Use of proceeds disclosures in IPO prospectuses: do issuers come clean?

We examined 174 IPO prospectuses issued during 1995–2000 to investigate the specificity on the use of proceeds disclosures, their accuracy and effects on shareholder returns. Our findings suggest that it may be useful to guide investors in making informed decisions by requiring firms to clarify why high levels of proceeds are being sought for working capital or to limit the proportion of the proceeds being raised for these and other unspecified uses.[1]

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Disclosure obligations to investors of equity issuers

An initial public offering (IPO) occurs when a previously unlisted entity seeks to raise funds from the public capital market by issuing its own equity securities. Part 6D.2 of the Corporations Act covers the disclosure obligations to investors for an offer of securities. For instance, Section 717 of the Act requires all entities intending to raise funds by offering securities to prepare a disclosure document (e.g. a prospectus) and lodge this with ASIC. The same section further requires that the disclosure document sets out all the information required but must not contain any misleading or deceptive statements, must be dated, and must include a director's consent to the disclosure document. Section 711 further requires specific disclosures such as: (1) terms and conditions of the offer; (2) nature and extent of the interests held by managers, directors, promoters, advisers and underwriters; (3) the amount that has been paid or agreed to be paid and its nature to all the parties listed in 2; (4) a statement as to whether the securities have been admitted for quotation on a financial market, or an application for admission has been made, or an application for admission will be made within seven days after the date of the prospectus; and (5) the expiry date is no longer than 13 months from the date of issue. Moreover, Section 715a requires that the information provided in a disclosure document be worded in a clear, concise and effective manner. Section 715a was added to the Act, as part of CLERP 9, but despite this amendment, there is still a view that more guidance is necessary for prospectus issuers to better understand their disclosure obligations.

To address this concern, ASIC issued a draft policy statement (PS) entitled 'Better prospectus disclosure' on 8 February 2006. The draft PS aims to provide guidance to prospectus issuers to comply with their disclosure obligations under the Act. It includes advice and guidance on: the content requirements for a prospectus; how to word and present a prospectus in a clear, concise and effective manner; and specific content issues that have arisen in practice.

Based on the submissions to the draft policy by industry organisations involved in prospectus preparation,[2] they appear to be in agreement that investors and professional advisers expect to find specific information recommended in the draft policy statement such as: description of the business and its structure, strategy and plans; financial information; information about prospects; risks; description of important contracts; use of proceeds; background of senior managers and directors and details of their remuneration; dividend policy; major shareholders and related party transactions; taxation; and disclosure about material litigation. However, they also highlight the tension between providing detailed information and the need to provide disclosures that are 'clear, concise and effective'. We are not aware of what may be contained in the policy statement when ASIC releases the updated version, but one notable aspect from the submissions made by industry organisations is that they seem to agree that 'use of proceeds' disclosures is useful to guide investors in making informed decisions.

While the use of proceeds disclosure is not explicitly required under the Act, the inclusion of this disclosure in the specific content issues of ASIC's draft PS, and with industry organisations making submissions highlighting the importance of this disclosure, suggest that an issuer should disclose use of proceeds in the prospectus to comply with the requirements of the Act under a reasonable investor test. The draft PS specifically recommends that the entity address how the funds raised will be used and provide a breakdown of the different uses of the funds (PS No. 63). The entity should also disclose the minimum subscription and the consequences it may bear if the amount required is not raised. Where the minimum subscription is less than the full amount, or the fundraising is not fully underwritten, the entity should disclose the financial position and prospects of the entity in the event that the offer is not fully subscribed. For example, it might affect the ability of the entity to continue as a going concern, or materially alter the debt levels (PS No. 64). The prospectus should also describe how the entity will apply the funds if less than the full amount is raised. For instance, the draft policy provides that the prospectus should say:

> Whether some or all of the stated activities might need to be scaled back, and how this will be done. Investors are not assisted if you merely state that the activities will be scaled back, for example, 'as appropriate' or 'as the directors determine', or whether the funds will be allocated to stated activities in any particular priority until each activity is fully funded, or whether they will be allocated pro rata. (PS No. 65)

These disclosure requirements are similar to the Prospectus Rules issued by the Financial Services Authority in the United Kingdom to implement the EU Prospectus Directive that took effect on 1 July 2005.

