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The emerging growth company status on IPO: Auditor Effort, Valuation, and underpricing

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ABSTRACT

The Securities Act of 1933 governs the going public process and the accompanying registration statement submissions to the Securities and Exchange Commission (SEC). The Jumpstart Our Business Start-ups (JOBS) Act of 2012 created several accommodations under the SEC securities laws for a new group of companies referred to as “emerging growth companies” (EGCs). We examine the associations between auditor effort, initial public offering (IPO) offer prices, and investors’ perceptions of the registrants’ intrinsic value (underpricing) and EGCs’ registration statements utilizing accommodations to reduce financial statement information disclosure. Our finding that auditor effort is reduced suggests that the potential for increased auditor risk for EGCs future financial statements could be higher because of issues related to financial statements not included in the registration statements. We also find a negative (positive) association between EGC filing and IPO offer prices (underpricing). Our results suggest potential unintended consequences associated with EGCs and that auditor effort might not be sufficient to reduce the possibility of future financial statement failures.

1. Introduction

The Jumpstart Our Business Start-ups (JOBS) Act of 2012 provided several special initial public offering (IPO) registration accommodations under the U.S. securities laws that created a new group of companies referred to as “emerging growth companies” (EGCs). These provisions under the JOBS Act were intended to reduce costs that registrants incur in their IPOs and to promote overall economic growth through U.S. job creation. The bill created a five-year “IPO on-ramp” for EGCs, allowing registrants some exemptions and deferrals in the disclosure requirements for public trading. The reduced disclosure requirements for registrants filing under the EGC status likely affects, directly or indirectly, the information risk inherent with IPO offerings. This study examines the extent to which the reduced financial statement disclosures affected the pricing of audit services, initial offer prices, and IPO underpricing of these new companies.

The IPO literature suggests that audited financial statement information reduces the ex-ante uncertainty confronting IPO investors (Beatty, 1989; Menon and Williams, 1991; Willenborg, 1999). However, reduced financial disclosure likely increases the information asymmetry for EGC registrants increasing the ex-ante uncertainty about EGCs. The reduced information in EGCs’ registration statements can also increase perceptions of registrants’ business risk. The EGCs’ perceived business risk is likely higher because the reduced information increases the risk of surprise (e.g., restatement) from information not included in the registration statement. The prior accounting literature provides evidence of positive associations between increased business risk and increased hours and fees on

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audit engagements (Bell et al., 2001; Bell et al., 2008; Brumfieldet al., 1983; Johnstone and Bedard, 2001). Thus, examining the pricing of audits services related to reduced financial disclosures informs the literature about whether the price of audit services incorporate this potential increase in the uncertainty about EGCs and the perceptions of EGC business risk.

Underwriters certify that the IPO offering price reflects both public and private information about the registrant and underwriters risk reputation capital if market participants subsequently conclude that the registrant provided misleading information or that the offering was inappropriately priced (Beatty and Ritter, 1986; Booth and Smith, 1986; Menon and Williams, 1991). Because the JOBS Act permits a reduction in financial statement information mandated for non-EGC registrants, EGC registrants likely have greater information asymmetry than non-EGC registrants, which could influence underwriter decisions regarding EGCs' initial offer prices.

Prior underpricing literature suggests that underpricing should increase with greater ex-ante uncertainty about registrants (Ljungqvist, 2007; Beatty and Ritter, 1986; Rock, 1986). This underpricing relies on the premise that investors purchase IPO shares if registrants' intrinsic value is greater than the offer price. We suggest that reductions in financial statement disclosures, through the accommodations available to EGCs, proxy for the increase in ex-ante uncertainty about EGCs. Thus, we examine whether there is an association between these accommodations and EGC registrants' IPO underpricing.

