The 2013 Capital Market Research Scholarship for Graduate Students

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"…The Effect of Corporate Governance on Earnings Management in Thai Market...."

By

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Research Objective

Benefits for Thai Capital Market

- This study examines whether corporate governance can reduce the level of earnings management and the negative effect of earnings in Thai stock market.
  - To examine the role of corporate governance on the level of earnings management in Thai stock market.
  - To examine how corporate governance has an impact on the effect of earnings management in Thailand.

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Executive Summary

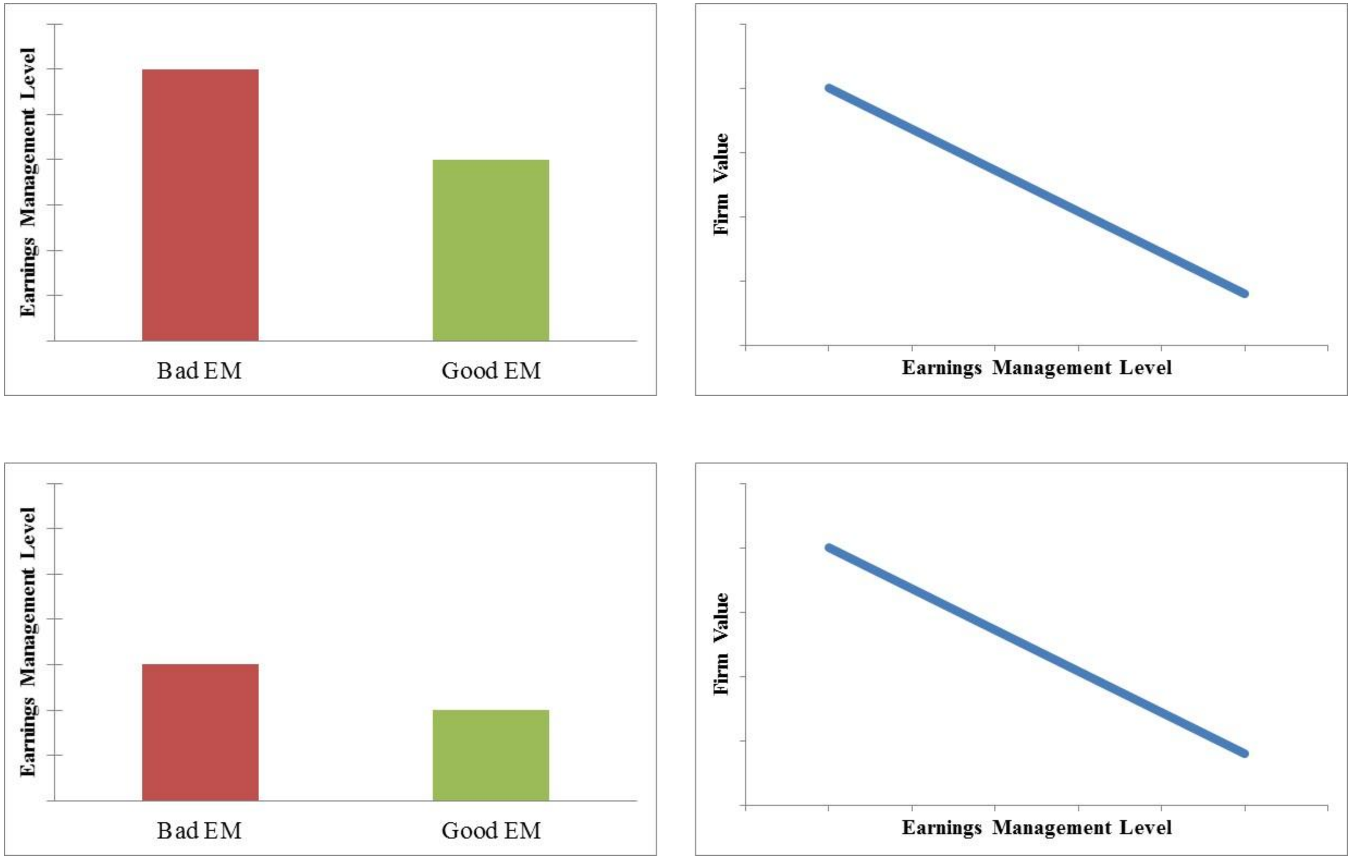
- Earnings management usually refers to the efforts of firm managers or executives to manipulate the earning figures in financial reporting.
- Previous literatures have discussed that earnings management can be both positive and negative to firm value, which depends on how managers use it.
- Moreover, previous empirical studies have shown evidence to support the role of corporate governance in reducing the level of earnings management.
- The SEC and SET has promoted the CG Practices in Thailand since 2001. The CG practices of the listed companies are evaluated based on the five criteria 1) Rights of shareholders 2) Equitable treatment of shareholders 3) Role of stakeholders 4) Disclosures and Transparency and 5) Board Responsibilities

