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Impact of Board Effectiveness and Shareholders Structure on Earnings Management in Thailand

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Abstract
This research aims to study the impact of board effectiveness and shareholders structure on earning management in Thailand. Panel data of four sectors of listed companies in stock exchange of Thailand, including agro and food industry, resources, technology, and consumer products during 2009-2013, was collected and analyzed using Panel Fixed Effects. The estimation results showed that in resource sector, good governance in board effectiveness and proportion of companies’ directors with expertise in finance and accounting are negatively correlated with earning management. Number of board meeting and audit committee ratio are positively correlated with earning management. It can be concluded that board effectiveness can reducing level of earning management which also eliminating principal-agent problem. Concerning on shareholders structure, the result shown that management increases the earning management by using accrued of management discretion. Concentration of the major shareholders positively related with earning management in consumer products sector while having negatively relationship in agro and food industry sector. Classification of the shareholding among agro and food industry sector showed a positive relationship with earnings management. This finding is in accordance with positive accounting theory that caused the motivation to choose the method of accounting to benefits themselves. However, the results of this study are not conclusive for all sectors.

Keywords: Earning Management Board Effectiveness, Shareholders Structure

1. INTRODUCTION
The economic crisis in 1997, the bankruptcy of America reputable energy company as Enron, cause investors and stakeholders to pay more attention on the quality of financial statements. Unclear financial statement preparation process leave a gap of creative accounting which results in the financial statements that reflect such unreal financial status and results of operations.

The actual purpose of the financial statements is to present financial status, performance, and changes in financial position for the user of business decisions. [1] Therefore, investors need to consider the accuracy of the financial statements in order to distinguish the between actual performance statement and decorative statement to obtain performance required by management. Lately, many countries pay more attention to the quality of financial statements especially in profit numbers.

In Thailand, the uncovering decorative accounting of Roynet Public Company Limited and Picnic Corporation Public Company Limited to increased net income were significantly effect to the financial and accounting of Thailand. Financial statement distortion of executive caused higher stock prices which was signal to investors to make discrepancy investment decisions. Thereafter, investors more consider on both quantitative and qualitative information before investing. Therefore, appropriate disclosure is so important to the financial statement
determination of all user for example management, investor, account payable, government. [1] Regulatory agencies, both public and private sector, has set up various measures in order to establish credibility to financial statement users. Particularly, Section 56 and Section 61 of the Securities Act requires that the financial statements of listed companies must be audited or reviewed and certified by consent CPA. These acts was established to ensure that the information in financial statements have been audited, accurate, and reliable. Also verify that the board can oversee management to disclose information in a transparent, fair and accountable to minority shareholders.

From the past, cause of the disclosure of false accounting, fraudulent concealment of information, or the decoration of accounting were the exploitation behavior [2] or agency theory [3] The theory stated that humans all want the most benefit for themselves which caused the conflict of interest between management (agency) and investors or shareholders (principal). In other words, the administration wants the highest return while the shareholders also want the highest returns as well, and this is causing "Agency Cost".

Management is obligated to prepare a financial report for submission to the shareholders of the Company. [4] Qualified financial reporting and information disclosure reduces the asymmetry of information derived between company and investors. [5] [6] Company looking to raise capital from external investors need to prepare financial accounting information to gain the confidence of the users. [7] [8] [9] Since management can use their own judgment in preparing financial statements thus causing a vulnerability for management to create earning management. [10] [11] Earning Management is the intent intervene in the financial report preparation process presented to outsiders to gain personal benefit. [12]

Shareholders structure of listed companies in stock exchange of Thailand are majorly concentrated with relative and family relationship. Major shareholders have the power to control company's direction not only the authority to control the vote but also the power to control over the management of company whether chairman, managing director or staff. The characteristic of concentrated structure create vulnerability for majority shareholders to migrate the interests of minority shareholders to benefit themselves. [13]

Therefore, shareholders could be agency problem the cause earning management which effect to earning quality. The international survey of ACFE found the growing trend of decorative accounting in numerous countries from 2010 to 2012. [14] European companies had the greatest increase in decorative accounting (5.5%), follow by the companies in Oceania (3.2%), United Stated (2.9%), Africa (2.7%), Asia (2.3%), and Canada (1.4%) respectively. Therefore, the researchers are interested in studying the impact of board effectiveness and shareholders structure on earning management in Thailand. The objective of this study is to determined the trend of decorative accounting of listed companies in stock exchange of Thailand. This will enable investors and financial statements users to be more cautious in their analysis before making an investment decision. This will reduce the potential for adverse effects on the nation's economy from the faulty decisions of investors.

