES	YES	YES
Obs.	9,111	9,111	9,111
R^2	0.336	0.332	0.334
Adj. R^2	0.333	0.328	0.330
Chi^2	1712.83	1698.91	1706.98

*Note: * p < 0.10, ** p < 0.05, *** p < 0.01.*

4.2.3. Change model

To further verify the robustness of our findings, we re-estimate the main regression model using a change specification, which examines whether year-to-year changes in financial statement comparability are associated with corresponding changes in D&O insurance coverage. This approach mitigates concerns about time-invariant omitted variables that could influence both levels of comparability and insurance coverage.

As reported in Table 6, the coefficient assessment of the change in financial statement comparability is negative and statistically significant. This result indicates that an increase in comparability from one year to the next is associated with a decrease in D&O insurance coverage, consistent with our main prediction. Overall, the findings from the change model provide additional evidence that enhanced financial statement comparability reduces firms' D&O insurance coverage and, consequently, agency costs.

Table 6. Regression result of financial statement comparability on directors' and officers' coverage: Change model

Variables	*Column (1)*	*Column (2)*	*Column (3)*
$D.Comp_{it}$	-0.001**	-0.003*	-0.004**
	(0.022)	(0.079)	(0.029)
$D.SIZE_{it}$	-0.006	-0.006	-0.005
	(0.246)	(0.263)	(0.285)
$D.LEV_{it}$	0.006	0.006	0.006
	(0.677)	(0.679)	(0.669)
$D.ROA_{it}$	0.058***	0.059***	0.057***
	(0.003)	(0.004)	(0.004)
$D.MTB_{it}$	0.006***	0.006***	0.006***
	(0.007)	(0.007)	(0.008)
$D.BS_{it}$	-0.000	-0.000	-0.000
	(0.612)	(0.627)	(0.642)
$D.INDR_{it}$	-0.001	-0.002	-0.002
	(0.852)	(0.830)	(0.818)
$D.BIGN_{it}$	-0.005	-0.005	-0.005
	(0.627)	(0.643)	(0.648)
$D.GCO_{it}$	0.013	0.012	0.012
	(0.534)	(0.541)	(0.550)
$D.ADEXP_{it}$	0.007	0.007	0.007
	(0.275)	(0.271)	(0.272)
Constant	-0.012	-0.011	-0.010
	(0.182)	(0.199)	(0.229)
IND	YES	YES	YES
YEAR	YES	YES	YES
Obs.	9,111	9,111	9,111
R^2	0.068	0.069	0.070
Adj. R^2	0.063	0.064	0.065
F	9.160	9.367	9.345

*Note: * p < 0.10, ** p < 0.05, *** p < 0.01.*

4.2.4. Use an alternative measurement of financial statement comparability

As an additional robustness test, we re-estimate our main regression model using an alternative measure of financial statement comparability following Imhof et al. (2017). Specifically, we compute each firm's comparability as the median value of comparability scores relative to all other firms (*j*) within the same industry during year *t*. This alternative specification mitigates potential sensitivity to extreme values in peer-firm comparability.

The results, reported in Table 7, show that financial statement comparability remains negatively and statistically significantly associated with D&O insurance coverage. This finding confirms that the specific construction of the comparability measure does not drive our inferences. Consistent with the primary analysis, the evidence supports our hypothesis that firms with higher financial statement comparability exhibit lower D&O insurance coverage, reflecting reduced agency costs.

Table 7. Regression result of financial statement comparability on directors' and officers' coverage: Alternative measurement

Variables	*Column (1)*	*Column (2)*	*Column (3)*
$Comp\_MED_{it}$	-0.735***	-0.681**	-0.695***
	(0.000)	(0.015)	(0.005)
$SIZE_{it}$	-0.034***	-0.035***	-0.035***
	(0.000)	(0.000)	(0.000)
LEV_{it}	0.016	0.022*	0.021*
	(0.202)	(0.074)	(0.092)
ROA_{it}	-0.107***	-0.149***	-0.145***
	(0.000)	(0.000)	(0.000)
MTB_{it}	0.006***	0.007***	0.007***
	(0.000)	(0.000)	(0.000)
BS_{it}	0.003***	0.003***	0.003***
	(0.001)	(0.001)	(0.001)
$INDR_{it}$	0.008	0.010	0.010
	(0.583)	(0.510)	(0.518)
$BIGN_{it}$	0.022***	0.021***	0.021***
	(0.000)	(0.000)	(0.000)
GCO_{it}	0.019	0.025	0.023
	(0.532)	(0.394)	(0.434)
$ADEXP_{it}$	0.035**	0.037**	0.036**
	(0.025)	(0.018)	(0.019)
Constant	0.294***	0.317***	0.314***
	(0.000)	(0.000)	(0.000)
IND	YES	YES	YES
YEAR	YES	YES	YES
Obs.	9,111	9,111	9,111
R^2	0.339	0.325	0.327
Adj. R^2	0.336	0.322	0.324
F	28.841	27.705	27.869

