EARNINGS MANAGEMENT, COST OF EQUITY CAPITAL AND CORPORATE GOVERNANCE: AN EMPIRICAL ANALYSIS OF THAI LISTED COMPANIES

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DECLARATION

I certify that the substance of this thesis has not already been submitted for any degree and is not currently being submitted for any other degree or qualification.

I certify that any help received in preparing this thesis, and all sources used, have been acknowledged in this thesis.

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(Supawadee Sukeecheep Moss)

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LIST OF ACRONYMS

Symbol	Name of item
ACACT	Audit committee activities
ACEXPERT	Audit committee financial expertise
ACIND	Audit committee independence
ACSIZE	Audit committee size
ADFEE	Audit fees
ADOPIN	Audit opinion
ADREPU	Auditor Reputation
AEM	Aggressive earnings management
AEM-	Aggressive negative earnings management
AEM+	Aggressive positive earnings management
BETA	Market beta
BIG4	Big 4 audit firms
BIND	Board independence
BINT	Board interlocking
BLOCK	Substantial shareholders
BMEET	Board meeting
BOT	The Bank of Thailand
BSE	Bangkok Stock Exchange
BSIZE	Board size
BTM	Book to Market
CAPM	The Capital Asset Pricing Model
CCC	The Civil and Commercial Code
CEODUAL	CEO-Chairman duality
CFO	Cash flow from operation
CG	Corporate governance
CGR	Corporate Governance Report
CGSCORE	Corporate governance score
COE	Cost of equity capital
CSR	Corporate Social Responsibility
DA	Discretionary Accruals
EASTON	The Easton Model

EM	Earnings management
EMCF	Cash Flow Modified Jones model
EMCFBM	Modified Jones model with cash flow and book to market
EMMJ	Modified Jones model
EMPM	Performance Matched Discretionary Accruals model
EPS	Earnings per share
FAMOWN	Family ownership
FAP	The Federation of Accounting Professions
GAAP	Generally Accepted Accounting Principles
IAS	International Accounting Standards
ICAAT	Institute of Certified Accountants and Auditors of Thailand
IFRS	The International Financial Reporting Standards
IMF	International Monetary Fund
INDEP	The Industry Adjusted Earning to Price ratio
IPO	Initial Public Offering
INSSHARE	Institutional ownership
IOD	Thai Institution of Director
LEV	Leverage ratio
LOGASSET	Company's size
MAI	Markets of Alternative Investments
MNGOWN	Managerial ownership
MOF	Ministry of Finance
MTB	Market to book ratio
NADFEE	Non-audit service fees

ABSTRACT

This study has three main objectives: (i) estimate earnings management of Thai listed firms during the period 2003 to 2010, (ii) investigate the relationship between corporate governance and earnings management, and (iii) examine the influence of earnings management and corporate governance on the cost of equity capital. The population of this study comprises all listed companies on the Stock Exchange of Thailand during the period 2003-2010, with the exception of financial and insurance groups, listed companies on the Market for Alternative Investments (MAI), listed companies under rehabilitation and companies under property fund. The final sample for this study consists of 3,120 firms-years.

Earnings management in this study is measured using five different models: the Modified Jones model, Performance Matched Discretionary Accruals model (with current ROA), Performance Matched Discretionary Accruals model (with lagged ROA), Cash Flow Modified Jones model, and Modified Jones model with cash flow and book to market. As well, the level of earnings management is divided into four different approaches including: signed earnings management, absolute earnings management, two groups of earnings management (low and aggressive), and three groups of earnings management (negative aggressive, low and positive aggressive). In terms of the cost of equity capital, three models; namely, the Capital Asset Pricing model (CAPM), Easton model, and Industry Adjusted Earnings to Price ratio model are employed to estimate the cost of equity capital in this study. To examine the relationship between earnings management, cost of equity capital, and corporate governance; the ordinary least squares (OLS) and binary logistic regressions are used in both pooled data and the fixed effects panel regressions. In addition, multinomial logistic regression is used in the pooled data regressions but not in panel data estimation. The advantage of panel data is the ability to control for individual specific, time-invariant, unobserved heterogeneity, omitted variables which could lead to bias when using pooled data. Therefore, preference is given to panel data regressions when summarising the results of this study.

This study provides several interesting findings. With regard to the first objective, trends in earnings management, there are consistent trends in earnings management in the five discretionary accruals models. These trends show that, overall, the level of earnings management in Thailand fluctuated from 2003-2010. Compared to other emerging and developed market, this study reveals that, on average, signed earnings management is higher for Thailand than Singapore, Hong Kong, Malaysia and China. However, it is

lower than for Indonesia. For absolute earnings management, the results of this study show that the level of earnings management in Thailand is similar to that in China but lower than those in Hong Kong and Singapore.

With respect to the second objective, the influence of corporate governance on earnings management, based on panel data, this study finds strong evidence that board size, board independence, audit committee activities, and audit committee financial expertise are significantly negatively associated with earnings management. These results are consistent with previous studies which suggest that firms with larger board size, higher proportion of board independence, higher frequency of audit committee activities, and higher proportion of audit committee financial expertise are less likely to engage in earnings management. Also, the results of this study strongly show that audit opinion is significantly positively associated with earnings management. This result is consistent with prior studies, showing that firms receiving a modified audit opinion (qualified, adverse, or disclaimer opinions) are more likely to engage in earnings management.

In contrast to prior studies, CEO-Chairperson duality, audit fee, and ownership concentration are significantly negatively associated with earnings management. Furthermore, audit committee size, and Auditor Reputation are found to have a positive relationship with earnings management. However, only weak evidence was found relating to these variables. Board interlocking, board meeting, audit committee independence, non-audit service fee, managerial ownership, family ownership, and institutional ownership are found to have both negative and positive relationships with earnings management.

The last objective is to examine the influence of earnings management and corporate governance on the cost of equity capital. As expected, the results reveal a positive relationship between earnings management and the cost of equity capital. This is consistent with findings of other studies, suggesting that earnings management decreases the accuracy and transparency of financial reports, which increases investor uncertainty and the cost of equity capital. In addition, most corporate governance variables have a significant influence on the cost of equity capital. Only board size is found to have insignificant relationship to the cost of equity capital. This result suggests that the number of board members does not affect the cost of equity capital in Thailand.

According to Agency Theory, in situations where the ownership (shareholders) and control (management) are separated, corporate governance is an important factor for monitoring management and directing firms to achieve their corporate goals on behalf of shareholders. The results of this study show that the most powerful corporate governance mechanisms in reducing earnings management and the cost of equity capital in Thailand are the board characteristics and audit committee effectiveness. External factors of corporate governance, such as external auditors, also have an influence on earnings management. However, only weak evidence between ownership structure and earnings management is found in the current study. In terms of Signalling Theory, this study also reveals that board characteristics and audit committee effectiveness may signal the effectiveness of controlling and monitoring systems, which thereby decreases earnings management and cost of equity capital. For example, board independence and audit committee financial expertise are important signals of the integrity, credibility and informativeness of a company.

Finally, when using CG score as a proxy for good corporate governance in the robustness test, results provide evidence that earnings management and the cost of equity capital are negatively associated with the CG score, suggesting that good corporate governance reduces earnings management, which thereby decreases the cost of equity capital.