II. THEORETICAL FRAMEWORK AND HYPOTHESIS REVIEW

A. THEORETICAL FRAMEWORK

2.1 Definition of Earning Management

There are many definitions of earning management defined by different scholars. [12] state that earning management is action with the intent to make a profit under the scope of generally accepted accounting principles [12] Identify as the intervention process for the preparation of financial report that will be presented to the public with intentionally causing private interests. Said that earning management is an effective decorative accounting using the flexibility of generally accepted accounting principles to reach the target set by management.
2.2 Agency Theory

Agency Theory was developed by [15] and extend by [3] This theory state that all human being was force to do anything for their own benefit. If business owner is the same person as management, the company is going to benefit in the same direction. However, if more share was distributed then owners can't be administered solely since there will management working as a represent of business owners. Thus Agency Theory explain relationship between ownership structure and quality of information disclosure. Agency relationship occur between authorizer (principle) and delegate authority (agency) [16]

2.3 Positive Accounting Theory

The motivation behind the management of opportunistic behavior by making earning management are as follows. [2]

1. Management may choose accounting policy that increase profit level in current period, when the executive compensation relative to the earnings report. (The Bonus Plan Hypothesis)

   This is consistent with the findings of [17]

2. Management of companies with high debt to equity ratio will more likely to choose accounting policies that increase the level of profits in the current period. Management do so in order to reduce the probability of loan agreement default or reduce the cost arising from bankruptcy (The Debt Covenant Hypothesis).

3. Management have incentives to use their discretion to choose accounting policies to increase the level of profits in the current period. Management do so to reduce the negative impacts on the stakeholder, non-owners and creditors, such as government agencies and regulatory authorities. (The Political Cost Hypothesis)

   However, previous researches found creative accounting occurred in some companies but not consider as an opportunistic behavior. Such execution can bring good performance to company in the future as reduce cost of debt [18] and increase management creditability[19][20]

B. Literature review and Hypothesis

Review of literatures found that earning management can divided into 3 groups of factors as (1) board effectiveness (2) shareholders structure and (3) control variables. Each group of factors consist of these following factors.

1. Board Effectiveness

1.1 Size of Board of directors' Size

The previous study found both positive and negative relation between number of board of directors and earning management. Some research found that large size of board of director have positive impact to enterprise in term of corporate performance [21] diversity of knowledge and capability which cause higher efficiency of work. [22] Large size of board of director also have a positive impact on work circumspection and the independent of management. [23][24][25][26][27][28] Moreover, large size board of director can reduce cost of debt to the company. [29]

   According to agency theory, large size of board of directors will cause agency cost such communication expenditures between those directors. [27] Free-rider problems may also occur as some directors could expect others to work for them. Moreover, earning management tend to happen if audit committee can't effectively audit board of directs. [30] suggest that board of director should be approximately 7-8 persons.

1.2 Proportion of independence committee

   Independence committee is one of the key mechanism in corporate governance. [31] Previous study found positive correlate between proportion of independence committee and earning management. It can decrease agency problem and earning management. [32] However, some research also found negative correlation between proportion of independence committee and...
1.3 The merger between the Chairman and CEO positions

Agency theory explain that the merger between the chairman and CEO positions will cause conflict of interest between principal and agency which will be increase agency problem. [3] Some research found such merger have positive impact to earning management as result in an inappropriate of corporate governance structure. [34] [34] This is consistence with the study of [35] whom found that such merger can be accused of violations in generally accepted accounting.

In contradiction, the study of [36] found that segregation of positions has a negative relationship with earning management. Moreover, some research found position mergers have no relation with accruals based on management's judgment. [37] [38] [39] [40]

1.4 Proportion of directors with expertise in finance and accounting

Past research found, the proportion of those with expertise in finance and accounting correlated in the opposite direction With accruals based on management's judgment both significantly [40] and insignificant [41] Directors with expertise in finance and accounting could reduce agency problem and help in control and inhibit the earning management.

