

**“WHAT’S WRONG WITH A PHENOMENON UNDERPRICING?”**

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**Abstract**

*The aims of this paper is to describe and explore the phenomenon of underpricing. Underpricing is the phenomenon of the low bid price and generally occurs during the initial public offering (IPO) and the seasoned equity offering (SEO) which the issuer using the underpricing as a "strategy". The phenomenon of underpricing caused due to asymmetry information between informed and uninformed investors which ultimately makes underpricing into a business strategy. Empirical studies indicates that the influence factors of the phenomenon of underpricing are underwriter reputation, auditor reputation, firm age, company size, larger board, board independence, the profitability of the company, and financial statements.*

**Keywords:** *underpricing phenomenon, IPO, SEO*

**JEL Classification:** *G02*

**INTRODUCTION**

Underpricing phenomenon is a phenomenon that exists in the world of capital markets. Underpricing phenomenon often discussed in various capital markets research (Darmadi and Gunawan, 2013; Flagg and Margetis, 2008; and Anggarwal et al., 2002) that contribute to the development of research on the phenomenon of underpricing. Underpricing phenomenon usually occurs in the capital markets, especially in the primary market. Jogyanto (2014), explained about the type of capital markets in Indonesia :

1. Primary Market

A fresh securities by the company are sold in this market, and for securities newly sold can be either an initial public offering to the public (Initial Public Offering or



IPO) or additional securities new one if the company has been going public (Seasoned New Issue or Seasoned Equity Offering).

2. Secondary Market

Market that trades securities has been in circulation traded in this market.

3. Third Market

Market that run by brokers who bring together buyers and sellers when secondary market was closed.

4. Fourth Market

Capital markets that committed between institutions large capacity to avoid paying a commission to the broker which use communications networks to trade the stock in a large number of blocks.

Some experts define underpricing (Jogiyanto, 2014; Hopkins and Ross, 2014; Ljungqvist and Wilhelm, 2003; Aggarwal and Rivoli, 1990). Jogiyanto (2014) defines the phenomenon of underpricing is an interesting phenomenon that occurs in the initial offering to the public. Hopkins and Ross (2014) defines underpricing in the IPO is the practice of setting the initial offering price below what the market expected related to the value of shares following the issue. Ljungqvist and Wilhelm (2003) argue that underpricing phenomenon may occur due to problems between the principal and the agent. Aggarwal and Rivoli (1990) defines that underpricing is a phenomenon of over-valuation of the IPO or a trend. Based on some of these definitions it can be concluded that the underpricing phenomenon is a phenomenon of the low offer price which generally occurs at the time of the initial offering to the public and when the additional offers.

When discussing about the underpricing phenomenon could not be separated from the discussion related to the IPO (Initial Public Offering) and SEO (Seasoned Equity Offering) as both are times when companies use "strategy" underpricing. Why are so many that the IPO? For companies it means the acquisition of funds quickly, while for the underwriters as the right time to enhance their reputation in the market, and moment IPO for an investors is always the main attraction (Nugraha, 2004).

Jogiyanto (2014) explains that the Initial Public Offering (IPO) is the company's offering for the first time. The decision for going public or remains a private company is a



decision that must be considered deeply because if the company decides to going public and throwing stock debut to the public (Initial Public Offering), the main issue that arises is the type of what stocks will be thrown, what price which should be set for a piece of the shares and when it is most appropriate (Jogiyanto, 2014). There are several advantages of going public is 1) the ease of raising capital in the future, 2) increase liquidity for shareholders, and 3) the market value of the company is known, but behind some advantages there are some disadvantages of going public is 1) the cost of the report increased, 2) the disclosure of truly information, and 3) the fear of being taken over (Jogiyanto, 2014).

The actors of IPO that causes underpricing phenomenon are the issuers, underwriters, and investors (De Lorenzo and Fabrizio, 2001) which allegedly occurred asymmetric distribution of information among actors IPO. Companies referred to here is the issuer, described in Law No. 8 of 1995 on capital markets that the definition of the issuer are parties to a public offering. The issuer is a designation for companies that issue shares or bonds (bond), and the buyers are public (Tandelilin, 2010). There are two treatments of issuers according Tandelilin (2010):

1. The issuer's shares sell shares through a public offering either IPO (Initial Public Offering, IPO) to public investors, the next stock offerings (Seasoned Equity Offering).
2. The issuer's bonds sell bonds through public offer both IPO and the next bond offerings.

