Institutional Investors’ Response to Earnings Management Before Initial Public Offering in Poland

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Abstract
The aim of the paper is to analyse the association between the use of accrual-based and real earnings management practices before the company goes public and the decision of institutional investors on buying or refraining from buying shares offered in initial public offering (IPO). The sample consists of 258 Polish new stock companies over the period 2005-2020. We find that such companies refrain from massive earnings management in the pre-IPO period: both real and accrual-based. However, we find evidence that the presence of institutional investors in the IPO is related to earnings inflation (selling, general and administrative expenses). Our study contributes to the debate on the role of institutional ownership in the IPO process in Central and Eastern Europe.

Keywords: Institutional investors, earnings management, initial public offering, IPO
JEL Classification: G23, G32, M41

Introduction
In the initial public offering (IPO) process, there is an information asymmetry between existing shareholders and potential investors. Financial reporting is perceived as a way to reduce information asymmetry and agency problems. Financial information is a signal to the stock market...
on a company’s financial standing and its prospects (Ritter and Welch, 2002). However, IPO companies may manage the financial information included in financial statements. Possible incentives for earnings management during the IPO process focus on affecting investor behaviour and equity issuing price. The motive for IPO firms’ earnings management is to inflate the IPO price, benefiting insiders (company/shareholders) at the cost of IPO subscribers. Managers of IPO companies can deliberately report high earnings to raise additional capital for the company (Armstrong et al., 2016).

The main objective of our empirical study is to answer the question whether the type and scope of earnings management before the company goes public affect the interest of institutional investors in buying shares offered in the IPO. More specifically, we examine whether earnings management practices in the pre-IPO period affect institutional investors’ decision to participate in the IPO.

We generally posit that institutional investors may affect earnings management activities and, as a result, the quality of IPO companies’ financial reporting. However, previous studies on the role of institutional investors in IPO have proved inconclusive (Armstrong et al., 2016; Gao et al., 2017). We assume that institutional investors are able to detect the earnings management process. Thus, a company that is interested in gaining such investors refrains from using earnings management in its IPO.

The motivation for our study is to find out whether institutional investors’ involvement in the IPO process might be a detector of financial reporting quality. We believe that institutional investors, as better informed investors, are able to detect earnings management practices (that lower the quality of financial reporting). If the earnings management practices are meaningful, then institutional investors refrain from investing in the IPO. This might be a signal for individual investors on the quality of the IPO company and affect their decision to buy shares in the IPO.

By examining the stock exchange in Poland, the most active IPO market in Central and Eastern Europe (CEE), over a substantial sample period from 2005 to 2020, we find that the earnings management process occurs before an IPO, but only certain types of managerial activities are relevant for the institutional investor’s readiness to purchase the company’s shares in the IPO. In this context, the use of discretionary expenses management, such as deliberate changes in selling, general and administrative expenses, plays an important role and affects the institutional investors’ involvement (influencing the success of a share offering on the public securities market).

Our study contributes to the broad strand of literature on the quality of financial reporting. Firstly, it provides insight into what management teams’ actual approach to pre-IPO earnings management looks like and whether institutional investors on one of CEE’s leading markets
are able to respond to such practices. Furthermore, we show that different ways of influencing the quality of reported earnings may play a different role in the face of specific corporate events and should not be treated as exact substitutes.

The remainder of this study is organized as follows. The next section reviews the background literature and develops testable hypotheses. Section 2 describes our sample construction and discusses the research design, while Section 3 presents and discusses the main empirical results. The last section concludes the paper.

1. Literature Review

1.1 Role of institutional investors in IPO

An institutional investor is a particular type of investor, namely an institution that manages and invests other people’s money. In doing so, it hires professionals with sufficient technical expertise. Investigating the role of institutional investors has a long research history. The increasing amount of research on institutional investors came along with their increasing role in ownership (OECD, 2011; Bebchuk et al., 2017). In recent years the share of institutional investors in the main market of the Warsaw Stock Exchange (WSE) in Poland has reached 70–80% of the trading volume, while individuals make up only 20-30% (Warsaw Stock Exchange, 2021).