1.5 The number of board meetings.

The number of board meetings is one of the indicators that will reflect the attention to the duties of the board. [42] A review of research found that negative relation between number of board meeting and earning management. [34] [40] [43]

1.6 Proportion of audit committee

Audit committee has critical role in ensuring the quality of the financial report. [44] Audit committee can work independently without the control of management. [45] Number of audit committee and also reduce agency problems and earning management. [16] [46]

1.7 Proportion of audit committee with expertise in finance and accounting

Audit committee is responsible for reviewing the financial report that is accurate and complete disclosure to the relevant data can be useful in decision-making. [33] [47] [48] [49] [50] Therefore audit committee must have the experience and technical expertise in the profession, in order to reduce information Asymmetry and agency problem [51]

1.8 Number of audit committee meeting

Previous research shown that number of audit committee meeting can reduce earning management behavior of executive. [33] [47] [48] [49] The meeting can also continuously provide knowledge and information to audit committee, especially in accounting, auditing and other knowledge. [52] Inappropriate meeting number is indicative of the lack of effective corporate governance. [53]

2. Shareholders Structure

2.1 Concentrated Shareholders

A review of past research found negative correlation between concentrated shareholders and earning management as most of concentrated shareholders are the real owners of business. [54] [55] [56] On the other hand, some research found that concentrate shareholders who work in executive position have a positive relationship with earning management. [34]

2.2 Type of shareholders with the highest proportion of the company

Type of shareholders could be divided into 3 groups by the regulation of stock exchange of Thailand. (1) Local Juristic Person : Institution Investors (2) Local Individual: Individual or family enterprise (3)Foreign Juristic Person : Foreign Institution. These majority of shareholders could affect or dominate the operation of business.

3. Control Factors

Control variables are used to control the effects from other variables. However, these factors may also correlate with earning management.

3.1 Firm Performance (measure by Return on Assets) The finding of [57] [58] [59] stated that lower performance organization tend to have higher earning management behavior.

3.2 Financial Leverage (LEVE)Past research found that executives of companies with a high financial risk are more likely to decorate financial report in order to maintain financial structure in terms of the loan agreement.
3.3 Firm Size (Log-assets) measured by the natural logarithm of total assets, to capture information asymmetry and any residual risk effect.

3.4 Audit firm quality (Big 4) A review of literature found that the type of audit is significantly related to earnings management. [60] Some study shown that world class audit firm will change in discretionary accruals less than general audit firm. [61] Therefore, quality of audit may affect to earning Management of the company.

3.5 Market to book value of equity (MBV) as a proxy for growth opportunities [62]

3.6 Industrial Sectors (INDU) : In this research, researcher divided industries into 4 sectors, in order to control the difference in business and the policy of accounting.

III. METHODOLOGY

A. Data collection and Sample
Data of this study collect from these following sources; (1) SETSMART in Stock Exchange of Thailand (2) Form 56-1 of listed company between the year of 2009-2013 (5 years); divided into 4 industry sectors as agriculture and food, resource, technology and consumer products.

B. Model Specification and variables
1. Model estimated by Fixed Effects Model (FEM), the result can be shown as follows;
Earnings Management = \beta_0 + \beta_1 (BOARD_NUM)_t + \beta_2 (INDE_BOA)_t + \beta_3 (CEO_DUA)_t + \beta_4 (BOAR_EXP)_t + \beta_5 (FREQ_BOA)_t + \beta_6 (AUDI_BOA)_t + \beta_7 (INDE_EXP)_t + \beta_8 (FREQ_AUD)_t + \beta_9 (OWN_E_CON)_t + \beta_{10} (CONC_CON)_t + \beta_{11} (ROA)_t + \beta_{12} (LEVE)_t + \beta_{13} (Log_assets)_t + \beta_{14} (Big4)_t + \beta_{15} (MBV)_t + \sum \epsilon_t (\beta_{16} \text{INDU}) + \epsilon_t \ldots \ldots \ldots (1)

