CHAPTER II

THEORITICAL REVIEWS

A. Review of Literature

1. Capital Market

A capital market is a market for securities (debt or equity), where business companies can raise long-term funds by selling stock or issuing bonds. The capital market includes the stock market (equity securities) and the bond market (debt). To attract buyers and sellers to participate, capital markets must be liquid and efficient. A capital market can be said to be liquid if the seller sells and the buyer can buy securities fast. Capital market is considered efficient if the prices of the stocks reflect the value of the company accurately.

If the capital market is efficient, the prices of the stocks also reflect the investors' assessment toward the future prospect of the company as well as the management. If investors have doubt about the quality of the management, it is shown in the falling price of the stocks. Therefore, capital market can be use as the indirect measurement to measure the quality of the management. Capital market also functions as a means of productive fund allocation to transfer the fund from the lender to the borrower (Jogiyanto).

2. Initial Public Offering

Initial Public Offering (IPO) is when a company issues common stock or shares to the public for the first time. Most companies start out by raising equity capital from a small number of investors, with no liquid market existing if these investors wish to sell their stock. If a company prospers and needs additional equity capital, at the same point the company generally finds it desirable to go public by selling stock to a large number of diversified investor. If a company has decide to go public and sell its initial stocks to the public, the primary concern is what type of stocks will be sold, how much per stock, and when is the right time to start the selling. When a company decides to go public, there are several factors to be considered. The benefits of going public are:

a. The convenience of raising funds in the future

Prospective investors are usually reluctant to invest in a private company due to lack of financial information between the management of the company and investors. In the other side, a go public company should inform its financial report to the public regularly after being checked by a public accountant.

b. Increasing the liquidity of the investors

Private companies that do not have market for its stock, the investors of this company have more difficulties to sell their stocks than those of a go public company.

c. Known the market value of a company

For several reasons the market value of a company should be made public. If a company wants to give an incentive in the form of stock options to its managers, they should know the actual value of the options. However, if the company is a private company, it will be difficult to determine the option value.

Besides the advantages of going public, there are some disadvantages as well :

d. Higher report fees

A going public company, each quarter of the year should submit its report to a regulator. It costs a lot of money especially for a small-scale company.

e. Disclosure

Generally, some people in the company are reluctant to disclose some important information about their company. The managers are reluctant to give the information because the competitor can use it. Whereas the owner of the company does not want to give the information about his stocks to the public because he does not want the public to know about how much wealth he has.

f. Worrying to be taken over

The manager of a company who has minor veto right will be worried if his company goes public. On the contrary, the manager of company who has minor veto right, usually will placed by a new manager when the company is taken over.

g. Loss of Control

Outsiders are often in a position to take control of corporate management and might even fire the entrepreneur or company founder. While there are effective anti-takeover measures, investors are not willing to pay a high price for a company in which poor management could not be replaced.

Some factors which influence the success of IPO of a company. According to Permatasari (1994) quoted by Kristinasari (2007), the factors are:

a. The position of company in the market and the competitive product it has

Strong capital structure results in competitive product of a company. When a company is secured with its competitive and promising product, the IPO process will be successful because a company cannot influence the stock market by issuing false data and report.

b. Advantageous company achievement record

Achievement record is focused on the profitability of the company during the last 4-5 periods. Investors will pay a close attention on how well the company can gain profit especially before IPO, as this can reflect whether the company is promising or not.

c. Having groups

A good and experiences management team of a company is the result of a solid cooperation that can influence the company performance, which will guarantee that the company will survive and succeed.

d. Senior manager runs the company

Besides a solid management, investors want to make sure that the team will stay in the company and hold their stocks. Although there is strong management team, senior management is still very much needed due to their ability and experience to solve problems faced by the company.

e. Long-term capital needed

If the company does not provide long-term capital, investors are not so sure that the stocks offered are good and valuable. Long-term capital is crucial to guarantee the existence of the company as well as to provide guarantee for investors that the stocks they bought are profitable.

f. The potential of long-term growth

Investors who buy the offered stocks believe that the company is able to grow consistently in a long-term period. Investors calculate their profit from the raising price of the stock and hope the company will keep gaining profits for several years.

g. Market responses toward IPO

Stock condition can change dramatically in a relatively short time. Therefore, company can find the right time to do IPO so that there is a strong market sentiment toward the offered stocks.

h. In booming industrial

Industrial state is not always "booming". It changes rapidly, so companies should be able to use this moment properly in order to be able to develop well in the future.

