

# Earnings Management and Corporate Governance in Thailand

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**Abstract.** This study aims to examine the role of corporate governance and the effect of earnings management to firm value for firms listed in Stock Exchange of Thailand. The results show that, in general, earnings management has the weakly positive effect to firm value. However, after classified those firms based on corporate governance level measured by CG-star, firms with good governance have more positive effect of earnings management. This evidence supports the role of corporate governance to reduce negative earning management arises from managerial opportunism.

**Keywords:** Earnings Management, Discretionary Accruals, Corporate Governance.

## 1. Introduction

Earnings Management usually refers to management discretions on earnings reporting. This management discretion can be from their opportunistic behaviours and may conflict with the firm value maximization principal. However, some argues that the earnings management may be informative that allows managers to communicate the earnings forecast to public. Based on this viewpoint, earnings management should have a positive effect to firm value and consistent with firm value maximization principal.

Many studies about earnings management have pointed out that earnings management is from the opportunistic behaviour of managers. In another word, managers use earnings management as a tool in order to transfer wealth to themselves, for example in form of compensation plan (Healy, 1985; Bregstreser and Philipon, 2006; Kuang, 2008). However, there are some studies that provide the argument to support earnings management. Dutta and Gigler (2002) have developed the model in order to justify the benefit of earnings management. In the model, they show that the shareholders wealth can be reduced when the potential of earnings management is restricted by accounting standard and auditing process. Therefore, under the restriction, the benefit of earnings management is reduced as it is more costly for the manager to communicate trustful forecasting.

Magrath and Weld (2002) discuss the benefit of earnings management to the firm value. Managers can use earning management to reduce the volatility of earning. This can help to reduce the level of firm perceived risks by investors and increase the value of the firm. Therefore, managers who have involved in earnings management also follow the value maximization principal. Ning (2006) has also argued that earnings management is not fraud because it is done within legitimate constraint. Moreover, the earnings management may create the misrepresentation of earnings reporting but it does not misrepresent the firm economic value in terms of total value of asset, liabilities, and equity. Jiraporn, Miller, Yoon, and Kim (2008) provide the empirical evidence using the data for US firms. Their result shows that earnings management is beneficial because there is the positive relation between firm value and earnings management.

Earnings management can be structured into good or informative earnings management and bad or opportunistic earnings management. It is difficult to clarify whether which parts of earnings management are informative or negative. However, if there is a controlling mechanism that can help to reduce the opportunistic behaviours, it should be able to reduce the bad earnings management. The earnings management will be more informative and beneficial to firm value.

Jensen and Meckling (1976) propose the agency theory to illustrate the conflict between firm managers and shareholders as managers who hold small portion of firm ownership tend to take more perquisites. In order to reduce this problem, the monitoring is required and the cost of monitoring is a part of agency cost.

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Fama and Jensen (1983) have discussed more on this issue in the concept of separation between ownership and control. Managers may not make decision to maximize shareholder wealth because they do not share wealth with shareholders if they hold no or small portion of ownership. Therefore, corporate governance is necessary to act as the effective controlling mechanism.

Therefore, if corporate governance works well as controlling mechanism to prevent the managerial opportunism, managers in firms with better governance should use earnings management in more positive or more informative ways. For the firms with better governance, the effect of earnings management should be more positive (or less negative) than the firms with poorer governance.

## 2. Data and Methodology

The data used in the research is collected from all firms listed in the Stock Exchange of Thailand during 2008-2011. The accounting data used in this study includes total asset, total equity, total debt, market value of equity or market capitalization, total revenue, property plant and equipment, total current assets, total current liabilities, cash and equivalent, short-term debts, and total depreciations. Firms in financial industries and firms with incomplete data are excluded from the analysis. Finally, there are 1,748 firm-year observations.

The earnings management is measured based on modified Jones' discretionary accruals. Jones (1991) has introduced the way to measure discretionary accruals as the difference between expected accruals and actual accruals. The following regression is used to estimate the expected accruals.

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

where Asset is total assets, REV is total revenue, and PPE is property, plant, and equipment. Accrual is total accrual, which is computed from a change in non-cash current assets less a change in non-debt liabilities and deducted by depreciation expenses. The regression based on equation 1 is estimated based on cross-section basis for each industry (DeFond and Jiambalvo, 1994). The residuals from the regression are used as discretionary accruals. Thereafter, the effect of earnings management to firm value can be estimated from the following regression.

$$FV_i = \beta_0 + \beta_1 ADA_i + \beta_2 DR_i + \beta_3 SIZE_i + \beta_4 GROWTH_i + \varepsilon_i, \quad (2)$$

where FV is firm value measured by Tobin's Q ratio or the ratio between market value and book value of firms. ADA is absolute discretionary accrual. DR is debt ratio. SIZE is the natural logarithm of total asset. GROWTH is the growth rate of total asset. The coefficient of ADA ( $\beta_2$ ) can be interpreted as the effect of earnings management to firm value.

