Do promoters practice what they preach?: Evidence from Australian IPOs

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1. Abstract

“We can only stop prospectuses with bad disclosure - you must decide if it's a bad investment,” is the official position of ASIC on prospectuses (http://www.fido.asic.gov.au, 2004). So what information is available to the investors have to use in their decisions and is that information valuable? This study focuses on the information content and quality of use of proceeds disclosures by Australian IPO firms. There has been little research on use of proceeds. This studies main innovation is the use of Cash flow statement data to assess the accuracy of the use of proceeds disclosure of disclosing firms. Other contributions to collective knowledge include the application of use of proceeds specificity to underpricing and long-run performance in Australia and a documentation of the effect of a principles-based disclosure requirement on the quality of the disclosure.

2. Introduction

When investors order shares in an Initial public offering (IPO) they are buying into the future of the company. The primary focus of the investor’s information search should be on forward looking information about the company (http://www.fido.asic.gov.au, 2004). Ho, Taher, Lee and Fargher (2001) note that forecast earnings data is rarely provided in Australia leaving the use of proceeds the only available forward looking data about the future prospects of an IPO firm. The use of proceeds should be related to future performance of the firm (as measured by share price and earnings) by providing funding for positive net present value projects, or by reduction in cost of capital as best related to share price by the EBO pricing model. Disclosure of use of proceeds should allow investors to monitor the subsequent actions of management by perusing postlisting financial statements. This study intends to evaluate the quality of use of proceeds disclosures by Australian IPO firms. This research also intends to examine whether managers spend the proceeds from an IPO in the manner that was disclosed in the prospectus by examination of the entities cash flow statements and whether this has an effect on underpricing, subsequent performance and the characteristics of these firms.

3. Motivation and Contribution of this research

This study is motivated by the lack of research in the information content of vital prospectus disclosures. The topic is interesting in Australia because it is not mandatory to disclose the intended use of proceeds from a public offering, unlike in the US and the UK, where this is a required disclosure. This approach is further reinforced by ASIC’s (and it predecessors) active avoidance of providing a checklist of required disclosures (Securities Institute of Australia, 1996). The ASIC is the main regulator over disclosure adequacy in Australia with the ASX providing no public guidance on the preparation of prospectuses. Nevertheless, my initial investigation of prospectus information reveals that most IPO firms disclose some information on the use of proceeds especially when the IPO is underwritten by reputable investment bankers, but the level of specificity does vary. This finding is consistent with the Securities Institute of Australia (1996) best practice guidelines and some interpretations of the Corporations law guidance provided in s710(1) which requires the disclosure of:

“The Assets and Liabilities, financial position and performance, profits and losses and Prospects of the body that is to issue (or issued) the shares, debentures or interests.”

However it is to be noted that the ASIC has not in recent years has not found a prospectus materially deficient on the basis of a lack of a use of proceeds disclosure. Another motivation to this study stems from the documented weak relationship between underpricing and long-run returns in Australia (Lee,

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1 The ASX listing rules may affect the level of disclosure of use of proceeds for Commitment Entities (entities admitted under rule 1.3.2 (b) as at 1/1/2003, the latest electronically available edition of the ASX listing rules). This listing rule requires a program of expenditure of half the entities “Cash” in a manor consistent with stated business objectives to be given to the ASX if it is not in the Prospectus or Product Disclosure Statement. These firms also must file 4C disclosure statements (quarterly direct cash flow statements).
Taylor and Walter, 1996) which questions market efficiency. Since the disclosure of use of proceeds implies reduction of information asymmetry at the time of offering, and possibly lower underpricing, a major change in plans or expectations (that is management doing something different to what they disclosed) should change the value of the firm and investors sentiments towards management.

This study contributes to the literature in several ways. First, this study will document and analyse the information on use of proceeds provided in the IPO prospectus. These results may shed light on possible firm characteristics which lead to the disclosure of different uses of proceeds. Do riskier firms use vaguer disclosures as suggested by Lee, Lee and Taylor (2003)? Second, this research will attempt to confirm whether the intended use of proceeds where used in a manner disclosed in the prospectus by examining cash flow statements subsequent to the offer. This may provide further explanation to the long-run performance anomaly for IPO firms and perhaps provide an answer to the question “Does subsequent use of proceeds impact underpricing and long run performance of IPO firms?” The sole published research that examines the intended use of IPO proceeds in Australia is Lee, Lee and Taylor (2003) which used the uses as a tool to separate the agency and signalling explanations of the choice to offer units (share and warrants) over offering only shares. This study intends to actually test the specificity of the disclosure at the time of offering, its accuracy subsequent to the offering and its effect on the performance of an IPO firm.

