



UNIVERSITI PUTRA MALAYSIA

**FORECAST ERRORS AND THE EFFECT OF UNDERWRITER
REPUTATION AND AUDITOR INFLUENCE DURING LISTING ON
IPOs**

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By

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NOVEMBER 2003

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The engagement of reputable underwriter and auditor by the listing firm is believed to provide a positive signal to the market, thus reducing the uncertainty surrounding the firm's value. Since audit quality is differentiated, some of the issuing firms switch to more reputable auditors during listing to increase the credibility of the financial information in the prospectus. The disclosure of earnings forecast in the prospectus is also perceived to provide information that could reduce the uncertainty. However, evidence from previous studies on these issues is inconclusive.

This study investigates the effect of underwriter reputation, auditor choice and auditor switch during listing and earning forecast error on the level of IPOs initial returns. Thus, the main objective is to examine whether these factors provide a signal to potential investors in IPOs that might have consequences on the level of initial return. This study also examines the relationship between the engagement of quality differentiated audit firms and level of earning forecast errors.

This study uses a sample of 100 KLSE Main Board IPOs and 100 KLSE Second Board IPOs for the period of 1990-2000. It was found that Malaysian IPOs were significantly underpriced at 89.19%. Findings on underwriters and auditors showed that most of the firms going public prefer to engage the services of reputable underwriters and Tier 1 auditors during listing. The evidence suggests that the initial returns of firms engaging reputable underwriters are higher compared to non-reputable underwriters, however the difference is not statistically significant.

The engagement of reputable audit firms was also found to have no significant effect on the initial returns of IPOs. Nonetheless, the management's decision to switch auditor during listing documented a significant positive relationship between auditor switch and IPOs' initial returns. Thus switching could be served as a signal for the firm's value. However the findings are inconsistent with theory. When the sample on auditor switch is classified into two sub-samples of different switch directions, it was found that there was no significant difference in the initial returns between firms with upward and lateral switch.

For the sample firms, high negative forecast errors of 14.96% were observed. About 59% of the IPOs' firms overforecasted their earnings. The finding reveals no significant relationship between earning forecast errors and IPO initial returns. There was no significant relationship between reputable auditors and earning forecast errors. However listing board characteristics and economic conditions had a significant impact on the initial returns of IPOs.

Abstrak tesis yang dikemukakan kepada Senat Universiti Putra Malaysia sebagai memenuhi keperluan untuk ijazah Master Sains

**KESILAPAN RAMALAN DAN KESAN REPUTASI PENAJA JAMIN DAN
PENGARUH JURUAUDIT SEMASA PENYENARAIAAN KE ATAS
TERBITAN AWAM**

Oleh

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Pengambilan penaja jamin dan juruaudit yang mempunyai reputasi yang baik oleh firma yang akan disenaraikan dipercayai memberikan isyarat yang positif ke atas pasaran, seterusnya mengurangkan ketidaktentuan persekitaran nilai firma. Oleh kerana kualiti juruaudit dibezakan, sesetengah firma penerbit bertukar kepada juruaudit yang mempunyai reputasi yang lebih baik semasa penyenaraian bagi meningkatkan kredibiliti maklumat kewangan di dalam prospektus. Pendedahan ramalan perolehan di dalam prospektus juga dilihat sebagai imformasi yang boleh mengurangkan ketidaktentuan. Walaubagaimanapun, bukti dari kajian-kajian lepas dalam isu-isu ini adalah tidak konklusif.

Kajian ini menyiasat kesan reputasi penaja jamin, pemilihan dan penukaran juruaudit semasa penyenaraian dan kesilapan ramalan perolehan ke atas pulangan awal saham terbitan awam. Oleh itu objektif utama adalah untuk mengkaji samada faktor-faktor ini memberikan isyarat kepada pelabur-pelabur yang berpotensi dalam terbitan awam yang mungkin memberikan kesan ke atas pulangan awal. Kajian ini

juga mengkaji perhubungan di antara kualiti juruaudit dan paras kesilapan ramalan perolehan.

