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Return and Value of the Shares in The Initial Public Offering with an Emphasis on Accounting Profit

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ABSTRACT

Due to the improved privatization process in recent years, Tehran Stock Exchange market faced companies which seek financing by providing a portion of their stock. The companies offer their shares with respect to previous activities and financial information so that share prices already have not been set in the market mechanism. Therefore, investors declare their own prices according to information published and initial expectations about the shares. Evaluation of interaction processes of initial offerings at the early days of offering and price discovery process indicates fluctuation. Given the fact that accounting information as the as the most important financial information available affects the investors' behavior and their expectations at offering, evaluation of the relationship is of high importance at and after offering. This study determines the relationship between accounting profit as the most important accounting data output and other variables related to the initial offering, including the amount of offering and return . Therefore, the data of 127 companies that had initial offerings between 2010 and 2014 was studied. Results indicated that there is a significant relationship between discretionary accruals before offering, sales growth and size of institutional ownership and the next year return. Moreover, the offering day value could be explained using the value of initial public offering, net income and book value in the valuation model. However, there is no significant relationship between size of institutional ownership and value of offering on the offering day

Keywords: *earnings, accruals, theory of information asymmetry*

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INTRODUCTION

Accounting information has always been considered as one of the most important source of information of investors for analysis and valuation of stocks. The literature on the stock assessment is full of studies that have examined the relationship between stock valuation and accounting information. In fact, usefulness of accounting information was questioned after proposing the labor market hypothesis and its development by Fama in the 1960s. The labor market hypothesis states that the previous information is reflected in prices and the market does not react to the previous information (historical cost) in a semi-strong and strong return state. However, Ball and Brown (1968) examined the price reaction about earnings announcements date. They remarked that the price reaction orientation to good and bad news (AIS) is the same before and after the earnings announcement. Furthermore, a lot of researchers explored the usefulness of accounting information for investors through market information. Some of the studies tested the valuation models based on the accounting information. This study deals with the usefulness of accounting information from a different perspective so that the importance of the stock valuation of the companies which offer initially their stock publicly resulted in the research's concern to investigate whether accounting information is related to the pricing of these companies. As investors and other stakeholders of the public enterprise companies emphasize the figures of the financial statements at the time of the company and managers' evaluation, the quality of the figures is of particular importance and is considered as a significant factor affecting the pricing of the companies shares. Although financial audited statements of the companies are one of the important bases of pricing during the initial public offering and somewhat analysts rely on such statements, issuers may mislead the institutional investors due to the benefits caused by institutional ownership for the companies so that they themselves could obtain the desired investment structure using the heroic benefit management. Hence, the study uses the institutional ownership variable as an important variable. The study aims to find a significant relationship between accounting information and marketing information during the initial public offering using two regression models. Thus, accounting and market information such as discretionary accruals, operating profit, institutional ownership, market value, the ratio of the book value to the market value, history and growth of the company was employed by developing a model to explain one year return . The variables of institutional ownership size, the offering value, net profit and the book value were used in the second model to explain the company value on the first day of the offering.

Theoretical Framework and literature review

The initial public offering of the stocks is done by companies that have a limited operating history in the initial offering. In comparison with other exchange companies, these companies present less public information to external investors at initial stock offering. In contrast, the initial suppliers have more

interior information about the companies. Therefore, there is information asymmetry between the publishers of the time of initial stock offering and potential external investors. Thus, external investors hardly trust in publisher disclosures at the time of initial stock public offering. The publisher's intention of manipulating reported benefits of initial stock offering may be the increase of profits or obtaining suitable ownership structure after the first offering of stocks.

Little empirical researches studied the factors of the conversion of private joint stock into public stock. Pagano et al. (1998) studied some factors that help the company to describe conversion into public joint stock. They used database of Italian private joint stock and compared them with the Italian public joint stock. Brow et al. (2003) compared the companies that intended to perform the initial public offering with the private companies in order to change into public joint stock. Myers and Majluf (1984), Mello and Parsons (1998), Ang and Brau (2003), and Chemmanur and Fulghieri (1999) considered these factors. The factors include:

Reduction of capital cost and increase of company's value,

Financing and increasing of liquidity,

Facilitating the transfer of ownership as a method for increasing credit reputation.

Negative long-term return in the years after the initial public offering is one of the challenging issues in financial texts. Ritter (1991) showed that the stock return of the companies that have initial public offering is remarkably lower than the offering of other companies after the initial public offering. The reason for poor performance of stock price may be that the investors were very optimistic about the future profit of the supplier companies. Therefore, when the optimistic expectations revise after the offering, we see a poor performance. A probable reason for the optimism may be the actions of the profit management at the time of offering.

