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A FRAMEWORK TO DETECT REAL EARNINGS MANAGEMENT ACTIVITIES PRIOR TO INITIAL PUBLIC OFFERINGS IN COLOMBO STOCK EXCHANGE

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ABSTRACT

In general, companies tend to boost their earnings prior to Initial Public Offerings (IPO) in order to quote a higher offer price and to attract more investors into the IPO. This purposeful manipulation of earnings by companies through real activities is known as Real Earnings Management (REM) and is less likely to draw attention of the auditor or regulatory scrutiny. When a company follows REM strategies price of the shares is likely to deteriorate following the IPO causing losses to the shareholders and damaging the public trust on the stock exchange. This study aims to provide a suitable framework to investigate whether the companies follow REM strategies prior to IPOs. More specifically, it seeks to develop a framework to find out whether there are evidences of REM activities of the companies listed on the Colombo Stock Exchange (CSE) prior to their IPOs, and if so the impact of the phenomenon on the IPO price and shares offered in the IPOs. The existing literature on IPO in the Sri Lankan context so far attempts to identify the reasons of short- and long-run underperformance of the IPO shares following the IPO issue. The proposed analysis need to be carried out based on the model developed by Roychowdhury (2006) in order to detect the abnormal cash flows from operations, abnormal production costs and abnormal discretionary expenses. Roychowdhury (2006) used these abnormalities as proxies to detect REM activities in his model.

Key Words: Real earnings management, Initial public offerings, Colombo Stock Exchange, Sri Lanka

1. INTRODUCTION

The term initial public offerings (IPOs) slipped into everyday speech during the market boom experienced in the recent past. Yet, there were also IPOs that experienced huge first-day gains but ended up by disappointing the investors in the long term. However, investors who had the foresight to exit the stock at the optimal level were rewarded with impressive capital gains. Even though the interest for IPOs declined, it continues to be a profitable investment. The focus has shifted from quick money to a long-term outlook. Rather than trying to capitalize on a stock's initial bounce, investors are more inclined to carefully scrutinize long-term prospects.

Corporations may raise capital in the primary market by way of IPOs. The IPOs are a type of public offering in which shares of stock in a company usually are sold to institutional investors that in turn sell to the general public, on a securities exchange, for the first time. The main IPO methods are book-building, auction method, and public offer (Seng, Yang and F. Yang, 2017).

Many suggested that it is riskier to purchase the shares of new entrants to the stock market as compared to other companies; since they have lack of trading experience and relevant historical data (Firth, 1998). This leads to information asymmetry between managers and investors. Many people invest their savings in securities at IPOs, where some investors rely on the company's reported profits meanwhile ignoring the performance indicators. Since the financial statements of listed companies are prepared based on GAAP and accruals, the managers may decide on the time for identification and calculation of income and expenses, thus taking advantage of the

investor's negligence about the temporary increase of profits through real activities manipulations and accruals. This might in turn lead to earnings management (Shamszadeh and Bakhtiari, 2015).

This study intended to provide a framework to clarify how managers apply the real earnings management activities before the IPOs. In addition to that whether real earnings management occurs prior to IPOs at the CSE.

Rao (1993) revealed that the firms, which are going for IPOs, do not have a market for price their shares. The most common starting point for setting the price of these shares is by comparable firms' approach. In this approach, the under writers take the Price to Earnings ratios (PE ratios) of comparable firms in the industry and then arrive at a multiple for the firm that is going public. Now if the earnings of the firm going public can be inflated, the price at which the shares would be offered to the public would be higher. Since higher prices result in wealth increase for the issuers, they have a motivation for inflating the earnings prior to IPOs. Looking at the same issue from the side of the investors, it is observed that there is very little financial information about the firm that is going public prior to its IPO (as cited in Teoh, Welch and Wong, 1998). Therefore, the firm's offer document named prospectors at the time of the IPO, which contains the summary of the financial statements of the last years, becomes a major source of information for the investors. In this document, if the earnings can be inflated by accounting choices, then the investors can be cajoled to pay higher prices for the shares to be allocated in the IPOs. For the purposes of this paper, Earnings Management is defined as the use of such accounting choices to temporarily increase the earnings unless otherwise stated. There are of course regulatory provisions under which issuers cannot falsify their earnings. Consequently, the use of real earnings management can be used by managers to engage in earnings management instead of accruals earnings management (AEM) where reported income can be manipulated when managers have to book accruals for events that require discretion in accounting standards.

