PacificCPE

COURSE
11458B

IPO Valuation Strategies and Third-Party Risk Governance

Two often-overlooked sources of financial misconduct are the IPO process and outsourced financial services. This course examines how underwriters strategically influence IPO valuations—sometimes at the expense of investors—and what governance structures help manage misconduct risk when financial services are outsourced to third parties. For CPAs advising companies going public or working with institutions that rely on vendors for critical functions, this course provides practical insight into where conflicts of interest arise and how strong governance frameworks can reduce exposure to fraud and regulatory risk.

CREDIT HOURS 2 | FIELD OF STUDY AUDITING | EXAM QUESTIONS 10

Start Course ↓ | Final Exam Copy ↓

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Identify the most widely used method for valuing firms.
- Recall the reasons given for outsourcing by the respondents of the author's survey of financial institutions.

Copyright Notice

© 2026 Pacific CPE, LP. All rights reserved.

The materials in this course — including the text, illustrations, exhibits, examples, exam questions, and review questions — are the copyrighted property of Pacific CPE, LP. No portion of this course may be reproduced, stored in a retrieval system, distributed, or transmitted in any form or by any means (electronic, mechanical, photocopying, recording, or otherwise) without the prior written permission of Pacific CPE, LP, except for the personal, non-commercial use of the registered learner.

Pacific CPE, LP grants the registered learner a single-seat, non-transferable license to access this course for the purpose of completing the associated continuing professional education credit. Account credentials may not be shared. Group access requires a separate enterprise license.

This course is provided "as is" for educational purposes. While Pacific CPE, LP makes a reasonable effort to ensure the content is current and accurate, the materials should not be relied upon as a substitute for professional advice. Pacific CPE, LP disclaims all liability for any error, omission, or loss arising from the use of, or reliance on, the course content.

Questions about reproduction, licensing, or use of these materials should be directed to support@pacificcpe.com.

Publication Date: July 2026

TABLE OF CONTENTS

CHAPTER 01

The Strategic Behavior Of Underwriters In Valuing Ipos 5

1.01 14.3 Literature Review 8

1.02 14.5 Results 14

1.03 Figure 14.1 Ipo Premium. 21

1.04 Table 14.7 Valuation Bias With Respect To Affi liated And Unaffi liated Analysts By Market. 26

1.05 Figure 14.4 Number Of Peers Changed And Valuation Bias. 32

1.06 14.6 Conclusions 35

Test Your Knowledge 37

CHAPTER 02

Governance Of Financial Services Outsourcing: Managing Misconduct And Third-Party Risks 39

2.01 15.1 Introduction 39

2.02 15.3 The Interaction Between Contracting And Monitoring 48

2.03 Table 15.3 Reasons For Outsourcing. 51

2.04 Table 15.5 Risks In The Outsourcing Relationship. 53

2.05 Table 15.7 Methods To Uncover Misconduct. 55

2.06 15.5 Conclusion 57

Test Your Knowledge 59

Final Exam Copy 90

Glossary 64

Index .....

Chapter 1: THE STRATEGIC BEHAVIOR OF UNDERWRITERS IN VALUING IPOs

Chapter Objective

After completing this chapter, you should be able to:

- Identify the most widely used method for valuing firms.

14.1 VALUING IPOs

An initial public offering (IPO) is the event in which a firm sells its shares to the public market for the very first time. This is done by listing on a stock exchange, in which two types of shares can be sold, namely primary and secondary shares. Primary shares are newly issued shares where capital is raised in exchange for a share of ownership in the company. This means that there is a capital inflow to the company's account and, at the same time, the firm's ownership structure is diluted since the equity stake owned by pre-IPO owners is reduced due to the issuance of new shares. Secondary shares are instead sold by pre-IPO shareholders. This means that the capital flows from market investors to the existing shareholders of the firm, whose balance sheet does not change because of this trade.

The main document associated with a public offer of shares is the prospectus, which is accompanied by a variety of agreements that, among others, include an arrangement setting out the responsibilities of the company and its directors for the prospectus, as well as the responsibilities of an investment bank for sponsoring and underwriting the offer. The underwriter ensures that the firm satisfies all regulatory requirements, such as filing with the appropriate regulatory bodies and depositing all fees, and makes all mandatory financial data available to the public. Underwriters are in contact with prospective investors, including institutional investors like mutual funds and insurance companies. Clearly, a firm conducting an IPO needs to have its equity valued before the listing, in order to determine a price range within which the shares will be offered to the public. The offer price, which is the price at which the shares will be sold, is usually set within this range. A high offer price would benefit both the issuing firm, because of the higher capital inflow, and the underwriter, because of its compensation scheme, which is usually defined as a proportion of the amount of capital raised. However, an excessively high price may undermine the success of an IPO, as investors may become reluctant to bid if the offer is too costly, thereby leaving the firm with unsold shares.

