MANDATORY DISCLOSURE REQUIREMENTS AND RATING AGENCY CATERING:
A STUDY OF THE RULE CHANGES FOR QUALIFIED SPECIAL PURPOSE ENTITIES

A Dissertation in
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by
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Abstract

This study investigates whether mandatory disclosure requirements for Qualified Special Purpose Entities (i.e., QSPEs) under SFAS 166/167 weakened credit rating agencies’ ability to provide bond issuers with inflated initial credit ratings (i.e., “cater” to bond issuers) by previously understating firms’ QSPE exposures. I find that once mandatory disclosure requirements concerning QSPEs were implemented under SFAS 166/167, rating agencies were less likely to provide inflated initial credit ratings to issuers with QSPE exposures. In addition, I also show that bond investors required less price protection when assessing the riskiness of such entities in the post-period, suggesting that bond investors accounted for rating agencies’ aggressive behavior in the pre-period. Collectively, these findings suggest that rating agencies provided inflated initial credit ratings to issuers with QSPE exposures because of disclosure exemptions under SFAS 140/FIN 46(R), but that mandatory disclosure requirements under SFAS 166/167 reduced such behavior by decreasing information asymmetry.
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1. Introduction

This study investigates whether mandatory disclosure requirements for Qualified Special Purpose Entities (i.e., QSPEs) under SFAS 166/167 weakened credit rating agencies’ ability to provide bond issuers with inflated initial credit ratings (i.e., “cater” to bond issuers) by previously understating firms’ QSPE exposures. Rating agency catering has been the focus of much recent debate concerning the problems inherent both before and during the 2008 financial crisis (SEC, 2008b; Credit Suisse, 2010). Some of the more serious concerns stem from rating agencies’ failures to articulate their reasoning for making (or failing to make) certain adjustments to firms’ financial statements in the years leading up to the financial crisis, their failure to verify key information prior to assigning credit ratings, and their inability to keep analysts from learning about the fees charged to debt issuers (SEC, 2008a). In addition, rating agencies turned over their models to certain bond issuers as the real estate bubble of the mid-2000s gained momentum, allowing such issuers to reverse engineer certain securitizations to achieve their desired rating (Smith, 2008; Morganson & Story, 2010).¹

Credit rating agencies have incentives to cater to bond issuers. For instance, issuers can provide rating agencies with more business in exchange for favorable credit ratings (Partnoy, 1999). In addition, issuers can threaten to use an alternate rating agency if satisfactory ratings are not provided, a practice known as “ratings shopping” (Partnoy, 2006; Skreta & Veldkamp, 2009). Bond issuers also benefit from receiving inflated credit ratings via lower financing costs, access to additional capital, and fewer disclosure requirements (Rosenkranz, 2009; Sorkin, 2009; Morgenson and Story, 2010).

Rating agencies could succeed in providing inflated ratings due to the mystique surrounding their rating parameters, particularly concerning the effects that qualitative adjustments have in offsetting quantitative adjustments (Kraft, 2011b). In addition, until recently rating agencies’ litigation risk has been very low with respect to ratings misrepresentation (Partnoy, 2006), further awarding rating agencies’ the opportunity to cater to bond issuers. This is particularly relevant as prior research suggests that rating

¹ For instance, a former Moody’s employee said, "I knew it was wrong at the time… It was either that or skip the business. That wasn't my mandate. My mandate was to find a way. Find the way."
agencies tradeoff their reputations during economic boom and bust cycles in an effort to maximize revenues when times are good and business is plentiful, while reversing such policies to rebuild their reputations when times are bad and market trust is of the utmost importance (Bar-Isaac and Shapiro, 2013).

QPSEs could have allowed rating agencies to cater to bond issuers. Since QSPEs were originally considered “passive” entities comprised of “easy-to-understand” securitization transactions, the Financial Accounting Standards Board (FASB) excluded such entities from consolidation consideration and discussion in firms’ public financial filings, even during times when other special purpose entities (i.e., SPEs) were believed to lead to significant financial misrepresentation (i.e., early 2000s). Over time, however, the nature of QSPEs changed as firms sought to hide more aggressive securitization transactions within QSPEs themselves, decreasing the passivity of such entities. Collectively, these characteristics could have allowed rating agencies to understate firms’ QSPE exposures, resulting in inflated credit ratings.

QSPEs eventually became part of the larger problem of complex and opaque transactions that are believed to have significantly influenced the 2008 financial crisis. For example, prior to the 2008 financial crisis many QSPE transactions began to center around complex mortgage securitizations, such as collateralized debt obligations (CDOs) and collateralized loan obligations (CLOs). In 2008, FASB Chairman Robert Herz described the more risky assets being put into QSPEs as follows, "the real problem, in hindsight, was that the assets were not Q-able," emphasizing that such assets required "intensive restructuring" that would not have been permitted for QSPEs (Leone, 2008). This led FASB to issue SFAS 166/167 in June 2009 which required firms to consolidate the QSPEs they controlled. In addition, the new rules aimed to “…enhance disclosures to provide financial statement users with greater

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2 Prior to the mid-2000s real estate bubble, common QSPE assets were accounts receivables, trust preferred securities, credit card loans, student loans, among others (Credit Suisse, 2010).

3 Rating agency catering can take several forms: 1) falsifying credit ratings despite the information provided to rating agencies from bond issuers, 2) failing to verify key information provided by issuers, and 3) failing to obtain relevant information from bond issuers, leading to “best estimates” concerning opaque transactions. Certain of these methods are more deliberate than others. However, since each method is likely to result in inflated credit ratings, it is beyond the scope of this paper to determine the severity of each method employed.
transparency about transfers of financial assets and a transferor’s continuing involvement with transferred financial assets… and improve transparency in financial reporting about an enterprise’s involvement with a variable interest entity…” (FASB 2009a; FASB, 2009b).

This rule change provides a strong setting in which to examine rating agency catering for two reasons. First, disclosure exemptions under SFAS 140/FIN 46(R) did not allow financial statement users to accurately determine firms’ QSPE exposures. In addition, information about certain QSPE transactions, such as mortgage-backed securities (MBS), was considerably opaque and difficult for these users to obtain. Conversely, rating agencies could have used their access to private information to accurately determine firms’ QSPE exposures. For example, rating agencies provide ratings for QSPEs that are distinct from corporate ratings. Hence, rating agencies receive detailed information concerning QSPEs’ assets, as well as updated information in the event QSPE investors request certain assets be replaced via a “kick out” option. Such replacements typically require rating agencies to rerate the QSPE. Since rating agencies could have more easily accessed key information concerning QSPEs compared to corporate bond investors, substantial information asymmetry could have existed between both groups under SFAS 140/FIN 46(R).

Second, SFAS 166/167 requires firms to fully disclose key information related to consolidated QSPEs, coupled with sensitivity analysis in the event key estimates change. By design, the new disclosure requirements made it easier for financial statement users to determine who ultimately controlled, and therefore were responsible for, QSPEs, as well as the magnitude of firms’ exposures (Credit Suisse, 2010; Deloitte & Touche, 2010; Grant Thornton, 2010; Oz, 2013). These characteristics allow me to employ a difference-in-differences research design to address my primary research question and determine whether rating agency catering was in fact as large of a concern as many market participants believed it to be.

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4 For a detailed discussion about the information available to rating agencies concerning various QSPE transactions, see Higgins & Mason (2004), Higgins & Rosner (2007), Stanton & Wallace (2010), Black et al. (2012), and Furfine (2012).

5 See Appendix for a more detailed discussion as to the different information available to both QSPE investors and credit rating agencies during QSPE securitizations.
Using the change from SFAS 140/FIN 46(R) (disclosure exempt regime) to SFAS 166/167 (mandatory disclosure regime), I investigate whether initial credit ratings assigned to bonds issued by firms with QSPE exposures weakened relative to initial credit ratings assigned to bonds issued by firms without QPSE exposures. To provide additional evidence, I also analyze the impact of mandatory disclosure requirements on bond market investors. Prior research suggests an inverse relationship between credit ratings and bond yield spreads (Ziebart et al., 1992). However, bond investors may require greater price protection for debt instruments when uncertainty about future payments on such instruments is considerably high (Duffie and Lando, 2001; Gagliardini et al., 2009). If bond investors had difficulty determining firms’ ultimate QSPE exposures and were aware of rating agencies’ propensity to cater to firms with QSPE exposures in the pre-period, then initial yield spreads for bonds of such issuers should decline relative to the initial yield spreads of bonds for issuers without QSPE exposures post-implementation. This is particularly true as new mandatory disclosure requirements would lead to decreased information asymmetry between rating agencies and bond investors in the post-period.

However, the possibility exists that a change in initial credit ratings and yield spreads following the implementation of SFAS 166/167 was attributable to the bond market learning over time about firms’ QSPE transactions rather than rating agency catering. Such learning was possible as significant, although daunting information concerning various QSPE transactions was available through numerous channels prior to SFAS 166/167. Given this, bond investors could have assessed issuers’ credit quality to be deteriorating over time, to which they could have priced debt securities accordingly, resulting in increased initial yield spreads for firms with significant QSPE exposures relative to firms without QSPE exposures in the post-period.

