



UNIVERSITI PUTRA MALAYSIA

**THE FORECAST ACCURACY OF SECOND BOARD IPOs
(1989 – 1994)**

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TESIS

**THE FORECAST ACCURACY OF SECOND BOARD IPOs
(1989-1994)**

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ABSTRACT

The reliability of the earnings forecasts has been a topic of criticism recently since some of the listed companies are found to have documented a large discrepency between the actual and forecast profits. This study intend to substantiate the previously documented evidence on the Initial Public Offerings forecast errors of the Main Board. The IPO for firms listed on the Second Board for the period 1989 to 1994. The companies under study covered a wide range of sectors such as Industrial, Consumer, Construction, Trading/Service and Finance.

The forecast accuracy is measured by forecast errors, absolute forecast errors and squared forecast error. The level of forecast accuracy appears to be better for the Second Board listed companies compared to that of Main Board IPOs. The accuracy levels are closed to the developed markets such as United Kingdom, United States and Australia.

A multiple regression model was needed to explain the variation in the absolute forecast errors (the dependent variable) with firms characteristics as independent variables. The only variable that showed significant relationship with absolute forecast errors was forecast interval that is the time between the prospectus issued date and the year end of the forecast pertain. Other variables, such as Auditor Choice, Age Size Financial Leverage, Industry sectors were not significant. In general, the findings are consistent with that reported for the Main Board IPOs (Shamser et. Al. 1994) and inconsistent with those reported in developed markets.

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CHAPTER ONE



CHAPTER ONE

1.1 INTRODUCTION

The KLSE put up a remarkable performance in 1996 placing itself among the region's best performers with 24 percent annual gain. The market's barometer, the KLSE Composite Index (KLCI) put up a reasonably good performance in 1996, improved by over 20 percent, exceeding the average annual increase of 15 percent from 1990 onwards. The KLSE saw a record with 92 new listing in 1996, with 40 listed on the main board and 52 on the second board.

In the blooming financial market, many companies went for public listing on the Kuala Lumpur Stock Exchange to obtain funds for future expansion, modernisation and future growth. To be listed on the KLSE, the companies had to comply with the listing requirement of KLSE and the provisions of the Companies Act, 1965. Other than that, the company should have a good track record and should have made reasonable profits with prospects of continued earnings.

The company need to understand and consider certain issues prior to float and listing of a company shares. The assessment on the company strength in relation to the listing potential such as shareholding and financial structures, track record, etc. The next section discusses the listing criteria on KLSE.

1.2 LISTING PROCEDURE

A) PRE-LISTING

The company should consider the following criteria before the flotation and listing of a company's share.

- Timing

One prerequisite for a public listing is that a company should have a good track record of reasonable profits with prospects of continued good earnings. The earnings must be sufficient to justify a price earnings (P/E) multiple within the limits set by the Security Commission (SC) and a share offer price that is attractive enough to the offerors of the shares since some listing of companies are by way of an offer for sale method.

- Capitalisation

The price of the shares, the P/E multiple, and the earnings per share (EPS) are determined not only by a company's pre-tax profits but also by the size of its issued capital. The more the shares are issued, the higher will be the P/E multiple and lower the EPS, and vice versa. A valuation of a company's properties may show a surplus over the balance sheet value. Moreover, to make the company's share more marketable at the offer price a further right issues to the existing shareholders before the flotation will be necessary, which will lower the offer price per share.

- The proportion of shares to be sold

For a Second Board Listing, the minimum proportion of a company's share that has to be offered for sale to the public is 25%. In addition, 30% of the equity has to be offered to Bumiputera investors or approved Bumiputera institutions (by MITI). The Bumiputera shareholdings can either be restructured at the point of making offer for sale to the public, or prior to the offer.

- Restructuring

In order not to burden the public with additional risk in investing in the company, a certain potentially profitable subsidiary which is still in the start up situation may need to be restructured and stay out of the company to be listed.

- Denomination Of Shares

As RM1 shares are considered to be norm in Malaysia, it was necessary to change the nominal value of companies shares by way of a share split before the flotation exercise if the nominal value of the company's share is more than RM1.

B) LISTING PROCESS

There are three modes of issue of shares to the public i.e. prospectus issue to the public, offer for sale and tender issue. A flotation exercise is a complex task which simultaneously involves the management, directors and existing shareholders; the merchant bankers, lawyers, issuing house, valuers, and auditors; and the relevant

authorities –FIC,SC, ROC, MITI, and the KLSE. Each will play a part in their respective approval.