Executive Summary

- Previous studies have shown that corporate governance can reduce the level of earnings management. However, if corporate governance can reduce managerial opportunism, it should help to reduce the negative earnings management but not positive one.
- Using the empirical data in Thailand and the corporate governance performance based on Thai IOD, it supports that corporate governance can reduce the level of earnings management and can also make the effect of earnings management become more positive.

Research Framework

Theoretical Model



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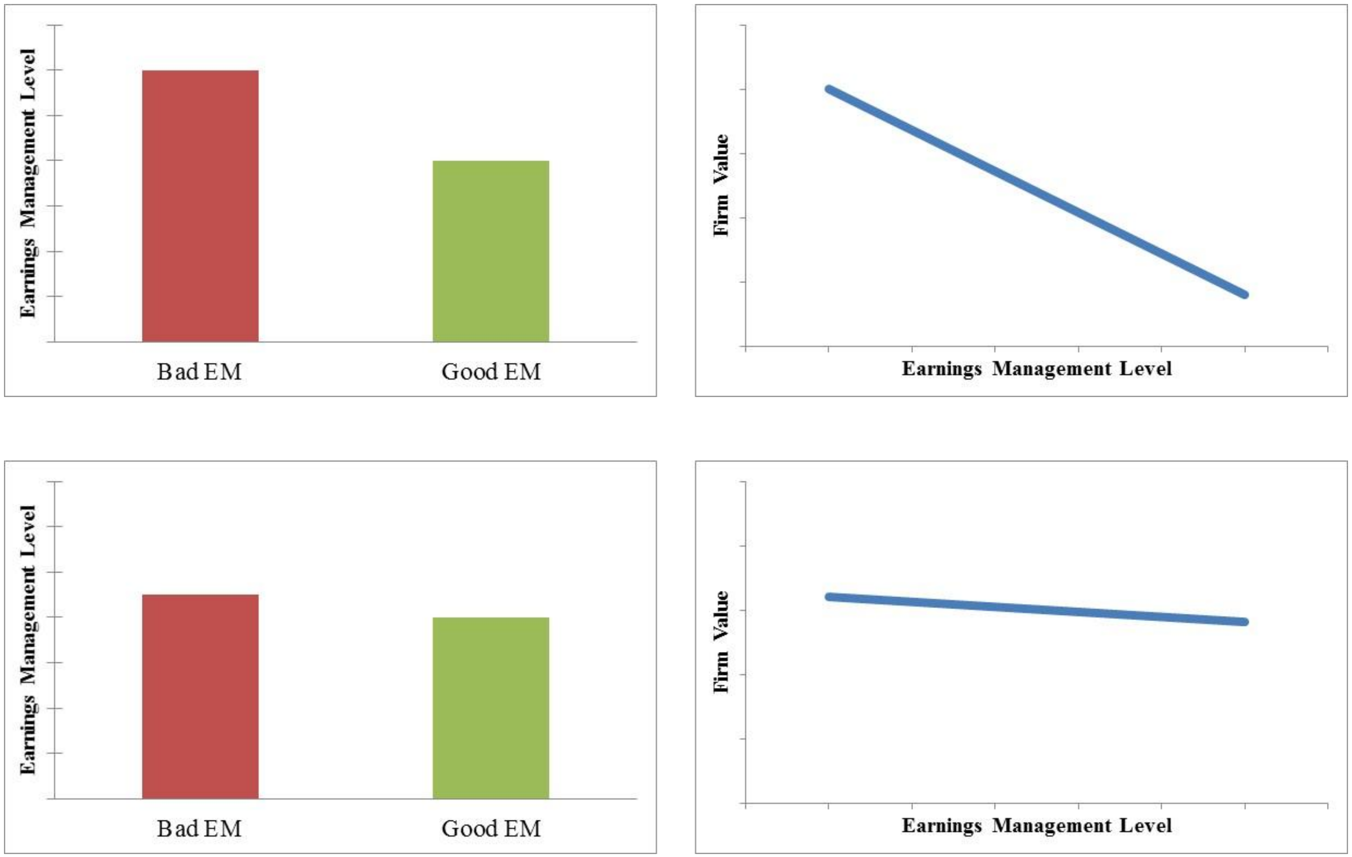
Research Framework

