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Earnings Management and IPOs – Evidence from Finland

Several studies have documented the presence of earnings management in initial public offering (IPO) firms. Research results show variation in the magnitude of firms' earnings management ranging from very aggressive to no earnings management at all. Also in the public discussion, some IPO firms are treated with more suspicion than others. The main task of this paper is to examine whether the ownership type of IPO firms is associated with their propensity for earnings management behaviour.

This paper specifically argues that there is a connection between high individual ownership and earnings management, which in turn may lead to weak performance after the IPO. Entrepreneurs are assumed to have more incentives to manage earnings than the institutional owners because they have more to gain and less to lose from this activity. Furthermore, it is hypothesized that entrepreneurs' incentives for earnings management should increase the more their ownership is reduced in the IPO.

Empirical tests are conducted on a sample of 56 firms that went public on the Helsinki Stock Exchange between the beginning of 1994 and the end of 2000. Following the previous research, evidence of earnings management is

sought by observing accruals. Accruals are calculated as the differences in working capital both with and without the depreciation accrual. In addition to the total sample, accruals are examined separately for the 22 entrepreneur firms and the 34 institutionally held firms. The main results are based on discretionary accruals estimated with the modified DeAngelo model and are examined for five periods surrounding the IPO year.

The results show only limited evidence of earnings management in the total sample. Separate analysis of the entrepreneur and institutionally owned firms demonstrates that earnings management is limited to the sub-group of the entrepreneur firms. Earnings management appears not to be connected to how much owners reduce their ownership in the IPO. The noted difference in earnings management behaviour between entrepreneur and institutionally owned IPO firms should be of value in assessing the reliability of the IPO firms' financial statements. ■