

## 2. Executive summary

Given the current global crisis and the recession in Thailand, the policy debate focuses on the deficiencies of capital market. An efficient infrastructure framework and an adequate shareholder protection mechanism are important concerns to enhance the function of capital market. It is well-accepted that good corporate governance can improve transparency and investor's confidence in the capital market, which consequently speed capital market development. Audit committee was the main concern in the first corporate governance guideline in Thailand in 1999, and the board structure was the main mechanism in the principles of corporate governance in 2002 and 2006.

Executives have incentives to manage earnings, which has an important role in representing a company's economic health. Besides, there exists an information asymmetry between executives and shareholders. Not only the timeliness, but also the quality of information is of interest to investors. Good corporate governance can reduce information asymmetry between managers and shareholders and to prevent the use of non-public material information. This research project aims to analyse earnings management practice in Thai listed firms and the impact of corporate governance mechanisms and insider trading on earnings management. This investigation can offer an insight into the effectiveness of corporate governance mechanism and the insider trading regulation to market regulators in Thailand.

Over the past couple of years, the growth rate of Thailand's stock market has been low and its relative size to GDP at 82% (World Federation of Exchanges dataset) is smaller than other countries in the region, e.g. Hong Kong at 1,208%, Singapore at 273%, and Malaysia at 164% (IMF dataset). Should this trend remain, Thailand's capital market will stagnate and become marginalized in the region. It is well-accepted that a strong capital market would lessen the impact of economic fluctuations, as well as increase the ability to raise and monitor resources efficiently. This will result in national growth opportunities, and improvements in the standard of living and prosperity. Two missions by Thai Capital Market Development Committee for the period of 2009-2013 are 1.) to develop an efficient infrastructure framework in the legal system, regulations, accounting standards, tax, information, technology and corporate governance, and 2.) to ensure that an adequate shareholder protection mechanism is in place.

Claessens (2003) argues that the behavior of corporate sectors affected the entire economies during the South East Asian Financial Crisis in 1997 and deficiencies in corporate governance

endangered the stability of the whole global financial system. Corporate governance has become a mainstream concern since the 1997 financial crisis and efforts have been exerted to promote investor protection and transparency, and enhance capital market development. In Thailand, like Singapore and Malaysia, the process of corporate governance reform began with the promotion of audit committees within firms. The Stock Exchange of Thailand (SET) issued the Code of Best Practice for Directors of Listed Companies in 1997. The listed companies had to form audit committees no later than December 1999. The Securities and Exchange Commission (SEC) joined the effort by requiring at least two independent directors, an internal audit department, and a remuneration committee existed in all firms. The Thai Principles of good corporate governance were then introduced in 2002 and revised in 2006 based on the OECD principles and the World Bank's recommendation.

The Code recommended that audit committees should consist of at least three independent members and at least one member must have knowledge, understanding or experience in accounting or finance. Also, audit committee meetings should be held, on average, four times a year. All listed firms must disclose how they have implemented the recommendations of the code in both the annual registration statements (Form 56-1) and annual reports.

Corporate financial reports provide information of corporate financial strength and performance to a wide range of users. Earnings- the most important item in the financial reports- attract investors' interest as they reflect the company's economic health. Although earnings are monitored by external auditors, the audit committee, board of directors, and financial analysts; many studies report that earnings are proactively managed to exceed a specified earnings threshold (Degeorge et al., 1999), or to avoid a decrease in earnings (Burgstahler and Dichev, 1997, Charoenwong and Jiraporn, 2009). One of the possible reasons is that management's employment and remuneration are linked with these earnings figures. It is therefore of interest to examine the effectiveness of Thai corporate governance mechanisms on earnings quality (i.e. earnings management).

