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Abstract: This study investigates if IPO firms in Indonesia manage their earnings around the time of their IPO. Using financial data from 1999 to 2012, I examine the abnormal accruals of IPO firms during the three years prior to their IPO year and in their IPO year. I find that issuing firms managed their earnings starting two years prior to their IPO year and that earnings management was most profound in the IPO year. Further tests indicate that firms used income-increasing accruals during the period leading to the IPO. These findings are consistent with the view that firms manage their earnings to maximize the initial offer price and the proceeds from the IPO.

Keywords: initial public offering, earnings management, accruals

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1. Introduction

An Initial Public Offering (IPO) is an event potentially clouded by severe information asymmetry between IPO firms and investors. Due to the lack of publicly available information, issuing firms are aware that financial statements in the prospectus become the main sources of information for investors to estimate the fair price of the initial offering. This creates an opportunity for firms to take advantage of the asymmetry by manipulating financial statement numbers in their prospectus. For example, firms could manage earnings upward to influence investors’ perception about the long-term outlook for the issuing firms. Managers have a large incentive to commit earnings management during the IPO process, especially when their wealth and performance assessment are tied to the stock price.

Previous research has extensively examined the issue of abnormal accruals during IPOs. However, these studies provide mixed findings on the direction of abnormal accruals around IPOs. Some studies (e.g. Aharony et al. 1993, Friedlan 1994, Teoh et al. 1998, Ahmad-Zaluki et al. 2011) found that to maximize the IPO proceeds, firms opportunistically use income-increasing accruals during the pre-IPO period to increase market expectation about IPO firms’ future performance. However, other studies (such as Venkataraman et al. 2008, Ball and Shivakumar 2008, Cecchini et al. 2012) found that firms’ report more conservatively by using income-decreasing accruals prior to the IPO to minimize the risk of litigation following the IPO and to respond to the higher demands for earnings quality during the IPO process. Fan (2007) and Armstrong et al. (2015) showed that abnormal accruals are significantly larger in the IPO year. However, Armstrong et al. (2015) found that the increase in abnormal accruals is not due to opportunistic earnings management. Instead, they argued that the issuing firms invest the IPO proceeds in working capital accruals in the IPO year, causing a significant increase in abnormal accruals in that year.

This study investigates the behavior of abnormal accruals around IPCs in Indonesia and test whether firms use income-increasing accruals during their IPOs to obtain a higher initial offering price. Examining the presence of earnings management around the IPO process in Indonesia is important for the following reasons. Firstly, most studies on earnings management around IPOs were conducted in developed capital markets with better investor protection and law enforcement. Similar studies in emerging capital markets with relatively weak investor protection and legal enforcement such as that in Indonesia (LaPorta et al. 1998, Leuz et al. 2003) are relatively limited. These two factors could potentially be determinants of the direction of abnormal accruals around IPOs. Secondly, the capital market in the country is growing and many more firms are expected to go public. Studies on earnings management around IPOs will shed more light on accruals behavior around IPOs and help investors in Indonesia assess the fair value of IPO firms in the future.

Our findings suggest that IPO firms in Indonesia manage their earnings around the IPO year. Using 168 IPO firms between 1999 and 2012, I found that the absolute abnormal accruals are higher during the periods prior to the IPO year and in the IPO year, relative to the accruals of (already) listed firms. Further, using the signed residuals from the Modified Jones model, I find that IPO firms are associated with positive abnormal
residuals, indicating the use of income-increasing accruals by the issuing firms. Our findings are consistent with Teoh et al. (1998) and Ahmad-Zaluki et al. (2011) in that firms opportunistically manage their earnings during their IPO. This study also found that issuing firms start managing their earnings two years prior to the IPO year and that the intensity of the earnings management is greater the closer it gets to the IPO year. Our findings are different from those of Roosenboom et al. (2003) who stated that IPO firms manage their earnings only in the IPO year, but not in the years before the IPO. Nonetheless, I do find that abnormal accruals are most profound in the IPO year.

This study contributes to the IPO literature by providing evidence that in an emerging market with low litigation risks such as that in Indonesia, IPO firms report more aggressively instead of conservatively, by using income-increasing accruals in the year of the IPO and in the two years prior to the IPO year. This study provides insights to investors interested in purchasing shares in IPO firms in assessing the firm performance and value at the initial offering. The use of income increasing accruals prior to and in the IPO year might lead investors to overestimate the future performance of the IPO firms. Investors should be aware of the presence of earnings management among IPO firms and make investment decisions accordingly. Regulators and policy makers are among those who might benefit from this study.