Consistent with my expectations, I find that initial credit ratings of bonds issued by firms with QSPE exposures declined relative to initial credit ratings of bonds issued by firms without QSPE exposures post-SFAS 166/167 implementation. In addition, I show that initial yield spreads for newly issued bonds

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6 For instance, certain property/borrower information is typically publicly available, while less aggressive transactions are considered easier to analyze, among others (Higgins & Mason, 2004; Higgins & Rosner, 2007; Stanton & Wallace, 2010; Black et al., 2012; Furfine, 2012).
declined for the former relative to the latter post-implementation. Taken together, these results suggest that rating agencies used disclosure exemptions under SFAS 140/FIN 46(R) to provide inflated initial credit ratings to issuers with QSPE exposures, but that such activities declined following the implementation of mandatory disclosure requirements with respect to QSPEs under SFAS 166/167. These findings also provide support for the notion that bond market investors benefitted from the passing of SFAS 166/167 via decreased information asymmetry, and thus were able to more accurately price debt securities for firms with significant QSPE exposures in the post-period.\(^7\)

These findings provide the first evidence that disclosure exemptions allow rating agencies to understate firms’ ultimate credit risk and cater to bond issuers. Currently, several similar opportunities exist, such as those related to derivative transactions, as well as various instances where considerable estimation is required concerning amounts reported on firms’ financial statements that are not readily disclosed. Future research may be able to address some of these instances.

These findings also clarify the cause of credit risk understatement documented in prior research (Kraft, 2011b; Barth et al., 2012). Until now, whether credit risk understatement is due to either a failure by rating agencies to adequately assess issuers’ true exposure to complex off-balance sheet transactions or the conflicts of interest to cater to clients has remained an open question.\(^8\) My findings suggest that credit risk understatement is due to rating agencies’ incentives to cater to bond issuing clients as rating agencies did not benefit from increased information precision post-FAS 166/167; thus, rating agencies should not have changed their assessments of issuers’ ultimate credit risk related to complex off-balance sheet transactions unless the incentives or risks afforded to them from prior disclosure exemptions had changed.

My study can also be of significance to regulators as my findings shed light on the success that mandatory disclosure requirements can have on rating agencies’ behavior. This is especially relevant as catering appears to have occurred with some frequency over the past two decades, suggesting that prior

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\(^7\) These results compliment prior research that suggests SFAS 166/167 reduced information asymmetry for equity market participants concerning securitizing banks (Oz, 2013) and brought about significant new information to such participants concerning firms’ off-balance sheet transactions (Bonsall and Bozanic, 2012).

\(^8\) Consistent with conflicts of interest in rating agencies’ revenue models, Kraft (2011b) suggests that off-balance sheet amounts can be underweighted for certain issuers by offsetting quantitative adjustments with qualitative ones.
crises and the rule changes that accompanied some of them were not enough to eliminate catering behavior over time. In addition, the findings of my study may encourage market participants to reconsider the weight given to credit ratings, particularly with respect to ratings ongoing use via various contracting mechanisms.

The remainder of my paper proceeds as follows. In the next section I provide a background on SFAS 166/167. In Section 3 I present my hypothesis, while in Section 4 I discuss my research design and sample composition. In Section 5 I present the results of my analyses, while in Section 6 I conclude my paper.
2. **SFAS 166/167 Background**

QSPEs were traditionally considered to be a special kind of SPE that were comprised of “easy-to-understand” transactions such as credit cards, auto loans, among others. Firms structured QSPEs and sold QSPE-related securities to investors in a manner similar to those for more complex SPEs. For instance, the securitizing firm transfers assets to a QSPE in exchange for a financial interest in the QSPE, and receives cash from QSPE investors. In exchange for cash, investors receive securities that signify their interest in the QSPE. QSPEs were considered “passive” due to both the simplistic nature of the assets typically put into such entities, in addition to the fact that QSPEs were considered “brain dead” as sponsoring firms had no control over a QSPE’s assets; thus, their primary purpose was to receive and distribute the cash flows related to their assets (Deloitte & Touche, 2001).

The accounting rules that governed whether SPEs were to be on- or off-balance sheet have changed several times over the past two decades. For instance, in 1996 SFAS 125 was issued, only to be replaced by SFAS 140 in 2000. This further changed when FIN 46(R) came about in 2003 as a result of several corporate failures related to SPEs (i.e., Enron, among others). QSPEs evolved post-FIN 46(R) as firms created or repackaged more complex securities that could be bundled and sold to investors. This was done in an effort to recover lost securitization volumes with respect to certain transactions brought about by the implementation of FIN 46(R).\(^9\) Because FIN 46(R) led to lower volumes of certain aggressive transactions that were traditionally excluded from QSPEs, firms altered QSPEs to become a conglomeration of “hard-to-evaluate” transactions that decreased transparency within firms’ financial disclosures.\(^10\)

With each rule change the new rules attempted to clarify the definition and classification of SPEs, with little benefit to financial statement users. Throughout this timeframe, firms were not required to consolidate their QSPE exposures, nor were firms required to disclose any key information or provide any

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\(^9\) For example, Bens and Monahan (2008) suggests that firms drastically reduced their use of asset-backed commercial paper post-FIN 46(R).

\(^10\) The most common securities that lessened the passivity of QSPEs were mortgage-backed securities (MBS), CDO/CLOs, among others (Credit Suisse, 2010).
meaningful discussion concerning such transactions in their public filings with the Securities and Exchange Commission (SEC).

Despite their best efforts, the financial crisis of 2008 highlighted that market participants still did not fully understand the risks associated with off-balance sheet securitizations. Thus, in mid-2008 FASB began discussions concerning new accounting standards that would clarify firms’ QSPE exposures and streamline the methods in which firms determined whether SPEs and QSPEs were to be consolidated or deconsolidated. This process lasted roughly a year, leading firms to only briefly mention if they would possibly be affected by the implementation of the new accounting standards.

For example, SLM Corporation stated in its December 31, 2008 10-K:

“...Based on the Company’s preliminary review of these exposure drafts, it is likely that these changes will lead in general to the consolidation of certain QSPEs that are currently not consolidated by the Company. Assuming no changes to the Company’s current business model, the Company would most likely consolidate its securitization trusts that are currently off-balance sheet on January 1, 2010, based on these exposure drafts as currently written. These proposed new accounting rules would also be applied to new transactions entered into from January 1, 2010 forward. However, the impact to the Company’s accounting for its QSPEs and VIEs cannot be determined until the FASB issues the final amendments to SFAS No. 140 and FIN No. 46(R) which is expected sometime in 2009...”

Ultimately, the FASB responded by issuing SFAS 166, Accounting for Transfers of Financial Assets, an amendment to SFAS 140 (codified in ASC 860, Transfers and Servicing) and SFAS 167, Amendments to FIN 46(R), (codified in ASC 810, Consolidation) on June 12, 2009. The new rules were required to be implemented on January 1, 2010, although firms were encouraged to discuss the expected impact from adoption as early as June 2009.\footnote{Professional auditing guidance states, “If an accounting change has no material effect on financial statements in the current year, but the change is reasonably certain to have a substantial effect in later years, the change should be disclosed in the notes to the financial statements (AU Section 420.20).”}

Under SFAS 166/167 firms are required to disclose and discuss several key characteristics with respect to all SPEs (Deloitte & Touche, 2010; Grant Thornton, 2010; Henry & Holzmann, 2010;
Reinstein et al., 2012). First, a separate balance sheet presentation for consolidated SPEs is required, provided SPEs’ assets can only be used to settle their liabilities. Second, firms are now required to provide additional information concerning the initial fair value measurements of consolidated SPE assets and liabilities, particularly key assumptions used to arrive at fair value (i.e., discount rates, default rates, among others), as well as any changes in key risks and assumptions associated with such activities.

Third, firms must disclose any restrictions on consolidated SPE assets and liabilities, including the carrying amounts of such assets and liabilities. Lastly, firms must provide users with the current financial effects concerning firms’ involvement with such SPEs, as well as the potential financial effects if conditions materially change. These required disclosures should not only help financial statement users better understand the nature of firms’ exposures to SPEs, but also the impact that such transactions can have on firms’ future financial performance.
3. **Hypothesis Development**

Credit rating agencies have incentives to cater to bond issuers. These stem from the possibility that rating agencies will be rewarded with more business by bond issuers in exchange for favorable ratings (Partnoy, 1999; Jiang et al., 2012). Bond issuers care a great deal about their credit ratings as they can influence their capital structure and capital investment decisions (Graham and Harvey, 2001; Kisgen, 2006; Kisgen, 2009). Such concerns can arise given the importance both firms and bond investors place on the broad credit rating category firms’ ratings fall into (e.g., AA, A, BBB). This is due to the fact that capital market access is generally restricted around broad credit rating categories (Cantor and Packer, 1995), coupled with the fact that bond investors tend to pool bonds within a broad rating category of sharing similar credit risk characteristics (Kisgen, 2006). Given this, rating agencies could have been more willing to provide issuers with more favorable credit ratings, or simply fail to obtain or verify pertinent issuer-provided information, thus allowing issuers to more easily access capital markets and obtain lower cost financing due to inflated credit ratings.