3. Earnings Management

General definitions suggest that managers exercise judgment for the purpose of hiding true performance in order to either influence the stock performance, to benefit from the contractual terms between the firm and managers, or to influence regulatory decisions (Sun and Ruth, 2008).Earnings management according to Scott (1997) is the choice by a manager of accounting policies, or actions affecting earnings, so as to achieve some specific earnings objective. Thus, earnings management includes both accounting policy choice and real actions. First, consider the policy choices. It is convenient to divide accounting policy into two categories. One is the choice of accounting policies, such as straight-line versus declining-balance amortization, or policies for revenue recognition. The other category is discretionary accruals such as provisions for credit losses, warranty costs and inventory values. Another way to manage earnings is by means of real variables, such as advertising, R&D, maintenance, timing of purchases, and disposal of capital assets.

There are also several different definitions one to another about earnings management (Sulistyanto, 2008). Davidson, Stickney, and Weil (1987) said that earnings management is the process of taking deliberate steps within the constraints of generally accepted accounting principles to bring about desired level of reported earnings. Earnings management, according to Schipper (1989) is a purposeful intervention of an external financial reporting process on purpose to gain some personal advantage. Scott (1997) makes a definition of earning management as the choice by a manager accounting policies to achieve some specific objectives. According to National Association of Fraud Examiners (1993), earnings management is the intentional, deliberate, misstatement or omission of material facts, or accounting data, which is misleading and, when considered with all the information made available, would cause the reader to change or alter his judgment or decision. Fisher and Rosenzweig (1995) define earnings management as an action of a manager, which serve to increase current reported earnings of the unit which the manager is responsible without generating a corresponding increase (decrease) in long-term economic profitability of the unit. Lewitt (1998) said that earnings management is flexibility in accounting allows it to keep pace with business innovations. Abuses such as earning occur when people exploit this pliancy.

Trickery is employed to obscure actual financial volatility. These in turn, make the true consequences of management decisions. While Healy and Wahlen (1999) said that earnings management occurs when managers uses judgment in financial reporting and in structuring transactions to alter financial report to either mislead some stakeholders about underlying economics performance of the company or to influence contractual outcomes that depend on the reported accounting numbers.

From all of the description above about earning management, there is same terminology that is used in each definition, which are the specific measures intended to manage profit (Davidson, Stickney, and Weil), intervention in compilation of financial report (Schipper), deliberate errors in financial reporting (National Association of Fraud Examiners), actions to manage earnings (Fisher and Rosenzweig), the flexibility that encourages abuse of profits (Lewitt), and using certain decisions to change the financial report (Healy and Wahlen). Although using different terminology, those definitions has the same meaning, which is earnings management, is a managerial activities to influence and intervention in the financial statements.

4. Earnings Management Object

There are several components of financial reports that can be the object of earnings management (Sulistyanto, 2008):

A. Current assets

Current assets are cash and other assets expected to be converted to cash, sold, or consumed either in a year or in the operating cycle. These assets are continually turned over in the course of a business during normal business activity. There are four main components of current assets that had been known and used as objects of earnings management in general are:

a. Cash

It is the most liquid asset, which includes currency, deposit accounts, and negotiable instruments (e.g., money orders, cheque, bank drafts).

b. Receivables

Usually reported as net of allowance for uncollectable accounts.

c. Inventory

Trading these assets is a normal business of a company

d. Prepaid expenses

These are expenses paid in cash and recorded as assets before they are used or consumed (a common example is insurance)

B. Fixed assets

Fixed assets are assets that the company has in physical form, used in company operational activities, owned by the company more than one accounting period, and is not intended to be sold. Also referred to as PPE (property, plant, and equipment), these are purchased for continued and long-term use in earning profit in a business. This group includes land, buildings, machinery, furniture, tools, and certain wasting resources, such as timberland and minerals. They are written off against profits over their anticipated life by charging depreciation expenses (with exception of land). The easiest way to do the earnings management in fixed assets is utilizing of depreciation method and freely to determining the estimated economic life that used by companies to determine the depreciation cost per period.