The underwriter is who make the process of underwriting, underwriting is the process of purchasing securities by investment bankers who will be sold back to the public (Jogiyanto, 2014) while also described in Law No. 8 of 1995 on capital markets that the underwriter are parties who makes a contract with the issuer to conduct a public offering for the benefit. Investors or capitalist are the ones who invest the funds in securities (Tandelilin, 2010) and make investments to improve utilities in the form of financial well-being (Jogiyanto, 2014), further described in Law No. 25 of 2007 on capital investment is an individual or business entity that makes an investment that can be either a domestic investor and a foreign investor.



For public bidding process in preparation for the IPO (Initial Public Offering) in stocks and bonds ([www.idx.co.id](http://www.idx.co.id)) can be classified into several stages:

1. Preparation Stage

This stage is beginning to prepare everything related to the public offering process. It was first performed by the Prospective Listed Company is doing a General Meeting of Shareholders for approval of the shareholders in the Public Offering of shares. After the approval, the appointment Prospective Listed Company doing Supporting Institutions and Professionals of the Capital Market, that is:

- a) Underwriter is the most involved in helping prospective companies listed in order to issue shares by preparing various documents, helping to make the prospectus and provide guarantees for the issuance of securities.
- b) Public Accountant (Independent Auditor) are the people in charge to conduct an audit or examination of the Listed Company's Financial Statements and the Prospective Listed Company.
- c) Independent assessors who is a party to make an assessment on assets Prospective Listed Company and determining the fair value of these assets.
- d) Legal Consultants is a party to give a legal opinion.
- e) The notary is a party to make the deeds of amendment, deed of agreements in order to the public offering and the meeting notes.
- f) The Bureau of Securities Administration, tasked to administer the stock ordering and administering shareholding.

2. Filing of Registration Statement Stage

In this stage, the Prospective Listed Company completes supporting documents to submit the Registration Statement to OJK until the OJK has stated that the Registration Statement becomes effective.

3. Public Offering Stage

This stage is the main stage for Prospective Listed Company offered its shares to the public (investors). Investors can buy shares through a selling agent who has been appointed. This public offering period of at least one working day and a



maximum of 5 working days. Keep in mind that all the desire of investors for shares Prospective Listed Company can be wholly satisfied in the event of excess demand (oversubscribe). For example, the shares offered to the public through the Primary Market for 100 million shares, while the demand for the purchase of shares from all investors of 150 million shares. In case investors do not get the shares were booked through the Primary Market, then the investor can buy the stock in secondary market is the market where the shares were listed and traded on the Stock Exchange.

#### 4. Registration of Shares on the Stock Exchange

After the completion of the sale of shares in the Primary Market, then shares are listed and traded on the Indonesia Stock Exchange.

Several studies have found evidence that when the IPO underpricing phenomenon usually occurs such as in Indonesia (Jogiyanto, 2014; Nugraha,) and in some countries, namely in the UK (Levis, 1993) and in the US (Loughan et al., 1994).

The phenomenon of underpricing most phenomenal for in Indonesia is when the IPO of PT. Krakatau Steel Tbk in 2010 dropped in which Lukas Setia Atmaja (2011) described that is like the investor has the cash machine where prices IPO shares of PT. Krakatau Steel Tbk on the primary market is Rp 850 per share while the investors can sell on the first day of trading in the Indonesia Stock Exchange Rp 1.270 per share. What is thought by PT. Krakatau Steel Tbk? Indeed, there is always a possibility that the IPO price are reasonable but investors act less rationally so that scrambling to buy shares. Krakatau Steel Tbk is currently traded in the secondary market. Still, the allegations of various parties that the price of shares. Krakatau Steel Tbk accidentally set underpriced and most stocks has been blocked a number of major institutions, including the politicians, for the sake of personal interests and groups with the aim of selling these shares at a much higher price when trading debut on the stock exchange and the facts show that after IPO PT. Krakatau Steel Tbk of total shares outstanding 15.755 billion, foreign investors have 7%, domestic investors 13% and government 80%.