Disclosure exemptions under SFAS 140/FIN 46(R) concerning QSPEs could have afforded rating agencies opportunities to overstate issuers’ credit quality, and thus provide inflated initial credit ratings to issuers. In fact, firms routinely cited SFAS 140/FIN 46(R) as the primary reason they did not discuss any potential involvement in QSPEs. Given this, disclosure exemptions under SFAS 140/FIN 46(R) made it nearly impossible for financial statement users to discern firms’ QSPE exposures. In addition, information about certain QSPE transactions, such as asset-backed securities (ABS) and MBS, were considerably opaque and difficult for these users to obtain. Likewise, multiple firms were typically involved in a QSPE, making it even more difficult to determine who was ultimately responsible for the entity during the pre-period.\(^\text{13}\)

\(^{12}\) Such broad rating categories can also have reputational effects of firms’ managers as “pooling” of credit risk characteristics can cause investors to view strong and weak firms within the same broad rating category as similar, even if such firms are not.

\(^{13}\) While more than one entity can still be involved post-SFAS 166/167, the new rule clarifies who is ultimately responsible for securitization transactions.
Rating agencies, however, did not suffer from disclosure exemptions as prior research suggests that rating agencies were significant participants in the creation of QSPE transactions and had access to private information (Higgins & Mason, 2004; Higgins & Rosner, 2007; Stanton & Wallace, 2010; Black et al., 2012; Furfine, 2012). For example, rating agencies routinely received detailed information on even the most complex QPSE transactions, particularly with regard to ABS and MBS transactions. In most instances, this included detailed property characteristics, as well as historical operating performance of each asset. These stark differences potentially created substantial information asymmetry in the pre-period between bond investors and rating agencies.

Due to disclosure exemptions concerning QSPEs under SFAS 140/FIN 46(R), as well as QSPEs’ potential for large profits, QSPE transaction volumes and amounts outstanding skyrocketed in the years leading up to the 2008 financial crisis. For example, according to the Securities Industry and Financial Markets Association (SIFMA) the average annual volume of certain non-agency mortgage-backed securities increased from $275 billion in 2002 to a peak of $780 billion in 2006 (See Figure 1). Similarly, the amount of certain U.S. non-agency mortgage-backed securities outstanding increased an alarming 190% over the same span to reach $1,992.6 billion (see Figure 2). These specific securities have taken considerable time to wind down as roughly $1.45 trillion remained outstanding as of calendar year end 2011 (SIFMA, 2011). This rapid rise in volumes increased the difficulty involved with analyzing and understanding QSPEs as greater securitization volumes were comprised of more complex (i.e., less passive) transactions. These characteristics, coupled with disclosure exemptions, created an environment that allowed rating agencies to understate issuers’ QSPE exposures under FAS 140/FIN 46(R), resulting in more favorable, albeit inflated initial credit ratings.

These conditions significantly changed after the 2008 financial crisis as FASB believed that firms were benefitting from disclosure exemptions that were no longer adequate. For example, upon initial discussions of SFAS 166/167, FASB Chairman Herz stated in 2008, “QSPEs were originally intended as passive entities but morphed into something different. Unfortunately, it seems that some folks used Qs

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14 Note that the amount outstanding peaked in 2007 at $2,353.3 billion (SIFMA, 2011).
like a punchbowl to get off-balance sheet treatment while spiking the punch. That has led us to conclude that now it’s time to take away the punchbowl” (Herz 2008, 11). This forced FASB to introduce a more comprehensive set of rules that not only significantly changed firms’ disclosure requirements with respect to QSPEs, but also changed the focus from quantitative to qualitative determinants when determining who ultimately controls a QSPE and therefore must consolidate it. The goal was to make it much more difficult for firms to skirt around the new standards by simply restructuring such entities to avoid consolidation and discussion, as was common under FIN 46(R).\textsuperscript{15} Given this, I hypothesize that mandatory disclosure requirements negatively impacted the initial credit ratings assigned to bonds issued by firms with QSPE exposures relative to the initial credit ratings assigned to bonds issued by firms without QSPE exposures.

Several considerations could prevent me from finding significant results with respect to my hypothesis. First, rating agencies face severe reputation risks from providing inaccurate ratings as their ratings have become more heavily relied upon over time by both regulators and market participants (Cantor & Packer, 1995; Covitz & Harrison, 2003; Cheng & Neamtiu, 2009; Bolton et al., 2012).\textsuperscript{16} Therefore, any reduction in capital in the eyes of market participants could potentially decrease the value that rating agencies provide to issuers (Jung et al., 2012). This is particularly true as my study examines a period in which rating agencies had time to respond to deteriorating market conditions prior to SFAS 166/167 implementation, potentially salvaging their reputations. Second, rating agencies state that they adjust firms’ financial statements for off-balance sheet transactions (Jonas, 2006; Kraft, 2011a; Fitch, 2012; Standard & Poor’s, 2012), resulting in lower credit ratings. Lastly, the participants engaged in investing in and the underwriting of QSPE transactions are considered “highly sophisticated” and have access to much of the same information inherent during the rating process that the rating agencies have. In addition, the financial crisis of 2008 could have forced market participants to request greater information from firms with respect to any securitization activities. These arguments suggest that rating

\textsuperscript{15} See Section 2 for a detailed discussion of the changes brought about by SFAS 166/167.

\textsuperscript{16} In addition, Jorion et al. (2005) suggest that market participants weight rating agencies’ actions more heavily post-Regulation Fair Disclosure due to their continued access to material nonpublic information.
agency catering in the pre-period could have been difficult and impractical to participate in, which would prevent me from finding significant results with respect to my hypothesis.
4. Research Design and Sample Selection

4.1. Research Design

4.1.1. Initial Credit Ratings

To test whether credit rating agencies used disclosure exemptions under SFAS 140/FIN 46(R) to cater to firms with QSPE exposures I employ a difference-in-differences design similar to Callahan et al. (2012) to examine the relationship between initial credit ratings and firms’ use of off-balance sheet financing via QSPEs. Employing the difference-in-differences research design allows me to attribute the changes in rating characteristics for the test group in excess of changes for the control group to the treatment effect of mandatory disclosure requirements concerning firms’ QSPE exposures. I estimate this relation using the following ordinary least squares regression, clustered by firm to control for cross-sectional dependence:

\[ \text{Rating}_t = \beta_0 + \beta_1 \text{Post} + \beta_2 \text{QSPE} + \beta_3 \text{Post} \times \text{QSPE} + \beta_4 \text{Size}_{t,t-1} + \beta_5 \text{L-TDebt}_{t,t-1} + \beta_6 \text{ROA}_{t,t-1} + \]
\[ + \beta_7 \text{MB}_{t,t-1} + \beta_8 \text{YOY}_{t,t-1} + \beta_9 \text{Loss}_{t,t-1} + \beta_{10} \text{Face}_{t,t-1} + \beta_{11} \text{Mat}_{t} + \epsilon \]

(1)

where \( \text{Rating} \) is the average of both Moody’s Investors Service (Moody’s) and Standard and Poor’s (S&P) initial credit ratings for an individual bond. \( \text{Rating} \) takes an ordinal value of 21 for the highest rated bonds (i.e., AAA on S&P’s rating scale) and 1 for the lowest rated bonds (i.e., C). Following Morgan (2002), I use initial credit ratings versus subsequent ratings as the latter could suffer from “staleness” in the rating process. For one of my primary variables of interest I employ a binary variable equal to one if a bond is issued after June 30, 2009 (\( \text{Post} \)), and zero otherwise. Because it is extremely difficult to determine firms’ QSPE exposures in the pre-period, I also use a binary variable to identify firms’ that had QSPE exposures in the post-period versus those that did not, similar to Callahan et al.

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17 Using an ordered logit model yields the same statistical and economic inferences but reduces the clarity of interpreting economic magnitudes. Accordingly, I report ordinary least squares estimation results throughout the paper.
Specifically, I include a binary variable equal to one if the firm was required to consolidate a non-zero QSPE amount post-SFAS 166/167 implementation (QSPE), and zero otherwise. QSPEs are relatively stable as their assets typically have long durations, which provides considerable assurance that firms with QSPE exposures in the post-period had QSPE exposures in the pre-period. My primary coefficient of interest relates to the coefficient on the interaction between Post and QSPE ($\beta_3$). Finding a negative $\beta_3$ suggests that initial credit ratings assigned to bonds issued by firms with QSPE exposures declined relative to initial credit ratings assigned to bonds issued by firms without QSPE exposures post-SFAS 166/167 implementation, consistent with SFAS 166/167 reducing catering activities by rating agencies.

