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# The role of internal and external certification mechanisms in seasoned equity offerings

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ABSTRACT

When conducting their seasoned equity offerings (SEOs), US firms have been increasingly relying on shelf offering or accelerated offering rather than non-shelf offering or traditional book building, the predominant issuance methods in the past. Previous studies find that the unpopularity of shelf or accelerated offering in the past is due to the under-certification problem. Therefore, the change in firms' preferred issuance methods suggests that firms must have obtained adequate certification through various ways. In this paper, we study several potential internal and external certification mechanisms that issuers can utilize and explore their roles in the SEO process. We find that the internal certification via sound corporate governance affects firms' choice of the issuance method between shelf (accelerated) and nonshelf (non-accelerated) offerings, while the external certification through acquiring high-quality auditing services impacts the issuance costs.



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## 1. Introduction

Extant research supports the view that corporate financing policy is strongly influenced by agency problems and information asymmetry arising from the separation of ownership and operational control of a firm (Jensen and Meckling, 1976; Myers and Majluf, 1984). Mande et al. (2012) investigate whether corporate governance quality affects a firm's choice between debt and equity financing. For a sample of more than 2000 US debt and equity offers, they find that firms with more effective corporate governance are more likely to issue equity, suggesting that effective governance reduces the higher (compared with debt) agency cost of equity financing. Moreover, they find that the positive relation between governance and the probability of equity financing is more pronounced when there is higher information asymmetry between an issuer and outside investors. Echoing Mande et al. (2012), Dutordoir et al. (2014) find that corporate governance quality is a significant determinant of Western European issuers' financing choice among convertible debt, straight debt, and equity. In particular, issuers with weaker governance are more likely to issue convertible debt. In this paper, our first motivation is to examine whether corporate governance quality influences issuers' choice between shelf and non-shelf offering and between accelerated and non-accelerated offering. A shelf registration allows an eligible firm to issue its securities whenever it chooses to do so within two years of the registration without seeking further regulatory approval. An accelerated offering enables an issuer to complete an offering within one to two days. Given the much-shorter time frame for underwriters and investors to conduct their due diligence for shelf or accelerated offerings, we expect more severe agency problems and higher information asymmetry among an issuer, its underwriter(s), and investors for such offerings. Therefore, we posit that an issuer with better corporate governance quality may be more likely to conduct a shelf or accelerated offering, because the benefit of good governance in reducing the costs of agency problems and information asymmetry is particularly higher (Mande et al., 2012; Dutordoir et al., 2014). Using a sample of US equity offerings over the period of 2001 through 2007, we find evidence supporting such an argument.

In the context of equity issuance, shelf registered offerings have lower issuance costs than traditionally registered offerings (Bhagat et al., 1985; Autore et al., 2008). Yet in the past the majority of issuers chose the traditional offerings over shelf registration when issuing equity (Denis, 1991; Autore et al., 2008). This preference for a relatively expensive method of equity issuance has been attributed to the problem of under-certification faced by shelf issuers. The under-certification problem arises due to the short time period between the announcement and the issuance of equity in shelf offers that precludes adequate due diligence by underwriters. Autore et al. (2008) suggest that issuers choose shelf registration only when they are partially certified by mechanisms other than underwriter due diligence. Autore et al. (2008) identify two of such mechanisms: conducting shelf offering after the issuer has made several SEOs before and hence the issuer has been certified during those SEOs prior to the shelf offering; conducting shelf offerings after smaller stock price runups to signal to investors that the issuer is not selling overvalued equity. Turning to the choice between accelerated and non-accelerated offerings, Gao and Ritter (2010) find that issuers with less elastic demand curve for their stocks tend to conduct a non-accelerated offering (that is, fully marketed offering with traditional book building and road show) in which underwriters are hired to create demand (that is, flatten the demand curve). Issuers with more elastic demand curve should therefore prefer to conduct an accelerated offering, which reduces the time taken to issue new securities and lowers the flotation costs. However, the accelerated offering method also suffers from the same drawback of limited due diligence time for underwriters. Thus, given the risky nature of the accelerated offer method, it makes sense for underwriters to ensure that a certification device is in place before accepting a deal in order to protect their reputation and lower their litigation risk. The second motivation of our paper is to examine whether a firm's internal corporate governance arrangement could serve as a potential certification device for a shelf or an accelerated offering. We expect that firms with high quality internal governance mechanisms may require less external certification via underwriters. Given the lower issuance costs of shelf or accelerated offerings as compared to non-shelf or non-accelerated offerings, we posit that firms with better governance quality are more likely to choose shelf (accelerated) offerings over non-shelf (non-accelerated) offerings. Our empirical evidence is consistent with such a view.