Theoretical Model



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Research Framework

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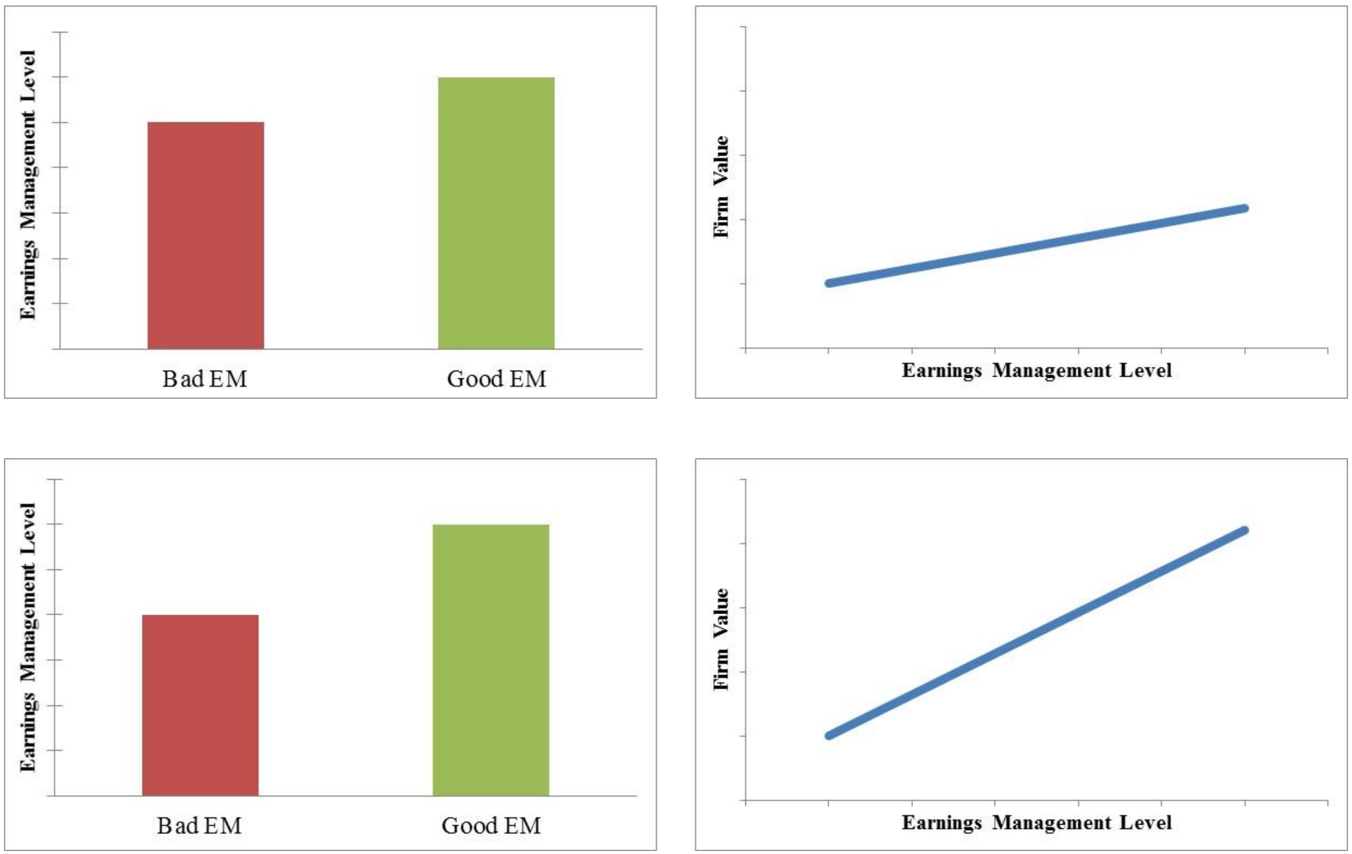