Not only in Indonesia, in early 2006 McDonald announced go public subsidiary, Chipotle Mexican Grill at the offering price of \$ 22 per share, while the first day of trading on the exchange, stock prices soared and closed at \$ 44 per share, many of Mr. Average and



enjoy greater profits, and vice versa if the shares "overprice" the IPO, Mr. Genius will let Mr. Average purchase all shares offered. Mr. Average "win" but lost money, one strategy to address the problem of Winner's Curse and interesting Mr. Average to keep buying IPO shares, so that underwriters must offer underpriced the IPO price (Atmaja, 2011).

Underpricing phenomenon is not only found at the time of IPO (Initial Public Offering), but also when SEO (Seasoned Equity Offering) (Chemmanur et al., 2009; Cook and Officer, 1996). Despite the fact, the phenomenon of underpricing in SEO is not as big as at the time of IPO (Kim and Shin, 2001). SEO (Seasoned Equity Offering or Seasoned New Issue) is a new additional securities if the company has been going public (Jogiyanto, 2014). Sulistyanto Explained (2008) that Seasoned Equity Offerings (SEO) is an additional stock offering conducted by public companies that need additional funds to finance operations and investment activities as well as finding funds to pay long-term debt maturing.

According Sulistyanto (2008) for a stock offering SEO can be done in two ways, namely:

1. Through the mechanism of a rights issue or sell the rights to the existing shareholders to buy additional shares with certain price and at a certain moment. This mechanism is usually done by a company that his ownership was is concentrated with the aim of separately protecting the interests of existing shareholders in order to maintain the same proportion as their ownership before this equity offerings (preemptive right). This mechanism is commonly used by companies in the capital markets of developing countries (emerging market) that his ownership was tends to be concentrated on the person, family, or group.
2. Through a second mechanism offerings, offerings third, and so on, or sell additional shares to any investor in a market that wants to buy it not only to existing shareholders. This mechanism is commonly used by companies in the capital markets of developed countries (developing market) that his ownership was tends to spread in many parties and there is no majority shareholder. However, in contrast to the rights issue, the share price in this mechanism is purely determined by the supply and demand in the market. The share price will be high if the market demand is high, otherwise the share price will be low if the



market demand is also low.

In Indonesia, all related to capital markets and investment has been regulated by the Law No. 8 of 1995 on the Capital Market and Law No. 25 of 2007 on Investment. Both of law is expected to be a reference or guidelines for market participants, particularly those associated with underpricing phenomenon in Indonesia. Because of this phenomenon does not only happen in Indonesia, but also in various parts of the world, then the question arises lay of this underpricing phenomenon: whether the phenomenon of underpricing can be tolerated or who the beneficiaries of this underpricing phenomenon? This research aims bridging the wide range of research related to the phenomenon of underpricing into a comprehensive unity and explore the phenomenon of underpricing.

### **HOW THE OCCURRENCE OF UNDERPRICING PHENOMENON?**

Darmadi and Gunawan (2013) and Cook and Officer (1996) explain that phenomenon of underpricing is supported the signaling theory. Scott (2009) definition that: "A signal is an action taken by a high-type manager that would not be rational if that manager was low-type." From these definition, it can be explained that the signal is an action taken by the manager high-type irrational if done by a low-type profile. This indicates that the transmission of signals conducted by the manager of the high-type where a manager of high-type seen by investors to have information that is more credible than the manager of the low-type, so that managers of high-type which will provide information to investors and is responsible for the provision of such signals. Then described further by Scott (2009) that the existence of a certain standard in a country about standardization in accounting would reduce the ability of high-type manager to transmit signals to the investor or prospective investor.

Research of Darmadi and Gunawan (2013) found that according to the signal theory described by Leland and Pyle (1977), because of the asymmetry of information between the issuer and investors, the company sends a signal about which aims to show the best quality companies and that the conflict of ownership between the principal and the agent can be minimized as well to show other signals companies IPO can communicate how the reputation of their external auditors.



Signal theory relating to the prospectus was information released about the company detailed which serves to provide information about the condition of the company to potential investors, so that the existence of such information, the investor will be able to know the company's prospects in the future, and further interested in buying securities issued from the issuer (Tandelilin, 2010).