Earnings management = Modified Jones (1995)

\beta_0 \quad \text{is The constant of the regression}
\beta_1 \quad \text{is The Standardized Coefficient}
BOARD_NUM \quad \text{is Size of Board of Directors}
INDE_BOA \quad \text{is The proportion of independence committee}
CEO_DUA \quad \text{is The merger between the Chairman and CEO positions set as dummy variables by}
\text{Chairman is the same person as Board of Directors} = 1
\text{Chairman is not the same person as Board of Directors} = 0
BOAR_EXP \quad \text{is The proportion of companies with expertise in finance an accounting}
FREQ_BOA \quad \text{is Number of meeting of the board committee with in 1 year}
AUDI_BOA \quad \text{is The proportion of audit committee}
INDE_EXP \quad \text{is The proportion of audit committee with expertise in finance and accounting.}
FREQ_AUD \quad \text{is Number of meeting of audit committee with in 1 year}
OWN_E_CON \quad \text{is Concentration of shareholders (calculated from the proportion of the greatest shareholders)}
CONC_CON \quad \text{is Type of shareholders that having the highest stake in the company set as dummy variables by}
\text{There is a greatest shareholders of the company} = 1
\text{No greatest shareholder of the company} = 0
ROA \quad \text{is Performance as measured by rate of return on total asset}
LEVE \quad \text{is Financial risk as measured by ratio of total debt to total asset.}
SIZE \quad \text{is Size of company as measure by the Natural Logarithm of total asset.}
Big 4 \quad \text{is Size of audit firm set as dummy variables by}
\text{Use large audit firm in Big 4} = 1
\text{Use other audit firm} = 0
MBV is Growth opportunities as market price per share divided by book value per share.

INDU is Industrial Sectors set as dummy variables

\( \varepsilon \) is Error term

2. The model used to measure Earning Management over the discretionary accruals by calculating from the Modified Jones Model (1995). Calculation procedure is as follows:

**Step 1** Calculation of Total Accruals

\[
TA_{it} = NI_{it} - OCF_{it} \tag{1}
\]

- \( TA_{it} \) = Total Accruals of company \( i \) at year \( t \)
- \( NI_{it} \) = Net Income of company \( i \) at year \( t \)
- \( OCF_{it} \) = Net cash flow from operations of company \( i \) at year \( t \)

**Step 2** Take the result from equation (1) to estimate the coefficients by using Ordinary Least squares (OLS) regressions model.

\[
\frac{T_{A_{it}}}{A_{it-1}} = a_{1i} \left( \frac{1}{A_{it-1}} \right) + a_{2i} \left( \frac{\Delta REV_{it}}{A_{it-1}} \right) + a_{3i} \frac{PP{E_{it}}}{A_{it-1}} + \varepsilon_{it} \tag{2}
\]

- \( TA_{it} \) = Total Accruals of company \( i \) at year \( t \)
- \( A_{it-1} \) = Total Accruals of company \( i \) year \( t-1 \)
- \( \Delta REV_{it} \) = Changed in revenue from sales and services of company \( i \) at year \( t \)
- \( PP{E_{it}} \) = Total property, plant and equipment of company \( i \) at year \( t \)
- \( a_{i} \) = Coefficient of correlation of the variable \( i \)
- \( \varepsilon \) = The error of the estimated total accruals

**Step 3** Calculating accruals from the business operations of each company by applying the coefficient \( (a_{i}) \) from step 2 to replace the values in the equation for accruals that are not caused by the discretion of the management. According to the concept of Dechow, Sloan and Sweeney (1995)

\[
NDA_{it} = a_{2i} \left( \frac{\Delta REV_{it} - \Delta REC_{it}}{A_{it-1}} \right) + a_{3i} \frac{PP{E_{it}}}{A_{it-1}} \tag{3}
\]

- \( NDA_{it} \) = Accruals from business operations of company \( i \) at year \( t \)
- \( \Delta REV_{it} \) = Changed in revenue from sales and services of company \( i \) at year \( t \)
- \( \Delta REC_{it} \) = Change in account receivable of company \( i \) at year \( t \)
- \( PP{E_{it}} \) = Total property, plant and equipment of company \( i \) at year \( t \)
- \( a_{4} \) = Coefficient of correlation of the variable \( i \)
- \( \varepsilon \) = The error of the estimated total accruals

