

Auditor Reputation, Auditor Independence and the Underpricing of IPOs

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We investigate the effect of reputation and independence of auditors on IPO underpricing. Auditor reputation and independence may reduce asymmetric information that exists between companies going public and external investors, therefore decreasing IPO underpricing. Multi-variable regression analysis of a sample consisting of IPOs from the period around SOX is performed. Results show that auditor independence does, but auditor reputation does not, reduce IPO underpricing.

INTRODUCTION

The goal of this study is to determine the effect of reputation and independence of auditors on the underpricing of IPOs during the period around the enactment of the Sarbanes-Oxley Act from July 2000 to July 2004. The pricing of an IPO determines the amount of capital a company would receive when they go public. Underpricing affects IPO companies mainly because it means that they receive less money than they would have raised. Furthermore, underpricing indicates that their price is less than their actual market value, which would understate the financial position of the companies and put them in a less favorable light in the potential investors' perspectives. As for auditors, they play an important role in verifying the financial statements that would be evaluated by underwriters (also known as investment bankers) to determine the pricing of the IPOs. In addition, investors heavily rely on the information provided by the companies' financial statements, and it's important that the auditor efficiently discloses an opinion that expresses whether the financial statements reasonably and accurately depicts the company's current financial position. The more reliable assurance the auditor provides (giving an unqualified opinion), the less asymmetric information there is between IPO firms and their external investors, and therefore the more efficient the financial market would be.

In this study, three hypotheses are developed that involve the main components of the relationship between auditing and IPO underpricing. The three components are the auditor reputation, auditor independence and SOX. Generally, auditor reputation and independence are closely associated with audit

quality. The SOX aims at improving audit quality by disciplining auditors' behavior. So, these factors would reduce the asymmetric information of IPO firms. Thus, it is expected that there is a negative correlation between each of the factors (the average auditor reputation ratio, auditor independence ratio, and SOX indicator) and IPO underpricing.

The results of this study demonstrate that auditor reputation is negatively correlated with underpricing, although not statistically significant. Secondly, auditor independence has a negative relationship with underpricing and is significant at the 5% level. This suggests that the increase in auditor independence would improve audit quality and mitigate the problem of asymmetric information. Lastly, the IPO underpricing in the post-SOX period is significantly lower than in the prior-SOX period, indicating that the Sarbanes-Oxley Act has reduced the asymmetric information and improved the market efficiency.

The remainder of this article is as follows. Section 2 provides the literature review, which discusses the articles that support the various variables that influence the relationship between auditor reputation and underpricing of IPOs. Section 3 discusses the hypotheses that are developed and tested in this study. Section 4 explains the regression model that will be used to determine the relationship. Section 5 describes the data sources and the sample descriptive statistics. Section 6 analyzes the results from the regression model. Section 7 presents the conclusions of the study.

LITERATURE REVIEW

Auditor reputation is the corporate image that the firm creates over time by its brand name, perceived audit quality, and quality of staff (Aronmwan et al., 2013). Kinney (1986) suggests the demanded auditing services will be heterogeneous due to the nature and extent of costs that firms are willing to pay to minimize costs that would arise from conflicts of interests. This heterogeneity causes CPA firms to invest in reputation capital to differentiate themselves and facilitate the attestation function. Reputation capital is the quantitative value of the firm's reputation. Since their reputation capital decreases through the ex post revealed errors or misstatements, auditors are motivated to report deviations from the applied accounting framework and principles (Palmrose, 1986).

There is a positive relationship between higher reputation and higher audit fees because higher audit fees equate to a greater number of auditing hours. Those higher audit fees and greater number of hours cause an increase audit quality for the auditor (Moizer, 1997). Therefore, there is a positive relationship between auditor reputation and audit quality. Also, it is found that there is a marginal benefit of firms selecting a more reputable audit firm to participate in the IPO process. There is an increase in the price obtained by the firm going public (Beatty, 1989). For example, since auditors with more prestigious reputations charge higher fees, the marginal cost will outweigh the marginal benefit for lower-quality firms, therefore, they tend not to employ more prestigious auditors' services (Michaely and Shaw, 1995). Titman and Trueman (1986) supported that a firm with better value will more likely select a higher-quality auditor than a firm with that is less valuable. Furthermore, they state that the higher quality of auditor chosen will lead to higher level of audit quality and a greater assessment of the firm's value. Therefore, the amount of revenues an auditor made for the year can help determine the auditor's reputation relative to its competitors.