I control for other factors expected to influence firms’ credit rating levels (Ashbaugh-Skaife et al., 2006; Gurun et al., 2011; Strobl & Xia, 2011). I include Size, defined as the natural log of a firm’s lagged total assets, as larger firms typically have higher credit ratings. \textit{L-T Debt}, defined as the lagged noncurrent portion of a firm’s long-term debt scaled by lagged total assets, is included as firms with higher debt loads will be viewed as having lower credit quality. \textit{ROA}, defined as net income before extraordinary items scaled by lagged total assets, is included because more profitable firms are less likely to default on future debt payments. MB, defined as the lagged market-to-book ratio, controls for high growth firms as such firms are typically viewed as less risky given their future earnings potential. I include a binary variable equal to one if the firm reported increases in net income before extraordinary items for the prior four quarters (YOY), and zero otherwise, as firms that fail to do so may have more volatile earnings or suffer from deteriorating financial conditions. I also include a binary variable equal to one if the firm experiences a loss over the prior four quarters (Loss), and zero otherwise, as this may signal deteriorating financial conditions for such firms. More volatile earnings or deteriorating financial conditions, if persistent, would be viewed negatively by the rating agencies, thus warranting lower initial credit ratings (Jung et al., 2012). To control for bond-specific characteristics, I follow Barth et al. (2012)

\footnote{The authors study the impact of FIN 46(R) adoption on cost of capital for firms affected by the new rule relative to firms not affected by the rule. Similar to SFAS 166/167, it was difficult to determine the magnitude of firms’ exposures to securitization pre-FIN 46(R); hence, the authors use binary variables for their main variables of interest.}
and include control variables, $Face$, defined as the natural logarithm of the principal amount of the bond issuance, and $Mat$, defined as the natural logarithm of the bond maturity period in years, as firms that issue greater amounts of debt or whose debt has longer maturities face greater default risk.

4.1.2. Initial Yield Spreads

If bond investors face substantial uncertainty regarding debt issuers’ default probabilities then bond investors will require greater price protection with respect to the debt instruments of such issuers (Duffie and Lando, 2001; Gagliardini et al., 2009). This is due to the fact that bond investors may act conservatively when information asymmetry is high so as to avoid significant shocks to their capital in the event conditions materially worsen.\(^\text{19}\) Therefore, if SFAS 166/167 brought significant information to debt market participants’ attention, thus lowering bond investors’ information uncertainty, initial yield spreads should decline for firms that were impacted by QSPE transactions relative to those that were not in the post-period. This is particularly true if bond investors were aware of rating agency catering in the pre-period as they would not place significant weight on the initial credit ratings applied to bonds for firms believed to have QSPE exposures.

However, bond market learning over time concerning QSPE transactions, rather than rating agency catering, could have occurred, causing initial yield spreads to increase for firms with QSPE exposures relative to firms without QSPE exposures post-SFAS 166/167 implementation. Given this, market participants could have simply assessed issuers’ credit quality to be deteriorating over time, particularly when one considers the various, yet daunting information available to market participants concerning QSPEs (Higgins & Mason, 2004; Higgins & Rosner, 2007; Stanton & Wallace, 2010; Black et al., 2012; Furfine, 2012).

To determine if initial yield spreads changed in the predicted manner due to reduced information asymmetry post-SFAS 166/167 implementation, I examine the relation between initial bond spreads and

\(^{19}\) Prior research suggests that investors typically assume worst-case scenarios when faced with high degrees of uncertainty (Cao et al., 2005).
firms’ use of off-balance sheet financing via QSPEs. I estimate this relation using the following ordinary least squares regression, clustered by firm to control for cross-sectional dependence:

\[
YieldSpread_t = \beta_0 + \beta_1 Post + \beta_2 QSPE + \beta_3 Post*QSPE + \beta_4 Size_{t-1} + \beta_5 LTD_{t-1} + \beta_6 ROA_{t-1} + \\
\beta_7 MB_{t-1} + \beta_8 YOY_{t-1} + \beta_9 Loss_{t-1} + \beta_{10} Face_{t-1} + \beta_{11} Mat_t + \varepsilon
\] (2)

where \(YieldSpread\) is the initial bond yield for an individual bond less the risk-free rate, which is defined as the Treasury Bill with the most similar duration. My primary coefficient of interest relates to the coefficient on the interaction between \(Post\) and \(QSPE\) (\(\beta_3\)). Finding a negative \(\beta_3\) suggests that initial yield spreads for firms with QSPE exposures declined relative to firms without QSPE exposures after the implementation of SFAS 166/167, consistent with the notion that bond investors were conservative in their assessment of firms’ QSPE exposures in the pre-period due to substantial information asymmetry concerns between themselves and credit rating agencies. Conversely, if bond investors learned that issuers’ credit quality was deteriorating over time with respect to QSPE transactions, I expect an increase in initial yield spreads for firms with QSPE exposures relative to firms without QSPE exposures in the post-period as the predicted decline in credit ratings in equation (1) would impact the spreads bond investors assigned to such issues. All other variables are previously defined as yield spreads are widely determined by firm and debt characteristics that typically determine corporate credit ratings (Ashbaugh-Skaife et al., 2006; Gurun et al., 2011; Strobl & Xia, 2011; Barth et al., 2012).

4.2. Sample Selection

Companies were encouraged to discuss the potential impact of implementing SFAS 166/167 in all financial statements published after June 30, 2009. I use Edgar to search the 10-Ks and 10-Qs of S&P 500 firms during the 2007 - 2011 periods. I read each statement during these periods to obtain the first filing in which the impact of SFAS 166/167 was disclosed. Most S&P 500 firms first discussed the potential impact of QSPE consolidation in their SEC filings immediately following June 30, 2009.20
While assessing firms’ QSPE exposure magnitudes in the pre- and post-periods would be ideal, such information is largely unavailable through firms’ SEC filings prior to June 30, 2009. Given this, my sample is primarily focused on firms that consolidated QSPE transactions in the post-period (QSPE firms) versus firms that stated that they did not consolidate QSPE transactions post-SFAS 166/167 implementation (non-QSPE firms). Ultimately, by late 2009 S&P 500 firms were estimated to have $5.5 trillion, or roughly 22.5% of total assets, exposed to QSPEs (Credit Suisse, 2010).

Initial bond rating data (i.e., Rating, YieldSpread, Face, and Mat) for firms rated by both Moody’s and S&P comes from the Securities Data Company (SDC). Since Moody’s and/or S&P may not rate each newly issued bond on the day in which the bond is offered to investors, my sample includes all bonds rated within 30 days from the time of issuance. I include only the first rating offered on such bonds in the event Moody’s or S&P provide multiple ratings for the same bond within 30 days of the offering date. Quarterly financial statement data comes from the CRSP/Compustat merged database. After deleting observations missing control variables, the final sample consists of 1,665 bonds with ratings from both S&P and Moody’s, of which there are 905 and 760 observations in the pre- and post-periods, respectively.

Table 1 presents descriptive statistics. The average initial credit rating is relatively high at 16.75 (i.e., A+ on S&P’s rating scale), which is expected as my sample consists of S&P 500 firms. The average initial yield spread is 223 basis points. The average firm in my sample is well capitalized with only 20.0% of lagged total assets financed with long-term debt. In addition, the average bond duration is 7.36 years, and has an average offering amount of $584 million. The shorter average maturity is indicative of the extensive use of medium-term notes rather than long-term debentures by issuers. Lastly, the average firm in my sample is 55% likely to report trailing twelve month increases in net income and only 7% likely to report losses in any given year. This is consistent with S&P 500 firms, which are typically relatively profitable and growing.

This is in stark contrast to FIN 46(R) as both firms and their auditors widely complained as to the complexities with regard to understanding firms’ ultimate exposure to SPEs, in addition to the difficulty both groups had implementing new policies under FIN 46(R) (Credit Suisse, 2003).
Table 2 presents mean differences for QSPE firms versus non-QSPE firms. QSPE firms have significantly higher credit ratings, although the significance of this result appears to be muted as both QSPE and non-QSPE firms have average initial ratings of roughly 17 (i.e., A+), consistent with the notion that rating agencies catered to QSPE firms by underestimating such firms’ QSPE exposures. While the initial yield spreads of QSPE firms are larger than non-QSPE firms, the difference is insignificant. In addition, QSPE firms are significantly more leveraged, less profitable, less likely to report increases in net income within that last twelve months, and more likely to report an operating loss within the last twelve months relative to non-QSPE firms. This is consistent with prior research that compares the quantitative characteristics of firms that engage in securitization transactions versus those that do not (Dechow et al., 2010).