*Note: * p < 0.10, ** p < 0.05, *** p < 0.01.*

4.2.5. Exclude period of voluntary purchase of directors' and officers' insurance

In 2018, the Taiwan Financial Supervisory Commission (FSC) implemented a major policy reform requiring all firms listed on the TWSE and the TPEx to purchase D&O insurance. This regulatory change introduced an exogenous shift from voluntary to mandatory insurance adoption, which could influence firms' insurance decisions and potentially bias our estimates.

To address this concern and mitigate potential sample selection bias, we re-estimate our model after excluding the pre-mandate period, during which firms voluntarily purchased D&O insurance. Table 8 reports the results. Consistent with our main findings, financial statement comparability remains negatively and significantly associated with D&O insurance coverage.

This robustness test confirms that our primary inference that higher financial statement comparability is associated with lower D&O insurance coverage holds even after accounting for the structural policy change in 2018. Hence, the documented relationship is unlikely to be driven by differences between voluntary and mandatory purchase periods.

Table 8. Regression result of financial statement comparability on directors' and officers' coverage: Exclude voluntary purchase

Variables	*Column (1)*	*Column (2)*	*Column (3)*
$Comp_{it}$	-0.006***	-0.016***	-0.015***
	(0.000)	(0.000)	(0.000)
$SIZE_{it}$	-0.033***	-0.033***	-0.032***
	(0.000)	(0.000)	(0.000)
LEV_{it}	0.019	0.017	0.015
	(0.116)	(0.155)	(0.192)
ROA_{it}	-0.086***	-0.090***	-0.084***
	(0.003)	(0.002)	(0.004)
MTB_{it}	0.005***	0.006***	0.006***
	(0.001)	(0.000)	(0.000)
BS_{it}	0.003***	0.003***	0.003***
	(0.004)	(0.004)	(0.004)
$INDR_{it}$	0.028	0.026	0.024
	(0.276)	(0.300)	(0.330)
$BIGN_{it}$	0.014**	0.015**	0.015**
	(0.020)	(0.011)	(0.012)
GCO_{it}	0.011	0.007	0.007
	(0.734)	(0.832)	(0.849)
$ADEXP_{it}$	0.025**	0.026***	0.025***
	(0.010)	(0.009)	(0.010)
Constant	0.255***	0.263***	0.261***
	(0.000)	(0.000)	(0.000)
IND	YES	YES	YES
YEAR	YES	YES	YES
Obs.	4,747	4,747	4,747
R^2	0.315	0.318	0.321
Adj. R^2	0.310	0.313	0.316
F	33.046	33.008	33.161

*Note: * p < 0.10, ** p < 0.05, *** p < 0.01.*

4.2.6. Financial statement comparability on abnormal directors' and officers' insurance coverage

Prior studies suggest that abnormal D&O insurance coverage captures the extent to which firms purchase insurance beyond levels justified by economic fundamentals, thereby reflecting excessive agency costs. Lin et al. (2013) find that abnormal D&O coverage is positively associated with loan spreads, while Li and Liao (2014) show that firms with higher abnormal coverage exhibit less efficient investment behavior. Similarly, Kalelkar and Nwaeze (2015) document that abnormal D&O insurance coverage is linked to aggressive financial reporting, riskier investment strategies, and abnormal profit performance. Collectively, these findings suggest that abnormal D&O insurance coverage provides a more sensitive measure of agency costs than total coverage. Following prior research, we re-estimate our analyses using abnormal D&O insurance coverage in place of the raw D&O coverage ratio (Core, 1997; Lin et al., 2013; Li & Liao, 2014; Kalelkar & Nwaeze, 2015). Specifically, we estimate expected coverage from the following benchmark model and define abnormal D&O insurance coverage (*ABDOCOV*) as the residual from this regression scaled by the firm's market value of equity:

$$DOCOV_{it} = a_0 + \beta_1 SIZE_{it} + \beta_2 LEV_{it} + \beta_3 INST_{it} + \beta_4 INDR_{it} + \beta_5 ROA_{it} + \beta_6 RETVOL + IND + YEAR + \varepsilon_{it} \quad (6)$$

where:

- $DOCOV_{it}$: The D&O coverage ratio of firm *i* in period *t*.
- $SIZE_{it}$: The natural log of the market value of firm *i* in period *t*.
- LEV_{it}: The debt ratio of firm *i* in period *t*.
- $INST_{it}$: The stock holdings of institution shareholders of firm *i* in period *t*.
- $INDR_{it}$: The ratio of independent directors of firm *i* in period *t*.
- ROA_{it}: The return on assets of firm *i* in period *t*.
- $RETVOL_{it}$: The volatility of the annualized stock return of firm *i* in period *t*.
- *IND*: Industry's fixed effect.
- *YEAR*: Years fixed effect.
- ε_{it}: The residual of firm *i* in period *t*.