2. Theoretical Framework and Hypothesis Development

Regulators in Indonesia require firms which have the intention to go public through an IPO to provide a prospectus for potential buyers. The prospectus should help investors assess the performance and the value of the IPO firm. IPO firms are usually characterized by the fact that public information about the firms is very limited. The financial statements in the prospectus become the main source of information for investors to assess the firm's value, including the issue price. A common way to value an IPO firm is by using the price earnings (P/E) ratio of similar firms listed on the capital market. This implies that the initial offer price depends greatly on earnings as an indication of the IPO firms’ current and future performance. Since IPO firms desire to maximize the initial offer price of their shares, they have an interest in improving the perception of investors about the outlook of the issuing firms. Further, managers’ wealth and compensation are often tied to the stock price, creating incentives for managers to overstate the performance of the firm to drive the stock price up. Managers may use real and accruals based earnings management to influence stock prices.

Empirical studies find that IPO firms use accruals-based earnings management to influence investors’ perceptions about the prospects of their companies. For example, Aharony et al. (1993) and Friedlan (1994) found that IPO firms used accounting choices that would manage their earnings upward during the IPO process. Based on the above arguments, I propose the following hypothesis:

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1 The prospectus contains three years of audited financial statements, of which at least the statements of the last two years receive unqualified opinion from the firm’s auditor.
H1. Firms manage their earnings during the initial public offerings.

Studies on the direction of accruals management during the IPO process produce conflicting results, with some studies reporting the presence of income-increasing actions, while others report income-decreasing accruals. Those who found that accruals around the IPOs were income decreasing (Venkataraman et al. 2008), argued that high litigation risks encourage the IPO firms to report income more conservatively. Issuing firms may also respond to the demand for higher earnings quality by reporting conservatively during the IPO process (Ball and Shivakumar 2008). Earlier studies such as Aharony et al. (1993) and Fredlan (1994) found that IPO firms report their income “liberally” instead of conservatively during the IPO process. Similarly, Teoh et al. (1998) found that IPO firms opportunistically manage their earnings upward through income-increasing earnings management to influence investors’ perceptions of the firms’ value. In a less developed market, Ahmad-Zaluki et al. (2011) found that IPO firms used income-increasing accruals in Malaysia, especially during the financial crisis periods in 1997-1998.

Previous studies discovered that using abnormal accruals to puff up pre-IPO earnings is risky. DuCharme et al. (2004) found that the incidence of lawsuits following IPOs are positively associated with the use of abnormal accruals before the stock issuance. IPO firms even use income-decreasing (instead of income-increasing) accruals to avoid the risk of litigation post-IPO (Venkataraman et al. 2008). Some studies have found that to minimize litigation risks, IPO firms under-price their shares at their IPO (e.g. Lowry and Shu 2002, Hanley and Hoberg 2012). I expect that conservative financial reporting by the use of income-decreasing accruals during an IPO is more likely to occur in countries with strong legal enforcement and high litigation risks. I hypothesize that in countries with weaker legal enforcement and low litigation risks, such as Indonesia, IPO firms would manage earnings upward to maximize the IPO proceeds instead of decreasing earnings to mitigate the risks of litigation.

H2. Firms use income-increasing accruals to manage earnings during initial public offerings.

3. Research Method

This study used firms listed on the Indonesian Stock Exchange from the period 1999 through 2012. I focused on the accruals management of IPO firms during a four-year period (three years prior to the IPO plus the IPO year) and compared the abnormal accruals with the non-IPO firm-years. When firms had the objective of influencing their initial offer price, they would manage their earnings in the period prior to and during the IPO year. Any accruals management in the post-IPO period would not affect the initial offer price.

Financial firms are highly regulated and for this reason they were excluded from the sample. Firms with missing data and extreme values were also eliminated from the sample.
In the final sample, I obtained our data of 168 IPO firms between 1999 and 2012 with a total observation of 3,679 firm-years. To test the possibility of firms managing earnings during the IPO process, I used the earnings management test known as the Modified Jones model (Dechow et al. 1995). I conducted a pooled regression to obtain the residuals (i.e. abnormal accruals) as a proxy for earnings management. The model was a modification of the original Jones model (Jones 1991), which is described as follows:

\[ TA_i = \beta_0 + \beta_1(\Delta REV_i) + \Delta_2(PPE_i) + e_i \]  

(1)

where,

- \( TA \) = total accruals, defined as income before extraordinary items less cash flows from operations in year \( t \), deflated by total assets at year \( t - 1 \),
- \( \Delta REV = \) revenues in year \( t \) less revenues in year \( t - 1 \), deflated by total assets at \( t - 1 \),
- \( PPE = \) gross value of property, plant, and equipment in year \( t \), deflated by total assets at \( t - 1 \),
- \( e = \) error term.