Going public is one of the most common events that create an opportunity for management to offer higher prices for their firms by distorting income numbers. Several studies in research literatures show evidences that firms manipulate earnings upwardly in this occasion (Friedlan, 1994; Teoh et al., 1998; DuCharme., 2001, 2004). Also, some studies show that discretionary accruals as a measure of earnings manipulation has a contradictory effect on long run return of these shares. This suggests that high degree of earnings manipulation is probably a strong reason for long run underperformance of IPO firms (Teoh et al., 1998; DuCharme et al., 2001). IPOs associated with more aggressive earnings management are more likely to delist due to performance failure and they tend to delist sooner. Interestingly, IPOs associated with less earnings management are more likely to be merged or acquired. (as cited in Pande, 2009, p.3).

Earnings Management

Earning management can be defined as "reasonable and legal management decision making and reporting intended to achieve stable predictable financial results." Earnings management is related to the importance of earnings amount for the investors' decision making. Earning management is not to be confused with illegal activities to manipulate financial statements and report results that do not reflect economic reality. These types of activities, popularity known as "cooking the books," involve misrepresenting financial results ("What is Earnings Management," n.d). Since earnings are composed of cash flow from operations and accruals, firms have two options to manage earnings. First, firms can manage earnings through deviation from the normal business operations, so that the cash flow from operations will be affected. Deviating from normal business practices to manipulate reported income is defined as real earnings management (Rowchowdhury, 2006). Second, a firm can alter the level of accruals to obtain the desired level of earnings. Managers use judgments in financial reporting which can be defined as accrual-based earnings management (Healy and Wahlen, 1998).

Based on previous studies, researchers found at least two reasons for managers to manipulate earnings through real operating activities (Cohen et al., 2008; and Zang, 2010). One is that after financial scandals such as Enron, World.Com, etc. and the passage of the Sarbanes and Oxley Act (SOX) in 2002, AEM is likely to draw more scrutiny by auditors, regulators, etc., thus firms would have less flexibility in accrual-based earnings management. Therefore, firms have more incentives to engage in REM. The other reason is that relying on AEM alone might be inadequate and risky. If reported earnings after AEM are still below the targeted earnings threshold, then it would be too late for managers to engage in REM because it takes time to be realized and cannot be manipulated at the end of year (Zang, 2010). Furthermore, they have examined the determinants for firms to engage in AEM and REM around the IPO year. Since managers of different firms face different types of incentives to manipulate earnings, previous studies identified the factors that affect firms' decisions to manipulate earnings for IPO firms by connecting the offering characteristics of IPO firms and levels of earnings management in general, regardless whether AEM or REM is engaged (as cited in chung et al.,2012, p.2) In the Sri Lanka context, a study was conducted by Wijesinghe and Kavinda (2017), by obtaining a sample of twenty five manufacturing companies listed in CSE with a firm-quarter observation for the period of 2009/2010 to 2014/2015, and the authors revealed that the companies manipulate cash flows from the operating activities and the production costs, but there are no evidence that companies are engaging in manipulating discretionary expenses of manufacturing companies listed in CSE, Sri Lanka.

Additionally, earnings management is a corporate decision endogenous to the fundamentals of the issuing firm, and the fundamentals are related to the delisting risk of the issuing firm. Given the information asymmetry between management and investors, the true firm value is not observed by public investors, consequently IPO issuers have incentives to signal the quality and value of their firms. Compared to some fundamental variables that are hard to manipulate, such as firm age, asset size and net cash flow, accounting earnings can be boosted at a cost in order to attract investors. Aggressive earnings management benefits the original entrepreneurs of low-quality IPOs because they tend to receive high cash proceeds concerning the true value of their offerings. (DuCharme, Malatesta, and Sefcik, 2001).