Further explained about how public investors or the general public to buy stocks or bonds in the primary market, where before deciding on investments, investors can start by learning the prospectus described by Tandelilin (2010) contains among others:

1. Type of business and history of the issuer
2. Number of share or bond that offered to the public and a bid price
3. The purpose of IPO
4. The issuer's prospect and business risk in the future
5. Debt payments and dividend policy
6. The historical financial performance
7. The sales agent who participated in the process of IPO
8. The implementation schedule of IPO

Tandelilin (2010) explained that investor can get prospectus in stock company and read in newspaper, financial reporting was included in prospectus and as additional, the issuer must be publish financial reporting regularly. It's supported research of Friedlan (1993) that financial reporting information effected IPO's bid price.

Jogiyanto (2014) describe that phenomenon of underpricing happened since the first offer to the public that the average cost of which is buy the average stock in the IPO could get back the initial high, mean the intention is not all the initial offering cheap, but it can also be expensive and means that they can be said to be cheap (underpricing). Further described that the initial return is the return earned on the assets in the initial offering from when purchased in the primary market until the first registered in the secondary market.

Companies usually hand over problems related with the IPO (Initial Public Offering) of the company to an investment banker (investment banker) who have expertise in the sale of securities in which the sale of new shares involving an investment banker is on sale in the primary market (Jogiyanto, 2014). Then the investment banker who is the intermediary



between companies that sell shares (issuer) with the investor, who did his job to advise the company in preparation for the sale of securities to the public in the form of recommendations concerning: 1) the type of securities what will be sold, 2) how much the price of the securities, 3) when the time throwing securities and also functions as a giver of advice (advisory function), investment bankers also serves as a buyer of shares (underwriting function) and serves as a marketer shares to investors (marketing function) as described Jogyanto (2014 ).

Some of the technical stages of the preparation process of go public including: (Rahardjo, 2006):

- BAPEPAM will declare the effectively registration on 45 days after the issuer and the underwriter (lead underwriter hand over a complete administrative file to BAPEPAM.
- Issuers (companies that go public) are expected to provide a complete prospectus for potential investors, as well as the prospectus that was published in a national newspaper; conducted three working days before the public offering
- Prospective buyers of shares who are interested can start an order to the underwriter by its appointed sales agents.
- After the offering period, followed by allotment of securities or securities allocation of orders from investors according to the number of shares available.
- Allotment period of about six days after the expiration of the offering period. Securities that have been allocated to investors in the form submitted a collective share certificate.
- If some or all reservations investor there are rejected (for example because of the limitations of securities sold) or turns the event of cancellation deals, investors will receive a refund no later than four working days after the date of allotment.

Issuers will make the process of preparation go public must make professional cooperation with various stakeholders such as a capable's lead underwriter who search potential investors. Friedlan (1993) revealed that the share price at the time of the IPO before selling it to potential investors, the issuer and underwriters must use non-financial information about the pricing of the company's offerings and accounting (as basis of



measurement) is often identified as being very useful in assessing the securities so that update report financial affect the IPO offering price.

In outline, the underpricing is a signal given by the company to potential investors in order for them to invest their money in shares of IPO (Initial Public Offering) and SEO (Seasoned Equity Offering) in which information to be launched by financial information (financial statements) and information non-financial (prospectus) described that the determination of the current stock price when the IPO and SEO suggested by underwriters using low price (underpricing).

### **WHY UNDERPRICING PHENOMENON HAPPEN?**

Many research that discussed the causes of the occurrence of underpricing be a topic that is still interesting area for research, considering that this phenomenon inevitable in part of the world countries. Described in the book *The Phenomenon of IPO Underpricing in the European and US Stock Markets* that there are four things that are considered to motivate the underpricing during the IPO that is asymmetry of information (information asymmetry), explanation of the institution (institutional explanations), a model of ownership and control (ownership and control models), an explanation of behavior (behavioral explanations).

Scott (2009), defines asymmetry of information is part of a business transaction where one side has more information than the advantages of others. According to Scott (2009), asymmetry of information is divided into two types, namely: 1) Adverse selection, is one type of information asymmetry if one side (the manager) has the benefit of information exceeds the other hand, many ways for managers and other insiders can exploit the benefit of their information on the cost of outside parties; 2) Moral hazard, arises because of the separation of ownership and control and moral hazard happened when one hand can observe the actions of other hand in the transaction.