The presence of institutional investors among company shareholders has been studied in terms of their impact on many aspects of corporate finance (Ferreira and Matos, 2008). Especially the positive impact of institutional investors is proved for firm performance – both market and operational performance. Field and Lowry (2009) and Anderson and Huang (2017) found that newly public firms with high institutional investment significantly outperform (in terms of market and operating performance) those with low institutional investment. Fernando et al. (2004) found that higher-priced IPOs show a higher fraction of institutional investment. Finally, Michel et al. (2020) investigated the holdings of institutional investors after IPO in relation to operating performance after IPO and confirmed previous findings on positive relations between institutional investors and firm performance.

There are several explanations for why companies with institutional holdings in ownership have better firm performance in the post-IPO period. Field and Lowry (2009) and Jenkinson and Jones (2009) found that this is mainly due to institutions being able to avoid the worst performers in the IPO process. Analysis of investor demand during the offer period shows that the participation of retail investors is significantly influenced by the participation of institutional investors (Neupane and Poshakwale, 2012), as individual investors recognize the ability to avoid worst performers.
The ability to avoid the worst performers in the IPO process could be explained by institutional investors’ use of private information (Chemmanur et al., 2010), their monitoring role (Aggarwal et al., 2015) or by better use of readily available public information (Field and Lowry, 2009). Individuals have access to the same public information, but they appear to either disregard or misinterpret its relevance for firm value (Cogliati et al., 2011). Information on institutional investors’ involvement in an IPO signals to retail investors how institutional investors perceive the offer (Neupane et al., 2014; Aggarwal et al., 2002). Therefore, individual investors follow the interest of institutional investors in IPO companies (Neupane and Poshakwale, 2012).

Michel et al. (2020) found that institutions prefer IPOs that are associated with ownership structure change because, in these IPOs, they can have more impact on governance. They also found that institutions are predisposed to invest in value firms rather than growth firms, and that institutions prefer large firms. Field and Lowry (2009) showed that firm age at the time of the IPO is significant in determining institutional holdings. Additionally, Gompers and Metrick (2001) showed that institutional investors prefer large, liquid and high book-to-market stocks, and that their preferences affect stock returns.

1.2 Earnings management in IPO

Several studies report that IPO issuers frequently manage earnings to increase offer prices when they go public (Teoh et al., 1998; DuCharme et al., 2004; Morsfield and Tan, 2006; Aharony et al., 2010). There are different earnings management practices adopted to manage earnings,
e.g., income-increasing depreciation policies, allocating smaller reserves for uncollectible receivables, higher short-term accruals, special accruals to accelerate revenue recognition, and under-investment in R&D in order to increase current reported earnings during the pre-IPO period (Darrough and Rangan, 2005). However, the earnings management practices in the pre-IPO period negatively affect post-IPO performance (DuCharme et al., 2004; Ahmad-Zaluki et al., 2011; Chahine et al., 2012).

One stream of research refers to the links between pre-IPO earnings management and the presence of institutional investors in the pre-IPO period. Lo et al. (2017) found that institutional investors, as existing shareholders in a pre-IPO company, have incentives to maximize their wealth by manipulating earnings when firms engage in IPOs. This is also true if private equity is among shareholders in the pre-IPO period. The study of Darrough and Rangan (2005) showed that the portfolio companies of private equity funds strive to present higher reported earnings to the public by reducing R&D expenditures in the year of the IPO. Chahine et al. (2012) found that the presence of a venture capital syndicate in the pre-IPO period increases the management of pre-IPO earnings, but the impact is higher in the USA than in the UK. However, Hu et al. (2012) provided evidence that the participation of private equity funds in pre-IPO ownership lowers earnings management in the period preceding IPO. By contrast, Sosnowski (2017) did not find evidence that the presence of a private equity fund among shareholders in the pre-IPO period constrains earnings management prior to the IPO.

Another stream of research has found that earnings management practices in an IPO might be hampered by the involvement of informed institutional investors in the IPO. This is because institutional investors can recognize pre-IPO earnings management (Gao et al., 2017). Existing research shows that when trying to draw the attention of institutional investors in the IPO process, companies might limit earnings management practices in the pre-IPO period (Morsfield and Tan, 2006; Lee and Masulis, 2011; Hochberg, 2012; Kalgo et al., 2015). Therefore, we posit our hypothesis as follows:

**H**: We expect to find a negative relationship between earnings management in the pre-IPO period and institutional investors’ interest in the IPO.

