When transparency pays:
The moderating effect of reporting quality
on changes in the cost of debt

Christine Cuny
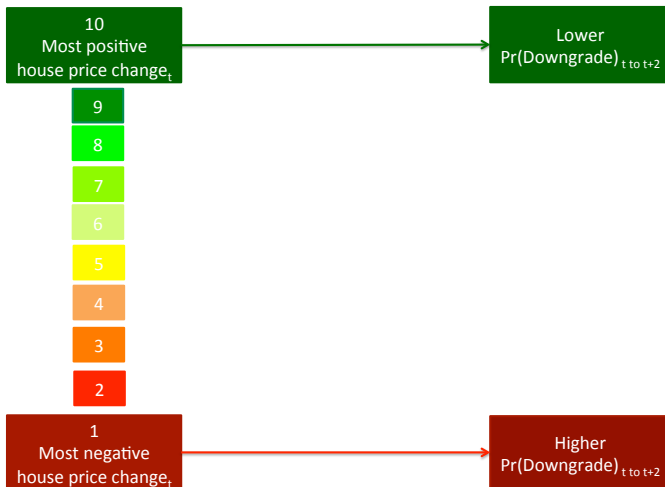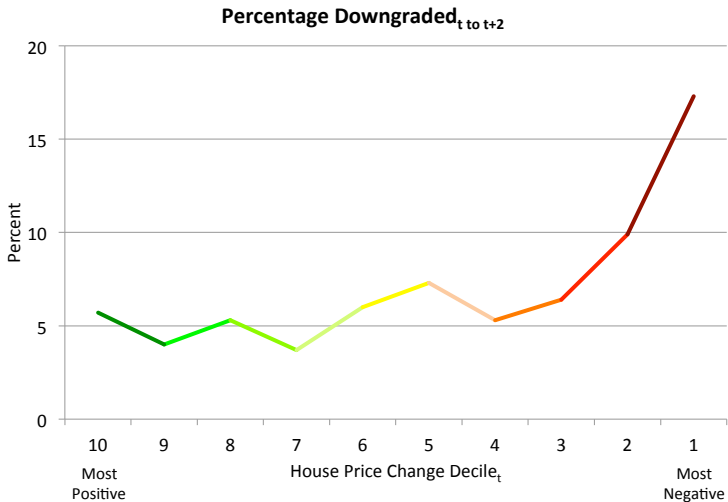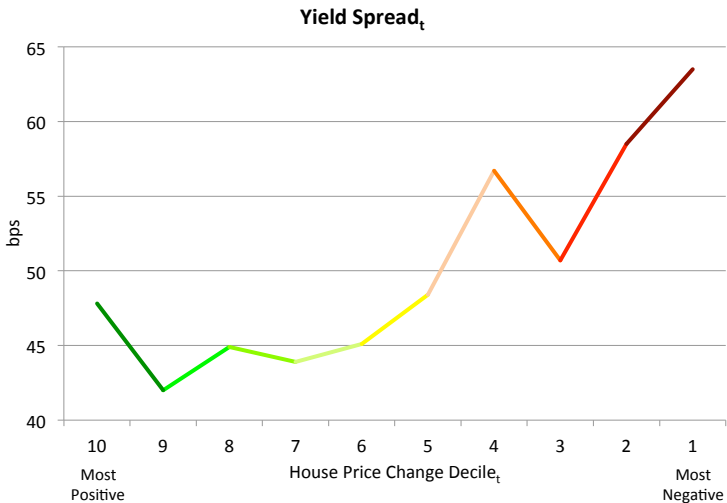Svenja Dube

Motivation

Research Question

Is the relation between changes in the economy and changes in the cost of debt moderated by financial reporting quality?

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Percentage Downgraded$_{t\ to\ t+2}$

