Journal of Global Economics

Research Article **Open Access**

Investment Bank Reputation and IPO Qualifications

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Abstract

In this paper, we examines the influence of investment bank's reputation and political connection on the IPO qualification of Chinese firm, The results show that firms which sponsored by prestigious investment banks more likely pass the regular's screening process, the investment bank's political connection have no significant impact on the IPO qualification. We further compared the investment bank's customer characteristic, and find that the customers of prestigious investment bank are more large-scale, high growth companies, and more central enterprises, indicate that high reputation investment bank tend choose low risk and high growth prospective IPO companies in order to avoid damage to reputation.

Introduction

How to avoid the lemons firms in the capital market? China's capital market has two thresholds, one is the certification of investment bank; the second is approved by China Securities Regulatory Commission (the CSRC), which operates under the authority of the State Council. There is a principal-agent relationship between investment banking and supervision department, which is similar to the investors. To ensure that the company recommended by the investment bank is a good company, China securities regulatory authorities introduced the sponsor system form ATM market in the UK and Hong Kong market, investment banks have sponsor qualification, responsible for recommending the listed companies, and continue to monitor the company's disclosure behavior listed within two years, if the violation occurs, the sponsor must bear some responsibility, and will be punished by the regulatory authorities. Therefore, the investment bank has the motivation to carry out checks on the quality of the enterprise, in order to maintain its reputation.

Whether an investment bank can choose a qualified enterprise depends on its ability and independence. High reputation investment banks usually have more professional research teams, more likely to hire high-quality auditors, and therefore more likely to find potential problems in the enterprise; on the other hand, high reputation investment banks are usually more customers, the impact of a single customer on its business is weak, it is more likely to maintain a high independence. Therefore, high reputation investment banks are more likely to have a rigorous examination of the quality of the enterprise, thereby enhancing the possibility of its customers through the approve. In addition to strict standards to improve the audit pass rate, investment banks may also establish relationships with the government to enable its customers to receive preferential treatment of the audit institutions, thereby improving the audit by the interest rate. Yang [1] shows that firms whose auditor have political relationship are more likely to pass the IPO approve. Therefore, the question of this paper is: 1) whether the investment bank's reputation can affect its customer IPO qualifications? 2) whether the investment bank's political relationship can affect its customer's IPO qualifications?

This paper has two contributions. First, the previous research on the reputation of investment banks mainly focused on the degree of earnings management before the listing, the first day underpricing rate and long-term rate of return. In this paper, from the perspective of the relationship between investment banks and government agency,

whether the reputation can reduce the information asymmetry between the investment bank and the supervision department, and improve the possibility of the customer to obtain the approval of the government. Second, the previous studies on the economic consequences of political relations are mainly focused on the enterprise, and less literature on the political relationship between financial intermediaries. Yang [1] studied the value of the auditor's political relationship; this paper examines the economic consequences of the investment bank's political relationship.

Literature Review

Carter et al. [2] show that there is significant negative relationship between underwriter reputation and IPO initial returns, high reputation underwriters can significantly reduce the information asymmetry between the issuer and investors, and reduce the cost of capital of issuers. Michaely et al. study also show that the higher the underwriter's reputation, the lower the first day return of its underwriting project, the long-term rate of return is higher. Carter et al. [3] show that underwriter reputation and post IPO long-term return has a significant positive correlation, underwriter reputation is high, the post IPO long-run returns more; underwriter reputation and the first day return significantly negative correlation is, the higher the underwriter reputation and IPO underpricing rate is low.