Figures 1 and 2 depict the amounts of non-agency mortgage-backed securities issued and U.S. non-agency mortgage-backed securities outstanding for both Residential Mortgage-Backed Securities (RMBS) and Commercial Mortgage-Backed Securities (CMBS) over time (SIFMA, 2011), respectively. Total volumes peaked in 2006, while amounts outstanding for both asset classes peaked in 2007. That total volumes for 2007 are similar to those for 2006 is striking as securitization activity disappeared during the second calendar quarter of 2007 and never returned, highlighting the considerable momentum that existed and the significant volumes that resulted from such momentum from 2002 thru the first half of 2007. Despite considerable progress to lessen the exposure to such assets over time, Figure 2 suggests that significant RMBS and CMBS amounts remained outstanding throughout my sample period, which is indicative of the various asset classes that lessened the passivity of QSPEs over time. Collectively, this descriptive evidence suggests that while significant opportunities existed for rating agencies to understate issuers’ QSPE exposures originally, limited opportunities arose throughout my sample period with respect to new QSPE volumes.\(^{21}\)

\(^{21}\) This presents the possibility that my primary findings are due to decreased liquidity in the QSPE market over time, which could have caused rating agencies to reevaluate the risk-relevance of QSPEs. I address this concern in Section 5.2.
5. Results

5.1. Main Results

5.1.1. Initial Credit Rating Results

Table 3 presents the results of estimating equation (1). The coefficient on Post is -0.85 and is statistically significant at the one percent level, suggesting that non-QSPE firms experienced a 0.85 notch (i.e., for instance, a one notch change is a change in rating from either A to A+ or A-) decline in average initial credit ratings post-SFAS 166/167 implementation. The coefficient on QSPE is 1.97 and is statistically significant at the one percent level. The higher ratings for QSPE firms relative to non-QSPE firms in the pre-period could be due to greater rating agency catering or the QSPE firms being more financially sound. To separate these two possibilities, I focus on the interaction term (Post*QSPE), which captures the effect of SFAS 166/167 on the credit rating agencies change in ability to cater to the QSPE firms. The coefficient on Post*QSPE is -2.22 and is statistically significant at the one percent level, suggesting that QSPE firms experienced a 2.22 notch decline in initial credit ratings in the post-period relative to non-QSPE firms. Ultimately, these results suggest that mandatory disclosure requirements weakened rating agencies’ ability to cater to QSPE firms post-implementation.

5.1.2. Initial Yield Spread Results

Table 4 presents the results of estimating equation (2). The coefficient on Post is -162.62 and is statistically significant at the one percent level, suggesting that non-QSPE firms experienced a 162.62 basis point decline in initial yield spreads post-SFAS 166/167 implementation. The coefficient on QSPE is -211.34 and is statistically significant at the five percent level. The lower yield spreads for the QSPE firms relative to non-QSPE firms in the pre-period is consistent with rating agency catering or the QSPE firms being more financially sound. To mitigate such differences, I focus on the interaction term (Post*QSPE) in the difference-in-differences design to captures the change in information asymmetry for the QSPE firms brought about by the adoption of SFAS 166/167. The coefficient on Post*QSPE is -188.39 and is statistically significant at the five percent level, suggesting that QSPE firms experienced a
188.39 basis point decline in initial yield spreads in the post-period relative to non-QSPE firms. These results are consistent with SFAS 166/167 reducing information asymmetry between rating agencies and bond investors, allowing bond investors to more adequately price the public debt of QSPE firms. These results are consistent with SFAS 166/167 reducing information asymmetry between rating agencies and bond investors. In addition, the results suggest that bond investors were aware of rating agencies’ propensity to cater to QSPE firms in the pre-period, and thus priced the public debt of such firms more conservatively so as to protect their invested capital from potential shocks in the event conditions materially worsened over time, consistent with prior research (Duffie & Lando, 2001; Gagliardini et al., 2009).

Collectively, the results from equations (1) and (2) suggest that rating agencies were able to use disclosure exemptions to offer inflated initial credit ratings to QSPE firms under FAS 140/FIN 46(R). However, once mandatory disclosure requirements concerning QSPEs were implemented rating agencies’ ability to cater to QSPE firms weakened and bond investors benefitted from such disclosures via decreased information asymmetry. This allowed bond investors to more accurately assess QSPE firms’ risk profiles and hence more accurately price the public debt of QSPE firms. Collectively, these results provide support for the notion that inflated initial credit ratings are due to incentives to cater to bond issuers and not an inability by rating agencies to adequately assess firms’ exposures to complex off-balance sheet transactions.

5.2. Robustness Tests

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22 It should be noted that an insignificant coefficient on the interaction term also suggests rating agency catering as such an outcome signals that investors adequately priced the public debt of QSPE firms in the pre-period, thus no change was required in the post-period relative to non-QSPE firms.

23 This is also consistent with prior research which finds that market participants view securitization transactions as secured borrowings, rather than asset sales (Niu and Richardson, 2006; Landsman et al., 2008), and that the risks associated with such transactions are not diversified away (Cheng et al., 2011).
In this section I conduct a variety of robustness tests to rule out alternative explanations for my primary findings, such as: 1) potential changes in firms’ risk profiles over time, 2) whether previously issued bonds are downgraded in the post-period, 3) whether issuers’ QSPE magnitudes are negatively associated with initial credit ratings post-implementation, 4) whether decreased securitization liquidity is responsible for my primary findings, and 5) whether private lenders were impacted by mandatory disclosure requirements under SFAS 166/167. Ultimately, my inferences remain unchanged in these tests.

5.2.1. Firms’ Changing Risk Profiles

Firms’ risk profiles can change over time due to both observable and unobservable factors. While my primary tests attempt to control for observable factors, unobservable omitted factors that I cannot capture with my control variables could influence my results. Because of this, I re-estimate equation (1) but now include YieldSpread as an additional control variable as bond investors should price issuers’ debt to account for such unobservable omitted factors. Since the inclusion of YieldSpread can significantly suppress my primary results, finding similar results to those in Table 3 adds credence to the strength of my primary findings.

Table 5 presents my results for re-estimating equation (1) with YieldSpread included. Consistent with my results in Table 3, the coefficients on both Post and the interaction term are negative and statistically significant at the one percent level. Ultimately, these results suggest that mandatory disclosure requirements reduced rating agency catering for QSPE firms relative to non-QSPE firms post-implementation, even after controlling for the possibility that firms’ risk profiles changed over time due to unobservable risk factors.

5.2.2. Previously Issued Bonds

If rating agencies used disclosure exemptions under SFAS 140/FIN 46(R) to assign inflated initial credit ratings to bonds issued by QSPE firms then these ratings should also decline post-implementation compared to non-QSPE firms. To determine this, I examine my primary research question using a sample of rating changes for firms that issued public debt in the pre-period.
Table 6 presents results consistent with my expectations. My dependant variable, ΔRating, is defined as the signed difference between the last credit rating assigned in the pre-period for an individual bond and the first credit rating assigned in the post-period for the same bond. The coefficient on QSPE is both negative and statistically significant at the five percent level. These results further support my primary analysis that mandatory disclosure requirements regarding firms’ QSPE exposures weakened rating agencies’ ability to cater to QSPE firms in the post-period as rating agencies could face reputational harm from maintaining inaccurate credit ratings.24

5.2.3. Magnitude of Firms’ QSPE Exposures

Greater QSPE issuance amounts and/or volumes could equate to more potential business for rating agencies. While I cannot determine firms’ QSPE exposures in the pre-period, I can determine the effect that eventual consolidation had on QSPE firms in the post-period. Therefore, if firms’ QSPE exposures are relatively stable over time, it is reasonable to assume that firms with large QSPE exposures in the post-period had similar exposures in the pre-period.25

Table 7 presents the results of estimating a regression similar to that in Table 3 but that now incorporates firms’ post-period QSPE exposure magnitudes. My variable of interest is the interaction (Post*Big), where Big is an indicator variable equal to one if a QSPE firm’s post-period QSPE exposure is greater than the post-period sample median exposure for QSPE firms, and zero otherwise.

Consistent with my expectations, I find that firms with above-median QSPE exposures suffered a 1.04 notch decline in initial credit ratings relative to QSPE firms with below-median QSPE exposures in the post-period, significant at the five percent level. That ratings agencies catered more to firms with larger QSPE exposures in the pre-period supports the notion that inflated initial credit ratings are due to

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24 Such harm could arise as credit ratings are routinely used for contracting purposes by various market participants, thus inaccurate credit ratings could cause market participants to place less significance on existing credit ratings. This monitoring function has recently come under intense scrutiny by various regulators after external investigations found that rating agencies failed to routinely monitor bond issuers or in some cases did not even have well defined procedures for conducting such activities (SEC, 2008a).

25 While it is possible that firms’ QSPE exposures could change from the pre- to post-periods, significant changes should be remote as securitization volumes disappeared in the second calendar quarter of 2007, making it difficult for firms to significantly alter their QSPE exposures (See Figure 1).
incentives to cater to bond issuers and not an inability by rating agencies to adequately assess firms’ exposures to complex off-balance sheet transactions.

5.2.4. Decreased Securitization Liquidity

Rating agencies could have viewed the decreased liquidity of the securitization market as a signal of increasing risk-relevance concerning QSPEs (see Figure 1). This would have caused rating agencies to adjust QSPE firms’ initial credit ratings downward over time, potentially explaining my primary findings. To rule out this possibility I run a similar regression to equation (1) but instead move the implementation date back exactly one year (i.e., June 30, 2008). In untabulated analysis, I find a negative and statistically insignificant coefficient on my interaction term, consistent with rating agencies using disclosure exemptions under SFAS 140/FIN 46(R) to offer inflated initial credit ratings to QSPE firms and not because of decreasing QSPE market liquidity over time, despite the latter’s occurrence. While my primary findings support prior research that suggests rating agencies tighten their rating parameters after severe market corrections that cause market participants to question rating agencies’ incentives and operations (Bar-Isaac and Shapiro, 2013), these robustness results also suggest that rating agencies do not take such actions expeditiously. This is interesting as rating agencies could have lessened the reputational damage inflicted upon them by lowering QPSE firms’ initial and existing credit ratings prior to the enactment of SFAS 166/167, a timeframe which encompassed the worst of the freezing of the securitization markets and the financial crisis. That such actions did not occur in the pre-period calls into question the importance rating agencies place on preserving their reputations in the event they fail to provide accurate and reliable credit ratings.