Recent studies show a positive relationship between the stock offering and institutional ownership. Nofsinger and Sias (1999) claimed that there is a strong and positive correlationshipbetween the changes of institutional ownership and their return at the same time. Strickland and Dennry (2002) found a positive relationship between the abnormal offering of a company with the degree of institutional ownership. Fernando et al. (2004) also mentioned that if more than one institutional owner chooses the initial offering companies, they experience less degree of losses (mistakes). In other words, multiple institutional owners will not mislead simultaneously. Furthermore, there are some other institutional ownership benefits. For example, Clyde (1997) showed a positive relationship between the institutional ownership and the profit of the companies that they supervised. Zechner and Stoughton (1998) also suggested that institutional investors should present supervisory tasks after the initial public offering. Baysinger et al. (1991) claimed that institutional ownership has a positive impact on the expenses of research and development. Furthermore, bigger institutional ownership can prevent imposing more prices on individual investors (Mcinish & Wood, 1991). Therefore, publishers may choose policies in line with heroic benefit management to obtain some of the benefits for increasing the offer price and stocks return so that they could attract institutional investors. It should also be noted that Field and Lowry showed that institutional investors cannot predict future return . Bagherzade et al. (2011) investigated effective factors on short-term stock offering of initial public offering and concluded that the asymmetry hypothesis is confirmed in these companies.

On the other hand, several aspects of initial stock offering motivate companies to manage the profit opportunistic by increasing the accruals accounting in the initial stock offering. Whether the use of the accruals is opportunistic at the time of initial public offering in capital market. In other words, whether companies that enter the capital market for the first time can affect the decisions of professional investors using accrual accounting. We try to answer this question by reviewing the related literature. Accrual accounting provides the managers the freedom of action in their profit reporting. It reflects management information that is useful in the current economical situation more correctly than the mechanical reporting. However, if the managers want to impact investor's decision in some situations, the flexibility of accounting standards will provide a wider range for hiding the real performance of the company. Specially, when the company decides to sale the stocks as the initial stock offering to people in the market, the intentions of profit management will increase. It is expected that exaggerated reporting of the profit will increase the price of the stocks and overprice is suitable when the company sells its common stocks. There is more uncertainty about the companies that offer stocks for the first time in capital market. There is information asymmetry between the companies and investors (seller and buyer). There is a limited independent and reliable information resources about them. Thus, judging about the suitability of accrual accounting of the companies that offer their stocks in the market for the first time, is difficult for the investors who want to evaluate the future performance. Accruals have an important role in evaluating the earning management. Accruals make a difference between the profit and the flow of cashes. Hence, supposing that cash flows are not manipulating, the only way for manipulating profit is the increase or decrease of accruals.

According to the difference in the level of the company activity, Jones measured difference within accruals through total assets, and did not suppose the level of optional accruals as a constant. De chow, Sloan and Sweeney (1995) compared different models of finding earning management and showed the feature of each model with weaknesses and strengths that include Healy (1985), De Angelo (1986), Jones (1991) models, revised model of Jones (1995) and the model of De chow, Sloan and Sweeney (1996). They concluded that Jones revised model is the best model for finding earning management.

The asymmetry information hypothesis is the most important theoretical framework in this research. Investors who want to take part in the initial public offering, usually do not have enough information about the intended company. Rock (1986) and Beatty and Ritter (1986) explained that significant information asymmetry between the external and internal investor leads to price reduction for their offering and affects investors' intention and their search for more information about the offering company.

Fan (2007) in a research titled "earnings management and ownership retention for initial public offering firms" argued that the time of initial public stocks offering, the reported earning is inflated by earning management (discretionary accruals) and he considered this earning increase as sending a sign for investors. So that they receives the sign and it impacts on their decision. In fact, Fan's basic research hypothesis was also the information asymmetry hypothesis. In his opinion, there is no doubt that there is information asymmetry in external and interned investors who do the initial public offering in the companies so it leads to incorrect decision. Fan expresses three reasons for the relationship between the reported profit accounting and the value of the company.

When the company does the initial public offering, the investors rely more heavily on the financial statements than other information resources for their evaluation. Therefore, the publisher (the initial public offer) has a strong motivation for reporting the desired accounting information to impact the valuation of the investors' decisions.