Kajian ini menggunakan sampel sebanyak 100 terbitan awam di Papan Utama dan 100 terbitan awam di Papan Kedua Bursa Saham Kuala Lumpur (BSKL) untuk tahun 1990-2000. Kajian menunjukkan saham-saham terbitan baru Malaysia ditawarkan secara signifikan di bawah paras harga sebenar sebanyak 89.19%. Kajian ke atas penaja jamin dan juruaudit menunjukkan kebanyakan firma yang akan disenaraikan cenderung menggunakan perkhidmatan penaja jamin yang mempunyai reputasi yang baik dan juruaudit Tier-1 semasa penyenaraian. Bukti menunjukkan bahawa pulangan awal firma-firma yang menggunakan perkhidmatan penaja jamin yang mempunyai reputasi yang baik adalah lebih tinggi berbanding penaja jamin yang mempunyai reputasi yang kurang. Walaubagaimanapun, perbezaan tersebut secara statistik tidaklah signifikan.

Penggunaan juruaudit yang mempunyai reputasi yang baik juga didapati tidak memberikan kesan signifikan ke atas pulangan awal terbitan awam. Namun begitu, keputusan pihak pengurusan untuk menukar juruaudit semasa penyenaraian menunjukkan perhubungan signifikan yang positif antara penukaran juruaudit dan pulangan awal terbitan saham. Oleh itu, penukaran juruaudit boleh dianggap sebagai isyarat nilai firma. Walaubagaimanapun, dapatan adalah tidak konsisten dengan teori. Apabila sampel juruaudit dikelaskan kepada dua arah penukaran yang berbeza, didapati tiada perbezaan yang signifikan dalam pulangan awal antara firma-firma penukaran keatas dan penukaran selari.

Bagi sampel firma, kesilapan ramalan perolehan negatif yang tinggi sebanyak 14.96% diperhatikan. Lebih kurang 59% daripada firma terbitan awam terlebih ramal perolehan mereka. Kajian mendedahkan tidak wujud perhubungan signifikan antara kesilapan ramalan perolehan dan pulangan awal terbitan awam. Kajian juga mendapati tiada perhubungan yang signifikan di antara juruaudit yang mempunyai reputasi yang baik dan kesilapan ramalan perolehan. Namun begitu, ciri-ciri papan penyenaian dan keadaan ekonomi memberikan kesan ke atas pulangan awal terbitan awam.

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LIST OF ABBREVIATIONS

CIC	Capital Issue Committee
FIC	Foreign Investment Committee
IPO	Initial Public Offering
KLSE	Kuala Lumpur Stock Exchange
MESDAQ	Malaysian of Securities Dealing and Automated Quotation
MITI	Ministry of International Trade and Industry
SC	Securities Commission

CHAPTER 1

INTRODUCTION

1.1 Introduction

Initial Public Offering or IPO is a new issue of shares, which is the sale of ordinary shares for the first time by a closely held company. In Malaysia, IPO is used by most companies as a means to raise the much needed funds and to be listed on the Kuala Lumpur Stock Exchange. IPO provides investors with opportunities either to purchase shares before they are publicly traded or to buy them in the open market when they do begin to trade.

There has been voluminous of studies on IPOs conducted since 1970s, due to underpricing phenomenon that has been persistently observed. A number of studies conducted both in developed and emerging markets show the existence of initial underpricing (Ibbotson, 1975; Aggrawal and Rivoli, 1990; Lee *et al.*, 1996; Kyimyaz, 2000).¹ Malaysian based studies on IPOs reported a large underpricing of 166% during 1978-1983 (Dawson, 1987) and 135% for the period of 1975-1990 (Shamsher *et al.*, 1994).² Due to such developments, Malaysian IPOs continuously receive overwhelming attention among academics, practitioners and researchers for a possible explanation for this phenomenon.

¹ Ibbotson, Aggrawal and Rivoli studied US IPO, Lee *et al.* studied Singapore IPOs while Kimyaz studied Turkey IPOs.

² Compared to Singapore (39.4%) and Hong Kong (13.8%), Dawson found that Malaysia had the most extreme cases of underpricing.

Regulations in Malaysia do not permit any documents of invitation to be released to investors before the application is approved. Public investors normally rely on the information contained in the prospectus, an introductory document before the issue. The prospectus normally contains information on the assets, historical profitability, economic prospects, investment plans, and earning and dividend forecasts of the issuing firm. Due to the uncertainty surrounding the firm's value, the management of the issuing firm normally tries to increase the credibility of the information conveyed through agent reputation and by disclosing information that can signal the firm's value.

The reputational standings of a firm's underwriter and auditor are potential signaling devices that convey the credibility of the issue. An issuing firm that engages the services of a reputable underwriter and auditor during listing is hypothesised as a high value firm, therefore reducing the uncertainty of the value of the firm. The audited report on the firm's current financial status is an important element in a prospectus. The fact that firms often change auditors at the time they go public provide evidence to support this contention. Meanwhile, earning forecast provided in the prospectus is also being argued as a potential signal for a firm's value. The investors may tend to interpret the absence of a profit forecast in the prospectus of new issues as a bad signal.

