

The Influence of Underwriter and Auditor Reputations on IPO

Under-pricing

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Abstract

Companies considering initiating public offerings (IPO) expect to raise funds and would like to maximize their initial return. The asymmetry of information between parties involved in initial public offerings often jeopardizes potential investors' involvement. Besides the financial factors, the reputations of the underwriters and auditors have a significant impact on the initial return of shares. This paper aims to investigate and measure the influence of underwriter and auditor reputation on under-pricing of share prices. The findings show that the higher the reputation, the lower is the initial return of shares, thus there is a higher level of undervaluation. The samples used are companies listed in the Indonesia Stock Exchange (IDX) during the period of 2004-2009. This study could contribute to academics', companies' and investors' knowledge about the impact of non-financial factors on share prices during initial public offerings.

Key Words: Underwriter Reputation, Auditor Reputation, Initial Public Offering, Under-pricing, Undervaluation

1. Introduction

To cope with intense competition in the business world, companies are required to stay in shape in order to survive. They must thrive and more often than not they need to develop and expand their business. A large amount of capital is vital for a company to maintain a sustainable expansion and the growth of its operations. One way of obtaining such capital would be to go public. An IPO is a significant event in the lifetime of an established firm and the initial listing process can be critical to the company's value. One of the main problems arising in an IPO is how to decide on the most appropriate price for the stock share price.

In the IPO process the determination of the offering price can be very tricky. Among others, the IPO involves several parties - namely the issuer, underwriter, auditor, and investors. This paper will investigate whether the reputation of underwriters and auditors will affect the IPO share prices.

A conflict of interest occurs when the issuer's goal is to obtain the highest amount of capital by pricing the IPO as high as possible. For the underwriters, they prefer to lower the price of the IPO in order to minimize the risk of having unsold shares in the open market. A lower price increases the chance to have all the shares sell out and reduces the financial burden of the underwriters. Underwriters are able to lower the share price from its ideal level because of the issuer's lack of market condition information. The issuers generally do not opt for the IPO to be underpriced, because it will result in a transfer of wealth from them to the underwriters (Beatty, 1989).

The price of shares offered in the primary market follows a negotiation between the issuer and its underwriters, while stock prices in the secondary market are determined through the market mechanism of supply and demand. These two pricing mechanisms can cause a difference in the stock price, resulting in under-pricing or overpricing. The term 'under-pricing' is used to express the difference between the offering price and the lower market-clearing price during issuance. During an IPO, overpricing occurs if the stock price is lower than the prices that occurred in the secondary market on the first day and vice versa (Beatty, 1989).

Several studies have attempted to explain the under-pricing of a firm's equity securities. Numerous reasons have

been proposed to explain why a firm would willingly under-price its securities and limit the funds received. Various asymmetric information models have been proposed to explain this phenomenon. The reputation of a third party involved in an IPO is an example of information asymmetry. Carter and Manaster (1990), and Megginson and Weiss (1991) found a negative relationship between underwriter reputation and under-pricing.

However Cooney et al. (2001) finds that the negative relationship between underwriter reputation and under-pricing holds only for firms whose offering price is within the original filing range; positive relationships were found for firms whose offering prices were above the filing range. Spence (1973) defined the concept of reputation as stakeholders' perceptions about a company's ability to create value relative to competitors.

Generally, the elements affecting IPO under-pricing may consist of financial and non-financial factors. Financial factors may include ROA, Earnings per Share, Current Ratio, Earnings Growth, and Financial Leverage (Misnen, 2003). Non-financial factors may include reputation, the firm's age, and the type of industry (Apriliani and Nikmah, 2006).

This paper will focus on the influence of the reputation of underwriters and auditors on IPO under-pricing. Underwriter and auditor reputations may have more significant impact on IPO under-pricing, as compared with other factors that have been examined in previous research. Information asymmetry provides underwriters with the opportunity to purchase unsold shares from the IPO at cheap prices. This causes the issuer to accept low prices for its inaugural offering, which means stock prices in the primary market are lower than the price of shares in the secondary market.