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Research Framework

Research Hypotheses

- **Hypothesis I**: Corporate governance can help in reducing the average level of earnings management.

- **Hypothesis II**: The relation between earnings management and firm value should be more positive (or less negative) in the firms with higher level of corporate governance.
  (Corporate governance can help in reducing the negative effect of earnings management.)

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Research Design

Empirical Data

- All firms traded on the Stock Exchange of Thailand (SET)
- Time period = 2008-2011
- Accounting data is available in the WorldScope database.
- Exclude Financial Sector to avoid heterogeneity of sample characteristics.
- There are 1,748 firm-year observations.

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Research Design

Corporate Governance Performance

- Thai IOD report on CG-star

	2008	2009	2010	2011	Total
N/A	215	242	159	180	796
★★★	121	63	100	123	407
★★★★	83	94	131	108	416
★★★★★	13	33	50	33	129
Total	432	432	440	444	1,748

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Research Design

Earnings Management Measurement

- Total Accruals (Healy, 1985)

$$Accruals_i = \left(\Delta CA_i - \Delta Cash_i\right) - \left(\Delta CL_i - \Delta STD_i - \Delta TP_i\right) - DEP_i$$

- Modified Jones's Discretionary Accruals

  (Jones, 1991, Dechow et al., 1995)

$$\frac{Accrual_i}{Asset_{t-1}} = \beta_0 \frac{1}{Asset_{t-1}} + \beta_1 \frac{\Delta REV_t - \Delta REC_t}{Asset_{t-1}} + \beta_2 \frac{PPE_t}{Asset_{t-1}} + \varepsilon_{it}$$

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Research Design

Testing Model

$$FV_i = \beta_0 + \boxed{\beta_1} EM_{it} + \gamma_1 DR_{it} + \gamma_2 SIZE_{it} + \gamma_3 GROWTH_{it} + \varepsilon_{it}$$

$$FV_i = \beta_0 + \beta_1 EM_{it} + \sum_{j=1}^{m} \boxed{\delta_i} D_{ji} \times EM_{it} + \sum_{j=1}^{m} \gamma_j CONTROL_{it} + \varepsilon_{it}$$

- FV = Firm Value → Tobin's Q Ratio (Yermack, 1996; Jiraporn et al., 2008)
- EM = Absolute Discretionary Accruals
- DR = Debt ratio (Jensen and Meckling, 1976; Ross, 1977; Bradley, Jarrell, and Kim, 1984)
- SIZE = Natural logarithm of total assets (Hirschey and Spencer, 1992)
- GROWTH = the growth rate of total assets (Gordon, 1959)
- D = Dummy variable for CG-star group

