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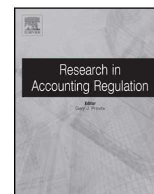

Research Report

The JOBS Act disclosure exemptions: Some early evidence

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ABSTRACT

This paper examines early evidence of IPO registrants' disclosure exemption choices in response to the optional disclosure relief provided by the recently enacted Jumpstart Our Business Startups Act (JOBS Act) of 2012. The JOBS Act provides firms going public classified as "emerging growth companies" (EGCs) with certain accounting and financial reporting and disclosure exemptions not available to other issuers. The study's results for EGC firms filing prospectuses through August, 2013, indicate that for the earliest companies affected by the JOBS Act, greater board independence and audit committee accounting expertise are associated with greater likelihood of *foregoing* financial reporting exemptions. Moreover, the study finds that scaled executive compensation disclosure exemptions had widespread acceptance while the private company accounting standards and reduced audited financial statements exemption provisions were initially less utilized. Finally, the study finds that even though the JOBS Act raised the threshold for disclosure relief up to $1 billion in revenues, those firms that were already classified as smaller reporting companies which already have less extensive disclosure demands under SRC Rule #33–8876, were those most likely to initially take these exemptions. The paper discusses the practical implications of the study's findings for accounting standard-setters, watchdogs, and policy makers.

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Introduction

This paper examines IPO registrants' disclosure exemption choices in response to the optional disclosure relief provided by the recently enacted Jumpstart Our Business Startups Act (JOBS Act) of 2012. The JOBS Act provides firms going public classified as "emerging growth companies" (EGCs) with certain accounting and financial reporting exemptions not available to other issuers. Specifically, I examine the relation between board composition, managerial ownership, and audit committee expertise and IPO registrants' choices to reduce the extent of regulatory disclosure under the JOBS Act provisions. I find that greater board independence and audit committee accounting expertise are associated with greater likelihood of foregoing financial reporting exemptions but do not find evidence of a significant relation between CEO–Board Chair duality and CEO/board ownership and JOBS Act exemption choice. The paper discusses the implications of these findings along with that of the variation in exemption choice by the first class of EGCs and their public policy implications.

This study's results have a number of practical implications for regulators. First, results indicate that even though the JOBS Act intended to provide disclosure relief to EGCs with up to $1 billion in revenues, the smallest of firms were the ones initially taking the JOBS Act exemptions. On the one hand, this indicates that the JOBS Act's target audience of smaller emerging growth companies is responding positively to these exemption choices. However, regulators should take note smaller reporting companies already have less extensive disclosure requirements as outlined in the SEC's 2007 SRC rule #33–8876. It is therefore questionable whether the JOBS Act exemptions have had their intended effect of incentivizing additional larger companies to go public by reducing the cost and burden of SEC disclosure requirements.

Second, the scaled executive compensation disclosure exemptions had widespread acceptance. One potential

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explanation for companies going public choosing to take the executive compensation disclosures exemptions (disclosing only the compensation of the top 3 instead of top 5 executives and omitting the Compensation, Discussion & Analysis (CD&A section)) may be that companies see the costs of disclosure as outweighing the benefits, i.e. managers do not think that this information is valuable to investors. While the compensation of the top five executives is information that is readily available to companies and can be disclosed with minimal preparation cost, drafting the CD&A is a more costly disclosure because it initially requires knowledge of Regulation S-K pertaining to the CD&A and multiple levels of review, including legal counsel. Others may argue that despite the additional time and effort that may be required, cost is not the issue; rather, firms may be choosing to minimize executive compensation disclosures due to weak corporate governance mechanisms and greater agency costs. Policy makers should consider the drivers behind JOBS Act company disclosure exemption choices to ensure that the law is having its intended effect.