However, earnings management in the IPO process cannot be maintained in the long term and tend to have detrimental impact on shareholders. In other words, earnings management has real economic costs and bears potential legal liability (Fudenberg and Tirole, 1995; DuCharme, Malatesta, and Sefcik, 2004). Accordingly, good companies with solid earnings streams and prospects have lower incentives to manipulate accounting numbers in a way that may spell trouble later on. Thus, the degree of earnings management in the IPO process should decrease with the quality of IPO, while the quality of IPO is inversely related to future delisting risk (Li, Zhang and Zhou, 2006).

Earnings Management through Real Activities Manipulations

Real Earnings Management is the deviation of ordinary business operation practices in order to make at least some stakeholders believe that financial reporting goals have been met through the normal activities of business (Roychowdhury, 2006, P.33). These departures do not necessarily contribute to firm value even though they enable managers to meet reporting goals. Also, a survey conducted by Graham, Harvey and Rajgopal (2005) suggested that managers prefer real activities manipulation to accrual earnings management. In their study they have quoted that,

“.....We find strong evidence that managers take real economic actions to maintain accounting appearances. In particular, 80% of survey participants report that they would decrease discretionary spending on R&D, advertising, and maintenance to meet an earnings target. More than half (55.3%) state that they would delay starting a new project to meet an earnings target, even if such a delay entailed a small sacrifice in value.....”

Dechow and Skinner (2000), Healy and Wahlen (1999) and Fudenberg and Tirole (1995) identified the companies that seem to engage in the following activities: [i] decreasing the expenses in R&D, [ii] decreasing of general and administrative expenses, [iii] the timing of sales by offering discounts or providing more flexible credit terms and [iv] the excess production. As with the studies of Durtschi and Easton (2005) and Burgstaler and Dichev (1997) assume that the discontinuities observed in the distribution of the earnings are real actions taken by management. They authors observe an increase in operating cash flow nearby zero thresholds. According to some researchers, such as Beneish (2001), the earnings management is often difficult to detect. Relying on Schipper (1989) work, they predict that it is difficult to distinguish between optimal management decision and willingness to manipulate accounting figures. It is only recently that researchers (Lambert and Sponem, 2005; Graham et al., 2005) based on qualitative studies are then oriented to modeling of real earnings management and that distinguishing the discretionary portion of the non-discretionary variable to handle. Roychowdhury (2006) study made several contributions which are summarized as follows: **in methodological terms:** from the study of Dechow, Kothari and Watts (1998), the authors develop a model to measure normal levels of cash flow from operations, production costs and discretionary spending (R & D, general, administrative, and advertising expenses). These variables should capture the effect of actual actions better than accruals.

Earnings Management in the IPO Process

It is hypothesized that the investors are unable to understand fully the extent to which IPO firms engage in earnings management by borrowing from either the past or the future, high reported earnings would translate directly into a higher offering price. But the firm also has an incentive to boost earnings soon after the IPO to maintain a high market price. The original entrepreneurs may wish to sell some of their personal holdings in the secondary market at the end of the lockup period. Furthermore, verbal earnings projections are also made to investors during road shows at the beginning of issue marketing. After trading begins, security analysts initiate coverage of the firm and disseminate these earnings projections widely. To keep the aftermarket price from dropping below the initial offer price, analysts at the underwriting investment banking firms are under pressure to make the most favorable earnings projections possible. In turn, the issuing firm is under pressure to meet those projections in the aftermarket to safeguard its reputation for reliability; to maintain the goodwill of investors, investment bankers, and analysts who made the initial earnings projections; and to avoid lawsuits by disgruntled shareholders after a shortfall in post- IPO earnings (Teoh et al., 1998).

IPO Process

Below are the steps a company should undertake to go public via an IPO process.