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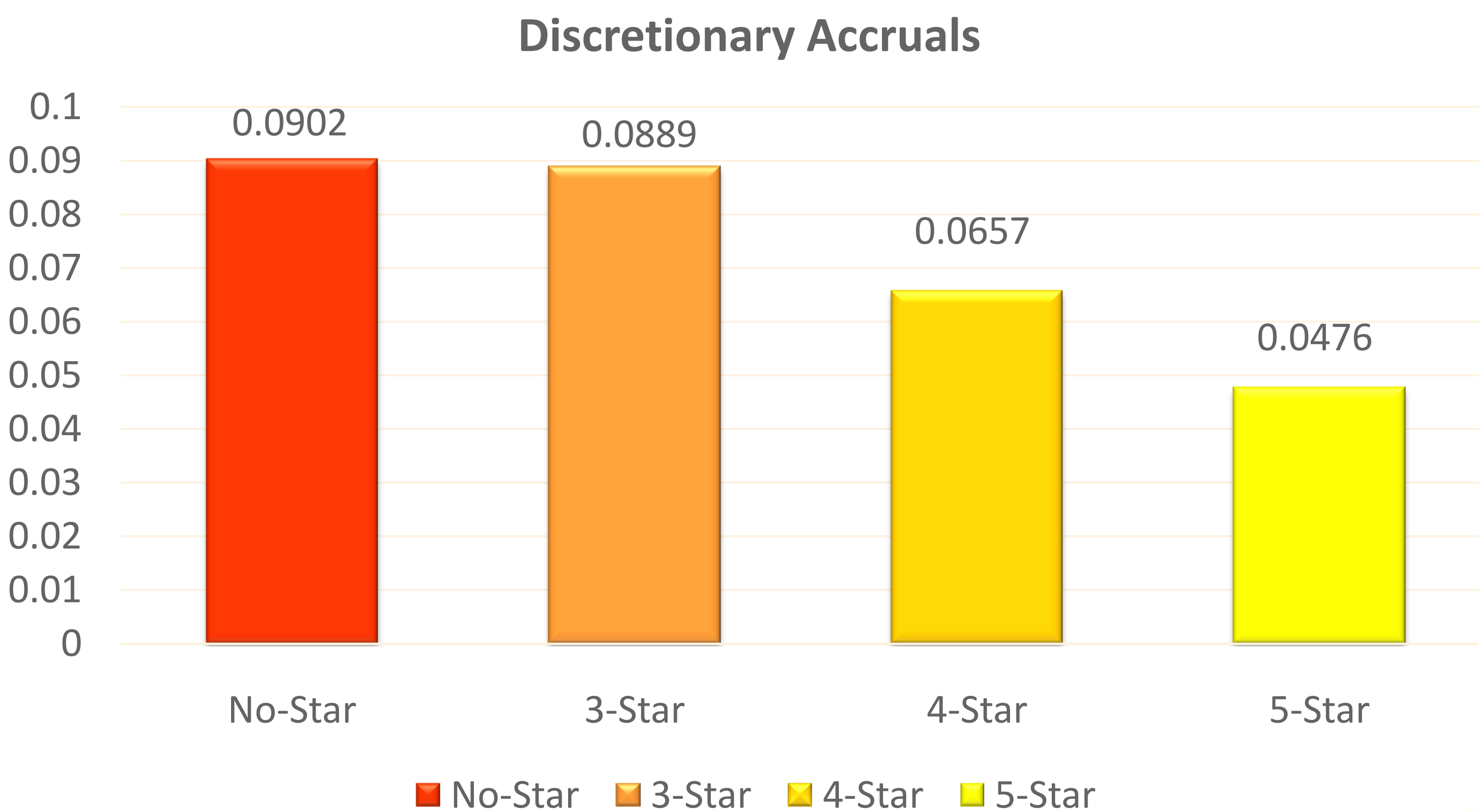
Analysis and Result