Under section 6, Security Industry Act 1983, the company must submit its application to the CIC. The company also need to submits its Memorandum and Articles of Association for KLSE's approval and files initial listing application and supporting papers with KLSE. The average time for approval is estimated to be 16-24 weeks. Upon approval from CIC and KLSE, the company registers its prospectus with the Registrar of Companies (ROC). Then the company will advertise and issue the prospectus to the public within the offer periods. If the shares are over subscribed by the public, balloting should provide for as wide a spread of shareholders as possible. The company then announces basis for allotment and issues shares pursuant to the allotment.

The role of professional advisers involved in the first listing :

1. Management Consultant

- To recommend and map out the listing strategies for the company.
- Advising on the management structure
- Coordinating and liaising with various professional advisers on listing
- Assisting clients in collating all information required for submission to the relevant authorities.

2. Merchant Bankers

- Underwriting of shares
- Dealing with the KLSE, SC and other relevant authorities
- Submission to Security Commission (SC)

3. Accountants and Auditors

- Preparing Accountants' Report for inclusion in the prospectus
- Auditor's letter on the profit forecast of the company
- Long form Accountants' Report for inclusion in the submission document

4. Tax Advisers

- Tax planning with the objective of reducing tax bills
- Advising client on tax implication on the followings issues :
 - i) Dividends
 - ii) Profit & Loss from sale of securities
 - iii) Corporate reconstruction

5. Legal Advisers

- To ensure necessary documentation and legal agreements are in order
- Review the prospectus to confirm that the contents of the prospectus are factually correct

6. Other Advisers

- Valuers
- Public relation

The regulatory authorities in the approval of the public listing are:

1. FIC (Foreign Investment Committee)

- Look into the compliance of the equity structure of a public listing company i.e. minimum 30% for Bumiputera and 25% public.

2. MITI (Ministry of International Trade and Industry)

- Approval concerned with the allocation of shares to employees under the pink form.

3. ROC (Registrar of Companies)

- The company seeking public listed in KLSE must registered with the ROC.
- The prospectus issues to the public must registered with ROC

4. SC (Security Commission)

The SC was established on 1 March 1993 under Securities Commission Act, 1993. Its establishment marked a significant milestone in the development of Malaysia's securities industry. The SC was formed to removed the problems of fragmented regulation of the capital market resulted by the rapid development of the capital market. The application of public listing will be prepared and submitted to the SC by the merchant bank based on the information provided by

the issuer. The policies and guidelines for admission of securities to listing admission is issued and reviewed by the SC. The main thrust of the main set of guidelines and policies in relation to the public offer are the requirement for the issuer of the securities to determine the share price.

5. KLSE (Kuala Lumpur Stock Exchange)

The KLSE was set up as an exchange of its own in July 1973 following the split of the Stock Exchange of Malaysia and Singapore into two exchanges namely the KLSE and the Stock Exchange of Singapore (SES). Before a company is listed on the KLSE, it must submit its application to Capital Issues Committee. Then, the company must submit Memorandum and Articles of Association of company to the KLSE for approval. The company also need to files initial listing application and supporting paper with KLSE.

(C) LISTING CRITERIA

The following are the admission criteria to listed in KLSE:

1. Main Board
 - a) Minimum issued and paid up capital of RM40 million, with no maximum specified.
 - b) A track record of 5 years except for privatised or Government-owned entities where a short track record could be considered by the Security Commission (SC).

- c) Should have achieved a minimum after-tax profit of not less than RM5 million per annum.
- d) Should have achieved a minimum after tax profit of RM2 million per annum for the past 5 years.
- e) Forecast before tax profit should be at least RM5 million.
- f) At least 25% of the issued and paid up capital in the hands of public, provided that at least a minimum percentage or a minimum amount (whichever is the greater) of the issued and paid-up capital is held by not less than 500 shareholders holding not less than 500 shares each.
- g) To advertise and issued a prospectus comply with the requirements of the Company Act 1965.

