Impact of Audit Opinion on the Pricing of IPOs in India

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Introduction

Unlike listed firms, there is a severe dearth of information and oversight in firms planning to raise capital through an Initial Public Offering (IPO). In the absence of complete information, the opinion of institutional investors, analysts, auditors, grey market participants, etc., act as signals that tend to fill this gap at the time of an IPO. Other than investor/analyst meets, roadshows, and advertisements, a vital avenue to conveying information regarding financial performance, governance & CSR initiatives, etc., is the Prospectus which the firm files before the IPO. Much of this prospectus information originates from top management, which needs to be authenticated by independent agencies to build trust among investors (Dunn, 1991; Lee, 1993). One significant independent agency, with a mandate to certify the financial disclosures, is the independent auditor. Capital markets in many economies mandate restatement of financial statements in the Prospectus[1] by an independent auditor. Thus, an IPO is an event when the independent auditor has access to proprietary client information. The success or failure of an IPO has a significant impact on the auditor's reputation. This engagement also exposes the auditor to a host of litigations. As a result, most auditors tend to issue detailed and conservative reports (Venkataraman et al., 2008). If the auditor cannot obtain sufficient appropriate audit evidence, s/he shall express a qualified opinion, adverse opinion, or a disclaimer of opinion. That audit opinion provides information to investors, and other stakeholders have been well established in recent studies (Czerney et al., 2018, Kaplan et al., 2020). This study tests if audit opinion[2] affects the level of under-pricing, if any, of book-built IPOs in India listed in the National Stock Exchange between 2009-2019. Accordingly, the study analyzed 183 IPOs, of which 65 IPOs were classified as having an audit opinion.

Analysis

Prior studies analyzing the impact of audit opinion on the extent of under-pricing find that firms with audit opinions had a significantly lower level of under-pricing since the audit opinion allows investors to assume risk in a more informed manner (Willenborg and McKeown, 2001; Bochkay et al., 2018).

> "… after controlling for other known effects, including an investor's assessment of the probability an IPO will delist…, a GC increases the precision associated with security valuation." (Willenborg and McKeown, 2001. Pg. 299).

This study analyses the impact of an audit opinion on one pre-listing (Expected Voluntary Under[3]-pricing -EVU) and one post listing (Classical Under[4]-pricing -CU measure of under-pricing (Clarke et al., 2016). Accordingly, Table 1 tabulates the annual average under-pricing of all IPOs, thus, helping us understand the trend in under-pricing over the years. Further, to assess the impact of an audit opinion on the under-pricing of IPOs, the study analyzed a hand-collected data of all IPOs in India between 2009 and 2019. Each audit opinion in the Prospectus filed before the IPO is assessed. Accordingly, the IPO is classified as those with some type of audit opinion and clean ones. Table 2 reports the number of IPOs that were under-priced/overpriced and had qualified or clean opinions.

Table 1: Pre and Post Issue Under-pricing

Year	EVU	CU	CU (Q)	CU (UQ)
2010	-4.58%	19.37%	0.69%	18.69%
2011	8.64%	-1.33%	-3.20%	1.87%
2012	9.73%	8.79%	1.16%	7.63%
2013	8.43%	4.80%	7.77%	-2.97%
2014	10.81%	26.52%	23.57%	2.96%
2015	12.04%	6.96%	5.01%	1.95%
2016	13.49%	14.50%	1.56%	12.94%
2017	15.05%	18.06%	5.07%	12.99%
2018	15.20%	0.22%	-2.16%	2.38%
2019	12.52%	-3.39%	0.00%	-3.39%

Table 2: Qualification and Under/Over Pricing

Pricing\Qualification	Qualified	Not Qualified
Over Priced	32	37
Under Priced	33	81

Findings

A secular increase in the pre-listing measure of under-pricing (EVU) is witnessed. This is because of the reluctance of issuers to set the upper end of the price band of a book-built issue at the maximum permissible limit of 1.2 times the floor of the price band. A trend which is more pronounced in recent years. This result poses some questions regarding the effectiveness of the book-building process in price discovery. A related question is then, why don't these firms opt for fixed price issues rather than book-built issues? The answer probably lies in the allocation rules and the history of profits that differentiate the two types of IPOs. In this backdrop, we can see that the pre-listing under-pricing or voluntary under-pricing becomes less relevant.

Based on the Classical measure of post-listing under-pricing, of the 183 IPOs analyzed, 114 IPOs were under-priced. That is more than 60% of the issues. Unmet demand is the primary driver of classical under-pricing (Clarke et al., 2016). The annual average under-pricing was 9.45%, of which IPOs with some negative audit opinion accounted for 3.95% and those without accounted for 5.5%.

Thus, the average level of under-pricing was less in IPOs with some type of qualified audit opinion than those with clean audit reports. Further, based on table 2, we can say that close to half the instances of overpricing were in IPOs that had some audit opinion. Such IPOs also seem less prone to under-pricing. If anything, they seem to be comparatively more prone to overpricing, which may be attributed to the unmet demand of investors. Thus, the disclosures by the auditors seem to provide information that reduces the uncertainty in the minds of investors.

It may be stated that the findings in this study are exploratory at best because no attempt at matching or balancing (based on covariates) the IPOs that have an audit opinion and those that do not is made. These preliminary findings confirm the findings of Kaplan et al. (2020), Bochkay et al. (2018), and Willenborg and McKeown (2001), who reason the lower under-pricing of IPOs with audit qualification to the (credible) information being provided in the auditor's report, which helps the investors better estimate the value of the IPO.

References

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[1] In India, Securities and Exchange Board of India's Issue of Capital and Disclosure requirement (ICDR) regulations 2009 required an issuer to provide five years of restated consolidated and standalone financial statements in the offer document accompanied by an audit opinion. This was later rationalised in 2018 and an issuer is now required to provide only restated consolidated financial statements for a period of three financial years.

[2] This study, being in the context of an IPO, takes a conservative view of audit qualification. Without attempting to assess the severity of a qualification in terms of its materiality, this study classifies an IPO with a qualified opinion, adverse opinion or even a disclosure of opinion in any one of the five years preceding the IPO, as an IPO with a qualified opinion.

[3] EVU is defined as the percentage difference between the permissible upper bound (MAXP) of the price band for book building and the actual upper bound (MAXA) set in the prospectus: (MAXP-MAXA)/MAXP

[4] CU is defined as the percentage difference between the closing price (CP) at the end of the first trading day and the offer price (OP): ((CP-OP)/OP)