In addition, the empirical evidence in many countries has documented information asymmetry between inside and outside shareholders since corporate insiders benefit from the information flow, (Lorie and Neiderhoffer (1968) and Lakonishok and Lee (2001) for the US, Hillier and Marshall (2002) for the UK, Del Brio et al. (2002) for Spain, Cheuk et al (2005) for Hong Kong, and Budsaratagoon et al. (2011) for Thailand). Nevertheless, it is still a debate whether insider trading harms or benefits financial markets. There is an argument that insider trading leads to an increase

in risky corporate investment (Scott, 1980, Manove, 1989), but a decrease in financial statement relevance and timeliness (Cho and Shaub, 1991), overall investor confidence (Leland, 1992), and less informed investor trading activity (Fishman and Hagerty, 1992, Bhattacharya and Nicodano, 2001). Supportive evidence shows an overall increase in firm value (Jensen and Meckling, 1976) and informational efficiency of the market when insiders trade the shares of their own company (Ross, 1978, John and Lang, 1991, Zhang, 2001, Chau and Vayanos, 2008).

A number of empirical studies document the strong relationship between insider trading activity and earnings surprises, for example Allen and Ramanan (1990), Sivakumar and Waymire (1994), Lustgarten and Mande (1995) Udpa (1996), Ke et al. (2003), Huddart et al. (2007) and Cheng and Leung (2008). Fidrmuc et al. (2006), Betzer and Theissen (2007) and Cheng et al. (2007) highlight that governance structure has a significant impact on the magnitude of insider profits. Further, Clacher et al. (2010) suggest that accounting systems and corporate governance systems are well-known to have an impact on the disclosure of information and insider trading patterns across firms. Another interesting area will be to examine how insider trading activity and corporate governance interact in improve earnings quality.

This project will contribute to the academic literature that investigates earnings quality (i.e. earnings management), as well as corporate governance and insider trading in many ways.

Firstly, earnings management, corporate governance and insider trading have recently received considerable attention by regulators, policy makers and the press. In this project, we plan to have two sub-projects, as well as two papers. The first one will analyze earnings management appearing in Thai listed firms and then evaluate whether earnings management is associated with corporate governance mechanisms. The second one will consider whether signal contained in insiders' trading behavior is informative about earnings quality, and then determine whether trading strategies jointly exploiting earnings management and insider trading signals can generate economically significant returns.

Secondly, existing literature examines either the relationship between earnings management and corporate governance or the relationship between earnings management and insider trading. Our project will revisit existing research questions with multi-disciplinary approaches to research design. This may provide further insights to the existing body of knowledge on earnings management, corporate governance, and insider trading. Finance research has focused on the market reaction and the financial signal of insider trades from a market perspective, whereas accounting research

has concentrated on the issue of voluntary disclosure to solve problems of informational asymmetry and earnings manipulation to insiders' benefit from trading. The development of systematic research design that addresses the issues raised in the disciplines of both finance and accounting may create a better framework for understanding the total economic implications.

Thirdly, the concurrent analysis of earnings management, corporate governance and insider trading allows us to measure the efficacy of the code of best practice for directors. This will result in important implications to market policy makers in enhancing transparency and investor protection mechanisms. The study period spanning from 2002 to 2010 provides us an opportunity to further investigate the efficacy of the principles of good corporate governance on earnings management before and after the revision in 2006. Besides, corporate governance structure in Asia is generally different from that in the US which is the sample in most of the existing literature. The difference may impact the extent of earnings management, offering us better understanding on earnings management and corporate governance.

Fourthly, the investigation of earnings management in emerging markets will fill a gap in the literature which limits the sample to the US or other developed countries. The Federation of Accounting Profession intends to fully assign Thai Accounting Standards (TAS) with the international Financial Reporting Standards (IFRS). SET requires large listed firms in SET50 to implement 27 standards of IFRS from 2011 onward and the other 3 standards will be implemented from 2012 onward. The rest (7 standards) are not currently assigned an implementation year. Understanding earnings management in the context of Thailand in the period prior to full implementation of IFRS represents a natural laboratory to make international comparison to the existing studies in the countries which fully apply IFRS.

Finally, this project extends the research ideas in our previous TRF funded project. Our previous one provides a good start in examining insider trading pattern and performance, as well as its relation to closing period of corporate announcement and the impact of corporate governance on insider trading profit and publicly information disclosure in emerging markets. The further linkage to earning quality in this project will extend the knowledge of the amount of information flow to the quality of information flow. The unique dataset of corporate governance is another important output from the project.