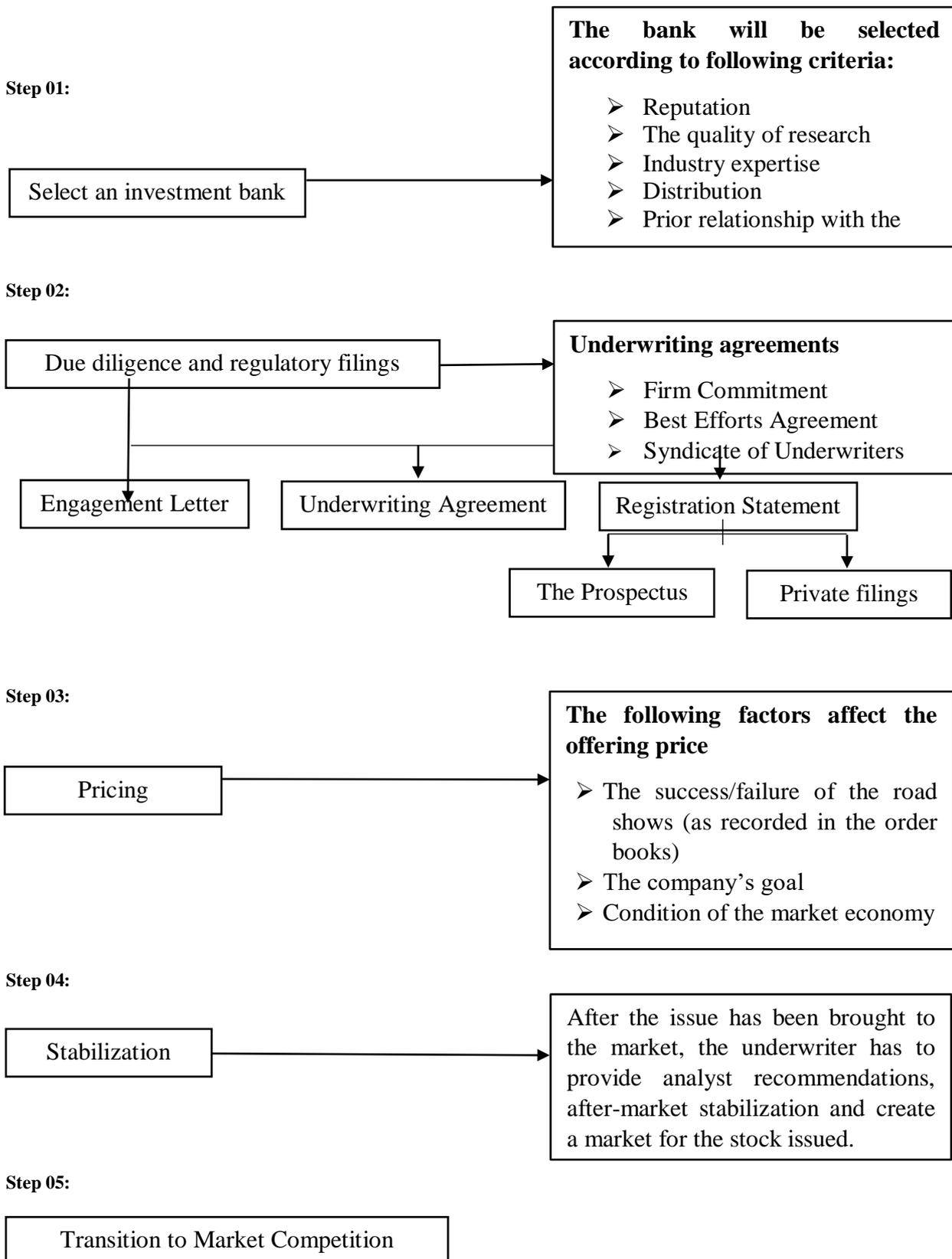


Figure 01: IPO Process

(Source: <https://corporatefinanceinstitute.com/resources/knowledge/finance/ipo-process/>)

2. LITERATURE REVIEW

Finance literature is however unable to fully explain the valuation of IPOs. In other words, very little work has been done on how the offer prices in IPOs are determined? Some exceptions are those of Benveniste and Spindt (1989), Kim and Ritter (1999) and Purnanandam and Swaminathan (2002) (as cited in Pande, 2009, p.3).

IPOs provide a powerful setting to investigate the relation between earnings management and firm fundamental (and hence delisting risk) for several reasons. First, the direction of earnings management is clear in the IPO process. IPO firms have incentives to engage in income-increasing activities to ensure that the issues are fully subscribed and are priced sufficiently high to garner adequate proceeds. Second, the IPO process is characterized by information asymmetry between managers and investors (Leland and Pyle, 1977) and between informed and uninformed investors (Rock, 1986; Beatty and Ritter, 1986). Third, *Accounting Principles Board Opinion 20* allows IPO firms to change accounting principles in the prospectus as long as financial statements of previous years are restated. This gives managers an opportunity to engage in earnings management.

