

2. Initial Public Offerings

2.1 Process of an IPO

The process of going public in the US is governed by the Securities Act of 1933. Usually, if companies decide to go public, an underwriting bank supports the process. After the due diligence, the offering prospectus is prepared. This document includes general information about the firm, future prospects, the competitive environment, and audited financial statements for the most recent three years. With the prospectus the company and its underwriter(s) promote the issue in road shows.²⁰

The process of setting a price for an IPO starts at the time the issue is registered and filed with the Securities and Exchange Commission (SEC). In the preliminary or the amended prospectus, the company makes a range of prices available which are built on expectation from the company and constitute possible offering prices.²¹

The time line of the IPO process is portrayed in Figure 1. The process of going public starts some months or years before the issue. The last 365 days before the IPO is defined as year -1 and portrays the pre-IPO results. Then follows the IPO and the shares are made available to the public. Only a part of the shares are available, because initial shareholders sell around 15-20 percent of a company.²² The remaining 80-85 percent of shares are restricted from sale for a certain time period. This is called the lock-up period.²³ In these months company insiders are not allowed to sell their shares for usually 180 days after public trading started.²⁴ This period is designed to prevent a stock from experiencing a high volatility, which might occur if too many shareholders sell at the same time. The market could interpret this behavior as revealing private information and the price would fall dramatically.

The time line shows the first 365 days after the IPO as year +1 (post-IPO). Actually, the lock-up period can expire before or after the end of the financial year +1, depending when the company goes public and when the next financial year-end is due. However, the lock-up

²⁰ Fan (2007), p. 29; Singer (2007), p. 49; Teoh et al. (1998c), pp. 177-178.

²¹ Lowry/Schwert (2004), p. 5; Lowry/Schwert (2002), pp. 1173-1174.

²² Bradley et al. (2001); Ofek/Richardson (2001), p. 22.

²³ DuCharme et al. (2001), p. 370. In primary offerings, the proceeds flow to the company for corporate expansion, for example, whereas in a secondary offering, the proceeds go to the owners for selling their shares. Typically, IPOs combine both methods.

²⁴ Field/Hanka (2001), p. 471.

period is most often six months and the earnings reporting lag is one to three months after the end of the financial year. Therefore, the lock-up period ends in close proximity to the financial statements of year +1 and its announcement.

Some prior studies used the notation “year 0” instead of “year +1” to refer to the first financial statements after the IPO. However, there are also some studies that use year 0 for all financial statements that are due in the whole calendar year of the IPO. This means some of these dates are before and some are after the IPO.²⁵ The outcome is a mixture of pre- and post-incentives when using these year 0 results and can bias the findings and their interpretation. To better differentiate between pre- and post-IPO statements, the terms year -1 and year +1 year clearly indicate the time period of the statements and the associated incentives.

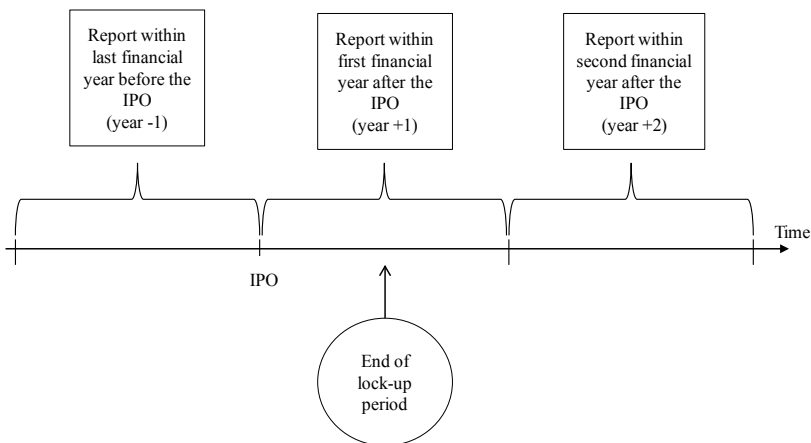


Figure 1: Time Line of IPO Years

²⁵ DuCharme et al. (2004), p. 34; Teoh et al. (1998b), p. 1936; Teoh et al. (1998c), pp. 178-179.