Despite of auditing by independent auditor, the publishers have a strong authority in reporting the methods of accounting because of current consideration of the standards. Therefore, publishers have a good chance for reinforcing the reported profits in the process of initial public offering.

According to Fan, the most important reason is the expensiveness of earning management by increasing profits for the company. However, when the inflated profit is reported, it will return in the next period and the accruals will equal to cash flows in the life cycle of the company, and this may lead to actual economic cost such as poor timing in selling and cashing earlier than the time of assets that their cash time is not arrived yet. All the expenses will probably increase by the degree of earning management. In other words, due to the information asymmetry between the external and internal investors at the time of initial public offering, the motif of earning management is high for the companies that have a lower quality than companies with high quality. Thus, we should find a criterion for segregating high and low quality companies, which use earning management (discretionary accruals) so that accounting profit and choosing accounting methods have an important role in it as the sign of the criterion.

A lot of researches have been done in relationshipwith studying important variable in initial stocks offering but there are little researches in Iran that have examined the accounting information before and after the initial public offering. Ebrahimi Kordlor and Hasani Azar Dariani (2006) reported the earning management before and after the initial public offering in companies accepted in securities exchange of Tehran. Alavi Tabari and Akhlaghi (2010) explored the quality of profit in the initial offerings. They reported differently when the initial offering is occurred in a year, the quality of the profit is higher. Bagherzadeh et al. (2011) investigated effective factors on short-term return of initial stock offerings and concluded that asymmetry hypothesis is confirmed about these companies.

Based on the previous subjects that expressed, the hypothesis of the research is as follows:

Hypothesis 1: accruals before the initial offering have a reverse and significant relationship with the one year return after the offering.

Hypothesis 2: the value of the company has a positive and significant relationship with accounting profit at the time of initial public offering.

DATA AND METHODOLOGY

This is a correlational research and according to the obtained information about kind and numbers is performed by cumulative data analysis. For evaluating the discretionary accruals in each initial stock offering of the company, we use the Jones' revised sectional model. The sectional model is used because the procedure of time series is not possible for the initial stock offerings. The benefit of the procedure is that changes of the companies' discretionary accruals result from the changes of economical condition of the whole industry. Therefore, using the data of both industry companies and companies that have initial offering, the required coefficients of calculating discretionary accruals were evaluated between the years 2000-2010.

$$\frac{TAC_{iy}}{TA_{iy-1}} = a_{0j}\left[\frac{1}{TA_{iy-1}}\right] + a_{1j}\left[\frac{\Delta REV_{iy}}{TA_{iy-1}}\right] + a_{2j}\left[\frac{PPE_{iy}}{TA_{iy-1}}\right] + e_{iy}$$

The above model was used to evaluate coefficients. The result of evaluationg coefficients of a_{0j}, a_{1j} and a_{2j} are 596.63, 0.079 and 0.0329, respectively. All coefficients were significant at the level of 99% and could explain 99% of changes of dependent variable. For evaluating the discretionary accruals, we used Jones' revised model that is presented by Dechow et al. (1995):

$$DAC_{jy} = \left[\frac{TAC_{jy}}{TA_{jy-1}}\right] - a_{0j}\left[\frac{1}{TA_{jy-1}}\right] - a_{1j}\left[\frac{\Delta REV_{jy} - \Delta REC_{jy}}{TA_{jy-1}}\right] - a_{2j}\left[\frac{PPE_{iy}}{TA_{iy-1}}\right]$$

Based on the first and second hypotheses, the models used in this research are as follows: Seven (2007) and Fan (2007) respectively;

$$BHR_i = C_0 + C_1 IO_i + C_2 DAC_i + C_3 OP_i + C_4 Ln(ME)_i + C_5 BM_i + C_6 SG_i + C_7 AGE_i + \varepsilon$$

Model (1)

$$V_i = w_0 + w_1 IO_i + w_2 GP_i + w_3 NI_i + w_4 BV_i + \varepsilon$$

Model (2)

In these models

Discretionary accruals (DAC) are calculated by Jones revised model, institutional ownership (IO) is equal to the degree of ownership, operational performance (OP) is equal to quotient of operating profit on total assets of the last year, total assets (TA) is the result of its natural logarithm, offering size (OS) is equal to the logarithm of the volume of offering in the offering price, sell growth (SG), age of companies in the time of initial public offering(AGE), that is obtained by logarithm plus its one, net income (NI), offering price multiplied by the volume of initial offering (GP), book value (BV), financial leverage (LEV), buying output and preserving stocks for one year (BHR), market value of equity (ME), and the ratio of book value to company's market value (BM).