5.2.5. Private Loan Spreads

Private lenders also benefit from access to material nonpublic information from borrowers. In addition, lenders derive little benefit from understating borrowers ultimate credit quality as doing so would allow borrowers to obtain private lender financing at more favorable interest rates than would otherwise be possible. Lenders also face incentives to price private loans accurately as increases in
default rates can damage lenders’ reputations and/or bring about increased oversight from regulators.\textsuperscript{26} Given this, lenders should have been able to accurately assess firms’ QSPE exposures despite the disclosure requirements brought about by SFAS 166/167.

To test this prediction I obtain a sample of private loans from the LPC Dealscan database for the 2007 – 2011 timeframe. Using a similar ordinary least squares regression to that of equation (2) for 173 unique private loans (untabulated), I find that lending spreads do not significantly change for QSPE firms relative to non-QSPE firms post-SFAS 166/167 implementation.\textsuperscript{27}

Collectively, these robustness results suggest that disclosure exemptions under SFAS 140/FIN 46(R) afforded credit rating agencies the opportunity to cater to QSPE firms, but that once mandatory disclosure requirements were implemented rating agencies were less able to engage in catering behavior. These findings lend support for the notion that rating agency catering is a function of improper incentives cater to bond issuers and not due to a failure by rating agencies to adequately assess issuers’ default risk.

\textsuperscript{26} For example, the savings and loan crisis of the late 1980s brought about various new regulations and oversight, such as the Financial Institutions Reform, Recovery and Enforcement Act of 1989 and the Office of Thrift Supervision, as did the 2008 financial crisis via the Dodd–Frank Wall Street Reform and Consumer Protection Act.

\textsuperscript{27} I use firm-specific control variables, as previously defined, in addition to Face, defined as the natural logarithm of the loan’s principal amount offered, and Mat, defined as the natural logarithm of the duration of the loan in years.
6. Conclusion

The financial crisis of 2008 brought about significant changes as standard setters sought to reduce information asymmetry between firms, credit rating agencies, and market participants, which in prior periods could have afforded rating agencies the ability to provide inflated initial credit ratings to firms with QSPE exposures. This led to the adoption of SFAS 166/167, which specifically targeted prior disclosure exemptions with respect to QSPEs. This study examines whether increased mandatory disclosure requirements weaken credit rating agencies’ ability to cater to bond issuers with QSPE exposures relative to firms without QSPE exposures.

Using a sample of S&P 500 firms, I find that initial credit ratings provided to bond issuers with QSPE exposures declined relative to firms without QSPE exposures as SFAS 166/167 required significant new disclosures concerning QSPEs in firms’ public financial filings. Additional results provide further support for this inference as initial yield spreads for firms with QSPE exposures declined relative to firms without QSPE exposures post-implementation. This suggests that once information asymmetry declined in the post-period investors were able to more accurately price corporate debt securities of firms with QSPE exposures. These results are important as rating agencies had enough time to lower their expectations with regard to the benefits provided by QSPE transactions as the market for such activities became significantly unstable throughout the pre-period of my sample.

My study is the first to show that rating agencies can cater to firms with QSPE exposures due to disclosure exemptions under SFAS 140/FIN 46(R). Because there are currently various opportunities for rating agencies to use disclosure exemptions for certain complex or opaque transactions, my study suggests that there are significant transactions that are of importance to both regulators and market participants that may be addressed by future academic research. In addition, my results further support the notion that inflated initial credit ratings are due to incentives to cater to bond issuers and not an inability by rating agencies to adequately assess firms’ exposures to complex off-balance sheet transactions.
References


Deloitte & Touche LLP. 2010. Securitization Accounting: The Ins and Outs (and Some Do’s and Don’ts) of FAS 166, 167, and Counting… Little Rock, AR. 1 – 126.


Appendix

QSPEs provided for a substantial amount of information to be available to both credit rating agencies and QSPE investors prior to the ultimate sale of QSPE securities to QSPE investors. This is due to the fact that during the sample period I examine, QSPEs were loaded with mortgage-backed securities (MBS) which required substantial information to be presented to both rating agencies and QSPE investors prior to purchase. This information should have helped both rating agencies and QSPE investors accurately assess the riskiness of the QSPEs firms were trying to issue. This is particularly true in the case of commercial mortgage-backed securitizations.

According to Furfine (2012) commercial mortgage-backed securities (CMBS) largely focus on default risk because CMBS pools typically forbid loan prepayments, thus reducing a key risk for fixed-income investors. Therefore, once the loans to be securitized are chosen, the underwriter provides a package of detailed data pertaining to each collateral loan in the pool. Typically, this data provides information on property location, type, tenant information, among others. In addition, specific loan information is provided such as size, interest rate, loan-to-value ratios, etc. Both QSPE investors and rating agencies are given access to this information.

However, if QSPE investors feel certain loans do not meet the risk criteria of the particular pool they are interested in, they have the option to “kick out” such loans from the proposed security. Such rights are particularly important for QSPE investors buying the riskiest loan securities as a failure to find such buyers typically dooms the possibility of selling any remaining securities related to this particular CMBS. Once QSPE investors “kick out” the loans they do not wish to be included in the CMBS and replace them with those they do want included, the security is sent to the rating agencies for their final ratings.

Given the information available to both QSPE investors and credit rating agencies prior to the finalization of the CMBS, it is unlikely that rating agencies were surprised by the information that was made publicly available with the implementation of SFAS 166/167. Therefore, rating agencies should have had a firm grasp on the creditworthiness of the securities typically included in QSPEs during the
sample period I study. This is particularly relevant as prior research suggests that less risky securitized assets, such as auto loans, credit cards, among others, were also included in QSPEs during the sample period I examine.\textsuperscript{28}

\textsuperscript{28} See Chen et al. (2008) for an excellent discussion of the risk relevance of various securitized assets that eventually made their way into firms’ QSPEs.
Figure 1: Issuance of Non-Agency Mortgage-Backed Securities

Figure 1 presents the amount of Non-Agency Mortgage-Backed Securities Issued for both Residential Mortgage-Backed Securities (RMBS) and Commercial Mortgage-Backed Securities (CMBS) transactions from 2002 – 2011 in billions (SIFMA, 2011).
Figure 2 presents the amount of U.S. Non-Agency Mortgage-Backed Securities Outstanding for both Residential Mortgage-Backed Securities (RMBS) and Commercial Mortgage-Backed Securities (CMBS) transactions from 2002 – 2011 in billions (SIFMA, 2011).
### Table 1: Descriptive Statistics

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<th>Std Dev</th>
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This table presents descriptive statistics for all variables pertinent to my research design. My sample consists of 1,665 new corporate bond issues from the 2007 – 2011 periods with available data from all data sources (SDC and CRSP/Compustat merged database). *Rating* is the average of both Moody’s and S&P’s initial credit ratings for an individual bond. *Rating* takes an ordinal value of 21 for the highest rated bonds (i.e., AAA on S&P’s rating scale) and 1 for the lowest rated bonds (i.e., C). *YieldSpread* is the initial bond yield for an individual bond less the risk-free rate, which is defined as the Treasury Bill with the most similar duration. *Size* is firms’ lagged total assets ($m). *L-TDebt* is the amount of noncurrent long-term debt scaled by lagged total assets. *ROA* is the ratio of net income before extraordinary items scaled by lagged total assets. *MB* is the lagged market-to-book ratio. *YOY* is an indicator variable that is equal to one if a firm reported increases in net income before extraordinary items for the prior four quarters, and zero otherwise. *Loss* is an indicator variable that is equal to one if a firm experiences a loss over the prior four quarters, and zero otherwise. *Face* is the principal amount the bond issuance ($m). *Mat* is the bond maturity period in years.
Table 2:
Difference in Means for QSPE Firms vs. Non-QSPE Firms Over Sample Period

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<th>Non-QSPE Firms</th>
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<td>N</td>
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<td>11.11</td>
<td>-0.11**</td>
<td>-2.05</td>
</tr>
<tr>
<td>L-TDebt</td>
<td>998</td>
<td>0.23</td>
<td>667</td>
<td>0.15</td>
<td>0.08***</td>
<td>12.20</td>
</tr>
<tr>
<td>ROA</td>
<td>998</td>
<td>0.027</td>
<td>667</td>
<td>0.033</td>
<td>-0.006***</td>
<td>-4.21</td>
</tr>
<tr>
<td>MB</td>
<td>998</td>
<td>1.38</td>
<td>667</td>
<td>1.51</td>
<td>-0.13</td>
<td>-0.94</td>
</tr>
<tr>
<td>YOY</td>
<td>998</td>
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<td>667</td>
<td>0.71</td>
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<td>-10.74</td>
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<tr>
<td>Loss</td>
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<td>0.02</td>
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<td>7.30</td>
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<tr>
<td>Face</td>
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<td>9.70</td>
<td>2.19***</td>
<td>15.26</td>
</tr>
<tr>
<td>Mat</td>
<td>998</td>
<td>7.91</td>
<td>667</td>
<td>6.38</td>
<td>1.53***</td>
<td>14.02</td>
</tr>
</tbody>
</table>