The justification for this assumption is threefold. Firstly, earnings management in the pre-IPO period prevents institutional investors from investing in the IPO of such a company. Secondly, IPO companies that try to attract institutional investors in IPOs refrain from earnings management. Thirdly, existing research proves a negative statistically significant relationship between institutional investors’ involvement and earnings management practices (see, e.g., Kalgo et al., 2015).

We examine the links between institutional investors’ interest in IPO and managerial earnings management activity in the pre-IPO period. Our sample covers the period 2005-2020 and consists of 258 companies that completed an IPO on the main market of the WSE. We focus on the WSE because it is the leading stock exchange in CEE (Meluzín et al., 2018). From the total number of 427 new companies on this market, we exclude those companies whose shares were previously traded in the alternative trading system of the public stock market (NewConnect) and those whose IPO did not involve the sale of primary or secondary shares to the public. We also exclude banks, insurance companies and foreign companies because specific regulations on financial reporting apply to these firms. Finally, we adjusted our final sample according to the availability of data required by the methodological approach we employed.

To identify earnings management in the period before the IPO, we use proxies for both (1) real earnings management (REM) and (2) discretionary accruals (DACC), which enables us to comprehensively assess the various activities of managers in modelling reported earnings of the firm \( i \) in the year \( t \). In creating the specific variables, we follow the methodological approach of Haga et al. (2018), who based their study on the widely applied empirical solutions proposed by Roychowdhury (2006) and Kothari et al. (2005). Real earnings management involves controlling sales, which results in changes in operating cash flow (CFO), manipulating discretionary expenses (DISEXP) such as selling, general and administrative expenses, and abnormal production (PROD), affecting the cost of goods sold. In this approach, to calculate REM, the linear function of the company size is used, as measured by total assets (TA), sales volume (S) and its changes (\( \Delta S \)), and the measure of earnings management in each scope is the error term (\( \varepsilon \)) from the following regression equations:

\[
CFO_{it} = \alpha_0 + \alpha_1(TA_{i,t-1})^{−1} + \alpha_2(S_{it}) + \alpha_3(\Delta S_{it}) + \varepsilon_{it}
\]

\[
DISEXP_{it} = \alpha_0 + \alpha_1(TA_{i,t-1})^{−1} + \alpha_2(S_{it-1}) + \varepsilon_{it}
\]

\[
PROD_{it} = \alpha_0 + \alpha_1(TA_{i,t-1})^{−1} + \alpha_2(S_{it}) + \alpha_3(\Delta S_{it}) + \alpha_4(\Delta S_{it-1}) + \varepsilon_{it}
\]

(1)

Similarly, to estimate the level of DACC, which is displayed by \( \varepsilon \), the following total accrual (TACC) model is adopted:

\[
TACC_{it} = \alpha_0(TA_{i,t-1})^{−1} + \alpha_1(\Delta S_{it}) + \alpha_2(PPE_{it}) + \alpha_3(ROA_{i,t-1}) + \varepsilon_{it}
\]

(2)

where PPE denotes the property, plant and equipment (part of fixed assets), and ROA is the net income divided by the total assets. All the figures taken from the balance sheet or profit and loss account have been deflated by lagged total assets to avoid heteroscedasticity in the error term (Han et al., 2008).
To avoid excessive heterogeneity that would introduce unwanted noise and distort the results, these equations are usually estimated using a cross-sectional regression (Durana et al., 2022). In our sample, this approach is not possible because, given the number of companies and the diversity of business profiles, the individual subsamples would be too small to perform the relevant calculations. Thus, we divided our sample into ten groups by company size and then estimated the equations separately for each group and derived our measures of earnings management.