2. Second Board

- a) Minimum Issued and paid-up capital of RM10 million and maximum of RM40 million.
- b) Should have a track record of 3 years.
- c) Should have achieved an average profit after tax of RM2 million per annum.
- d) Should have achieved a minimum profit after tax of RM1 million per annum.
- e) Forecast year's profit after tax of RM2.5 million.
- f) At least 25% but not more than 50% of the issued and paid-up capital must be in the hands of the public. Regardless of the size of paid-up capital, at least 15% of the issued and paid-up capital must be in the hands of 500 shareholders holding 500 to 10,000 shares each.

- g) No requirement to advertise the full prospectus. Only summary of the relevant details is required to be advertised.

1.3 INITIAL PUBLIC OFFERS

Based on the requirement of Part 7, the Company Act 1965, the company seek for listed on the Kuala Lumpur Stock Exchange is required to issue a prospectus to the public. Under this method, new shares are being issued to the public at the offer price (IPO), with the full sum of the offer price going into the company's account. The prospectus must contained all the information required by the Stock Exchange so that the investing public can make an informed decision when subscribing for the company's share. Investors subscribing to the new issues should understand the content of the prospectus.

There are two types of IPOs. First, the sales of new shares to the public by the issuer for the raising new funds. Second, the offer for sales, where a sale of previously issued shares by their owners, rather than issuers. The funds were received by the original investors. Private placements of shares are permitted in limited cases, and account for about 5-10 percent of the funds raised in the stock exchange.

The underwriters believe that investors will be more inclined to have a stronger confidence in an issuer if there is a profit forecasts available. Analysis can be done

to determine the potential profitability of the entity. Hence it is the fundamental for the evaluation process of the Initial Public Offer (IPOs) by the investors.

1.4 OBJECTIVE OF THE STUDY

Earnings forecasts of the issuing companies have become a topic of criticism recently since some of the listed companies are found to have a wide gap between their actual earnings and what have been forecasted in their respective prospectus. The regulatory authorities approve new issue with care, and it takes about 4-6 months for the approval process. The potential for the higher risk of price changes relative to the offer prices makes it interesting to study IPOs in developing markets.

When a company's management decides to raise external capital to finance an investment project, they have the access to the information as to the project's future returns than other potential investors. Without the transfer of the information to the investors, the market mechanism will fail and the investors will discount the potential profitability of the investment project.

This study intend to substantiate the previously documented findings on the IPO forecast error. (Dr Shamser Mohamad (UPM), Dr Annuar Md Nassir (UPM), Mr Tan Kung Kuing (MASB) and Dr Mohamed Ariff (NUS), 1994)

The objectives of the studies are:

1. Investigates the predictive accuracy of profit forecasts made by Malaysian IPOs (listed on the KLSE in the period 1989 – 1994 for Second Board) in their prospectuses.
2. To investigate the forecast errors based on different industrial categories.
3. Assesses the degree of professionalism of accounting firms responsible for certifying such forecasts.
4. To determine the possible factors that influence the accuracy of the forecast profit.

CHAPTER TWO



CHAPTER TWO

2.1 LITERATURE REVIEW

The reliability of the Initial Public offer forecast error has been an area of frequent research. The investors are unable to observe a consensus market price if the forecast is not reliable. When the management decides to raise external capital to finance an investment project, they are more likely to have monopolistic access to information as to project's future returns and other potential investors. Information asymmetry exists between the sellers and the buyers will lead to failure in the market mechanism.

The investors rely on the accounting figures to evaluate the subscription price asked by the issuer is warranted. Therefore, the forecast accuracy is important concern for the investors. In United States and United Kingdom, the usefulness of the profit forecasts provide by the management in the prospectuses is a regulatory concern.

Most of the studies have shown the reliability achieved was not encouraging. In UK, Devv & Webb (1972) have found that the forecast errors is ranging from negative 50% to positive 100%. Meanwhile, Firth & Smith (1992) has studied on the New Zealand new issues and the errors ranges from negative 500% to above positive 500%.

Jaggi and Sannella (1996) examines whether there is association between discretionary accounting changes and the accuracy of management earnings forecasts. The findings suggests that the managers will release a forecast on a voluntary basis only they are able and willing to “control” reported earnings through discretionary accounting changes. These result thus support Brown’s (1988) argument that the release of a management forecast reflects the self-selection bias of the forecaster, and that the forecaster has the ability to control events that impact reported earnings and affect the magnitude of the forecast error.

