F I X E D   I N C O M E

Asset Reliability and Security Prices Evidence From Credit Markets

March 3, 2014

This paper explores the relation between the reliability of an enterprise's accounting and its security prices. We focus on how inaccurate accounting can affect a firm's credit spreads, for several reasons. For one thing, each company can have multiple debt instruments of different terms trading in the markets; this permits sharper tests to determine where the effect of reliability is greatest. Second, using multiple instruments for a single company reduces the influence of potentially correlated omitted variables (e.g., earnings expectations), since they are likely to be common across these instruments.

Our work follows a seminal paper by Duffie and Lando (2001) that presented a theoretical model in which a hypothetical firm is owned by equity holders who were fully informed about its assets. However, the firm's creditors received only incomplete information through periodic accounting statements.

In this model, the precision — or lack thereof — of accounting information is an additional source of credit risk, and is most relevant for short-term credit spreads. (Over the longer term, the uncertainty around the evolution of asset value will dominate the lack of precision in information available to creditors. Thus the effect of noise in accounting information will decrease with horizon of debt.)

For two companies with different precision of accounting information, but which are otherwise identical, the credit spread term structures will be farther apart at the short end than at the long end. The firm with noisier accounting information will have proportionately higher default risk in the short run, at least as perceived by its creditors.

be relied on in making an investment or other decision. There can be no assurance that an investment strategy will be successful. Historic market trends are not reliable indicators of actual future market behavior or future performance of any particular investment which may differ materially, and should not be relied upon as such. Diversification does not eliminate the risk of experiencing investment losses.

The information in this paper may contain projections or other forward-looking statements regarding future events, targets, forecasts or expectations regarding the strategies described herein, and is only current as of the date indicated. There is no assurance that such events or targets will be achieved, and may be significantly different from that shown here. The information in this document, including statements concerning financial market trends, is based on current market conditions, which will fluctuate and may be superseded by subsequent market events or for other reasons.