The information asymmetry between IPO issuers and outside investors is the main reason why underwriters and auditors are crucial (Li et al. 2005). Due to this asymmetry, IPO issuers may seek to increase their offering proceeds through manipulation of reportable earnings before going public. Firms recognize the importance of presenting strong earnings in the prospectus, hence 'window-dressing' might sometimes be necessary. Underwriters and auditors have to play their parts in producing an IPO prospectus that includes a description of its present and future operations and audited financial statements.

An experienced and reputable underwriter will be able to professionally organize and provide a better service to investors. That will strengthen the firm's image in the eyes of investors as it shows the reliability and seriousness of the company. Mudrik and Imam (2002) asserted that companies would prefer hiring a reputable underwriter to reduce the undervaluation of shares. Kim, et al (1995) also supported that underwriter reputation has a negative and significant relationship with the level of under-pricing.

The other factor affecting the under-pricing of shares is the selection of trustworthy auditors. Holland and Harton (1993) affirmed this that could act as a determiner of the quality of the issuer company. Hiring a reputable auditor will reduce the chance for issuers to cheat in presenting inaccurate information to the market and reduce the uncertainty that will affect the level of under-pricing of the shares offered to the public. Balver et al (1988) revealed that the investment bankers or underwriters with strong reputations would prefer working with a highly reputable auditor, as that could reduce undervaluation.

Auditor credibility is characterized in recent research as one of the attributes of a differentiated audit product (DeAngelo 1981). It is contended that the credibility of financial statements depends on the perceived quality of the audit. Since the actual quality of the audit is not observable, auditors attempt to communicate their quality through such signals as brand names and reputation. As a consequence, different levels of credibility are offered in the audit market at different prices (Simunic and Stein, 1987).

Basically, the presence of a prestigious underwriter and auditor may serve as an effective means to reduce uncertainty about future cash flows of the newly-traded firm and, consequently, under-pricing. Hence the type and amount of experience possessed by the underwriter and auditor leading a firm through its IPO process can provide a powerful symbol of legitimacy to critical third parties, such as the investment community. Spence (1973) defined that symbolic role as the signaling theory.

Usually reputation is viewed as a valuable intangible asset that provides a firm with sustainable competitive advantages because it influences stakeholders' economic choices and contributes to differences in organizational performance (Elsbach & Kramer, 1996). The prestige of institutions involved in an IPO is very important to the IPO context because its performance will influence the perception of prospective investors. (Certo, 2003)

In most cases, firms that suffer from the liability associated with market newness generally go public with the endorsement of a lead investment bank that underwrites the firm's security offerings and a prominent auditor to inspect the financial statements. At the time of the IPO, potential investors rely on the investment bank's evaluation of the quality of a firm when deciding whether to buy stock in a company. Carter and Manaster (1990) acknowledged that getting hold of the endorsement of a prestigious investment bank can be critical for the success of an IPO.

The motivation of this research is to prove that the reputation of underwriter and auditor affects IPO under-pricing. It could provide knowledge to Indonesian companies who are considering going public. It could contribute as a basis for further research on initial public offerings for local and international academics.

The remainder of this paper proceeds as follows. Section 2 reviews IPO literature. Section 3 describes the methodology, while Section 3 discusses the implications of the findings and the last section summarizes the key conclusions.

2. Literature Review

The ultimate goal of many experienced business people is to undertake an IPO. Even though it is associated with many financial responsibilities, it also represents prestige and glamour and is a milestone of success.

As one of the most significant events in the life of a business, an IPO provides businesses with the ability to expand into new markets or grow through acquisitions. It can help a company attract new talent with stock options and other equity awards and reward initial investors with liquidity.

Under-pricing is a phenomenon that is often encountered in an initial public offering. There is a tendency that the offering price in the primary market is always lower than the closing price on the first day of trading. According to Weston et al (1993), under-pricing happens when the stock price in the public market is higher than the offering price. Based on these definitions, then under-pricing may be regarded as a situation where the stock price at the time of initial public offerings is considered lower than the actual price. The opposite of under-pricing is overpricing, which is a condition in which the market price of the new shares offered on average tends to be more expensive than the bid.