Hypothesis I

One-way ANOVA F-test
is significance at 5%



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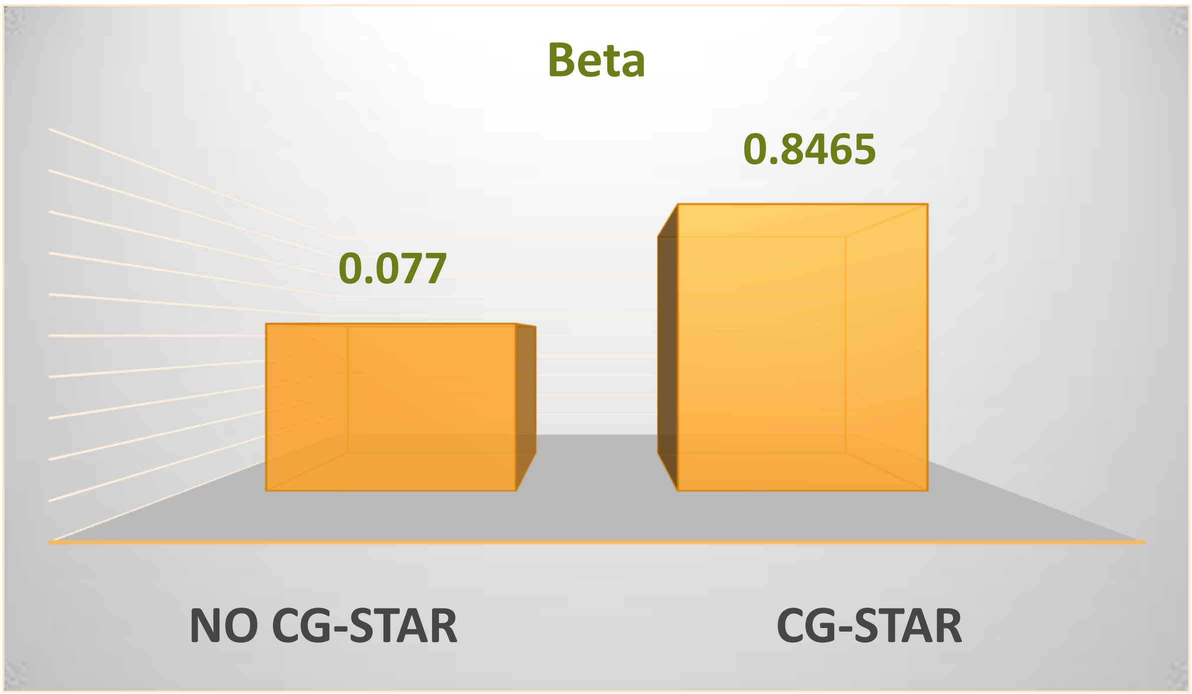
Analysis and Result

Hypothesis II

- The Coefficient of EM (The effect of EM on firm value)

$$FV_i = \beta_0 + \boxed{\beta_1} EM_{it} + \gamma_1 DR_{it} + \gamma_2 SIZE_{it} + \gamma_3 GROWTH_{it} + \varepsilon_{it}$$



Analysis and Result

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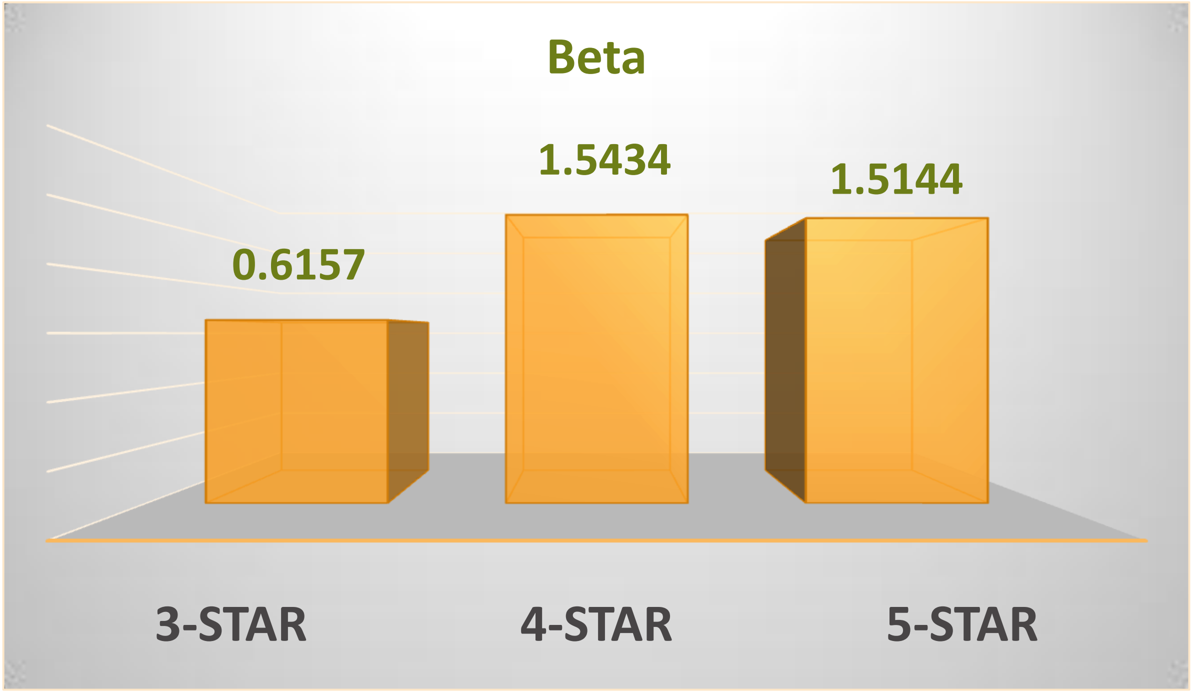