In a research with entitled "Regulatory Strategies Under Asymmetric Information" performed by Baron (1982) explains that the information asymmetry happened between the issuer (company) and the underwriter caused by underwriters have more information than the issuer (company). The share price could drop in the first week on the secondary market if the IPO price was set too high. The underwriters will be facing angry's investor who buy stocks



overpriced. To "calming" the investor and image building, underwriters tends to propose a price "underpriced" (Atmaja, 2011). This is unexpectedly and indicates the asymmetry of information between underwriter with issuers.

In a study entitled "Why New Issue Are underpriced" by Rock (1986) explains that underpricing occurs because of the asymmetry information that exists in the IPO among investors who have information (informed investors) to investors who do not have the information (uninformed investors) who then this information asymmetry is called "Winner's Curse".

This was in line with research conducted by Hanley, et al. (1993) and Ruud (1993) that the phenomenon of underpricing happened because it is dominated asymmetry of information. Not only in the case when the IPO, underpricing phenomenon but also happened because of the asymmetry of information at the time of SEO, it is the result of research of Chemmanur and Jiao (2011). Thus outline can be concluded that an information asymmetry consists of two models, and it's called Baron's Model (1982), which revealed that the asymmetry of information occurred between the owner of the company (management) with underwriters and model of Rock (1986), which revealed that the information asymmetry happened among investors who have information and investors who do not have the information. Discusses the phenomenon of underpricing is not separated from the relation with the reputation underwriter, explained that the reputation underwriter and underpricing is positively correlated (Loughran and Ritter, 2004; Cooney, et al., 2001; Ruud, 1993) which proves that there is a role of underwriter to the phenomenon of underpricing, Flagg and Margetis (2008) also discusses whether the characteristics of underwriters influence the underpricing phenomenon.

Several things that became the reason of the occurrence of the phenomenon of underpricing, implying that most of company do an IPO and SEO improve "underpricing treatment" on their shares so that seems to be the company's strategy to encourage investors to invest in their IPO's stock and SEO's stock , and with the findings of Rock (1986) that "discount price" of these shares used to attract investors, consistent case this very suitable for investors who expect a capital gain and initial return. In addition underpricing occurs when SEO is also one of the company's business strategy (Chemmanur and Jiao, 2011) to be in line



with that presented at the IPO, underpricing phenomenon can be used as a strategy for companies to attract investors.

### **WHAT ARE THE FACTORS THAT INFLUENCING UNDERPRICING PHENOMENON?**

Several previous research discusses the factors considered to influence the phenomenon of underpricing. Darmadi and Gunawan (2013) found the facts in the company's IPO in Indonesia who experienced the phenomenon of underpricing that independence board has a positive correlation to underpricing, but the phenomenon of underpricing has a negative correlation with board size and institutional ownership which indicates that they play a role in reducing information asymmetry that occurs between the issuer and potential investors in the IPO. Further explained that the company's profitability was found to positively affect the level of underpricing, which indicates that investors see the high level of performance as a signal of good quality of the company, as well as the auditor reputation and the reputation of underwriters are found to be significant and negative which supports the notion that the auditor and underwriter leading play an important role in reducing the asymmetry of information between issuers and potential investors. In addition, a senior official and Gunawan (2013) also explains that with the supervision of the government to the company led to the underpricing the higher tendency for case studies in Indonesia by using a sample of 101 companies in the primary market in the years 2003-2011.

Hearn (2011) conducted a study in West Africa find results that larger board positively related to the level of underpricing, which is reflected in the cost of information asymmetry arising from coordination and decision-making problems. Aggarwal, et al. (2002) wrote a journal titled Strategic IPO Underpricing, Information Momentum, and Lockup Expiration Selling that test IPO in 1994 and 1999 which have an extreme underpricing on the first day. The findings of this study are caused of underpricing magnitude as well shares managerial and ownership and selection of the first day underpricing to create a momentum.

Kim and Shin (2001) explains that there is underpricing at the time of SEO during the 1990s but did not find the phenomenon of underpricing during the 1980s in which SEO for this research using more than 3.000 Seasoned Equity Offering (SEOs) from 1983 to 1998.