Under-pricing is an indirect cost for companies participating in an IPO. That is, the stock prices should be similar in both markets so issuers can circumvent loss in the process (Dechow, 1995). Company owners will always attempt to minimize undervaluation because it can potentially trigger a transfer of wealth from the owner to the investors (Beatty, 1989). McDonald and Fisher (1973) stated that in the event of under-pricing, the difference between the offering prices and the market price after the initial offering is the 'rent' or fees that are distributed by the underwriters to the initial purchaser of shares, so that IPO will rise sharply after trading in the secondary market.

Several literatures have provided explanations of under-pricing roles in the marketing of IPOs. Signaling theory suggests that high-quality firms under-price their IPOs in order to signal private information about the firm's value to investors. High-quality firms subsequently reap the signaling benefits by issuing seasoned equity in a follow-on offering at more favorable prices (Grinblatt and Hwang, 1989).

Benveniste et al., (1996) suggested that there can be information asymmetry during an IPO. They suggested that investors must be compensated for truthful revelation of their private information about the value of the issuing firm. That information will provide a useful picture of the corporate issuers for investors to make decisions (Firth and Liao-Tan, 1998). Under-pricing serves as a reward for truthful information revelation, and rationing allows the investment bank to distribute that reward selectively to informed investors. Information asymmetry allows underwriters to make an optimal IPO price deal, which is the price that will reduce the risk to have unsold stocks.

Another validation suggests that under-pricing stimulates new share purchases in IPOs by absolving potential shareholders. Rationing and under-pricing create more winners and so reduce the bad news learned by investors receiving allocations in an IPO (Rock, 1986; Bulow and Klemperer, 1999). This encourages uninformed investors to raise their bids for shares.

When a company unanimously decides to go public, it will choose an investment banking partner that has the necessary capability to successfully execute an IPO. The underwriter is expected to have wide knowledge of the

stock market. The right choice of underwriter may influence a company's stock price, because of the bargaining process that occurs in the secondary market with investors.

The reputation of an underwriter such as an investment bank may influence investors' opinions about the quality of an issuer and its long-term prospects. Logue et al, (2002) stated that, since a firm typically goes public only once, issuers may be unable to use their own reputation and aftermarket bonding activities to sell shares efficiently. They typically rely on the underwriting services of an investment bank to market their IPOs. Thereby the underwriter's reputation is crucial during the IPO process.

The underwriter's knowledge and ability is the assurance and guarantee for the company. A highly capable underwriter grants confidence to the IPO issuer in its bidding process. By appointing a reputable underwriter, the company can reduce the risk of offering shares to the public, thus reducing the risk of under-pricing.

The ability and knowledge possessed by an underwriter is proved to be an assurance for the company. A reputable underwriter will enable the issuer to have confidence that their public bidding process is being handled properly. Furthermore, investors also expect issuers to use an experienced underwriter who acts as a guarantee for them in making investments.

The reputation of an underwriter influences the level of IPO under-pricing. Kooli and Suret (2001) proved that the level of IPO under-pricing in Canada, handled by a less reputable underwriter reaches 31.13%, as opposed to only 9.37% by a prestigious underwriter. They concluded that underwriter reputation is correlated with the level of under-pricing of IPOs. Mudrik and Imam (2002) also proved the relationship whereby underwriter reputation has a significant negative effect on IPO under-pricing.

Auditors play an important part during IPOs. Arens and Loebbecke (1996) pointed out that an auditor must be competent, independent, and able to determine and report the suitability of referred information, with all of the specified criteria. The critical role of auditing is to detect expropriations by insiders and to deter such behavior (Jensen and Meckling, 1976). Auditors have an incentive to investigate and report deviations in applications of accounting principles since their reputation capital is reduced by ex-post revelation of errors or misstatements (Palmrose, 1988).

Titman and Trueman (1986) provided models in which the initial value for an IPO is an increasing function of audit quality. Firth (1978) in Roybark (2009), examined the influence of the qualified opinions on the auditor's annual financial statements and its links to the company's stock price movements in the UK. The author found that the stock price declined sharply on the announcement date of the annual financial statements.