This table presents a difference in means analysis for my regression variables. My sample consists of 1,665 new corporate bond issues from the 2007 – 2011 periods with available data from all data sources (SDC and CRSP/Compustat merged database). Rating is the average of both Moody’s and S&P’s initial credit ratings for an individual bond. Rating takes an ordinal value of 21 for the highest rated bonds (i.e., AAA on S&P’s rating scale) and 1 for the lowest rated bonds (i.e., C). YieldSpread is the initial bond yield for an individual bond less the risk-free rate, which is defined as the Treasury Bill with the most similar duration. Size is the natural logarithm of lagged total assets. L-TDebt is the amount of noncurrent long-term debt scaled by lagged total assets. ROA is the ratio of net income before extraordinary items scaled by lagged total assets. MB is the lagged market-to-book ratio. YOY is an indicator variable that is equal to one if a firm reported increases in net income before extraordinary items for the prior four quarters, and zero otherwise. Loss is an indicator variable that is equal to one if a firm experiences a loss over the prior four quarters, and zero otherwise. Face is the natural logarithm of principal amount the bond issuance. Mat is the bond maturity period in years. Size, L-TDebt, ROA, MB, Face, and Mat are winsorized at the 1% level. Results are clustered by firm to control for cross-sectional dependence. *, **, and *** indicate two-tailed statistical significance at the 10, 5, and 1 percent levels, respectively.
<table>
<thead>
<tr>
<th></th>
<th>Rating</th>
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<tr>
<td>Intercept</td>
<td>0.70</td>
<td>0.22</td>
</tr>
<tr>
<td>Post</td>
<td>-0.85***</td>
<td>-3.77</td>
</tr>
<tr>
<td>QSPE</td>
<td>1.97***</td>
<td>3.19</td>
</tr>
<tr>
<td>Post*QSPE</td>
<td>-2.22***</td>
<td>-3.36</td>
</tr>
<tr>
<td>Size</td>
<td>1.62***</td>
<td>6.43</td>
</tr>
<tr>
<td>L-TDebt</td>
<td>-3.48</td>
<td>-1.43</td>
</tr>
<tr>
<td>ROA</td>
<td>-9.80**</td>
<td>-2.09</td>
</tr>
<tr>
<td>MB</td>
<td>0.06**</td>
<td>2.29</td>
</tr>
<tr>
<td>YOY</td>
<td>-0.50**</td>
<td>-2.60</td>
</tr>
<tr>
<td>Loss</td>
<td>-1.32***</td>
<td>-2.78</td>
</tr>
<tr>
<td>Face</td>
<td>0.17***</td>
<td>3.27</td>
</tr>
<tr>
<td>Mat</td>
<td>-0.30**</td>
<td>-2.27</td>
</tr>
<tr>
<td>Adjusted R2</td>
<td>0.56</td>
<td></td>
</tr>
<tr>
<td>n</td>
<td>1,665</td>
<td></td>
</tr>
</tbody>
</table>

This table presents the parameter estimates from running an ordinary least squares regression of average initial credit ratings (across S&P and Moody’s) on my variables of interest and controls. My sample consists of 1,665 new corporate bond issues from the 2007 – 2011 periods with available data from all data sources (SDC and CRSP/Compustat merged database). Rating is the average of both Moody’s and S&P’s initial credit ratings for an individual bond. Rating takes an ordinal value of 21 for the highest rated bonds (i.e., AAA on S&P’s rating scale) and 1 for the lowest rated bonds (i.e., C). Post is an indicator equal to one if the bond is issued after June 2009, and zero otherwise. QSPE is a dummy variable equal to one if the firm had QSPE exposures in the post-period, and zero otherwise. Post*QSPE is the interaction between Post and QSPE. Size is the natural logarithm of lagged total assets. L-TDebt is the amount of noncurrent long-term debt scaled by lagged total assets. ROA is the ratio of net income before extraordinary items scaled by lagged total assets. MB is the lagged market-to-book ratio. YOY is an indicator variable that is equal to one if a firm reported increases in net income before extraordinary items for the prior four quarters, and zero otherwise. Loss is an indicator variable that is equal to one if a firm experiences a loss over the prior four quarters, and zero otherwise. Face is the natural logarithm of principal amount the bond issuance. Mat is the natural logarithm of bond maturity period in years. Size, L-TDebt, ROA, MB, Face, and Mat are winsorized at the 1% level. Results are clustered by firm to control for cross-sectional dependence. *, **, and *** indicate two-tailed statistical significance at the 10, 5, and 1 percent levels, respectively.
Table 4: Adoption of SFAS 166/167 on Initial Yield Spreads

<table>
<thead>
<tr>
<th></th>
<th>YieldSpread</th>
<th>t-statistic</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intercept</td>
<td>2199.67***</td>
<td>4.44</td>
</tr>
<tr>
<td>Post</td>
<td>-162.62***</td>
<td>-3.38</td>
</tr>
<tr>
<td>QSPE</td>
<td>-211.34**</td>
<td>-2.54</td>
</tr>
<tr>
<td>Post*QSPE</td>
<td>-188.39**</td>
<td>-2.07</td>
</tr>
<tr>
<td>Size</td>
<td>-40.91*</td>
<td>-1.81</td>
</tr>
<tr>
<td>L-TDebt</td>
<td>353.10**</td>
<td>2.04</td>
</tr>
<tr>
<td>ROA</td>
<td>987.30</td>
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</tr>
<tr>
<td>MB</td>
<td>-9.26</td>
<td>-1.37</td>
</tr>
<tr>
<td>YOY</td>
<td>29.73</td>
<td>1.28</td>
</tr>
<tr>
<td>Loss</td>
<td>158.44**</td>
<td>2.37</td>
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<tr>
<td>Face</td>
<td>53.26***</td>
<td>6.06</td>
</tr>
<tr>
<td>Mat</td>
<td>116.99*</td>
<td>1.99</td>
</tr>
</tbody>
</table>

Adjusted R2 0.37
n 1,665

This table presents the parameter estimates from running an ordinary least squares regression of initial yield spreads on my variables of interest and controls. My sample consists of 1,665 new corporate bond issues from the 2007–2011 periods with available data from all data sources (SDC and CRSP/Compustat merged database). YieldSpread is the initial bond yield for an individual bond less the risk-free rate, which is defined as the Treasury Bill with the most similar duration. Post is an indicator equal to one if the bond is issued after June 2009, and zero otherwise. QSPE is a dummy variable equal to one if the firm had QSPE exposures in the post-period, and zero otherwise. Post*QSPE is the interaction between Post and QSPE. Size is the natural logarithm of lagged total assets. L-TDebt is the amount of noncurrent long-term debt scaled by lagged total assets. ROA is the ratio of net income before extraordinary items scaled by lagged total assets. MB is the lagged market-to-book ratio. YOY is an indicator variable that is equal to one if a firm reported increases in net income before extraordinary items for the prior four quarters, and zero otherwise. Loss is an indicator variable that is equal to one if a firm experiences a loss over the prior four quarters, and zero otherwise. Face is the natural logarithm of principal amount the bond issuance. Mat is the natural logarithm of bond maturity period in years. Size, L-TDebt, ROA, MB, Face, and Mat are winsorized at the 1% level. Results are clustered by firm to control for cross-sectional dependence. *, **, and *** indicate two-tailed statistical significance at the 10, 5, and 1 percent levels, respectively.
Table 5:
Sensitivity Analysis: Adoption of SFAS 166/167 on Initial Credit Ratings
Controlling for Issuer Yield Spreads

