of Michigan researcher says yes.

Jun. 22, 2014

Do companies distort their investments to influence their credit rating? A University of Michigan researcher says yes.

"I investigate this question by examining firms' investment behavior during periods when their rating is arguably most important to them—prior to bond issuance," said Taylor Begley, who earned his doctorate in finance from U-M's Ross School of Business.

The rating impacts the cost of borrowing by boosting interest rates that investors

not innocuous," he said. "When they are cutting their R&D spending, there are long-term effects as far as their innovation, productivity and operating performance, as well as firm value more broadly."

Credit ratings have emerged as a key mechanism to bridge the information gap between firms and investors. Ratings give better access to debt markets for firms, expand the universe of investment opportunities for investors, and are deeply interwoven into financial regulation.

Because credit ratings are an important factor in firms' level of access to and cost of debt capital, firms have incentives to take potentially costly actions to improve their rating.

Not all firms have the equal incentive to make rating-related changes. Those closest to a salient debt-to-operating earnings ratio threshold that credit rating agencies emphasize are much more likely to cut their R&D and overhead costs, or selling, general and administrative costs, in the periods leading up to getting a bond rated.

In terms of the size of the reductions, these firms cut their R&D expenditures by 10 percent and overhead expenditures by 3 percent compared to control firms.

The credit rating agencies publicly release guidelines and methodologies with specific criteria that they focus on when assessing a firm's creditworthiness. The relationships between key financial ratios and credit ratings have jumps at certain economically arbitrary thresholds, which the agencies place at round numbers such as 2.0 and 3.0.

Standard and Poor's recognizes the potential distortions that ratings can create and state the following in their rating methodology handbook:

“We do not encourage companies to manage themselves with an eye toward a

incentives to improve their debt to operating earnings ratio have a considerably higher likelihood of declines in the quality of their innovation output.

Begley found find similar results for future profitability. Treatment firms are about 12 percent and 10 percent more likely to experience declines in return on operating assets and return on equity, respectively, during the years following issuance than the control group.

“These findings highlights an important cost of arms-length financing and suggest that the benefits of increased transparency and disclosure of credit rating criteria should be carefully balanced against the corporate behavioral distortions they may induce,” Begley said.

Small Business