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Accounting information and the valuation of Seasoned Equity Offerings (SEOs)

Georgia Siougle *

Department of Accounting and Finance, Athens University of Economics and Business, 76 Patission St., 10434, Athens, Greece

Abstract

This study investigates the association between publicly available information disclosed in the SEO prospectus and offer prices of SEOs, as well as the association between this type of publicly available information and stock returns subsequent to an SEO after controlling for self-selection bias. The empirical evidence shows that disclosure of the planned uses of the SEO proceeds reveals value-relevant information which has been incorporated by the underwriters in setting the offer prices. Control for self-selection bias appears necessary to obtain unbiased estimates in the regression model explaining the determinants of offer price in SEOs.

Keywords: Seasoned equity offerings; Self-selection bias; SEO prospectus; Planned uses of proceeds

1. Introduction

A number of studies have attempted to explain stock returns subsequent to Seasoned Equity Offerings (SEOs) by using variables that rely on historical accounting information. Specifically, these studies use historical financial information as potential drivers of post-

* Tel.: +30 210 8203928.
E-mail address: gsiougle@aueb.gr.

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issue stock returns.[1,2] Firms, however, operate in a complex environment where the investor's needs for information force firms to provide additional information with a forward-looking orientation. The prospectuses of SEOs, for firms listed on the Athens Stock Exchange, contain information about the planned uses of the SEO proceeds and the forecasted earnings.

The planned uses of the SEO proceeds provide information with a forward-looking orientation that has not been used to explain the post-issue stock return performance.[3] The introduction of the planned uses of the proceeds as additional explanatory variables is important as it reveals to the stock market the future investments of the issuing firm.

Another important aspect that has been neglected in the case of SEOs is that the external-financing decision comprises a natural self-selecting event. A firm's intention to seek external financing, through a rights issue, could itself reveal information about the capital structure and/or financial performance of the firm. To control for this self-selection-bias phenomenon, the study includes Heckman's (1979) inverse Mills' ratio in the regression models examined. This methodology requires that the sample include not only firms that have issued equity but also firms that have not (i.e. *non-issuers*).

Cross-sectional regression models are used to investigate the association between the planned uses of the proceeds disclosed in the SEO prospectus. This includes the price at which the new shares are offered to the public and the stock returns subsequent to the seasoned equity offering event. The SEO prospectus discloses the intended uses of the proceeds, which are desegregated into four different categories: payment of pre-SEO debt, investments in working capital, investments in fixed assets, and investments in other companies. The study examines the following research questions: Do the underwriters efficiently price the SEOs by incorporating in the offer price all publicly available information, including information with a forward-looking orientation? If they do, then no association is expected between stock returns subsequent to the SEO event and the forward-looking information regarding the planned uses of the proceeds. In addition, is self-selection correction an important variable in explaining offer prices and stock returns?

[1] Loughran and Ritter (1995); Spiess and Affleck-Graves (1995); Yoon and Miller, 2002, have focused on examining the poor stock-price performance in the post-offering period. Loughran and Ritter (1995) and Spiess and Affleck-Graves (1995) find that issuers underperform their benchmark firms on average about 7% per year in a 5-year horizon. They attribute the underperformance to the information asymmetry between managers and investors that allows firms to issue overvalued securities. Other studies, Teoh et al. (1998); Rangan (1998); Shivakumar (2000), have examined the phenomenon of using an earnings management technique to inflate earnings prior to seasoned equity offering in order to succeed a positive price reaction at the equity issuance.

[2] Loughran and Ritter (1995) find the book-to-market ratio and the market value of equity, as a control for size, to be the most important determinants of post-issue returns during their sample period. Teoh et al. (1998) find a significant negative association between pre-issue discretionary accruals and two-and three- year post-issue stock returns. Also that firm size is only marginal by significant in predicting future returns, while the book-to-market ratio is highly significant. Rangan (1998) finds that discretionary accruals over a one-year period around the offering are negatively associated with market-adjusted returns in the following year. This finding is robust to the inclusion of other explanatory variables such as firm size, book-to-market ratio, sales and capital expenditures growth. Shivakumar (2000) documents that abnormal accruals prior to the SEO do not predict future returns above and beyond the book-to-market ratio and the firm size.

[3] Jeanneret (2005) examines the long-run performance of French SEOs by using the intended uses of the proceeds as a classificatory mechanism and not as explanatory variables.