As we identified managerial practice in the earnings management of newly listed companies, we were able to assess the role of institutional investors in discouraging such actions. To test the influence of pre-IPO earnings management on institutional investors’ interest in purchasing shares when the company goes public for the first time, we estimate the following ordinary least squares (OLS) model:

\[ \text{INST}_{\text{IPO}} = \beta_0 + \beta_1 \text{EM}_{t-1} + \beta_2 \text{OWNER}_i + \beta_3 \text{SEC}_i + \beta_4 \text{BIG4}_i + \beta_5 \text{TA}_{t-1} + \beta_6 \text{ROA}_{t-1} + \beta_7 \text{DR}_{t-1} + \epsilon_{i,t} \]  

(3)

The dependent variable \( \text{INST}_{\text{IPO}} \) is the number of shares bought in the IPO by institutional investors divided by the sum of all primary and secondary shares offered. The \( \text{EM} \) index represents one of our measures of REM or DACC in the year before the IPO \( (t-1) \).

As in previous studies, we also include several commonly used control variables (Nikbakht et al., 2021; Pan et al., 2022). Specifically, \( \text{OWNER} \) refers to a set of characteristics of the company’s ownership structure before the first listing of shares on the stock exchange. Thus, we control for the share \( \text{FIN} \) and number \( \text{FINno} \) of financial and institutional investors among original shareholders (e.g., banks, insurance companies, investment funds). We also add two dummy variables that take the value of 1 if the Treasury \( \text{STATE} \) or private equity funds \( \text{PE/VC} \) were present in the group of original owners of the company, and 0 otherwise. Furthermore, we address the motives for going public by controlling for disinvestment intention. We include an indicator variable \( \text{SEC} \), which takes the value of 1 if secondary shares were offered for purchase in a public offering, and 0 otherwise. Moreover, because the external audit quality may affect the credibility of financial information disclosed to the public, we introduce a dummy variable \( \text{BIG4} \), which takes the value of 1 if the company is audited by Deloitte, EY, KPMG or PwC, and 0 otherwise. Finally, we also include \( \text{TA} \), which represents the size of the new stock company \( \text{i.e., the natural logarithm of total assets} \) and \( \text{ROA} \), which shows its efficiency. \( \text{DR} \) serves as a characteristic of capital structure and is the ratio of total debt to total assets.

We obtained the necessary financial data from the NotoriaSerwis database \( \text{i.e., the commercial database that gathers and provides financial statements of companies listed on the Warsaw Stock Exchange} \). Ownership, type of sold shares and auditor data were hand-collected from prospectuses. Information about the participation of institutional investors in the IPO was retrie-
ved directly from company announcements available in the ESPI/EBI database (i.e., electronic systems that are obligatorily used by public companies in Poland to convey all legally required information).

3. Results and Discussion

Table 1 shows the descriptive statistics of the variables applied in our study. It includes variables that were used to detect the earnings management process before the IPO and the control variables.