Fernando et al. [4] shows that issuers and the underwriters associate by mutual choice, large-scale and high quality issuers more likely choose more prestigious underwriters. Jo et al. [5] examines the association between the choice of investment bank and earning management, and the results show that there is an inverse association between underwriter quality and earning management, and underwriter quality is positively related to SEOs' post-issue performance. Agrawal et al. [6] shows that probability of restatement by an initial public offering (IPO) firm is positively related to underwriter reputation, the results suggest that underwriters' concerns about revenue generation outweigh their concerns about reputation. Chang et al. [7] shows that IPO firms with

more prestigious underwriters are likely to exhibit substantially less-aggressive earnings management. Indicate that prestigious underwriters will carefully monitoring and certifying financial information on IPO firms, limiting any potential earnings manipulation to protect their reputation.

Su et al. [8] examines the effect of underwriter reputation on IPO first day return and post IPO long-term return in China a share market. The results shows that there was no significant relationship between underwriter reputation and IPO initial return, but the underwriter reputation have significantly positive impact on the post IPO long-term return. Use Chinese IPO firms as sample, Chen et al. [9] examines the relationship between underwriter reputation and pre-IPO earnings management behavior, they find that compared to state-owned holding companies, underwriter reputation have negative significant effect on the non-state-owned company's pre-IPO earnings management.

Use Chinese companies as a sample, Francis et al. examine the effect of political relation on the firm's listing characteristic. The results shows that political related firms issues by higher PE ratio, the underpricing rate is lower, political connections can help enterprise to obtain more funds through IPO. They also examine the effect of the underwriter's political relations, and find that firms whose underwriter have political connection always issue by higher PE, and the first day return always lower. Yang [1] studied the effect of political relations of auditor business. The results showed that political related audit firms have higher market share, higher audit fees and its customers more likely through the IPO Audit Commission.

Methodology

Table 1 details our sample selection procedures for IPO application firm, we limit our sample to 2004-2015 because from the beginning of 2004, China started the implementation of the sponsor system [10]. Finally we have 1757 prospective IPO companies, of which 1523

companies pass the IPO screening process, the 234 companies did not get through. The data of this paper comes from WIND.

To determine whether investment bank's reputation improve the possibility of IPO approval for their clients, the following logistic models are estimated.

$$
\begin{aligned}
prob(approve=1)_{i,t} &= \alpha_0 + \alpha_1 REPU_{i,t} + \alpha_2 CENTR\_UW_{i,t} + \alpha_3 SIZE_{i,t-1} \\
&+ \alpha_4 OPROA_{i,t-1} + \alpha_5 GROWTH_{i,t-1} + \alpha_6 LEV_{i,t-1} + \alpha_7 INTAN_{i,t-1} \\
&+ \alpha_8 CENTR_{i,t-1} + \alpha_9 MULAPP_{i,t} + \alpha_{10} MKTRET_{i,t} + \alpha_{11} GEM_{i,t} \\
&+ \alpha_{12} SMB_{i,t} + YEAR + INDU + \varepsilon
\end{aligned} \quad (1)
$$

REPU is underwriter reputation variables. If in year t-1, investment bank's IPO business market share ranked in the top ten, the variable is equal to 1, otherwise is equal to 0, if the estimated coefficient of the variable is significantly positive, indicate that IPO application firm which recommended by high reputation investment bank are more likely pass the screening process.

CENTR_UW, An investment bank is defined to be central government-controlled if the immediate largest shareholder of the investment bank is Ministry of Finance or State-owned Assets Supervision and Administration Commission (SASAC). China's financial market is highly regulated by the central government, so we adopt the central government holding company as an alternative to the political relationship. If the estimated coefficient of this variable is significantly positive, indicate that the investment bank's political relationship can improve the probability of obtaining the listing qualification for their clients. Table 2 is the specific definition of other control variables.