External auditors are crucial in providing reasonable assurance to companies' financial statements. Due to their objectivity, independence and expertise, investors heavily rely on the auditors to verify that a company's financial statements do not contain any material misstatements that would have an impact on their business decisions. A big factor of auditor reputation and independence is the size of an audit firm. Salehi and Mansoury (2009) state larger audit firms tend to have a reputation to safeguard assets and will more likely provide an independent quality service. They have better financial resources, superior technology and more proficient employees than smaller audit firms do, which puts them in an advantage to engage in larger company audits. Also, due to the advantage of having better resources, larger audit firms have a bigger variety of clients and would be less inclined lose their independence to please a client. To measure auditor independence, Krishnamurthy, Zhou and Zhou (2006) utilized the audit fee ratio,

which is audit fees divided by total fees. A lower audit fee ratio indicates a lack of independence and vice versa. The reasoning of the statement is that audit firms would be less independent if they provided more services other than auditing, such as taxes. Before the enactment of the Sarbanes–Oxley Act of 2002, accounting firms were allowed to provide consulting and auditing services to the same client during the same period. If the client doesn't perform well and it shows in their financial statements, accounting firms would fear that their consulting services would be terminated. Since consulting services produce a lot of revenue for accounting firms, they couldn't afford to lose their clients. Thus, they could use their auditing services to put their client in a better light and this jeopardizes their independence.

More prestigious auditing firms tend to provide services for IPOs that are larger, have more tangible assets and collaborate with more prestigious underwriters (Michaely and Shaw, 1995). A model was developed by Titman and Trueman (1986) that demonstrates the firm's motivation to signal the quality of the selected underwriter or auditor for the IPO. Furthermore, the investment banker prefers a higher-quality auditor to prevent mispricing and preserve its reputation (Balvers, McDonald and Miller, 1988). Therefore, underwriter reputation has a positive relationship with auditor reputation because both of their reputations help reduce underpricing (Titman and Trueman, 1986). However, if either one of their reputations reach higher levels, then the other firm's (being the underwriter or auditor) impact on diminishing underwriting decreases (Balvers, McDonald and Miller, 1988).

When there is an excess demand, underwriters can decide to whom they will allocate shares to. Usually, they favor regular investors who provide information about their demand which will be useful in pricing an IPO. They do this to reduce the average amount of underpricing, causing an increase of the expected proceeds to issuers (Loughran and Ritter, 2004). This demonstrates how underwriter discretion can be utilized to benefit issuing firms (Sherman and Titman, 2001). Generally, the regular investors that are approached by the underwriters in these situations are well-informed and understand the importance of the audit reports. There is a possibility that auditor reputation will influence how they perceive the reliance and accuracy of the financial statements of a firm and therefore, possibly influence their perceived demand on the company's IPO. Thus, it is important to incorporate the average underpricing in the previous month to potentially show the effect of an auditor's reputation on the demand and pricing of an IPO.

Asymmetric information regarding an IPO has an effect on underpricing. Carter and Manaster (1990) found that potential investors have substantially less information regarding the IPO than the owners of the company. Current owners have an incentive to misrepresent the company to potential investors, considering that the law doesn't require firms to fully disclose information. It can lead to potential returns based on inaccurate or incomplete disclosures, which can be substantial and cause potential investors to question the validity of information regarding IPOs (Cohen and Dean, 2005). It is important to have less asymmetric information regarding the IPO to increase the efficiency in the market.

It is found that firm value is an increasing variable of auditor and investment banker quality (Titman and Trueman, 1986). Therefore, the current financial position of a company that is going public will influence the quality of the audit.

A huge influence on auditor reputation is the events that resulted in the passing of the Sarbanes-Oxley Act (SOX) of 2002. The purpose of SOX is to enhance the accuracy and reliability of a firm's financial statements and to reduce information risk. The indictment of Arthur Andersen leads to a negative market reaction towards the clients of Andersen (Krishnamurthy, Zhou and Zhou, 2006). However, after the passing of SOX, the Securities and Exchange Commission (SEC) heavily enforced SOX which resulted in positive, abnormal returns in the market (Li et al., 2008). The negative reactions before SOX are more significant if the auditor's independence appears to be compromised. Overall, it is determined that auditor reputation and independence have a significant impact on perceived audit quality and credibility of financial statements which is priced by the market (Krishnamurthy, Zhou and Zhou, 2006). Moreover, SOX improves auditor independence, but it is found that there isn't any actual auditor independence lost before the passing of SOX (Chung and Kallapur, 2003).