There are several methods to value a firm. The most widely used approaches are the discounted cash flow and the relative valuation method. The latter relies on the comparison of the firm with a

number of publicly traded peers, typically belonging to the same industry and with similar characteristics, for which valuation multiples can be easily computed. In the absence of a publicly observable price, private peers that have been involved in equity transactions may also be selected.

Equity valuation using multiples is an approach based on the market valuation of companies that are thought to be comparable to the firm that needs to be priced. The idea is that the multiple of similar firms can be used as a driver for the valuation of a specific company. This implies that investors evaluate a company in the same way in which they evaluate comparable firms. For example, when using the price-to-earnings valuation multiple, the estimated value is obtained by multiplying the firm's earnings to the peers' average (or median) multiple. Thereby, the selection of the group of peers, which is at the underwriter's discretion, becomes crucial for the outcome of the valuation process. This is particularly relevant to our case, as the comparable method carries the risk of self-justifying an over- or undervaluation of firms in a certain industry.

Relative valuation methods have the advantage of being intuitive and simple to apply. However, they are accompanied by several concerns. The first issue is that the definition of a comparable firm is essentially a subjective one. The use of other firms in the industry as the control group is often not the solution because firms within the same industry can have very different business mixes, as well as risk and growth profiles, that make it difficult to find two identical companies. If the established selection criteria are too strict, few comparable firms can be identified, which leads to the pricing process being strongly affected by the valuation of a small number of firms. If, on the other hand, the selection criteria are too loose, the risk is to obtain a sample of firms that are not fully comparable with the one that is being evaluated. The correct selection of the peer group therefore requires the optimization of a trade-off between more and less strict selection criteria. Furthermore, given a certain peer group, different valuation estimates can be obtained simply because different types of accounting measures as a basis for the valuation multiples (e.g., book value of equity, earning before interests and taxes). Thus, the choice of which multiples have to be used in the valuation process is also critical. The most popular multiple used in practice is the price-to-earnings ratio. Earnings can be normalized for unusual or one-off items that can impact earnings abnormally. One way to normalize earnings is to use the average earnings over prior periods. A close variant of this approach is to estimate the average operating or net margin in prior periods and apply this margin to current revenues to arrive at normalized operating or net income. The price-to-earnings ratio, however, cannot be used for valuation purposes for firms with negative earnings. This is one of the reasons why most valuations do not rely exclusively on this ratio, but make use of other metrics, such as the price-to-book or enterprise value-based multiples.

14.2 THE UNDERWRITER'S INCENTIVES IN THE VALUATION OF IPOs

The IPO underpricing phenomenon has drawn considerable attention by academics, practitioners, and market participants in general. Underpricing is defined as the difference between the official closing price of the issuer's stock at the end of the first day of trading and the offer price at which

shares are sold to IPO investors. This difference is, on average, positive, and has been approximately 14% of the offer price for US IPOs during 2001-2016.[1] This implies that the average investor who is allocated shares in an IPO gets a positive 14% return by selling her shares just after one day. Ritter (2011) argues that agency problems between issuers and underwriters have become increasingly important to understand underpricing.

From the issuer's perspective, underpricing is traditionally seen as one of the costs of going public, which explains why it is often referred to as "money left on the table." More precisely, it can be considered as an opportunity cost to an issuing firm because a positive first day return implies that the shares were sold to IPO investors at a lower valuation (i.e., underpriced) than the one recognized by the market once trading activity has begun. In other words, a deeper underpricing means that the issuing firm could have potentially raised a larger amount of money at the IPO.