4. Equity Pricing Models

The generally accepted theoretical model of share pricing is the Dividend Discount model. This model determines the share price (or market value of equity) of a firm by discounting all future dividends of the firm by the firm specific cost of capital. This model requires estimates of all future dividends including the terminal dividend and an estimate of the firm’s weighted average cost of capital in every period until the termination dividend or the discounted dividends become insignificant (normally between 10-20years). This model however is generally impractical to use in the valuation of shares due to the weighted average cost of capital not generally available and prediction of future dividends particularly in the US is difficult due to many firms not paying dividends and not planning to in the near future. Modigliani and Miller’s dividend irrelevancy assumptions remove the dividend estimation problem however replace it with the estimation of earnings. This leads to the Edwards-Bell-Oshlson (EBO) pricing model which uses the accounting book value of the firm and its forecasted earnings and calculates the future return in-excess of the cost of capital and generates a present value of the firm (Curtis, 2004). These models generate an estimate of the firm value based on estimates future earnings and firm specific cost of capital. The markets estimates of future earnings and cost of capital can be seen to have their own probability distributions. Uncertainty over the true value of these components of pricing can be seen as a proxy of price risk. Actions reducing uncertainty over these variables (disclosure and firm characteristics) should reduce the price risk premium impounded in the buy sell spread. The discussions of effects of different firm actions on the firm’s market price are hence based on the theory outlined above.

5. Hypotheses Development

Underpricing

Underpricing is the general tendency of IPO firm’s issue value (price) to be lower than the best market estimate of the value of the equity of the firm (proxied in the literature by first day closing price). The underpricing abnormality has been found consistently (though its magnitude has varied) in major stock markets and different time periods (Loughran and Ritter, 2002; Lee, Taylor and Walter, 1996; Ho et

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2 This is generally simplified for practical implementation by the use of a fixed equity premium over the short term government bond (or cash) rate and the addition of a termination value with assumptions of future economic earnings (industry mean reversion or constant).

3 This is the whole point behind scenario and assumption testing of forecasts.
Its existence has been argued to be a rational reaction to market constraints (heavily discounted in Australia by Lee, Taylor and Walter, 1996) and information heterogeneity (Rock’s winners curse). The first widely cited model of rational underpricing is Rock (1986)’s winners curse model that argues that uninformed investors are at an information disadvantage compared to investors willing and able to acquire costly information about the “true” value of the offering. This leads to the uninformed investors receiving their full allocations of shares in overpriced IPOs and a reduced allocation in underpriced IPOs, since rational informed investors only invest in the latter category of IPO. IPOs on average must therefore be underpriced maintain the value (economic rationality) of investing in IPOs for uninformed investors.

Rock (1986) provides a rational reason for the existence of underpricing. Ritter and Welch (2002) identify three main theories in the current literature that predict effects of firm characteristics and level of disclosure on the level of underpricing; these are asymmetric information, agency and signalling. Differences in firm characteristics have been found to predict underpricing these include issue type, issue size, age of firm, short-term return to the market of a SEO and retained ownership. Differences in disclosure also should predict underpricing, based on the three theories described in Ritter and Welch (2002).

Disclosure is the release of private information to the public. Using the Information Asymmetry model of reasoning, enhanced disclosure should reduce the gap between manager’s estimates of firm value and the public’s estimates of firm value. Disclosure in this case reduces the uncertainty of over the determents of price (earnings and discount rate). This should lead to the market accepting a higher valuation of the firm in the prospectus (higher proceeds from sale) leading to a greater realisation of firm value. This greater realisation of firm value should leaves less room of rational underpricing.

An agency based argument would centre on the reduction of the moral hazards facing the management team through an increase in the ability of the investment community to monitor the actions of management (Leone, Rock and Willenborg, 2003). This reduces underpricing by the reduction in the risk of misappropriation of funds and in turn leads to a reduction in the return required to compensate for the risk of miss use of funds (Leone et al., 2003).

A firm may signal its high quality as an investment by enhanced disclosure (Leone et al., 2003). The disclosure reduces the information advantage of informed investors (hence reducing the winners curse) and also allows the management’s actions to be monitored. This reduces underpricing by removing the component of underpricing which compensates the uninformed investor for not knowing the quality of this investment.

Under any of the theories outlined above enhanced disclosure should reduce underpricing. Disclosures of forward earnings and use of proceeds should both therefore reduce underpricing. The use of proceeds disclosure is very common and hence the comparative advantage (reduction in underpricing) due to the act of disclosing this information should be small. Leone et al. (2003) introduced the idea of differential information content in the disclosure of use of proceeds and showed that increased in the amount of proceeds allocated in monetary amounts to specific uses reduced underpricing. Leone et al.

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4 The results of Loughran and Ritter (2002)’s longitudinal study found average underpricing of between 1.9% of the 1980’s and 7.8% for 1990-1998 and 32.3% during the “Tech Bubble” (1999-2000). Lee, Taylor and Walter (1996) found mean underpricing in Australia of 12-16% (1976-1989) and Ho et al. (2001) found mean (median) of 50(21)% underpricing during Australia’s “Tech Bubble.”

