

Rating Agency Adjustments to GAAP Financial Statements and Their Effect on Ratings and Credit Spreads

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ABSTRACT

I examine a dataset of both quantitative (hard) adjustments to firms' reported U.S. GAAP financial statement numbers and qualitative (soft) adjustments to firms' credit ratings that Moody's develops and uses in its credit rating process. I first document differences between firms' reported and Moody's adjusted numbers that are both large and frequent across firms. For example, primarily because of upward adjustments to interest expense and debt attributable to firms' off-balance sheet debt, on average, adjusted coverage (cash flow-to-debt) ratios are 27 percent (8 percent) lower and adjusted leverage ratios are 70 percent higher than the corresponding U.S. GAAP ratios. I then find that Moody's hard and soft rating adjustments are associated with significantly higher credit spreads and flatter credit spread term structures. Overall, the results indicate that Moody's quantitative adjustments to financial statement numbers and qualitative adjustments to credit ratings enable it to better capture default risk, consistent with it effectively processing both hard and soft information.

Keywords: [rating agency](#), [off-balance sheet finance](#), [corporate credit risk](#), [soft information](#)

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