TABLE 1: Characteristics of 174 IPO firms during 1995–2000

	Mean	Median	Standard Deviation	Maximum	Minimum
Issue size ($ millions)	18	8	54	694	1
Total assets ($ millions)	73	17	468	6,146	2
Retained ownership	63%	64%	17%	100%	0
Firm age at IPO (years)	5.82	6	3.96	10	0
Underpricing $\frac{\textit{First-day Price less Issue Price}}{\textit{Issue Price}}$	39%	20%	69%	500%	-70%
One-year buy-and-hold abnormal return	-24%	-31%	66%	338%	-100%
Three-year buy-and-hold abnormal return	-47%	-82%	112%	104%	-100%
Forecast accuracy (n=131) $\frac{\textit{Actual Earnings Less Forecast}}{\textit{Forecast}}$	-407%	-25%	237%	207%	-233
Big audit firm dummy	0.63	1	0.48	1	0
Independent directors (ratio to board size)	51%	50%	19%	100%	0
Independent chairman (proportion of firms with the CEO different from the chairperson)	82%	100%	39%	100%	0

Sample characteristics

Table 1 summarises the offer statistics for our sample of 174 IPO firms. We included all underwritten and fixed-price IPOs but excluded mining firms, trusts, financial institutions and foreign entities. The mean (median) firm size was $73 million ($17 million) with the entities receiving an average of $18 million (median of $8 million) in useable proceeds from the equity issue. After listing, 105 IPO firms had more than 50% of their expected total assets derived from the offering. Such a large proportion suggests that use of proceeds disclosure is indeed an important aspect of the prospectus.

The average retained ownership was 63%, higher than the 51% reported in Balatbat et al. (2004), but consistent with US evidence (Loughran and Ritter, 2002). A higher ownership retention by pre-IPO owners signals higher expected cash flows (Leland and Pyle, 1977). On average, the IPO firms in our sample had six years prior operating history, slightly less than comparable US IPO firms.

Our results generally support earlier findings that IPOs are underpriced with a mean (median) underpricing of 40% (20%), similar to the discount reported by Ho et al. (2001) in Australia and Loughran and Ritter (2002) in the United States during the 'tech bubble'. The magnitude of the discount is reflective of three-quarters of our sample firms going public during the high-tech boom in the 1999 to early 2000 period. Moreover, our results support the well-documented anomaly in equity raisings in which we observed a long-term post-IPO decline in performance. Average (median) one-year buy-and-hold abnormal return (BHAR)

... we found underpricing to be unrelated to the extent of disclosure of use of proceeds. This suggests that, contrary to Leone et al. (2006), the level of specificity does not reduce information asymmetry at the time of offering. Hence, issuers should go beyond disclosure of quantitative dollar amounts if the objective is to provide more value relevant information to investors.

TABLE 2: Specificity of use of proceeds disclosure and shareholder returns

Panel A: Specificity and market effects

	No. of Firms	Underpricing (First-day)	One-year BHAR	Three-year BHAR
Full Disclosers	120	42%	-26%	-54%
Partial Disclosers	52	32%	-17%	-28%
Non Disclosers	2	45%	-39%	-74%

Panel B: Specific use of proceeds

	No. of Firms	Proportion to Total Proceeds (%)
Acquire other entities	40	38
Repay debt	74	35
Invest in R&D	50	34
Working Capital	111	34
Invest in capital assets	74	25
Marketing and advertising	41	24
Invest in intangible assets	6	17
Offer expenses	166	13
Fees to pre-IPO owners	6	12
Other uses	46	28

Panel C: Market effects of uncommitted funds

	No. of Firms	Underpricing (Firstday)	One-year BHAR	Three-year BHAR
15% or less committed in working capital	91	36%	-15%	-33%
> 15% committed in working capital	83	41%	-37%	-55%

was -24% (-31%). This declines further to -48% (-89%) after three years. Interestingly, earnings forecasts were skewed towards optimistic forecasts at the time of offering.

We also found that IPO firms in our sample value third-party certification with 63% of the prospectuses having had their financials certified by large audit firms. The firms also had strong corporate governance structures in place with half the sample firms having a majority of independent directors and with 82% having a non-executive chairperson.

Specificity of use of proceeds disclosure

The level of specificity represents the proportion of IPO proceeds for which a dollar amount is indicated for a specific purpose in the 'use of proceeds' section of the prospectus. This measure is consistent with Leone, Rock and Willenborg's (2006) measure. We found that issuing firms attained a high score on the level of specificity with seven in 10 IPO firms reporting full disclosure (See Panel A of Table 2) even prior to the release of ASIC's draft policy statement. This reflects the fact that investors expect to find this information in the prospectus. However, we did not find a positive effect on underpricing for firms that achieved full disclosure. In fact, we found underpricing to be unrelated to the extent of disclosure of use of proceeds. This suggests that, contrary to Leone et al. (2006), the level of specificity does not reduce information asymmetry at the time of offering. Hence, issuers should go beyond disclosure of quantitative dollar amounts if the objective is to provide more value relevant information to investors.[3]

We show in Panel B of Table 2 that it is commonly intended that the proceeds from the offering will be used to acquire other entities, repay debt, invest in research and development, pay for working capital, cover offer expenses, pay fees to pre-IPO owners, purchase intangible assets, invest in capital assets and for marketing expenses, among others. Almost all firms in our sample bore the costs of the offer which were estimated at 13% of total proceeds, except for eight firms where the costs of the offer were borne by pre-IPO owners. Less than one-third of our sample issued secondary shares (vendor shares) as part of the offering but the amounts received from these issues were excluded as our focus was on useable funds available to the firm.