Table 1: Descriptive statistics of dependent and independent variables

<table>
<thead>
<tr>
<th>Specification</th>
<th>Mean</th>
<th>Std. dev.</th>
<th>Median</th>
<th>Q1</th>
<th>Q3</th>
<th>N</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Panel A: Pre-IPO (t−1) earnings management characteristics</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>REM (CFO)</td>
<td>0.0000</td>
<td>0.1937</td>
<td>−0.0095</td>
<td>−0.0871</td>
<td>0.0956</td>
<td>225</td>
</tr>
<tr>
<td>REM (DISEXP)</td>
<td>0.0010</td>
<td>0.4135</td>
<td>0.0252</td>
<td>−0.0624</td>
<td>0.1241</td>
<td>208</td>
</tr>
<tr>
<td>REM (PROD)</td>
<td>0.0000</td>
<td>1.1415</td>
<td>−0.0749</td>
<td>−0.3564</td>
<td>0.2107</td>
<td>214</td>
</tr>
<tr>
<td>DACC</td>
<td>0.0000</td>
<td>0.1798</td>
<td>−0.0005</td>
<td>−0.0934</td>
<td>0.0799</td>
<td>217</td>
</tr>
<tr>
<td><strong>Panel B: Other variables</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>INST\textsubscript{IPO}</td>
<td>0.7449</td>
<td>0.2251</td>
<td>0.8000</td>
<td>0.7000</td>
<td>0.8920</td>
<td>251</td>
</tr>
<tr>
<td>FIN</td>
<td>0.0231</td>
<td>0.1055</td>
<td>0.0000</td>
<td>0.0000</td>
<td>0.0000</td>
<td>253</td>
</tr>
<tr>
<td>FIN\textsubscript{no}</td>
<td>0.3518</td>
<td>0.6415</td>
<td>0.0000</td>
<td>0.0000</td>
<td>1.0000</td>
<td>253</td>
</tr>
<tr>
<td>STATE</td>
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<td>0.2880</td>
<td>0.0000</td>
<td>0.0000</td>
<td>0.0000</td>
<td>253</td>
</tr>
<tr>
<td>PE/VC</td>
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<td>0.3990</td>
<td>0.0000</td>
<td>0.0000</td>
<td>0.0000</td>
<td>253</td>
</tr>
<tr>
<td>SEC</td>
<td>0.4545</td>
<td>0.4989</td>
<td>0.0000</td>
<td>0.0000</td>
<td>1.0000</td>
<td>253</td>
</tr>
<tr>
<td>BIG4</td>
<td>0.2778</td>
<td>0.4488</td>
<td>0.0000</td>
<td>0.0000</td>
<td>1.0000</td>
<td>252</td>
</tr>
<tr>
<td>DR</td>
<td>0.5338</td>
<td>0.2400</td>
<td>0.5586</td>
<td>0.3706</td>
<td>0.6868</td>
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<td>LnTA</td>
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<td>1.8279</td>
<td>11.2750</td>
<td>10.3361</td>
<td>12.5012</td>
<td>253</td>
</tr>
<tr>
<td>ROA</td>
<td>0.1617</td>
<td>0.3096</td>
<td>0.1001</td>
<td>0.0565</td>
<td>0.1780</td>
<td>242</td>
</tr>
</tbody>
</table>

Source: Authors' own elaboration

The descriptive statistics of the earnings management process before the IPO show that different forms of earnings management are used to some extent. Although the mean values of earnings management proxies are close to 0, and this value is expected due to the applied
methodology, the high values of standard deviation reveal that the earnings management proxies significantly vary across companies. For example, the average value of REM (CFO) before an IPO is 0.0000, with a standard deviation of 0.1937. Also, the proxy for accrual-based earnings management DACC shows that this form of earnings manipulation is used by IPO companies. Our findings are in line with several previous studies that report that IPO issuers manage earnings (Teoh et al., 1998; DuCharme et al., 2004; Morsfield and Tan, 2006; Aharony et al., 2010).

However, the range of earnings management is much lower than in previous studies. Our study shows an average of less than 1%. Teoh et al. (1998) found that their earnings management proxy was higher than 4% in the pre-IPO period. Ahmad-Zaluki et al. (2011) found the median (mean) of their earnings management proxy at 2.92% (3.78%), while Premti and Smith (2020) reported an earnings management proxy average higher than 4% in the IPO year. We might state that the companies included in our sample manage earnings but refrain from significant operations in terms of both real and accrual actions. This is in line with Ball and Shivakumar (2008) and Sosnowski (2021), whose findings revealed that when going public, companies tend to use conservative rather than aggressive pre-IPO financial reporting, anticipating the high adverse costs and negative market consequences.

On average, the variable that refers to the presence of institutional investors in the IPO process (INSTĪPO) accounts for 74.49%, and its median value is 80%. It reveals high participation of institutional investors in the IPO process.

As for the presence of financial and institutional investors among original shareholders (e.g., banks, insurance companies, investment funds) in the pre-IPO period, our research shows quite a low level of participation: the average share is 2.3%. Only in 9% of the IPO companies did we identify state capital involvement (STATE), and in 20% of IPO companies, we identified the presence of private equity funds (PE/VC) in the group of original owners of the IPO company.

Apart from newly issued shares, almost half of the companies offer secondary shares (SEC) in the IPO. However, less than 30% of the companies cooperate with an external auditor from the Big4 group. On average, IPO companies present 16% profitability (ROA), and their financial leverage is 53% (DR).

