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Accruals quality, underwriter reputation, and corporate bond underpricing: Evidence from China

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ABSTRACT

This study examines the relationship between accruals quality and the underpricing of corporate bonds in China and how underwriter reputation affects this relationship. We find that (1) accruals quality is negatively associated with the magnitude of bond underpricing and (2) the impact of low accruals quality on underpricing is partially offset by hiring reputable underwriters. A path analysis shows that approximately 11% of the effect of accruals quality on underpricing is attributable to the indirect path through reputable underwriters, suggesting that accruals quality is more effective than reputable underwriters in lowering bond underpricing. These findings are significant for initial bond offerings, but not for secondary bond offerings. We also find that low accruals quality is associated with more restrictive non-price contract terms such as greater collateral requirements and stricter covenants.

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1. Introduction

A growing number of studies have documented that information asymmetry theory can explain the underpricing of firms' initial public offerings (IPOs) (Rock, 1986; Cai et al., 2007; Zheng and Stangeland, 2007). Jog and McConomy (2003) find that IPO firms that do not include earnings forecasts face higher underpricing, although this difference is concentrated among small firms. Schrand and Verrecchia (2005) conclude that firms with more frequent disclosures before the IPO are associated with lower underpricing. Leone et al. (2007) document that IPO underpricing decreases when issuers disclose more specific information in the “uses of

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proceeds” section of their prospectus. In addition, [Boulton et al. \(2011\)](#) study the relationship between earnings quality and international IPO underpricing and find that IPOs are underpriced less in countries where public firms produce higher quality earnings information.

Although there is a sizable body of research on the impact of information asymmetry on IPO underpricing, the vast majority of that research focuses on equity markets. Given the inherent differences between equity markets and bond markets, such as market liquidity, conclusions drawn from studies of equity underpricing may not provide reliable indications of the patterns of bond underpricing ([Cai et al., 2007](#); [Liu and Magnan, 2014](#)). Due to the asymmetric payoff function and their fixed claims on corporate assets, bondholders have stronger incentives than equity investors to demand high-quality financial reporting to reduce the information asymmetry problem ([Ball et al., 2008](#)). More specifically, [Bessembinder and Maxwell \(2008\)](#) point out that a corporation issues bonds at different points in time with contracts that vary in terms of bond features, and that these distinct bonds are traded separately. From this perspective, bonds differ substantially from equity; therefore, bond and equity investors could have different expectations of the supply of financial information. In this study, we consider corporate bond offerings made by public firms (including initial bond offerings (IBO) and secondary bond offerings, (SBO)).¹ We then focus on the quality of borrowers’ financial information and examine how it relates to bond underpricing in the context of the information asymmetry problem in China.

In addition, a growing number of studies have documented that reputable underwriters can signal and certify the quality of issuers’ financial information during IPOs ([Chemmanur and Krishnan, 2012](#); [Yang et al., 2017](#)). [Cooney et al. \(2001\)](#) show that there is a negative relation between underwriter reputation and underpricing, which is consistent with the certification role of underwriters. [Brau and Fawcett \(2006\)](#) find that hiring a top investment bank to underwrite an IPO is a positive signal, and [Kim et al. \(2010\)](#) also provide evidence that reputable underwriters are able to differentiate the quality of issuers and to reflect this information in the underwriting spread. Thus, reputable underwriters can reduce information asymmetry between issuers and public investors ([Dong et al., 2011](#)), which to some extent can mitigate the negative impact of low information quality on bond underpricing.

Based on these findings, this study focuses on the effect of accounting information quality on the costs of corporate bonds. We argue that more precise and reliable earnings mitigate adverse selection costs by reducing information asymmetries between the issuer and bondholders. Accordingly, we first document that firms with lower accruals quality are associated with higher bond underpricing. One mechanism that can mitigate this uncertainty is the presence of a reputable underwriter, which can signal and certify issuer accruals quality. Thus, we infer and verify the second conclusion, that is, the impact of low accruals quality on underpricing is partially offset by employing a reputable underwriter. However, in our additional tests, we find that this association is only robust for initial bond offering, whereas no significant association is found for the secondary bond offering.

To broaden our tests, we use path analysis to evaluate the extent to which reputable underwriters reduce the negative effect of poor accruals quality on underpricing. In our path model, we posit an indirect link through reputable underwriters between accruals quality and bond underpricing. We follow the procedure in [Bhattacharya et al. \(2012\)](#) to weight the relative importance of both direct and indirect paths. Our path analysis results show that although high-quality underwriters have a significant mediation effect on the relationship between accruals quality and bond underpricing, only approximately 11% of the total effect of accruals quality on underpricing can be attributed to the indirect path through reputable underwriters. The results again indicate the predominant role of accruals quality in determining bond underpricing and highlight the importance of information quality in bond financing.

We perform a battery of sensitivity tests to assess the robustness of our findings. First, we use a treatment effects model to mitigate the potential endogeneity problem of accruals quality. In addition, as previous studies show that corporate governance, issuer market risk and coupon rate are likely to impact bond underpricing

¹ [Glushkov et al. \(2014\)](#) indicate that public companies can be divided into three categories through their choice on listing paths: (1) traditional IPOs with no public debt outstanding; (2) private firms undertaking an initial public debt offering; and (3) all public firms that undertake public debt offering for the first time. They find significant differences between these types of firms in several aspects. As all issuers of Chinese corporate bonds are listed firms, our research focuses on the third category.

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