It is also worth noting that in Panel B of Table 2 six out of 10 firms intended to use a substantial proportion of funds on working capital (34%). Often, it was not clear in the prospectus why these firms asked for such a high level of uncommitted funds. This was due to the lack of any requirement in Australia to explain why firms seek such a high level of uncommitted funds. In contrast, some jurisdictions mandate an explanation where uncommitted funds reach a certain threshold. For instance, Washington State Department of Financial Institutions requires entities to explain why they are seeking more than 15% of the proceeds designated for working capital or other general uses while other regulators limit the proportion of uncommitted funds that may be raised. North American Securities Administrators' Association Inc. has in their guidelines a clause that 'the issuer may not reserve more than 15% of the proceeds for working capital or general corporate purposes (or any other unspecified use)'.

To investigate how the level of uncommitted funds affects shareholder returns, we partitioned the sample by the size of funds committed to working capital using 15% as the cut-off point. As reported in Panel C of Table 2, we

TABLE 3: Accuracy of use of proceeds disclosure and shareholder returns

	No. of firms	Underpricing	One-year (BHAR)	Three-year (BHAR)
Panel A: Repay debt (n=74)				
None spent in this category	10	47%	-40%	-77%
< 10% underspending in this category	24	24%	-28%	-54%
Spent within +/- 10% in this category	10	16%	-6%	-31%
> 10% overspending in this category	30	39%	-31%	-30%
Panel B: Invest in capital assets (n=73)				
< 10% underspending in this category	50	45%	-25%	-35%
Spent within +/- 10% in this category	6	10%	-24%	-21%
> 10% overspending in this category	17	34%	-0.23%	-40%
Panel C: Acquire other entities (n=40)				
None spent in this category	12	49%	-44%	-56%
< 10% underspending in this category	11	63%	-45%	-85%
Spent within +/- 10% in this category	4	0%	-51%	-75%
> 10% overspending in this category	13	40%	18%	-44%

found underpricing to be slightly lower and the long-term poor performance less pronounced for firms with concrete uses for the proceeds of funds.

Accuracy of use of proceeds disclosure

There is also no requirement in Australia for IPO issuers to explain ex-post how proceeds were spent. In comparison, the US SEC requires IPO issuers to explain in their Form S-R filings how the proceeds were applied. We calculated the accuracy of the use of proceeds disclosures by investigating whether firms used the proceeds of the offering as intended in subsequent years. This was done by examining cash flow statements for up to two financial reports after the offering and matching the cash outflows with specific use of proceeds. However, we were only able to perform this test where the proceeds were intended to be used to repay debts or acquire capital assets or other entities, as these are required line items in the cash flow statement.

The difficulty of confirming the use of funds from equity raisings in subsequent financial reports highlights the need for a separate report to explain how the funds raised were applied. Furthermore, Table 3 shows that the majority of firms underspent the useable proceeds, with four in five firms underspending on capital expenditures and half the firms underspending on acquiring other entities or repaying debts. These results perhaps reflect the long period of time it takes for IPO firms to execute plans for expansion whereas only a relatively short period of time is necessary to adjust their financial structures. Table 3 also reports that underpricing is lowest for firms that spent the money as intended. We also observed lower negative returns in this category over a three-year period. These findings suggest that firms disclosing concrete intentions regarding the use of proceeds and that do so as intended, perform better than firms with less disclosure of their use of proceeds.

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Conclusion

Even in the absence of specific guidelines, we found that the majority of the IPO firms self-regulated effectively by voluntarily disclosing the use of proceeds in the prospectus suggesting that, as recommended in ASIC's draft policy statement, this information is necessary for a reasonable investor to make an informed decision. However, our results indicated that it may be useful to require firms to clarify why high levels of the proceeds are being sought for working capital or to limit the proportion of the proceeds being raised for working capital or any other unspecified use. There is also the question of whether IPO firms should be required to have a US-style disclosure of how the funds raised were applied and, in the event that the funds were not used as intended, to require firms to 'please explain'.

Notes

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2 For example, the Law Council of Australia, the Australian Institute of Company Directors and the Australian Shareholders' Association.

3 For example, it may be useful to explain in the prospectus whether working capital funds are to be spent to provide funds for specific items such as: debtors, inventories, among others, rather than simply indicating the dollar amounts sought for working capital.

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