5 This has been noted to be more important in Australia than the US due to the legislation governing prospectuses and IPOs that makes “road showing” illegal (Lee, Taylor and Walter, 1996). Though one could argue issues which require the registration to gain a copy of the prospectus could act as an alternative method of assessing demand. This method primarily targets unsophisticated investors, (e.g. Promina and Pacific Brands).

6 To assess performance/compliance you require to know what managers plan (or say they plan) to do.

7 Either by more detailed mandatory disclosure or by increased voluntary disclosure.

8 I.e. the investor does not require compensation for the chance that firm is a lemon if they know it is not a lemon.
(2003) argue that disclosure of monetary amounts should reduce underpricing by either further reduction in the information asymmetry or the reduction in the ability of management to expropriate funds. The different uses of proceeds themselves were shown to interact with the information content of the monetary disclosure in Leone et al. (2003). This was attributed to the future effects of the uses on future performance. An alternate argument consistent with the agency perspective is that the uses vary in their ability to reduce of agency problems due to variations in monitor-ability (transparency). This assumes that different uses of proceeds communicate different intended actions that can be monitored and assessed for compliance. The action of retiring debt reduces liabilities and generates a cash outflow. The action of capital expenditure should increase assets and generate a cash outflow in investing activities. Some uses do not have readily identifiable transactional consequences such as working capital which Leone et al. (2003) combined with their other. Lee, Lee, and Taylor (2003) found that working capital and other uses were a statistically significant difference between unit and share only IPO firms. They argue that the higher amount of other uses in unit IPOs may indicate that the firm unit IPO is more risky however was not argued however could have been for working capital. This leads to the first hypothesis:

**H1a: Specific prospectus disclosure of use of proceeds leads to lower underpricing**

Agency and signalling explanations are difficult to separate due to both predicting reduced underpricing from the same stimulus (enhanced disclosure of use of proceeds). Differences in corporate governance may provide a solution to this problem. For the disclosure to reduce underpricing under agency theory there must be inadequate mitigation of agency costs from internal sources. The board of directors are ultimately responsibility for coordinating internal control and the monitoring of management. The role of Independent directors on the board is to guide and question management decisions. The board’s ability questioning management’s judgments and provide an independent strategic vision is suggested by regulators and some corporate governance research in Australia to be enhanced by independent board leadership (i.e. separation of Chair and CEO positions; Balatbat et al., 2004). Internal monitoring by directors is likely to be the preferred option due to the greater investigative powers of the directors, the protection of proprietary information and potentially a lower cost of capital since sophisticated investors do not have to monitor managers actions as closely. Form this it is expected that firms driven by agency considerations would create a strong board in preference to disclosure. However since they choose to disclose, this would indicate that the board does not adequately mitigate the agency costs. If the reason for the enhanced disclosure it is expected that the specificity of disclosure is inversely related to the quality (independence) of the board because the board is inadequate to mitigate the required amount of agency risks.

An alternate relationship is predicted for a firm signalling its quality. This firm should not need to disclose to reduce agency. A signalling firm would be expected to have a high quality board with strong internal controls to have removed the major agency conflicts. The release could be indicative of the firm trying to reduce the winners curse premium or the directors wishing to demonstrate their quality to other potential employers by allowing their success in restraining management to be observed. This conflicts with the agency prediction of a trade off between disclosure and corporate governance. These conflicting predictions lead to the use of the following null hypothesis:

**H1b: Specific disclosure of use of proceeds is not related to the strength of Corporate Governance.**

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9 Specifically Payments for Property Plant and Equipment

10 An alternate test would be to regress a proxy of agency costs (retained ownership) against specificity of use of proceeds disclosure and Corporate Governance variables (while controlling for factors mentioned in prior literature).

11 Particularly after Daniels v Anderson (1995) 13 ACLC 614, NSW Court of Appeal (better known as the AWA case). The important finding for this paper is that Non-Executive directors are to be held to the same standard as Executive directors (discussed in Lipton and Herzberg, 2003).

12 Hence insure costs which they have to be compensated for by higher returns.
Long Run Performance

The evidence on Long-run performance of IPO firms shows poor abnormal returns in both Australia and the US (Lee, Taylor and Walter, 1996; Schultz, 2003). Furthermore the only a weak relationship between underpricing and long run return has been demonstrated in Australia (Lee, Taylor and Walter, 1996). This generates the questions over the efficiency of the market when deciding on the initial market price (Lee, Taylor and Walter, 1996). The questioning of market efficiency is only valid if the market should have known at the time of listing. If no new (price sensitive) information is released between the date of issue and the end of the long run return window (1, 2 or 3 years) the criticism is valid. Post-listing information changes, (like reporting earnings below forecasts) appear not to be have been controlled for in Lee, Taylor and Walter (1996). This leaves unanswered questions on market efficiency, the effect of post-listing events (observable to the market after the firm has listed) which reveals new information about the firm to market. This reasonably leads to the search for causes of the market revaluing the firm.

