Earnings Management in Initial Public Offering and Its Affect on the Long-Term Performance of Stock

CHAPTER I

INTRODUCTION

A. Background of the Research Study

Go public is one way for an emerging company to get additional funds in order to finance or business development. Funds obtained from go public usually used for expansion and for the repayment of debt, which is expected to eventually strengthen the financial position of companies in addition to strengthening the capital structure. Go public is also intended to strengthen the company's working capital (Gumanti, 2001). Companies to go public usually begin with a decision to do an IPO in the primary market (Amin, 2007). IPO is when a company issues common stock or shares to the public for the first time (wikipedia, 2009)

At the time of the IPO, the prospectus is the only source of information in the initial offering of stock because prospectus is the only source available for investors. The more information a prospectus has, the more information investors can get, on the contrary the less information it has, the less information investors can receive. Therefore, the quality of information received by investors mainly depends on the quality of the information contained in the prospectus of the company at the time of initial offering

(Sulistyanto, 2008). The lack of information available will encourage and motivate the manager of the company to perform the earnings management. Earnings management is a purposeful intervention of an external financial reporting process on purpose to gain some personal advantage (Schipper, 1989 in Ujiyantho and Pramuka, 2007). Companies tend to provide positive things so that investors also response positively on the offered stock. Managers will hide, suspend, or change the information that could make investors have a negative perception of the company because this will cause the falling of the relevant company's stock price (Sulistyanto, 2008).

Gumanti (1996) tested the possibility of earnings management of the company when it went public on Jakarta Stock Exchange. The research was conducted on 62 companies that went public during the period of 1991 until 1994. Gumanti did not find any strong evidences on the existence of earnings management in the period one year before going public. Evidence on earnings management was found a year after going public.

Gumanti (2001) explained that earnings management could be done by selecting certain accounting methods (income-increasing discretionary accruals) which was aimed to raise the level of income and profit. Gumanti (2001) was able to prove that strong earnings management occurred two years before the IPO. However, it was not as strong as the previous one. Amin (2007) in his research on detecting the earnings management, underpricing, and the measurement of company's performance found that companies which did IPO in Indonesia were engaged in earnings management three years before and after the IPO by playing the accrual components.

Although theoretically, there is an opportunity for the management to arrange the reported profits, this earnings management phenomenon has never been proven so far. Empirical evidence about earnings management which cited by Gumanti (2001) also shown by Ayres (1986), Perry and Williams (1994), DeFond and Jiambalvo (1994), Teoh, Welch and Wong (1998), and Rangan (1998). Meanwhile, the research found no evidence of earnings management shown by DeAngelo (1986), Liberty and Zimmerman (1986), and Aharony, Lin, and Loeb (1993).

After the IPO, asymmetric information between management and investors is no longer high. Investors already have a lot of information about the company. Management no longer has the opportunity to manipulate the financial statements for personal gain. One interesting thing to study is whether the earnings management which is done by the company around the IPO affects the long-term performance of the company itself (Adi, 2007).

Based on the background mentioned above, in this thesis which is entitled “Earnings Management in Initial Public Offering and Its Affect on the Long term Performance of Stock” the researcher wants to find out whether the company did earnings management around the IPO and whether the earnings management affects the performance of stock..

1. Problem Formulation of the Research Study

An Initial Public Offering (IPO) occurs when a security is sold to the public for the first time. As the main purpose of company going public through IPO is to allowing the initial owners of a firm to raise capital by transferring and sharing some of the firm's risk with the wider investing public. In order to make the offered stock in first offering can be adsorbed by investor, the company is forced to proof that it has a good prospect in the future by shows a good financial statement and its growth level. The financial information of the going public company is relative hard to be known by the investor. The investors only rely on information in prospectus. This condition gives the manager opportunity to do the earnings management, which result on manipulation on the financial reported.

The earnings management is intended to provide a positive signal to the market about the company condition. This positive signal embodied in the reported performance (usually in a prospectus). However, these positive signals in the long term cannot be maintained by management, which is reflected the declination in the performance reported by the company (Teoh et al., 1998).

Based on the description above and explanation on the background, the researcher formulated the following issues:

1. Did the company that did IPO in Indonesia Stock Exchange conduct earnings management in period around the IPO?
2. Did earnings management affect the long-term performance of stock?

2. Scope of the Research Study

In order to limit the discussion on the issues and to obtain a clearer direction for the researcher in discussing this problem, so the researcher has set limits on the following issues:

1. Company that became a sample in this research is companies do the IPO that listed in Bursa Effect Indonesia for period 2004 until 2006.
2. This research used an earnings management type which is income-increasing.
3. Discretionary accrual (DA) as a proxy in assessing whether or not there earnings management. The occurrence of earnings management will be showed by positive DA coefficient, and if the coefficient of DA is negative, so earnings management does not occur.
4. Abnormal Return (AR) as a proxy of stocks' performance

3. Benefits of the Research Study

The benefits of this research study hopefully will be able to bring benefits toward:

1. For Investor

   These research results can be input or help in decision-making investments in stocks and advice investor to more pay attention on the quality of the financial statement in the prospectus that can help in investment decision.

2. For writer

   This study is important to make a better understanding about stock portfolio especially those related with earnings management, Initial Public Offering (IPO) and long-term performance of stock.

3. For readers

   This research can be used as additional information on capital markets in Indonesia.

4. For other researchers

   This research can be a reference in order to support subsequent researchers, especially in relation to the study of the earning management, Initial Public Offering (IPO) and long-term performance of stock.

4. Originality of the Writing

The researcher compiled this research study by herself. She did not duplicate nor except it from the previous research studies compiled by another researcher. All writing, research data, data analysis, and conclusions in this research study were analyzed and explored by the writer, except or the written sources which were used as the references in this study.

B. Objectives of the Research Study

The objectives of this research are to examine whether companies do the earnings management in period around the IPO and whether earnings management affects long-term performance of stock. According to the previous research, many companies do the earnings management around the period of IPO and earnings management also has potential explanation for poor post-IPO performance. The most recent study there was a significant decline in the operating performance after the companies went public (Zaluki, 2008). Therefore, this research goal's is to find out whether there is or not earnings management around the IPO in the companies which do the IPO and its affects to the performance of stock after IPO.

C. Organization of the Writing

The writing is divided into five chapters, which are:

CHAPTER I INTRODUCTION

This chapter provides the background of the research study, problem formulation, problem limitation, objectives of the research study, benefits of the research study, and organization of the writing

CHAPTER II THEORETICAL REVIEWS

This chapter containing the related theoretical background, previous research, and the hypothesis development

CHAPTER III RESEARCH METHODOLOGY

This chapter describes the population and sample used in this research, data and data gathering, measurement of variables and method of analysis.

CHAPTER IV ANALYSIS

This chapter provide and presenting the data analysis and discuss the results obtained in the study.

CHAPTER V CONCLUSION

This chapter providing the conclusion from this research, limitation of the research and managerial implication, and further research, which provides some points that can be made to improve research with similar or same topic.