The constant and parameters \( \beta_0, \beta_1, \text{ and } \Delta_2 \) obtained from the original Jones model in Equation (1) were used to estimate the abnormal accruals in the following equation:

\[ AAC_i = TA_i - \beta_0 - \beta_1(\Delta REV_i - \Delta REC_i) - \Delta_2(PPE_i) \]  

(2)

where,

- \( AAC = \) abnormal accruals,
- \( \Delta REC_i = \) receivables in year \( t \) less receivables in year \( t - 1 \), deflated by total assets at year \( t - 1 \).

The variable \( AAC \) from Equation (2) was then used in Equation (3) as a proxy for earnings management. A positive (negative) \( AAC \) in a certain year indicated that the company had income-increasing (income-decreasing) accruals during the period. The model to test the possibility of earnings management is stated as follows:

\[ AAC_i = \beta_0 + \beta_1IPO_i + \beta_2SIZE_i + \beta_3LEV_i + \beta_4AGE_i + \beta_5ROA_i + \beta_6LOSS_i + \beta_7GROWTH_i + e_i \]  

(3)

where,

- \( AAC = \) the residual obtained from the Modified Jones model,
- \( IPO = \) a dummy variable set to 1 if the financial report was from within the three years prior to the IPO year,
- \( SIZE = \) natural log of total assets,
- \( LEV = \) total liabilities divided by total assets,
- \( ROA = \) net income divided by average total assets,
- \( GROW = \) sales in year \( t \) less sales in year \( t - 1 \), divided by sales in year \( t - 1 \),
- \( LOSS = \) a dummy variable set to 1 when net income was negative, and 0 otherwise,
- \( e = \) error term.
In this regression model, following Wang (2006), I controlled for firm size (SIZE), leverage (LEV), profitability (ROA) sales growth (GROW), and negative income (LOSS).

4. Results

The descriptive statistics suggested that the median value of abnormal accruals was positive or income-increasing, consistent with many other studies on earnings management (Ahmad-Zaluki et al. 2011). The average size of the firms was around 900 billion rupiah (the natural log value of 13.710). The mean value of debt to assets ratio was 51.3% while the average ROA was 4.4%. Sales growth was on average 18.8%, while the proportion of the firm-years reporting losses during the sample periods was 19.3%.

Table 1. Descriptive Statistics of the Variables

<table>
<thead>
<tr>
<th>Variables</th>
<th>Mean</th>
<th>StdDev</th>
<th>Min</th>
<th>0.25</th>
<th>Median</th>
<th>0.75</th>
<th>Max</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAC</td>
<td>0.000</td>
<td>0.097</td>
<td>-0.330</td>
<td>-0.054</td>
<td>0.0011</td>
<td>0.0522</td>
<td>0.330</td>
</tr>
<tr>
<td>IPO</td>
<td>0.124</td>
<td>0.330</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>LEV</td>
<td>0.513</td>
<td>0.225</td>
<td>0.020</td>
<td>0.347</td>
<td>0.521</td>
<td>0.675</td>
<td>1</td>
</tr>
<tr>
<td>ROA</td>
<td>0.044</td>
<td>0.085</td>
<td>-0.260</td>
<td>0.005</td>
<td>0.035</td>
<td>0.084</td>
<td>0.380</td>
</tr>
<tr>
<td>GROW</td>
<td>0.188</td>
<td>0.337</td>
<td>-0.700</td>
<td>0.011</td>
<td>0.140</td>
<td>0.295</td>
<td>1.990</td>
</tr>
<tr>
<td>LOSS</td>
<td>0.193</td>
<td>0.395</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>1</td>
</tr>
</tbody>
</table>

Notes: Number of observations = 3,679, where AAC = abnormal accruals (signed residuals) obtained from the Modified Jones model, IPO = a dummy variable set to 1 if the firm is in its IPO year or the 3 years prior to its IPO, SIZE = natural log of total assets, LEV = total liabilities divided by total assets, ROA = net income divided by total assets, GROW = sales in year t less sales in year t-1, divided by sales in year t-1, LOSS = a dummy variable set to 1 if the net income is less than zero.