For evaluating the above models and testing research hypothesis, we used multivariate regression. For collecting needed information, we employed Rahavard Novin software and the information that is published by Tehran's securities exchange organization. For analyzing data, we also used the Eviews software.

Data analysis

Descriptive statistics

The information related to descriptive statistics of research variables is shown in Table 1. The results show that the average percent of institutional investors in sample companies is 20% and its maximum is 99.9%. The maximum and minimum values of research values research variables show that they have a suitable range and data have a suitable variability.

Standard deviation of data also shows that the data have enough consistency for better evaluation of the model. The main point is the mean return of initial offering companies that in average has an return of 50% in a year after the initial public offering. From 101 chosen companies, the most and the least age of companies was 54 and 1 year, respectively. The average age of the sample company was 20 years. However, for optimum use of the model, the natural logarithm has been used. We should explain that for the scale of model's data and better evaluation of the model, the natural algorithm of data has been used. Table 1

Table 1. Descripive statistics

Descriptive statistics / Variables	Mean	Max.	Min.	SD	Number of observations
Percent of institutional investors	20.67238	99.9	-0.000	29.48048	101
Return of the next year	50.17382	395.6991	-55.65793	97.42032	101
Discretionary accruals	0.041232	1.424715	-1.258303	0.260125	101
Natural logarithm of net profit	10.77208	16.29831	0.000	2.294685	101
Natural logarithm **of company value**	26.61776	31.91006	23.13021	2.030754	101
Natural logarithm **of offering value**	23.05438	28.91433	19.11383	2.211694	101
Natural logarithm **of book value of assets**	11.83851	17.81639	8.721602	1.96933	101
Ratio of sales growth	0.438575	12.48192	-1	1.271499	101

Hypothesis-testing

Before any interpretation about the results of models, econometrics considerations include investigating classic hypothesis and other related subjects have occurred in relationshipwith dependent variable. So, White tests, Multiplier Lagrange (LM), Durbin-Watson (DW) and Jarque-Bra have been used respectively for testing heterogeneity of variance, serial correlationshipand normality of disturbing elements. Autoregression techniques and moving average have been used for dependent variable. It should be noted that in both models, outlier data have been controlled for better assessment of the model. These tests have been done equally for both models, the result of statistical tests of models (1) and (2) are presented in tables (2) and (3), respectively.

Testing the first hypothesis

The result of this hypothesis is presented in Table 3. Fisher statistics (F) shows that the model is linear, and adjusted R square (R^2) shows the explanatory power of dependent variable by independent variable in the percent of 50. From 9 tested independent variable, three variable of institutional ownership, discretionary accruals of the year of initial public offering and sell growth have a significant relationship with a year output after initial public offering.

In defining the model, autoregression techniques and moving average have been used. The result of using these techniques is arrival of the first autoregression variable in the model which is significant. We should note that by applying autoregression variables and moving average, we can explain the use of endogenous and exogenous variables in dependent variable. In other word, as defining the dependent variable depends on some variables, we use exogenous variables (independent and control) and endogenous variables (autoregression and moving average). Autoregression variable is used in econometrics because of the relationship of dependent variable with its interruption, and moving variable is used because of the relationship of dependent variable with its residue interruption.

Table 2. Results of testing model 1

$$BHR_0 = 39.066 + 0.5\ (IO_0) - 50.02(DAC_0) + 10.007(SG_0) + AR(1)$$

Sig.	t-student	Coefficient	Result / Independent variable
*0.0996	1.663585	39.06682	**Constant**
**0.0249	2.280611	0.500739	**Percent of** institutional **stakeholders**
*0.0691	-1.839195	-50.02736	Discretionary accruals
*0.0735	1.81066	10.00742	**Sales growth**
***0.0001	3.961273	0.665191	**First order** autoregression
Durbin-Watson: 1.92		**Coefficient of determination: 0.524**	
Fishers' test: 13.98		**adjusted coefficient of determination: 0.499**	
***0.0000: significance of Fishers' test**			
*** error level of 99%, ** error level of 95%, * error level of 90%			

The results of the tests showed that increasing the ratio of institutional ownership, reduction of discretionary accruals and increasing the sell growth in the offering year lead to the increasing of stocks output after the initial offering. From the three mentioned variables, the percent of discretionary accruals show the stronger effect of this variable on output in comparison with other significant variables. So that based on the model, we expect that reduction of discretionary accruals will explain the increasing of output in the next year. But the main point in this model is that the effect of discretionary accruals on the next year output has happened in a state that the institutional ownership variable has not been successful and significant in explaining the one year output. It shows that the output of the companies that present initial stock offering is related mainly to the quality of reported accounting benefit than the behavior of institutional investors.

