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The effects of venture capital syndicate diversity on earnings management and performance of IPOs in the US and UK: An institutional perspective[☆]

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ABSTRACT

This study examines the extent to which principal–principal agency conflicts within venture capital (VC) syndicates lead to additional principal–agent conflicts in IPO firms in two institutional contexts. Using a matched sample of 274 VC-backed IPOs in the US and the UK, it shows that the diversity of a VC syndicate increases pre-IPO discretionary current accruals, used as a proxy for earnings management, but the impact of such diversity is higher in the US. There is also evidence of higher underpricing and lower aftermarket performance in firms with higher earnings management and VC diversity, and these negative performance effects are also higher in the US. Our findings indicate that local and informal institutions have a significant effect on multiple agency conflicts in IPO firms and performance outcomes.

1. Introduction

We have recently witnessed the emergence of an active class of private equity investors, venture capital (VC) firms, who invest in privately held firms with a successful business model and take them public. However, the governance roles of VCs and their impact on performance during and after an initial public offering (IPO) are not well understood. More specifically, there is very little research on multiple agency problems associated with VC syndicates, e.g. VC backing of an IPO firm that involves two or more venture capitalists. In this paper we seek to not only understand how diversity among VCs in a syndicate might influence various performance indicators at the time of the IPO, but also how these effects may depend on institutional environments surrounding an IPO.

Prior research grounded within an agency framework documents that issuers frequently manage their earnings around the IPO (Teoh et al., 1998a, 1998b) since they are motivated to improve the short-term performance of their firms when approaching the IPO. Accordingly, they may exercise some accounting discretion when the opportunity is present. This opportunity also

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reflects the existence of a principal–agent conflict of interest between the insiders and public market investors. A number of researchers argue that managers' discretion is affected by the presence of VC firms (Cumming et al., 2007). VCs usually screen their portfolio companies and prepare them to go public. As sophisticated investors, they employ an extensive set of covenants to protect their investments (Barry et al., 1990), and their active involvement in portfolio companies is likely to deter earnings management and strengthen the corporate governance of their firms (Brau and Johnson, 2009; Morsfield and Tan, 2006). However, venture capital firms are subject to different pressures from their limited partners (Bruton et al., 2010) and, as syndicate members, they have different objectives which can result in principal–principal conflicts of interests among members of a VC syndicate, and thus adversely affect the quality of the monitoring of their portfolio companies (Hochberg et al., 2007). Some syndicate members are likely to encourage earnings management which is consistent with the grandstanding hypothesis (Gompers, 1996). Although previous studies have explored separate effects of principal–agent and principal–principal conflicts on performance of VC-backed IPOs, there has been no analysis of inter-dependencies between these two types of agency relationships and their combined impact on IPO performance.

In addition, while VC incentives can impact their portfolio firms, recent research is beginning to recognize the importance of contextual issues in VC investments. More specifically, the institutional environment in a particular country can have a significant impact on governance and firm valuation (Banerjee et al., 2011; La Porta et al., 2002). For example, VC investors in the UK operate within a closer network economy where "relationship" governance is underpinned by extensive networking and trust considerations that may mitigate opportunism within VC syndicates. In contrast, although VC syndicates in the US network based on trusted relationships in an industry rife with potential asymmetric information, there is an incentive to develop more extensive networks to identify and source new potential venture ideas, which requires more distant relationship in both industry and geography (Sorenson and Stuart, 2008). Although this diversity is also found in the UK among VC syndicates, the informal institutional relationship mechanism we note in the UK VC industry is lacking in the US as syndicate diversity increases. The informal networks and voluntary behavior codes in the UK capital market have allowed for the development of a 'gentlemanly capitalism' model that characterizes the intermingled economic, social, and political power centered geographically in the confines of the City of London (Cain and Hopkins, 1986). This concept is driven by voluntary normative behavior over law, where agents (usually concentrated in a geographically small area that reinforces ties and social networks) act collectively to regulate affairs and develop norms and codes of practice. Such social ties and networks might help to overcome conflicts of interest and reduce goal incongruence among VCs within a networked syndicate (e.g., Jones et al., 1997).

The goal of this paper, therefore, is to bring together these two strands of agency research and examine the effects of goal incongruence among VC syndicate members on earnings management and performance of IPO firms. In our analysis of VC syndicates, we focus on the diversity of VCs within the syndicate. We consider this diversity as a potential source of principal–principal conflicts. We also examine the simultaneous effects of both types of agency problems on short- and long-term performance of IPO firms. Finally, our analysis explores how institutional differences between the US and UK can moderate complex inter-relationships between VC syndicate diversity, earnings management and IPO performance.

Combining finance research with an institutional perspective, we argue that the impact of the 'gentlemanly capitalism' in the UK and its associated informal institutional context strengthen the homogeneity of interests among VCs in any syndicate. This reduces the potential gains from principal–principal conflict and improves collective monitoring of managers within an IPO firm. As a result, VC-syndicated firms in the UK are less likely to realize any rent from conflicting principal–principal relationships and thus have weaker opportunities to manage their earnings at IPO than their US peers. Within this networked environment, the effects of a negative reputation on future relations for UK VCs will be stronger, and is thus likely to provide a safeguard against opportunistic behavior (Jones et al., 1997). This issue of reputational effects on earnings management in the IPO setting has been raised in the literature (e.g., Ball and Shivakumar, 2008), but has not been theoretically or empirically explored in previous research. Our empirical results strongly support our arguments. More specifically, VC syndicate diversity is positively associated with earnings management in an IPO firm, and the effect is much stronger in the U.S. context. Both earnings management and syndicate diversity have a mutually enforcing and negative impact on IPO performance, and this performance decline is much worse among U.S. compared to U.K. IPOs.

2. Review of literature

Although VCs often do not have detailed scientific knowledge about the specific technology in their portfolio firms, they are able to economize on their selection and monitoring costs by focusing their investments in certain industries. By specializing in these industries, they are able to develop a comparative advantage over other investors (Cumming et al., 2007). Additionally, their experience helps them to rapidly bring these ventures to a successful exit through an IPO and aids them in generating added value beyond the capital provided (Hsu, 2004). Successful VC experience is valuable in at least two ways. First, this experience leads to the development of a reputation for quality (Lerner, 1994) which allows VCs to command a premium (i.e. more ownership for less capital extended) from future entrepreneurs (Hsu, 2004) and makes future investment fundraising easier (Nahata, 2008). Second, the reputation for quality also helps VCs to certify the value of ventures (Megginson and Weiss, 1991).

The effects of these governance roles of VCs become particularly important in the context of potential manipulation of information provided to the public market investors by managers of IPO firms. Information asymmetry between insiders and outside investors offers managers the incentives and opportunity to engage in earnings management behavior to increase the attractiveness of the IPO for potential investors (Teoh et al., 1998a, 1998b). Prior research suggests that IPO firms often use income-