For corporate governance data, Thai Institute of Director (Thai IOD) has collected the data about the corporate governance of firms listed in the Stock Exchange of Thailand. Instead of reporting CG score, Thai IOD has reported the CG performance in term of a number of stars. The firms in the best group of corporate governance are classified as 5-star group.

Thereafter, the regression model in equation 2 is re-estimated separately based on CG-star group. Firms without CG-star are classified as another group. To examine the role of corporate governance and the effect of earnings management, the regression model with interaction techniques is used as follow.

$$FV_i = \beta_0 + \beta_1 ADA_i + \sum_{j=1}^m \gamma_j D_{ji} \times ADA_i + \beta_2 DR_i + \beta_3 SIZE_i + \beta_4 GROWTH_i + \varepsilon_i \quad (3)$$

From equation 3, the coefficient  $\beta_1$  will represent the effect of earnings management for firms without CG-star.  $D_j$  is the dummy variable that equals to one if that firm is in  $j$ -star group. Therefore,  $\gamma_j$  will represent the differential effect of earnings managements between firms without star and firms in  $j$ -star group. If corporate governance can act as the effective controlling mechanism to avoid opportunistic earnings management, the coefficient  $\gamma_j$  should be positive and statistically significant at convention level.

## 3. Analysis and Results

Table 1: Data description of Thai firms by year

Year	Number of Firms	Debt Ratio	Growth Rate (%)	Total Asset (Million Baht)
2008	432	0.4409	8.276	12,479.58
2009	432	0.4336	4.020	13,458.94
2010	440	0.4352	14.768	14,606.07
2011	444	0.4507	21.411	17,370.70
Average	1,748	0.4401	12.195	14,499.26

Table 1 reports the firm descriptive data of important variable used in this study. The data is collected during 2008-2011 for 4 years with 1,748 firm-year observations. The average debt ratio is around 0.44 for sample firms. The growth rate of asset is lowest at around 4% in 2009 and highest in 2011 at 21.4%. The average growth rate during the analysis period is 12.2%. The firm size measured by average total assets has increased from 12,479 million Baht in 2008 to 17,370 million Baht in 2011.

Table 2: Data description of Thai firms by CG-star

CG-star	Number of Firms	Debt Ratio	Growth Rate (%)	Total Asset (Million Baht)
No Star	796	0.4658	15.832	4,606.01
3 Stars	407	0.3818	7.107	5,915.79
4 Stars	416	0.4332	10.970	19,738.40
5 Stars	129	0.4884	9.756	85,731.94

Table 2 reports the description similar to table 1 but classified based on CG-star. 796 firm-year observations are not classified by Thai IOD in any CG-star group, which is around 45% of total observations. Usually, these firms are much smaller than firms with CG-star. There are only three groups of CG-star firms, 3-star, 4-star, and 5-star. There is no firm with only one or two CG-star. Therefore, unclassified firms may be firms who did not disclose information enough or may be firms who got star lower than 3-star but do not want to be reported. Among CG-star firms, firms in 5-star group are much larger than firms in other groups. 5-star firms have average asset size of 85,731 million Baht. The firms in 4-star group have an average asset size of 19,738 million Baht whereas firms in 3-star group has an average asset size of only 5,915 million Baht. This difference in size can help to explain why firms in higher CG-star group have more leverage or debt ratio.

Table 3: The effect of earnings management and firm value

	Full Sample	No CG-Star	3 CG-Star	4 CG-Star	5 CG-Star
Constant	0.7434 (4.25)**	1.9443 (6.99)**	1.3664 (3.44)**	-0.3419 (-0.67)	0.9126 (1.46)
ADA	<b>0.3155</b> <b>(1.91)*</b>	<b>0.0769</b> <b>(0.40)</b>	<b>0.6156</b> <b>(2.12)**</b>	<b>1.5434</b> <b>(2.46)**</b>	<b>1.5143</b> <b>(1.56)</b>
Debt ratio	0.0939 (1.35)	0.2133 (2.65)**	-0.1338 (-0.91)	-0.4927 (-2.05)**	0.0633 (0.16)
Growth	0.0543 (2.80)**	0.0554 (2.93)**	0.5568 (4.39)**	-0.0377 (-0.34)	-0.0787 (-0.22)
Size	0.0252 (2.16)**	-0.0631 (-3.26)**	-0.0224 (-0.81)**	0.1130 (3.32)**	0.0231 (0.67)
No. of Obs.	1,748	796	407	416	129

Table 3 reports the effect of earnings management and firm value. The first column reports the result for all firms in the sample. The coefficient of absolute discretionary accruals is positive and significant at 10% level. This means that there is a positive effect between earnings management and firm value. Thereafter, firms are classified into a group based on their CG-star. There are only three group of CG-star, which are 3-star, 4-star, and 5-star group. None of firms are reported to be in 1-star or 2-star group. Those firms who did not have been classified in any star groups are put into no-star group. As reported in table 3, the relation between earnings management and firm value is neutral as the coefficient of discretionary accruals is not significant at convention level. The effect of earnings management for those firms in 3-star and 4-star group

is positive and significant at 5% level. Even though the coefficient of firms in 5-star group is positive and as large as 4-star group, it is not significant at convention level.