**Step 4** The calculation of accruals depends on discretionary of management by deduct net accruals from business operation out of total accruals as shown in following equation.

\[
DA_{it} = \left( \frac{T_{A_{it}}}{A_{it-1}} \right) - NDA_{it} \tag{4}
\]

- \( DA_{it} \) = Discretionary Accruals of company \( i \) at year \( t \)
- \( TA_{it} \) = Total Accruals of company \( i \) at year \( t \)
- \( A_{it-1} \) = Total Asset of company \( i \) at year \( t-1 \)
- \( NDA_{it} \) = Net accruals from business operation of company \( i \) at year \( t \)
IV. RESULTS

Researcher analyze collected data by using Panel Fixed Effect model, result shown in table 1

**TABLE 1** : Effect of Board Effectiveness and Shareholders Structure on Earning Management

<table>
<thead>
<tr>
<th>Industry</th>
<th>Total</th>
<th>AGRO</th>
<th>RESOURCE</th>
<th>TECHNO</th>
<th>CONSUMP</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Board Effectiveness</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>BOAR_NUM</td>
<td>0.0007177</td>
<td>0.00482608</td>
<td>0.0124984</td>
<td>0.0345731</td>
<td>0.00061713</td>
</tr>
<tr>
<td>INDE_BOA</td>
<td>0.0013634</td>
<td>0.00041345</td>
<td>0.0007351</td>
<td>0.00407609</td>
<td>0.00396284</td>
</tr>
<tr>
<td>CEO_DUA</td>
<td>-0.014264</td>
<td>0.02121612</td>
<td>(omitted)</td>
<td>(omitted)</td>
<td>-0.0105422</td>
</tr>
<tr>
<td>BOAR_EXP</td>
<td>0.0007076</td>
<td>0.00090917</td>
<td>-0.0362584 **</td>
<td>0.00569763</td>
<td>0.00246491</td>
</tr>
<tr>
<td>FREQ_BOA</td>
<td>0.0064323 **</td>
<td>0.00300731</td>
<td>0.0213321 *</td>
<td>0.0087021</td>
<td>0.00407024</td>
</tr>
<tr>
<td>AUDI_BOA</td>
<td>7.993E-05</td>
<td>-0.0038341</td>
<td>0.0104718</td>
<td>**</td>
<td>0.00085748</td>
</tr>
<tr>
<td>INDE_EXP</td>
<td>0.0002369</td>
<td>-0.0007457</td>
<td>0.0030164</td>
<td>0.00045759</td>
<td>-0.0010863</td>
</tr>
<tr>
<td>FREQ_AUD</td>
<td>-0.005201</td>
<td>-0.00378959</td>
<td>0.0068943</td>
<td>0.00090733</td>
<td>0.01122702</td>
</tr>
<tr>
<td><strong>Shareholders Structure</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>OWNE_CON</td>
<td>0.0022036</td>
<td>0.00039552</td>
<td>-0.0246111 **</td>
<td>-0.00172861</td>
<td>0.00583168 ***</td>
</tr>
<tr>
<td>CONE_CON</td>
<td>-0.002013</td>
<td>-0.01909994</td>
<td>0.3434595 **</td>
<td>0.05721203</td>
<td>(omitted)</td>
</tr>
<tr>
<td><strong>Control Variables</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ROA</td>
<td>-0.001726 **</td>
<td>0.000240413 **</td>
<td>-0.000485</td>
<td>-0.00286114 **</td>
<td>0.00226475 **</td>
</tr>
<tr>
<td>LEVE</td>
<td>0.0005665</td>
<td>0.0016819 **</td>
<td>-0.0027254</td>
<td>0.00371377 **</td>
<td>-0.0004094</td>
</tr>
<tr>
<td>SIZE</td>
<td>-0.000274</td>
<td>0.01606504</td>
<td>0.0356593</td>
<td>0.05091925 **</td>
<td>-0.002123</td>
</tr>
<tr>
<td>BIG4</td>
<td>-0.021268</td>
<td>-0.01738942</td>
<td>(omitted)</td>
<td>(omitted)</td>
<td>0.00974676</td>
</tr>
<tr>
<td>MBV</td>
<td>-0.003452</td>
<td>-0.00137157</td>
<td>0.0402778 **</td>
<td>-0.02195101</td>
<td>0.08433262 ***</td>
</tr>
<tr>
<td>Constant</td>
<td>-0.143496</td>
<td>-0.34275877</td>
<td>0.6959275</td>
<td>-1.8102532 *</td>
<td>-0.33777876</td>
</tr>
</tbody>
</table>

