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Earnings management in Malaysian IPOs: The East Asian crisis, ownership control, and post-IPO performance ☆

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Abstract

We find evidence of income-increasing earnings management in Malaysian IPOs, which occurs primarily for IPOs during a period of severe economic stress (the East Asian crisis). Within the high-ownership-concentration Malaysian market, post-IPO control concerns also appear to constrain IPO earnings management: owners seem willing to accept reduced IPO proceeds and signaling opportunities to increase the likelihood of retaining control of the company post-IPO. The requirement to provide a profit guarantee does not seem to greatly affect earnings management. IPO companies engaging in aggressive income-increasing earnings management have significantly worse market-based performance than their more conservative counterparts, but again only for IPOs issued during the economic crisis period. Overall, the results suggest that personal liquidity concerns are an important factor in IPO decisions during the economic crisis.

JEL classification: G32
Keywords: Initial public offerings; Earnings management; Ownership structure; Long-run stock market performance

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1. Introduction

Most prior studies of earnings management in the context of IPOs (*e.g.*, Chen, Lin, & Zhou, 2005; DuCharme, Malatesta, & Sefcik, 2001, 2004; Roosenboom, van der Goot, & Mertens, 2003; Teoh, Welch, & Wong, 1998a) suggest that companies opportunistically manage their earnings upward through income-increasing accruals to increase offering proceeds.[1] These studies also typically find that issuers with unusually high accruals in the IPO year experience poor post-IPO stock returns. More recently, Ball and Shivakumar (2008) question the "hypothesis of widespread and substantial earnings management by IPO firms," arguing that enhanced scrutiny by market monitors and regulators likely reduces managers' incentives to engage in such activity.

While a small number of prior studies investigate cross-sectional variation seeking to assess the determinants of IPO earnings management propensity in different contexts (*e.g.*, Aharony, Lin, & Loeb, 1993; Chen et al., 2005; Cormier & Martinez, 2006; Nagata & Hachiya, 2006; Neill, Porciau, & Schaefer, 1995; Zhou & Elder, 2002), these mainly use data from developed markets. The present study investigates the pervasiveness of earnings management across IPOs and the specific factors that affect decisions to manage earnings, within the context of a specific developing market, Malaysia. The Malaysian environment is particularly interesting as it has several distinctive features that may affect managerial incentives to manage earnings within the IPO context. First, there is a high level of ownership concentration (often involving family ownership) in Malaysia, and higher levels of post-IPO involvement can reduce short-term incentives. Second, prospectus earnings forecasts are mandatory, which may discourage managers from unrealistic optimism, especially when coupled with the requirement for some companies during the study period to provide profit guarantees. Third, the period encompassed by the analysis includes the East Asian crisis, a period of significant economic stress that reduced profitability and confidence. These features increase the difficulty of taking a company to market. However, if a successful IPO is necessary to address liquidity issues for a company (or its owners), IPO deferral may not be an easy option. Fourth, Malaysia provides a rich environment to assess the relative impacts of owners' short-term wealth gain/loss from the IPO, signaling, and post-IPO control concerns while controlling for other potential determinants of earnings management (*e.g.*, auditor reputation, underwriter prestige, company age, initial returns, leverage, and company size). Finally, it provides an opportunity to investigate the relationship between earnings management and post-IPO market-based performance heretofore unexplored.

Using a sample of 250 IPOs over the period 1990–2000, the results provide evidence of IPO-year income-increasing earnings management, but this occurs primarily during the period of economic stress. The requirement to provide a profit guarantee does not appear to greatly affect earnings management. Within the high-ownership-concentration market of

[1] Exceptions include Aharony et al. (1993) who find no evidence of income-increasing pre-IPO discretionary accruals. Also, Kimbro (2005) finds that managers respond differently to the managerial agency issues in the distinctive institutional environment in China; they engage in income-*reducing* earnings management prior to A-share IPOs in China to reduce the initial IPO offer price and/or to shift profits to future years.