I tested H1 by using the absolute value of residuals from the Modified Jones model. Using the absolute value of residuals, earnings management in both directions (income-increasing and income-decreasing) was captured by the model. Our regression results in Table 2 support the hypothesis that the issuing firms managed their earnings during the IPO. The absolute abnormal accruals of IPO firms were significantly larger compared to those of (already) listed firms. The variable IPO was positive with a parameter value of 0.016 and was significant at 1% level (see Table 2, column a). Further, I analyzed the absolute abnormal accruals on a year-by-year basis to examine if there was a pattern of earnings management during the four-year period. Our analysis suggested that earnings management increased in intensity the closer it got to the IPO year and was most profound in the IPO year. Earnings management was most evident in the IPO year as shown in Table 2 column b (p-value < 0.001), and less strong in the year immediately before the IPO year as shown in column c (p-value 0.008). Earnings management was weaker in year t-2 (p-value 0.058) and it does not exist in year t-3 (p-value 0.923) as shown in Table 2 columns d and e, respectively. All control variables were statistically significant.

These findings supported H1 and suggested that issuing firms managed their earnings in the period prior to the IPO year, and that the intensity of earnings management was
systematically greater the closer it came to the IPO year. Table 2 shows that the significance of the variable IPO increases consistently from year to year. In year $t-3$, year $t-2$, year $t-1$, and year $t$, the $p$-values are 0.923, 0.058, 0.008, and 0.001, respectively. The results further show that issuing firms started managing their earnings in year $t-2$ or two years prior to the IPO year. Year $t-3$ becomes the only year (among the four years) where earnings management was not present, as shown by the insignificance of the variable IPO in the regression results.

Table 2. Results on the effect of IPO on Absolute Abnormal Accruals

<table>
<thead>
<tr>
<th>Variable</th>
<th>All IPO Years</th>
<th>Year $t$</th>
<th>Year $t-1$</th>
<th>Year $t-2$</th>
<th>Year $t-3$</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>a</strong></td>
<td>Beta</td>
<td>Sig.</td>
<td>Beta</td>
<td>Sig.</td>
<td>Beta</td>
</tr>
<tr>
<td>Constant</td>
<td>0.092</td>
<td>&lt;.001</td>
<td>0.09</td>
<td>&lt;.001</td>
<td>0.092</td>
</tr>
<tr>
<td>IPO</td>
<td>0.016</td>
<td>&lt;.001</td>
<td>0.023</td>
<td>&lt;.001</td>
<td>0.014</td>
</tr>
<tr>
<td>SIZE</td>
<td>-0.004</td>
<td>&lt;.001</td>
<td>-0.004</td>
<td>&lt;.001</td>
<td>-0.004</td>
</tr>
<tr>
<td>LEV</td>
<td>0.041</td>
<td>&lt;.001</td>
<td>0.043</td>
<td>&lt;.001</td>
<td>0.042</td>
</tr>
<tr>
<td>ROA</td>
<td>0.034</td>
<td>0.043</td>
<td>0.029</td>
<td>0.043</td>
<td>0.038</td>
</tr>
<tr>
<td>LOSS</td>
<td>0.014</td>
<td>&lt;.001</td>
<td>0.014</td>
<td>&lt;.001</td>
<td>0.014</td>
</tr>
<tr>
<td>GROW</td>
<td>0.017</td>
<td>&lt;.001</td>
<td>0.017</td>
<td>&lt;.001</td>
<td>0.017</td>
</tr>
</tbody>
</table>

$Adj-R^2$  5.2%  4.9%  4.7%  4.8%  4.3%

Note: $ABS_{AAC} = \beta_0 + \beta_1 IPO + \beta_2 SIZE + \beta_3 LEV + \beta_4 ROA + \beta_5 LOSS + \beta_6 GROWTH + e$.

The previous discussion shows the presence of earnings management during the IPO process, as indicated by the larger absolute abnormal accruals of the IPO firms vs. those of (already) listed firms. Existing studies provide mixed findings on the direction of earnings management. Some studies (e.g. Teoh et al. 1998) reported that firms used income increasing, while others (e.g. Ball and Shivakumar 2008) reported firms using income-decreasing accruals during the IPO process. I further examined if the earnings management among IPO firms in Indonesia was income-increasing or income-decreasing in nature. I use signed abnormal accruals (instead of the absolute value) to test the direction of the earnings management. A positive (negative) sign on the variable $IPO$ indicated that firms used income-increasing (income-decreasing) accruals.