Carpenter and Strawser (1971) stated that hiring a reputable auditor will provide the highest bidding price. When the bidding price is high, the level of underpriced issuers will be low. Furthermore, Hogan (1997) states that a reputable auditor can provide good audit quality, which can reduce the occurrence of under-pricing when firms execute an initial public offering.

The choice of auditor (and underwriter) may convey to the market additional information about the firm's quality. Prestigious auditors may be associated with higher-quality IPOs because they have their reputation to uphold. Beatty (1989) provides evidence that larger and less risky IPO clients tend to hire 'Big Four' audit firms. Association with lower quality IPOs may adversely affect their reputation not only in the IPO business but in their entire array of activities. In addition, they charge higher fees. Lower-quality firms will have less incentive to enlist their services because of a lower marginal benefit (Michaely and Shaw, 1995). A financial statement audited by a reputable, well-known accounting firm carries more weight than an unknown one. (Sutton and Benedetto, 1988)

The reputation of the auditor is also believed to affect the under-pricing of IPO. By hiring reputable or professional auditors, issuers will reduce the opportunity to cheat in presenting misleading information about its prospects in the future. Thus, this shows that by employing a highly reputable auditor, the company will reduce the uncertainty in the future, hence reducing the level of IPO under-pricing.

An auditor's reputation affects the credibility of financial statements when a company goes public. Therefore to maintain credibility, the company will choose a reputable auditor (Misnen, 2003). Selection based on the financial statements that are audited by reputable auditors will be more trusted by investors compared with those deemed not reputable (Misnen, 2003).

(Roybark (2009) revealed that the investment banker (underwriter) will prefer working with a reputable auditor, as both will reduce the level of under-pricing. From the above views it could be inferred that the auditor has a significantly negative effect on IPO under-pricing.

According to Beatty and Ritter (1986), Rock (1986) and Balvers et al. (1988), engaging a reputable auditor helps to reduce the uncertainty about the value of the issue. Beatty's (1989) findings suggest that under-pricing is lower for firms with higher-priced and presumably more reputable auditors. In addition, Balvers al. (1988) also found that the clients with more reputable auditors have lower under-pricing. The findings of Simunic and Stein (1987), Beatty (1989), and Balvers et al. (1988) that IPO market participants are willing to pay a premium for auditor credibility is consistent with the auditor credibility hypothesis.

Financial ratio analysis can help investors in making investment decisions and predicting a firm's future performance. It can also give early warnings about the slowdown of a firm's financial condition (Ohlson 1980). Mulyono and Khairurizka (2009) found that in five industries under study, financial ratios such as Total Asset Turnover (TATO), Debt Equity Ratio (DER), and Price to Book Value (PBV) have effects on the stock price. Hamzah (2007) demonstrated that current ratio, Return on Investment (ROI), Total Assets Turnover (TATO), and Debt to equity have positive correlations with capital gain (loss).

Return on Assets is used to assess a company's profitability, equal to a fiscal year's earnings divided by its total assets, expressed as a percentage. With high corporate profitability it will reduce uncertainty for investors to purchase the company's stocks; therefore the level of under-pricing will tend to be lower. This is supported by research conducted by Mudrik and Imam (2002)

The 'asset turnover' measures how effectively a business is using assets to generate sales. From an investor's point of view, it can be argued that current liabilities should be deducted from the amount of assets used. Investors are concerned with returns on their investment; therefore the funding of current assets from current liabilities can be ignored. Beaudry and Portier (2004) examined the relationship between share prices and productivity, and based on their findings these two variables have a strong positive relationship implying that an increase in productivity over time should lead to 'irrational exuberance' in the stock market.

'Current ratio' indicates the liquidity of a company, namely the ability to pay short-term financial obligations on time. According to Sartono (2000), the notion of liquidity actually contains two dimensions, (1) the time required to convert assets into cash, and (2) certainty that the price is going to happen. The higher the current ratio of a company is, the smaller the risk of failure of the company to meet its short-term obligations. As a result the risk that will be borne by shareholders also gets smaller.