Maximizing IPO proceeds is sought after not only by the issuing firm, but also by its underwriter. An important part of the underwriter's remuneration comes from the investment banking fee, known as the gross spread, which is expressed as a percentage of IPO proceeds. Therefore, a higher offer price should make both issuers and underwriters happy. However, gross spread is not the only remuneration channel for underwriters, but there are at least two other important sources of profit. First, underwriters often give preference in favorable IPO allocations to rent-seeking investors, who pay commissions in excess of direct execution costs, known as soft dollars (Loughran and Ritter, 2002). Second, underwriters tend to allocate underpriced IPOs to corporate executives as a way of influencing their choice of investment banking decisions, a practice known as spinning (Liu and Ritter, 2010).[2] The necessary condition that enables underwriters to exercise their discretionary power in IPO allocations and engage in spinning practices is the presence of excess demand for shares, which is in turn stimulated by underpricing as long as the prospect of a positive first day return encourages investors to subscribe IPO shares. Therefore, the trade-off faced by underwriters when valuing IPOs can be modeled as follows: on one hand, gross spread generates the incentive to raise the offer price in order to maximize proceeds, thereby minimizing underpricing; on the other hand, the amount of profits arising from the soft dollars and spinning mechanisms increases with underpricing, which generates the incentive to propose a lower offer price than would be optimal for the issuer.

Valuing IPOs using the comparable firms methodology may be particularly suitable for underwriters to optimally solve their trade-off, due to the considerable degree of discretion associated with this valuation technique. Ultimately, the underwriter wants to maximize the difference between the offer price and the subsequent market price. This increases profits from the soft dollars and spinning channels. One way for underwriters to maximize this difference would be to lower the offer price. This, however, would cause a reduction in the profit arising from the gross spread. An alternative, more profitable way to maximize the above difference is therefore to induce a higher subsequent market price. This would guarantee a significant amount of profits from the

gross spread, while simultaneously ensuring a certain level of underpricing, which would allow underwriters to obtain soft dollars and engage in spinning practices. Thus, by selecting comparable firms that justify a high valuation, the underwriter is able to increase the offer price while simultaneously presenting the IPO as conservatively valued, which may shift the demand of investors and result in a higher market price.

14.3 LITERATURE REVIEW

Kim and Ritter (1999) is the first paper to investigate the valuation of IPOs. They do so using a sample of US IPOs. As American IPO prospectuses do not reveal details about the pricing mechanisms, they compare the valuation of issuing firms with that of peers selected using different algorithms. They find that valuing IPOs on the basis of multiples such as the price-to-earnings, price-to-sales, enterprise value- to-sales, and enterprise value-to-operating cash flow ratios of comparable firms may lead to inaccurate estimates if historical numbers rather than forecasts are used. The reason for such large valuation errors is simple: within an industry, the variation in these ratios is so large that their predictive power becomes modest. In other words, among publicly traded firms in the same industry, price-earnings (P/E) ratios typically display such great variation that just about any price can be justified.

Kim and Ritter's paper served as a reference for following studies on the valuation of IPOs. Their contribution, however, is limited by the scarce disclosure of the valuation procedures in the prospectuses of US IPOs. In Europe, this information is instead often disclosed in IPO prospectuses. IPO value estimates by the underwriting investment bank are indeed often published in the IPO-prospectus, which is made available at the start of the public offering. The availability of this information allows to examine how IPOs are valued, and how this valuation affects the offer price. It can be expected that the accuracy of ex ante valuation by investment banks will differ from the valuation accuracy measured by academics, for several reasons. Value estimates by investment banks may be less accurate because academics are more objective than investment banks, who may be tempted to report valuations that justify a high price, for instance by choosing comparable firms with high multiples. On the other hand, value estimates by investment banks may be more accurate than value estimates by academics because investment banks have more information available for valuation. In any case, the disclosure of information about the valuation of firms going public makes it possible to assess how it is done.

The seminal studies using such real world estimations to investigate the different valuation approaches are those by Cassia, Paleari, and Vismara (2004) and by Deloof, De Maeseneire, and Inghelbrecht (2009). Cassia et al. (2004) study how underwriters value firms that went public on Italy's Nuovo Mercato during the period 1999-2002. They document that the most frequently used method was peer comparables. Deloof et al. (2009) compare the value estimates obtained by lead underwriters of Belgian IPOs for the offer price with the stock price over the first month of listing.

They find that underwriters consciously underprice IPO shares by relying on a valuation method that tends to underestimate value. They also find that the use of price-earnings and price-cash flow multiples computed with forecasted earnings and cash flows for the year after the IPO leads to more accurate valuations than multiples using forecasted earnings and cash flows for the IPO year.