In order to test the difference for the effect of earnings management, the regression technique with interaction dummy is employed. If the coefficient of interaction term is significantly positive, it means that the effect of earnings management is more positive for firms with better governance. The results of these regression analyses are reported in table 4.

Table 4: The role of corporate governance and the effect of earnings management

	<b>Model 1</b>	<b>Model 2</b>	<b>Model 3</b>	<b>Model 4</b>
Constant	0.9636 (5.33)**	0.8179 (4.58)**	0.2141 (0.81)	0.1863 (0.71)
<b>ADA</b>	<b>0.1491</b> <b>(0.80)</b>	<b>0.1315</b> <b>(0.70)</b>	<b>0.1896</b> <b>(0.56)</b>	<b>0.1892</b> <b>(0.56)</b>
<b>D3 x ADA</b>	<b>-0.1950</b> <b>(-0.58)</b>			
<b>D4 x ADA</b>	<b>1.6123</b> <b>(3.79)**</b>		<b>1.6515</b> <b>(3.30)**</b>	
<b>D5 x ADA</b>	<b>2.5781</b> <b>(3.24)**</b>		<b>2.3956</b> <b>(2.80)**</b>	
<b>D345 x ADA</b>		<b>0.5855</b> <b>(2.05)**</b>		
<b>D45 x ADA</b>				<b>1.7881</b> <b>(3.77)**</b>
Debt ratio	0.0949 (1.37)	0.1029 (1.48)	-0.2191 (-1.69)*	-0.2159 (-1.66)
Growth	0.0563 (2.91)**	0.0568 (2.92)**	0.1065 (1.33)	0.1035 (1.29)
Size	0.0091 (0.75)	0.0195 (1.63)	0.0653 (3.67)**	0.0671 (3.80)**
No. of Obs.	1,748	1,748	952	952

Table 4 reports the regression analysis with dummy interaction term. If firms are in 3-star group, the variable D3 equals to one, or zero otherwise. The variable D4 and D5 is for those firms in 4-star and 5-star group respectively. The variable D345 is for those firms are in any CG star group. The variable D45 is for the firms in either 4-star or 5-star group. Model 1 has included three interaction dummies for 3-star, 4-star, and 5-star. The coefficient of discretionary accruals is not significant whereas the coefficients of interaction term for 4-star and 5-star group are significantly positive. Model 2 has included one dummy interaction for those firms in any CG-star group. This result means the positive effect of earnings management is higher for firms with CG-star than firms without CG-star.

The previous analysis implies that firms with no CG-star have poorer governance. However, it is also possible that those firms have no CG-star because of data availability or they are small firms and are excluded from the analysis. Model 3 and Model 4 in table 4 report only firms with CG-star. Therefore, the coefficient of discretionary accruals in model 3 and model 4 represents the effect of earnings management for firms in 3-star group. This coefficient is positive but not significant. The coefficients of interaction term for both 4-star and 5-star group are positive and significant. In model 4, the coefficient of interaction term is also significantly positive.

#### 4. Conclusion

In general, earnings management is perceived as adverse things. It is because firm managers can use it to take their private benefit at the cost of firms, which can deteriorate shareholder value. This expropriation is commonly known as managerial opportunism. However, some researches have argued that earnings management can be used in the beneficial way like to reduce volatility and communicate some future earnings forecasting to investors.

In this study, I have proposed that if there is effective controlling mechanism like corporate governance, the managerial opportunism should be less likely. The effect of earnings management will be more positive (or less negative) for firms with better corporate governance. In Thailand, the corporate governance data for listed firms is available in form of CG-star. Firms are classified into 3-star, 4-star, or 5-star group. The empirical evidence shows that the earnings management is more positive for firms with higher CG-star.

This empirical evidence supports the role of corporate governance to reduce the negative effect of earnings management. Sometime, the earnings management are perceived as negative. Managers can use their discretions to report earnings by using accrual accounting. However, firms with good governance are less likely to use earnings management in negative way and the earnings management in these firms are perceived more positively than poor governance ones. Therefore, it is important to encourage corporate governance as much as to control earnings management.

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