Butler et al. (2014) apply five different methodologies to identify the strongest influences on the pricing of IPOs. The five methodologies are the extreme bounds approach, the best subset approach, the

least absolute shrinkage and selection operator approach, the weighted average least squares approach, and the Bayesian Model Averaging approach. They discover that information regarding previous IPOs does affect the current IPO underpricing. The results of the study are that offer price revision, average underpricing in previous month, leverage and prior 30 day CRSP (Center for Research in Security Prices) equal weight index return influence the underpricing of IPOs the most. The prior 30 day CRSP return suggests the equity market conditions at the time the firm goes public is reflected by the underpricing of IPOs in that current period. These factors will be used as control variables in the regression model.

HYPOTHESIS DEVELOPMENT

Three hypotheses are tested to understand the relationship between auditor reputation and the pricing of IPOs. First, an auditor with a favorable reputation would reduce the asymmetric information of IPO firms. Thus, it is expected that there is a negative relationship between the average auditor reputation ratio and IPO underpricing. The average auditor reputation ratio quantifies auditor reputation and allows us to measure how the extent of an auditor's reputation impacts the IPO underpricing.

The second component that is addressed is the relationship between the auditor's independence and the underpricing of IPOs. It is predicted that the use of an independent auditor would reduce the asymmetric information of IPO firms. Thus, it is expected that there is a negative relationship between the audit fee ratio and IPO underpricing. The audit fee ratio measures the auditor's independence, which is another important factor in the quality of an audit.

The third hypothesis is SOX would reduce the asymmetric information of IPO firms. Thus, it is expected that the SOX indicator has a negative effect on the IPO underpricing. As mentioned previously, many frauds occurred prior to the passing of SOX. In this study, it is important to determine whether the passing of SOX gave more credibility to auditors and financial statements and how it would impact the pricing of underpricing.

MODEL

In this study, the regression model as follows is used to determine the relationship between the auditor reputation and IPO underpricing.

$$U = \beta_0 + \beta_1 AR + \beta_2 AI + \beta_3 SOX + \beta_4 (SOX*AR) + \beta_5 (SOX*AI) + \beta_6 IBR + \beta_7 S + \beta_8 L + \beta_9 OPR + \beta_{10} AU + \beta_{11} CRSP + \varepsilon \quad (1)$$

where:

- U = Underpricing;
- AR = Auditor Reputation;
- AI = Auditor Independence;
- SOX = SOX Indicator;
- IBR = Investment Bank Reputation;
- S = Log of Book Value of Total Assets;
- L = Leverage; Debt over Total Assets;
- OPR = Offer Price Revision;
- AU = Average Underpricing in Prior Month;
- CRSP = Prior 30 Day CRSP Equal Weighted Index Return;
- ε = residual.

This study mainly tests the auditor reputation, auditor independence, SOX indicator, SOX indicator*auditor reputation, and SOX indicator*auditor independence in the regression model. The rest of the regression consists of control variables that are factors in underpricing.

DATA AND SAMPLE DESCRIPTIVE STATISTICS

For the period from July 2000 to July 2004, there are 447 IPOs. First, to measure auditor reputation, the average auditor reputation ratio is developed. The auditor reputation ratio is the audit fees of the IPO divided by the number of planned shares multiplied by the offer price. Since each auditor audited multiple IPOs, the ratios are averaged together to get the average auditor reputation ratio. As previously mentioned in the literature review, audit fees are a good indicator of the auditor's reputation. The denominator of the ratio (number of planned shares times the offer price) takes into account that audit fees are influenced by the size of the IPO and would depict an accurate measure of the auditor's reputation, regardless of the size of the IPO. The higher the ratio, the more reputable the auditing firm is. The offer price of the IPOs, along with the dates of the IPOs, the average underpricing in previous month, and the underwriters chosen to participate in the IPOs are collected from the IPOscoop database. The audit fees and number of planned shares data is derived from the DEF 14A and S-1 forms, respectively, from the Securities Exchange Commission (SEC) Edgar database. The DEF 14A form is the proxy statement that is released to shareholders and states the audit and total fees that the auditor charges the firm for the stated year. The S-1 form is the registration form of the IPO that is required to be filed to the SEC to formally start the process of going public. The form also contains information regarding the auditor selected to provide services in the IPO, liabilities and equities of the IPO (to get the leverages) and the initial price range. The initial price range is used to find the offer price revision. The equation of the offer price revision is the offer price minus the midpoint of the initial price range, divided by the midpoint of the initial range.

To measure the degree of auditor independence, the audit fee ratio is utilized. The audit fee ratio consists of audit fees divided by the total fees. The higher the ratio, the greater the degree of auditor independence.

