CORPORATE FRAUD TENDENCIES VERSES IPOS INITIAL RETURNS VOLATILITY

A.A.A. Bruce[1] and P.M.C. Thilakaratne[2]

[1] *Department of Business Administration, Gombe State University, Nigeria and University of Kelaniya, Sri Lanka;* [2] *Department of Accountancy, University of Kelaniya, Sri Lanka*

Corresponding author: *lal@kln.ac.lk*

Initial Public Offerings has unusual characteristics of volatile initial returns. This volatility is usually revealed via the offer/issue price and the market price which communicate either appropriate or inappropriate valuation (mispricing) of the stocks by the issuers, underwriters or the investors. While several researchers conclude that the mispricing is usually a strategy for the issuer and the underwriter to get the stocks subscribed and to compensate for information gathering and many other related views, others view such practice as a fraudulent act by the issuers in anticipation for "money left on the table" or "promise for future banking business to the underwriters who are mostly financial institutions". We therefore, examined the causes of IPOs initial returns volatility by ascertaining; (1) whether mispricing (overpricing or underpricing) actually takes place during IPOs in Nigeria and Sri Lanka; and (2) whether the mispricing could constitute corporate fraud tendency since data to measure fraud in emerging markets are restrictive and unattainable hence we use dummy proxies. These dummy proxies represent fraud tendency via underpricing and fraud tendency via overpricing obtained from the initial returns given as the ratio of market price to issue price of the IPO stocks from 1987-2012 and 1988-2012 for the Nigerian Stock Exchange (NSE) and the Colombo Stock Exchange (CSE), respectively; placing special emphasis on the first-day trading of the IPOs slated during the sample period. The appropriate correlation that depicts fraud tendency in our study context is (-) for overpricing and (+) for underpricing. We identified 158 IPOs in the NSE and 139 IPOs in the CSE during the sample period by including IPOs of second-Tier and Diri Savi Markets. Using the GARCH models (a composition of TGARCH and EGARCH), we find that fraud tendency via underpricing is more prominent and highly pronounced in the Nigerian stock market than overpricing tendencies even though all are significant while overpricing is more pronounced in the Sri Lankan stock market than underpricing tendencies; meaning that in most cases corporate representatives pursue "money left on the table" because they probably have less stake in the companies in Nigeria while more companies IPOs create bubbles on the CSE in anticipation for future banking business. This is further substantiated by the descriptive test where we note that the average initial returns of IPOs in the NSE and CSE is 24.29% and 202.22%, respectively, confirming the divergent nature of the mispricing in the two markets as purported by Cornelli, et al (2005). We further observed stylized facts that indicate volatility clustering, high information asymmetry, leptokurtic and thick-tailed distribution and non-normal distribution that is highly skewed to the right.

Keywords: Corporate fraud tendencies, Initial return volatility, Mispricing overpricing, Underpricing