The existing literature on IPOs in the Sri Lankan context so far attempts to identify the reasons of short- and long-run underperformance of the IPO shares following the IPO issue. However, researches on real earnings management around IPOs are limited, and evidences are scarce in Sri Lanka. Hence it will be better to analyze and document the previous studies which have been done on this phenomenon in other countries, which will assist to develop a framework to detect REM activities prior to IPOs and its impact on IPO price and number of shares issued in IPOs in Sri Lanka.

Wongsunwai (2013) studies the effect of venture capitalist (VC) quality on earnings management during initial public offerings using an aggregate REM measure as in Cohen and Zarowin (2010). He reports a negative mean of the aggregate REM and interprets his findings that IPO companies on average are less likely to engage in real earnings management than more mature companies in the same industry.

IPO underperformance has been well documented in the literature and many studies have tied IPO underperformance to market timing and information asymmetry theories. That is, managers take advantage of their superior information and issue shares at a time when they can receive the highest price possible. Chemmanur and He (2011), Schaub (2011), Alti (2006), and Brau and Fawcett (2006) support this view by presenting evidence consistent with market timing, and by showing that insiders are able to use inside information to their advantage as these IPOs underperform in the long run. In addition to timing the market, insiders can also inflate the price of the firm's equity by inflating the firm's earnings prior to the IPO. Higher earnings have a positive effect on equity prices. Although accounting standards guide the way firms report, managers have some discretion when reporting earnings. This discretion includes the choice of accounting method, its application, and the timing of cost recognition. In an IPO setting, managers not only have the incentive to report higher earnings in order to receive a higher IPO price, but also, they have the ability to do so because of the opacity that surrounds private firms. TWW proxy for earnings management through DCA0, and find that U.S. firms, on average, manage earnings prior to the IPO. Furthermore, they show that DCA0 is a good predictor of IPO underperformance. This evidence is consistent with managers using their discretion to inflate earnings prior to the IPO, receiving an inflated IPO price, and benefiting at the expense of the new shareholders. Consistent with these results, DuCharme, Malatesta and Sefcik (2001) also find that pre-IPO abnormal accruals result in a significantly higher initial firm value (as cited in Premti, 2013, p.11). In the context of Sri Lanka, Ediriwickrama and Azeez observed that IPO portfolios are underperforming in the long run under both event study and calendar time methodologies. Thus, it suggests that investing in IPO stocks is not a financially sound decision and it doesn't payback investors after even five years from the IPO listing. Samarakoon (2010) investigates the short-run underpricing of initial public offering in Sri Lanka and finds that IPO are underpriced by about 34%. Issue size is negatively related, and investor sentiment and privatization are positively related with underpricing. Small issues are more underpriced than large issues, and privatization issues are more underpriced than conventional issues. Investor sentiment affects both small and large issues similarly and does not explain the difference in underpricing between small and large issues.

Before firms go public, there is no market value for reference. The major purpose of firms making IPOs is to raise cash. Thus, firms have strong incentives to manage earnings. Firms with better figures in financial reporting have the opportunity to set higher offering prices. Such incentive also plays an active role when firms are to issue seasoned equity offerings (SEO), since firms also make SEO to raise cash. On a voluntary disclosure basis, Clarkson, Dontoh, Richardson and Sefcik (1992) empirically tested the hypothesis that earnings forecasts communicate firms' prospectuses. They found evidence that the Canadian market positively responds to such earnings forecasts that conveys good news (as cited in Miloud, 2014, p.122).