Table 3 reports the descriptive statistics of the variables for both firms which passed the CSRC's screening process and firms not pass, it can be seen that 1757 of the samples, 87% of the sample pass the CSRC's screening process, 13% of the companies did not pass. 45% of the approved company hired a high reputable investment bank as a sponsor, in the companies not pass the screening process, only 37% of the company hired a high-reputation investment bank, this difference is significant. There is no significant difference in types of ultimate controlling shareholder of investment bank; the size of approved companies is significantly greater than the companies not approved; but the growth rate of approved company is lower than the company not approved. Table 4 reports the correlation coefficients. The investment bank's reputation is positively related to the size and

Sample	Total
Initial sample of IPO application firm s over the period 2004-2015	1892
Exclude firms in the financial industry	28
Exclude firms with missing data	107
Final sample	1757
pass	1523 (86.7%)
Not pass	234 (13.3%)

Table 1: Sample selection procedures.

Prob (approve=1)	The variable equal 1 if the firm pass the screening process, otherwise equal to 0
$REPU\_UW_{i,t}$	The variable is equal to 1 if investment bank's IPO business market share ranked in the top ten in year t-1, otherwise is equal to 0
$CENTR\_UW_{i,t}$	The variable is equal to 1 if the investment bank's largest shareholder is Ministry of Finance or State-owned Assets Supervision and Administration Commission (SASAC), otherwise is equal to 0
$OPROA_{i,t-1}$	Annual operating income divided by the average total assets in year t-1
$LEV_{i,t-1}$	Total debts divided by total assets in year t-1
$SIZE_{i,t-1}$	Natural logarithm of total assets in year t-1
$GROWTH_{i,t-1}$	The annual sales growth rate in year t-1
$INTAN_{i,t-1}$	Intangible assets divided by total assets in year t-1
$CENTR_{i,t-1}$	The variable equal to 1 if the firm is controlled by central government
$MULAPP_{i,t}$	The variable is equal to 1 if the company has applied IPO before, otherwise equal to 0
$MKTRET_{i,t}$	Cumulative rate of return on the Shanghai Composite Index for the year before the company's Application
$GEM_{i,t}$	The variable is equal to 1 if the company applies for listing on the GEM, or equal to 0
$SMB_{i,t}$	The variable is equal to 1 if the company is listed on the SME board market, otherwise it is equal to 0
YEAR	Year dummy variable
INDU	Industry dummy variable

Table 2: Variable definitions.

	Pass (1523)			Not pass (234)			
Variable	Mean	p50	Mean	p50	T	Z	
REPU_UW	0.45	0.00	0.37	0.00	2.42**	2.42**	
CENTR_UW	0.22	0.00	0.20	0.00	0.91	0.91	
OPROA	0.15	0.13	0.15	0.13	0.13	0.21	
SIZE	20.28	20.06	19.97	19.82	4.01***	3.80***	
GROWTH	1.28	1.21	1.32	1.25	1.63	1.93*	
LEV	0.45	0.45	0.46	0.45	0.80	0.86	
INTAN	0.05	0.04	0.05	0.04	0.31	0.52	
CENTR	0.06	0.00	0.02	0.00	2.19**	2.19**	
MULAPP	0.07	0.00	0.03	0.00	2.42**	2.42**	
MKTRET	16.68	7.64	8.82	-3.74	3.21***	3.44***	
GEM	0.34	0.00	0.32	0.00	0.57	0.57	
SMB	0.49	0.00	0.54	1.00	1.54	1.54	

Table 3: Descriptive statistics.

	APPROVE	REPU_UW	CENTR_UW	OPROA	LEV	SIZE	GROWTH	INTAN	CENTR	MULAPP	MKTRET
APPROVE	1										
REPU_UW	0.058**	1									
CENTR_UW	0.022	-0.036	1								
OPROA	0.003	0.039	0.017	1							
LEV	-0.019	-0.028	0.038	-0.553***	1						
SIZE	0.095***	0.094***	0.178***	-0.399***	0.473 ***	1					
GROWTH	-0.039	0.054**	0.021	0.168***	-0.008	-0.008	1				
INTAN	0.007	-0.004	-0.021	-0.017	-0.036	0.027	-0.118***	1			
CENTR	0.052**	0.041*	0.153***	-0.117***	0.112***	0.332***	-0.013	-0.035	1		
MULAPP	0.058**	0.007	-0.048**	-0.043*	-0.028	0.034	-0.036	-0.002	-0.020	1	
MKTRET	0.076***	0.009	0.011	-0.113***	-0.056**	0.113***	-0.009	-0.063**	0.093***	-0.036	1

Table 4: Correlation.

growth of the enterprise, central government controlled companies are more likely to choose a high-reputation underwriter.

