Comments on
*Do Sophisticated Investors Understand Accounting Quality? Evidence from Bank Loans*

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The views expressed here are those of the author and not necessarily those of the Federal Reserve Bank of New York or the Federal Reserve System.
Paper’s data & method

• Data
  – US data on syndicated loans

• Method
  – Estimate regressions of the type
    \[ Y = C + \alpha \cdot AA + \beta \cdot X + \theta \cdot Z + \epsilon \]

where:
AA = Firm abnormal accruals
X = Vector of other firm characteristics
Z = Vector of loan characteristics
Y = Loan spreads, Loan maturity or Loan secured dummy
Paper’s main results

• Ceteris paribus, firms with higher AA:
  – pay higher spreads on their loans
  – have loans with a shorter maturity
  – are more likely to have secured loans
Comments

• Data
  – Sample selection: 10,000 loans ⇒ 4,500 loans

• Other controls worth considering
  – Was the loan syndicated?
  – Number of lenders in the syndicate
  – Did the borrower have a guarantor?
  – Were there dividend restrictions imposed on the borrower?
  – What is the borrower’s sector of activity?

• Estimation strategy
  – When risk controls are included, dummies on loan type, loan purpose, on whether the loan is secured, and profitability controls are excluded
Definition of abnormal accruals

\[ AA = \left| \frac{\text{Firm total accruals}}{\text{Assets}} - \text{Firm normal accruals} \right| \]

Total accruals = Earnings before extraordinary items and discontinued operations - operating cash flow

Normal accruals is an estimated measure of the firm’s accruals

• Authors’ interpretation of AA

“...we interpret a large unsigned abnormal accrual as a high abnormal deviation between cash flows and earnings of a firm that makes it harder for outside investors to discern the true economic performance”

• According to the authors AA is a good proxy of accounting quality
Comments

• Why does a large AA makes it harder for “outside investors to discern the true economic performance”?  
  – AA is computed based on publicly available information

• In what sense is AA a good proxy of *accounting quality*?
  – Shouldn’t a proxy for *accounting quality* of a firm be solely dependent on the information/fundamentals of that firm?

• Why cannot AA be interpreted instead as a proxy for risk/uncertainty and/or opaqueness/complexity?
Do Sophisticated Investors Understand Accounting Quality?

- The authors argue that because banks take into account AA this proves they understand accounting quality.
- They also argue that this provides evidence that other “sophisticated investors misprice the information contained in financial statements” as “various papers have documented that stock market investors as well as sophisticated bond market investors do not seem to price poor accounting quality as reflected in accruals.”
- They further argue that their findings “provides direct evidence supporting the specialness of banks.”
Comments

• Does this paper proves that banks understand accounting quality?
  – Note that banks have access to private information.

• Does the relationship the authors find constitutes supporting evidence that investors in other markets misprice available information?
  – The information that is relevant for pricing stocks does not coincide with the relevant information for pricing debt securities
  – The same, though to a less extent, is valid for bonds.
  – Furthermore, it is possible that bond market investors do not take into account AA because other variables account for the effect of this variable. Note that, ceteris paribus, split ratings increase bond credit spreads at issue date by about 7 bp, Santos (2003).

• Does the paper provides direct evidence that banks are special?