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# Going public: The role of accounting and shareholder value in making sense of an IPO

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ABSTRACT

This study draws on interviews with corporate executives from four companies that went public and financial analysts involved in evaluating these firms. Top managers in all companies became more focused on short-term financial results than they had been when the companies were private. We contribute to existing research by analyzing, empirically and theoretically, the processes producing this focus. Following an IPO process offered a unique insight into a gradual increase in emphasis on accounting metrics through the outcomes of guided and restricted sensemaking. When preparing for the IPO, guided sensemaking produced an IPO prospectus incorporating quantitative and qualitative commitments. Quantitative commitments were based on accounting metrics, such as earnings per share and profit margin, which provided an important foundation for the financial focus. These commitments became the anchor for subsequent sensegiving and restricted sensemaking when the companies were listed. With the financial analysts as the social anchors, the richer communication in the prospectus was narrowed down to comprise an exclusive focus on the quantitative accounting commitments. The long-term accounting commitments in the prospectus were transformed into short-term targets that must be met when the financial measures served as specific and concrete extracted cues to quickly provide structure to the uncertain situation, gain the financial analysts' confidence and sustain action. One year after the IPO, the financial focus was taken for granted and managers had accepted the rules of the game.



## 1. Introduction

> "As a private company, we definitely did not focus on the short-term... After the IPO [initial public offering], however, whether you want it or not, the short-term key financial ratios published in the quarterly reports become extremely important. And as a public company, it is much harder for the company and the board not to become oriented on the short-term performance. It is important to deliver good financial results quarter after quarter, without any surprises. In reality, it is the case that one has to focus much more on short-term financial results when a company is listed on the stock exchange than had been the case before, when the company was private." (Board member of a company that went public, describing the situation one year after the IPO).

This research draws on interviews with corporate executives from four companies that went public on the Swedish stock exchange and financial analysts involved in evaluating these firms. It contributes to the emerging literature on encounters between the top management in listed companies and capital market actors, and the role of accounting therein (e.g. Ezzamel et al., 2008; Froud et al., 2006; Gleadle and Cornelius, 2008; Kraus and Lind, 2010; Roberts et al., 2006). This research suggests that top

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managers become focused on short-term financial results. For instance, Ezzamel et al. (2008) (p. 135), in their case study of an American publicly listed company, Conglom, concluded:

> "Raising and supporting the share price, we contend, became the foremost and overriding preoccupation of senior managers at Conglom... The 'search for continuous improvement' was principally a search for ways of impressing and/or placating Wall Street. What failed to impress, or did not impress sufficiently quickly, was simply abandoned by Conglom's most senior executives. The share price as valued in the stock market became the ultimate 'acid' test of the performance of Conglom and its CEO."

In order to pass this 'acid test', the company's manufacturing strategy was constantly being revised. Bottom-line profitability was improved by squeezing costs through divestment, outsourcing and rationalization (Ezzamel et al., 2008). Similarly, based on case studies of General Electric, Ford and GlaxoSmithKline, Froud et al. (2006) found that growing pressure from the capital market had redefined company strategy. The general strategic problem for the large quoted firms was delivering the appropriate financial numbers, accompanied by a narrative of strategic intent to support it.

Our findings support these results, as indicated in the opening quotation. All four companies became oriented on short-term financial performance following the stock exchange listing, and their top management experienced demanding external, capital-market-induced pressures. As the CEO in one company put it: "We had much stronger focus on internal processes when we were private. As a services company, we need to optimize the processes, and this received a great deal of top management attention. Now that we are on the stock exchange, our focus is more on the financial performance, which of course was also important before. But not in the same way as it is now, on the stock exchange." Similarly, when describing the situation one year after the IPO, a CFO in another company stated: "We believe that, for the sales force, numbers are important, productivity is important and that is what we used internally. We looked at those every month, every day sometimes, for example, the number of recruits we got in. But now that we are on the stock exchange, the focus for us, the top management, is much more financial and short-term in terms of profits, margins and cash flow."

This paper analyses, theoretically and empirically, the processes that produce this focus on short-term financial results among the top management. It differs from previous ones in two respects. The first relates to the type of companies studied. In previous research, companies investigated were well established on the stock exchange, whereas we study companies that had only recently gone public. Such firms suddenly experience "the public eye" on them (Reuer and Shen, 2003) upon entering a world occupied by financial analysts and fund managers. This new situation is often trying, not only for corporate executives, but also for the financial analysts who must evaluate relatively new companies about which they may have little firm-specific knowledge (Pollock and Rindova, 2003). We explore the preparation for the IPO, the introduction on the stock exchange, and the situation one year after the IPO when the companies are better established on the exchange. Following an IPO process longitudinally offers a unique insight into how a financial short-term focus among top managers gradually evolves as the companies become subject to "quarterly capitalism" on the stock exchange.

The second difference concerns the theoretical lens used to examine our findings. We draw primarily on the concepts of sensemaking and sensegiving (Weick, 1995; Gioia and Chittipeddi, 1991). In turbulent situations like an IPO, explicit sensemaking and sensegiving efforts tend to occur because the contemporaneous state of the world is perceived as different from expectations (Maitlis, 2005; Weick et al., 2005). Following Maitlis (2005), we analyze top management's sensemaking as a social process whereby managers interpret their environment in and through interactions with others in order to construct accounts that allow them to comprehend the world and act collectively. Sensegiving is concerned with top managers' and other stakeholders' attempts to influence the outcome, and to communicate their thoughts about the IPO to others (Gioia and Chittipeddi, 1991). Following an introduction on the stock exchange, top managers must make sense of the evolving situation. We argue that accounting metrics[1] function as important sensemaking and sensegiving devices in relationships between the companies' top management and the other stakeholders involved in the IPO process, such as investment bankers, auditors, investors and financial analysts (see also, Swieringa and Weick, 1987; Tillmann and Goddard, 2008). We propose the following research questions:

1. What sensemaking and sensegiving processes occur when top managers and other involved stakeholders prepare for the IPO and what is the role of accounting metrics in these processes?
2. What sensemaking and sensegiving processes occur between top managers and other involved stakeholders following the listing on the stock exchange and what is the role of accounting metrics in these processes?

To date, accounting research on shareholder value and capital market pressure has largely neglected the processes by which the capital market logic is transmitted into listed companies (for an exception, see Roberts et al., 2006). This paper contributes to an understanding of these processes. The next section presents the theoretical underpinnings of the research concerning sensemaking and sensegiving, and it discusses the role of accounting metrics in these processes. Thereafter, the methodology of the study is described. This is followed by a case analysis of the IPO processes in the companies investigated. The paper ends with conclusions and suggestions for future research.

[1] In this paper, the term 'accounting metrics' refers to financial measures only and does not encompass non-financial measures. Accounting metrics and financial measures will be used interchangeably in the paper.