\[N = 347, N_{g} = 91, F = 2.2553818, R_{2,w} = 0.1230966, r_{2,o} = 0.0386897, F_{f} = 1.8637543\]

\[*p<0.05, **p<0.01, ***p<0.001,\]

The result from panel fixed effect model that use to determine the relationship between board effectiveness and earning management shown that the merger between the Chairman and CEO positions (CEO_DUA) have positive correlation with Earning Management. While there is no relationship between other factors in board effectiveness and shareholders structure on earning management. However, considering other factors, business performance (ROA) and financial risk (LEVE) have positive correlation with earning management. On the other hand, audit quality and growth opportunities (MBV) have negative correlation with earning management. While there is no relation between size of company (SIZE) and earning management.

V. CONCLUSION

The impact of board effectiveness and shareholders structure on earning management which deduct total accrual with non-discretion accrual. Earning Management measurement can be divided into 2 parts. (1) The measurement of total accruals by using cash flow method since it's more appropriate than using balance sheet. (2) The measurement of non-discretion accrual by using Modified Jones Model of Dechow [63] by using regression coefficient for 5 years.
In this study, board effectiveness measured by the proportion of expertise in finance and accounting, number of meetings of the board, the proportion of the audit committee, and shareholder structure. The study found that the resource sectors is the only sector that board effectiveness correlate with earning management as the proportion of companies directors with expertise in finance and accounting are negatively correlated with earning management, which consistent with the finding of [41] Such finding can be interpreted that the high proportion of financial and accounting expertise can control earnings management more efficiently. Therefore, the sufficient of specific expertise committee can prevent earning management and reduce agency.

The study found that number of board meeting have positive correlate with earning management, which consistent with the concept of Jensen (1993). Jensen stated that management of company that hold board meeting too often will lose too much time in the meeting instead of overseeing management's performance. Therefore, numbers of the meeting can't reduce earning management. Moreover, researcher also found positive relationship between proportion of audit committee and earning management. [31] [40] The execution of audit committee can be dominated by authorized shareholders [64] thus earning management can't be reduced.

In term of shareholder structure, the concentrated shareholders structure have negative correlation with earning management in resource sector. It cause by the good corporate governance of companies in resource sector that equalization all shareholders, so major shareholders can not intervene in the financial reporting process to take advantage from minority shareholders.

In contrast, the concentrated shareholder structure of companies in consumer products have positive correlation with earning management. This result consistent with Positive Accounting Theory which can describe as authorized shareholders and management Are motivated to use accounting methods to make profits in the current period to increased an additional bonus as well as majority shareholders.

Some control variables also correlate to earning management, business performance have positive impact to earning management in 3 sectors as agriculture, food, consumer product. Which represent that business sectors that gain higher return of asset tend to have more earning management than those sectors with lower return on asset. [65]

The result show that financial risk have positive impact to earning management in technology, agriculture and food sectors. This finding consistent with positive account theory that management of companies with high debt tend to make earning management in order to avoid debt problem. [66] [37]

Size of corporate also have positive relation with earning management in agriculture and food sectors. It can imply that the larger of corporation tend to have higher level of earning management. [36][43] This is also inconsistent with positive accounting theory which stated that large corporation are more likely to have less earning management for a social and political reason.

Growth opportunity, indicated from MBV, have positive impact to earning management in the resource and consumer product sectors. It can describe as companies in these 2 sectors with higher market value tend to have more earning management.

This study may not be able to state the impact of board effectiveness and shareholders structure on earnings management for every business sector. However, the result of this study may use for the consideration of investors and shareholders before making investment decision.

REFERENCE