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Analysis and Result

Additional Analysis

- Include year dummy to reduce the effect from time series variation.
- Using robust standard error to mitigate the heteroskedasticity problem.
- Using Fama-MacBeth regression to reduce cross-sectional correlation problem.

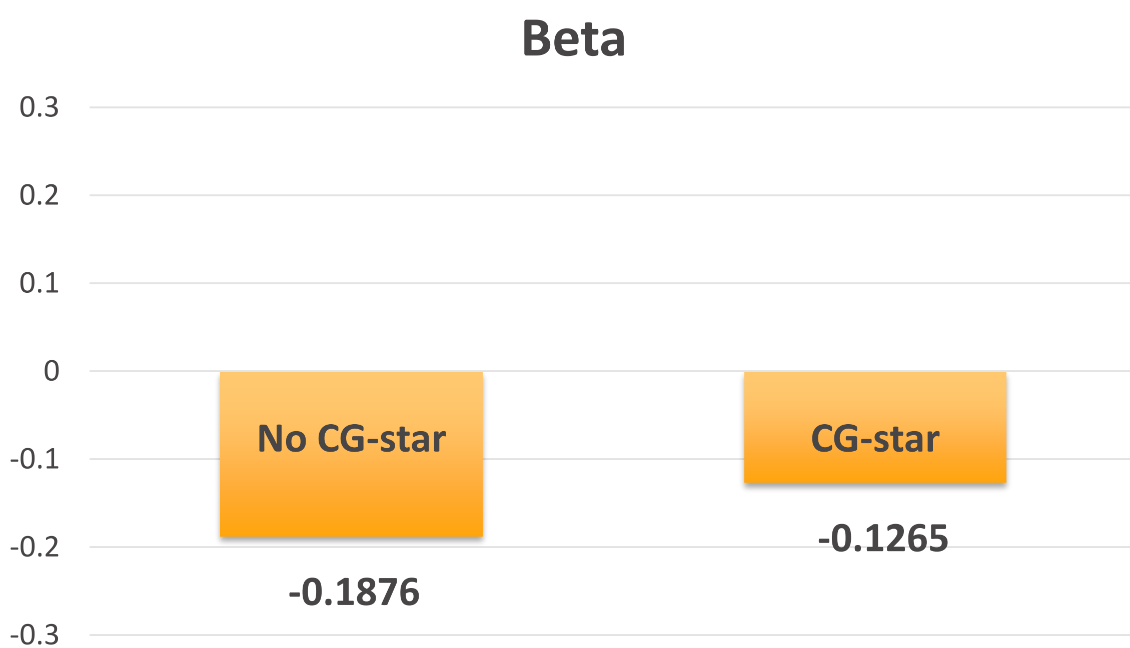
- Use stock return in 1st year and 2nd year after knowing CG-star instead of Tobin's Q

Analysis and Result

Additional Analysis

- The Coefficient of EM (The effect of EM on 1st year stock return)

$$R_{i,t+1} = \beta_0 + \boxed{\beta_1} EM_{it} + \gamma_1 DR_{it} + \gamma_2 SIZE_{it} + \gamma_3 GROWTH_{it} + \varepsilon_{it}$$