Two papers examined whether and how firms engage in REM around SEOs. Mizik and Jacobson (2007) make use of panel data time series models to forecast sized-adjusted earnings and R&D expenditures. They predict that firms reporting positive abnormal return on assets (ROA) and negative abnormal R&D are more likely to manipulate real activities. Their test results are consistent with the prediction and provide evidence that firms are likely to coordinate accounting and real activities to inflate earnings at the time of SEO. Their tests also show that financial market mis-valuates the firms that manipulate real activities, which is supported by negative stock returns of those firms subsequent to SEOs. Cohen and Zarowin (2010) focuses on three issues: whether managers manipulate earnings via both accruals and real activities; how firms make tradeoff between accrual and real earnings management, and the economic consequences of accrual and real earnings management around SEOs. The results show that firms use both AEM and REM around SEOs, and those firms tend to outperform their industry peers in the period preceding SEOs and underperform their peers following SEOs. The authors found that the probability of firms using REM increases with the presence of a Big 8 auditor, auditor tenure, in a high litigation industry, the level of net operating assets, and in the post SOX period. Additionally, in the SEO context the economic costs of REM are likely more than that of AEM.

Further, Cohen and Zarowin (2010) also studied the consequences of REM around SEOs. They examine the effect of each of the three types of REM methods in Roychowdhury (2006) on SEO firms' future performance. Their results suggest that the decline of firm performance in the post-SEO period is driven by both AEM and REM while the decline attributed to REM is more severe than that to AEM.

Although the existing literature emphasis more on earnings management results in to a higher offer price, there are limited evidences which declare the opposite view of this. According to Ball and Shiva Kumar (2006) they have contested the results of TWW regarding earnings management. Their main argument is that the firms going for IPOs tend to be more conservative than aggressive due to increased disclosure and public scrutiny and therefore they do not indulge in earnings management. They conducted their study on 393 firms going for IPOs in UK and found that firms, which go public, adopt higher quality of financial reporting. They find empirical evidence that increased regulation as well the threat of shareholder regulation motivates these firms not to engage in earnings management. Lee and Masulis (2006) conducted their empirical study on 1382 US firms that went to IPOs between 1993 and 2002 and found that reputed under writers restrain earnings management by firms whereas venture companies' reputation does not affect earnings management either way. Nagata and Hachiya (2006) relate earnings management to the IPO offer price. They found evidence amongst 589 Japanese firms that went public from 1989 to 2000 that earnings management leads to a lower offer price by the under writers. This seems to be counter intuitive since the very basis of earnings management during IPOs is to get a higher offer price. However, Nagata and Hachiya (2006) argue that if higher earnings management were to lead to a higher price, then there is a greater probability that the issue might not be fully subscribed and this might damage the under writers' reputation. Accordingly, the under writers have incentive to detect earnings management by issuers and give them a lower offer price. However, although they do mention about underpricing, they just leave their results by arriving at the offer price and do not look at the first day of trading to measure the degree of underpricing. In another paper, Nagata and Hachiya (2006b) evaluate the competing motives of earnings management-preventing wealth loss and diluting control of the firm. In a sample of 830 firms they find the motive for reducing wealth loss to be dominating over the motive for keeping control of the firm (as cited in Pande, 2009, p.8).

3. PROPOSED METHODOLOGY

Research Propositions

In order to response to the question of the research, the following propositions are put forward:

- Propositions_{0A} : Companies are not having abnormal levels in cash flows from operations, production costs, and discretionary expenses prior to IPOs.
- Propositions_{0B} : There is no positive relationship between REM and IPO_Price.
- Propositions_{0C} : There is no positive relationship between REM and IPO_Quantity.

Measurement for dependent Variable: IPO price and IPO Quantity

The study should follow quantitative research approach. IPO prices (IPO_Price) of the selected firms could be taken as dependent variable. Moreover, firm size could be taken as one of the measure for the moderate variable in order to mitigate the impact from different firm sizes (using total assets). In order to capture the quality of audit this study recommended to use type of the auditor (Big 3 audit firms) as second moderating variable: consider it as dummy variable. Further, the quantity of shares issued (IPO_Quantity) in the IPO considered as second dependent variable.

Measurement for independent Variables: REM

Following Roychowdhury (2006) this study defines REM as actions managers take that deviate from normal business practices. This study employs three metrics (proxies for REM) to examine REM, namely abnormal cash flow from operations (RES_CFO), abnormal production costs (RES_PROD) and abnormal discretionary expenses (RES_DISEXP). (as cited in Wijesinghe and Kavinda, 2017, pp.63).