The limitation of these papers lies in the fact that they do not investigate how underwriters select the comparable firms. This is done by Paleari, Signori and Vismara (2014) and Vismara, Signori, and Paleari (2015). Using a large sample of firms going public in France and Italy, Paleari et al. (2014) develop empirical evidence that underwriters perform a biased selection of comparable firms for valuing the firms they are taking public. They find that peers published in IPO prospectuses show higher multiples than peers obtained using different selection methodologies, including the selections done by sell- side analysts or the list of peers proposed by websites of data providers. Specifically, they find that underwriters often excluded those comparable firms with the lowest multiples. Even when underwriters apply a discount to their value estimates to set the final offer price, the valuation of the IPO firm remains significantly higher than that of alternatively selected peers. As an example, the limited availability of publicly traded boat manufacturers leads the underwriter of Ferretti, an Italian yacht producer, to choose four comparable firms, two of which are luxury motor vehicles manufacturers (Ducati and Porsche) with very high valuation ratios.

Vismara et al. (2015) compare the selection of peer firms made by investment banks as underwriters at the IPO with that done shortly thereafter as analysts. Surprisingly, they find that 3 out of 7 comparable firms, on average, are changed. This is a large change, if we consider that analysts' reports are published few months after the IPO. A large proportion of the firms used as comparables for pricing the IPO are no longer used when assessing the firm as "external" analyst. The peers published in the IPO prospectuses have higher valuations than those published in the post-IPO equity research reports of the same firm. They conclude that underwriters select comparable firms that make the issuer's shares look conservatively priced at the IPO, while this conflict of interest tends to fade afterwards. The upward bias in peer selection is larger for underwriters with greater market power, and lower for repeat players in the IPO market.

None of the above-mentioned papers explicitly address the role of industry. In particular, the characteristics of the industry in which an IPO firm operates shapes the degree of discretion enjoyed by underwriters in the selection of comparable firms. This, in turn, is likely to affect both the way in which the valuation process is carried out and its estimates. For instance, the selection of peers of a firm operating in the automotive industry is arguably a less ambiguous process that that of selecting peers of a technology firm, which may produce goods or deliver services that profoundly differentiate the firm from industry competitors. In this chapter, we fill this gap by taking an industry perspective to address how IPO underwriters value companies going public.

14.4 SAMPLE, DATA, AND METHODOLOGY

14.4.1 Sample and Data

We use the population of IPOs in the period 1999-2013 on the three largest economies in Continental Europe, namely Euronext (which comprises the stock exchanges of Belgium, France, Netherlands, and Portugal), Germany, and Italy, from the EurIPO database.[3] We focus on Continental Europe because these markets are characterized by a higher level of disclosure of information about valuation techniques used by underwriters in the official IPO prospectuses. Despite the introduction of a Prospectus Directive (2003/71/EC) by the European Commission that established a harmonized format for IPO prospectuses, the level of disclosure varies considerably across countries.[4] For an IPO to be included in our sample, it has to report in the prospectus information about the methodologies used by the underwriter in the valuation process; 480 IPOs meet this criterion, 452 of which declare to be valued using the peer comparables approach. Of these 452 IPOs valued using comparable firms, only 370 make full disclosure of both the names of the peers selected by the underwriter and their multiples at the time of the valuation process. These 370 IPOs represent the core sample in this chapter, which will be matched with comparable firms from alternative selection criteria in the main empirical analyses.

Table 14.1 reports the distribution of the 480 IPOs across valuation methods, both at an aggregate level and by market where the firm went public. In terms of market distribution, the majority of our sample IPOs took place in Euronext (64.2%), while German offerings represent only a small proportion of the sample (3.3%), due to the considerably lesser propensity of German issuers to disclose information in the prospectus. In terms of valuation method, exactly one third of the IPOs were valued using comparable firms as the only valuation methodology, while the largest portion (56.9%) has been valued using both the comparable firms and the discounted cash flow (DCF) methods. In a few IPOs, underwriters have used either the DCF as a stand-alone methodology (5.8%) or the peer comparables approach together with the dividend discount model (DDM) (4%). The table also reveals some differences in the adoption rates of the valuation techniques across markets. While the pattern associated with Euronext is similar to that of the whole sample, Germany is characterized by a relatively higher percentage of IPOs valued using comparable firms only (62.5%), and in Italy the simultaneous use of comparable firms and DCF is by far the most common approach adopted by underwriters (85.3%).

TABLE 14.1 VALUATION METHODS.

Valuation methods used by *underwriters to value IPOs, as declared in official IPO prospectuses.*