Financial theories suggest that the reputation of underwriter, auditor choice and auditor switch during listing, and earning forecast errors reflect on the level of initial

returns of IPOs. Empirical evidence on these factors provides inconclusive evidences, which in turn, provide opportunities for further research into the issues.

1.2 Malaysian IPO Market and the Process of Listing

The process of Initial Public Offering is currently regulated by the Securities Commission (SC), established in March 1993. Previously, the listing process was handled by the Capital Issue Committee (CIC), the Ministry of International Trade and Industry (MITI) and the Foreign Investment Committee (FIC). The SC has taken over these functions, thus reducing the time taken to obtain approval for listing. However, in some cases the application may also need to be submitted to MITI and FIC to obtain official clearance.

There are two trading sections on the KLSE, the Main Board and the Second Board. Listing requirements on these two boards differ slightly, being less stringent for the Second Board. The Second Board was launched on November 1988 to facilitate the raising of external capital by smaller companies with good growth potentials. As shown in Table 1, up until December 2002, the total number of listed companies was 846, of which 562 companies were listed on the Main Board and the remaining were listed on the Second Board. Due to the rapid economic growth during the 1990s, many Malaysian private companies went public. The years 1996 and 1997 showed the highest number of new listings with 92 and 88 companies respectively. However, the Asian financial crisis, which started in mid-1997, resulted in a decline of the number of new listings.

Table 1.1 - Number of New Listing

Number of New Listing 1992-2002			
Year	Main Board	Second Board	Total
2002	22	22	44
2001	6	14	20
2000	12	26	38
1999	10	11	21
1998	6	22	30
1997	25	63	88
1996	40	52	92
1995	18	33	51
1994	19	47	66
1993	12	32	44
1992	25	20	45

Source: KLSE Listing Statistic (2002)

Besides the Main Board and Second Board, the MESDAQ market was created on March 18, 2002 following the merger of the Malaysian of Securities Dealing and Automated Quotation (MESDAQ) Berhad with the Kuala Lumpur Stock Exchange (KLSE). It operates as a unique market with a separate identity from the KLSE Main Board and Second Board, capturing specifically the capital raising needs of technology and high-growth potential companies. Up until the end of December 2002, the number of new listings in the MESDAQ market was seven.

Once the decision on the amount of capital and types of shares to be raised are made and approved by the board of directors, a firm needs to hire an adviser, normally a merchant bank who acts as an underwriter for the issue. This is a statutory requirement directed by the Securities Commission. The underwriter will assist the company that goes public in pricing the offering, writing the prospectus and

marketing the stock. Currently, there are twelve merchant banks involved in the IPOs process as shown in Table 2.

Table 1.2 - Merchant Banks in Malaysia

Name of Banks	Year of Commencement of Business in Malaysia	Total assets at the end of Financial Year 1998/99 (RM Million)
1. Amanah Merchant Bank Berhad	1975	1,890.4
2. Arab Malaysian Merchant Bank Berhad	1976	14,823.2
3. Aseambankers Malaysia Berhad	1973	3,724.5
4. BSN Merchant Bank Berhad (formerly known as Rakyat MB)	1974	629.3
5. Bumiputra Merchant Bankers Berhad	1972	1,806.3
6. Commerce International Merchant Bankers Berhad	1974	3,478.8
7. Malaysian International Merchant Bankers Berhad	1974	2,256.6
8. Perwira Affin Merchant Bank Berhad (formerly known as Permata MB)	1970	3,849.0
9. Perdana Merchant Bankers Berhad (formerly known as Intradagang MB)	1975	653.6
10. Sime Merchant Bankers Berhad (formerly known as Asian Int. Merchant Bankers Berhad)	1973	858.1
11. RHBSakura Merchant Bankers Berhad (formerly known as D&C Sakura MB)	1974	4,406.5
12. Utama Merchant Bank Berhad (formerly known as Utama Wardley Berhad)	1975	1,440.5

Source: The Central Bank and the Financial System in Malaysia 1989-1999, Bank Negara Malaysia (1999)

Once the price of the issue is agreed on, the issuing firm through its adviser submits the application to the Ministry of International Trade and Industry (MITI) and the Foreign Investment Committee (FIC) for approval. The approved application is then

submitted to the Securities Commission (SC) for examination and approval before the conclusion of the underwriting agreement and the announcement of the offer price.