The aggregate proxy serves as an appropriate measure of REM when a firm faces a clear task of meeting or beating certain earnings benchmarks like positive earnings or analysts' expectations, in order to avoid severe negative market reaction. However, an IPO firm presumably faces a different objective – to achieve the highest possible market valuation from the investors. A link between earnings and firms' value is not uniform among IPO firms as prior literature demonstrates that earnings are not always informative for the firm's valuation. Hayn (1995) shows that negative earnings are less informative than positive earnings. Bartov et al. (2002) find that during the IPO, for Internet firms earnings are not priced, while negative cash flows are priced perhaps because they are viewed as investments. Callen et al. (2008) find that investors value loss firms based on their sales growth rather than earnings. Therefore, in order to detect real activities management in the IPO setting, a researcher should study separately individual REM components that can be subject to different incentives (as cited in Fedyk and Khimich, 2015, p.8)

The study estimates RES_CFO, RES_PROD, and RES_DISEXP as the residual from the following models, respectively.

Model for RES_CFO

$$CFO_{it} / A_{it-1} = \beta_0 + \beta_1 [1/A_{it-1}] + \beta_2 [Sales_{it}/A_{it-1}] + \beta_3 [\Delta Sales_{it}/A_{it-1}] + \varepsilon_{it} \quad (1)$$

Where,

CFO_{it} =Cash flow from operation of firm i in period t .

A_{it-1} =Total assets of firm i in year $t-1$.

$Sales_{it}$ =Sales of firm i in year t .

$\Delta Sales_{it}$ =Sales of firm i in year t less sales of firm i in year $t-1$.

ε_{it} =A residual term that captures the level of abnormal cash flow of firm i in year t .

Model for RES_PROD

$$COGS_{it} = \beta_0 + \beta_1 [1/A_{it-1}] + \beta_2 [Sales_{it}/A_{it-1}] + \varepsilon_{it} \quad (2)$$

$$\Delta INV/A_{it-1} = \beta_0 + \beta_1 [1/A_{it-1}] + \beta_3 [\Delta Sales_{it}/A_{it-1}] + \beta_4 [\Delta Sales_{it-1}/A_{it-1}] + \varepsilon_{it} \quad (3)$$

$$PROD_{it} = COGS_{it} + \Delta INV \quad (4)$$

The normal production cost is estimates as follows.

$$PROD_{it}/A_{it-1} = \beta_0 + \beta_1 [1/A_{it-1}] + \beta_2 [Sales_{it}/A_{it-1}] + \beta_3 [\Delta Sales_{it}/A_{it-1}] + \beta_4 [\Delta Sales_{it-1}/A_{it-1}] + \varepsilon_{it} \quad (5)$$

Where,

$PROD_{it}$ = the sum of cost of goods sold and change in inventory of firm i in year t .

$\Delta Sales_{it-1}$ =Sales of firm i in year $t-1$ less sales of firm i in year $t-2$; and all other variables are as previously defined.

Model for RES_DISEXP

$$DISEXP_{it}/A_{it-1} = \beta_0 + \beta_1 [1/A_{it-1}] + \beta_2 [Sales_{it-1}/A_{it-1}] + \varepsilon_{it} \quad (6)$$

Where,

$Sales_{it-1}$ =Lagged Sales.

$DISEXP_{it}$ =The sum of Research and Development (R&D) expenses and Selling, General & Administrative (SG &A) expenses of firm i in year t ; and all other variables are as previously defined.

According to Roychowdhury (2006) firms that manage earnings upwards are likely to have one or all of these accounting effects: (i) unusually low cash flow from operations due to the increasing of price discounts or lenient credit terms in order to accelerate sales for the current period, (ii) unusually low discretionary expenses due to the aggressive reduction in R&D, advertising and SG &A expenses in order to improve earnings for the current period, and (iii) unusually high production costs in order to reduce Cost of Goods Sold (COGS), which in turn increase the operating margin for the current period (as cited in Wijesinghe Kavinda, 2017, pp.63).