2.2 Motivations for Going Public

The decision to go public is important for every company and depends on various factors. Prior research mainly examined underpricing and long-run performance of IPOs but paid little attention to the reason for the listing on a public exchange. However, there are several motives which partly contradict each other and therefore, they are difficult to include into one theory.²⁶ Some are presented here.

The first motive is the minimization of capital costs to optimize the capital structure.²⁷ This motive is supported by Fama/French (2004, 267) who argue that more unprofitable firms go public due to lower capital costs. Capital costs decline due to spreading the risk of equity owners and lowering borrowing costs because of transparency and reputation, for example. Therefore, issuing equity minimizes the cost of capital and thus maximizes the value of the firm. This helps shareholders to sell their stocks at a high price. Another motive is to increase bargaining power with banks. Being present in the equity market reduces the cost of capital due to more pellucidity about the company.²⁸

A third motive could be that companies become a takeover target and shareholders want to establish a market price when they intend to cash out or sell the company at a higher value than without the issue.²⁹ This can also be true for venture capitalists and underlines the intention of shareholders as well as the management to increase the share price.³⁰ Again, there are studies that partly disprove this motive which leaves only a part of companies that have this notion in mind.³¹ The aforementioned motive also includes that an IPO itself could indicate an overvaluation of the company because shareholders intend to sell at the peak of valuation. Then investors would be conspicuous about the step towards public listing. However, there are studies that find counterintuitive arguments.³² Therefore, this motive is true for only a part of the companies.

Fourth, a motive for going public certainly is the intention to create publicity or reputation for the firm.³³ The IPO causes the firm to become known to the public which can help to make

²⁶ Brau (2010), pp. 18-19; Pagano et al. (1998), p. 36.

²⁷ Baxter (1967); Modigliani/Miller (1958); Modigliani/Miller (1963); Stiglitz (1969).

²⁸ Pagano et al. (1998).

²⁹ Lerner et al. (2005); Zingales (1995).

³⁰ Black/Gilson (1998).

³¹ Brau et al. (2010).

³² Ritter (1991).

³³ Maksimovic/Pichler (2001); Pagano et al. (1998).

the company more interesting to investors than a firm that operates in the dark. Furthermore, it sometimes has a first mover advantage in the niche of an industry and indicates that it intends to grow intensively in the future. This motive might be relevant especially for small Internet companies or those operating in the Technology industry, but less for companies that are already well-established.

Furthermore, if the shareholders want to cash in, then maximizing the share price is of interest. The associated adverse selection problem inherits the informational asymmetry between the issuer and possible investors. The larger the gap of information between the two parties, the lower the share prices and the higher the underpricing.³⁴ Since more informational symmetry leads to lower underpricing, an improvement of understanding of the financial report would decrease this anomaly.³⁵ Therefore, earnings management studies can help to decrease the information asymmetry.

The results of the motives are tested in several studies and indicate that they apply to specific samples of companies.³⁶ This supports a differentiation between particular sets of firms and underlines the importance of separating companies into subgroups when examining them.

For all companies there exist pros and cons for an IPO which are associated to the motives. On the one hand, companies have a number of benefits when issuing stock.³⁷ It is the first opportunity for a firm's shareholders to receive money for the value of their ownership stake and diversify their property.³⁸ Additionally, the corporation receives financing and implements a capable ownership structure.³⁹ Another benefit from going public is the minimization of the cost of capital and the facilitation of takeover activity.⁴⁰ It advances the growth process of a company while later in the life cycle of a company growth usually declines. Further benefits include the increase of publicity, attraction to top executives etc. However, not only the motives and benefits are decisive when companies go public, but prior literature finds that IPO markets are cyclical over time in terms of the amount of companies

³⁴ Leland/Pyle (1977), p. 371-372; Rock (1986), pp. 188-189.

³⁵ Arthurs et al. (2008), pp. 277-279.

³⁶ See for example Pagano et al. (1998) and Brau (2010, 7).

³⁷ The aspects are primarily intended for US IPOs. However, they are similarly true for IPOs in Europe, although the likelihood of going public and the underlying motivations may differ due to structural, cultural and other differences.