To find the percentage of underpricing of each IPO, the offer price is subtracted from the closing price and divided by the offer price. The closing price is the market price for which is the IPO's market value. As for underwriter reputation, the data from the study conducted by Loughran and Ritter (2004) is utilized. Loughran and Ritter retrieved the data from the Thomson Financial Securities Database and used the Carter and Manaster ranking and Carter, Dark, and Singh ranking to rank underwriter reputation. They created rankings for the period from 1980 to 2015 and divided that period into smaller periods. The 2001 – 2004 period rankings are selected given that they pertain to the period for my study. Loughran and Ritter ranks the underwriters on a scale from 0 to 9. Any underwriter that receives a ranking of 8.0 to 9.0 are the most prestigious underwriters. Those that have a ranking of 5.0 to 7.9 are considered to be quality regional or niche underwriters. Lastly, underwriters that have a ranking of 0 to 4.9 are generally associated with penny stocks. Also, many of those with a rank of 3.0 or lower have been charged by the SEC with market manipulation (Loughran and Ritter, 2004). The size of the firms going public are retrieved from COMPUSTAT. From the data from COMPUSTAT, there were a few leverage ratios that were negative or above 1. As for size, it is measured by the book value of the firm's assets. Lastly, the prior 30 day CRSP equal weight index return is retrieved from the Center for Research in Security Prices database.

Table 1 presents the summary of statistics for pre-SOX and Table 2 for post-SOX. Table 3 presents the differences in the value of variables between pre-SOX and post-SOX.

TABLE 1
SUMMARY OF STATISTICS FOR PRE-SOX PERIOD

	MEAN	STANDARD DEVIATION	MINIMUM	MAXIMUM	N
Underpricing	0.248	0.416	-0.331	2.121	312
Auditor Reputation	1499.4	912.3	601.1	10636.8	312
Auditor Independence	0.325	0.230	0.032	1	243
Underwriter Reputation	7.336	2.922	.001	9.001	310
Log of Book Value of Total Assets	5.277	1.476	0.962	10.929	306
Leverage	0.298	0.276	0.007	2.821	306
Ave. Underpricing in Prior Month	0.288	0.206	0.052	0.617	278
Offer Price Revision	-0.005	0.118	-0.375	0.462	312
CRSP Index Return Prior 30 Days	-0.002	0.062	-0.139	0.269	320

TABLE 2
SUMMARY OF STATISTICS FOR POST-SOX PERIOD

	MEAN	STANDARD DEVIATION	MINIMUM	MAXIMUM	N
Underpricing	0.117	0.178	-0.155	1.036	154
Auditor Reputation	4075.4	3035.3	247	28686.9	156
Auditor Independence	0.713	0.279	0.144	1	149
Underwriter Reputation	7.928	1.709	0.001	9.001	151
Log of Book Value of Total Assets	5.185	1.496	0.188	10.145	152
Leverage	0.3561	0.3322	0	2.113	152
Ave. Underpricing in Prior Month	0.188	0.067	-0.027	0.259	157
Offer Price Revision	-0.043	0.116	-0.5	0.158	154
CRSP Index Return Prior 30 Days	0.025	0.050	-0.105	0.159	157

The mean of underpricing is 24.8% in the pre-SOX period and 11.7% in the post-SOX period. Therefore, the mean of underpricing has decreased once SOX was enacted. This decrease in the mean is statistically significant at the 1% level (Table 3). On the other hand, the means of auditor reputation and auditor independence have increased after SOX. The increases in both auditor reputation and auditor independence are significant at the 1% level. Together, these results indicate that SOX has decreased the IPO underpricing by regulating the auditor behavior.

TABLE 3
COMPARISON OF PRE-SOX AND POST-SOX SUMMARIES OF STATISTICS

	Difference in Means (Pre-SOX – Post-SOX)	t-Stat	p-value
Underpricing	0.130	3.72	<0.01***
Auditor Reputation	-2576	-13.81	<0.01***
Auditor Independence	-0.388	-14.89	<0.01***
Underwriter Reputation	-0.592	-2.3	0.02**
Log of Book Value of Total Assets	0.092	0.62	0.53
Leverage	-0.058	-1.97	0.05**
Ave. Underpricing in Prior Month	0.171	10.06	<0.01***
Offer Price Revision	0.039	3.33	<0.01***
CRSP Index Return Prior 30 Days	-0.027	-4.75	<0.01***

* significant at the 1% level, ** significant at the 5% level, *** significant at the 10% level

EMPIRICAL RESULTS

The first regression tests the relationship between the underpricing of IPOs and auditor reputation, the second regression tests the relationship between underpricing and auditor independence, and the third regression tests the relationship of the underpricing with both auditor reputation and independence. In the first and third regressions, the product of SOX and auditor reputation ratio, is incorporated to see if the interaction of the two variables, SOX and auditor reputation ratio affects the underpricing. The same rule applies to the SOX and auditor independence variables when they are incorporated into the second and third regressions to capture the joint effect of SOX and auditor independence. The results of these regressions are presented in Column (1), (2), and (3) of Table 4, respectively.