<table>
<thead>
<tr>
<th></th>
<th>Rating</th>
<th>t-statistic</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intercept</td>
<td>3.67</td>
<td>1.22</td>
</tr>
<tr>
<td>Post</td>
<td>-0.90***</td>
<td>-4.08</td>
</tr>
<tr>
<td>QSPE</td>
<td>2.20***</td>
<td>3.22</td>
</tr>
<tr>
<td>Post*QSPE</td>
<td>-2.37***</td>
<td>-3.20</td>
</tr>
<tr>
<td>Size</td>
<td>1.55***</td>
<td>6.73</td>
</tr>
<tr>
<td>L-TDebt</td>
<td>-3.27</td>
<td>-1.45</td>
</tr>
<tr>
<td>ROA</td>
<td>-8.85*</td>
<td>-1.94</td>
</tr>
<tr>
<td>MB</td>
<td>0.05</td>
<td>1.58</td>
</tr>
<tr>
<td>YOY</td>
<td>-0.43**</td>
<td>-2.51</td>
</tr>
<tr>
<td>Loss</td>
<td>-1.14**</td>
<td>-2.41</td>
</tr>
<tr>
<td>Face</td>
<td>0.10*</td>
<td>1.91</td>
</tr>
<tr>
<td>Mat</td>
<td>-0.46***</td>
<td>-3.52</td>
</tr>
<tr>
<td>YieldSpread</td>
<td>-0.01**</td>
<td>-2.45</td>
</tr>
<tr>
<td>Adjusted R2</td>
<td>0.58</td>
<td></td>
</tr>
<tr>
<td>n</td>
<td>1,665</td>
<td></td>
</tr>
</tbody>
</table>
This table presents the parameter estimates from running an ordinary least squares regression of average initial ratings (across S&P and Moody’s) on my variable of interest and controls, including YieldSpread. My sample consists of 1,665 new corporate bond issues from the 2007 – 2011 periods with available data from all data sources (SDC and CRSP/Compustat merged database). Rating is the average of both Moody’s and S&P’s initial credit ratings for an individual bond. Rating takes an ordinal value of 21 for the highest rated bonds (i.e., AAA on S&P’s rating scale) and 1 for the lowest rated bonds (i.e., C). Post is an indicator equal to one if the bond is issued after June 2009, and zero otherwise. QSPE is a dummy variable equal to one if the firm had QSPE exposures in the post-period, and zero otherwise. Post*QSPE is the interaction between Post and QSPE. Size is the natural logarithm of lagged total assets. L-TDebt is the amount of noncurrent long-term debt scaled by lagged total assets. ROA is the ratio of net income before extraordinary items scaled by lagged total assets. MB is the lagged market-to-book ratio. YOY is an indicator variable that is equal to one if a firm reported increases in net income before extraordinary items for the prior four quarters, and zero otherwise. Loss is an indicator variable that is equal to one if a firm experiences a loss over the prior four quarters, and zero otherwise. Face is the natural logarithm of principal amount the bond issuance. Mat is the natural logarithm of bond maturity period in years. YieldSpread is the initial bond yield for an individual bond less the risk-free rate, which is defined as the Treasury Bill with the most similar duration. Size, L-TDebt, ROA, MB, Face, and Mat are winsorized at the 1% level. Results are clustered by firm to control for cross-sectional dependence. *, **, and *** indicate two-tailed statistical significance at the 10, 5, and 1 percent levels, respectively.
### Table 6:
Sensitivity Analysis: Adoption of SFAS 166/167 on Changes in Existing Bonds’ Ratings Levels

<table>
<thead>
<tr>
<th></th>
<th>∆Rating</th>
<th>t-statistic</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intercept</td>
<td>2.37***</td>
<td>6.46</td>
</tr>
<tr>
<td>QSPE</td>
<td>-0.35**</td>
<td>-2.54</td>
</tr>
<tr>
<td>∆Size</td>
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<td>-0.90</td>
</tr>
<tr>
<td>∆L-TDebt</td>
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<td>0.54</td>
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<tr>
<td>∆ROA</td>
<td>-0.00</td>
<td>-0.72</td>
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<tr>
<td>∆MB</td>
<td>0.01</td>
<td>0.92</td>
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<tr>
<td>YOY</td>
<td>-0.01</td>
<td>-0.91</td>
</tr>
<tr>
<td>Loss</td>
<td>-0.00***</td>
<td>-3.78</td>
</tr>
<tr>
<td>Face</td>
<td>-0.04**</td>
<td>-2.30</td>
</tr>
<tr>
<td>Mat</td>
<td>-0.26***</td>
<td>-4.22</td>
</tr>
<tr>
<td>Adjusted R2</td>
<td>0.41</td>
<td></td>
</tr>
<tr>
<td>n</td>
<td>905</td>
<td></td>
</tr>
</tbody>
</table>

This table presents the parameter estimates from running an ordinary least squares regression of the signed magnitude of ratings changes in the post-period for bonds issued in the pre-period on my variable of interest and controls. My sample consists of 905 new corporate bond issues from the first quarter of 2007 thru the second quarter of 2009 with available data from all data sources (SDC and CRSP/Compustat merged database). ∆Rating is the signed difference between the last assigned numeric credit rating for an individual bond in the pre-period and the first assigned numeric credit rating in the post-period for the same bond. QSPE is a dummy variable equal to one if the firm had QSPE exposures in the post-period, and zero otherwise. ∆Size is the change in total assets. ∆L-TDebt is the change in the amount of noncurrent long-term debt scaled by lagged total assets. ∆ROA is the change in the ratio of net income before extraordinary items scaled by lagged total assets. ∆MB is the change in the lagged market-to-book ratio. YOY is an indicator variable that is equal to one if a firm reported increases in net income before extraordinary items for the prior four quarters, and zero otherwise. Loss is an indicator variable that is equal to one if a firm experiences a loss over the prior four quarters, and zero otherwise. Face is the natural logarithm of principal amount the bond issuance. Mat is the natural logarithm of bond maturity period in years. ∆Size, ∆L-TDebt, ∆ROA, ∆MB, Face, and Mat are winsorized at the 1% level. Results are clustered by firm to control for cross-sectional dependence. *, **, and *** indicate two-tailed statistical significance at the 10, 5, and 1 percent levels, respectively.
Table 7: Sensitivity Analysis: Adoption of SFAS 166/167 on Firms with Large QSPE Exposures

<table>
<thead>
<tr>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>Intercept</td>
<td>5.26*</td>
<td>1.72</td>
</tr>
<tr>
<td>Post</td>
<td>-2.06***</td>
<td>-5.38</td>
</tr>
<tr>
<td>Big</td>
<td>-0.27</td>
<td>-0.36</td>
</tr>
<tr>
<td>Post*Big</td>
<td>-1.04**</td>
<td>-2.31</td>
</tr>
<tr>
<td>Size</td>
<td>1.44***</td>
<td>4.36</td>
</tr>
<tr>
<td>L-TDebt</td>
<td>-2.15</td>
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</tr>
<tr>
<td>ROA</td>
<td>-3.35</td>
<td>-0.35</td>
</tr>
<tr>
<td>MB</td>
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<td>2.50</td>
</tr>
<tr>
<td>YOY</td>
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<td>-2.76</td>
</tr>
<tr>
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<td>-1.04*</td>
<td>-1.75</td>
</tr>
<tr>
<td>Face</td>
<td>0.10**</td>
<td>2.33</td>
</tr>
<tr>
<td>Mat</td>
<td>-0.49**</td>
<td>-2.56</td>
</tr>
<tr>
<td>Adjusted R2</td>
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<td></td>
</tr>
<tr>
<td>n</td>
<td>998</td>
<td></td>
</tr>
</tbody>
</table>
This table presents the parameter estimates from running an ordinary least squares regression of average initial ratings (across S&P and Moody’s) for QSPE firms whose QSPE exposures are greater than the sample median relative to QSPE firms whose QSPE exposures are below the sample median on my variables of interest and controls. My sample consists of 998 new corporate bond issues from the 2007 – 2011 periods with available data from all data sources (SDC and CRSP/Compustat merged database). Rating is the average of both Moody’s and S&P’s initial credit ratings for an individual bond. Rating takes an ordinal value of 21 for the highest rated bonds (i.e., AAA on S&P’s rating scale) and 1 for the lowest rated bonds (i.e., C). Post is an indicator equal to one if the bond is issued after June 2009, and zero otherwise. Big is a dummy variable equal to one if the firm’s post-period QSPE exposure is larger than the sample median, and zero otherwise. Post*Big is the interaction between Post and Big. Size is the natural logarithm of lagged total assets. L-TDebt is the amount of noncurrent long-term debt scaled by lagged total assets. ROA is the ratio of net income before extraordinary items scaled by lagged total assets. MB is the lagged market-to-book ratio. YOY is an indicator variable that is equal to one if a firm reported increases in net income before extraordinary items for the prior four quarters, and zero otherwise. Loss is an indicator variable that is equal to one if a firm experiences a loss over the prior four quarters, and zero otherwise. Face is the natural logarithm of principal amount the bond issuance. Mat is the natural logarithm of bond maturity period in years. Size, L-TDebt, ROA, MB, Face, and Mat are winsorized at the 1% level. Results are clustered by firm to control for cross-sectional dependence. *, **, and *** indicate two-tailed statistical significance at the 10, 5, and 1 percent levels, respectively.
Vita Kevin J. Koharki

EDUCATION

Doctor of Philosophy in Business Administration – Accounting, The Pennsylvania State University, Expected in 2014
Master of Business Administration – Finance, The Pennsylvania State University, May 2009
Bachelor of Accounting, The Pennsylvania State University, May 2004

SELECTED PUBLICATIONS

Firms’ Use of Accounting Discretion to Influence Their Credit Ratings (with Walid Alissa, Sam Bonsall, and Michael Penn). *Journal of Accounting and Economics, 2013, 55(2 – 3): 129-147.*

CONFERENCE PRESENTATIONS

2013 American Accounting Association Annual Meeting Anaheim, CA

INVITED CONFERENCES

2014 Financial Accounting and Reporting Section Midyear Meeting
   Penn State Accounting Conference Houston, TX
   University Park, PA

2013 American Accounting Association Annual Meeting
   Midwest Accounting Conference Iowa City, IA
   Penn State Accounting Conference University Park, PA

2012 Journal of Accounting and Economics Conference
   Nick Dopuch Accounting Conference St. Louis, MO
   FASB PhD Conference Norwalk, CT
   Penn State Accounting Conference University Park, PA

2011 Penn State Accounting Conference University Park, PA

2010 Penn State Accounting Conference University Park, PA

2009 Penn State Accounting Conference University Park, PA

2008 Penn State Accounting Conference University Park, PA