Accounting Conservatism and Corporate Reporting
in a High Information Asymmetry Environment:
Analysis of Initial Stock Offering Firms

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Abstract

This thesis investigates whether Initial Public Offering (IPO) firms adopt a high degree of conservatism in response to investors’ demand for high quality earnings and subsequently experience increased capital market benefits. The accounting literature suggests that the enforcement of timely loss recognition under a conservative reporting policy can mitigate managerial opportunistic behavior reducing information asymmetries between managers and outside investors (e.g., Watts 2002; LaFond & Watts 2008). This thesis hypothesizes that such benefits of accounting conservatism should be more pronounced for IPO firms because there is inherently high information asymmetry in the IPO market. In particular, financial reports are one of the primary information sources available for investors that provide information regarding a firm’s past and expected future performance. As a result, the IPO environment provides an important research setting to investigate the capital market consequences of accounting conservatism.

Based on a large sample of U.S. IPO firms over the period from 1990 to 2010, this thesis investigates whether the extent to which accounting conservatism adopted by IPO firms can predict: (i) the well-documented IPO market anomalies, IPO underpricing and IPO long-term stock return underperformance, (ii) the probability of seasoned equity issue (SEO) in the post-IPO market and the costs associated with the SEO and (iii) the longevity of IPO firms.

The empirical findings of this thesis suggest that firms adopt a higher degree of conservatism prior to going public in response to high information asymmetry at the
IPO and issuers adopting higher conservatism incur a lower indirect cost of going public through less underpricing. The results also suggest that IPO issuers adopting higher conservatism are less likely to reissue equity within five years of the IPO, indicating that these firms do not have short-term cash needs soon after the IPO. However, these firms are more likely to be able to issue their next equity financing on more favorable terms by experiencing less SEO underpricing and better announcement returns. Moreover, the results indicate that issuers adopting a higher degree of conservatism face less risk of failure and survive longer in the stock market. In particular, these firms are more likely to acquire another entity within five years of the IPO and their acquisition announcement returns are positively associated with the extent of conservatism adopted prior to going public.

This thesis makes a significant contribution to the literature on conservatism by providing empirical evidence that: (i) IPO issuers adopting a higher degree of conservatism experience various benefits that the capital markets offer in response to less uncertainty and information asymmetry; and shows (ii) how conservatism can contribute to resolving information asymmetry problems in the IPO market. Specifically, this thesis has important implications for accounting standard setters, policy makers and regulators associated with the IPO market. Against the recent movements of the Financial Accounting Standards Board (FASB) toward fair value accounting, the evidence in this thesis suggests that, in the absence of conservatism, the information quality of financial statements may be jeopardized in the IPO environment, leading to higher information asymmetry between firm insiders and outside investors.
Declaration

I certify that this work contains no material which has been accepted for the award of any other degree or diploma in my name in any university or other tertiary institution and, to the best of my knowledge and belief, contains no material previously published or written by another person, except where due reference has been made in the text. In addition, I certify that no part of this work will, in the future, be used in a submission in my name for any other degree or diploma in any university or other tertiary institution without the prior approval of the University of Adelaide and where applicable, any partner institution responsible for the joint award of this degree.

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