C. Current liabilities

Current liabilities are considered liabilities of the business that are to be settled in cash within the fiscal year or the operating cycle, whichever period is longer. For example, accounts payable for goods, service or supplies that were purchased for use in the operation of the business and payable within a normal period of time would be current liabilities.

5. Patterns of Earnings Management

There are several pattern of earnings management (Scott, William R,2007. *Financial Accounting Theory*. Prentice Hall, New Jersey) ;

a. Taking Bath

This can take place during periods of organizational stress or reorganization. If a firm must report a loss, management may feel it might as well report a large one. Consequently, it will write-off assets and provide for expected future costs. Because of accrual reversal, this enhances the probability of future reported profits. In effect, the recording of large write-off puts future earnings “in the bank”

b. Income Minimization

This is similar to taking bath, but less extreme. Such a pattern may be chosen by a politically visible firm during periods of high profitability, Policies that suggest income minimization include rapid write-off capital assets and intangibles, expensing of advertising and R&D expenditures, and so on.

c. Income Maximization

From positive accounting theory, managers may engage in a pattern of maximization of reported net income for bonus purpose, or to attract investor if they company go public.

d. Income Smoothing

This is perhaps the most interesting earnings management patter. From a contracting perspective, risk adverse managers prefer a less variable bonus stream, other things equal. Consequently, manager may smooth reported earnings over time so as to achieve relatively constant compensation.

6. Earnings Management and IPO

One cause of difficulty in determining the selling price in the primary market is the lack of relevant price information. This is because before the implementation of first offering, the stock of the company has not been traded. Investors, issuer and underwriter are face difficulties to assess and determine the reasonable price of an IPO. One of the relevant information is the financial statements contained in the prospectus (Gumanti, 2001). The information in this prospectus will give an idea of the condition, the economic prospect, investment plans, profit and dividend forecast which could be the basic in making rational decisions about the risks and value of shares offered by the company. This information is important for investors to assess, determine, and make a decision whether that company concerned is as the place to invest funds (Sulisyanto, 2008). When the prospectus is the only information used by investors to decide to invest in the company that do IPO, it will occur high asymmetry information between management and external parties. This information asymmetry occurs because the management has more information than with external parties about the condition of the company. This provides an opportunity to management to do earnings management (Teoh et al, in Adi, 2007). This information asymmetry occurs because the management has more information than the external parties about the condition of the company. This provides an opportunity to management to do the earnings management (Teoh et al, in Adi, 2007).

7. Earnings Management and Long-term performance of stock

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). Teoh et al (1998) in Scott (2007) investigated the stock market performance of a sample of firm issuing IPOs during 1980-1992, following their share returns for several years after the IPO. They estimated the discretionary accruals of these firms around the IPO date, using a version of the Jones model. After extensive tests to control for other factors affecting accruals and share returns, they found the subsequent abnormal stock market returns of IPO firms with high discretionary accruals were significantly negative relative to IPO firms with low accruals. This suggest that many IPO firms do manage earnings upward and that lower reported earnings in subsequent years, driven by accrual reversals, contribute to poor shares return performances. Loughran and Ritter (1997) found the five-year operating performance after the offering, which is a decrease in long-term performance. Rodoni (2002) also found that the performance of IPO in the long term shows a negative performance. Denis and Serin (1999) noted that the low performance due to post-IPO is because earnings measurement was undertaken "not appropriate" by management. These conditions affect the interpretation of the investor toward company's performance and make investors have false expectation towards the profitability of the company in the future. In other words, the naive investors will be over-optimistic in forecasting the future earnings and will be disappointed with the reality. Declination in performance occurs during the five years after the IPO.

8. Earnings management measurement

According to Konings et.al.(1998)The measurement of earnings management earnings uses Jones model (1991) which modified by Dechow, Sloan and Sweeney (1995), which prove to be working the best of all published earnings management detection models (Dechow, Sloan and Sweeney,1995; Guay, Kothari and Watts, 1996). Total accruals can be divided in discretionary and non-discretionary accruals. In an attempt to measure the net effect of all accounting choices that impact reported income, earnings management models try to examine the behavior of discretionary accruals. The models we use and estimate non-discretionary accruals as a function of the change in revenue and the level of property, plant and equipment.

