Audit Quality and the Pricing of Initial Public Debt Issues

Although prior studies examine the importance of auditor selection to the pricing of equity initial public offerings, there is no evidence about its impact on the pricing of initial bond issues. We contribute to extant research by estimating the influence of auditor reputation on the at-issue yield spreads (over similar Treasury bond yields) on firms’ initial straight debt offers. Our tests document whether choosing a high-quality auditor, which can moderate debt-related monitoring costs by reducing uncertainty about firms’ financial statements, lowers the borrowing costs on these securities.

In this research, we investigate whether auditor choice matters to the at-issue yield spreads on firms’ initial public bond offerings for several reasons. First, the significant financing changes that accompany these issues provide an opportune setting to examine the impact of auditor quality on debt pricing. Specifically, entering the public bond market usually results in a major shift in firms’ capital structure policy by expanding the debt ownership structure to include public bondholders and by extending debt maturity.

Second, the relatively young, small firms that typically conduct first public debt offers suffer from greater informational asymmetry since they have short histories (Diamond, 1989 and Lang, 1991). Adverse selection and moral hazard problems may affect these firms more, which suggests that they would particularly benefit from the presence of a high-quality auditor. Third, examining initial public bond issues avoids confounding from monitoring by existing bondholders, enabling our design to isolate the link between bank cross-monitoring and auditor choice in the debt pricing under study. Fourth, identifying the determinants of these borrowing costs is important since young firms demand relatively more external financing (Rajan and Zingales, 1998). Finally, there is more variability in the choice between Big Six and non-Big Six auditors in firms’ early public years that coincide with their first bond offers (Pittman and Fortin, 2004).

Consistent with our predictions, we estimate that engaging a Big Six auditor, on average, reduces the at-issue yield spread on bond initial public offerings by about 29 basis points. Results from additional tests suggest that monitoring by a high-quality auditor lowers interest rates even more for firms that are relatively young when issuing these securities. This evidence implies that these younger firms, which experience worse information problems according to prior research, substitute auditor reputation for their own fledgling reputations. We also find that auditor choice has a stronger impact on the initial bond pricing of firms intending to refinance their bank debt, which would diminish cross-monitoring among lenders. The evidence supporting these predictions is robust to examining the influence of auditor quality on bond ratings, rather than yield spreads.