Ferris (1976) undertaken an investigation to generate empirical evidence on the apparent effects on managerial behavior in the forecast-disclosing firms. The results showed that the managers act as if they under-estimate the published prospectus forecast. 24.7% of the companies reported results within a zone of acceptable values around the forecast and only 7 companies reported results within the zone because they had apparently utilised accounting adjustments for that purpose. Therefore, the managerial behavior that can be deduced from the findings are the management may utilise internal discretionary actions to ensure achievement, but they do not accounting adjustments.

Richard (1976) carry out study on the accuracy of the analysts’ forecast and to identify differences in forecasting ability among analysts. Five analysts were identified who made forecasts for a common sample of 93 firms. The forecasts of 1972 earnings were made during the period from December 1971 through February 1972 in New York.

The various tests has carried out, however, do suggest that differences among the forecasts of various analysts are not significant. The ANOVA showed that the accuracy of the forecasts studied was a function of industry and firm but that the analyst making the forecast made no significant difference.

The recent study by Vivek Mande (1996), compared the US and Japanese Analysts' forecast earnings and sales. This study finds that Japanese analysts provide superior forecasts of sales when compared to their US counterparts. Their relative superiority could not be attributed to any timing advantage with regard to forecasting. Instead, the results suggest that Japanese analysts have an informational advantage over their US counterparts. Selected proxies for the information environment were used to explain the Japanese analysts forecasts superiority over his/her US counterpart. Specifically, they showed that as the number of lines of business and domestic affiliates (firm size) increased, the relative sales forecast accuracy of the Japanese analysts also increased. The percentage of foreign ownership was strongly related only to relative earnings forecasts accuracy; as the outside ownership increased, the relative advantage of the Japanese analyst decreased. The results also suggested that investors interested in foreign stocks may be informationally disadvantage if they do not familiarise themselves with capital market norms and culture of the foreign country. Related research by Brown, Hagerman, Griffin and Zmijewski (1987) suggests that superior forecasts result from a timing advantage (i.e. analysts with recent forecasts are likely to forecasts more

accurately) and an informational advantage (i.e. analysts with access to superior information sets are likely to forecast more accurately) with regard to forecasting.

Imhoff & Pare (1982) extends previous empirical work on the comparative accuracy of all three forecasting sources i.e. security analysts, corporate management, and naïve forecast models by using a single sample of firms. All of the forecast agents are evaluated using both previously applied error metrics, and alternative error metrics which seem superior relative to those used in prior studies. The results using the relative error metrics confirm that no significant differences between forecasts agents. If the information is symmetrical and is acquired and process efficiently, then no differences between the non-deterministic forecast sources would be expected and no meaningful differences between their information sets would be observed.

Harford (1969) comment that the profit forecast would appear to be important in fixing the issue price. It is assumed that the IPO is correctly priced, with the given forecast profit, then the initial listing price would be expected to be close to the issue price. Unfortunately, the IPO underpricing in the short run is normally observed. In Malaysia, extensive research has been carried out on the underpricing of the IPO. Shamsher, Annuar & Ariff (1994) documented that new issues in United Kingdom, Australia, United States and other developed markets, Malaysia and Singapore and others developing markets are substantially underpriced because offer prices appear to be a deep discount of the initial listing day market prices. The short run underpricing of 135 percent

in Malaysia is 7.5 times the normal secondary market return of 18 percent (Ratio for Singapore = 2.6). Ariff and Chung (1993) work out an average ratio of 1.6 for the developed markets.

Beatty (1989) relates the initial public offering pricing with the auditor reputation. He hypothesised that an inverse relation exists between the reputation of the auditor of an initial public offering and the initial return earned by an investor. Specifically, clients that hire more reputable CPA firms should exhibit lower initial returns than clients that choose to hire CPA firms with less reputation capital at stake. Two proxies for auditor reputation are used to test this hypothesis. The first reputation proxy uses indicator variables for auditor size. Results indicate that widely used Big-Eight/non-Big Eight classification may measure CPA firm reputation capital with error particularly for the smaller Big Eight and larger non-Big Eight firms. A second reputation proxy is developed by regression compensation paid to the auditing firms on measures of marginal cost of performing the audit. Results indicate that clients that pay a premium for their registration audit exhibit lower initial returns for their investors. Thus, the results of both tests provide support for the hypothesised inverse relation between reputation and initial public offering initial return.

Collins & Hopwood (1980) study the extents past research by providing a comparison of the relative accuracy of annual earnings forecasts generated from the quarterly forecasts of financial analysts and the four univariate time-series models