Financial leverage indicates the risk of a company, which impacts the uncertainty of a stock price. Financial leverage indicates the ability of the company to pay debt with equity owned. High levels of liability would complicate the predictions of a company's future. Roybark (2005) states that the higher the level of leverage a company has, the higher the level of risk and uncertainty faced by the company.

Daljono (2000) found that financial leverage has a positive effect on initial returns. According to Sartono (2000), the use of debt for the company itself has three dimensions, namely (1) lenders will focus on the extent of collateral for loans, (2) by using the debt then if the company gets more profit from its fixed expenses, the owner of the company's profits will increase, (3) by using the owner's debts to get funds without losing control over the company.

Rock (1986) differentiates investors according to the amount of information they possess. Informed investors have access to superior information about the firm, and are in a better position to decide whether or not a new offering is worth the effort, while uninformed investors know only the probability distribution of a firm's value. Purchase orders will only be submitted by informed investors where new offerings are expected to be underpriced. In contrast, uninformed investors will submit orders indiscriminately, having a greater chance of receiving overpriced offerings and a smaller chance of receiving underpriced offerings. Consequently, under-pricing is needed in order to compensate the uninformed for trading against superior information.

Beatty and Ritter (1986) have developed several testable hypotheses. The first and most examined proposition is the direct relation between the uncertainty surrounding the after-market clearing price of new offerings and their initial returns. As this ex-ante uncertainty is not directly observable, proxy measures are therefore adopted and tested. Possible proxies suggested in the IPO's literature include the age of the issuing firm, the average sales before going

public, the number of uses of the raised funds and the proceeds from the offering.

Numerous IPO studies by Buckland and Davis (1990), Kim et al. (1995), Clarkson and Merkley (1994,) have confirmed the positive relation between those measures of risk and initial returns. Ritter (1984) hypothesizes that the ex-post volatility of aftermarket returns is also a good risk measure since new offerings with a high volatility of aftermarket returns may have come from the high-risk category of firms.

Another frequently tested proposition of Beatty and Ritter's (1986) focuses on the role of underwriters in enforcing the underpricing equilibrium. According to them, underwriters, when dealing with the more speculative offerings, prefer to lower the offering price so as to avoid being punished later by either issuing firms (if they underprice too much) or investors (if they underprice too little). They notice that underwriters who deviate from the expected behavior lost their market share.

Logue (1973) has found that returns are smaller when new offerings are taken by prestigious underwriters. Similar results are reported by Johnson and Miller (1988) and Carter and Manaster (1990) where a more refined and detailed classification of underwriter reputation is adopted and tested.

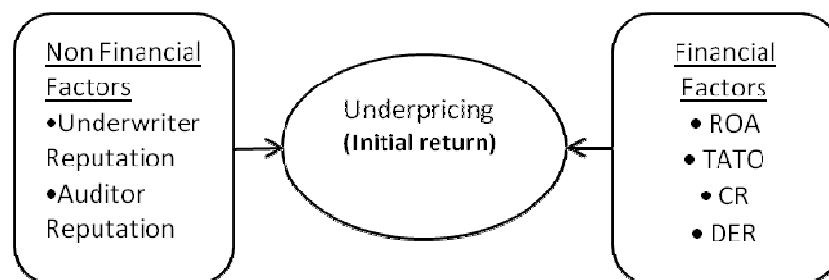
Meggison and Weiss (1991) consider another measure of reputation where they define reputation as the number of new offerings that an underwriter has underwritten relative to other underwriters. Although a modified measure of reputation is being tested, the same inverse relation between underwriters' prestige and underpricing emerges.

Later, Carter et al., (1998) examined both the categorical and continuous definitions of reputation and concluded that the more reputable an underwriter is, the lesser the amount of initial returns, and of the two different measurements of reputation, the former proxy performs better. Bates and Dunbar (2002) also tested the effect of these two types of reputation measures on the level of underpricing in their IPO study, but the results were inconclusive.

