

DISSERTATION DEFENSE

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4:00 pm

261 Posner Hall

“Essays on Information and the Bond Market”

Essay 1: Asymmetric Credit Watches before Downgrades and Upgrades: Evidence on Conservatism of Certified Credit Rating Agencies

Certified credit rating agencies issue credit watches to warn about changes in firms' creditworthiness and possible future rating changes. More rating downgrades are preceded by credit watches than rating upgrades, consistent with the rating agencies being conservative, that is, responding more quickly to bad news than to good news. Downgrades are more likely to be preceded by credit watches than upgrades when (1) the ratings are of investment grade, (2) there are rating triggers, and (3) the issuer's securities-related litigation risk is high. These results suggest that rating agencies' conservatism, like accounting conservatism, is likely motivated by contracting and litigation.

Essay 2 (with Zhaoyang Gu): Quality of Private Information and Bond Yield Spreads

Private information of investors could play a different role in the over-the-counter (OTC) market for corporate bonds than in the equity market. In particular, private information could reduce dealer market power and assessed default probability while having limited effect on creating information asymmetry among mostly institutional investors. We show that precision of both private and public information is *negatively* related to bond yield spreads. There is also a substitution effect between the two sources of information. In addition, we find that the information effect is especially large when bond maturity is relatively short, consistent with the theory of Duffie and Lando (2001). Our results suggest that, when assessing their reporting strategy, managers should not only consider the relation between public and private information, but also weigh the relative importance of the bond and equity markets in each context.

Essay 3 (with Zhaoyang Gu): Income Smoothing and Bond Ratings

Accounting accruals affect not only the levels but also the volatility of the reported earnings. We show in this paper that the income-smoothing use of accruals plays a useful role in the debt market. More income smoothing is associated with more favorable bond ratings and larger weight on accruals in bond ratings. These results are consistent with the argument that income smoothing signals superior firm performance. They complement the consistent findings from the equity market on the reward to income smoothing and cast doubt on the recent plea to “stop smoothing earnings” (Jensen, 2005).