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Firms' use of accounting discretion to influence their credit ratings

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ABSTRACT

This paper examines whether firms that deviate from an empirically modeled ("expected") credit rating engage in earnings management activities, as measured by abnormal accruals and real activities earnings management. We find evidence that firms use income-increasing (-decreasing) earnings management activities when they are below (above) their expected ratings. We then test whether such actions are successful in helping these firms move toward their expected credit ratings. The results suggest that firms below or above their expected credit ratings may be able to move toward expected ratings through the use of directional earnings management.

1. Introduction

Firms care deeply about their credit ratings. Recent survey evidence presented by Graham and Harvey (2001) shows that chief financial officers pay strong attention to their firms' credit ratings when making capital structure decisions. Kisgen (2006) finds that firms near a broad rating boundary issue less debt than firms elsewhere, indicating that firms attempt to avoid downgrades and obtain upgrades. Kisgen (2009) finds additional evidence suggesting that firms are more likely to change their capital structure to reverse recent negative changes in their credit ratings. Taken together, these studies suggest that firms focus on specific credit ratings and that these ratings hold meaning for managers.

Deviating from an expected credit rating could have significant implications for firms' access to capital. For example, a firm slightly below the investment-grade threshold can experience a significant increase in its access to new investors by achieving a rating upgrade. Most likely new investors were not investing in the firm before the upgrade because of either self-imposed or regulation-based cutoffs. One such cutoff is Rule 2a-7 of the Investment Company Act of 1940, which requires money market mutual funds to limit investments in bonds rated in the three (two) highest long-term (short-term) categories. Additionally, a downgrade to speculative-grade could be costly if it forces investors to liquidate their positions in affected bonds or triggers rating-based covenants.

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Other credit rating implications include signaling, maintaining relationships with third parties such as suppliers and customers, and maintaining firms' credit ratings in line with competitors. A credit rating represents a signal of overall quality, and firms in the same rating category are pooled together as being of the same quality (Kisgen, 2006). If a firm desires to signal a certain quality, then a rating upgrade could convey that information. Conversely, a rating downgrade could also be warranted to avoid increased scrutiny from market participants, particularly if higher credit ratings are believed to be unsustainable.

We use a model from the target capital structure literature that allows us to estimate an "expected" credit rating for a given firm in a given year. We construct a measure of deviation from this expected rating and examine whether the estimated deviation is associated with earnings management activities. We argue that firms below their expected rating (hereafter, below-expected-rating firms) have incentives to manage earnings upward and that firms above their expected rating (hereafter, above-expected-rating firms) have incentives to manage their earnings downward.

We then investigate whether earnings management activities for above-expected-rating firms or below-expected-rating firms are associated with future changes in credit ratings. A positive association would suggest firms successfully influence their credit ratings through earnings management. Rating agencies have stated that they do not see their role as that of auditors (Securities and Exchange Commission, 2003; Standard & Poor's, 2006) and thus they assume financial statements to be reasonable and accurate. This creates a potential opportunity for issuers to benefit from earnings management in the ratings process. Firms may also try to pit one agency against another in an attempt to achieve the best rating; hence, rating agencies may face fewer incentives to detect earnings management by issuers.

This study provides three sets of findings. First, we provide evidence on how well our rating model identifies deviations from expected ratings. We use standard time-series Dickey–Fuller tests to examine whether firms tend to drift back toward their expected ratings over time. The results suggest that our measure of deviation exhibits such mean reversion and that the earnings management activities studied in this paper appear to magnify the mean reversion. Second, we provide evidence of a negative (positive) association between deviations from expected credit ratings and income-increasing (-decreasing) earnings management activities. Firms that straddle the investment-grade threshold seem to manage earnings to a greater extent than do other firms. Finally, we find that firms that engage in income-increasing (-decreasing) earnings management activities and are below- (above-) expected ratings achieve future upgrades (downgrades), enabling them to move toward their expected credit ratings.

We contribute new insights into the credit ratings literature by providing empirical evidence that managers employ financial reporting strategies to affect credit rating agencies' perceptions of firm risk. This is in contrast to Kisgen (2006, 2009), as capital structure decisions can have long-term consequences for firms while the earnings management activities we study typically are focused more on the short-term and thus can provide another set of tools for managers to influence their credit ratings. The various proxies we consider for earnings management are distinct from the firm capital structure choices examined by prior research.

Our study also contributes to the earnings management literature. While much prior research has focused on the benefits earnings management can have on executive compensation and on the ability to beat analysts' earnings estimates, our study considers an additional incentive for firms to manage earnings. We are among the first to look at earnings management as a tool to influence credit ratings. Jung et al. (in press) show that firms near broad rating changes (i.e., from A+ to AA−) engage in earnings smoothing to avoid or achieve a change in rating. These results suggest that credit rating agencies view firms with less volatile earnings as having lower credit risk than firms with more volatile earnings. We differ from Jung et al. (in press) by showing that firms have expected ratings they attempt to reach, and that *directional* earnings management appears to help firms reach their expected rating.

The remainder of our paper proceeds as follows. In the next section we formally describe and motivate our hypotheses; in Section 3, we review the models for estimating expected credit ratings and earnings management, and also describe our other control variables and our sample's composition; in Section 4, we describe our research design and test results; and in Section 5, we present our study's conclusions.

2. Hypothesis development

Substantial evidence shows that firms take their credit ratings into account when making capital allocation decisions. For example, in a survey by Graham and Harvey (2001), chief financial officers identify credit ratings as their second highest concern when determining capital structure. Hovakimian et al. (2009) show that firms make operating, financing, and investing decisions based on the objective of achieving an expected credit rating. Prior literature also shows that firms take actions to regain their credit ratings after downgrades (Kisgen, 2009), as well as to avoid downgrades ex ante (Kisgen, 2006). Firms likely take these actions because they believe that market participants use credit ratings as a key metric in assessing default risk. When used in this manner, credit ratings serve as a vehicle to reduce information processing costs for investors.

Several forces put pressure on below-expected-rating firms to improve their ratings. Because many investment rules and regulations are based on credit ratings, below-expected-rating firms that desire access to more capital may feel pressure to improve their ratings.[1] If a firm drops below a certain rating, investors could be forced to liquidate their

[1] For a discussion of regulation based on ratings, see the Financial Crisis Inquiry Report at http://www.gpo.gov/fdsys/pkg/GPO-FCIC.