Chemmanur et al. (2009) describes the relation of SEO and underpricing find evidence that there is an average of 3.5% underpricing on SEO in the period of 1999-2004.

Rahman and Yung (1999) examined the underpricing theory using data from the Wall Street Journal which is the Directory of Corporate Finance since January 1983 to December 1990. This paper discusses whether the underpricing in IPOs in regulated industries such as insurance in America. The research found significant evidence of the combined effect on price support and asymmetry of information about insurance IPO. This shows that there are regulatory problems, monitoring, and reporting on the insurance industry do not eliminate the underlying factors that lead to information asymmetry IPO underpricing. Also explained that underpricing is more significant when the issues covered by the non prestigious underwriters, it is in accordance with the literature or previous research.

Utaminingsih, et al. (2013) found that IPO trading based on asymmetric information between heterogeneous investors. Using data from various sources and databases from January 2001 to December 2010. The results Utaminingsih, et al. (2013) that in the process of underpricing an IPO, underwriters have an active role which underpricing is the main issues and underwriter managing IPO's trading by determining the range of the price offered and discriminatory treatment between institutional and individual investors. Furthermore, underwriters give priority to institutional investors, especially when they indicate a powerful interest to buy at the time of book building. This research proves that underpricing is higher when the price of the IPO is closer to the upper limit of the price range. It was also found that underpricing is higher when the allocation of shares to institutional investors greater.

Triani and Nikmah (2006) describes the impact of IPO practices in Indonesia that carried out to all the company's IPO on the JSE over the period 1994-2000 with a total sample of 90 companies and using OLS regression and chow test for hypothesis test. The results of this research shows that underwriter reputation positive significant effect on the initial return, the stock offering significant negative effect on the percentage of the company's performance one year after the IPO. Furthermore, the auditor's reputation shows no correlation with the initial returns. Friedlan (1993) in a journal entitled "Accounting Choices of Issuers of Initial Public Offerings" by using a sample of 277 companies IPO in the US during the years 1981-1984. Friedlan research results (1993) explains that earnings of the IPO



issuers increase discretionary accruals in financial statements released before the stock offering. The conclusion that the financial statement information affecting the bid price when the IPO.

From the various previous research, it can be concluded that the factors that influence the occurrence of the phenomenon of underpricing which is underwriter reputation (Ruud, 1993; Darmadi and Gunawan, 2013; Rahman and Yung, 1999; Utaminingsih, 2013), auditor reputation (Beatty, 1989; senior official and Gunawan, 2013), age of the firm (Beatty, 1989), the size of the company (Beatty, 1989), larger board (Hearn, 2011), board independence (Darmadi and Gunawan, 2013), the company's profitability (Darmadi and Gunawan, 2013), and financial statements (Friedlan, 1993).

## **CONCLUSION**

Underpricing phenomenon is a phenomenon that exists in the world of capital markets. Underpricing phenomenon often discussed in various capital markets research that contribute to the development of research on the phenomenon of underpricing. The underpricing phenomenon is arises phenomenon when IPO (Initial Public Offering) and SEO (Seasoned Equity Offering). This is the time for companies to use "strategy" underpricing. The actors of IPO that causes underpricing phenomenon are the issuers, underwriters, and investors. The question arises lay of this underpricing phenomenon: whether the phenomenon of underpricing can be tolerated or who the beneficiaries of this underpricing phenomenon?

The underpricing is a signal given by the company to potential investors in order for them to invest their money in shares of IPO (Initial Public Offering) and SEO (Seasoned Equity Offering) in which information to be launched by financial information (financial statements) and information non-financial (prospectus) described that the determination of the current stock price when the IPO and SEO suggested by underwriters using low price (underpricing).

Several things that became the reason of the occurrence of the phenomenon of underpricing, implying that most of company do an IPO and SEO improve "underpricing treatment" on their shares so that seems to be the company's strategy to encourage investors to invest in their IPO's stock and SEO's stock , and with the findings of Rock (1986) that



"discount price" of these shares used to attract investors, consistent case this very suitable for investors who expect a capital gain and initial return. In addition underpricing occurs when SEO is also one of the company's business strategy (Chemmanur and Jiao, 2011) to be in line with that presented at the IPO, underpricing phenomenon can be used as a strategy for companies to attract investors

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