Estimated Model

$$RES_REM = \beta_0 + \beta_1 IPO_Price + \beta_2 IPO_Quantity + \beta_3 Firm_Size + \beta_4 Auditor + \epsilon_{it} \quad (7)$$

Proposed framework for the analysis

Framework to analyze the impact of real earnings management activities on initial public offerings.

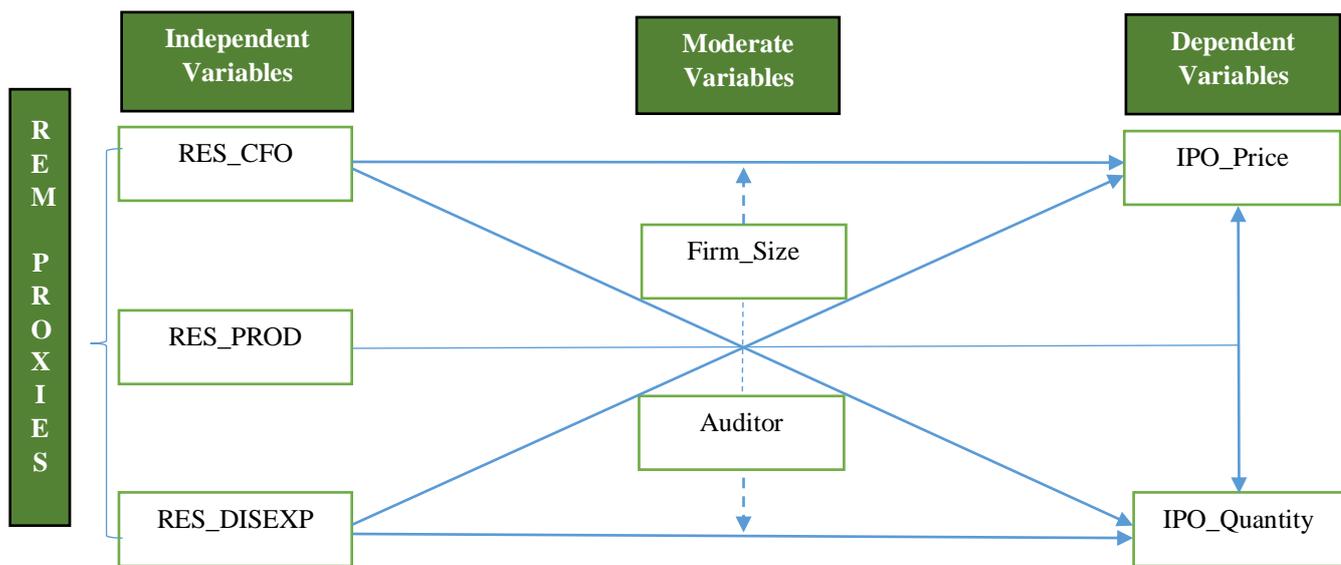


Figure 02: Proposed Framework

4. SUMMARY AND CONCLUSION

Initial public offerings, even though risky, typically underperform the indices for the first few years after offering. This can be explained by high divergence of opinion raising the initial market price, and by this divergence of opinion declining over time. Most of the research focused on the long-run underperformance of these IPOs rather than detecting of earnings management activities before the period of IPO. REM is a situation where the companies manage real activities of the business in order to make some stakeholders believe that financial reporting goals have been met through the normal activities of business. Hence, the aim of this study is to provide a framework to analyze whether there are any REM activities prior to IPOs and the impact of such REM activities to IPO price and quantity of shares issued in IPOs in the context of Sri Lanka. The study is motivated by recent researches which only focused on post-IPO impact and correspondingly this study attempted to focus on pre-IPO circumstances by identifying REM activities prior to IPOs. It was documented that three proxies to detect REM activities namely, abnormal cash flow from operations abnormal production costs and abnormal discretionary expenses, which could be used as a dependent variable. Price of the IPOs shares, no of quantities issued in IPO could be taken as an independent variable whereas firm size and type of the auditor would be taken as moderating variables.

Finally, based on the discussion in this paper the proposition that “existence of REM activities prior to IPOs and its impact to both IPO price and number of shares issued in IPOs” has been developed and can be examined in future research by using the proposed framework (figure:2).

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