The results, presented in Table 9, show that financial statement comparability is negatively and significantly associated with abnormal D&O insurance coverage across all three comparability measures: the mean industry-wide comparability (*COMPIND*, Column (1)), the average of the four most comparable peers (*COMPT4*, Column (2)), and the average of the 10 most comparable peers (*COMPT10*, Column (3)). These findings reinforce our central argument that higher financial statement comparability enhances the information environment, reduces litigation risk, and consequently lowers agency costs both in terms of total and abnormal D&O insurance coverage.

Table 9. Regression result of financial statement comparability on abnormal directors' and officers' coverage

Variables	*Column (1)*	*Column (2)*	*Column (3)*
$Comp_{it}$	-0.004***	-0.006**	-0.006**
	(0.000)	(0.039)	(0.013)
$SIZE_{it}$	-0.003	-0.004*	-0.003
	(0.134)	(0.099)	(0.117)
LEV_{it}	-0.005	-0.004	-0.005
	(0.682)	(0.767)	(0.705)
ROA_{it}	0.024	0.014	0.018
	(0.369)	(0.611)	(0.520)
MTB_{it}	0.002	0.003*	0.003*
	(0.131)	(0.068)	(0.080)
BS_{it}	0.003***	0.003***	0.003***
	(0.001)	(0.001)	(0.001)
$INDR_{it}$	0.009	0.011	0.011
	(0.542)	(0.450)	(0.456)
$BIGN_{it}$	0.020***	0.020***	0.020***
	(0.000)	(0.000)	(0.000)
GCO_{it}	0.017	0.017	0.016
	(0.559)	(0.551)	(0.588)
$ADEXP_{it}$	0.036**	0.036**	0.036**
	(0.019)	(0.018)	(0.019)
Constant	-0.028*	-0.019	-0.021
	(0.085)	(0.243)	(0.187)
IND	YES	YES	YES
YEAR	YES	YES	YES
Obs.	9,111	9,111	9,111
R^2	0.026	0.023	0.025
Adj. R^2	0.022	0.018	0.020
F	4.227	3.267	3.444

*Note: * p < 0.10, ** p < 0.05, *** p < 0.01.*

5. CONCLUSION

This study examines the relationship between financial statement comparability and D&O insurance coverage using data from firms listed in Taiwan's capital market. We document a negative and significant association between financial statement comparability and D&O insurance coverage. The results remain robust after controlling for potential omitted-variable bias, reverse causality, and sample selection issues. Consistent findings are obtained from change analyses when applying alternative measures of comparability. Furthermore, we show that financial statement comparability also reduces abnormal D&O insurance coverage, suggesting that enhanced comparability mitigates excessive agency costs.

Our findings yield several implications for both practice and research. From a corporate governance perspective, firms can reduce agency costs by improving the comparability of their financial statements, thereby enhancing transparency and accountability. Under the mandatory D&O insurance regime introduced in Taiwan, improving comparability may help firms more efficiently determine appropriate coverage levels. From an insurance perspective, our results offer valuable insights into insurers' underwriting and pricing decisions. Higher financial statement comparability allows insurers to assess litigation risk and price coverage more accurately, improving the overall quality of D&O insurance contracting. Collectively, these findings underscore the broader benefit of enhancing financial reporting quality in reducing agency costs and strengthening stakeholder confidence.

This study is subject to several limitations that provide opportunities for future research. First, our analysis focuses on Taiwan, where legal, regulatory, and litigation environments may differ from those in other markets. Future studies could extend this research to alternative institutional settings to test the generalizability of our findings. Second, we employ D&O insurance coverage as a proxy for agency costs. Following Jensen and Meckling (1976), future research could explore alternative proxies such as audit fees, executive compensation design, or internal control quality to capture different dimensions of agency costs. Finally, due to data limitations, we are unable to examine how financial statement comparability affects audit fees in the Taiwanese context. Future research could investigate this relationship to provide additional evidence on the governance role of financial statement comparability.

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