Table 2 provides some insight into the results of our multiple regression models. To avoid multicollinearity, we calculated the variance inflation factors (VIF). All the VIF values remain below 4; thus, we can conclude that there is no indication of multicollinearity (Wooldridge, 2013). The findings provide evidence that earnings management tools are applied before the IPO to gain institutional investors. The dependent variable INSTĪPO refers to the presence of institutional investors in the IPO offer and reflects their interest in the IPO. We made four models. In all models, the dependent variable is the share of institutional investors in an IPO. The model differences lie in the fact that in each model, the independent variable reflects different types of earnings management practices (accrual or real).
### Table 2: Impact of earnings management in pre-IPO period on institutional investors’ involvement in IPO process – multiple regression analysis results

<table>
<thead>
<tr>
<th>Specification</th>
<th>Model 1</th>
<th>Model 2</th>
<th>Model 3</th>
<th>Model 4</th>
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<tr>
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<td>REM (DISEXP)</td>
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</tr>
<tr>
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<tr>
<td>DACC</td>
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<td>0.0398</td>
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<tr>
<td>STATE</td>
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<td>–0.1541**</td>
<td>–0.1784***</td>
<td>–0.1886***</td>
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<tr>
<td>SEC</td>
<td>0.0445</td>
<td>0.0741**</td>
<td>0.0512*</td>
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<td>DR</td>
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<td>0.0575***</td>
</tr>
<tr>
<td></td>
<td>(–4.4924)</td>
<td>(–5.6113)</td>
<td>(–4.3319)</td>
<td>(–4.3640)</td>
</tr>
<tr>
<td>ROA</td>
<td>0.0203</td>
<td>0.0495</td>
<td>0.0325</td>
<td>0.0297</td>
</tr>
<tr>
<td></td>
<td>(–0.4406)</td>
<td>(–1.0619)</td>
<td>(–0.6891)</td>
<td>(–0.6464)</td>
</tr>
<tr>
<td>N</td>
<td>217</td>
<td>200</td>
<td>207</td>
<td>216</td>
</tr>
<tr>
<td>Adj. $R^2$</td>
<td>0.1090</td>
<td>0.1832</td>
<td>0.0911</td>
<td>0.1008</td>
</tr>
<tr>
<td>F-statistic</td>
<td>3.6417</td>
<td>5.4623</td>
<td>3.0647</td>
<td>3.4098</td>
</tr>
<tr>
<td>p-value</td>
<td>0.0002</td>
<td>0.0000</td>
<td>0.0012</td>
<td>0.0004</td>
</tr>
</tbody>
</table>

The t-statistics are in parentheses. *, **, and *** indicate significance at the 10%, 5%, and 1% levels, respectively.

Source: Authors’ own elaboration
All the models prove statistically significant, which means that they are suitable for predicting the involvement of institutional investors in IPO.

The estimations of coefficients for independent variables in Table 2 show that in the year preceding the IPO, only one proxy of earnings management, REM (DISEXP), is important in explaining the changes in the dependent variable (model 2). The positive value of the coefficient means that institutional investors positively react to IPO companies increasing their reported earnings due to changing discretionary expenses such as selling, general and administrative expenses. Institutional investors may accept this form of altering reported earnings and do not react negatively. The process of going public requires companies to cover such costs (especially the IPO promotion, which is part of selling, general and administrative expenses). Thus, an increase in these expenditures is expected. This gives some leeway to managers of companies going public, as an increase in this category of costs is expected in the period around this specific corporate event. It seems that institutional investors are aware of the need to bear such costs and the impact they have on firm performance.

However, we did not observe a significant correlation between INST_IPO and the other proxies of earnings management, REM (CFO) and REM (PROD), which are related to changes in operating cash flow (CFO) and abnormal production (PROD) affecting the cost of goods sold. Furthermore, our findings do not show any association between the participation of institutional investors in the IPO and the use of accrual-based earnings management tools (DACC). As previous research indicates (Armstrong et al., 2016), companies pursuing IPO are under close scrutiny by specialized institutions and experienced investors. Being in the limelight at such an important moment in the life of a company and its managers may prevent them from using earnings manipulation techniques that are relatively well known and can be easily recognized by the stock market investor community.