Meanwhile, Misnen (2003) demonstrated that from nonfinancial variables such as economic conditions, reputation of underwriter, auditor reputation, firm age, and industry type, only economic conditions significantly influenced initial returns. From the financial ratios, only earnings per share influenced the initial return of shares.

Apart from the reputation of the underwriter and the auditor, other variables such as ROA, Total Asset Turnover, Current Ratio and Debt to Equity Ratio are also predicted to influence underpricing of an IPO as well. They will describe that the higher the profitability and productivity, the lower will be the level of underpricing of shares.

Figure 1 Factors Influencing Underpricing



3. Research Methodology

This study uses initial return (IR) to evaluate IPO underpricing of shares. Initial return is the percentage difference between the closing price on the secondary and primary market prices. Underpricing is the positive difference between the market price and offering, while overpricing is the negative difference.

$$\text{Initial Return} = \frac{P_1 - P_0}{P_0} \times 100\%$$

Where,

P_0 = the price of the IPO

P_1 = first day closing price on the secondary market

3.1 Reputation of Underwriter

Underwriter reputation (UDW) is measured by the amount of annual trade value of the company. Several proxies for underwriter reputation have been employed in previous studies. However in this paper, the underwriter reputation will be measured based on the underwriter trade value issued by the Jakarta Stock Exchange. The median will define the level of reputation of the underwriter. The nominal of the trade value itself will determine the reputation of the underwriter. Hence, the higher the amount of annual trade values of the investment bank, the more reputable the underwriter.

3.2 Reputation of Auditor

There are many factors that can be used as a source of measurement of the reputation of an auditor (AUD). Years of establishment of the accounting firm act as a measurement for the amount of experience the Certified Accounting Firm has gained over the years and which determines the reputation of its auditors. The greater the years of establishment means the more reputable the accounting firm is. The author uses the following control variables in the model:

Return on Assets (ROA) indicates how profitable a company is relative to its total assets. It is calculated as the ratio between after-tax profit and total assets owned by companies.

$$ROA = \frac{\text{Profit after tax}}{\text{Total asset}} \times 100\%$$

Asset turnover (TATO) is a general financial ratio used to measure a company's performance in regards to asset management and turnover. The total asset turnover ratio is the amount of sales a company has for every dollar of total assets.

$$\text{Assets turnover ratio} = \frac{\text{Sales}}{\text{Total assets}}$$

Current ratio (CR) is a short-term solvency or liquidity measure. It measures the ability of a firm to pay current liabilities.

$$\text{Current ratio} = \frac{\text{Current asset}}{\text{Current liabilities}}$$

Financial leverage (DER) indicates how much a business relies on debt in order to operate. This ratio gauges the financial solvency of a business and shows its dependency upon borrowing.

$$\text{Debt to Equity Ratio} = \frac{\text{Short Term Debt} + \text{Long Term Debt}}{\text{Total Shareholders' Equity}}$$

The dataset is from prospectus and annual reports over the period 2005-2009. The main data sources are the Indonesia Stock Exchange database and the Indonesian Capital Market Directory (ICMD). The selected samples are companies that went public during the period 2005-2009, have information for the analysis, and exclude finance and banking companies. The exclusion of the latest is due to the difference in financial performance between financial and non-financial companies.

3.3 Hypothesis Development

Asides from financial factors, does the reputation of underwriters and auditors affect the initial income of IPO issuers?

Based on the aforementioned aim, the following hypotheses have been formulated:

- H_1 : The reputation of an underwriter affects stock under-pricing
- H_2 : The reputation of an auditor affects stock under-pricing
- H_3 : Financial factors affect under-pricing of IPO initial returns
- H_{3a} : Return on assets positively affects under-pricing of IPO initial returns
- H_{3b} : Asset turnover positively affects under-pricing of IPO initial returns
- H_{3c} : Current ratio positively affects under-pricing of IPO initial returns
- H_{3d} : Debt to equity ratio positively affects under-pricing of IPO initial returns

This paper uses the following regression model to examine the related hypotheses:

$$IR = \beta_0 - \beta_1 UDW - \beta_2 AUD + \beta_3 ROA + \beta_4 TATO + \beta_5 CR + \beta_6 DER + \epsilon$$

4. Findings and Discussion

Table 1 demonstrates that initial return is significantly correlated with both Underwriter Reputation and Auditor Reputation, whereas the financial variables failed to display any correlation towards the independent variable.