The obvious cause of a change in firm valuation is unexpected change in earnings (operating performance) this was first demonstrated by Ball and Brown (1968). If the firm disappoints the market with unexpectedly poor earnings the market will react and revalue the firm downwards. This maintains efficiency as long as the market could not have predicted the results at the time of underpricing. Balatbat, Taylor and Walter (2004) found that IPOs in Australia during the period 1975-1994 had comparatively poor operating performance for up to 4 years post IPO. If this is expected it may not have valuation consequences since it is unlikely for a firm to raise capital while claiming they will perform worse than comparable firms.

A further difference in the information environment at the time of the initial market valuation and the time of calculation of long-run return is the markets knowledge over the use of proceeds. The use of proceeds is regularly disclosed in prospectuses and provides potentially valuable information on the valuation of the firm. Disclosure of debt repayment impacts the share valuation through providing an indication of the change in the firm specific discount rate (weighted average cost of capital)\(^{14}\). Capital Expenditure and Acquisitions provide indications of potential for growth and changes in earnings. These disclosures are of particular importance with relation to valuation since the IPO potently represents a point discontinuity in the value of the firm with variation in cost of capital (Pagano, Panetta and Zingales, 1998), capital expenditure (Balatbat et al., 2004; Pagano et al., 1998) and earnings (Balatbat et al., 2004). The effect of the uses of proceeds on the value of the firm should have been priced into the market value of the firm at listing. Hence any material change in the use of proceeds the market becomes aware of after listing should have a pricing effect. The finding of inaccuracies may indicate an unexpected change in the firm situation which requires a change in valuation.\(^{15}\) This may also lead to a reassessment the effectiveness of the corporate governance structures of the firm. The following hypothesis will test this conjecture:

**H2a: Inaccurate use of the proceeds post-listing leads to poor the long-run performance**

Ritter and Welch (2002) called for semi-rational explanations for underpricing. Ho et al. (2001) appears to have answered their call in Australia. Ho et al. (2001)’s findings of “hype” generating greater underpricing of technology firms during the “technology bubble” in Australia leads to a suggestion that the market had drifted from fundamental value for these firms. Curtis (2004) demonstrated that the co-integration relationship between the market price and the EBO pricing model broke down during this period. This fad explanation was discounted by Lee et al. (1996) on evidence from 1975-1989 however Curtis (2004)’s findings suggest that the “technology bubble” was a far greater drift from fundamental value than any post World War 2 bubble and hence may change the

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\(^{13}\) The level of this test depends on the level of market efficiency you subscribe to.

\(^{14}\) Noting that this is unobservable from public information.

\(^{15}\) Examples include the failure to acquire a targeted firm and new wonder drug kills guinea-pigs.
findings of Lee et al. (1996) and provide additional explanatory power to their long run performance model. This will be only controlled for in this study.

6. Methodology

To test the above hypotheses, the uses of proceeds must be obtained from the prospectus of the IPO firm and the level of specificity of disclosure should be evaluated similar to that of Leone et al. (2003) and Balatbat (2004). Prospectus information will be downloaded from Aspect datanalysis (Aspect) and supplemented by information from Connect 4. Furthermore, to evaluate accuracy of the use of proceeds, I will examine the statement of cash flows and other disclosures that may shed light on how the proceeds from the issue were spent by the IPO firm. I will obtain cash flow data from Aspect and other disclosures from Connect 4. Further analyses will require post-listing performance of these firms using share returns (first day and 3 years of annual returns). The share returns are expected to be sourced from SIRCA. The long-run performance will be measured by three year buy-and-hold abnormal returns as used in Brown, Gallery and Goei (2003). Specificity will be assessed in two ways: the percentage of proceeds allocated (in dollar amounts) to identifiable uses and the characteristics of the use of proceeds.

7. Data sample

The methodology of this study to test H2 requires a cash flow statement subsequent to an IPO\textsuperscript{16} and up to three years financial statements and share returns to obtain post-listing performance. Hence, the sample will consist of all Australian industrial initial public offerings between 1 July 1991 to 30 June 2000. Initial sample from SDC platinum reveals approximately 300 IPO firms.

\textsuperscript{16} AASB 1026 (“Statement of cash flows”) is effective for reporting entities releasing a financial report on 30 June 1992. This requirement also leads to the exclusion of the finance industry due to the use of a different format. Trusts are excluded due to different reporting requirements and different taxation methods.
References

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