Testing the second hypothesis

The second model that is used for testing the second hypothesis, investigates the relationship between company's value at the time of initial stock public offering with accounting benefits. The main idea of this model is taken from Olson model (1995), and by using accounting variable (book value and accounting profit, offering value and institutional ownership) we can assess the first day value stocks. Total significantness of regression is performed by Fisher statistics so we can comment about their coefficients and significantness.

Statistical results of this hypothesis show that there is appositive and significant relationship between the two mentioned variable. Moreover book value of assets and the value of initial offering have a positive and significant relationshipwith the company's value at the day of offering. From tested variables, institutional stakeholders did not show a significant relationship with company's value. Therefore it is excluded from the model. Also, moving average and autoregression techniques are used for better definition of the

model. Hence, the first autoregression and the first moving average were significant and entered in the model.
As mentioned earlier, the hypotheses of classic regression were investigated by the test of Jarque-Bra, White, LM, and Durbin-Watson for normality, heterogeneity of variance and serial correlationshipbetween the disturbing elements. As seen in Table 3, statistics of Durbin-Watson with the amount of 2.007 shows that there isn't a serial correlationshipbetween the disturbing elements. In general, significant independent variable of this model can define 91% of dependent variable changes by determination coefficient.

Table 3. Results of testing model 2

$$V_i = 9.57 + 0.428\,GP_i + 0.167NI_i + 0.448BV + 0.94\,AR(1) - 0.74\,MA(1)$$

Sig.	t-student	Coefficient	Result / Independent Variable
***0.0000	9.835212	9.571703	Constant
***0.0014	3.304615	0.167943	Natural logarithm of net profit
0.2748	-1.098663	-0.002375	Percent of institutional stakeholders
***0.0000	8.293273	0.428177	Natural logarithm of offering value
***0.0000	6.841997	0.448495	Natural logarithm of book value of assets
***0.0000	15.44542	0.94386	First order autoregression
***0.0000	-6.622658	-0.749146	Variable mean of the first order
Durbin-Watson: 2.0007		Coefficient of determination: 0.92	
Fishers' test: 160.67		Adjusted coefficient of determination: 0.91	
***0.0000: significance of Fishers' test			
*** error level of 99%, ** error level of 95%, * error level of 90%			

The direct and significant relationship between the accounting variables and dependent variable (company's value at the day of offering) is a good reason for this subject. At the time of valuation of the stock of companies which publish their stocks for the first time, financial statements are the most important information resources and people rely heavily on the degree of reported accounting profit

SUMMARY AND CONCLUSION

Based on the importance and role of accounting information in pricing the stocks of companies that offer publicly for the first time in the securities exchange, we tried to understand whether the output and value of the company is affected by accounting profit or not. For this purpose, we study the relationships via two hypotheses. In the first step, we obtained explanatory variable by using two regression models and measuring the related variables and solving the econometrics problem of models. Then by using current theories, we analyzed the results. The result of the first hypothesis which consider the relationship between the one year output after the initial stock offering and conventional variable (specially discretionary accruals that is related to accounting profit), showed that there is a reverse and significant relationship between the stock output and discretionary accruals. This relationshipis so strong that we can expect that the stock output is affected by earning management (unexpected increase or decrease of earning).
On the other hand, in the second hypothesis we tried to by using another model find variables that explain the company's value in the first day of offering. What can be inferred from the literature of initial offering is that the financial statement of the supplier companies is the only reliable source for the investors for valuation of stocks. Therefore, it is expected that reported accounting benefit in financial statement has a high explanatory power for company's value. The results of the second hypothesis confirmed this idea, an important part of the company's value can be followed in the amount of accounting variables, which accounting profit is one of the important items of them.
The result of this research is consistent with the result of researches of Nofsinger and Sias (1999), Stickland and Dennis (2002), Fernando et al. (2004), Fan (2007), Rock (1986), Beaty and Ritter (1986), Bagherzade et al. (2011), and Ebrahimi Kordlor and Hasani Azar Dariani (1385) and is opposed to the researches of Field and Lowry (2005) and Alavi Tabari and Akhlaghi (2010). For future researches, we propose testing the other models of evaluating stocks for initial offering companies.

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