We find an association between the reduced information in EGC registration statements and reduced auditor effort when comparing EGC registrants to pre-JOBs Act non-EGC registrants. Specifically, we find that EGC registrants that utilized reduced financial statement disclosure accommodations incurred accounting fees that are 26.6 percent lower, on average, than pre-JOBS Act non-EGC registrants. We find that EGC registrants that utilized reduced financial statement disclosure accommodations experienced mean offer prices that are 18.3 percent lower than pre-JOBS Act non-EGC registrants. Overall, we suggest that the information risk because of the reduced financial statement disclosures in EGC IPO registration statements, conveyed by the IPO offer price, is greater than that of pre-JOBs Act non-EGC registrants. Finally, we find that EGC registrants that utilized reduced disclosure accommodations experienced mean underpricing that is 10.1 percent greater than pre-JOBS Act non-EGC registrants. Overall, we suggest that EGC registrants that reduced financial statement information experienced higher underpricing.

In an additional sensitivity analysis, we also re-estimate our analyses using an entropy-balanced sample, and our results continue to suggest associations between EGC registrants' and lower accounting fees, lower IPO offer prices, and greater underpricing.

Investigating the effect of reduced financial statement information disclosure by EGCs on the related auditor effort associated with EGC registrants, on EGCs' valuations, and on underpricing contributes to several streams of literature. First, this study contributes to the literature on information asymmetry and the value of financial statement disclosures by providing evidence on the effect of reduced financial statement disclosure on the four key stakeholders in IPO registrations: the registrant, underwriters, auditors, and investors. Second, we contribute to the audit literature by providing evidence that the increased information asymmetry resulting from reduced financial statement disclosures does not appear to increase auditor effort to offset potential issues related to future financial statements. Third, we contribute to the extant literature on IPO valuations by providing evidence on the effect of the reductions in financial statement disclosures on IPO offer prices and evidence suggesting that investors perceive greater information uncertainty for EGCs with reduced financial statement information. Finally, we contribute to the discussion on the benefits of incentives to encourage initial public offerings. We provide evidence on the costs associated with regulations that reduce information available to investors. This reduction in information is important because a majority of IPO registrants (i.e., 83 percent of EGC eligible registrants) during the first 18 months after the JOBS Act elected the EGC status and 62 percent of EGC registrants utilized the accommodations to reduce information disclosed in their registration statements.

Finally, this study's results are important to regulators for several reasons. First, the estimated average cost of an IPO is $3 million, with most of the expense related to accounting and legal fees (Knight, 2016). The work required to prepare IPO registration statements remains relatively fixed, irrespective of the offer price. Thus, the regulators should examine the extent to which the accommodations lower IPO registration costs given the negative effects associated with initial offer price and underpricing. Second, a critical factor for IPO registrants is the IPO price. Thus, evidence provided in this study suggests regulators should consider whether the lower IPO offer price offsets the potential cost savings intended for the EGC accommodations. Third, several studies indicate an association between EGC registrants and higher underpricing (Chaplinsky et al., 2017; Agarwal et al., 2016). This study extends their findings by providing evidence that the reduced financial statement disclosures in EGC IPO registration statements lead to greater underpricing. Thus, regulators should consider whether reduced IPO registration statement disclosures are valuable to market participants and the trade-off between perceived intrinsic value and the reduction in compliance costs. Overall, the unintended consequences of lower valuations and higher underpricing observed in this study suggest issues for consideration when contemplating future changes to the IPO registration process.

The remainder of this paper proceeds as follows. Section 2 describes the IPO process, the JOBS Act, auditor effort, information asymmetry, and underpricing literature and develops the hypotheses. Section 3 describes the research design and sample. Section 4 provides descriptive statistics and the results of the analyses. Section 5 provides the conclusion.

2. Background and hypotheses development

2.1. Background: IPO process

The Securities Act of 1933 outlines the process of going public and the requirements for registration statements. A registration statement includes a preliminary prospectus, information about the proposed offering, company background, risk factors, use of proceeds, management (including the registrant's officers, directors, and principal shareholders), the auditors and underwriters involved with the offering, and audited financial statements. After the preliminary prospectus filing, the underwriters market the