Regression Results

Table 5 reports the regression results of the model (1). The estimated coefficient of REPU_UW is 0.416, which is significant at the 1% level, indicates that firms which recommended by high-reputation investment banks are more likely to pass the audit. The estimated coefficient of CENTR_UW is 0.078, but not significant, indicate that the type of ultimate controlling shareholder of the investment bank has no significant impact on the enterprise audit pass rate.

The estimated coefficient of OPROA is 3.004, significant at the 10% level, the estimated coefficient of size is 0.738, this shows that large and profitable enterprises are more likely to pass the audit. The estimated coefficient of MULAPP is 1.2, significant at the 1% level, indicate that the re application are more likely pass the audit. The estimated coefficient of GEM and SMB are significantly positive, indicate that compared to the main board market, the IPO audit pass rate is higher in GEM and small and medium enterprises board market.

Table 6 reports the characteristics of prospective IPO companies sponsored by different reputation investment banks, we divided the companies into two groups, one group is sponsored by the high reputation investment bank, one group is sponsored by low reputation investment bank, then we compare financial performance differences between the two groups. We found that, compared to the companies sponsored by the low reputation investment banking, companies sponsored by high reputation investment are significantly higher in the scale and growth. There are more central enterprises recommended by high reputation investment banks, indicate that considering for their own interests, high reputation investment banks tend to choose low-

	(1) Approve	(2) Approve	(3) Approve
REPU_UW	0.504***		0.416***
	(3.34)		(3.01)
CENTR_UW		0.132	0.078
		(0.72)	(0.36)
OPROA			3.004*
			(1.75)
LEV			-1.223
			(-1.38)
SIZE			0.738***
			(5.23)
GROWTH			-0.039
			(-0.13)
INTAN			0.294
			(0.19)
CENTR			0.598
			(1.10)
MULAPP			1.200***
			(2.97)
MKTRET			0.003
			(1.26)
GEM			1.442***
			(4.85)
SMB			1.024***
			(4.23)
_cons	0.138	0.434	-14.985***
	(0.15)	(0.47)	(-5.08)
N	1717	1717	1717
pseudo R^2	0.062	0.054	0.104

t statistics in parentheses, *$p<0.10$, **$p<0.05$, ***$p<0.01$

Table 5: Regression results.

	REPU_UW=1(774)			REPU_UW=0(983)		
Variable	Mean	p50	Mean	p50	T	Z
OPROA	0.151	0.136	0.145	0.131	1.62	1.59
SIZE	20.350	20.091	20.145	19.993	3.94***	3.53***
GROWTH	1.311	1.236	1.274	1.202	2.27**	2.34**
LEV	0.451	0.447	0.460	0.457	1.19	1.2
INTAN	0.051	0.041	0.052	0.044	0.17	0.22
CENTR	0.061	0.000	0.043	0.000	1.71*	1.71*

Table 6: The characteristics of prospective IPO companies.

risk and highly profitable business, these companies are more likely to pass the CSRC's screening process.

Conclusion

This paper examines the influence of investment bank's reputation and political connection on their clients' IPO qualification. The results shows that firms which sponsored by prestigious investment banks more easily approved by the government, the investment bank's political connection have no significant impact on the IPO qualification. We further compared the investment bank's customer characteristic, and find that high reputation investment bank's customers are more large-scale, high growth companies, and more central enterprises, indicate that high reputation investment bank tend choose low risk and high growth prospective IPO companies in order to avoid damage to reputation.

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