Discussion of: To Hide or Highlight? How Borrowing Firms Summarize Their Loan Contracts (Xiangu Li, USC)

Arthur Morris, HKUST

¶1 is a thing of beauty.

"This study examines how firms summarize complex disclosures in the setting of loan announcements. Firms that enter into material loan contracts are required by the U.S. Securities and Exchange Commission (SEC) to file a Form 8-K within four business days. These filings typically include both the full contract as an exhibit ("loan contract") and a summary in the main file ("loan summary"; see Appendix A). Loan summaries are substantially shorter than the full contracts, granting firms substantial discretion to hide or highlight material information. This study examines the determinants and implications of firms' summarization choices. Specifically, it addresses three questions: (1) Do firms use summaries to hide or highlight material information? (2) Do summaries influence investors' information processing? and (3) Do summarization choices convey useful information about firm or loan quality?"

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Broad topic:

> “***This study examines how firms summarize complex disclosures in the setting of loan announcements.***

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Setting:

> ***Firms that enter into material loan contracts are required by the U.S. Securities and Exchange Commission (SEC) to file a Form 8-K within four business days.***

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Setting:

> ***These filings typically include both the full contract as an exhibit ("loan contract") and a summary in the main file ("loan summary"; see Appendix A).***

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Setting:

Loan summaries are substantially shorter than the full contracts, granting firms substantial discretion to hide or highlight material information.

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Narrow topic:

> ***This study examines the determinants and implications of firms' summarization choices.***

¶1 is a thing of beauty.

Research Questions:

> ***Specifically, it addresses three questions: (1) Do firms use summaries to hide or highlight material information? (2) Do summaries influence investors' information processing? and (3) Do summarization choices convey useful information about firm or loan quality?***"

Three points

1. **This paper is about financial covenants, and financial covenants are a very big deal.**
2. **Disclosure of covenant strictness is a contracting friction.**
3. **The strength of the economic mechanism is key.**

Point 1: This is a paper about financial covenants (and disclosure).

Current pitch is using debt contract/summary differences as a setting to learn about disclosure.

- This is clever and effective. I wish that I had noticed this!

But. . .

- What you *measure* is the treatment of **financial covenants** in the summary.

Point 1: This is a paper about financial covenants (and disclosure).

My argument:

1. Financial covenants are a big deal, and should interest *all* accountants.
2. The summary treatment of financial covenant strictness is uniquely salient to investors, relative to other contract terms.

Point 1.1: Financial covenants are a big deal.

Three quick facts for folks who don't think about financial covenants in debt contracts all the time:

1. Financial covenants are **events of default**.
2. For financially constrained firms, covenant violations can lead to insolvency. (See next slide for an example from the paper.)
3. If you ask Ray Ball, accounting exists *because* of contracting applications like this.

Point 1.1: Example

From Footnote 5:

> *"Furthermore, our failure to comply with our debt covenants **could** result in a default under our debt agreements, which **could** permit the holders to accelerate our obligation to repay the debt. If any of our debt is accelerated, we may not have sufficient funds available to repay it."*

This statement understates what happens when you fail to comply with a debt covenant!

Point 1.1: Representative event of default language

"***9.1 Events of Default.*** *The existence or occurrence of any one or more of the following events, whatever the reason therefor and under any circumstances whatsoever, shall constitute an Event of Default:. . .*"

"*(a) Borrowers fail to pay any principal on any of the Notes, or any portion thereof, on the date when due; or. . .*"

"*(e) Any Credit Party or any other Party fails to perform or observe any other covenant. . .*"

"***9.2 Remedies Upon Event of Default.*** *(a) Upon the occurrence, and during the continuance, of any Event of Default. . .*"

"*(2) the Issuing Lender may, with the approval of the Administrative Agent on behalf of the Requisite Lenders, demand immediate payment by the Credit Parties of an amount equal to the aggregate amount of all outstanding Letters of Credit. . .*"

"Could" is doing a lot of work in the previous example.

Point 1.2: The summary is uniquely salient to investors.

Covenant Strictness is not Trivial to Measure

- Dyreng, Ferracuti, Hills, and Kubic (2022) show that covenant strictness is not trivial to measure, and that the literature on covenant violations gets it wrong in ways that matter (should be in print ASAP).
- The paper handles the empirical implications of DFHK well.
- However, **investors** may struggle to calculate strictness from the contract.

Point 1.2: The summary is uniquely salient to investors.

Covenant Strictness is not Trivial to Measure

Three reasons:

1. You have to find the covenant in the contract.
2. You have to understand the covenant (e.g., what is the threshold, what is the definition of the accounting metric, what is the time period, etc.)
3. You have to predict the future value of the accounting metric to know whether the covenant is likely to be violated. Good historical data is a minimum requirement, but clairvoyance is also a plus.