Methods of underwriting in Malaysia are generally based on firm commitment. In an underwriting agreement between the firm and the investment banker, the banker underwrites the entire issue of shares and then sells them to the general public. The underwriter bears all the risks in underwriting the IPO. The underwriter's profit is from the difference between the cost of issuing the securities and the price of offering to public. This profit is known as the underwriting spread. Book building, which is practiced in some countries, is not allowed in Malaysia. Pre-market surveys whereby the underwriter can test the market or fine-tune the offer price, which are applicable in a developed market are also not allowed here. The offer price and the number of shares to be issued must be clearly stated in the prospectus and no changes can be made. The content and form of the prospectus should be according to the Companies Act 1965 and KLSE Listing Requirements. Part 8.13, Section 8.24 of the Listing Requirements states that the firm has to provide a profit estimate or profit forecast, the principal basis of the assumptions for the year subsequent to the registration date of the prospectus. It is noted that part II of the Fifth Schedule of the Companies Act specifies that the auditor gives an opinion on the compilation of the specific forecast and the accounting policies used.

Due to the potential risk it is exposed to in underwriting the IPO, the investment banker typically does not handle the purchase and distribution of issues by itself. It usually forms an underwriting syndicate by which a group of investment bankers underwrite the issue. The underwriting group appoints a managing underwriter or lead underwriter who also acts as the originating investment banker and prepares all the necessary registration documentation for the regulatory authorities, and to oversee the underwriting exercise to protect themselves from possible risks.

Companies have different reasons for seeking a listing on the KLSE. The primary reason is to raise capital since it is considered as an efficient and cost effective way to raise funds for the expansion of business operations and as an alternative to borrowing. Some other reasons for getting listed are for obtaining a higher profile, increasing investors' confidence, and increasing potential to raise additional funds and recognition for expansion, as there is more publicity on their activities.

1.3 Methods of Listing

A public company seeking listing of a quotation for its securities must be an ongoing concern or a successor of an ongoing concern. Normally, there are four methods of listing. The first is 'Public Issue', which is an offer to the public for subscription or purchase by, or on behalf of an issuer of its own securities. The second method for listing is 'Offer for Sale'. 'Offer for Sale' is an offer for the public on behalf of the holder or allottees of securities that are already issued and subjected to be subscribed.

The third method that can be applied for listing is 'Placement'. 'Placement' refers to the obtaining of subscription for the sale of securities by an issuer primarily from or to person(s) selected or approved by the issuer. 'Placement' is normally made to dispose securities before the commencement of dealing in order to comply with the requirement that a minimum prescribed size of listed securities must be held by the public. The fourth method for listing is called 'Tender'. A 'Tender' is an offer of a portion of the securities by way of tender, subject to a minimum price being described.

When a company plans to be listed on the Exchange, the method of offering should consider the needs of capital for the company. Generally, a public issue of new securities is preferred, as it would benefit the company financially.

1.4 Listing Requirements

For a company to apply for listing on the Kuala Lumpur Stock Exchange, there are some quantitative requirements that the applicants should fully comply with, which are as follows:

1. Issued and Paid-up Capital

- For listing on the Main Board – A minimum issued and paid-up capital of RM60 million, comprising of ordinary shares of not less than RM1.00 each.
- For listing on the Second Board - A minimum paid up capital of RM40 million, comprising of ordinary shares of not less than RM1.00 each.

2. Shareholding Spread

For the Main Board and the Second Board, the shareholding spread requirements are the same.

- a. An applicant must have at least 25% of its issued and paid-up capital in the hands of a minimum number of public shareholders holding not less than 1,000 shares each, which are as follows:

Table 1.3 - Public Spread Before Amendments

Nominal value of issued and paid-up capital	Minimum number of shareholders
RM40 million to less than RM60 million	750
RM60 million to less than RM100 million	1000
RM100 million and above	1250

Source: Listing Requirement on KLSE Handbook (1997)

- b. The employees of an applicant, its subsidiaries and holding company are not excluded from the minimum number of public shareholders.
- c. An applicant must ensure that at least 500 shareholders, if its issued and paid-up capital is less than RM60 million, or at least 750 shareholders, if its issued and paid-up capital is RM60 million or more, are public shareholders who are not employees of the applicant, its subsidiaries or holding company.