Percent (y-axis): 0, 5, 10, 15, 20

House Price Change Decile$_t$ (x-axis): 10 (Most Positive), 9, 8, 7, 6, 5, 4, 3, 2, 1 (Most Negative)
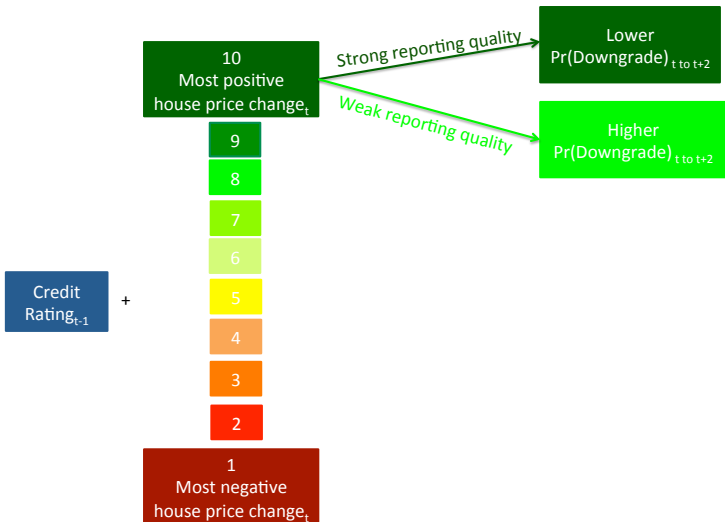
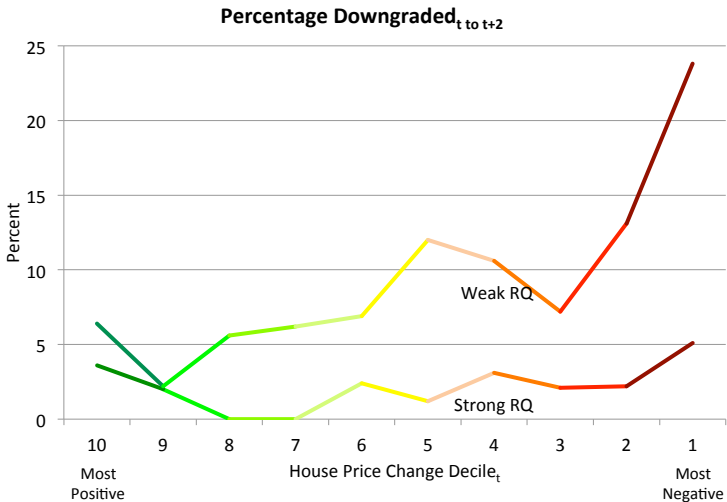Yield Spread$_t$

Research Question

Is the relation between changes in the economy and changes in the cost of debt moderated by financial reporting quality?

What is Financial Reporting Quality?

Attribute	Empirical measure
(1) Accessible	Web site transparency grade
(2) Comprehensive	GFOA Certificate
(3) Reliable	Unqualified audit opinion
	No material weakness
	Independent auditor
(4) Timely	Date of audit opinion
	Date of EMMA filing
(5) Compliant	GAAP State
	Annual EMMA filings

Percentage Downgraded$_{t \text{ to } t+2}$

Weak RQ

Strong RQ

Percent

House Price Change Decile$_t$

Most Positive

Most Negative

Yield Spread$_t$

A line chart with y-axis labeled "bps" ranging from 20 to 100, and x-axis labeled "House Price Change Decile$_t$" ranging from 10 (Most Positive) to 1 (Most Negative). Two labeled series: "Weak RQ" and "Strong RQ".
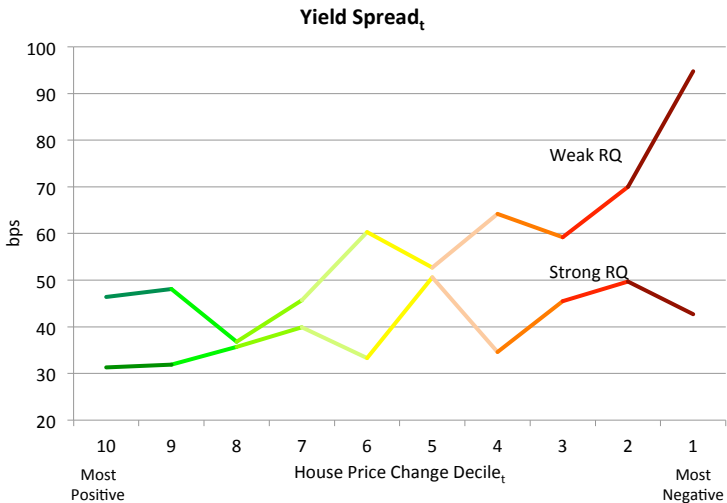
$$\log\left[\text{Odds(Downgrade}_{i;t,t+1,t+2}) \mid \text{CreditRating}_{i,t-1}, \text{HousePriceChangeDecile}_{i,t}\right]$$
$$= \beta\text{ReportingQuality}_{i,t-1} + \sum\gamma\text{Controls}_{i,t} + \varepsilon_{i,t}$$

	Pred.	Downgrade$_{t+2}$
Reporting quality	<1	0.677***
Controls for other rating inputs		YES
Controls for other downgrade determinants		YES
Observations		2,917
Chi-squared		177.4
p>Chi-squared		0.00

Problem: Is it financial reporting quality, *per se*?
Solution: Bond insurance as an Instrument

	Pred.	Downgrade$_{t+2}$	
Instrumented Reporting quality	<1	0.008***	0.015***
Controls for other rating inputs		YES	YES
Controls for other downgrade determinants		YES	YES
Time period		All years	<= 2010
Observations		2,902	1,567
Pseudo R-squared		0.212	0.306

Key Takeaway

- Strong reporting quality attenuates the impact of negative economic outcomes