Table 3 demonstrates that issuing firms had positive abnormal accruals during the four year period ending with the IPO year. In column a, the variable $IPO$ has a positive sign ($\hat{\alpha} = 0.026$ and $p$-value of <0.001), indicating that issuing firms generally had positive abnormal accruals compared to the firm-years of non-IPO periods. The $p$-values of the effect of the $IPO$ on abnormal accruals in year $t$, year $t-1$, year $t-2$, and year $t-3$ are <0.01, 0.010,
0.097, and 0.879, respectively. This is similar to the results in Table 2 where earnings management tends to be more profound the closer it gets to the IPO year. The results suggest that issuing firms start to use income-increasing accruals in year $t-2$, or two years prior to their IPO year. Table 3, column e suggests that in year $t-3$, issuing firms had not yet started to manage their earnings.

Overall, the results confirm our prediction in H2 that firms manage earnings upwardly using income-increasing accruals. While some studies such as Roosenboom (2003) found that earnings management exclusively occurs in the IPO year, I found that the use of income-increasing accruals occurred not only in the IPO year, but also in the two years prior to the IPO year.

Table 3. Results on the Effect of IPO on Signed Abnormal Accruals

| Model: $AAC_i = \beta_0 + \beta_1 IPO_{t} + \beta_2 SIZE_{t} + \beta_3 LEV_{t} + \beta_4 ROA_{t} + \beta_5 LOSS_{t} + \beta_6 GROWTH_{t} + \epsilon_i $ |
|-------|-------|-------|-------|-------|-------|-------|-------|
| Variable | All IPO Years | Year $t$ | Year $t-1$ | Year $t-2$ | Year $t-3$ |
| Beta | Sig. | Beta | Sig. | Beta | Sig. | Beta | Sig. | Beta | Sig. |
| Constant | 0.021 | 0.101 | 0.019 | 0.152 | 0.018 | 0.168 | 0.010 | 0.422 | 0.014 | 0.300 |
| IPO | 0.026 | <0.01 | 0.045 | <0.01 | 0.020 | 0.010 | 0.014 | 0.097 | 0.003 | 0.879 |
| SIZE | -0.001 | 0.440 | -0.001 | 0.409 | -0.001 | 0.436 | 0.001 | 0.768 | 0.001 | 0.768 |
| LEV | -0.044 | <0.01 | -0.043 | <0.01 | -0.044 | <0.01 | -0.042 | <0.01 | 0.042 | <0.01 |
| ROA | 0.096 | <0.01 | 0.114 | <0.01 | 0.110 | <0.01 | 0.122 | <0.01 | 0.123 | <0.01 |
| LOSS | -0.005 | 0.187 | -0.005 | 0.222 | -0.008 | 0.028 | -0.004 | 0.276 | -0.006 | 0.124 |
| GROW | -0.017 | 0.021 | -0.013 | 0.107 | -0.010 | 0.190 | -0.011 | 0.161 | -0.011 | 0.153 |

| Adj-$R^2$ | 7.3% | 8.1% | 7.3% | 7.2% | 7.3% |

Note: $AAC_i$ = signed abnormal accruals obtained from the Modified Jones model, $IPO = a$ dummy variable set to 1 if the firm is in its IPO year or the 3 years prior to it, $SIZE_i = \text{natural log of total assets}$, $LEV_i = \text{total liabilities divided by total assets}$, $ROA_i = \text{net income divided by total assets}$, $GROW = \text{sales in year } t \text{ less sales in year } t-1$, divided by sales in year $t-1$, $LOSS_i = \text{a dummy variable set to 1 if the net income is less than zero}$. The first regression (all IPO years) tests if earnings management exists during the four years leading to IPO year (including the IPO year or year $t$). Additional regressions test if earnings management exists in individual year from the IPO year (year $t$) to three lagged years before IPO (year $t-3$).

5. Conclusion, Implication and Limitation

This study examined if firms managed their earnings during the IPO process. IPOs are characterized by the presence of information asymmetry between the issuing firms and the investors. Firms have incentives to manage their earnings, either using income-increasing accruals to maximize the initial offering price, or income decreasing accruals to minimize the risk of litigation. I hypothesized that in Indonesia, where the risk of litigation is relatively low, IPO firms managed their earnings upward.

Based on our regression analysis, using absolute abnormal accruals, the results supported our hypothesis that firms managed their earnings during the IPO process. Using
signed abnormal accruals. I further found that earnings management tended to be income-increasing. Firms started managing their earnings two years prior to the IPO year, and earnings management became more profound the closer it came to the IPO year, with the most prevalent earnings management occurring during the IPO year.

Further studies could examine the firms' stock performance following their IPOs among Indonesian firms. Some studies (e.g. DuCharme et al. 2004) found that abnormal accruals in the IPO year were negatively correlated with post-IPO stock returns. When IPO earnings were "borrowed" from future earnings, it is likely that accruals will reverse in the post-IPO periods, reducing the financial performance post-IPO.

References


