



Seasoned equity offerings: Quality of accounting information and expected flotation costs[☆]

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ABSTRACT

Flotation costs represent a significant loss of capital to firms and are positively related to information asymmetry between managers and outside investors. We measure a firm's information asymmetry by its accounting information quality based on two extensions of the Dechow and Dichev [2002. The quality of accruals and earnings: the role of accrual estimation errors. *Accounting Review* 77, 35–59] earnings accruals model, which is a more direct approach to assessing the information available to outside investors than the more commonly used proxies. Our main hypothesis is that poor accounting information quality raises uncertainty about a firm's financial condition for outside investors, though not necessarily for insiders. This accounting effect lowers demand for a firm's new equity, thereby raising underwriting costs and risk. Using a large sample of seasoned equity offerings (SEOs), we show that poor accounting information quality is associated with higher flotation costs in terms of larger underwriting fees, larger negative SEO announcement effects, and a higher probability of SEO withdrawals. These results are robust to joint determination of offer size and flotation cost components and to adjustments for sample selection bias.

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1. Introduction

Flotation costs in seasoned equity offers (SEOs) represent an economically important portion of gross proceeds. Many studies show that underwriting fees range between 3% and 8% of SEO gross proceeds and that SEO announcement effects range between -2% and -3% . The extant literature has generally concluded that a substantial portion of SEO flotation costs are caused by asymmetric information between issuers and outside investors. (See the discussion in Eckbo, Masulis, and Norli, 2007, survey of the security offering literature.) However, information asymmetry is not directly observable, and no generally agreed upon measure exists for it. As a result, many SEO flotation cost studies employ a wide range of distinctly different measures of information asymmetry. This makes it difficult to assess the importance of information asymmetry or pinpoint the other key determinants of flotation costs.

Common measures of asymmetric information used in the finance literature include stock return volatility, analysts' earnings forecast dispersion, proportion of intangible assets, debt rating, and stock bid–ask spread (or a component). Many SEO studies employ proxies for information asymmetry and price uncertainty. Drucker and Puri (1999), Altinkilic and Hansen (2000), and Corwin (2003) use stock return volatility; Marquardt and Wiedman (1998) use analysts' earnings forecast dispersion; Liu and Malatesta (2006) use debt ratings; and Corwin (2003) uses bid–ask spreads. While heavily used in empirical analysis, none of these variables has a strong theoretical claim to being a clear or complete measure of information asymmetry between issuers and outside investors. Moreover, these measures are likely to capture other economic effects beyond asymmetric information. For example, stock return volatility is also a widespread measure of uncertainty and is influenced by industry- and economy-wide shocks, for which firm managers are unlikely to have a significant information advantage relative to other investors. Dispersion in analyst forecasts can be affected by the number and quality of analysts following a stock, analyst herding, and whether the analysts are affiliated with investment banks, to name just a few of the problems that researchers have highlighted. Debt ratings have been criticized for being slow to incorporate new information and to be more focused on the solvency of a firm, which is strongly related to its leverage. The proportion of intangible assets is also a proxy for a proportion of a firm's value represented by growth opportunities, which could be modest for many firms with sizable information asymmetries. Finally, bid–ask spread is strongly affected by the stock's market microstructure environment, such as exchange rules, trading activity, execution costs, and dealer borrowing costs needed to support inventory positions. It is also often used as a liquidity measure. This liquidity measure is also found to be related to SEO flotation costs as shown in Butler, Grullon, and Weston (2005). In short, none of these commonly used proxies represents a clean measure of asymmetric information between insiders and outside investors regarding a firm's expected future financial performance.

In this study, we examine the relation of expected flotation costs to an alternative measure of information asymmetry that is directly related to the information available to outside investors about firm performance. We argue that the quality of a firm's accounting information, which is taken from the current accounting literature, is a reasonable proxy for asymmetric information between managers and outside investors. Our view is that, because accounting statements are the primary source of information about firm performance available to outside investors, its quality should be directly related to investor uncertainty about a firm's financial health and past performance. Because managers have better internal sources of information, financial accounting statement quality is unlikely to cause a similar rise in manager uncertainty, implying that this rise in uncertainty represents an asymmetric information effect.

The accounting literature measures accounting information quality by a number of alternative, but related, approaches. The early accounting literature focuses on manager manipulation and earnings management as the primary cause for reduced information quality. In contrast, the more recent literature places more emphasis on uncertainty about operating fundamentals, which Dechow and Dichev (2002, hereafter DD) measure by firm size, length of the operating cycle, sales and cash flow volatility, frequency of negative earnings, and size of accruals, as a major cause of reduced information quality, but also continue to include the effects of manager discretion over accounting decisions. Dechow and Dichev (2002, pp. 46–49) examine the relation of these firm fundamentals to accruals quality and find they have significant explanatory power. Thus, the primary measures of poor accounting information quality we study reflect operating fundamentals and managerial discretion, both of which make firm valuation and earnings forecasting inherently difficult. We decompose accruals quality into its operating fundamentals and discretionary components to assess whether expected flotation costs of SEOs are associated with both causes of impaired accruals quality.

As accounting quality deteriorates, investor uncertainty about a firm should rise and demand for its equity should fall. In addition, as issuer accounting quality falls, investment bankers, who write fixed-price underwriting contracts that have a put option structure, are likely to price their underwriting services more dearly. (Smith, 1977, was first to emphasize the put option characteristic of fixed price underwriting contracts.) So we expect greater investor uncertainty to lead to increased equity underwriting and distribution costs. However, we are unaware of any existing studies that directly examine the relation of accounting information quality to equity flotation costs.¹ We address this current gap in the literature by investigating the relation of accounting information quality to SEO offer size and expected

¹ Studies by Francis, Lafond, Olsson, and Schipper (2004, 2005) investigate the question of whether accounting information quality is associated with a firm's equity cost of capital, and they report a significant negative relation.

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