Measures like PVIOL are good for tests of the hypotheses, but they would not be what an analyst or investor would do (i.e. an analyst would not ignore non-GAAP adjustments).

Point 1.2: Covenant Strictness is not Trivial to Measure

Strengthens the claim that summarization matters!

Does not generalize to contract terms like spreads, which are easier to observe and interpret.

Point 2: Disclosure of Contract Terms Is a Contracting Friction.

If explaining covenants to investors matters, then the requirement to disclose (and summarize) covenants is likely to shape the covenants themselves.

Point 2.1: Contribution to the Debt Contracting literature.

1. We know that covenant selection and strictness is informative (Demiroglu & James 2010).
2. We know that covenant violations generate negative market reactions (Stice 2018).
3. This paper shows that market reactions to violations are stronger when covenant strictness is not summarized.
4. The possibility that disclosure of covenant strictness itself is a contacting friction is an *underemphasized* contribution of this paper to the debt contracting literature.

Another benefit of the setting: You cannot observe the covenant choices that were not made, but you can observe the covenant choices that managers attempt to obscure.

- *Debt contracting folks should cite this paper.*

Point 2.2: This friction makes the setting less clean, but more interesting.

> "*First, while the source information in prior work (e.g., earnings releases) is itself a summary, the source information in this setting (i.e., loan contracts) is not prepared by management and thus more closely approximates the full information set.*[8]"

Footnote 8:

> "*Relatedly, the setting mitigates concerns about reverse causality, whereby the need to provide summaries influences how the source information is constructed (Donelson et al. 2025).*"

If explaining covenants to investors matters, then the requirement to disclose (and summarize) covenants is likely to shape the covenants themselves.

Point 2.3: This friction may impact the trade-off between covenant strictness and spreads.

Gigler et al. (2009), Accounting Conservatism and the Efficiency of Debt Contracts. Journal of Accounting Research, 47: 767-797.

> "*debt holders would always be willing to accept a lower interest rate in return for more frequent transfer of decision rights to them... lenders would be willing to accept lower implicit interest rates on the debt in exchange for more stringent debt covenants...*"

Point 2.3: This friction may impact the trade-off between covenant strictness and spreads.

Hiemann, Moritz. Covenants, Interest Rates, and the Cost of Debt. Working Paper.

> *"If the borrower has greater scope than the lender to affect risk and return, low interest rates and restrictive covenants are optimal."*

The results in this paper suggest that the trade-off between covenant strictness and spreads may be distorted by the consequences of disclosing covenant strictness.

Point 3: The Mechanism Is Critical

- To *argue* that summary information covenant strictness is important, you need to *show* that summary information about covenant strictness is important.
- The current results support this, but seem more focused on validating the relation between PVIOL and the summary score than on validating the mechanism.

Point 3.1: What are managers trying to hide?

- What is the benefit of hiding covenant strictness?
- What is the cost of hiding covenant strictness?

Why would managers ‘hide’ covenant strictness?

Point 3.2: Who is getting fooled, and does it matter?

- The information is still there.
- Some investors are still processing the information.
- So, who is getting fooled, and does it matter?

Point 3.3: An option for the flow of results

1. Document that managers ‘hide’ covenant strictness (PCov).
2. Document that ‘hiding’ covenant strictness predicts poor performance.
3. Document that ‘hiding’ covenant strictness works.
4. Document who is getting fooled?

Point 3.3: An option for the flow of results

1. Document that managers 'hide' covenant strictness (PCov).

- Tables 4 & 5 (negative relation between PVIOL Pcov and summary score)

2. Document that 'hiding' covenant strictness predicts poor performance.

- Table 8 (neg. rel. between summary score and ROA, pos. rel. with violations)

3. Document that 'hiding' covenant strictness works.

- Table 9 (neg. rel. between summary score and market reaction at loan ann.).
- Table IA10: Worse market reaction when covenants are violated.

4. Document who is getting fooled?

- Table 6 Cols 1 & 2: borrowers with low inst. ownership drive result.
- Table 6 Cols 5 & 6: the effect is mitigated by XBRL.
- *Why does XBRL mitigate the effect, but ChatGPT does not?*

Point 3.4: Careful attention to the economic magnitudes of the results.

- For each stage of the mechanism, it would be helpful to give a concrete sense of the magnitude of the effects you estimate relative to the variation in the data.
- Are the market reactions you document making folks rich or poor?
- Are the differences between ‘hiders’ and ‘highlighters’ large?

We need more papers like this.

1. Deep consideration of an overlooked disclosure choice.
2. Careful attention to an overlooked use of accounting information.

- Overlooked in the sense that I would like more of my debt contracting papers to be published and cited :)

3. Important implications for multiple streams of literature:

- Disclosure and debt contracting.
- Contracting-based and decision usefulness-based origins of the accounting activity.