³⁸ Pagano et al. (1998), pp. 36-42; Zingales (1995), p. 425.

³⁹ Mello/Parsons (1998), p. 80-82.

⁴⁰ Brau/Fawcett (2006), p. 406; Schöber (2008), pp. 44-49.

issuing stock and proceeds raised.⁴¹ Accordingly, companies should file the issue in hot markets or after periods of high underpricing.⁴²

On the other hand, there are also disadvantages when becoming publicly traded. The direct and indirect costs of going public include the registration and underwriting (which account for around 15 percent of the raised funds), underpricing, employing a more sophisticated financial reporting standard and report in short time intervals, as well as the agency problems generated by a separation between ownership and control to a larger extent.⁴³ Additionally, the new investors have specific interests and can try to influence the behavior of the company in contrast to the founders' interest.⁴⁴

Overall, there are several motives for going public with the corresponding benefits and downsides, but all include that shareholders sell a part of their stakes in the company and try to receive a high price which fosters earnings management.

2.3 Industry Differences

When going public, companies are valued dependent on several factors including their industry. For example, the future development of the industry has to be taken into account or the peer group (for calculation of the multiples etc.) of existing companies from the same industry.⁴⁵ Prior literature finds evidence for differences in industries; therefore, a discrepancy between companies can be expected. Following the Internet bubble, some studies examined financials of IPOs in the Internet and Technology industries and evidenced their difference to other industry sectors. Usually, this procedure means that the (control) sample is a mixture of various industries. However, this assortment of industries mixes influences and varies in itself if specific industries differ in amount of companies. To overcome this problem, studies should focus on one industry at a time instead of mixing industries in the (control) sample.

Some researchers include the Internet and Technology industries which are specific in their financials for several reasons. Internet companies usually have an income lower than zero when going public whereas Technology companies are ambiguous concerning profitability. Furthermore, Internet companies are even younger and grow faster than established

⁴¹ Ibbotson/Jaffe (1975); Ibbotson et al. (1988).

⁴² Lowry/Schwert (2002); Pastor/Veronesi (2005).

⁴³ Jensen/Meckling (1976), pp. 306-309; Ritter (1987), pp. 271-272; Zingales (1995), p. 425.

⁴⁴ Pagano/Röell (1998), pp. 188-191.

⁴⁵ Dong/Michel (2012), p. 2.

companies. Other characteristics of these companies are their rapid growth, a predominant equity financing, and the fact that these firms are not valued by their earnings.⁴⁶ Similarly, the science (Biotech) industry also shows negative income when going public and it is valued by its R&D expenditures, for example.⁴⁷ The specifics of these industries are long-term research and development investments that are meaningful for their future competitiveness. Depending on the results of these projects, companies can create benefits for investors which have to cope with the associated risks. Investments in R&D are expensed as incurred and produce losses over years before the company receives benefits. This attracts venture capital investors in these three industries which take the current risk for future benefits. In contrast to these R&D-intensive industries, Construction, Manufacturing, and Wholesale industries are usually profitable when going public, more commercially established, older, and grow less strongly. However, their growth is stronger than companies in the same industry which are already publicly traded. Moreover, earnings are value relevant for investors while R&D investments are not important in these well-established industries.⁴⁸ They are financed by debt as well as equity in contrast to the above industries which are mainly financed by equity.⁴⁹ These industries are equipped with many tangible assets. Therefore, they obtain more possibilities of accounting flexibility in reporting earnings which enables them to extend the discretionary amounts over several accounts and obscure the discretion. Firms with many tangible assets can, for example, lower estimates of bad debt, increase inventory valuation, or sell assets for gains instead of merely focusing on sales management to boost reported earnings.⁵⁰

⁴⁶ Bowen et al. (2002); Damodaran (2012); Davis (2002); Hand (2003).

⁴⁷ Guo et al. (2005); Lévesque et al. (2012).

⁴⁸ Bassioni et al. (2004), p. 46; Chan/Chan (2004), p. 210.

⁴⁹ Graham et al. (2005); Fedyk et al. (2012); Joos/Zhdanov (2004).

⁵⁰ Singer (2007), p. 21.

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