Table 1 Correlation Matrix

	IR	ROA	CR	DER	TATO	AUD	UDW
Pearson Correlation							
IR	1	-0.037	0.064	-0.014	0.064	-0.289	-0.291
		(0.38)	(0.3060)	(0.46)	(0.31)	(0.009)**	(0.009)**
ROA	-0.037	1	0.079	-0.055	0.045	0.028	-0.054
	(0.38)		(0.27)	(0.33)	(0.36)	(0.41)	(0.33)
CR	0.064	0.079	1	-0.225	-0.17	-0.003	-0.138
	(0.31)	(0.27)		(0.04)	(0.09)	(0.49)	(0.13)
DER	-0.014	-0.055	-0.225	1	0.023	0.381	0.21
	(0.46)	(0.33)	(0.04)		(0.43)	(0.00)	(0.05)
TATO	0.064	0.045	-0.17	0.023	1	0.005	-0.135
	(0.31)	(0.36)	(0.09)	(0.43)		(0.49)	(0.14)
AUD	-0.289	0.028	-0.003	0.381	0.005	1	0.056
	(0.009)**	(0.41)	(0.49)	(0.00)	(0.49)		(0.33)
UDW	-0.291	-0.054	-0.138	0.21	-0.135	0.056	1

	(0.009)**						
		(0.33)	(0.13)	(0.05)	(0.14)	(0.33)	

IR – Initial Return, UDW - Reputation of Underwriter, AUD - Reputation of Auditor, ROA Return on Assets, TATO – Assets Turnover, CR - Current Ratio, DER – Debt to Equity Ratio

** Significance at 1% level

VIF in Table 2 shows that there is no multicollinearity among the predictors. The significance level of 0.012 demonstrates that H1 is accepted. Statistically, UDW is significantly affecting IR. The negative relationship demonstrates that the higher reputation of underwriter tends to lower initial returns, with the assumption that other independent variables stay the same. Low initial returns indicates a higher level of under-pricing; therefore companies hiring more reputable underwriters will set a higher offering price compared to those with a lower reputation.

This study suggests that more reputable underwriters are able buy to shares at a higher price in the primary market, which means a higher level of under-pricing. The findings support that, since the initial return is the difference between the offering price and the market price, and the result shows a negative relationship between initial returns and the reputation of the underwriter. The more prestigious investment bankers tend to market the stocks of larger firms with a higher issuance price. As a result, the market-adjusted initial return is negatively related to underwriter reputation (Wang, Liu and Wu, 2002).

AUD also significantly influences IR. The significance of 0.007 implies that that H1 is accepted. Their negative sign suggests that initial returns will decrease if the auditor’s reputation increases; with the assumption that all the other variables stay the same. Companies employing the service of reputable auditors will obtain higher initial returns compared to those who hire auditors who are less reputable.

In theory, the selection of auditors with different levels of reputation affects the under-pricing of shares of companies participating in an IPO. The use of highly reputable auditors can be used as a sign or clue of the quality of corporate issuers in order to increase the level of under-pricing (Daljono, 2000). Simunic & Stein (1987), Balvers et al. (1988), Beatty (1989), Menon & Williams (1991) proved that the reputation of advising accountants is negatively affecting initial returns.