Issues related to executive compensation, such as say-on-pay and CEO-to-employee pay ratio, have captured the attention of both investors and policy makers in the past decade. The SEC and Congress have pushed for increasing transparency of executive compensation policies and for the "reining in" of "out-of-control" increases in executive compensation that are not in line with company performance. Ironically, the JOBS Act did the opposite of the Dodd–Frank Act by decreasing executive compensation transparency. If the recent regulatory attention devoted to executive compensation at public companies is perceived to be an issue more related to large multinational corporations rather than emerging growth companies, than Congress's scaling down the regulatory disclosure requirements for EGCs would make sense. In other words, if policy makers saw these disclosures as costly and unnecessary for emerging growth companies, the results should put them at ease. More clarification from policy makers on their intention for reduced executive compensation disclosures for EGCs in light of increased requirements for other public companies would be helpful to market participants in interpreting these results.

While most companies initially affected by the JOBS Act took executive compensation disclosures, most did not choose to initially take exemptions pertaining to the application of new accounting standards as private companies and the provision of 2 instead of 3 years of audited financial statements in the IPO prospectus. On the one hand, these two exemptions reduce the cost of financial reporting both in terms of the extent of public company accounting standard financial expertise required in-house and the cost of an additional year of external audits and the time and effort required on the part of management to draft and review the related discussion of selected financial data in the Management, Discussion & Analysis (MD&A) section of the prospectus. A potential explanation for companies choosing to forgo the accounting standards exemption is the rationale that it can only be foregone for 5 years and the company will eventually have to adopt public company financial accountings standards, thus, it may as well do so initially. On the other hand, the significant positive association between corporate governance strength and the decision to provide additional years of audited financial statements suggests that agency costs may be at play; companies with weaker governance may be choosing to take the exemptions while those with stronger governance are choosing to forgo them altogether.

Consequently, some of the study's findings suggest that the JOBS Act disclosure relief provisions, instead of just helping decrease the cost of initial public offerings, may have the unintended consequence of exacerbating the already high information asymmetry of the IPO process, which contributes to further moral hazard and adverse selection issues. The SEC and investors should devote extra scrutiny to EGC SEC filings to ensure that management is acting in the best interest of shareholders and the U.S. capital market.

The remainder of the paper is organized as follows: The next section provides a brief background on the JOBS Act and develops testable hypotheses. The third section describes the research design, data, and sample selection, and the fourth section presents the results and analysis. The last section sets forth the conclusions and discusses implications and limitations.

Background and hypothesis development

Background

The U.S. Securities and Exchange Commission (SEC) has had a long history of increasing mandatory disclosure requirements (e.g., Hughes, Sander, & Snyder, 2009). Despite continuing calls by some to increase disclosure requirements in some areas (Hughes et al., 2009), the past several decades have also seen a turning of the tide toward reduced mandatory disclosure in other SEC reporting areas (e.g., Behn, Riley, Gotti, & Brooks, 2011), in order to decrease the costly reporting burden on issuers, particularly smaller public companies. For example, the deregulation, meant to spur U.S. capital markets and job growth, began in 2007 with the Small Reporting Company Regulatory Relief and Simplification (SRC) rule #33–8876. This rule provided disclosure relief in SEC filings to small reporting companies with less than less than $50 million in revenues or $75 million public float (Cheng, Liao, & Zhang, 2013). The JOBS Act of 2012 strives to reduce the reporting burden on even larger companies going public.[1]As one of its many provisions, the JOBS Act raises the triggering threshold for certain SEC reporting obligations under the Securities Exchange Acts of 1933 and 1934 to $1 billion total gross revenues (U.S. Congress, 2012).[2]It also provides additional reporting exemptions to

[1] Some companies disclose the costs associated with going public and the costs of Sarbanes–Oxley Act compliance; however, it is difficult to identify the costs of specific exemptions considered in this paper. The costliest provision is the SOX 404(b) provision followed by the audited financial statements and public company accounting standards requirements, which require additional audit costs and the hiring of more accounting expertise with knowledge of GAAP for public companies. However, executive compensation records are already available and require comparatively minimal additional work to reproduce in SEC filings.

[2] An issuer remains an EGC until its annual revenues exceed $1 billion, the last day of the fiscal year following the fifth anniversary of the issuer's IPO, the issuer qualifies as a large accelerated filer, or the date the issuer issued more than $1 billion in non-convertible debt during the previous three-year period, whichever comes first (Lynn & Pinedo, 2012).

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