To sum up, we cannot confirm our hypothesis that the relationship between institutional investors’ involvement in an IPO is negatively related to earnings management before the IPO. However, one proxy for earnings management (promotion expenses) does allow the company to attract the attention of institutional investors. Our findings contradict previous studies that showed a negative and statistically significant relationship between pre-IPO earnings management and institutional involvement in an IPO (Morsfield and Tan, 2006; Lee and Masulis, 2011; Hochberg, 2012; Kalgo et al., 2015).

The dependent variable INST_IPO is also affected by some control variables. The ownership structure of existing shareholders before an IPO seems to have no impact on institutional investors’ involvement in an IPO. This is especially true for financial investors (banks, insurance companies, investment funds) and private equity investors. However, all models show a statistically significant (p-value < 0.01) and negative coefficient for the STATE variable. Institutional investors are less likely to buy IPO shares of state-owned companies. This is in line with
the findings of Michel et al. (2020), who showed that institutions prefer IPOs that are associated with ownership structure change because in these IPOs, they can have more influence on governance.

Our investigation also provides evidence that the percentage of institutional investors is higher if the IPO includes both old and new shares (SEC). This finding contradicts those of Michel et al. (2020), who found that institutional investors are indifferent to whether the motivation behind the IPO is fund-raising or original owners’ value liquidation.

Institutional investors’ involvement in an IPO does not appear to be affected by the type of audit company. This, again, contradicts some previous research, e.g., Kalgo et al. (2015), who found a positive and statistically significant relationship between institutional investor involvement and the auditor agency proxy that reflects the Big4.

All models show a positive and statically significant coefficient for the variable LnTA. Institutional investors are more likely to buy shares offered by large IPO companies, or large companies can easily attract the interest of institutional investors. However, the participation of institutional investors in an IPO decreases as IPO companies’ debt ratio increases. A statically significant coefficient for the variable DR is observed in three models. Additionally, profitability (ROA) has no impact on institutional investors’ participation. These findings are in line with previous studies. Michel et al. (2020) found that institutions prefer large firms, while Gompers and Metrick (2001) showed that institutional investors prefer large and liquid companies. Liquidity is frequently negatively related to both profitability (Eljelly, 2004) and financial leverage (Guney et al., 2007), which might explain the negative relationship between financial leverage and the participation of institutional investors in our research.

Conclusions

Financial statements provided by IPO companies aim to reduce the information asymmetry between companies and potential investors. To attract the interest of future owners and increase IPO proceeds, a company might manipulate its earnings (Gao et al., 2017). However, a special type of investor, i.e., institutional investor, is able to detect whether a company uses earnings management to depict its earnings more favourably. If institutional investors (as better informed investors) detect unreasonable earnings management, they might refrain from investing in IPO and thus send a signal to individual investors (less informed investors).

We investigated the association between the participation of institutional investors in IPOs and earnings management before an IPO. Analysing the example of the leading capital market in CEE, we found that different tools of earnings manipulation – both real and accrual-based – are used before an IPO. However, the scope of earnings management is quite low. We believe that IPO companies are aware of the negative effects of earnings management, and they refrain
from it. Thus, we assumed in our hypothesis to find a negative relationship between earnings management in the pre-IPO period and institutional investors’ interest in the IPO. However, we found a statistically significant relation between institutional investors’ involvement and one of the earnings management tools, i.e., manipulating discretionary selling, general and administrative expenses, but this relation was positive. This finding indicates that investors should be aware and particularly cautious that this particular category of expenses creates room for managers to portray a favourable image of the company.

Our investigation is not free of limitations. Our research sample includes only Polish companies. Thus, our findings may be biased by the institutional context of that particular capital market. Therefore, it is advisable to carry out related studies on other markets, especially in emerging and non-Anglo-Saxon countries, as these markets are usually heavily under-researched. We also note some limitations of the methodology employed. There are still no perfect tools to comprehensively assess the quality of financial reporting. The solutions applied so far are somewhat fragmentary and cover selected areas of a company’s activity. It creates challenges for further research into the quality of financial information disclosed in corporate reports. This is especially problematic with companies whose information is not generally available to the public and when there is growing information asymmetry.

References


