

Do Sophisticated Investors Understand Accounting Quality? Evidence from Bank Loans

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BIS

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Background

Firm value depends on the future cash flows' level and riskiness.

Shareholders appear to over-estimate the implications of accounting accruals for future cash flows.

Sloan [1996] and Xie [2001]

Abnormal returns on zero-wealth portfolios that are long low-accrual firms and short high-accrual firms.

Bhojraj – Swaminathan 2004

The Basic Idea

Greater accruals make it more difficult to predict cash flows

Forecast errors, σ , are larger for firms with high abnormal accruals. Think of higher PD and LGD.

Hence, debt with higher σ requires a higher promised return.

Why don't rational stock and bond investors see through the accounting distortions?

This paper investigates whether another ("informed" or "special") investor can see through the noise – banks making loans recorded in DealScan.

Findings

The authors find that higher UAA →

- higher loan rate
- lower maturity
- higher probability of collateral
- (Univariate) lower probability of performance pricing in the loan contract.

The empirical work is very nicely done, particularly when comparing signed vs. unsigned abnormal accrual concepts.

The authors identify two possible reasons why higher UAA means higher loan rates.

a) Same info, but harder to gather.

b) Less information is available.

They conclude it is "b" because fees don't vary with UAA.

Additional evidence points in the same direction:

maturity down

more likely to have collateral

less performance pricing

Thus, it seems safe to say that the accounting raises uncertainty about the firm.

Interpretations

1. Banks are special – “smarter” than stock or bond investors.
2. Limited information about a firm
 - a) Is a priced source of risk
 - b) Therefore lowers firm value.
3. Accounting quality affects the firm’s cost of debt, and hence its cost of capital.

Can the three conclusions be taken at face value?

The fact that *contract* rates are positively related to UAA does not mean that *realized* returns are unusually high or low.

Sloan's and Xie's papers measure *ex post* stock price performance.

This LPC evidence here concerns contract design.

Conclusion #1: Banks are special –
“smarter” than stock or bond
investors.

How do we know the contract rate's
sensitivity to UAA has the right
magnitude?

Need *ex post* realizations to analyze the
banks' underwriting ability.

Conclusion #2: Limited information is a priced source of risk and hence lowers firm value.

True because uncertainty raises cost of debt (and "debt overhang").

But this seems different from the idea of "priced information risk" in the asset pricing literature. It seems idiosyncratic and diversifiable.

Conclusion #3: Accounting quality affects the firm's cost of debt, and hence its cost of capital.

This one seems obvious.

But does high UAA raise the cost of debt relative to

- other firms, with lower UAA?
- THIS firm, if it did its accounting differently?

Summary

- Great idea
- Very solid empirics
- The implications need more refined interpretations.

Smaller points/suggestions

- 1. Marginal loan maturity vs. overall (average) maturity – as in page 19 discussion of their result vs. Barclay-Smith
- 2. “loan concentration” variable is meaningless, I think – see page 19.
- 3. Is this a problem: Bias to lagged cash flow variables in Table VIA panel regressions.?
- 4. INTUITIVELY VERY APPEALING.
- 5. Identify nicely two alternative interpretations (page 23)
 - Same info, at higher cost to obtain
 - Worse info
- 6. Should interact asset beta measure with leverage.
- It would be nice to see more about the correlations between UAA or SAA and various firm features, particularly CF vol, reported earnings
- 7. instead of, or in addition to, figure 1, report t-stat for equality of SAA coefficient pairs in Table V.C.
- 8. Investigate interaction between many variables and UAA, as noted in Table III B. As they do in Table IV for “Regulated*capital Mkt Access”. E.g. leverage, profitability, cfo volatility, market-to-book. It seems likely that firms with extreme accruals will differ in how the market interprets these numbers. In some of these case, the signed UAA might be appropriate – e.g. I’m really upset/confused by a firm that reports large positive accruals and lower earnings. But not so upset if the reported earnings are large.
- Other econometric observations
 - Need clustering adjustment to standard errors, I think.

You should know about (if you don’t already) a paper by Gande, Saunders, and Walter, which compares prices for bonds and traded bank loans to the same firm: “Informational Efficiency of Loans versus Bonds: Evidence from Secondary Market Prices” (with Edward Altman, and Anthony Saunders), April 2004.