Table 2 Regression Results

Model	Unstandardized Coefficients		t	Sig.	Collinearity Statistics	
	B	Std. Error			Tolerance	VIF
1 (Constant)	.598	.124	4.801	.000		
ROA	.0001	.001	-.333	.740	.986	1.014
CR	.018	.027	.662	.510	.893	1.119
DER	.016	.010	1.533	.131	.775	1.291
TATO	.016	.058	.270	.788	.942	1.062
AUD	-.017	.006	-2.807	.007**	.837	1.195

UDW	-.035	.000	-2.600	.012*	.899	1.112
R ²	.208					
DW	1.622					

Dependent variable: IR

Predictors: UDW - Reputation of Underwriter, AUD - Reputation of Auditor, ROA Return on Assets, TATO – Assets Turnover, CR - Current Ratio, DER – Debt to Equity Ratio

** Significance at 1% level

* Significance at 5% level

This paper confirms the findings from Misnen (2003), Carpenter and Strawser (1971), who stated that hiring a reputable auditor will provide a higher bidding price. Thus engaging a highly reputable auditor would increase the level of under-pricing. The findings indicate that the higher the reputation of the auditor who performs financial audits for the company participating in an IPO, the higher the level of confidence in the audit of financial statements, which allows the company to set higher prices for its shares in an initial offering.

The financial variables, ROA, CR, DR, and TATO have not shown significant effects which may indicate that they may not contribute to the variation of IR. That could also imply that most investors are relying on the reputation of both the underwriters and auditors. However, the results differ with the findings from Kim et al (1995) who stated that the high profitability and productivity of a company will reduce uncertainty for investors thus the lower is the level of under-pricing. The reason why ROA is not significant is because the investors in making investments not only pay attention to ROA, but also consider other financial factors such as return on equity, earnings per share, and earnings growth.

Logue, 1973; Beatty and Ritter, 1986; Titman & Trueman, 1986; Carter & Manaster, 1990; and Carter et al., 1998 have investigated the effects of underwriter and auditor's reputation towards under-pricing of IPOs. Most of their studies have investigated the markets of developed countries, such as the U.S. stock market. None of them have ever examined the effects of underwriter and auditor reputation on the performance of IPO stocks in developing countries, such as Indonesia. This paper may provide proof of the findings' similarity or divergence between developed and developing countries.

5. Conclusion

Under-pricing as a phenomenon has been seen across most capital markets in the world. Ritter (1984) stated that there is an abnormal return on the first day of stock trading of an IPO share price. The findings have a significant impact on the theory of under-pricing. The reputations of the underwriter and auditor have a significant impact on the initial returns resulting from undervaluation of shares of the companies that participate in an IPO.

There is a negative relationship between the reputation of the underwriter and the auditor the initial return. Hence the more reputable the underwriter and auditor the lower is the initial result of the share price. The findings may also suggest that owners of IPO firms would choose an auditing firm based on its strong reputation rather than the quality of its auditing. It is also possible that the under-pricing during the first day return could be attributed to the willingness to pay of investors compared to the market price. Investors who are tightly related to share price can minimize information asymmetry by considering information related to the issuer's choice of underwriter and auditor.

Underwriter reputation may be more important in Indonesia as the investors are less knowledgeable and have less information on the new stock issues. Thus investors may be more willing to accept less under-pricing (premium) when investment bankers with better reputations underwrite stocks.

Issues such as corruption or supremacy of wealthy businessmen may also play a very crucial role in IPO under-pricing as well as in the selection of underwriter and auditor. In Indonesia, most often the hired underwriters are based on full-commitment; therefore they are entirely responsible for the sale of the securities.

Business financial factors namely ROA, Current Ratio, DER, and TATO, have no significant affect on initial return and under-pricing of shares. For investors, that may suggest that paying more attention to the reputation of underwriters and auditors of the issuing company will help them to make the right decision for their investment. In a country like Indonesia where corruption is rampant, the integrity of underwriters and auditors has more weight over any business financial figures.

Companies participating in IPOs should pay more attention to non-financial factors by selecting a reputable investment bank and certified public accountant because of their weighty influence on initial returns of share price and therefore increase the level of under-pricing, which will be of great importance for the company's future.

Almost none of the previous research has ever examined the effects of underwriter and auditor reputation on the performance of IPO stocks in developing countries, such as Indonesia. This paper may provide proof of the findings similarity or divergence between developed and developing countries. For further research, Southeast Asian countries and finance and banking industry should be included to increase the sample and enhance the findings' impact.

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