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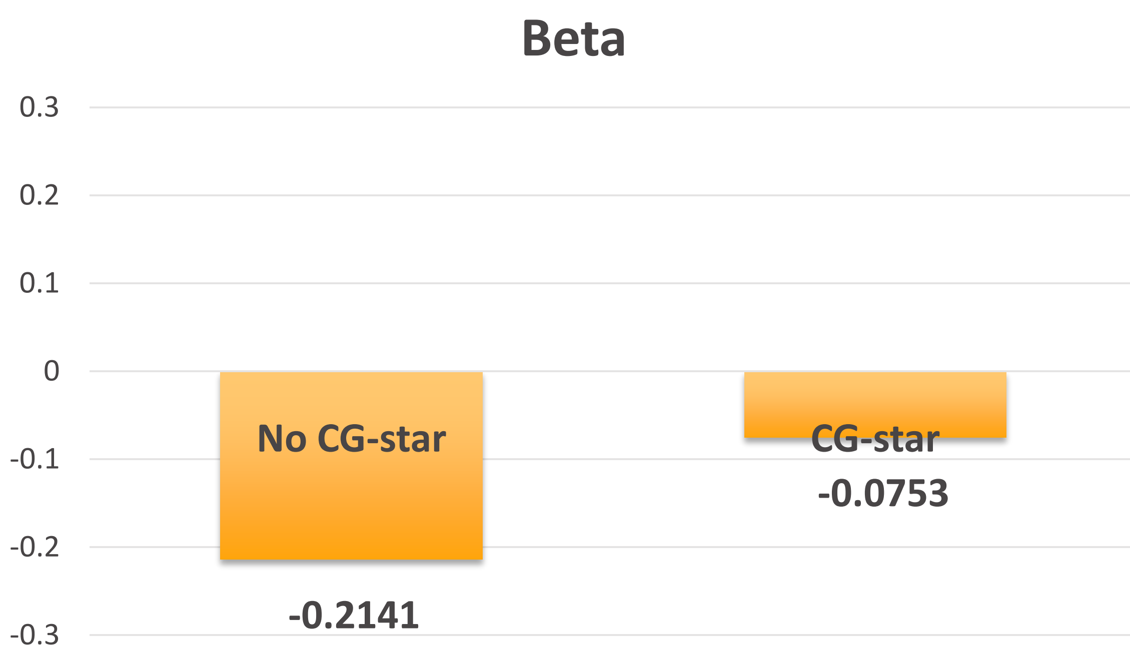
Analysis and Result

Additional Analysis

- The Coefficient of EM (The effect of EM on 2nd year stock return)

$$R_{i,t+2} = \beta_0 + \boxed{\beta_1} EM_{it} + \gamma_1 DR_{it} + \gamma_2 SIZE_{it} + \gamma_3 GROWTH_{it} + \varepsilon_{it}$$



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Conclusion and Implication

Main Finding

- The average level of earnings management (discretionary accruals) is highest for firms with no-star and lower for firms with higher CG-star.
- The effect of earnings management is more positive for firms with higher CG-star compared to firms with lower CG-star or no-star.
- Using stock return instead of Tobin's Q ratio to measure the effect of earnings management, the result is qualitatively similar.

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Conclusion and Implication

Research Implication

- Firms with better corporate governance should be less vulnerable to managerial opportunism. The level of bad earnings management should be lower. Managers may use earnings management in beneficial way rather than for private benefits.
- Investors may also perceive earnings management more positively in firms with better governance. Therefore, the effect of earnings management is more positive for higher-CG firms.
- The accounting professions have discussed and improved accounting standards to provide more meaningful accounting figures and to reduce managerial discretions in the report of earnings.

Conclusion and Implication

Research Implication

- In the firms with good governance, shareholders rights should be well-protected and they will be less vulnerable to opportunistic earnings management.
- Therefore, encouraging good governance is as important as improving accounting rules and standards in order to restrain the negative earnings management.
- Firms can improve their corporate governance performance based on Thai IOD's five principals 1) Rights of shareholders 2) Equitable treatment of shareholders 3) Role of stakeholders 4) Disclosures and Transparency and 5) Board Responsibilities.

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Conclusion and Implication

Limitation and Future Research

- The availability of corporate governance in Thailand is in form of discrete group, known as CG star. This limits the statistical technique that can be used in the analysis.
- If CG data is available in form of continuous score, more analysis can be conducted.
- For future research, other proxies of earnings management, e.g. real earnings management, can be used in order to confirm the result.
- Moreover, other perspectives related to corporate governance that can help to control managerial opportunism e.g. investor protection (how shareholders rights are protected by law and legal enforcement) can be used.

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