TABLE 4
REGRESSIONS OF AUDITOR REPUTATION, AUDITOR INDEPENDENCE AND SOX

	UNDERPRICING, AUDITOR REPUTATION AND SOX	UNDERPRICING, AUDITOR INDEPENDENCE AND SOX	UNDERPRICING, AUDITOR REPUTATION, INDEPENDENCE AND SOX
	(1)	(2)	(3)
Intercept	0.259*** (0.00)	0.264*** (0.00)	0.318*** (0.00)
Auditor Reputation	0.000 (.78)		-0.000 (0.29)
Auditor Independence		-0.179** (0.04)	-0.171** (0.05)
SOX	0.014 (0.82)	-0.064 (0.40)	-0.093 (0.31)
SOX * Auditor Reputation	0.000 (.990)		0.000 (0.39)
SOX * Auditor Independence		0.145 (0.23)	0.139 (0.26)
Underwriter Reputation	-0.003 (0.62)	-0.002 (0.83)	-0.002 (0.79)
Log of Book Value of Total Assets	-0.012 (0.31)	0.002 (0.88)	-0.001 (0.96)
Leverage	-0.090* (0.08)	-0.107** (0.04)	-0.103* (0.06)
Ave. Underpricing in Prior Month	0.235*** (0.01)	0.201** (0.04)	0.193** (0.05)
Offer Price Revision	0.863*** (0.00)	0.835*** (0.00)	0.841*** (0.00)
CRSP Index Return Prior 30 Days	0.027 (0.91)	-0.029 (0.91)	-0.034 (0.89)
N	466	466	466
Adj. R ²	0.224	0.235	0.273

* significant at the 1% level, ** significant at the 5% level, *** significant at the 10% level

The first regression of underpricing and auditor reputation (Table 4, column 1) and the third regression of underpricing, auditor reputation, independence and SOX (Table 4, column 3) show that auditor reputation has a negative relationship with the underpricing of IPOs. The negative relationship found does support the hypothesis that predicts the auditor reputation is negatively correlated with underpricing. However, in both regressions, the results indicate that the negative relationship between auditor reputation and underpricing are not statistically significant. The significance of the relationship between auditor reputation and underpricing might be due the fact that there is only a small range of auditor reputations in the sample. It might be more significant if there is a wider range of auditors and more mid-size or small auditors providing services to more IPOs. As for the results for auditor independence, the second regression of underpricing and auditor independence (Table 4, column 2) shows a negative and significant relationship at the 5% level. In the third regression, the auditor independence and underpricing relationship is negative, again; however, it is only significant at the 10% level. These

results support the second hypothesis that predicted a negative relationship between underpricing and auditor independence.

In the second and third regressions, SOX is negatively correlated with underpricing. These results support the third hypothesis, but do not have statistical significance. It is also found that the variable, SOX*auditor reputation, is positive, but not significant in the first and third regressions. Lastly, the SOX*auditor independence is also positive and not significant in regressions 2 and 3.

Overall, underpricing and auditor independence have a negative relationship at the 5% significant level and underpricing and SOX have a negative relationship at the 1% significant level. Therefore, when there is an increase in auditor independence, asymmetric information decreases and market efficiency increase. Auditor independence is an influential factor in the underpricing of IPOs and is something that IPOs should take into deep consideration when selecting an auditor. Auditor reputation has the same effect; however, it does not have the significant influence on underpricing where it could be consider has a factor of the pricing of IPOs.

CONCLUSIONS

The objective of this study is to evaluate the relationships of auditor reputation, auditor independence and the enactment of SOX with the underpricing of IPOs during the period from July 2000 to July 2004. The results of the comparison between prior- and post-SOX periods show that SOX has improved auditor reputation and independence and reduced the IPO underpricing. The results of the regressions demonstrate that auditor reputation negatively correlates with underpricing, but it is not statistically significant, and that auditor independence is negatively correlate with underpricing and it is statistically significant at the 5% level. These results indicate that the Sarbanes-Oxley Act has mitigated the asymmetric information problem in IPO firms mainly by improving auditing quality. Future researches can have robust results by investigating the effect of auditor reputation and independence on the IPO underpricing in a longer period and can improve the methodology by developing more relevant measures of auditor independence.

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