9. Stock performance

Performance of stocks after the IPO can be seen from the magnitude of abnormal returns earned by investors. The greater the abnormal return earned by investors indicates that the stock's performance is good. Conversely, the smaller the abnormal returns earned by investors indicates that the stock performance is low (Pratiwi and Kusuma, 2001 in Adi, 2007). Long-term performance is measured using the abnormal return (AR).

B. Previous Research

Some research on earnings management in initial public offering have been carried out. The research that conduct by Teoh, Welch, and Wong at 1998 with the title "Earnings Management and the Long-Run Market Performance of Initial Public Offerings". This research examines the relation between the long-run post-IPO return underperformance and IPO firms' earnings management. In this paper found that discretionary accruals, which are under the control of management and proxy for earnings management, are high. The paper documents that issuers with higher discretionary accruals have poorer stock return performance in the subsequent three years. Adi (2007) examined "Earnings management in initial public offering (IPO) and its impact on stock performance after initial public offering (IPO) on the Indonesian Stock Exchange". The results showed that 60 samples from the study, there were only 35 companies which have a positive discretionary accruals, or it can be concluded that in a period of one year before the IPO company does not do earnings management. In addition, the earnings management does not affect short-term performance of stock. Gumanti (2001) examined the "Earnings management in initial public offering in Indonesia Stock Exchange". Test on 39 IPO firms that went public between 1995 and 1997 with total accruals using the approach shows a strong evidence for the occurrence of earnings management, particularly in a period of two years before going public. This means that issuers have chosen accounting methods that raise reported profits by applying the income-increasing discretionary accruals. Another evidence was found that earnings management also happened one year before the IPO but not too strong. 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 around the IPO by playing the accrual components. However, when viewed on the distinction in DA before implementation of IPO and after implementation of IPO, the difference was not significant. This shows that the company continue do the earnings management until three years after the IPO. The results of testing differences in financial performance before the IPO and after IPO nonexistent significant difference, but the companies that carry out IPOs decreased financial performance and stock performance over the long term (one or several years) after the IPO. While the market's performance showed no difference in the return before the IPO with the return first day of trading on the Stock Exchange, and there is a tendency to fall after the IPO at the end of the year especially.

Many studies have documented the tendency of IPOs to underperforms the market in the long run. The previous research by Ritter (1991) report that the long-term low returns in the first three years of trading on stocks of those firms that carry out IPO. Using a sample of 1,526 IPOs that went public in the U.S during 1975-84, he finds that after 3 years of going public, these firms significantly underperformed. The long-run underperformance of IPO is found to continue after the three-year period examined by Ritter (1991).Yi (1992), using the same IPO sample as in Ritter, and Loughran (1993), using 3,656 firms going public during 1967-87, find that the underperformance continues until 6 years after going public. Ibbotson (1975) reported negative performance of the IPOs between the second and fourth years for IPOs during 1960-1969. In addition, Stem and Bornstein (1985) showed that over a period of 10 years the IPOs underperformed the Standard & Poor's 500 stock index by 22 percent. Denis and Serin (1999) noted that the low performance due to post-IPO is because earnings measurement was undertaken "not appropriate" by management.. Declination in performance occurs during the five years after the IPO. Zaluki (2008) investigates the operating performance and the existence of earnings management for a sample of 254 Malaysian IPO companies over the period 1990-2000. Using accrual-based measure of operating performance, this study finds strong evidence of declining performance in the IPO year and up to three years following IPOs relative to the pre-IPO period. The results confirm that the decline in post-IPO operating performance is due to the existence of earnings manipulation by the IPO manager at the time of going public.

C. Hypothesis Development

Several studies have shown that companies do the earnings management around the IPO**.** 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 around the IPO by playing the accrual components. The hypothesis as follow:

H1 = Company which did IPO do the earnings management in the period around IPO

The research that conduct by Teoh, Welch, and Wong at 1998 with the title "Earnings Management and the Long-Run Market Performance of Initial Public Offerings". This research examines the relation between the long-run post-IPO return underperformance and IPO firms' earnings management. In this paper found that discretionary current accruals*,* which are under the control of management and proxy for earnings management, are high. The paper documents that issuers with higher discretionary accruals have poorer stock return performance in the subsequent three years. Another hypothesis as follow:

H2 = Earnings management affects the long-term performance of stock